

PRIVATE MONITORING  
IN COMMON FUND CLASS ACTIONS

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## **Private Monitoring in Common Fund Class Actions**

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### *Abstract*

Class actions have come to play a significant role in American legal system. Law enforcement is no longer left to the state alone, as private pursuit of self interest is harnessed to promote the common good. But private law enforcement has also had its down sides. Lawyers' gain has often come at the price of class members' loss, and misalignment of interests has many times resulted in less compensation and deterrence and more private attorney profits than desired. The question therefore has been how to guarantee that lawyers pursue their self interest yet leave society at large and class members in particular as well off as possible. This paper analyzes the different monitoring schemes that have been unsuccessfully applied in class actions, namely, monitoring by courts and by class members. Building on this analysis it then proposes a workable alternative: private monitoring by self interested individuals and organizations, not necessarily class members, who would compete and pay to obtain the monitoring position, and would receive a share of the class recovery in return.

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# Private Monitoring in Common Fund Class Actions

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## I. Introduction

Class actions have come to play a significant role in American legal system. Law enforcement is no longer left to the state alone, as private pursuit of self interest is harnessed to promote the common good.<sup>1</sup> Deterrence of anticompetitive behavior, enforcement of full disclosure in the stock market, compensation of innocent workers and customers for malignant illnesses, and assurance of adequate product quality, have all become to rely to a large extent on the viability of class actions. Private lawyers, seeking private gain, have become self employed attorney generals,<sup>2</sup> searching for causes of action and pursuing them to recovery. Using private resources, class attorneys have made substantial contribution to deterrence and compensation, supplementing the public sector in pursuit of these goals.

But private law enforcement has also had its down sides. Lawyers' gain has often come at the price of class members' loss, and misalignment of interests has many times resulted in less compensation and deterrence and more private attorney profits than desired. It has

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<sup>1</sup> For example, in his testimony before the Subcommittee on Telecommunications and Finance Committee on Commerce, United States House of Representatives concerning litigation reform proposals, February 10, 1995, Arthur Levit, chairman of the Securities and Exchange Commission (SEC) has stated that "Private actions are crucial to the integrity of our disclosure system because they provide a direct incentive for issuers and other market participants to meet their obligations under the securities laws."

<sup>2</sup> The term "private attorney general" was first coined in *Associated Industries of New York State, Inc. v. Ickes*, 134 F.2d 694, 704 (2d Cir. 1943), vacated as moot, 320 U.S. 707 (1943). For an interesting historical review of the use of this term see Jeremy A. Rabkin, *The Secret Life of the Private Attorney General*, 61 Law & Contemp. Probs. 179 (1998).

often been claimed that class attorneys are the prime beneficiaries from common fund class actions, and although hard evidence for such claims is very hard to find,<sup>3</sup> there are good reasons to believe that lawyers, acting rationally and (even partially) out of self interest, do indeed gain higher than optimal rents in class actions. In the absence of adequate monitoring it is expected that lawyers would take advantage of the class action, at the expense of class members and of social interests. The question for policy and rule makers has therefore been how to guarantee that lawyers pursue their self interest yet leave society at large and class members in particular as well off as possible; how, and to what extent should lawyers' gain be restrained; and who should see to it that the private does not rob the public.<sup>4</sup>

The initial premise has been that courts would supervise class counsels, in the same ways they perform other judicial duties - overseeing litigation, holding pretrial conferences, promoting settlements, and deciding issues of law and fact. Moreover, in class actions courts are allowed wider prerogatives than they have in ordinary litigation as they choose

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<sup>3</sup> Some figures drawn from a most recent study of ten consumer and mass torts demonstrate the difficulty in appraising these claims. See Deborah H. Hensler et. al, *Class Action Dilemmas: Pursuing Public Goals for Private Gain*, (2000) [hereinafter "*Class Action Dilemmas*"]. In these suits class attorneys' fees ranged from 5 percent of the total dollars defendants agreed to pay to settle the lawsuit to about 50 percent of the total settlement value (p. 435). Of each dollar the defendant paid to the class, class members received less than 20 cents in one class action, less than 50 cents in three class actions, and about 50 cents in another two class actions. In the remaining class actions class members received 65 cents on the dollar, or more (p. 442). Which of these outcomes were optimal from the class perspective depends on variables such as the cases' merits, their probability of success, the aggregate damages class members suffered, and the lawyers' actual costs. These were difficult to evaluate even for researchers who interviewed lawyers and judges involved, and who surveyed available records of these cases (p. 424).

<sup>4</sup> One major critique of the class action device is that it allows plaintiff attorneys to bring frivolous strike suits and force defendants to settle such suits only to avoid the litigation and reputation costs and the huge risks involved. See for example David J. Bershaw & Edward J. Yodowitz eds., *Securities Class Actions: Abuses and Remedies* (1994). Although this paper does not investigate this problem it is readily verifiable that our proposal can only mitigate such problem as it reduces lawyers' excessive rent from bringing class actions.

class attorneys, set their fee, and review all settlements they propose.<sup>5</sup> Courts have been granted these powers only to ensure that lawyers do not take advantage of class absence, and that they do not appropriate class members' rights. Yet, courts have not performed these functions well enough. Constrained by the institutional requirements of neutrality and passivity set by the adversary system, on the one hand, and lacking sufficient adversity between the defendant and the class attorney whenever attorney fees and proposed settlements are concerned, on the other, courts have been left by and large uniformed about the parameters necessary to effectively regulate class attorneys. Taking also into account their constrained resources and overburdened dockets, it is not surprising that courts have failed to adequately monitor class actions.

But courts are not the only ones who may monitor class counsels. Class members are also expected to directly supervise their appointed lawyers. Named plaintiffs are required to render adequate representation to the class if the outcome of the class action is to have a binding and preclusive effect on all class members, and unnamed class members are supposed to provide an external check on the class action litigation or settlement. Yet, the former are usually chosen by class attorneys, are passive, unsophisticated, and completely disregarded by courts, all because their interests in the class action are too small to justify appropriate investment of time and money in supervising class attorneys. As for the latter, their information and opportunities to affect the actual outcome are scarce, and they usually abstain from any true involvement, preferring to free ride the class action without risking any costly active involvement in it.

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<sup>5</sup> See Fed. R. Civ. P. 23 [hereinafter "Rule 23"].

Efforts to engage large stake class members and encourage their active participation in class actions, most prominently the one attempted by the Private Securities Litigation Act of 1995 (hereinafter “PSLRA”) have also failed. Institutional investors have kept their safe place on the sidelines, demonstrating outright preference against enmeshing themselves in messy litigation.

This paper presents a third, workable, alternative: private monitoring by self interested individuals and organizations, not necessarily class members, who would compete and pay to obtain the monitor’s position, and would receive a share of the class recovery in return. Monitors would supervise class attorneys, set their fee, and oversee them in litigation and settlement. They would have the resources and the expertise necessary to guarantee higher expected payoff for class members, and they would be sufficiently compensated to do so. Instead of direct regulation of lawyers, courts would only have to supervise monitors. Monitors would do the rest of the job.

The proposal consists of the following three elements:

*The monitor’s fee.* The monitor would be paid a percentage of the total class recovery. That percentage would be the minimum necessary to motivate the monitor to invest the time and costs required for effective supervision of the class attorney. Since that required investment would often be low, the price class members would have to pay by yielding part of their joint fund would be more than outweighed by their savings from minimization of class attorneys’ rents and opportunistic behavior.

*Selecting the monitor.* The monitor would be selected by an auction, where every candidate would submit the highest price he is willing to pay if he is given the monitor’s position. The candidate whose bid is highest would be selected, and would then pay his bid which may be

either distributed to the class or used to finance part of the class' litigation costs, according to the court's discretion. Thus, a large part of the price the class pays for monitoring would be earned in advance through the winning monitor's bid.

The pool of candidates would not be restricted to class members only. Anyone who would want to serve as the monitor may submit his bid, subject to structural restrictions that are intended to limit possible collusion between monitor and lawyer. The winner in the auction would be the one who would monitor the lawyer most efficiently, as he would be able to earn the highest net rent in monitoring, thus being able to bid highest for the job.

*The monitor's duties and authority.* After being chosen, the monitor would select the class attorney, determine her fee arrangement, and submit it to the court's approval. During litigation the monitor would supervise the class attorney, and would submit reports to the court when required. Any settlement would have to be approved by the monitor, subject to his absolute discretion. If the monitor accepts the settlement he would submit it to the court, who would hold a fairness hearing allowing objections from members of the class and then decide whether to approve the settlement or not.

This scheme would overcome most of the problems encountered by class members' monitoring. Failure of monitoring as it is presently practiced, both under Rule 23 and (in the more specific context of securities litigation) under the PSLRA can be explained by the faulty design of both arrangements. Rule 23 leaves control of the class action in the hands of the class action bar, who chooses class representatives that are most convenient for the lawyers, namely, ones whose stakes are too low to justify real monitoring. The PSLRA, although recognizing that monitoring can only be performed by class members whose share of the class is sufficient to justify adequate investment in monitoring, ignores the



idiosyncratic high costs large class members incur in monitoring and their often explicit preference for external monitoring, as unnamed class members, over direct representation of the class.

By awarding the monitor a percentage of the class' recovery the proposed scheme would motivate potential candidates to bid for that position, and to select the most efficient monitor of those candidates. By opening the auction to all potential monitors and not only to class members it would avoid being restricted to a limited pool of candidates, of whom the most adequate do not want to monitor, and the ones who monitor are always inadequate. It would thus takes control of the class action out of the class action bar and establishes a new professional level of monitors who necessarily protect class members more adequately than courts as well as class members themselves. Furthermore, compared to the PSLRA which relies on the existence of large institutional class members, this proposal would be applicable in other contexts where all class members have too small stakes to be involved.

The proposal is targeted at common fund class actions. These are class actions that create, increase or preserve a common fund whose monetary benefits extend to the whole class.<sup>6</sup> The lawyer's fee in such class actions is paid from the common fund, thus allocating the proceeds from the lawsuit between the class and the lawyer, who can never collect a fee higher than the actual amount recovered, whether in settlement or in judgment. A different type of class actions which this paper does not discuss is the fee shifting class action in which no common fund is

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<sup>6</sup> See, e.g., *Boeing Co. v. Van Gemert*, 444 U.S. 472 (1980); *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375 (1970); *Sprague v. Ticonic Nat. Bank*, 307 U.S. 161 (1939); *Central R.R. & Banking Co. v. Pettus*, 113 U.S. 116 (1885); *Trustees of the Internal Improvement Fund v. Greenough*, 105 U.S. (15 Otto) 527 (1882). For a general review of the common fund doctrine see John P. Dawson, *Lawyers and Involuntary Clients: Attorney Fees from Funds*, 87 Harv.L.Rev. 1597 (1974). See also *infra* notes 105-109.

created, and the class attorney fees are paid by the losing defendant.<sup>7</sup> Fee shifting class actions create different incentives as far as settlements and attorney fee motions are concerned. In particular, defendants have a true interest in limiting the class attorney's fee, and thus the adversary process which is so lacking in common fund class actions, performs much better in the fee shifting contexts. Furthermore, most of these suits are initiated by interest groups and are handled by public interest attorneys, whose incentives largely differ from those of the private class action bar. Finally, in the absence of a common fund neither the class attorney nor any potential monitor can be paid a share of it. Payment must be input based, according to the time and costs actually spent. Our proposal to auction a share of the class to potential monitors is therefore both of a lesser necessity and its applicability more doubtful in such cases.<sup>8</sup>

Most of the literature that has analyzed the various agency problems in class actions has focused on the optimal regulation of the class attorney's fee. This paper takes on these problems from a different perspective. It is a first effort to analyze basic questions such as who should monitor class action lawyers, how the monitor should be selected and compensated, and what are the conditions that would promote his effective monitoring. Although some have written on the efficacy of court and class member monitoring, few have tried to sketch an analytical framework

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<sup>7</sup> When the class seeks non-monetary remedies such as structural reforms, injunctions or declaratory relieves no fund is available for the lawyer's compensation. Examples include many of the civil rights, prisoners, school desegregation and environmental protection class actions. In the absence of a paying client, the class lawyer's fee in such cases would often be paid by the losing defendant. That is an exception to the rule in American courts according to which each litigant must bear his litigation costs, irrespective of the litigation outcome, see e.g., *Alyeska Pipeline Serv. Co. v. Wilderness Soc'y*, 421 U.S. 240 (1975). Access to judicial relief in these contexts therefore requires explicit legislative authorization of fee shifting from a losing defendant to the lawyer.

<sup>8</sup> Common fund class actions accounted for about 75% of all class actions reported in judicial opinions, in the general media and in the business press in 1995-1996. See Deborah H. Hensler et. al., *Class Action Dilemmas*, *supra* note 3, 52-53.

within which such efficacy can be evaluated and improved. A goal of this paper is thus to encourage further discussion and research of these somewhat neglected issues.

The paper proceeds as follows. Section II gives a short summary of the main agency problems that affect performance of attorneys in class actions. In section III we describe the inherent constraints and barriers that prevent courts from effectively supervising class counsels. In section IV we discuss the ineffectiveness of monitoring schemes under Rule 23 and under the PSLRA. Section V details our proposal, and discusses its advantages over current practices. Section VI discusses possible solutions to problems of collusion between lawyers and monitors, and section VII concludes.

## **II. Why Monitor – Class Attorney Agency Problems**

The less lawyers are supervised the more they would tend to slack, misrepresent facts, and collude with defendants. This does not imply that lawyers are immoral or unethical by nature. It only means that they are human. Indeed, there exists an extensive literature that has analyzed and documented similar problems in various relationships as between an employer and her employee, a landlord and his tenant, a shareholder and a corporate manager, an insurance company and its insured, or a patient and her doctor.<sup>9</sup> These are all agency relationships. In each of them an agent performs some tasks for a principal, the agent's interests and incentives diverge from those of the principal, and the agent holds some (relevant) private information which is not shared by the principal.

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<sup>9</sup> For a non-technical presentation agency relationships and their costs see Eric A. Posner, *Agency Models in Law and Economics*, The Coase Lecture (Winter 2000), Paper No. 92 University of Chicago John M. Olin Law & Economics Working Papers (2d Series). A more formal analysis can be found in Andreu Mas-Colell et. al., *Microeconomic Theory*, 436-510 (1995), which includes references to the essential literature on this topic.

Since the agent's interests are different than the principal's she might misrepresent her information in a way that would benefit her, yet impede the principal. If the principal could perfectly monitor his agent he would make sure the agent acted optimally, but since perfect monitoring requires perfect information, it is not feasible.

Similarly, if the principal and the agent had exactly the same interests, no agency problems would arise. But this is highly unlikely. Even if doctors were purely altruistic they would still value each patient's health less than the patient himself, and even if tenants cared about their apartments, they would still value their use of apartments more than their landlords would. More generally, unless both principal and agent internalize their total costs and benefits and weigh them identically, their interests would oftentimes diverge. Class attorneys are no exception to this general observation even under a most favorable account of their morals and ethics.

Agency problems are traditionally divided to moral hazard and adverse selection problems. The former include all cases where the agent's actions are not observed by the principal.<sup>10</sup> The latter consist of cases in which the agent's decisions depend on some unobservable characteristics only she can observe, in a manner that may adversely affect the principal.<sup>11</sup> In the class action (and more generally in the attorney client) context moral hazard refers mainly to the lawyer's private information concerning the effort, time and skill she has invested in the lawsuit. Adverse selection consists of all other private information the lawyer holds that may affect the class' expected recovery, such as the expected (ex ante) probability of winning the suit, the lawyer's quality, or her attitudes toward risk.

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<sup>10</sup> Mas Colell et al. *Id.* at 477.

<sup>11</sup> Mas Colell et al. *Id.* at 440.

The following subsections give a more detailed account of the various inefficiencies inherent in client attorney relationships in general, and particularly in class actions. They show that these inefficiencies remain largely unsolved under attorney's fee regulation, and that there is therefore need for improvement in the direct monitoring of class counsels.<sup>12</sup>

#### A. *Litigation Inefficiencies*<sup>13</sup>

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<sup>12</sup> One note is due. The term 'inefficiency' as it is used in this paper includes any situation in which the class earns a lower expected payoff than it would if all information were available to the court. The point of view taken is that of the class, after the cause of action has already been in effect. This is the point of view taken by the court when deciding the class counsel's fee, serving as a fiduciary for the class. See e.g. *Brown v. Phillips Petroleum*, 838 F.2d 451, 456 (10th Cir., 1988). The analysis does not encompass costs incurred by defendants and courts, nor does it embody the deterrence effects of the alternative class action structures. Professor Steven Shavell has written extensively on the general divergence between the private and the social interests in litigation. See for example Steven Shavell, *The Fundamental Divergence Between the Private and the Social Motive to use the Legal System*, 26 J. Legal Stud. 575 (1997). For an excellent discussion of the effect of class action on deterrence, insurance and compensation see David Rosenberg, *The Causal Connection In Mass Exposure Cases: A "Public Law" Vision of the Tort System*, 97 Harv. L. Rev. 849 (1984), and David Rosenberg, *Individual Justice and Collectivized Risk Based Claims in Mass Exposure Cases*, 71 N.Y. U. L. Rev. 210.

Nevertheless, it should be clear that the two main objectives of common fund class actions, namely deterrence and compensation, are positively correlated with class members' recovery. Everything else equal, the larger the class' recovery, the more plaintiffs are compensated and the more prospective defendants are deterred. Whether such higher compensation and deterrence are optimal is beyond the scope of this paper.

<sup>13</sup> This section draws on the vast literature on client attorney agency relationships. For a general analysis of the agency problems in ordinary litigation see Daniel Mitchell, Murray Schwartz, *An Economic Analysis of the Contingent Fee in Personal Injury Litigation*, 22 Stan. L. Rev. 1125 (1970); Kevin Clermont, John Currivan, *Improving on the Contingent Fee*, 63 Cornell L. Rev. 529 (1978). Bruce L. Hay, *Contingent Fees and Agency Costs*, 25 J. Legal Stud. 503 (1996) analyzes the optimal contingent fee in a simple mechanism design framework. In the class action context these topics have been extensively explored by John C. Coffee. John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of the Law Through Class and Derivative Actions*, 86 Colum L. Rev. 669, 724-25 (1986) [hereinafter Coffee, *Understanding the Plaintiff's Attorney*]; John C. Coffee, *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working*, 42 Md. L. Rev. 215 (1983)[hereinafter, Coffee, *Rescuing the Private Attorney General*]; John C. Coffee, *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 Law & Contemp. Problems 5 (Summer 1985); John C. Coffee, *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. Chi. L. Rev. 877 (1987). See also 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) [hereinafter 'The Plaintiff's Attorney'].

Litigation requires investment of time, effort, and financial resources. Legal researching, drafting and answering interrogatories, conducting depositions, interviewing experts, and arguing cases in court are all tasks the lawyer must perform in order to advance the value of the case. Additionally, numerous fixed expenses must be borne, including filing fees, experts fees, administrative costs (document production, postage, long distance and fax charges, lawyer transportation, typing services, etc.), and overhead and fixed costs of maintaining a law office. Class action attorneys bear all these costs, yet enjoy only part of the returns. Whenever the class wins the lawsuit or settles it the attorney's share of the recovery would be less than one hundred percent.

Moreover, in no class action can the class attorney expect to be always fully reimbursed for her costs. First, there is always a chance that the class would lose, in which case there is no available fund to pay the lawyer. And second, even if the class wins or settles, the highest share the lawyer would be allowed may still be insufficient to recoup the lawyer's investment and expenditures. Lawyers would therefore tend to invest less than they would if they were the sole owners of the proceeds from the lawsuit, or if they were directly and effectively monitored by the owner and paid always to cover their costs.<sup>14</sup>

Suppose first that the lawyer is paid a percentage of the class recovery. Such a fee would motivate the lawyer to spend more than the minimum possible hours, as she would enjoy part of

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<sup>14</sup> One proposal intended to eliminate the separation between ownership and control of the class action was to auction the aggregate claim to the highest bidder. See Macey & Miller, *The Plaintiff's Attorney*, *Id.*; Jonathan R. Macey & Geoffrey P. Miller, *Auctioning Class Action and Derivative Suits: A Rejoinder*, 87 Nw. U.L. Rev. 458 ;Jonathan R. Macey & Geoffrey P. Miller, *A Market Approach Toward Tort Reform Via Rule 23*, 80 Cornell L. Rev. 909. After buying the aggregate claim the lawyer becomes its full owner and would therefore make optimal decisions to maximize the claim's value. In spite the theoretic appeal of this proposal, courts have nevertheless refrained from experimenting with it. It seems that the aversion toward claim selling, due process issues, and the fear that class claims would be sold too low due to lawyers' risk aversion, collusion or the lack of viable capital market for claim financing, have all prevented serious consideration of the full auction proposal. For a more restricted experimentation with auctions in class actions see note 29 below.

the returns. Yet, she may still earn some rent over and above the value of the hours she would actually spend, and her investment would tend to be lower than optimal. Generally, spending more time on the case should increase its value for the client, but at a decreasing rate. This means that the increase in expected gross recovery generated by each additional hour is less than the one produced by the preceding hours. Optimally, the lawyer should stop investing only at the point where the increase in the expected recovery equals the cost of her time. In economic terms, that is the point where the marginal return to the lawyer's time equals its marginal cost. However, since the lawyer only gains part of the returns she would stop investing before, at the point where *her* marginal return equals the cost of her time. Since all hours spent before that point produce a higher marginal return for the lawyer, she would earn a positive rent above her total costs.

For example, think of a class action in which the expected judgment<sup>15</sup> would be \$100,000 if the lawyer spends 100 hours, and \$180,000 if she spends 250 hours. The lawyer's regular hourly rate is \$100, and her fee in the class action is 15% of the judgment. Since the class earns 85% of the expected judgment it would prefer the lawyer to work 250 hours, leaving the class net \$153,000, whereas if the lawyer works 100 hours the class earns only \$85,000. Yet, the lawyer would only spend 100 hours, earning \$5,000 (\$15,000 minus the \$10,000 opportunity cost of her time). If she spends the additional 150 hours necessary to increase the judgment to \$180,000, she would earn less, as her fee would increase by \$12,000 yet the additional time investment would cost her \$15,000.

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<sup>15</sup> The term 'expected judgment' is used throughout this paper. It equals the judgment's mean value, or the weighted average of possible judgments, with weights assigned according to the probability of each judgment.

Although it might seem that an hourly rate would solve this agency problem,<sup>16</sup> that is far from being true. First, an hourly rate requires verification of the number of hours the attorney spent on the case, or she would file excessive time reports. Second, even if the number of hours actually spent is verifiable it is difficult to know whether they were all necessary and cost effective. That requires information of the state of the case and its merits at each point throughout the litigation.<sup>17</sup> Third, and most importantly, since the class attorney can only be paid if the class wins and a common fund is created, the hourly rate must be multiplied by a ‘risk multiplier’, accounting for the risk of non-payment. That is indeed the practice under the lodestar fee arrangement which is currently practiced in class actions.<sup>18</sup> Yet, the multiplier depends on information which the class attorney privately holds – namely the probability that the class would

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<sup>16</sup> The class would require the attorney to work 250 hours, pay her \$25,000 and earn a net expected recovery of \$155,000. Clearly, this compensation scheme requires the lawyer’s hours to be observable and verifiable.

<sup>17</sup> In the example this information was available to whoever sets the lawyer’s fee. This, however, is highly unlikely in real practice.

<sup>18</sup> The lodestar fee was introduced by the Third Circuit in *Lindy Bros Builders v. American R&S San Corp*, 487 F2d 161 (3<sup>rd</sup> Cir., 1973), 166-170. According to this fee arrangement the court must first determine the hours reasonably expended by counsel that created, protected, or preserved the fund. Then the number of compensable hours should be multiplied by the counsel’s reasonable hourly rate. The product is the ‘lodestar’, which may then be increased or decreased based upon the risk of nonpayment and the quality of the attorney’s work. In *City of Burlington v. Dague*, 505 US 557 the Supreme Court has eliminated the use of contingency (or risk) adjustment in statutory fee shifting cases. Nevertheless, most courts have not regarded this decision as binding in common fund class actions and have therefore allowed for risk multipliers. See *McLendon v. Continental Group*, 872 F Supp 142 (DNJ 1994); *Rawlings v. Prudential-Bache Properties*, 9 F3d 513 (6th Cir. 1993); *Florin v. Nationsbank of Georgia*, 34 F3d 560 (7th Cir. 1994); *In re Washington Public Power Supply System Litigation*, 19 F3d 1291 (9<sup>th</sup> Cir. 1994); *Swedish Hospital corp. v. Shalala*, 1 F3d 1261 (DC Cir. 1993); See also *Skeleton v. GM* 860 F3d 250, 254 (7<sup>th</sup> Cir., 1988) which held that the arguments -- equitable and statutory -- against risk multipliers in statutory fee cases have much less application in common fund cases (notice though that this case was decided before the Supreme court’s decision in *Dague*); But see *In re General Motors Corp. Pick-Up Truck Fuel Tank Prods. Liability Litig.*, 55 F3d 768, 804 (3rd Cir. 1995) (not distinguishing between fee shifting and common fund class actions as far as the prohibition on using risk multipliers under the lodestar method).



win the suit, at each point during the litigation.<sup>19</sup> Whenever this multiplier is set too high the attorney would over-invest in the lawsuit, and whenever it is set too low, the attorney would tend to under-invest.

Hence, whether paid by the percentage of recovery fee arrangement or by the lodestar fee, the lawyer's investment of time, effort, and costs would often be non-optimal. Maximizing her fee she would set her investment at a level different than the one the class, if it had all relevant information, would have chosen.

### B. *Settlement Inefficiencies and 'Sweetheart Deals'*<sup>20</sup>

Litigants bargain in the shadow of the law.<sup>21</sup> This seemingly obvious observation is nonetheless often misleading. In practice, lawyers, not litigants, are the ones who bargain, and the shadow against which they bargain is the expected litigation outcome, affected by lawyers litigation incentive structures as well as the law. This is mostly true in class actions, where the decision whether, when, and for how much to settle is left to the class attorney. Unlike in

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<sup>19</sup> See Affidavit of Steven M. Shavell at 2-3, *In re Burlington Northern, Inc., Employment Practices Litigation*, Nos. MDL 374, 78 C 269, 1985 WL 1808 (N.D. Ill. May 31, 1985), as quoted in Peter H. Huang, *A New Options Theory For Risk Multipliers Of Attorney's Fees In Federal Civil Rights Litigation* 73 N.Y.U.L. Rev. 1943 (1998), 1968-1969.

<sup>20</sup> Client attorney agency relationships in settlement were first introduced in Geoffrey P. Miller, *Some Agency Problems in Settlement*, 16 J. Legal Stud. 189 (1987), and further developed in Bruce L. Hay, *Optimal Contingent Fees in a World of Settlement*, 26 J. Legal Stud. 279 (1997). Application to the class action context can be found in Bruce L. Hay, *Asymmetric Rewards: Why Class Actions (May) Settle for Too Little*, 48 Hastings L. J. 479 (1997) [hereinafter Hay, *Asymmetric Rewards*] and Bruce L. Hay, *The Theory of Fee Regulation in Class Action Settlements*, 46 American U. L. Rev. 1429 (1997) [hereinafter Hay, *Fee Regulation*]. Sweetheart and collusive settlements have been extensively documented in the context of 'settlement class actions' – class actions that are certified for the purpose of settlement only. See, for example papers that appeared as part of a symposium held by the Cornell Law Review: 80 Cornell L. Rev. 811-1235 (1995). References to relevant papers on these topics are made below.

<sup>21</sup> This phrase was first coined by professors Mnookin and Kornhauser in Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 Yale L.J. 950 (1979).

ordinary litigation where a client may override the lawyer and settle, in class actions the class attorney is the only one who can initiate a settlement. The court may veto it, but can never force an alternative settlement on the lawyer.<sup>22</sup> Therefore, class attorneys must be at least as well off in settlement as in litigation,<sup>23</sup> or they would not settle.<sup>24</sup> The question is to what extent, if at all, the class is made better off by the settlement.

Since litigation consumes both the defendant's and the class attorney's resources and exposes them to risk there is a range of possible settlements where both, as well as the class, can be made better off. The court's objective should at least be that the class' net recovery in

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<sup>22</sup> But see *Manual for Complex Litigation (Third)* §30.44. which states that:

“When class representatives favor acceptance of a settlement offer that class counsel believe is inadequate, they should be permitted to submit it to the court for preliminary approval and, if the court so orders, a fairness hearing. Although the court will ordinarily not approve a settlement that counsel do not recommend, class counsel—like class representatives—have no veto power over settlement of class actions” (p. 243).

We are not aware of any case where a named plaintiff negotiated a settlement over the class attorney's disapproval.

<sup>23</sup> The assumption throughout this paper is that law casts some shadow on settlement negotiations. Put more clearly, the assumption is that the litigation alternative is viable, posing a threat of adverse aggregate judgment to the defendant. This assumption is clearly violated by a 'settlement class action' - a class action that is certified only for the purpose of settlement. In 1996 the advisory committee on civil rules has considered adding rule 23(b)(4) which allowed for certification of a class action if “the parties to a settlement request certification under subdivision (b)(3) for purposes of settlement, even though the requirement of subdivision (b)(3) might not be met for purposes of trial”. Proposed Amendments to the Federal Rules of Civil Procedure, 167 FRD 559. This proposed amendment was eventually rejected. In *Amchem Products, Inc. v. Windsor*, 521 U.S. 591, 619-622, the Supreme Court has ruled that although settlement is relevant to a class certification, the class should still satisfy all requirements set by one of the alternatives in Rule 23.

<sup>24</sup> Some have suggested that class counsel should not simultaneously negotiate both a settlement and attorneys' fees. See *Prandini v. National Tea Co.*, 557 F.2d 1015 (3d Cir. 1977); but see *Evans v. Jeff D.*, 475 U.S. 717, 738 n.30, holding that parties may simultaneously negotiate a "defendant's liability on the merits and his liability for his opponents' attorney's fees. A review of federal and state courts to this issue can be found in David Brainerd Parrish, *The Dilemma: Simultaneous Negotiations of Attorney's Fees and Settlement in Class Actions*, 36 Hous. L. Rev. 531 (1999). Even if class attorneys do not negotiate their fee simultaneously with the class settlement they still have some expectation what that fee would be. Whenever that fee depends on the settlement amount, it would the lawyer's bargaining position and her minimum accepted settlement.

settlement would not be lower than in litigation. That is a weak requirement.<sup>25</sup> For example, a settlement equal to the expected judgment, out of which the class counsel is paid the same fee as in litigation although she spends less time and incurs lower costs would satisfy this requirement because the class' net payoff is the same. Such a settlement rewards the lawyer all the rent from saving her litigation costs. The court could require the lawyer to share this rent with the class. Nevertheless, the weaker standard is the one most often used by courts when conducting the fairness hearing into the adequacy and fairness of the proposed settlement.<sup>26</sup> Furthermore, to demonstrate the inherent problematics in monitoring settlements it is simplest to adopt the weak requirement as a benchmark. Showing that the court cannot ensure that all settlements would satisfy that requirement evidently implies that the stricter standards also cannot be met.

Since the class counsel bears the total litigation costs and since part of these costs are saved if the case is settled, any time the lawyer earns the same percentage in trial and in settlement she might agree to a settlement that would leave the class worse off than in litigation.<sup>27</sup>

For example, suppose the expected judgment is \$100,000, the lawyer has to spend 100 hours on trial but only 50 hours on settlement, her regular hourly rate is \$100, and her fee in the class action is 25%. The lawyer would earn a net rent of \$15,000 in trial. She would therefore agree to settle for \$80,000, as her fee would then be \$20,000, leaving her the same net rent after

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<sup>25</sup> For a general discussion of the difficulty in establishing unfairness of class action (especially mass tort) settlements see Geoffrey C. Hazard, Jr., *The Settlement Black Box*, 75 B.U. L. Rev. 1257, 1264-1268 (1995).

<sup>26</sup> See for example *Cotton v. Hinton*, 559 F.2d 1326, 1330 (5th Cir.1977); *In re Corrugated Container Antitrust Litigation*, 643 F.2d 195, 212 (5th Cir. 1981); *Mars Steel Corp. v. Continental Illinois National Bank*, 834 F.2d 677, 681-682 (7th Cir. 1987).

<sup>27</sup> This argument was initially suggested in the broader client-attorney context by Geoffrey Miller, *supra* note 20. It was applied to class actions in Bruce L. Hay, *Asymmetric Rewards* and Bruce L. Hay, *Fee Regulation*, *supra* note 20. For a most recent application see Bruce L. Hay & David Rosenberg, *Sweetheart and Blackmail Settlements in Class Actions: Reality and Remedy*, 75 Notre Dam L. Rev. 1377 (2000).

subtracting the \$5,000 opportunity cost of her time. The class, however, would earn only \$60,000, less than the \$75,000 it could expect in trial. If the court knew what the expected judgment is, it could decline to approve any settlement which leaves the class a lower net payoff. In the lack of such information, however, the court can never be sure whether that is the case.

It has been proposed that the class can be secured its litigation payoff if the lawyer's percentage is bifurcated, setting the percentage in settlement lower than in litigation.<sup>28</sup> This would account for the lower costs the lawyer incurs if the case settles, as compared to litigating it to judgment. Although such bifurcation would result in higher settlements its optimal application requires information about the lawyer's expected litigation costs, information which the lawyer privately holds. Some of the settlement inefficiencies are thus bound to remain, unless such information is available to whoever monitors the class attorney.<sup>29</sup>

Like in litigation, here too the lodestar contingent hourly fee would also involve serious agency costs. On the one hand the lawyer would tend to invest excessive number of hours at the point where she is certain of a future settlement with the defendant. Whenever her hourly adjusted fee is higher than her opportunity cost she would want to delay the settlement and have the opportunity to spend, and earn, more hours, although at that point the settlement is practically certain. On the other hand, when a settlement is less than certain the lawyer would have excessive incentives to settle because a settlement would guarantee her fee for the time and costs she

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<sup>28</sup> See Hay, *Asymmetric Rewards*, *id.* at 502; Hay, *Fee Regulation*, *id.* at 1456-1463.

<sup>29</sup> Several courts have recently experimented with auctioning the class attorney's position in securities class actions. In some of these auctions bidders were required to submit their proposed percentage on a grid, changing according to the stage in litigation in which the case is resolved and the amount recovered. The idea is similar to that proposed by Hay, *id.*, trying to reduce the lawyer's rent, on the one hand, and to better align her settlement incentives with the class interests. See e.g. *In re Cendant*, 182 F.R.D. 144, 151-152 (N.J., 1998); *In re Lucent Techs.*, 2000 U.S. Dist. LEXIS 6621; *Wenderhold v. Cylink Corp.*, 188 F.R.D. 557, 587-588 (N.D. Ca., 1999).

already spent on the case, whereas in litigation she would risk losing that fee altogether.<sup>30</sup> This brings back the agency problems which are very similar to the one introduced under the percentage fee. To equalize the lawyer's expected fee in settlement and in litigation the court would have to know the risk of non-payment in trial. Without knowing that the lawyer would either be excessively paid in settlement, leaving the class with less than it could earn in trial, or the lawyer would be under-paid in settlement, which would result in unnecessary litigation.

If courts are presented with inaccurate information not only regarding the *projected* earnings of the class and lawyer in trial but also with respect to their *actual* rents in settlement, inefficiencies would indeed be exacerbated. Whenever the court is led to believe that class members earn more than they actually do, or that the lawyer's payoff is less than it is in fact, defendants and class attorneys would benefit at the expense of the class. Fee regulation is simply inapplicable to such cases. The reason should be obvious. A fee arrangement can regulate the lawyer's conduct if it makes such fee contingent on observable parameters such as the settlement amount or the time the lawyer spent. By misrepresenting any of these parameters, or by concealing part of the lawyer's payoff, the defendant and the class attorney deprive the court of its means of regulation.

Several forms of collusion and sweetheart deals have been documented in the literature on class actions. First, there are settlements in which the value presented to the court is higher than the actual benefit to class members.<sup>31</sup> In kind settlements, providing class members with non-monetary benefits that are difficult to evaluate, often leave much leeway for the defendant and

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<sup>30</sup> For a discussion of these problems see John C. Coffee, *Understanding the Plaintiff's Attorney*, *supra* note 13, at 714-720.

<sup>31</sup> See Charles Silver, *Class Actions – Representative Proceedings*, in *Encyclopedia of Law and Economics* (B. Bouckaert & G. De Geest eds., 1999).

class attorney to convince the court that the value rendered is higher than it actually is.<sup>32</sup> Similarly, broad definition of the class, extensive scope of defendant's release, and imposition of difficult to satisfy conditions on class members who wish to collect their share, all may falsely increase the perceived value of the settlement. Finally, reversion of unclaimed funds to the defendant, accompanied by large settlement amounts would increase the lawyer's fee, with no accompanying benefit to the class (assuming the fee is calculated from the dedicated, as opposed to the actually collected, fund).

Second, in some contexts (especially in mass torts) defendants can make side transfers to class attorneys in ways that are not transparent to courts.<sup>33</sup> Side transfers can be facilitated, for example, through inventory settlements, where class attorneys settle cases in which they were retained on an individual basis outside the class action for more favorable terms than those obtained for the class.<sup>34</sup> Even if the individually retained cases remain within the class the attorney may still gain more than is awarded by the court as she earns her contractual fee from her clients. Thus, although the class action fee may be kept low the attorney would still earn a

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<sup>32</sup> See Note, *In-Kind Class Action Settlements*, 109 Harv. L. Rev. 810 (1996); Geoffrey P. Miller & Lori S. Singer, *Nonpecuniary Class Action Settlements*, 60 Law & Contemp. Prob. 97 (1997). In some instances even monetary settlements are difficult to evaluate. See Susan P. Koniak & George M. Cohen, *Under Cloak of Settlement*, 82 Va. L. Rev. 1051; Susan P. Koniak, *Class Action Against Class Counsel*, 1 J. Inst. Stud. Leg. Eth. 249 (documenting the alleged collusion in settlement proceedings and the aftermath of *Hoffman v. BancBoston Mortgage Corp.*, No. CV-91-1880 (Mobile Cty. Cir. Ct.)).

<sup>33</sup> See John C. Coffee, *Class Wars: The Dilemma of Mass Tort Class Action*, 95 Colum. L. Rev. 1343, 1373-1384 (1995), defining these methods as the 'new collusion', as opposed to the non-monetary 'old' collusive settlements. See also Susan P. Koniak, *Feasting While the Widow Weeps: Georgine v. Amchem Products, Inc.*, 80 Cornell L. Rev. 1045 (1995), describing similar allegations against class counsel in *Georgine v. Amchem Products, Inc.*, 157 F.R.D. 246 (E.D. Pa. 1994).

<sup>34</sup> See *Georgine v. Amchem Prods., Inc.*, 157 F.R.D. 246, 294-99, 307-10 (E.D. Pa. 1994), rev'd on other grounds, 83 F.3d 610, 622 (3d Cir. 1996), aff'd 521 U.S. 591 (1997); *In re Asbestos Litig.*, [\*5] 90 F.3d 963, 978-80 (5th Cir. 1996), cert. granted and judgment vacated on other grounds, 117 S. Ct. 2503 (1997).

high percentage over all his inventory of cases. The larger this inventory is, the higher is the unobserved payoff to the lawyer.

To summarize, the unfair, collusive or sweetheart settlement is made possible by the court's inferior information as compared to the class attorney. When misrepresentation of projected litigation value is possible regulation through fee design is helpful, but would not solve all possible opportunities for unfair settlements that provide the class less than it could get in trial. When manipulation of the settlement value and concealment of attorneys' side benefits are also possible, fee regulation is rendered totally ineffective.

### III. Monitoring by Courts

Common to all agency problems is their correlation with information asymmetry between the principal and the agent. The less the principal is informed, the higher would agency costs be. A court that wishes to guarantee optimal performance by class counsel needs to know how much time she has invested in the case, how she has used her time, what expenditures she has made, how promising the case was, what her quality is, her usual hourly rate, and more. When settlements are considered the court must evaluate, in addition, the expected recovery the class would gain in trial, equal to the expected judgment multiplied by the probability the class would prevail, and the expected litigation investment the class attorney would have made had the case proceeded to judgment.

Yet, common law courts are institutionally incapable of obtaining information unless presented to them by the litigants. Unlike inquisitorial civil law judges who may demand parties to produce documents in their possession, examine witnesses, and select and commission expert opinions,<sup>35</sup> the paradigmatic common law court is passive and relies solely on the adversary procedure for its education about the case.<sup>36</sup> Sustaining distance from active participation in trial is perceived to be essential for remaining impartial.<sup>37</sup> Only the litigants, seeking to convince the court to support their positions, are supposed to

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<sup>35</sup> See Benjamin Kaplan & Arthur T. von Mehren, Rudolph Schaefer, *Phases of German Civil Procedure*, 71 Harv. L. Rev. 1193, 1225-1227 (1958); John H. Langbein, *The German Advantage In Civil Procedure*, 52 U. Chi. L. Rev. 823, 826-830 (1985); For a proposal to adopt an inquisitorial mechanism by appointing a 'disinterested person' to conduct prior inquiries in derivative actions see Joel Seligman, *The Disinterested Person: An Alternative Approach to Shareholder Derivative Action*, 55 Law & Contemp. Probs. 357 (1992).

<sup>36</sup> Fleming James, Geoffrey C. Hazzard, & John Leubsdorf, *Civil Procedure* 4-10 (4th ed.1992).

<sup>37</sup> In *Haas v Pittsburgh National Bank*, 77 F.R.D. 382 (W.D. Pen. 1977), at 382 the court said: "The dilemma thereby created for the Court finds the judge playing 'devil's advocate' on behalf of the disinterested defendants, while at the same time attempting to exercise his impartiality in making a just determination of reasonable fees. To require the judge to occupy an adversary position during the fee proceedings is highly inconsistent with his acknowledged duty to act as an impartial arbitrator."



provide the court with the necessary facts. And the accuracy of these facts is only guaranteed by the conflicting positions of the parties.

Although judges may assume active roles in pretrial conferences, these actions cannot significantly improve the court's information. Pretrial conferences help to organize lawsuits and clarify controversies, they may be used to force concessions on the parties and facilitate settlements, but by their nature as *pre-trial* they cannot be used to gather and present evidence. At the pretrial stage courts act as facilitators, not investigators. Even courts who are active and resourceful in their handling of pretrial stages rely for their information on the parties and do not initiate factual investigations on their own initiative.<sup>38</sup>

On top of these institutional barriers, courts are also constrained by their limited resources. Dockets are full,<sup>39</sup> and supporting personnel are scarce. Conducting meaningful investigations without the necessary means is often unworkable. Moreover, in the specific context of attorney fee applications courts are expected to apply restraint and limit the

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<sup>38</sup> A most activist approach of judicial role and authority has been expressed and practiced by Judge Jack B. Weinstein whose involvement in the Agent Orange class action settlement has been documented in Peter H. Schuck, *Agent Orange on Trial* (1986). See for example, Jack B. Weinstein, *Ethical Dilemmas in Mass Tort Litigation*, 88 Nw. U.L. Rev. 469, 538-560 (1994). Weinstein encourages judges to "reach out to embrace what competent and natural help they can secure...", (*Id.* at p. 559) to use special masters, and to educate themselves about the relevant scientific reports and studies. Even this extremely activist view does not allow the judge to hold case specific factual investigations. For a critique of this approach see Linda S. Mullenix, *Mass Tort as Public Law Litigation: Paradigm Misplaced*, 88 Nw. U.L. Rev. 579 (1994). The Manual for Complex Litigation (Third) also recognizes the possibility of sua sponte experts appointment by the court, in accordance with Rule 706 of the Federal Rules of Evidence, yet advocates careful consideration before practicing this authority (§23.51 at 109-11).

<sup>39</sup> In the years 1995-1999 the average number of cases filed annually (civil and criminal) per authorized judgeship was 485. The actual average per judge is even higher because of about 10% vacancy in the judicial positions. The weighted (where weights are assigned according to difference in time consumption across cases types, following a weighting system developed by the Federal Judicial Center in 1993) filings for authorized judgeship in 1999 were 472. *Judicial Business of the United States Courts – 1999 Annual Report of the Director* (Administrative Office of the United States Courts, 2000). A RAND study has found the mean reported time on civil cases in federal courts to be 185 minutes; see James S. Kakalik et al., *An Evaluation of Judicial Case Management Under the Civil Justice Reform Act* (RAND, 1996) 243-251.

extent of factual investigations. They are urged not to allow protracted satellite litigation, and to control and expedite fee award determinations.<sup>40</sup>

It should thus come as no surprise that courts often find it almost impossible to monitor attorneys in common fund class actions. Since class counsels' fees are paid from the common settlement fund or judgment defendants have no interest in them.<sup>41</sup> Adversary litigation is thus lacking and courts are left by and large uninformed about numerous relevant issues such as the class attorneys' regular hourly rates, the quality of representation they rendered, and the time and cost they spent.<sup>42</sup>

This is certainly true when the case is settled early on.<sup>43</sup> The court, unaware of information that was exchanged and discovered between the parties is often in no better position than it was when the suit was filed. It does not know how meritorious the case is, how meaningful is the settlement remedy for class members, how much time and costs the class attorney invested in the case, and how effective and efficient these investments were.

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<sup>40</sup> *Hensley v. Eckerhart* 461 US 424, 437. See also Justice Reform Act of 1990, Pub. L. No. 101-650, 104 Stat. 5089 Codified as Chapter 23 of 28 U.S.C., which required development of civil justice expense and delay reduction plan in federal district courts.

<sup>41</sup> Common fund class actions are distinguished from fee shifting cases, in which the defendant is charged with the class attorney fees in case the class prevails. Both are exceptions to the American rule by which litigants bear their fees and costs irrespective of whether they prevail or not. See *Court Awarded Attorney Fees: Report of the Third Circuit Task Force*, 108 FRD 237, 256-257 (1985)[hereinafter *Task Force Report*]at 250-251; *Alyeska v. Wilderness Society*, 421 U.S. 240.

<sup>42</sup> Defendants often agree not to oppose the attorney fee request under a 'clear sailing' agreement. See discussion of the problematics of such agreements in *Malchman v. Davis*, 761 F.2d 893 (2d Cir.1985), abrogated on other grounds; *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591 (1997).

<sup>43</sup> For discussions of the difficulties courts face in evaluating the strength of a case in the context of a settlement, see, for example, Coffee, *Understanding the Plaintiff's Attorney*, *Supra* note 13; Geoffrey C. Hazard, Jr., *The Settlement Black Box*, *supra* note 25; Jack B. Weinstein & Karin S. Schwartz, *Notes from the Cave: Some Problems of Judges in Dealing with Class Action Settlements*, 163 F.R.D. 369 (1995).

Having to decide on an all or nothing basis, either to approve the settlement or to veto it, the court often has no choice but to approve it.<sup>44</sup>

Moreover, since the court is burdened by prolonged litigation it is often interested in terminating the case as soon as possible. Whereas in ordinary litigation the litigants initiate the settlement only when they prefer it to litigation,<sup>45</sup> in class actions the control over the decision to conclude the litigation is, to a large extent, at the hands of the court, whereas class members have little influence over it. The court, being unduly affected by its own interests in clearing its dockets, might be tempted to approve unworthy settlements.<sup>46</sup>

But, information scarcity also hinders the court's effectiveness in monitoring when the suit has proceeded to trial and judgment. The court may find it difficult to evaluate the relevant parameters for setting the lawyer's fee even if it has considered the evidence before it and has observed the lawyer's performance. Nowhere during trial is the court informed about the number of hours the lawyer invested in the case before trial, and no one but the class attorney (and sometimes, the defendant) knows what investment she should have optimally made at each point throughout the litigation. Lacking this information, the court is left with crude estimation of these parameters, unable to properly structure the

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<sup>44</sup> On the 'all or nothing' problem in judicial approval of class actions settlements see Brian Wolfman & Allan B. Morrison, *Problems of Representation In Class Action: Representing the Unrepresented In Class Actions Seeking Monetary Relief*, 71 N.Y.U. L. Rev. 439, 490-495 (1996); Weinstein & Schwartz, *id.*.

<sup>45</sup> For the economic model of litigation and settlement see for example, Richard A Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. Legal Stud 399 (1973); Steven Shavell, *Suit, Settlement, and Trial: A Theoretical Analysis under Alternative Methods for the Allocation of Legal costs*, 11 J. Legal Stud. 55 (1982).

<sup>46</sup> For the claim that judicial self interests in promoting settlements and clearing dockets account for courts' approval of collusive settlements see Koniak and Cohen, *Supra* note 32 ,at 1122-1130.

lawyer's incentives in trial or in settlement.<sup>47</sup> Here too, the class attorney and the defendant are not true adversaries, as the defendant has no interest in the way the judgment is allocated between the lawyer and the class.

Courts have often voiced their frustration with current practices. They expressed their inconvenience with the tasks of reviewing fee applications and conducting thorough investigations of the class attorney's performance, tasks they are called to perform only after the case has been resolved.

One court, for example, described the lodestar motions after settlement as follows:

“Then began the process which all too often consumes a disproportionate share of the court's time, the application for attorneys' fees. It is at this point in these and other common fund cases that the court is abandoned by the adversary system and left to the plaintiff's unilateral application and the judge's own good conscience. Rarely do the settling defendants, who have created the pool of money from which the attorneys' fees are awarded, offer any counterpoint; rarely do members of the class come forward with any response or opposition to the fees sought. There are no amici curiae who volunteer their advice”.<sup>48</sup>

And another court stated:

“Judicial monitoring also is necessarily imprecise. The judge cannot readily see what legal work was reasonably necessary at the time; the judge

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<sup>47</sup> For evidence that courts indeed often abstain from interfering in proposed settlements see Howard M. Downs, *Federal Class Actions: Diminished Protection for the Class and the Case for Reform*, 73 Neb. L. Rev. 646, Appendix A. (1994).

<sup>48</sup> *In re Activision Secs. Litig.*, 723 F. Supp. 1373, 1374 (1989).

first sees the application for fees after the case is over, and hindsight may obscure the difficult decisions made under uncertainty as much as it illuminates them. The Supreme Court's oft-repeated wish that litigation about fees not turn into a second major lawsuit is an unattainable dream.”<sup>49</sup>

One way that courts try to overcome their institutional and resource constraints is by appointing guardians ad litem and special masters for the class during settlement negotiations.<sup>50</sup> Yet, the special master and the guardian ad litem are also resource constrained, as their fees must be paid by the settling defendant and class attorney who obviously have no interest in meaningful inquiries. Moreover, like courts, they too operate ex post, only after a settlement has been proposed, at which point they can only obtain limited evidence of the actual value of the case as class attorneys know it, and can learn even less of potential avenues for litigation that could improve the class position in trial yet were forgone by the class attorneys. Finally, the powers and authorities of the special master and guardian are derivatives of the courts’ powers. Whenever the latter operates with both hands tied, so is the former. Without sufficient remuneration, adequate incentive structure and early involvement in the case, these court appointed officers cannot render significant assistance in securing the class interests.

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<sup>49</sup> *Kirchoff v. Flynn*, 786 F.2d 320, 325 (7th Cir., 1986). See also Task Force Report, *supra* note 41, at 246-249, for an extensive critique of the lodestar method.

<sup>50</sup> Sylvia R. Lazos, *Abuse in Plaintiff Class Action Settlements: The Need for a Guardian During Pretrial Settlement Negotiations*, 84 Mich. L. Rev. 308; Christopher P. Lu, *Procedural Solutions to the Attorney’s Fee Problem in Complex Litigation*, 26 U. Rich. L. Rev. 41, 60-66 (1991) Robert G. Bone, *Rule 23 Redux: Empowering the Federal Class Action*, 14 Rev. Litig. 79, 92 n. 45 (1994); Eric D. Green, *What Will We Do When Adjudication Ends? We’ll Settle in Bunches: Bringing Rule 23 into the Twenty-First Century*, 44 UCLA L. Rev. 1773, 1796-97 (1997); Some courts have used guardians to assess the fairness of a proposed settlement to the class. See *infra*, notes 95-97.

Courts must therefore rely on private monitoring to satisfy their fiduciary obligations to represented class members. One obvious source for private monitoring is the class itself. We next investigate why performance of class representatives is also ineffective.

#### **IV. Monitoring by Class Members**

By requiring courts to select an adequate representative plaintiff, and by allowing class members to intervene and object during trial or settlement hearings, Rule 23 has established a conceivable framework for internal as well as external monitoring. Similarly, by establishing a presumption in their favor, the Private Securities Litigation Reform Act (PSLRA) has sought to encourage large investors to assume the lead plaintiff role, in order to render supervision of class attorneys more effective. Yet, both Rule 23 and the PSLRA have failed to deliver on their promise due to their flawed design.

This section identifies the necessary conditions for rendering monitoring successful and examines whether current procedures satisfy these conditions. Although different forms of private monitoring have been considered before, no one has yet attempted to analyze how monitoring should be structured to render it effective. As the following discussion suggests, this lack of rigor may account for the failures of past practices.

Rule 23 addresses the class action as if it is initiated by members of the class who may sue on behalf of all.<sup>51</sup> Of the four prerequisites to class certification two focus on the class representative,<sup>52</sup> whose claims or defenses must be typical of the claims or defenses of the

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<sup>51</sup> Rule 23(a).

<sup>52</sup> *Rules Advisory Committee Notes*, 39 FRD 69, 100 (1966).

class,<sup>53</sup> and who must fairly and adequately protect the interests of the class.<sup>54</sup> The typicality requirement is said to limit the class claims to those fairly encompassed by the named plaintiff claims,<sup>55</sup> so as to assure that his self interests are aligned with those of the class.<sup>56</sup> Adequacy of representation requires that the interests of the representative do not conflict with the class and that his attorney would be qualified, experienced and willing to pursue the litigation vigorously.<sup>57</sup>

A recent empirical study conducted by the Federal Judicial Center has demonstrated the significance of the typicality and adequacy of representation issues in precertification litigation. The study has found that defendants opposed certification in about 50% of the class actions examined. Disputes regarding adequacy of representation or typicality were raised in 63% and 62% of these cases, respectively.<sup>58</sup> Courts and litigants therefore spend substantial time addressing whether the named plaintiff would render proper representation to the class. Yet, as far as post certification issues are concerned, courts demonstrate outright disregard of the representative, they rarely consult him on any relevant issue, and

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<sup>53</sup> Rule 23(a)(3).

<sup>54</sup> Rule 23(a)(4).

<sup>55</sup> *General Telephone Co. v. EEOC*, 446 US 318, 330 (1980).

<sup>56</sup> Herbert B. Newberg & Alba Conte, *Newberg on Class Actions* §3.13.

<sup>57</sup> For the general requirement of adequate representation see *Hansberry v. Lee*, 311 US 32 (1940). The specific test for Rule 23(a)(4) requirement was first stipulated in *Eisen v. Carlisle & Jacquelin*, 391 F2d 555, 562 (2d Cir 1968) vacated on other grounds, 417 U.S. 156 (1974). See also *General Telephone Co. of Southwest v. Falcon*, 457 U.S. 147, 157-158 (1982); *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 812 (1985).

<sup>58</sup> Thomas E. Willging et al., *Class Actions and the Rulemaking Process: An Empirical Analysis of Rule 23 to Address the Rulemaking Challenges*, 71 N.Y.U.L. Rev. 74, 114 (1996).

they often prefer the lawyer's views over his.<sup>59</sup> In doing so courts recognize the reality that the named plaintiff has insufficient interest to adequately monitor, on the one hand, and that she may seek to hold the class or its attorney hostage only to promote her own interests, on the other.<sup>60</sup>

Monitoring requires investment of start up costs in studying the case, analyzing its merits, and establishing adequate reporting and monitoring procedures with the class attorney, and additional variable costs in applying these procedures throughout pre-trial, and (although to a lesser extent, because of the court's direct supervision) in trial.<sup>61</sup> Assuming the monitor's compensation is a percentage of the class recovery it immediately follows that there is a minimum, 'break even', percentage below which the monitor would refrain from making the required investment because it would be more costly than his expected benefit.

This explains why courts do not involve representative plaintiffs in major decisions whenever their share in the total stake is small. Courts can be certain that such plaintiffs would not spend the costs necessary for monitoring as the increase in their expected returns

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<sup>59</sup> For example, although the court must consider objections of class representative to proposed settlement, it may nevertheless approve it. See Manual for Complex Litigation (Third) §30.44. See also *Laskey v. International Union (UAW)*, 638 F.2d 954 (6th Cir. 1981); *Kincade v. General Tire & Rubber Co.*, 635 F.2d 501; *Flinn v. FMC Corp.*, 528 F.2d 1169, 1174 n.19 (4th Cir. 1975), cert. denied, 424 U.S. 967, 96 S. Ct. 1462, 47 L. Ed. 2d 734 (1976); *Bryan v. Pittsburgh Plate Glass Co.*, 494 F.2d 799 (3d Cir.), cert. denied, 419 U.S. 900 (1974); *Robertson v. National Basketball Ass'n*, 72 F.R.D. 64 (S.D.N.Y.1976); *Purcell v. Keane*, 54 F.R.D. 455 (E.D.Pa.1972); *Pettway v. American Cast Iron Pipe Co.*, 576 F.2d 1157 (5th Cir. 1978), cert. denied, 439 U.S. 1115 (1979); *Saylor v. Lindsley*, 456 F.2d 896, 899-900 (2d Cir.1972); *Reed v. General Motors Corp.*, 703 F.2d 170 (5th Cir. 1983) See also *Maywalt v Parker & Parsley Petroleum Co*, 67 F3d 1072, 1077-1079 (2d Cir 1995) holding that a class representative has no right to replace class counsel at will. For a comprehensive examination of the ambivalent treatment of class representatives in doctrine and in practice see Jean Wegman Burns, *Decorative Figureheads: Eliminating Class Representatives in Class Actions*, 42 Hastings L.J. 165.

<sup>60</sup> *Parker v. Anderson*, 667 F2d 1204, 1211 (5th Cir., 1982).

<sup>61</sup> For a more detailed discussion of these claims see section V.A. below.



would not be sufficient to justify it. Even if they would get some positive net return from monitoring, such small stake plaintiffs would be easily ‘bribed’ by class attorneys into not monitoring, as the lawyers would only need to match that small net return. Thus, if they can select the representative plaintiff class attorneys are sure to choose the one whose share is smallest.

The ensuing status quo is inefficient. Lawyers choose plaintiffs with low stakes to represent the class, monitoring is not worth these plaintiffs’ costs and time, and courts do not trust them to monitor class attorneys and do not reward them for representing the class.

The concern over ineffectiveness of monitoring by small stake class representatives underlined the PSLRA’s rebuttable presumption that the most adequate plaintiff is the person or group of persons that has the largest financial interest in the relief sought by the class.<sup>62</sup> By establishing this presumption the PSLRA intended to encourage large investors to compete for the lead plaintiff role.<sup>63</sup>

It was recognized that as long as courts do not favor large stake class members to represent the class the status quo under Rule 23 cannot be changed.<sup>64</sup> Most class actions are initiated by

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<sup>62</sup> §27(a)(3)(B)(iii) to the Securities Act of 1933 (codified at 15 U.S.C. § 77z-1(a)(3)(B)(iii) (1994 & Supp. I 1995)) and § 21D(a)(3)(B)(iii) to the Securities Exchange Act of 1934 (codified at 15 U.S.C. §78u-4(a)(3)(B)(iii) (1994 & Supp. I 1995)).

<sup>63</sup> The lead plaintiff provisions were “[intended] to encourage the most capable representatives of the plaintiff class to participate in class action litigation and to exercise supervision and control of the lawyers for the class. These provisions are intended to increase the likelihood that parties with significant holdings in issuers, whose interests are more strongly aligned with the class of shareholders, will participate in the litigation and exercise control over the selection and actions of plaintiff’s counsel “. H. Rept. 104-369, 141 Cong. Rec. H 13692, 136700 [hereinafter “Conference Report”].

<sup>64</sup> Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L. J. 2053 (1995). See also Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 Stan. L. Rev. 1487, 1527-1537 (1996), proposing to require large investors to opt in class actions if they are to participate in their recoveries, and participate in their management. Although the idea of monitoring by institutional investors was not

lawyers who search for potentially profitable claims and for class members on whose behalf these claims can be filed. The costs involved in searching for claims and plaintiffs, the large investments required in litigation, and the risk of non-payment result in a small and specialized class action bar. Members of this specialized bar hold a significant advantage over other law firms when competing to be appointed to represent a class, as the data on appointment of class attorneys indeed demonstrates.<sup>65</sup> Therefore, even if members whose stakes in the suit are high want to be appointed class representatives, they are likely to fail. Class action lawyers would prefer smaller class members because of the rent they can extract under inadequate monitoring, and would be able to find such class members for most suits they trace. High stake class members would only be able to hire attorneys who do not specialize in class actions, but these attorneys would usually fall short of being appointed to represent the class. This is a Catch 22. A class member must have sufficient stakes in the class action to justify monitoring, yet if she does she would not be chosen to monitor. The only way out could therefore be to impose a presumption in favor of large institutional investors.

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adequately appreciated in the class action context before Weiss and Beckerman published the above article, it resembles earlier discussions of similar themes in the corporate finance literature. See for example Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLR L. Rev. 811 (1992); John C. Coffee, *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 Colum. L. Rev. 1277 (1991).

<sup>65</sup> Miller and Singer, *supra* note 32, have explored a sample of 127 class actions whose notices appeared in the *New York Times* in the years 1993-1996. In more than 25% of these class actions the firm of Milberg Weiss Bershad Hynes & Lerach was one of the law firms selected to represent the class. Moreover, five other law firms have appeared in 5%-10% of the notices (*Id.* Appendix A). Thomas Willging et al., *Empirical Study of Class Actions in Four Federal District Courts: Final Report to the Advisory Committee on Civil Rules* (Federal Judicial Center 1996) have found that three law firms have each been appointed lead or co-lead counsel in about 10% of 160 class actions examined, and that twelve firms were aggregately lead or co-lead counsel in 63% of the certified cases in the study. Joseph A. Grundfest & Michel A. Perino, *Securities Litigation Reform: The First Year's Experience* < [http://securities.stanford.edu/report/pslra\\_yr1/index.html](http://securities.stanford.edu/report/pslra_yr1/index.html) > table 11 (1997) (last visited January 26, 2001) have found that Milberg Weiss law firm has appeared in securities class actions against more than 45% of the 109 companies sued between 12.22.95 and 12.31.96.

However, as far as experience since enactment of the PSLRA has proved, it has failed to achieve its goal, as large institutional investors have rarely competed to be appointed lead plaintiffs.<sup>66</sup> Moreover, most institutional investors that were appointed for that position were public pension funds whose shares in the class were relatively modest.<sup>67</sup>

Why have large institutional investors refrained from proposing to be appointed lead plaintiffs? The reason, which Congress did not anticipate when it enacted the PSLRA, lies in the large costs these investors incur if they are appointed to monitor. Having to bear these costs, yet enjoy only their share of the accrued benefit, institutional investors prefer to monitor from the outside as unnamed class members, than to represent the class. They would rather have someone else monitor, even if he would do so less effectively, while they remain on the sidelines, objecting to a proposed settlement, opting out of the class or

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<sup>66</sup> In a report submitted to the president and the Congress on the first year of practice under the PSLRA the Securities and Exchange Commission (SEC) found that in 105 cases filed in that period institutions have moved to become lead plaintiff only in eight (8) cases. In seven of these eight cases the institution has been represented by a group of law firms which includes at least one traditional plaintiff's law firm. U.S. Securities and Exchange Commission Office of the General Counsel, Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995 (April 1997)[hereinafter 'SEC Report']. In a later testimony before the House of Representatives, Arthur Levit, chairman of the SEC has reported that in 124 lawsuits filed under the PSLRA institutional investors sought to be appointed lead plaintiffs only in six. He further reported that institutions were active as external monitors, objecting to what they perceived as unfair settlements in few class actions. Testimony of Arthur Levit before the Subcommittee on Finance and Hazardous Materials, Committee on Commerce, House of Representatives, October 21, 1997 [Levit testimony]. See also Joseph A. Grundfest & Michel A. Perino, *Ten Things We Know and Ten Things We Don't Know About the Private Securities Reform Litigation Act of 1995*, Joint Written Testimony Before the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs, US Senate July 24 1997.

<sup>67</sup> See Elliott J. Weiss, *The Impact to Date of the Lead Plaintiff Provisions of the Private Securities Litigation Reform Act*, 39 ARIZ. L. REV. 561, 572 (1997), admitting this is a development he and Beckerman have not predicted when proposing to appoint institutional investors to lead plaintiffs. Weiss & Beckerman, *Supra* note 64. Prof. Weiss raises the concern that "some attorneys will nurture relationships with the elected officials who control public pension funds and that those officials, as a sort of political payoff, will have their funds move to be named lead plaintiff in class actions in which they have modest, but not insubstantial, stakes and will designate those attorneys as lead counsel if and when they are found to be the "most adequate plaintiff". "

opposing other moves they consider inadequate, and refraining from too active involvement in the lawsuit.

Here too a simple example may help in understanding this claim. Suppose an institutional investor owns 5% of the class' shares, and if she monitors the class attorney she would spend \$4,000 and increase the class' net gain by \$100,000. This would leave her net \$1,000. Suppose also that by maintaining a watchful eye as an unnamed class member, possibly objecting to clearly unfavorable settlements, the institutional investor can assure a net gain of \$50,000 to the class, investing only \$1,000. Obviously, the institutional investor would choose the latter alternative, which would leave her with net \$1,500, although the class as a whole (including the institutional investor) would gain \$96,000 if the institutional investor were to assume the monitoring position, as compared to \$49,000 if she does not.

According to institutional investors,<sup>68</sup> the primary concern which has inhibited them from taking the lead plaintiff role is litigation-related expenses. Subjecting the institution's records to review both by plaintiffs' and defendants' lawyers, and making key personnel available for testimony may exact too heavy tolls, which private investors are not willing to bear. Additionally, private institutions expressed their reluctance to disclose their proprietary investment strategies in the course of litigation.<sup>69</sup> Also, institutions fear that service as class representatives would expose them to liability to other class members. Finally, some institutions commented that they can get better return if they proceed with their claims individually.

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<sup>68</sup> Levit testimony and Sec Report, *id.*

<sup>69</sup> That is one cost which public institutions do not incur as they are usually subject to state disclosure rules.

These concerns indicate that large private institutional investors have to bear higher monitoring costs than other class members or non members, and that they bear these costs only if they are appointed to be lead plaintiffs. Since the PSLRA has explicitly limited the recovery of lead plaintiffs to reasonable costs and expenses directly relating to the representation of the class,<sup>70</sup> institutional investors have been better off not monitoring.

Congress' main reason for not allowing additional compensation to lead plaintiffs lies in its ambition to limit the practice of professional plaintiffs who file frivolous suits for a bounty or bonus.<sup>71</sup> Congress has not anticipated that this provision would only serve the opposite of its goal. Since institutional investors have refused to propose themselves as lead plaintiffs, the traditional plaintiff class action bar could retain control by recruiting smaller plaintiffs who would not monitor, yet provide the ticket to being appointed as class attorney.<sup>72</sup> The Congress' expectation "[that] the plaintiff will choose counsel rather than,

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<sup>70</sup> §27(a)(4) to the Securities Act of 1933 (codified at 15 U.S.C. § 77z-1(a)(4) (1994 & Supp. I 1995)) and § 21D(a)(4) to the Securities Exchange Act of 1934 (codified at 15 U.S.C. §78u-4(a)(4)(1994 & Supp. I 1995)).

<sup>71</sup> Conference Report, *supra* note 63, at 13700.

<sup>72</sup> This practice is documented in the SEC Report, *supra* note 67. It relies on the explicit language of the PSLRA which provides that the lead plaintiff would be a "person or a group of persons", *Supra* note 62. See also *In re Network Assoc.*, *Infra* note 78, 1019-1027. In the absence of large institutional investors courts had to determine whether the PSLRA's presumption for the person or group of persons having the largest financial interest in the relief sought by the class should be examined according to the aggregate financial interest of a proposed group, or according to the individual stakes of each candidate. They also had to decide whether the number of members in a lead plaintiff group should be restricted. The SEC has taken position that this number should be usually limited to no more than three to five persons in number and that such a group should provide appropriate, reasonably available information to the court about its members, structure, and intended functioning, to allow the court to determine if such a group will be able to actively oversee the litigation. The SEC has also expressed objection to appointment of competing lead plaintiff applicants as "co-lead plaintiffs". See, for example, Corrected Brief of the Securities and Exchange Commission as Amicus Curiae in *Parnes, et al., v. Digital Lightwave, Inc.*, No. 99-11293 (11th Cir. Aug. 25, 1999) and cites to federal court decisions relevant to these issues. See also R. Chris Heck, *Conflict and Aggregation: Appointing Institutional Investors as Sole Plaintiffs Under the PSLRA*, 66 U. Chi. L. Rev. 1199 (1999) (documenting the practice of aggregating small plaintiffs to a group that would satisfy the PSLRA presumption).

as is true today, counsel choosing the plaintiff<sup>73</sup> was bound to fail since it did not take care to provide adequate motivation for institutional investors to compete for the lead plaintiff position.

It should be emphasized that large part of the idiosyncratic costs to which institutional investors are exposed as lead plaintiffs are a consequence of the mere appointment to that role (e.g. disclosure and possible liability). Therefore, if an institutional investor is appointed to lead plaintiff she is likely to perform her duties properly. Moreover, once appointed the institutional investor is likely to monitor well not only to increase the class expected net recovery, but also to minimize its future liability costs. The problem is not to motivate large investors to monitor adequately when they are appointed lead plaintiffs, but to motivate them to assume that position. Favorable accounts of the PSLRA that found support in evidence from case studies, demonstrating adequate monitoring by institutional investors, have nevertheless missed the point.<sup>74</sup> The lead plaintiff provisions of the PSLRA have not achieved their main goal, namely, to encourage large institutional investors to become lead plaintiffs.

## **V. Private Monitoring – The Proposal**

Recognizing the large agency costs incurred when lawyers represent unnamed class members, on the one hand, and the numerous deficiencies in court monitoring and in monitoring by class members, on the other, we propose an alternative – monitoring by private parties, not necessarily class members, who would be compensated by a fixed share

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<sup>73</sup> Conference Report, *supra* note 63, at 13700.

<sup>74</sup> See Elliott J. Weiss *supra* note 67, at 565.

of the class recovery. The proposal is divided to three parts: how the monitor would be paid, how he would be chosen, and what powers he would have.

1st. *The Monitor's Fee*

As the discussion of inadequate monitoring by small class members has demonstrated, the monitor must have a sufficient stake in the outcome of the class action to induce him to spend the necessary monitoring costs. Thus, monitors must be paid a high enough percentage of any judgment or settlement, net of all payments made to the class attorney and all other costs borne by the class. The interests of the class and the monitor would thus be aligned, subject to some agency problems we discuss below, which, because of the specific cost structure of monitoring, are not expected to be too significant.

The monitor's share must be at least as high as what we termed above the 'break even' percentage.<sup>75</sup> Let  $R_1$  be the expected net recovery in litigation if monitoring is performed,<sup>76</sup>  $R_0$  be the expected net recovery in litigation if monitoring is not performed,  $s$  be the monitor's share of the expected net recovery, and  $c$  be the expected monitoring costs. Then the court should set the monitor's share according to the following condition:

$$s > c / (R_1 - R_0).$$

Interpreting this condition, the monitor's share must be such that that his gain from monitoring is higher than his costs. Notice that the 'break even' percentage is higher than the ratio between the monitoring costs and the expected judgment when monitoring is

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<sup>75</sup> See section IV.B. above.

<sup>76</sup>  $R_i$  ( $i=0$  or  $1$ ) is the judgment's mean value, or the weighted average of possible judgments, with weights assigned according to the probability of each judgment, net of all litigation costs including lawyer's fees.

performed. This insight, although simple, has nevertheless not been mentioned in the literature, as no one has attempted to define the necessary conditions for motivating the monitor, be it a class member or anyone else, to perform his duties adequately if he is paid a share of the class.

For example, if monitoring costs are \$4,000, the expected judgment is \$100,000 if monitoring is performed, and it is \$50,000 if monitoring is not performed then allowing the monitor 5% of the recovery, which would presumably more than cover the monitor's costs, would actually fail to motivate him to spend these costs. Although the monitor's expected recovery if he monitors is higher than his costs, he would still be better off not monitoring. If he monitors his net payoff equals 5% out of \$100,000 minus the \$4,000 costs, which comes to \$1,000, whereas if he doesn't monitor his net payoff is 5% out of \$50,000, or \$2,500. When the monitor is awarded a percentage of the net recovery he earns his share on the part of the recovery that does not depend on monitoring. This share is the monitor's net rent from monitoring, and he must gain at least that rent if he monitors. Therefore, in this example the monitor must be paid at least 8% if he is to monitor properly.

The minimum fee necessary to induce monitoring is justified from the class' perspective, as any lower fee would result in no more than \$50,000, whereas if the monitor is paid the minimum 8%, the class would net \$92,000. More generally, the class would benefit from appointing the monitor whenever its net recovery, after paying that fee, is increased by an amount higher than that fee.<sup>77</sup>

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<sup>77</sup> In fact, since we propose to auction the monitor's job, part of his fee would be paid by his winning bid, thus reducing the cost of employing him for the class.



One may still wonder why the same problems that induce large inefficiencies in the lawyer - class members agency relations would not infect the relationships between the class and the monitor. After all, so might the argument go, the same moral hazard and adverse selection costs that are incurred because of the lawyer's private information would be replicated when the monitor is paid a fixed percentage of the class' net recovery. The reason why that would often not be the case lies in the different cost structure of the monitor and the lawyer:

*Monitoring is relatively inexpensive.* Compared to litigating a class action, monitoring is much cheaper and easier to perform. Periodical examination of relevant files and records, constant communication with the class attorney, and consistent participation in settlement conferences and important hearings would often suffice to supervise the class attorney.<sup>78</sup>

Although these are all costly enough to discourage any class member whose stakes are too small

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<sup>78</sup> The following excerpt from the court's decision in *In re Network Assocs.*, 76 F. Supp. 2d 1017, 1032-1033 (1999) may suggest the scope and duties of the monitor (the court detailed the duties of the lead plaintiff under the PSLRA):

"In this case, the lead plaintiff shall take affirmative steps to keep itself fully informed at all times on the progress and status of the case, the strengths and weaknesses of the case, the prospects for settlement, and the resources invested in the suit or proposed to be invested. With respect to each major litigation event, such as important motions, settlement discussions, trial and trial preparation, the lead plaintiff shall actively inform itself in advance and shall have the authority and responsibility to direct counsel, after, of course, receiving the advice of counsel. To minimize reduction from recovery for attorneys' fees, the lead plaintiff shall consult with counsel in advance to determine whether major tasks proposed by counsel are likely to add more value to the case than would be incurred in time and expense. In this connection, the lead plaintiff shall review monthly time and expense records prepared by class counsel. The lead plaintiff shall meet in person with counsel at least quarterly to review the progress and status of the case, shall attend all major hearings and shall attend all sessions of the trial, at a minimum, where the jury is present. Reasonable travel, telephone and business expenses incurred as a result of the lead plaintiff duties, if detailed and itemized, may be reimbursed as expenses from any recovery. The lead plaintiff shall recommend class counsel after completing the steps set forth below. To carry out its responsibilities, the lead plaintiff shall identify a single officer or internal counsel with experience in managing litigation to be primarily responsible for carrying out the duties set forth herein".

from performing them, they do not require the same professional and financial resources needed to actually litigate the case.

*Monitoring costs are easy to predict.* The costs involved in monitoring are, to a large extent, fixed and predictable. Once the proper reporting procedures are established the monitor would be adequately informed of most relevant facts. Monitoring costs would not depend much on specific characteristics of the case beyond those that are readily identifiable, such as the stakes involved. Furthermore, since courts are currently monitoring class actions, estimating the required procedures and necessary costs is easier for them than similar estimations concerning attorney litigation expenditures.<sup>79</sup>

*Monitoring costs are front loaded.* Since trial proceedings are conducted in court, private monitoring is less of a necessity at that stage.<sup>80</sup> To evaluate the lawyer's performance in trial the court need not consult the monitor as its direct observation would suffice. Furthermore, the conflicting goals of the defendant and the class attorney at the trial stage are likely to foreclose any opportunity for collusion between them and expose any faults and weaknesses in the class attorney's performance, making them transparent to the court. Because private monitoring requires setting the lawyer's fee in advance<sup>81</sup> the problem of post judgment fee litigation also becomes less important. Therefore, monitoring is essentially required at the pretrial stage and that is when most monitoring costs are incurred.

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<sup>79</sup> For a review of practices used to review attorney fee motions in class actions see Alan Hirsch & Diane Sheehy, *Awarding Attorneys' Fees and Managing Fee Litigation*, 95-117 (Federal Judicial Center 1995).

<sup>80</sup> The monitor would need to have his representative attend court hearings to be able to evaluate further settlement opportunities. Such attendance, however, would probably not be too costly, as it does not require preparation and intensive staffing, as is required from the class counsel who conducts the trial.

<sup>81</sup> See section V.C. below.

The benefit to class members from monitoring would depend on the extent to which the above three characteristics prove true. That is an empirical question which the court has to examine in each case. The more expensive and complicated monitoring is, the more sophisticated would the monitor's fee need to be, and the less profitable it would be to employ him. However, in class actions where these characteristics are expected to hold monitoring would prove effective in obtaining fair and efficient results for plaintiffs:

With respect to litigation, because the monitor's costs are more predictable and since monitoring is much less costly than litigation, the court can guarantee adequate monitoring performance by setting a fixed, relatively low and simple, percentage fee. Given such percentage the court is assured a sufficient level of investment and sufficient incentives to monitor properly. Moreover, monitoring investment is easier to verify (for example through periodical reports to the court) because it involves less complicated decisions, and more routine procedures, whereas litigation decisions rely much more on case specific characteristics and on much more sophisticated, path dependent, strategic decisions, all of which the court would have to know if it were to properly verify an adequate investment by the lawyer. The court's tasks in setting the monitor's fee and in supervising the monitor are therefore much simpler, and require much less information than the respective tasks regarding the class attorney.

As far as settlement goes, if the monitor's share in settlement equals her share in litigation then she, like the class attorney,<sup>82</sup> might have an incentive to agree to settlements that leave the class with lower net recovery than it could expect in litigation. Yet, this problem is of much less importance for monitors because their costs are usually front-loaded. As explained above monitors would be expected to exert minimum effort at trial

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<sup>82</sup> See discussion 4.B. above.

because at that point courts would be sufficiently informed to guarantee the class interests. Thus, the remaining monitoring costs after settlement negotiations would not significantly affect the monitor's considerations whether to accept a proposed settlement or not.

Finally, controlling against side payments between the class attorney (or the defendant) and the monitor is easier to perform than controlling for similar transfers between the lawyer and the defendant. We detail the ways to do so in section VI below. Thus, the problem of collusive settlements would be easier to control when the monitor, instead of the class attorney, is in charge of the lawsuit.

One problem that might remain under private monitoring is that of accurate evaluation of in-kind settlements. A partial solution may be to further align the interests of the monitor and the class by prohibiting any divergence in the *form* of payment between them. Thus, if class members are awarded coupons or securities interests there is little reason why monitors would not be similarly paid.<sup>83</sup> Their payment can also be calculated out of the fund actually claimed by class members, as opposed to the potential fund created in settlement.<sup>84</sup> Such measures would ensure that monitors take notice of the practicable value of any proposed settlement to class members. Yet, equating the form of payment between the monitor and the class is likely to be beneficial only when their preferences are similar. Thus, when class members' interests tend to be uniform, when class members can and want

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<sup>83</sup> For non-cash attorney fees, distributed in the same kind as the class' recovery see for example *In re Brown Co. Secs. Litig.*, 355 F. Supp. 574, 593 (S.D.N.Y. 1973); *Miller v. Mackey Int'l, Inc.*, 70 F.R.D. 533 (D.C.Fla.1976).

<sup>84</sup> In *Boeing v. Van Gemert*, 444 US 472, 478-481 (1980) the Supreme Court held that attorney fees should be calculated against the total fund available for class members, even if part of it were not collected. In that case, however, the common fund was created after the class won on trial. The decision has not been applied to settlements, in which courts reserve the authority to restrict attorney fees to collected funds. See, for example *In re Prudential Ins. Com.* 148 F3d 283, 334 n. 110 (3rd Cir., 1998); *Bowling v. Pfizer*, 922 F. Supp. 1261, 1284 (S.D. Ohio,1996).

to be immediately compensated, and when they are indifferent between any form of compensation and its present value monetary equivalent, paying the monitor in the same coin as the class would prove optimal. This would be true in many of the securities, antitrust and consumer class actions. However, in other contexts, demonstrably mass torts, where class members may be interested in delaying or spreading their payoffs they would be better off allowing the monitor's compensation to be monetary even if their remedy is not. Otherwise the monitor might attempt to force a monetary remedy which would not satisfy class members' needs.

2nd. *Selecting the Monitor*

The monitor would be selected by a price auction.<sup>85</sup> Bidders would submit the price they are willing to pay to assume the role of monitor, and the highest bidder would be chosen.<sup>86</sup> The winner's bid would either be distributed to the class, or used to finance early litigation costs.

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<sup>85</sup> We have not specified the exact timing of the auction. It would seem advisable to select the monitor before the class is certified, and return the selected monitor her bid if certification fails. This way the monitor would be able to choose the purported class attorney and supervise her even before certification, for the purposes of prior discovery, class certification preparation and settlement negotiations. Auctioning of class actions as a whole has been proposed before. See Jonathan R. Macey and Geoffrey P. Miller, *The Plaintiffs' Attorney*, *supra* note 13. More recently some courts have experimented with auctioning the class attorney position to the bidder who offers the lowest percentage fee. The first case to adopt this procedure was *In re Oracle Securities Litigation*, 131 F.R.D. 688, 132 F.R.D. 538 (N.D. Cal. 1990), 136 F.R.D. 639 (N.D. Cal. 1991), and several other courts followed. For a most recent use of the auction mechanism in a somewhat different framework, and its analysis see *In re Auction Houses Antitrust Litigation*, 197 F.R.D. 71 (S.D.N.Y. 2000). See also 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 (1999) (evaluating past class action attorney auctions).

<sup>86</sup> Although the proposal uses a 'first price auction' procedure, where the winner pays his bid, there is no inherent advantage in this type of auction. If it can be shown that a 'second price auction', where the winner (whose bid his highest) would pay the second highest bid, is more efficient from the class' perspective, then such auction should indeed be used. For an accessible review of the literature on auctions see R. Preston McAfee & John McMillan, *Auctions and Bidding*, 25 J. Econ. Lit. 699 (1987).

Candidates who can monitor more efficiently would expect higher rents and would therefore be able to bid higher for the job. Similarly, class members who believe they would be able to better monitor the class lawyer would enjoy an additional rent on their existing share of the class, and would also be able to bid higher if their monitoring costs are not significantly higher than outside bidders.

Courts could use different procedures than auctions to select the monitor. They could do so on the basis of the candidates' past record serving in similar positions (e.g. special masters, mediators, or class action lawyers), their reputation, or the details of monitoring schemes they would propose. Nevertheless, advantages of the auction include its simplicity and its selection of the most efficient monitor. Moreover, the auction would inform the court about the likely value of the lawsuit, as a higher value would attract higher bids.<sup>87</sup> Although bids would reflect the *net value* of monitoring, after subtracting the necessary costs, which must be lower than the value of the relative share awarded to the monitor, they may still serve to signal the true expected value of the case.

Finally, since the winning bidder must pay his bid most of his rent would be extracted and transferred to the class, thus reducing the cost of employing him, and rendering the whole proposal more attractive. Apart from the direct benefit to class members this would also render the problem of evaluating the expected monitoring costs less critical. If the court overestimates these costs and awards the monitor a larger than minimum percentage, the class would still be compensated for the additional share through the monitor's bid. Thus, although it is not necessary for implementing the monitoring scheme, it would seem that an auction would often be the most efficient way for doing so.

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<sup>87</sup> Since the auction may indicate to the court the expected value of the case, it may help to screen suits whose probability of success is lower. It is, however, not clear whether low value suits should indeed be screened out, from the perspective of society at large. See Shavell, *supra* note 12.

The pool of candidates may include class members but it need not be restricted a-priori to class members alone. By allowing non-members to compete to monitor that role may attract more experienced candidates, with larger resources and expertise in the fields concerned in the class action. Former special masters, venture capital firms, and consulting groups, are some of the professionals in law and finance who may compete for the monitoring position. Specialization in monitoring class actions is expected to evolve, in the same way it developed in the outgrowth of the class action bar.

In fact, it is possible that the class action bar would enjoy, at least initially, an advantage in competing to monitor. Assuming the potential for collusion can be properly accounted for by means discussed below, the resulting mechanism would make use of a *separate and conquer* strategy. Class action lawyers would supervise their peers.

This mechanism is to be distinguished from current practices of plaintiff steering committees.<sup>88</sup> The linchpin of our proposal, as compared to current practices, lies in the sharp separation between the two roles of monitoring and litigation, and the respective payoffs in these roles. Whereas members of plaintiff steering committees are inclined first to enlarge their total slice of the pie and only then to capture the largest possible share of that slice, the monitor's slice is pre-defined. To increase its value the monitor has to operate in ways that would benefit the class, thus extracting the optimal rent out of both the defendant and the class attorney.

By awarding the chosen monitor a share of the class his interests are made very similar to those of class members. There are reasons to believe, however, that the problems in

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<sup>88</sup> For an elaborate analysis of the perverse incentives created by the democratic control in plaintiff steering committees see Coffee, *Rescuing the Private Attorney General*, *supra* note 13, at 249-261.

schemes like the PSLRA which rely on class members' supervision would not be replicated under our proposal:

First, as explained in section IV.B. above, the monitor is exposed to fiduciary duties, reporting, and external supervision by unnamed class members. If his share is sufficiently high he would therefore prefer to monitor adequately. The problem with the PSLRA has not been the lack of incentives to monitor, once chosen, but the disincentives to volunteer to monitor. Owning a share of the class anyway, large institutional class member have preferred not to be appointed for that position. By awarding the chosen monitor an additional share in the class action recovery our proposal would motivate both class members and non-members to bid for the monitor's role.

Moreover, a related problem which this proposal solves is the lack of coordination among large class members. It may well be that there are some large class members who would prefer to monitor if no one else does. Still, there is a problem of coordinating who among those class members would take the job since each of them is better off free riding on adequate monitoring performed by one of the others. The coordination problem might result in situations where none of those class members monitors. This problem is clearly solved by our proposal.

Second, it may well be that class members are not the most effective monitors possible. Opening the monitor's position to all professionals and institutions that might develop expertise in the field may only benefit class members. Large stake class members may still bid for the job, and if they are indeed more efficient they are likely to win it.

Third, large institutional class members exist mainly (if not only) in securities litigation. In other contexts like consumer protection, antitrust or mass torts, class members usually



hold a small share of the whole class. Our proposal would guarantee adequate monitoring in these contexts too.

### 3rd. *The Monitor's Discretion and Authority*

Once chosen, the monitor would select a lawyer after negotiating her fee agreement and submitting it to the court's approval. Since by awarding the monitor a percentage of the recovery his interests are effectively aligned with the class, he would choose the lawyer who would maximize the class' net recovery, and offer the best possible fee arrangement for the class.<sup>89</sup> By imitating a market structure, this scheme would allow the monitor to maintain most bargaining power in his negotiations with competing lawyers, and he would likely be able to force the best conditions for the class.<sup>90</sup>

Once the lawyer is chosen and the court approves her fee arrangement the monitor should be allowed no further authority to replace her or change her fee, because of the relationship specific characteristic of the lawyer's investment in the lawsuit. That problem is familiar from the literature on the economics of contracts.<sup>91</sup> Because the lawyer's effort is

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<sup>89</sup> Absent any other restrictions it is possible that lawyers would use 'straw' candidates to bid for the monitoring role, and then assume the class attorney position and award themselves high rents. These problems are discussed in section VI below.

<sup>90</sup> We have refrained from explicitly limiting the pool of lawyers to those who filed motion to certify the class action. It may well be that the monitor would choose a lawyer who not involved in the case. One concern is that this structure may not provide sufficient incentives for lawyers to search for future causes of action, because they may be appointed to represent the class even if they were not the ones to file the class action. See *Coffee supra* note 88 above. One solution could be to compensate the lawyers who initiated the suit out of any fund created. Another would be to limit the pool of potential lawyers to those who filed motions to certify as a class action, similarly to the current regime. Notice, however, that this alternative, like present practice, still allows lawyers to free ride others' efforts and piggy back their filings.

<sup>91</sup> See Oliver E. Williamson, *The Economic Institutions of Capitalism* (1985); Paul A. Joskow, *Vertical Integration and Long Term Contracts: The Case of Coal-Burning Electric Generating Plants*, 1 J. L.

largely unverifiable to the court the monitor might threaten to replace her, after she has incurred large part of her litigation costs, unless the lawyer is willing to reduce her fee. Having her previous costs sunk, the lawyer would agree to any fee arrangement that would compensate her for her future costs. However, expecting this to happen, lawyers would tend to under-invest in the lawsuit, anticipating being left uncompensated for any early investment.

For example, suppose the lawyer's fee is initially set at 20% of the class recovery, and she has to spend \$10,000 before trial, and additional \$10,000 in trial.<sup>92</sup> Suppose also that the expected recovery in trial is \$100,000, if the lawyer makes the early preparations, and it is only \$50,000 if she does not. The lawyer would agree to take the case on these terms if she were secured the 20% fee.

However, if the lawyer's investment is not verifiable, the monitor might threaten to replace her unless she agrees to reduce her fee to 10% after she had spent the early \$10,000. Assuming the lawyer's investment cannot be verified she would have no recourse against the monitor, and would prefer to agree to the new terms (or to a slightly higher percentage), that would leave her with a net profit from that point on. Yet, to avoid a net loss the lawyer would choose not to make the early investment. Her fee would remain 20% (as this would be the minimum required to motivate any lawyer to take the case to trial, after no early investment was taken) and the class would be much worse off, earning net \$40,000 rather than \$80,000 if the monitor were committed to the initial fee.

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Econ. & Org. 33 (1985); Klein et.al., *Vertical Integration, Appropriate Rents, and the Competitive Contracting Process*, 21 J. L. & Econ. 297 (1978).

<sup>92</sup> The lawyer's expenditures need not be monetary. They may reflect the alternative value of his time, if he were to take other legal work instead of pursuing the class action.

The monitor may still be allowed to motion the court to replace the attorney, but he would have to support such motion with credible evidence, as opposed to relying merely on his authority. Because of the unverifiable nature of the lawyer's performance such occasions are expected to be rare.

Finally, the monitor would retain the power to veto any proposed settlement. A settlement would therefore require agreement of both the class attorney and the monitor. After being endorsed by both, the settlement would be submitted to the court's approval, which would be granted only after a fairness hearing is held, where all objecting class members can appeal the court and notify him their concerns.

Adequate monitoring according to this proposal would significantly limit the opportunities for collusion between the class attorney and the defendant. Under current practices collusion has to be proved to the court in the fairness hearing if the settlement is to be revoked. Since collusion is difficult to verify, courts are often inclined to dismiss claims asserting a collusive settlement as unfounded.<sup>93</sup> Under the suggested scheme, however, monitors may veto any proposed settlement without being required to justify their decision. Verifiability of collusive agreements would thus become insignificant. Clearly, monitors would still have to take pains to identify any possible collusion. Yet, lawyers would want to provide monitors with securities against collusion and with means for identifying it so that their fee would not be discounted in advance. Just as the lawyer would not want to make early investments if she is not assured her fee, so would the monitor refrain from awarding the lawyer a high fee if he knows the lawyer might take advantage of such fee and collude with the defendant. It would thus be in the best interest of both to

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<sup>93</sup> See Cohen & Koniak, *supra* note 32.

commit to their initial terms and provide each other with sufficient securities for the credibility of such commitments.

#### *D. Implementing the Monitoring Proposal – Taking Legal Constraints Into Account*

Clearly, the proposal made here may be implemented through a legislative reform. Yet, it seems that it can already be applied and experimented with under current doctrine. This section briefly outlines the issues at stake and possible solutions.

*Appointing a monitor.* It has always been recognized that courts have ample judicial powers to manage class actions, and since 1966 amendment to Rule 23 these powers have been commonly practiced under the auspices of Rule 23(d)(5).<sup>94</sup> Rule 23(d)(5) allows the court to make appropriate orders concerning procedural matters that are not specified in other subsections of Rule 23(d). It has been interpreted to allow broad discretionary powers to courts handling class actions, including the appointment of guardians ad litem to review the fairness of proposed settlements to class members,<sup>95</sup> to protect the class interests with regard to the class attorneys application for fee,<sup>96</sup> or to represent future class members.<sup>97</sup> Alternatively, courts have the power to appoint special masters according to Rule 53 and 16(c)(8) of the Federal Rules of Civil Procedure or experts according to Rule 706 to the

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<sup>94</sup> Charles A. Wright, Arthur R. Miller, Mary Kay Kane, *Federal Practice and Procedure*, §1796.

<sup>95</sup> *Ahearn v. Fibreboard*, 1995 U.S. Dist. LEXIS 11532 (E.D. Te., 1995) pp. 259-277 of original opinion.

<sup>96</sup> *Miller v. Mackey Int'l, Inc.*, 70 F.R.D. 533, 535 (D.C.Fla.1976) stated that “Although specific authority for the appointment of a guardian ad litem is not provided for in Rule 23, it is inherent within Rule 23(d)” See also *Haas v Pittsburgh National Bank*, *Supra* note 37 and *In re THC Financial Corp. Litigation*, 86 F.R.D. 721 (D.Hawai'i, 1980)

<sup>97</sup> *In re Joint Eastern and Southern Dist. Asbestos Litigation*, 129 B.R. 710, 732-733 (1991); *Meyer v. Citizens and Southern Nat. Bank*, 677 F.Supp. 1196, 1209 (M.D.Ga., 1988).

Federal Rules of Evidence.<sup>98</sup> Appointment of a non judicial representative for the purpose of negotiating the class attorney's fee has also been proposed by the Third Circuit Task Force in 1990,<sup>99</sup> and similar recommendations were incorporated in proposed (although eventually not enacted) amendments to rule 23 in 1993 and 1995.<sup>100</sup>

Monitoring, as it is proposed here, shares the basic features of the guardian or the special master. It is merely an extension of these already practiced devices. Compared to the special master or guardian ad-litem who are usually appointed only after a settlement is proposed or after the case is concluded and the attorney's fee is to be determined, the monitor's representation begins right after the suit is filed and ends only when it is concluded. The monitor's scope of authority is also broader, as he selects the class attorney, sets her fee and supervises settlement and litigation throughout. Yet, these differences, although essential for effective monitoring, do not seem critical from a doctrinal perspective. Appointment of the monitor is thus well within the powers of the court presiding the class action.

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<sup>98</sup> See Manual for Complex Litigation (Third) §23.14 p. 172, advocating the use of special masters to review the fairness of proposed settlements. Interestingly, the Manual for Complex Litigation (Second)(1986) has proposed to use a 'special counsel' to conduct settlement negotiations on behalf of either of the parties (§23.12 p. 163), but this suggestion has been dropped from the third edition. For a preference of a masters over a guardian to review of attorney's fee motions see for example *Gottlieb v. Barry*, 43 F3d 474 (10th Cir., 1994).

<sup>99</sup> Task Force Report, *supra* note 41, at 256-257.

<sup>100</sup> Committee on Rules of Practice and Procedure of the Judicial Conference of the United States, Preliminary Draft of Proposed Amendments to the Federal Rules of Appellate, Civil, and Criminal Procedure, 1993 and November 1995. The November 1995 draft read in section 23(e):

“(3) A proposal to dismiss or compromise an action certified as a class action may be referred to a magistrate judge or a person specially appointed for an independent investigation and report to the court on the fairness of the proposed dismissal or compromise. The expenses of the investigation and report and the fees of a person specially appointed shall be paid by the parties as directed by the court”.

As far as the auction as a method for selecting the monitor is concerned, there are two separate issues to be addressed. First, there is a question whether it is proper for the court to divest the choice of monitor in the hands of an external mechanism. To this the simple reply is that the court maintains all powers to supervise the auction and to veto any choice of monitor if it sees fit.<sup>101</sup> Second, it might be asserted that paying for his position, on the one hand, and being paid a share of the class recovery, on the other, the chosen monitor is in fact buying a share of the claim.<sup>102</sup> Yet, the two should be separately examined. The monitor, like the class attorney, is paid a percentage fee, and the application of the common fund doctrine to his fee is possible, as we discuss below. That he pays for earning this position must be viewed as a mere advantage of the proposed scheme as it benefits the class and provides an objective and efficient mechanism for the monitor's selection.

*The monitor's discretion.* It is the general rule that an appointed neutral can only assist but not replace the adjudicator in its decisions of fact and law.<sup>103</sup> It would seem, however, that as long as the court approves the monitor's decisions this concern would not preclude the use of monitors. Furthermore, from a doctrinal perspective the monitor's role is not much different from that of the class attorney's. Both are professionals who serve to represent the class. The monitor is not supposed to act as a neutral evaluator of the case or of the lawyer's performance, and his discretion thus does not substitute for the court's in

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<sup>101</sup> As mentioned above, *supra* note 85, auctions are already practiced for selection of lawyers under the PSLRA.

<sup>102</sup> In individual litigation such sale might be considered a violation against the rule of champerty. Even there, however, it is not clear how applicable is that rule in view of contingent fees for lawyers. See Stephen C. Yeazell, *Collective Litigation as Collective Action*, 1989 U. Ill. L. Rev 43, 52.

<sup>103</sup> *La Buy v. Howes Leather Co.*, 352 U.S. 249, 256.

any formal way. The court still remains in charge of protecting the absent class members' interests, and maintains all powers to that effect.<sup>104</sup>

*The monitor's fee.* The court's power to allow the monitor a share in the proceeds from the lawsuit should be derived from the same doctrinal basis on which lawyers are allowed a share in the class action proceeds, namely, the common fund doctrine.<sup>105</sup> The doctrine establishes the equitable entitlement of a litigant or his lawyer who recover a common fund for the benefit of others to a reasonable attorney's fee from the fund as a whole.<sup>106</sup> It has been applied also to awards of incentive fees to representative plaintiffs,<sup>107</sup> and to payment of attorney fees and costs to intervening unnamed plaintiffs and their lawyers.<sup>108</sup> Although it has usually been applied only to *parties* who rendered common benefit to the class, the doctrine is conceivably extendable to non parties as well. For example, in the past some

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<sup>104</sup> Application to securities class actions may turn out more difficult as the PSLRA instructs that the lead plaintiff shall, subject to the approval of the court, select and retain counsel to represent the class (§27(a)(3)(B)(v) to the Securities Act of 1933 (codified at 15 U.S.C. § 77z-1(a)(3)(B)(v) (1994 & Supp. I 1995)) and § 21D(a)(3)(B)(v) to the Securities Exchange Act of 1934 (codified at 15 U.S.C. §78u-4(a)(3)(B)(v) (1994 & Supp. I 1995))). Yet, even after enactment of the PSLRA courts have repeatedly emphasized their discretion to use other mechanisms for selecting the class attorney, especially through auctions. See references, *supra* note 85.

<sup>105</sup> For review of the doctrine see Alba Conte, *Attorney Fee Awards* 22-30 (2d. ed. 1993); Alan Hirsch & Diane Sheehey, *supra* note 79, at 49-63.

<sup>106</sup> *Trustees v. Greenough*, 105 U.S. 527, 536-538 (1882); *Central Railroad & Banking Co. v. Pettus*, 113 U.S. 116, 124-125 (1885); *Boeing v. Van Gemert*, 444 U.S. 472, 478-482 ((1980).

<sup>107</sup> See *In re Continenta Illinois Se. Litig.*, 962 F.2d 566, 571 (7<sup>th</sup> Cir., 1992); *Enterprise Energy Corp. v. Columbia Gas Transmission Corp.*, 137 F.R.D. 240, 250-51 (S.D. Ohio 1991); *In re VMS Ltd. Partnership Sec. Litig.*, No. 90 C 2412, 1991 U.S. Dist. LEXIS 9624, at \*10-11 (N.D. Ill. July 15, 1991); *In re Dun & Bradstreet Credit Servs. Customer Litig.*, 130 F.R.D. 366, 373-74 (S.D. Ohio 1990); *In re Smithkline Beckman Corp. Sec. Litig.*, 751 F. Supp. 525, 534-35 (E.D. Pa. 1990). But notice that the Supreme Court in *Greenough, Id.* at 537-538, has declined to award private costs to the representative plaintiff.

<sup>108</sup> See e.g. *Kargman v. Sullivan*, 589 F.2d 63, 68-69 (1st Cir., 1968); *Lindy Bros. v. American Radiator*, 540 F.2d 102, 112 (3d Cir., 1976); *County of Suffolk v. Long Island Lighting Co.*, 907 F.2d 1295, 1326-1327 (2nd Cir., 1990).

courts have awarded costs and attorney fees to non party amicus who contributed to the class' benefit.<sup>109</sup>

## **VI. Controlling Against Collusion Between Class Attorneys and Monitors**

Because the above proposal confers the monitor broad authority in choosing the class attorney, setting her fee and approving settlement, it is sensitive to problems of collusion between the monitor and the lawyer.<sup>110</sup> Whenever side payments between them are possible the lawyer would be able to share her rent with the monitor, motivating the latter to increase the lawyer's rent at the expense of the class. At the limit, where side payments have zero transaction costs, the monitoring proposal would break down, monitor and lawyer acting as one, similar to the current situation where no monitoring is effectively practiced. Separation between the monitor and the lawyer is the linchpin of this paper's proposal. The more it is maintainable, the more attractive this proposal is. The following discussion details some possible ways to guarantee such separation.

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<sup>109</sup> See e.g. *Bowling v. Pfizer, Inc.*, 922 F. Supp. 1261, 1285 (S.D. Ohio 1996), allowing a fee paid to 'Public Citizen', an amicus whose objections to proposed settlement were, according to the court, invaluable and beneficial to the class; But see *Fiorito v. Jones*, 72 Ill. 2d. 73 (1972) where the Supreme Court of Illinois rejected the award of attorney fees to non members.

<sup>110</sup> Collusion between the monitor and the defendant is also, theoretically, possible. However, it would be difficult for the defendant to pay the monitor in ways that would not be transparent to the court. Indirect collusion, facilitating payments from the defendant to the class attorney, and from her to the monitor, may be more plausible. However, controlling for collusion in the attorney monitor chain would render the greater scheme inapplicable.



1st. *Limiting Repeated Interaction Between the Monitor and the Class Attorney*

Collusion requires side transfers. As the literature on collusion clearly demonstrates, when side transfers cannot be simultaneously exchanged repeated interaction between the monitor and the agent becomes the key factor in enforcing collusive agreements.<sup>111</sup> Give-and-take requires long run relationship, allowing parties to reward each other if they cooperate, and punish otherwise. The longer the time horizon of the relationship the more cooperation (qua collusion) can be sustained.<sup>112</sup>

Collusion is easiest if both monitor and lawyer operate under a joint organizational framework that may smooth transfers between them. Similarly, if the monitor and the law firm are operated and controlled by the same individuals then they can exchange payments easily. Finally, if both have a continuing contractual relationships beyond the class action context it would possibly be difficult for the court to identify side transfers between them. Any relationship of these kinds should therefore be forbidden, and both monitor and class attorney should submit their statements to that effect. Since the relationships, as distinguished from the side payments within them, are easily identifiable and verifiable, false statements would subject the lawyer and the monitor to a high risk of being detected and sanctioned.<sup>113</sup> If no one else, competing candidates to both roles would surely exhaust any opportunity to disqualify the chosen monitor or class attorney and get a second chance at replacing them. The chances that they would uncover some evidence of continuing

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<sup>111</sup> See for example Jean Tirole, *Hierarchies and Bureaucracies: On the Role of Collusion in Organizations*, 2 J. L. ECON. & ORG. 181, 201-203 (1986) and references therein.

<sup>112</sup> See e.g. David Kreps, Paul Milgrom, John Roberts and Robert Wilson, *Symposium on Finitely Repeated Models of Reputation*, 1982 J. Econ. Theory 245-312.

<sup>113</sup> On such sanctions see section VI.D. below.

relationships and provide it to the court would probably be high, posing a realistic possibility that sanctions for false statements would be imposed.

A different, harder to control, type of cooperation and collusion might follow from allowing class action lawyers to be appointed monitors. It is possible that a lawyer who is appointed to monitor would agree to set a higher than optimal fee for the lawyer she chooses to represent the class, who in return would guarantee that if she is chosen to monitor in another case she would choose the current monitor to represent the class and would award her accordingly.<sup>114</sup>

One possible remedy is to exclude class action lawyers from the competition to monitor by requiring, for example, that a candidates would certify that their law firm has not represented plaintiffs in class actions during the preceding year (or any other sufficiently long time period). A less extreme remedy against reciprocation would be to prohibit the monitor from choosing any lawyer who, as a monitor in an earlier class action, had chosen him to represent the class. This would render reciprocation, and consequently collusion, too costly to operate between the two lawyers.

The above measures for countering collusion all operate by restricting the pool of possible candidates to monitor, or by limiting the respective pool of lawyers from which the monitor may choose the class attorney. Clearly, if the pool of monitors is restricted to class members only then the opportunity for collusion is minimized. Class members would usually not be involved in more than one class action, and even if they are there can be no way of predicting if and when that indeed would be the case. Reciprocation and side

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<sup>114</sup> Some commentators have alleged that similar reciprocation currently exists in selection of lawyers to plaintiff steering committees and in the choice of lead attorneys. See e.g. Coffee, *supra* note 88 above. Monitor auctioning could render such collusion even more likely, as the colluding lawyers would gain combined high rents because of the inefficient monitoring they provide, and would thus be able to outbid other candidates for the monitoring position.

transfers would therefore not be available beyond the present lawsuit, and within it they would be easily foreclosed. By ensuring a structural separation between the monitor and the class attorney (and allowing no contractual relations beyond the present class action) courts would be able to forestall any side payments.

Nevertheless, the advantages of attracting experienced, financially stable, and knowledgeable monitors may outweigh the enhanced risk of collusion that would result if non class members are allowed to compete for the monitor's position. The decision should therefore depend on the context and the substantive content of the litigation, as well as on experience from past lawsuits.

Note, though, that repeated cooperation for the purpose of class actions only, where the monitor chooses the same lawyer in more than one suit in which he is appointed, does not pose a significant threat of collusion as long as other means for side payments between them are prevented. If separation is maintained then the lawyer would have no way of repaying the monitor in exchange for being allowed a higher than optimal rent in a class action. Since the potential for collusive agreements relies on the scope of opportunities for side payments, concerns in this respect should not be too difficult to handle.

This may seem to conflict with the long standing suspicion towards what has been termed in the securities litigation literature the 'professional plaintiff'. Stories about shareholders who filed 50 or more class actions caused an outrage in the legal community and were used to support call for limiting the use and abuse of the class action device.<sup>115</sup>

The PSLRA even went to require that no lead plaintiff would serve in that role in more than

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<sup>115</sup> See Weiss & Beckerman, *supra* note 64 at 2060 note 28. It is not clear how significant the phenomenon of 'professional plaintiff' really is. For example, the Federal Judicial Center study in 1996 has found few multiple appearances of named plaintiffs in the four districts it examined. See Willging et al., *supra* note 58, at p. 99.

5 class actions during any three year period.<sup>116</sup> Yet, the main concern with professional plaintiffs has not been, so it seems, the possibility for collusion at the expense of class members, but the opportunity for strike suits, exercised by law firms using the plaintiff as a mere ticket for imposing frivolous litigation threats on defendants.<sup>117</sup> Clearly, this concern is unfounded under the proposed scheme where monitors do not participate in filing the suit, on the one hand, and are sufficiently paid to justify adequate supervision of the class attorney, on the other.

2nd. *Increasing the Monitor's Share*

Paradoxically as it may seem, the wider the opportunity for collusion, the higher the monitor's fee should be.<sup>118</sup> The rationale is simple. By colluding with the class attorney the monitor gains side transfers the attorney pays him, yet he shares the lost rent with the class. The higher his share in the class recovery the larger his loss from collusion. Once this loss is higher than the possible side transfers the monitor would not collude. The opportunity for collusion simply raises the monitor's reservation value in case he does not perform his duties properly.

The necessary increase in the monitor's share would depend on the available 'technology' for side transfers. The more difficult and risky it is to agree on, transfer and

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<sup>116</sup> One of Congress' main goals in adopting the PSLRA was to "reform abuses involving the use of 'professional plaintiffs'". Conference Report, *supra* note 63. See §27(a)(3)(B)(vi) to the Securities Act of 1933 (codified at 15 U.S.C. § 77z-1(a) (3)(B)(vi) (1994 & Supp. I 1995)) and § 21D(a) (3)(B)(vi) to the Securities Exchange Act of 1934 (codified at 15 U.S.C. §78u-4(a) (3)(B)(vi)(1994 & Supp. I 1995)).

<sup>117</sup> "The Conference Committee believes these practices have encouraged the filing of abusive cases". Conference Report, *id.*.

<sup>118</sup> See Tirole, *supra* note 111.

enforce side payments, the more expensive and consequently smaller they would be. The monitor's share need only be increased to the point where his potential cut of the lawyer's excessive rents does not justify the reduction in his share of the class recovery.

Raising the monitor's fee substitutes for direct restrictions on side payments and collusion. The more difficult it is for the lawyer and the monitor to exchange side transfers, the less would the necessary increase in the monitor's fee be. Since restricting side payments is costly, the question which measure to use is a matter for specific cost benefit analysis. If, for example, class action lawyers are potentially more efficient and effective in monitoring, it may be better to allow them to compete for the monitor's position yet increase the monitor's fee so that collusion would not be beneficial. If, on the other hand, collusion is so easily facilitated through give and take relations within the class action bar, then the increase in the monitor's fee might only impose an additional cost on the class, without substantial decrease in collusion. The court may then want to bar active class action firms from bidding to monitor.

### *C. Encouraging External Monitoring by Class Members*

Class members who believe they are not represented adequately have the right to opt out if the class was certified under rule 23(b)(3). Yet, opting out is often unavailable, either because the suit is not a 23(b)(3) class action, or because litigating the case separately is too costly, which leaves intervention as the main channel through which class members may supervise the class attorney in litigation.<sup>119</sup> Similarly, after a settlement is proposed the

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<sup>119</sup> See Rules 23(c)(2)(c), 23(d)(2), and Rule 24 of the FRCP. See also *Woolen v. Surtran Taxicabs, Inc.*, 684 F.2d 324 (5th Cir., 1982), deciding that even if the representative plaintiff adequately represents the class for purposes of Rule 23(a)(4), an unnamed class member may still have the right to intervene according to Rule 24(a)(2).

court conducts a fairness hearing according to rule 23(e), in which all objecting class members may bring their plea before the court.

In practice, unnamed class members rarely intervene during litigation, and although more object in the settlement stage, they often drop their objections, allegedly after entering some side agreement with the defendant and the class attorney.<sup>120</sup> Even when they do intervene, class members are rarely treated seriously by courts, and their claims are usually rejected.<sup>121</sup>

As in the case of representative plaintiffs, here too the explanation for class members' passivity and for courts' lack of appreciation lies in the insufficient incentives to search for abuses and inadequate representation, to intervene, and to object. Since compensation to intervening or objecting class members is usually small,<sup>122</sup> they have no reason to search for

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<sup>120</sup> See Koniak & Cohen, *Supra* note 32, at 1107, fn. 184 and references therein. See also *Duhaime v. John Hancock Mut. Life Ins. Co.*, 183 F.3d 1 (1st cir., 1999), rejecting allegations of side settlements between defendant and an objector during an appeal of the settlement.

<sup>121</sup> A 1996 Federal Judicial Center's empirical study confirms these observations; See Willging et al., *supra* note 65, at 52-59. In the four districts examined in that study the median percentage of members who opted out in certified 23(b)(3) class actions (in certification or settlement) was between 0.1% and 0.2%. In only 6% of the cases class members have attempted to intervene in the litigation, and only half of these were allowed by the court. In the settlement stage objections were filed in about 48% of the cases, mostly in writing, yet approximately 90% or more of the proposed settlements were approved without changes in each of the four districts. Furthermore, in nineteen out of twenty one cases in which objections to the amount of attorney's fees were filed the court awarded 100% of the fee requested by class counsel.

<sup>122</sup> In the absence of an empirical work on objecting class members' compensation we only refer to anecdotal evidence, based on our search for cases in which such fee was awarded. A simple search would reveal that the number of cases documenting no payoff to intervening and objecting class members is much larger. In the absence of evidence of the merit of each objection or the time and costs spent by objectors it is clearly impossible to evaluate whether its compensation was lower than justified. In *Ace Heating & Plumbing Co. v. Crane Co.*, 453 F.2d 30 (3d Cir. 1971) an objecting class member was awarded \$3,000 out of a \$2,000,000 settlement fund. In *Bowling v. Pfizer, Inc.*, 922 F. Supp. 1261, 1285 (S.D. Ohio 1996) Public Citizen, an amicus, was awarded \$105,037.46 out of a more than \$100,000,000 fund; In *Seigal v. Heirst*, 74 Civ. 2475 (CBM) (S.D.N.Y., 1979) a derivative suit settlement was rejected as a consequence of objector's petition. Although the suit has not been concluded the court estimated the benefit conferred by the objector to be roughly 2.5 million dollars,

information, unless their share in the class recovery is sufficiently high. Moreover, even if a class member discovers information attesting to an impropriety in settlement or in litigation she is better off calling the defendant or class attorney and offering her silence in return for some payment, than moving the court and being only nominally compensated. Because of the unnamed nature of potentially objecting class members, side settlements with them are not transparent and the court cannot directly restrict nor supervise them in any substantial manner. Additionally, claims of collusion are often difficult to verify and lack sufficient evidentiary foundation. Faced with such claims courts cannot be blamed if they prefer to overlook them than to risk a continuing litigation that would impose large costs on both the court and the parties, and would endanger whatever it is that class members have gained in the proposed settlement.

The remedy therefore lies in adequate compensation for objecting class members.<sup>123</sup> Their compensation should depend on their success, as the court would evaluate the contribution rendered by their intervention to the class.<sup>124</sup> Because courts would rarely learn

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and awarded them a lodestar fee of \$269,538.03, including expenses; In *In re Domestic Air Transp. Antitrust Litigation*, 148 F.R.D. 297, 359 (N.D.Ga., 1993) the court has awarded objectors' counsel fees of \$718,030.20 and expenses of \$92,327.04, equal to .266% of the median value of the common fund in that action.

<sup>123</sup> Similar proposals have been made by Miller & Singer, *supra* note 32 at 120, and by Koniak & Cohen, *supra* note 32, at 1107.

<sup>124</sup> Indeed, this is currently the rule for compensating objecting class members, only courts rarely award them substantial amounts. In *Milstein v. Warner*, 58 FRD 544, 552 (S.D.N.Y., 1973) the court quoted from *Schleiff v. Chesapeake & Ohio Railway Co.*, Docket No. 68 Civ. 3478 et al., S.D.N.Y., March 12, 1968, summarizing the rule pertinent to applications by objectors for allowance of compensation to counsel or of expenses as follows:

“The basis for an allowance in such cases is that as a result of the objections the fund has been increased. There is, of course, no such basis for an allowance in the case at bar. In principle, there can be no allowance except where the applicant has helped to create a fund, in which event it is only fair that an allowance be made out of the fund created in whole or in part by the efforts of applicant. When there are objections to a settlement but the settlement is approved as

of side agreements with objecting class members their compensation must be significant enough to motivate them to reveal their information rather than accept hush moneys from defendants, class attorneys, or monitors. This fee, however, would not necessarily be too high since defendants, class attorneys and monitors can never secure themselves against future objections. As the supply of class members who might do so is large, they would not be able to pay each objector too high compensation, since the assurance that follows it would by no means be complete. The compensation for objecting class members should therefore not be significantly higher than the costs involved in objecting, multiplied by the risk of non-payment.<sup>125</sup>

The crucial difference between internal and external monitors is in the type of information which is available to them, and the scope of discretion they are allowed. Internal monitors maintain close supervision of the proceedings and therefore information which is unverifiable to the court is readily accessible to them. Since it is unverifiable, such

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submitted, the making of the objections has been of no benefit to the corporation or its stockholders and no allowance can be made to objectants.” (Case citations omitted).

See also *Frankenstein v. McCrory Corp.*, 425 F.Supp. 762, 767 (S.D.N.Y.1977); But see *In re Gas Meters Antitrust Litigation*, 500 F. Supp. 956, 962 (E.D. Penn., 1980) holding that the common fund doctrine is not intended to include fees requested by and objector to the class counsel’s request for fees.

<sup>125</sup> The objecting plaintiff’s compensation may take two basic forms, similar to currently practiced class counsel fees. Either the objecting plaintiff would get a percentage of the benefit conferred to the class, or she would get an hourly fee contingent on prevailing in her objections. The percentage fee is dependant on the court’s ability to quantify the benefit. If a settlement is changed as a result of the dissident plaintiff’s objection, the benefit would often be readily quantifiable. If the parties choose not to settle but pursue litigation as a consequence of the objection then the court can award the objecting plaintiff a percentage of the difference between the proposed settlement and the eventual recovery; See *Seigal v. Heirst, supra* note 122. Yet, if an unnamed plaintiff intervenes to inform the court of some form of collusion or non disclosure of relevant facts concerning relationships among the defendant, the class attorney and the monitor, the gain may be unquantifiable. Compensation of the intervening plaintiff may then either be from the eventual fund created, in the form of hourly fee and expenses multiplied by the risk of non success, or it may be imposed on the colluding parties, as a sanction for their inappropriate conduct.



information cannot be proved to the court, and internal monitors must therefore be allowed wide discretion in structuring the lawyer's fee and approving any proposed settlement. Requiring the internal monitor to support its claims by hard evidence would often render him ineffective. As far as unnamed class members are concerned, however, the court may not rely on unfounded claims they make, or they would find it in their interest always to intervene, notwithstanding the merit of their allegations. They should therefore be required to prove these allegations, and support them with hard evidence. Obviously, this restricts the utility of external monitoring and limits its effectiveness. Nevertheless, as far as detecting collusive agreements, inflated settlement value estimations, prior relationships and side payments are concerned, motivating class members to apply active supervision may prove beneficial to all.<sup>126</sup>

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<sup>126</sup> One issue which is not addressed in the text is whether non members, including interest groups and government agencies, should also be allowed to intervene in class proceedings. Examples include the SEC which is often asked to submit amicus briefs in securities class actions (these briefs can be retrieved from the SEC's web site at <<http://www.sec.gov/news/leglindx.htm>>, last visited July 15, 2000) and the Public Citizen group which has recently intervened in few highly celebrated class actions (for a summary of class actions in which Public Citizen has intervened see <<http://www.citizen.org/litigation/class.html>>, last visited July 15, 2000). Since the incentive structures of such organizations and agencies rely only to a very limited extent on their monetary compensation, controlling for the optimal quantity and quality of their interventions defies the simple mode of analysis used in this paper. Further research is therefore called for in this respect.

#### D. *Sanctioning Class Attorneys and Monitors*<sup>127</sup>

Collusive agreements expose both class attorneys and monitors to the risk of sanctions. Lawyers may face disciplinary actions if they abrogate their ethical and professional responsibilities; both lawyers and monitors may be sued for malpractice and breach of fiduciary duties, as well as for statutory and common law fraud; in addition both might face grave reputational losses if such proceedings are indeed initiated. Increasing the sanctions following such proceedings may therefore be conceived as an appropriate remedy against the various types of inappropriate conduct adversely affecting the class.

Increased sanctions would have two effects. First, for any given probability of imposing the sanction the level of deterrence would increase. Second, increased sanctions would provide greater incentives for private detection and enforcement, thus increasing the probability the sanction is indeed imposed. Thus, for example, if intervening or objecting class members are awarded part of the sanction imposed on colluding lawyers or monitors, they would be inclined to invest greater resources in detecting such conduct and providing the court with evidence about it. Although this would also increase the incentives for monitors and lawyers to pay these class members hush moneys, the result would nevertheless be similar. Whether the sanction is paid after disciplinary proceedings and

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<sup>127</sup> Some have suggested that effective enforcement and higher sanctions against class counsels would reduce much of the inefficiencies inherent in class actions. See e.g. Koniak & Cohen, *supra* note 32; Koniak, *supra* note 32. Yet, increased sanctions would only affect deterrence as far as verifiable information would be detected and provided to the court. As our previous discussion has demonstrated, many of the inherent inefficiencies in class actions relate to information that is either unobservable or very costly to verify, including information concerning projected trial outcomes, lawyers' time investment, their quality of representation, various forms of side payments and settlement valuation. These types of information would not be available to external monitors, unnamed class members or other interested parties, and even if they would, courts would not be able to condition their decisions on such information as the problem of opportunistic abuse would foreclose any such reliance. Information is again, the key. To have it obtained and enable its use, appointed private monitoring would be necessary.

satellite litigation, or whether it is paid in settlement (covert or not), the price of unethical and illegal conduct would increase, making such conduct less profitable.<sup>128</sup>

## VII. Conclusion

In this paper we have suggested that private monitoring of class actions should be seriously considered as a viable alternative to the highly deficient supervision which courts and class members currently render. Instead of concentrating on attorney fee regulation, as most of the literature on class actions has, we have chosen to focus on optimal design of monitoring structures. We have examined the necessary requirements to facilitate adequate monitoring in class actions, and have concluded that to satisfy these requirements the pool of potential monitors must be expanded beyond class members, that monitors should be selected by a mechanism that would imitate the market, namely an auction, and that monitors should be allowed a share of the class recovery if they are to perform their duties adequately.

Our analysis significantly extends previous discussions of monitoring by examining why and how self interested individuals and institutions can be induced to monitor properly. Courts and commentators alike have often complained that named class members are figureheads and that only large stakeholders can perform monitoring adequately. They have nevertheless refrained from explicit discussion of numerous relevant questions such as what it is in large stake holders that would render them effective monitors; whether and how they

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<sup>128</sup> Like any other settlement, bribing an objecting class member to maintain her silence would not be as expensive as the expected sanction. Yet, it would also save some of the administrative costs involved in formal proceedings. For an analysis of the effect of corruption and collusion on deterrence see Steven Shavell & A. Mitchell Polinsky, *Corruption and Optimal Law Enforcement*, National Bureau of Economic Research, Working Paper 6945, forthcoming, Journal of Public Economics.

should be paid for their work; whether monitoring should be restricted to class members only; and what scope of discretion should monitors be allowed. This lack of rigor is quite unfortunate as the main reform aimed at facilitating monitoring, that attempted by the PSLRA in the securities litigation context, has failed to achieve satisfactory results exactly because care has not been taken to adequately compensate selected lead plaintiffs qua monitors. To rephrase the title of a most celebrated article on which this reform was instated,<sup>129</sup> its failure resulted because it did not let the monitoring have enough money.

If private monitoring is indeed cheaper and its costs more predictable than litigation then it holds promise in limiting the scope of agency costs and collusion in class actions. We have taken pains to detail each and every empirical assumption and analytic move we have made in sketching our proposal, only to render it more amenable to further discussion and critique. Refining the scheme and examining its utility is left for future research and experimentation. Private monitoring, however, must be seriously considered if effective solution to class action abuse is sincerely sought.

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<sup>129</sup> Weiss & Beckerman, *supra* note 64.