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Financing the Class: Strengthening the Class Action Through Third-Party Investment

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Financing the Class: Strengthening the Class Action Through Third-Party Investment

ABSTRACT. Class action lawsuits compensate harmed individuals and enforce public norms. Their success depends largely on the ability of a private bar of entrepreneurial, fee-seeking attorneys to finance lawsuits through contingency fee representation. But the current method of awarding fees and restrictions on nonlawyer investment in lawsuits distort the set of class actions that make it into court and potentially inflate attorney fees. This Note proposes a novel method of financing class actions and setting attorney fees. Instead of relying on judges to award fees once the suit is over, this method would sell equity in a prospective class action award or settlement to financial investors before the case begins. Realigning the economics of the class action lawsuit in this way would enhance the ability of aggregate litigation to benefit plaintiffs and society.

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INTRODUCTION

The class action lawsuit, a mechanism of civil procedure that facilitates collective action where individual action would be financially or administratively infeasible, is a critical component of the American regulatory state. It provides at least two services to society. First, the class action enhances the ability of plaintiffs with legally cognizable harms to secure the remedy due to them under the law. Second, it promotes the rule of law, complementing the government’s enforcement powers by enabling private parties to deter deep-pocketed defendants from malfeasance. But the system we have does not do as well as it could. The viability of class action lawsuits depends on an industry of fee-seeking attorneys to discover, orchestrate, and finance lawsuits. Deficiencies in how these suits are financed and attorneys are paid distort the economics of this industry, undermining its ability to deliver on its potential.

The first deficiency involves financing class action lawsuits. Class actions are often expensive to litigate. Antiquated laws and rules prohibit nonlawyers from taking financial interests in lawsuits, so funding typically comes from the plaintiffs’ lawyers themselves. Class action attorneys agree to front litigation costs through contingency fee arrangements in which they receive a portion of the funds awarded to the plaintiffs. This makes the financial viability of the lawsuit entirely dependent on the financial means and risk appetite of the plaintiffs’ lawyers. It also raises the cost of capital—the financial return on their investment that the lawyers must achieve in order for the enterprise to be profitable.

The second deficiency is the method courts use to set attorney fees. When they front the litigation costs, the lawyers take on the risk that the lawsuit will not prevail—a risk they can only properly appraise before the case commences. However, the fee, which partially compensates the lawyers for taking on this risk, is only set by the judge at the end of the case. Moreover, while the price of risk-taking and the price of providing legal services are dictated by markets, class action attorney fees—set by judges—are generally not tested by any competitive market. As a result, even independent of the restrictions on outside financing, attorney fees often do not reflect the going market rate of legal services or the price of the risk of an individual lawsuit.

This financing and fee regime undermines the class action’s effectiveness. A failure to adequately differentiate lawsuits with differing levels of risk distorts the set of commercially viable lawsuits. It potentially suffocates some meritorious suits, and it privileges less socially beneficial suits that ride the coattails of government regulatory action over more beneficial suits based on novel claims. Moreover, the current system can raise the overall level of fees awarded to class counsel at the expense of plaintiffs. Finally, it can encourage—or even force—the plaintiffs’ attorneys to settle for less than a claim is worth.
because the lawyers cannot or will not bear the responsibility of financing additional litigation, even where the risk-adjusted marginal benefit to the plaintiffs would exceed the marginal costs. As a result, plaintiffs with sound claims go without compensation and wrongdoers are not held accountable.

This Note proposes a novel financing and fee-setting mechanism for a wide range of common fund class action lawsuits that would couple third-party funding with competitive price setting. Under this proposal, the plaintiffs’ attorney auctions off an interest in his potential fee award to financiers, other attorneys, or even the plaintiffs themselves to fund all or part of the litigation. The auction would draw capital, allowing the lawsuit to proceed independently of the lawyer’s ability or appetite to finance it. The auction would also set the plaintiffs’ attorney’s fee at a level determined by a competitive bidding process, driving down the price and maximizing the plaintiffs’ share of the compensation for their injuries.

Three other mechanisms for giving attorneys and plaintiffs financial flexibility could complement this “equity auction” procedure. First, courts could allow financial investors to purchase the claims of individual plaintiffs at the price set by the initial financing auction, giving plaintiffs the opportunity to sell their claims—in other words, to cash out, rather than opt out. This would allow plaintiffs to divest themselves of the risk of an adverse judgment and to benefit from cash payment before the completion of the lawsuit. Second, the equity auction could be accompanied by settlement bonding—an arrangement whereby a third party foils a defendant’s settlement offer by indemnifying the plaintiffs and attorneys against the risks of rejecting the settlement and financing continued litigation. This could reduce the impact of the plaintiffs’ attorneys’ incentive to settle prematurely. Finally, the winning bidder in the initial auction could syndicate her financial interest in the suit, bringing a wider panel of financiers to the table to share the risk. This could enhance many of the benefits of opening lawsuit financing to wider financial markets.

Deficiencies in how class action plaintiffs’ attorneys are compensated have long been a topic of academic and political debate. While this Note is not the first attempt at a solution, it offers a fresh approach. The analysis provides an account of the economic distortions inherent in the current class action financing and fee system, drawing on well-developed critiques of agency costs.

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1. A “common fund” class action is one in which the plaintiffs are jointly awarded a sum of money. See William B. Rubenstein, Newberg on Class Actions § 15:36 (5th ed. 2011).
3. For example, John Coffee, Jr. has long criticized how class action plaintiffs’ attorneys are compensated. See John C. Coffee, Jr., Rethinking the Class Action: A Policy Primer on Reform, 62 IND. L.J. 625, 626 (1987) (noting that recent class action proposals lacked “any sustained
asymmetry in the plaintiffs' and defendants' stakes, and the futility of setting fees by judicial fiat after the lawsuit is complete. The proposal draws on recent literature about the benefits of third-party litigation financing. While the equity auction builds on and incorporates features of several attempted and proposed auction procedures, it is the first to incorporate improvements based on fee-setting procedures and external financing for a broad range of suits for damages and in a way that allows plaintiffs to retain ownership of their claims.

Part I of this Note defends the normative foundation of this project, arguing that compensating plaintiffs and enforcing the law are worthwhile goals of the class action. Part I also addresses objections that converting the role of the plaintiffs' lawyer into a commercial enterprise is inappropriate. It replies that commodification of the class action is a natural result of reliance on the private bar to finance aggregate litigation and an essential corollary of our regime of public regulation through private rights of action. Part II demonstrates that the class action has fallen short of its potential due to restrictions on outside financing and irrational procedures for setting attorney fees. Part III provides an overview of the equity auction procedure, and elaborates on its advantages over the current system and other alternatives.

focus on the incentive effects on the plaintiff's attorney that the proposed procedural changes would have). Coffee's observations arose in the midst of a broader campaign to undermine the class action. See DEBORAH R. HENSLER ET AL., CLASS ACTION DILEMMAS: PURSUING PUBLIC GOALS FOR PRIVATE GAIN 15-22 (2000) (providing a concise history of the "[h]oly [w]ar" against class actions in the press and academia during the 1960s and 1970s).

While many of these contemporary critiques challenged the inherent viability of the class action, Coffee argued that "many of the deficiencies . . . are the judicially self-inflicted consequence of legal rules that establish serious misincentives." John C. Coffee, Jr., Understanding the Plaintif's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions, 86 COLUM. L. REV. 669, 671 (1986).

4. See, e.g., In re Rhone-Poulenc Rorer, Inc., 51 F.3d 1293, 1298 (7th Cir. 1995) (pointing to the potential for, in the words of Judge Friendly, "blackmail settlements" in class actions where there is "a small probability of an immense judgment" (quoting HENRY J. FRIENDLY, FEDERAL JURISDICTION: A GENERAL VIEW 120 (1973))).

5. See, e.g., 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, 767-68 (1999) (noting that "the process which leads to an award of attorneys' fees often makes judges feel uneasy" because of the lack of arm's-length negotiation); see also Vaughn R. Walker & Ben Horwich, The Ethical Imperative of a Lodestar Cross-Check: Judicial Misgivings About "Reasonable Percentage" Fees in Common Fund Cases, 18 GEO. J. LEGAL ETHICS 1453, 1464-68 (2005) (finding support for the "judicial intuition" that percentage of fund awards "may be over-compensating the lawyer (as an award from a common fund represents a zero-sum exercise) and thus under-compensating the plaintiff class").

Finally, Part IV responds to counterarguments that allowing third-party financing would increase agency costs and further enable socially undesirable negative-value lawsuits. Rather than making these problems worse, an open market in lawsuit financing could reduce agency costs and make it more difficult for unscrupulous lawyers to use the class action to extort unjustified damages from defendants.

I. THE VIRTUES OF THE PRIVATE BAR

This Note proposes a novel way to improve the contingency fee class action, but it must begin by laying the normative antecedent that the privately prosecuted, contingency-fee class action is something worth keeping and improving. We should encourage private, fee-seeking attorneys to prosecute class action lawsuits to enforce the law on behalf of society and compensate plaintiffs for harm they have sustained. Moreover, we should reject normative counterarguments premised on squeamishness at commercializing the lawsuit. Such arguments deny the critical role that money already plays in American civil justice.

A. Plaintiffs' Lawyers Provide a Valuable Service

For the rule of law to obtain, the law must be enforced. Enforcement is not free; the resources required to prosecute a claim must come from somewhere. Who should provide this service? We often turn to the government to enforce the law for us, with resources drawn from the public fisc. But there is an alternative: we can empower private citizens to enforce the law on behalf of themselves, others, and society at large. The American system of civil law enforcement is a mixture of both public and private efforts. We often rely on private individuals to enforce the law through private rights of action, supplementing or replacing public bodies without the resources or mandate to enforce a particular claim. The private enforcer provides a critical public service: he is, in the now-famous words of Judge Jerome Frank, a "private

7. See, e.g., THOMAS HOBBES, LEVIATHAN 117 (Richard Tuck ed., Cambridge Univ. Press 1991) (1651) ("For the Lawes of Nature . . . of themselves, without the terror of some Power, to cause them to be observed, are contrary to our naturall Passions . . . . And Covenants, without the Sword, are but Words, and of no strength to secure a man at all.").

8. William B. Rubenstein, On What a "Private Attorney General" Is—and Why It Matters, 57 VAND. L. REV. 2129, 2132 (2004) ("Lawyering . . . is like sex. There are not just two pure forms—the private attorney on the one hand and the government attorney on the other—but rather an array of mixes of the public and private.").

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Attorney General,\textsuperscript{9} leveraging the collective claims of a class of plaintiffs to seek justice on their behalf and enforce the norms embodied in the law. While there are certainly alternative methods of public norm enforcement—for example, a model favored in Western Europe that relies more heavily on public bureaucracy for enforcement\textsuperscript{10}—the United States has decisively chosen to place many important enforcement responsibilities in private hands.\textsuperscript{11}

Indeed, this choice, besides its consonance with a particularly American zeal for private enterprise over public provision,\textsuperscript{12} reflects an inveterate conflict between the legislative and executive branches of government. As Stephen Burbank and Sean Farhang have observed, Congress's enablement of private enforcement through statutory private rights of action and fee shifting is "a form of insurance against the President's failure to use the bureaucracy to carry out Congress's will."\textsuperscript{13} It is no coincidence that private enforcement took off in the 1960s, "when divided party control of the legislative and executive branches became the norm and relations between Congress and the President became more antagonistic."\textsuperscript{14}

Of course, the notion that the class action is responsible for enforcing the law over and apart from any duty to compensate plaintiffs is not without its critics. One prominent such critic is Martin Redish, who argues that class action plaintiffs' attorneys are "bounty hunters" that have "transformed the essence of [the] substantive law" in a way that "undermine[s] fundamental notions of democratic theory."\textsuperscript{15} Congress, Redish argues, did not intend for private causes of action to enable lawyer-driven suits whose primary focus is to

\begin{itemize}
\item \textsuperscript{9} Associated Indus. of N.Y. State, Inc. v. Ickes, 134 F.2d 694, 704 (2d Cir. 1943). For a concise history of the private attorney general concept, see Rubenstein, \textit{supra} note 8, at 2133-37.
\item \textsuperscript{12} Cf. Paul Starr, \textit{The Meaning of Privatization}, 6 YALE L. & POL'Y REV. 6, 37 (1988) ("[T]he United States, which has never nationalized industry in the first place, stands in a position fundamentally different from the Western European countries with extensive public enterprise sectors. . . . The relations between the public sector and political leadership are drastically different in the United States from those prevailing in Latin America, the Soviet bloc, and even many Western European countries.").
\item \textsuperscript{14} Id.
\item \textsuperscript{15} Martin H. Redish, \textit{Class Actions and the Democratic Difficulty: Rethinking the Intersection of Private Litigation and Public Goals}, 2003 U. CHI. LEGAL F. 71, 108.
\end{itemize}
enforce norms (and, through the bounty, enrich lawyers) rather than to provide actual plaintiffs with a meaningful remedy.\textsuperscript{16} Redish suggests that the only acceptable class action lawsuits seeking primarily monetary (rather than injunctive) relief are those in which all members of the class have expressly chosen to participate in the lawsuit and would, if successful, receive meaningful compensation for their harm.\textsuperscript{17} Any public interest accruing to society at large should be merely "incidental" to the private plaintiffs' compensation.\textsuperscript{18}

This argument incorrectly characterizes the content of the substantive laws that create private rights of action. These substantive laws exist to proscribe actors from undertaking certain kinds of undesirable activities; the private right of action granting the individual a right to recover against the lawbreaker is incidental to the prohibition of the offending activity. When viewed this way, it is the substantive norm embodied in the law, rather than the procedural right belonging to the individual, that bears emphasis. The attachment of a private right of action to a substantive law is a ticket into court—a legislative provision of an alternative enforcement mechanism designed to ensure the fulfillment of democratically endorsed norms. The class action is one of the procedural mechanisms to which the private cause of action grants private citizens access. Far from impinging on the democratic prerogative, private class action enforcement leverages an accepted procedural paradigm to deliver on democratic mandates. As Burbank and Farhang show, this arrangement is a compromise resulting from the interaction of the political institutions of Congress and the presidency.

In sum, two goals drive the value of class action lawsuits: general enforcement, as I have argued above, and compensating individual plaintiffs. Martin Redish would emphasize this latter value to the exclusion of the former. Meanwhile, Myriam Gilles and Gary Friedman occupy the opposite extreme, arguing that "[t]he reflexive inclination to service both objectives . . . is unprincipled and often counterproductive," and that enforcement of public norms is all that matters.\textsuperscript{19} I insist that both values are important: while

\textsuperscript{16} See id. at 75-84 ("[A] procedural device that has been designed to do nothing more than facilitate the enforcement of substantive law's authorization of private damage suits transforms that private remedial model into a qualitatively different form of remedy that was never part of that substantive law." Id. at 81-82.).

\textsuperscript{17} Id. at 120-37.

\textsuperscript{18} Id. at 76.

deterrence is a legitimate aim of the class action, the fact that it supervenes on rights belonging to individual plaintiffs is not a mere formality, and should not be cavalierly dismissed.20

B. The Profit Motive Does Not Debase the Class Action

The profit motive is an essential corollary of the private right of action, and we should harness its power to promote the class action's normative ends. Some lawyers may take offense at such commoditization, viewing it as antithetical to the mission of an important social actor with an awesome, ethically significant responsibility as "a representative of clients, an officer of the legal system and a public citizen having special responsibility for the quality of justice."21 Such ethical significance is magnified in the context of the class action lawsuit, where the lawyer often takes on the mantle of the public-norm enforcer, simultaneously vindicating the rights of her client and serving society at large.22

But the sentiment that the legal profession "must be insulated from the more vulgar mores of the marketplace" limits the potential of the class action device.23 Such discomfort with profiting and risk-taking in litigation is a relic of the past that is blind to reality. We must not allow this ill-conceived reluctance to mix law with market forces to handicap an enforcement mechanism that plays such an important role in our regulatory state.

Antipathy toward taking a financial interest in lawsuits has varied bases. Historical objections took on a religious tone.24 Today, political philosopher Michael Sandel argues that the "corrosive tendency of markets" can corrupt things on which we place nonmonetary value.25 Meanwhile, others argue that

20. See Tidmarsh, supra note 2, at 237 n.39. This Note remains agnostic as to which of these values should prevail when they compete, as they inevitably will in some cases. However, these values will only compete at an efficient horizon that the class action, due to its shortcomings, does not yet reach. The aim of this Note is to propose a system that would simultaneously advance both general public and individual private ends, without prejudicing either.
24. See infra note 40 and accompanying text.
disassociating a claim from the person with whom it originated offends Aristotelian notions of corrective justice, which posit that holding a legal claim helps repair the injustice inflicted on its bearer. Other objections to claim commodification include concerns that it corrodes the attorney-client relationship, and that it undermines the public perception of the legal system because people find it offensive.

These objections are philosophically engaging, but they deny the realities of contemporary American civil justice. Access to our courts is expensive—prohibitively so for the vast majority of class action plaintiffs, who would never be compensated but for the efforts of attorneys motivated by profit. Moreover, we rely on members of a private bar to use their own private resources, taking on tremendous risk and committing immense resources to secure public ends. If we value these ends, and if commodification is necessary to achieve them, it would be irresponsible to plug our ears to pragmatic discussions on how to build an appropriate incentive structure in an attempt to stand on principle. We must either embrace and utilize market forces, or undermine the class action’s normative aspirations. In such a contest, the former must win. Whether we like it or not, we have left an important public role in the hands of a private market, which must marshal its own resources in furtherance of the public good. The private market will not provide the resources necessary to realize the good unless the investment draws rent.

The legacy of antipathy toward commodification of the lawsuit still hobbles the class action, preventing it from delivering on its potential. Specifically, restrictions preventing third parties from financing litigation have isolated class action lawsuits from the capital markets. The result is higher capital costs, fewer worthwhile suits brought to court, and a plaintiffs’ bar that focuses on lower-value lawsuits. The next Part examines how the restrictions on third-party financing and an irrational compensation mechanism hinder the ability of the class action to be an effective tool for plaintiffs and for society.

26. See Michael Abramowicz, On the Alienability of Legal Claims, 114 YALE L.J. 697, 712-17 (2005); cf. Jules L. Coleman, The Practice of Corrective Justice, 37 ARIZ. L. REV. 15, 30 (1995) ("Corrective justice is, in my view, the principle that one has a duty to repair the wrongful losses for which one is responsible.").

27. For an enlightening discussion of (and response to) all of these complaints, see Abramowicz, supra note 26; and Anthony J. Sebok, The Inauthentic Claim, 64 VAND. L. REV. 61, 135 (2011).

28. Removing the profit motive does not remove the need to assess the (financial) costs and (financial) benefits of bringing a particular regulatory action. In a world of constrained resources, even government enforcers will have to undertake some form of calculus. See infra note 56 and accompanying text.
II. THE DEFECTIVE ECONOMICS OF THE CLASS ACTION LAWSUIT

The economics of the class action are defective for two reasons. First, plaintiffs' lawyers are generally prohibited from seeking financing from outside sources. Second, attorney fees in contingency fee cases are set by the judge after the services have been provided, on the recommendation of those to be compensated, without the benefit of any competitive bidding or arm's-length negotiation.\(^29\) As a result of these two characteristics, the set of lawsuits that are financially attractive to the plaintiffs' bar is both under- and over-inclusive, and fees are potentially higher than they need to be. This Part describes the current regime for setting fees and restrictions on third-party funding and explains how these features undermine the class action's ability to enforce the law and make plaintiffs whole.

A. Background: Fees and Financing

1. Ex Post Fee Awards

In successful class actions for money damages, courts typically award fees under the common fund doctrine, which allows counsel to collect compensation out of the damages due to the plaintiff.\(^30\) The most popular way to calculate fees under the common fund doctrine—and the method this Note focuses on—is the percentage-of-fund method, through which the lawyers are paid a percentage of the overall recovery fund due the plaintiff class.\(^31\) Under

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29. Federal Rule of Civil Procedure 23(h) allows courts to award attorney fees on the basis of a motion. Fed. R. Civ. P. 23(h)(1). A court awarding fees is required to state its factual and legal conclusions supporting the fee award. Fed. R. Civ. P. 23(h)(3). Although Rule 23 does not explicitly require the ex post calculation of fees through the percentage of fund method, such a practice has become standard in contingency fee cases. See MANUAL FOR COMPLEX LITIGATION (FOURTH) § 14.121 (2004).

30. MANUAL FOR COMPLEX LITIGATION (FOURTH), supra note 29, § 14.11. Courts may also award fees under a fee-shifting statute, depending on the cause of action. See, e.g., 15 U.S.C. § 15(a) (2012) (allowing a prevailing plaintiff in an antitrust suit to recover "the cost of [the] suit, including a reasonable attorney's fee"); 42 U.S.C. § 1988(b) (2012) (providing that "the court, in its discretion, may allow the prevailing party . . . a reasonable attorney's fee" in certain civil rights suits). There are over 150 such statutes. MANUAL FOR COMPLEX LITIGATION (FOURTH), supra note 29, § 14.11.

31. Empirical studies have suggested that the percentage-of-fund method is the most popular mechanism for awarding fees under the common fund doctrine. See, e.g., Brian T. Fitzpatrick, An Empirical Study of Class Action Settlements and Their Fee Awards, 7 J. EMPIRICAL LEGAL STUD. 811, 832 (2010) (noting that, of federal class action settlements between 2006 and 2007, sixty-nine percent employed the percentage-of-fund method, twelve percent employed the lodestar method, and the remainder did not state the method.
this method, upon motion of class counsel after the completion of the lawsuit, the court sets the fee based on "benchmarks" established by surveys of past attorney fee awards in previous class actions. Alternatively, the court may award fees under the "lodestar" method, which multiplies the number of attorney hours spent on the case by those attorneys' hourly fees. Even where the percentage-of-fund method is used, courts use the lodestar as a "cross-check" to ensure the fees are not excessive. Provided the absent class members do not object, the inquiry ends there.

2. Financing Restrictions

Third-party investment in class action lawsuits is prohibited. Plaintiff classes must therefore depend entirely on class counsel to cover litigation

used or used another method altogether to arrive at the attorney fees. For cases where attorney fees are awarded under the common fund doctrine, most circuits give district courts the discretion to use either a lodestar or a percentage-of-fund method in calculating fees. See Goldberger v. Integrated Res., Inc., 209 F.3d 43, 49 (2d Cir. 2000); see also MANUAL FOR COMPLEX LITIGATION (FOURTH), supra note 29, § 14.121 ("[T]he vast majority of courts of appeals now permit or direct district courts to use the percentage-fee method in common-fund cases." (citations omitted)). Where a statute authorizes fee shifting, the lodestar method is usually required. See Perdue v. Kenny A. ex rel. Winn, 559 U.S. 542, 550-53 (2010); MANUAL FOR COMPLEX LITIGATION (FOURTH), supra note 29, § 14.63.

32. See FED. R. CIV. P. 23(h)(1).
33. These so-called benchmarks sometimes take the crude form of a round figure around twenty-five percent of the overall fund. See, e.g., Torrisi v. Tucson Elec. Power Co., 8 F.3d 1370, 1376 (9th Cir. 1993) (establishing a general common fund benchmark of twenty-five percent). Other courts take a more nuanced approach, setting benchmarks based on the size of the fund. See, e.g., In re Prudential Ins. Co. of Am. Sales Practice Litig. Agent Actions, 148 F.3d 283, 339 (3d Cir. 1998).
34. See MANUAL FOR COMPLEX LITIGATION (FOURTH), supra note 29, § 14.122. Sometimes, the lodestar award will be augmented with a multiplier to compensate attorneys for the zeal and skill of their representation, the complexity of the litigation, and other specific factors. Id. ("The lodestar figure may be adjusted, either upward or downward, to account for . . . inter alia, the quality of the representation, the benefit obtained for the class, the complexity and novelty of the issues presented, the risk of nonpayment, and any delay in payment." (citations omitted)). But see Perdue, 559 U.S. at 553-55 (holding that such enhancements are only appropriate in "rare circumstances").
35. MANUAL FOR COMPLEX LITIGATION (FOURTH), supra note 29, § 14.121 ("A number of courts favor the lodestar as a backup or cross-check on the percentage method when fees might be excessive.").
36. The absence of objectors is commonly cited as a factor in support of accepting a fee request. See, e.g., Gunter v. Ridgewood Energy Corp., 223 F.3d 190, 195 n.1 (3d Cir. 2000) (noting that "the presence or absence of substantial objections by members of the class to the settlement terms and/or fees requested by counsel" is a factor to be considered by district courts in setting fee awards).
expenses. In exchange for this commitment, the lawyers receive a fee at the end of the case. While attorneys hoping to represent the class are allowed to solicit funds from—and thus spread the risk among—other lawyers and law firms, nonlawyers cannot contribute. Although these restrictions are not limited to class actions, they have a particularly significant effect on lawsuits that, like class actions, require large-scale strategic investment.

Restrictions on third-party financing derive from ancient prohibitions on "maintenance" and "champerty," which still haunt the common law of many states. Maintenance, defined as "maintaining, supporting or promoting the litigation of another," and champerty, which involves "a bargain to divide the proceeds of litigation between the owner of the litigated claim and the party supporting or enforcing the litigation," have existed since at least medieval times. In addition to impeding the formation of contracts, some state laws on maintenance and champerty even provide defendants in funded litigation with a cause of action in tort. While the law of champerty and maintenance has been in a state of flux for more than a century, these prohibitions nevertheless

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37. Given the complexity, riskiness, and expense of major class action litigation, a plaintiffs' firm will often not take on the role of class counsel alone. Instead, upon the filing of an action (or, as is often the case, multiple duplicative actions) various firms will agglomerate through a private ordering process into a "pyramid-shaped" coalition to prosecute the lawsuit. Gilles & Friedman, supra note 19, at 148. Allowing counsel to arrange themselves before applying to be class counsel is "[b]y far the most common" approach. MANUAL FOR COMPLEX LITIGATION (FOURTH), supra note 29, § 21.272. At the top of the pyramid will sit one or a handful of firms serving as lead counsel, in charge of providing direction and cohesion and liaising with the court and counsel for other parties. Other roles, such as a place on a steering committee or lead responsibility for some aspect of discovery, will also be handed out. Some attorneys may even join the coalition purely as financial investors. See Hensler, supra note 6, at 504.


39. Id.

40. Some may even argue that it goes back to the Roman Empire. See Max Radin, Maintenance by Champerty, 24 CALIF. L. REV. 48, 48 (1935) (providing a historical account of the development of the concepts of maintenance and champerty from "the legal development of the ancient Greek communities," through "earlier stages of Roman law," and, finally, "the medieval law of Western Europe, especially in England"). These prohibitions may have had some basis in a pragmatic rationale to discourage abusive litigation. See, for example, the economics-based arguments presented in Abramowicz, supra note 26, at 727-55. Disapproval of such practices, however, also had a moral element arising from a general disapproval of litigation. Litigation, on this view, bordered on usury and displayed an un-Christian tendency toward "vexatiousness." Radin, supra, at 58.

remain widely in force. These antiquated common law doctrines are reinforced by state-bar ethical rules, which prohibit lawyers from sharing fees with nonlawyers in each of the fifty states in accordance with the ABA's Model Rules of Professional Conduct.

Notwithstanding these prohibitions—and the resistance that has kept them firmly in place—opening lawsuits to outside financing has myriad benefits. Perhaps the greatest of these is the most obvious: access to wider financial markets lowers the cost of capital. Financial investors agree to take on a given amount of risk for a given return on their capital. The ability to participate in financial markets therefore allows those seeking to secure capital for a lawsuit to sell the risk associated with the lawsuit's failure to the party willing to buy it for the lowest return. A lower cost of capital means that less of the contingency fee goes to financing costs.

A second important advantage of open lawsuit financing is its ability to allow lawyers and plaintiffs with risks tied to the success of the litigation to offload some of that risk by selling investors a stake in the contingency fee. The ability to divest risk is a key tool for any business or individual making an investment or undertaking financial planning; lawsuit risk can significantly constrain the decision making of a plaintiff or contingency fee lawyer in

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42. For example, as far back as 1928, the Supreme Court of Arizona declared that champerty had been "practically discarded both in England, the country of its origin, and in the United States." Strahan v. Haynes, 262 P. 995, 997 (Ariz. 1928). Nearly extinct as it may have been ninety-four years ago, it continues to be illegal in many states. See Ari Dobner, Comment, Litigation for Sale, 144 U. PA. L. REV. 1529, 1545 (1996).

43. MODEL RULES OF PROF'L CONDUCT r. 5.4 (AM. BAR ASS'N 2013). The Model Rules of Professional Conduct provide for limited exceptions that allow for attorney estate planning, compensating firm employees, and sharing fees with non-profit firms that assist in litigation. Id. Only the bar of the District of Columbia offers a meaningful exception: it allows those offering certain other types of professional services to hold equity in law firms. DIST. OF COLUMBIA RULES OF PROF'L CONDUCT r. 5.4(b) (D.C. BAR ASS'N 2015); Molot, supra note 6, at 98. The bar of Washington also allows lawyers to share fees with a novel class of professionals called Limited License Legal Technicians. WASHINGTON STATE RULES OF PROF'L CONDUCT r. 5.9 (WASH. STATE BAR ASS'N 2015).

44. It is generally accepted that market segmentation raises the cost of capital. See, e.g., SHANNON P. PRATT & ROGER J. GRABOWSKI, COST OF CAPITAL: APPLICATIONS AND EXAMPLES 57 (4th ed. 2010); see also infra note 55 and accompanying text.

45. This may not result in a net decrease in absolute litigation costs. Indeed, by lowering the marginal cost of maintaining litigation, it could lead to an absolute increase in net litigation costs. See Steven Garber, Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns, RAND CORP. 34-36 (2010), http://www.rand.org/content/dam/rand/pubs/occasional_papers/2010/RAND_OP306.pdf [http://perma.cc/4L5S-35QT]. However, litigation costs as a share of total recoveries would remain less than or equal to current levels, as it would remain irrational to incur the marginal cost without the promise of the same or greater marginal benefit.
deciding whether to bring or maintain a lawsuit. An asymmetry of ability to bear (or hedge) risk between the defendant and the plaintiff in a lawsuit can lead to a settlement that does not accurately reflect the merits of the case.46 This could play out adversely to the interests of a plaintiff class: large corporations that are frequently subject to litigation are often more able to bear the risk of loss than plaintiffs or their lawyers.47

Despite general restrictions on lawsuit financing that prohibit direct third-party investment in lawsuits, a nascent litigation financing industry has developed in the United States. Much of this industry serves businesses, which can circumnavigate the prohibitions by structuring the financing as investments in special corporate entities.48 Other segments of the industry provide indirect support to lawsuits in the form of nonrecourse loans to individual plaintiffs in tort suits and law firms conducting litigation. Investors in such financing schemes include wealthy individuals, hedge funds, institutional investors, and even law firms. These investors seek returns that are not correlated with macroeconomic conditions, allowing them to disaggregate the risk of their investment strategies.49 They offer their capital either directly, or through a company specializing in such investments.50 Meanwhile, litigation financing has a more significant presence in some non-U.S. common law jurisdictions, including Canada, the United Kingdom, and Australia. In Canada and Australia, third-party finance even plays a role in aggregate litigation.51

46. As Jonathan Molot points out, a plaintiff (or contingency fee attorney) with a strong case could be pushed to settle if there is even a small outlier chance of an adverse judgment for which he has a low tolerance. In such a case, the party in the worse risk position would settle toward the median judgment, rather than the mean, even if the median is significantly lower than the mean. See Molot, supra note 6, at 83-90.

47. Corporations with large litigation portfolios are able to manage lawsuit risk more effectively than individuals or entities with less lawsuit exposure. The larger the portfolio of lawsuits, the more likely it is that its actual value will converge to the portfolio’s expected value.

48. See Molot, supra note 6, at 97.

49. Id. at 96.

50. Id. at 95-96.

51. See generally Jasminka Kalajdzic et al., Justice for Profit: A Comparative Analysis of Australian, Canadian and U.S. Third Party Litigation Funding, 61 AM. J. COMP. L. 93 (2013). In Australia, class action lawsuits are frequently funded with the help of outside investors. Id. at 96-113. Under Australian class action law, plaintiffs must cover defense expenses if the lawsuit fails. Id. at 97-98. Investors are therefore needed to cover this potential liability.
B. Valid Claims Suffocate Due to Lack of Financing

Economic incentives regulating the plaintiffs' bar smother some potentially meritorious claims in their infancy because lawyers are unable or unwilling to front the costs required to pursue them in court. Other claims suffocate during the course of litigation, with attorneys accepting low-ball settlement offers because they are unable or unwilling to finance continued litigation. As a result, plaintiffs do not receive full compensation for their injuries, while rule violators are let off the hook entirely, or get off easier than the law prescribes. These outcomes are the result of financing restrictions that both increase the cost of capital and make it more difficult for attorneys to offload risks associated with a lawsuit. Taken together, these defects skew the fundamental risk-reward calculus that any rational profit-seeking plaintiffs' attorney, like any rational business owner, will undertake to determine the attractiveness of an investment.

The risk-reward calculus is reducible to a basic economic model, taking into consideration the potential fee payout, discounted for risk and the cost of capital, and the estimated costs associated with litigating, including attorney time and outlays for experts and administrative expenses such as notice. Specifically, the lawyer evaluates the basic economics and logistics of the lawsuit, including its potential payout (based on the number of plaintiffs and the estimated value of their claims), and the cost of litigation (based on a litigation plan, including a rough timeline; the number of attorney and staff hours required; and the cost of experts). The lawyer also estimates the likelihood of success. This estimate may be based on the strength of the case, how other suits with similar claims have fared, and even an assessment of the likely venue and the temperament of its judges. On the basis of this information, the lawyer decides either that the case is a worthwhile investment or that his resources would more profitably be spent elsewhere. This process can take place with more or less formality and rigor depending on the size of the investment and the disposition of the lawyers involved. It may be especially abbreviated if the promised payout is large and the risks are low. In any

52. See infra note 55 and accompanying text.
53. See, e.g., William J. Lynk, The Courts and the Market: An Economic Analysis of Contingent Fees in Class-Action Litigation, 19 J. LEGAL STUD. 247, 250 (1990) (seeking to "develop an economic model of the competitive determination of private contingent fee percentages and show how those percentages are governed by the inherent difficulty of winning the case, the dollar amount at stake, and the cost of legal services").
54. This is often the case with lawsuits "piggybacking" on government regulatory actions, where the likelihood of a large payout is very high. See, e.g., John H. Beisner et al., Class...
event, the decisional calculus will take the same basic shape. Consider the following inequality:

\[ EV \left[ \frac{c \cdot R + E}{(1 + i)^T} \right] \geq \sum_{t=0}^{T} \frac{H_t \cdot f_t + k_t}{(1 + i)^t} \]

where

\( EV \) is an expected value function based on the probability density of potential outcomes;
\( c = \) share of the recovery the attorneys will collect as a fee;
\( R = \) total potential plaintiff recovery;
\( E = \) total reimbursement for nonattorney expenses;
\( i = \) lawyer's cost of capital;\(^5\)
\( T = \) total number of time periods between the initial investment and the recovery;
\( H_t = \) total number of attorney hours not spent on other cases in time period \( t \);
\( f_t = \) attorneys' market rate hourly fee; and
\( k_t = \) total out-of-pocket outlay for nonattorney expenses in time period \( t \).

The left side of this inequality expresses the expected present value of an award of fees and costs. The right side expresses the present value of the fees the lawyer would earn working at the hourly rate \((H_t \cdot f_t)\), plus all additional expenses required over the course of the litigation \((k_t)\). Conceptually, we can see why this inequality must hold in the long run. While the law firm may miscalculate in the odd case, the firm that consistently fails to achieve this inequality will ultimately lose all of its lawyers, who will leave the firm to earn the market rate for their services. If we understand the left side of the inequality as actual revenues and cash reimbursements, and the right side as

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\(^5\) Theoretically, in a truly open market for financing lawsuits and law firms, this cost of capital should approach the return on risk-free securities. Most of the risk associated with the law firm is not correlated with macroeconomic trends. See supra note 49 and accompanying text. Rather, the risks are specific to the circumstances of individual law firms and the legal industry in general. If restrictions on third-party finance were relaxed, such specific risk could be eliminated through diversification: investors would be able to hold the equity of many law firms in a well-rounded portfolio in which the specific risks cancel each other out. Where the risk is diversifiable, it should not impact the cost of capital. See Richard A. Brealey et al., Principles of Corporate Finance 156-78, 224 (10th ed. 2011) (providing a background description of financial risk and its relationship to the cost of capital).
achievable revenue and cash, we see that the inequality fails only when a firm is underperforming its manifest potential.

While the inequality captures the basic idea of the viability of the lawsuit as a business investment, there are two additional important constraints on the lawyer's decision as to whether to take the case. The first constraint is risk appetite: how prepared is the lawyer for an eventuality in which he recovers little or nothing at the end of the lawsuit? If his firm's financial exposure to the lawsuit is significant enough, he and his partners may be uncomfortable with even a small likelihood of failure, as that failure could put the firm out of business. The second constraint is cash flow: between the time the suit is initiated and the fee is awarded, will the firm have difficulty meeting payroll obligations and paying experts? The firm's level of financial exposure to the potential lawsuit will again be relevant in this determination, as will the time horizon of the litigation and the likelihood that it will go on longer than anticipated.56

To see how the increased cost of capital distorts this calculus, note that the lefthand side of Figure 1 varies inversely with the cost of capital (i): the higher the cost of capital, the lower the expected present value of the potential payout.57 This means that a higher cost of capital requires a higher expected fee award for a case to be an attractive investment. By raising the cost of capital, funding restrictions create a vicious cycle, simultaneously inflating class action fees and preventing lawyers from taking potentially meritorious cases that would have been viable if the cost of capital were lower. Because of the increased capital costs, lawyers will only take higher-fee cases. Over time, this tendency inflates the fees in the pool of past cases judges refer to in determining fees in the cases before them (recall that judges set fees based on "benchmarks" established by surveys of past fee awards in previous class actions). Ultimately, the higher level of fees impacts the market price of the

56. This type of decision making is not limited to firms that seek to maximize profits. Even a public interest firm will have to engage in some form of cost-benefit analysis. Unless a firm has unlimited resources, it will have to weigh the opportunity costs of bringing a particular claim against the potential benefits. The financial viability of claims, risk appetite, and cash flow constraints loom especially large when attorney fees are the firm's only source of income. Nonmonetary concerns may factor into one side of the inequality or the other, but the decision will always have a financial core: will the lawsuit be an outsized burden on the organization's resources, preventing it from undertaking other socially useful projects? (If we wanted to be truly rigorous about it, we could add coefficients $U_L$ and $U_R$ to each side of the inequality, where $U_L / U_R$ expresses the comparative social utility of the action under consideration with that of the organization's next-best alternative.)

57. The higher cost of capital will affect the right side of the inequality as well; however, the increase in $i$ will have a relatively higher impact on the left side, as cash flows on the left are concentrated in the terminal time period $T$. 

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lawyer's services. This drives up the lodestar itself \( (H \ast f) \), inflating the right hand side of the inequality, thereby further raising the threshold for bringing a case. The result of this cycle is that fewer claims meet the threshold required to make them attractive investments for contingency fee lawyers. This effect is exacerbated by the inability of the attorney to offload the risk of a lawsuit; even where the lawsuit has an acceptable present expected value, its particular risk profile may be unattractive to the lawyers.

Such distortions may also encourage premature settlement. When capital costs are higher, the marginal costs associated with prolonging litigation are higher. The attorney's cash flow constraints and risk aversion can amplify the settlement incentive. Without access to outside funding, class counsel will pursue the class's claims only as long as the attorneys are able to maintain working capital and manage their financial exposure. If, during the course of litigation, class counsel's working capital is depleted, or the partners determine they can no longer sustain their exposure to the risk, they will have an incentive to settle early. While loans from banks or investment funds may be available, such financing is expensive and would be an unattractive and risky alternative to a settlement offer.

The cost of capital and risk considerations are not the only causes of early settlement. Even absent any consideration of the source of their financing, class action attorneys will have an incentive to settle at the point where the marginal cost of litigating is equal to the expected marginal fee that will be generated

58. The Federal Rules of Civil Procedure do contain safeguards intended to protect the integrity of class action settlements; however, these safeguards are not an effective bar to early settlement. In theory, settlements in class action suits in federal court are subject to review under Rule 23(e), which requires the court to find that the settlement "is fair, reasonable, and adequate" before approving it. FED. R. CIV. P. 23(e)(2). As with a Rule 23(h) fairness review of attorney fees, a class member, having received notice of the settlement, may object to its terms. FED. R. CIV. P. 23(e)(5). But, as with review under Rule 23(h), we cannot expect judges to adequately evaluate the economics of a settlement offer through Rule 23(e) review. See Tidmarsh, supra note 2, at 235-38 ("[C]ourts' lack of knowledge about the strength of the claims, as well as many courts' desire to move big cases off their dockets, renders the 'fair, reasonable, and adequate' check on settlements an imperfect mechanism to avoid agency costs."). Indeed, while courts may be on the lookout for egregious unfairness such as collusion between the defense and plaintiffs' counsel, they afford significant deference to settlement offers. See, e.g., In re Prudential Ins. Co. of Am. Sales Practices Litig., 962 F. Supp. 450, 534-35 (D.N.J. 1997) ("[T]he Court should be careful not to substitute its image of an ideal settlement for the compromising parties' views . . . . [T]he issue is whether the settlement is adequate and reasonable, not whether one could conceive of a better settlement.").

59. See Molot, supra note 6, at 99-100.
from the effort.\(^6^0\) This results from the fact that the contingency fee theoretically reflects more than just the hourly cost of their labor. Even where plaintiffs may get a significantly bigger award, class counsel—who have all the information and call the shots—will settle at the point that maximizes their expected value.

This problem may be especially pressing in cases where the plaintiffs are also seeking some form of nonmonetary relief in which the contingency fee attorney generally has no fee interest.\(^6^1\) In such cases, class counsel have the incentive "to settle . . . on the eve of trial, knowing that in so doing they obtain most of the benefits they can expect from the litigation while eliminating their downside risk."\(^6^2\) While restrictions on outside financing do not cause this problem, they do preclude arrangements that could alleviate the problem, such as allowing investors to buy out the settlement and continue litigating.\(^6^3\)

C. Incentives Favor Claims with Less Social Utility

Because fees are set through a noncompetitive process at the end of the lawsuit, and because only lawyers are allowed to provide financing, the fee awarded to class action attorneys does not accurately account for risk. As a result, there is little price differentiation between lower-risk suits, such as those piggybacking on regulatory action, and higher-risk suits involving more complex or novel claims. Given a choice between a lower-risk suit and a higher-risk suit that otherwise yields a similar return on investment, rational attorneys will focus on the lower-risk suit. These lower-risk suits, which are often duplicative of government regulatory action, have less deterrence value than higher-risk alternatives that pursue novel or complex claims.

While it is possible to accurately value an attorney's legal services after those services have been rendered—after all, a competitive and transparent

\(^6^0\) See, e.g., Gilles & Friedman, supra note 19, at 140-42. Though Gilles and Friedman present the problem as it exists with respect to the lodestar method, a percentage-of-fund calculation can also encourage the settlement problem.

\(^6^1\) While it is generally the case that injunctive relief does not contribute toward the common fund, which serves as the denominator of percentage-of-fee calculations, some courts have entertained the idea of adding the value of injunctive relief to the common fund where the value of the injunctive relief is measurable. See, e.g., Staton v. Boeing Co., 327 F.3d 938, 973-74 (9th Cir. 2003).


\(^6^3\) See infra Section III.A.2.
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market for legal services priced in hours already exists—it is not plausible to set a correct price for financing a lawsuit in isolation after the lawsuit is over. The price of financing should track information about the risks and rewards of a particular lawsuit before that lawsuit commences. While this information will never be perfect—the variables involved in making the risk-reward assessment are many and subjective—a fair market price is the result of many different potential investors independently making their own ex-ante assessments based on the information they are able to obtain through due diligence.

Without any reason to believe that they will receive a higher premium on their effort for a riskier lawsuit, rational lawyers will choose to pursue less risky suits. But these less risky suits often correspond to diminished enforcement benefits relative to suits that involve more risk. Ideally, class action plaintiffs’ lawyers should supplement government regulators by marshaling private resources to discover and develop viable class action claims on their own initiative. But many class action suits ride the coattails of government regulatory action in a practice known as “piggybacking.” Because these suits are easier to discover and the government has done most of the work developing the claims and determining their viability, piggybacking suits are low risk for lawyers but offer only modest marginal enforcement benefits for the public.

In contrast, higher-risk suits can do more to serve the class action’s unique and valuable role in enforcing public norms. Consider In re NASDAQ Market-Makers Antitrust Litigation, an antitrust case that settled for more than one billion dollars. Private attorneys brought the case against NASDAQ market

64. This is not an endorsement of the billable-hour model of attorney compensation, which is not without its own problems. See infra text accompanying note 76.

65. This deficiency has been well rehearsed, and has inspired a push to reform through innovations like the lead counsel auction. See Niebler, supra note 5, at 766; see also In re Oracle Sec. Litig., 131 F.R.D. 688, 692 (N.D. Cal. 1990) (“Hindsight will invariably alter the perceived fairness of class counsel’s compensation arrangements . . . . Moreover, it is inherently illogical for lawyers to undertake litigation on the basis of the risks and rewards they perceive at the beginning, yet be compensated on the basis of the risks and rewards the court perceives at the end of the litigation.”).

66. Innovation and creativity in finding claims has led to novel areas of class action practice, such as consumer privacy lawsuits against technology companies. See Conor Dougherty, Jay Edelson, the Class-Action Lawyer Who May Be Tech’s Least Friended Man, N.Y. TIMES (April 4, 2015), http://www.nytimes.com/2015/04/05/technology/unpopular-in-silicon-valley.html [http://perma.cc/8GRX-sF2N].

67. See Beisner et al., supra note 54, at 1453.

makers after an academic article pointed out peculiarities in NASDAQ quotations that suggested the spreads on listed securities were being rounded up. The private attorneys aggressively investigated the claims for nearly a year before filing a case, in the face of dogged resistance from the securities industry, by retaining expert economists and even conferring with nondefendant market makers to try to influence the spreads on certain securities to test the plaintiffs' hypothesis. The effort was risky, but it paid off. The suit yielded the largest antitrust recovery in history, and resulted in significant reductions in trading costs. As the judge noted in approving the settlement, the case was the antithesis of a piggybacking suit, as the filing of the claim by intrepid private attorneys ultimately spurred the government into action.

Blockbuster cases like In re NASDAQ may provide some incentive for intrepid lawyers to seek out meaningful cases, but they are not the norm. Difficult lawsuits that require creativity and persistence will always be at a disadvantage where there is no reliable way to ensure that the fee accurately reflects the lawsuit's risk. Plaintiffs' lawyers should be rewarded for bringing novel cases rather than finding the quickest route to the courthouse.

D. Fees Are Inflated Due to Lack of Competition

The attorneys' share of the class action award or settlement can sometimes be excessive, benefitting class action attorneys at the expense of the plaintiffs. There are at least four reasons for this phenomenon. The first is the vicious cycle generated by the increased cost of capital that results from financing restrictions. Second, restrictions on outside financing create barriers to competition from potentially skilled practitioners who may not have the capital or risk appetite to offer a contingency fee service. Third, the way in which judges award fees typically prevents the possibility of price competition

69. Kaplan, supra note 68, at 114-16.
70. Id.
71. Id. at 111.
74. Allowing litigants to secure the services of attorneys not willing to work on a contingency fee is a selling point of litigation financiers. See, e.g., The New Economics of Litigation, BURFORD CAP. 7 (2015), http://www.burfordcapital.com/wp-content/uploads/2015/01/3_Burford_Business_US.pdf [http://perma.cc/Z7KR-YB5T]; cf. Hensler, supra note 6, at 508 (“Commercial litigation financing might be attractive to new entrants to the market or as a means of allowing an established firm to penetrate or develop a new segment of the class action market while limiting its risk.”).
between attorneys. Finally, attorneys can manipulate judicial fee determinations through churning—undertaking non-value-adding activities for the purpose of padding the number of hours spent on the case. Such churning impacts the lodestar, which serves as a benchmark even where the fee is calculated as a percentage of the common fund.

The rudimentary checks and corrections judges perform under Federal Rule of Civil Procedure 23(h), which requires them to review fee awards for fairness, do not eliminate the problem of inflated fees. The standard techniques for reviewing fairness, most notably comparing a percentage-of-fund fee with benchmarks based on previous class actions, often perpetuate the faulty fee setting of previous lawsuits, and do nothing to calibrate the fee to the particular circumstances of the suit at bar. The lodestar “cross-check” attempts to take into account the particular circumstances of the lawsuit, but it can only calibrate for the legal services of class counsel and not for the financing. Finally, the judge’s reliance on the fact that no objectors have come forward can hardly inspire confidence in the outcome when absent class members will often lack the sophistication or the inclination to scrutinize the fees, and any benefit of objecting, spread across the class as a whole, will not justify the individual’s effort.

III. THE SOLUTION: AUCTIONING EQUITY IN THE CLASS ACTION TO FINANCIAL INVESTORS

Auctioning shares of the potential recovery in a class action lawsuit, and using the proceeds to cover litigation expenses, could improve the class action’s ability to secure compensation for plaintiffs and enforce the law. This method of financing lawsuits and awarding fees to attorneys combines the competitive market advantages of a fee-setting auction with those of third-party financing.

75. See, e.g., Niebler, supra note 5, at 768 (“Attorneys’ fees set by judicial fiat are generally poor substitutes for arm’s-length, negotiated fee arrangements agreed to in the open market by a willing buyer and a willing seller.”).


77. See supra note 29 and accompanying text.

78. FED. R. CIV. P. 23(h); see also supra note 29 and accompanying text.

Lawyers seeking appointment as class counsel could conduct an auction, offering financial investors (both lawyers and nonlawyers) equity in the potential recovery in exchange for the capital required to prosecute the case. This process would set an attorney fee based on prevailing market capital costs and ex-ante assessments of the lawsuit's riskiness, and would liberate class action litigation from the financial circumstances of class counsel.

This proposal would depend on opening the financing of class action lawsuits to third-party, nonlawyer investors with no underlying interest in the claim, a practice that is largely prohibited by common law doctrine and state-bar ethical rules. Supposing that legal restrictions on alternative financing could be lifted, adopting the equity auction would require no changes to Rule 23 or its application.

A. The Equity Auction Proposal

Imagine a class action universe in which lawyers are allowed—indeed, encouraged—to seek outside financing, and there exists a well-developed market of sophisticated investors willing to put capital into such lawsuits. Once a plaintiffs' lawyer has decided to file an action, he raises capital by auctioning equity stakes in the final judgment. Financial investors bid on the responsibility to provide a fixed share of the litigation expenses. Their bids are denominated as a percentage of the potential final judgment due to the plaintiffs. The lowest bid specifies the percentage of the judgment damages that will constitute the percentage-of-fund fee awarded if the lawsuit succeeds.

The equity sale process, of which the auction is a part, is analogous to procedures followed in auction-based mergers and acquisitions. Following is a step-by-step outline of how the sale process might unfold, as well as potential ways of enhancing or supplementing the equity sale by (1) allowing plaintiffs to sell their shares in the award, (2) allowing investors to buy out a settlement proposal, and (3) syndicating investors' equity stakes to increase liquidity. Finally, this subpart untangles some of the technical challenges that might arise when lawyers' and financiers' presale estimates of litigation expenses, time horizon, and fee award are inaccurate.

80. See supra Section II.A.2.

1. The Equity Sale Procedure

a. Step One: Preoffer Preparation

Before initiating a bidding process, the lawyers decide how much of the liability for litigation expenses they wish to transfer to investors. They could transfer all of it, accepting an obligation from investors to cover cash expenses and compensate the attorneys on an hourly basis for the time required to find and develop the claim and the time they estimate will be required to pursue the lawsuit to the end. This would allow them to divest all of the risk that the lawsuit will not succeed; they would get paid as any other lawyer working by the hour. Another option would be to transfer liability for some of their expenses, allowing the attorneys to offload some of the risk and recoup some of their initial investment in the case while retaining some interest in the final award.

After determining how much capital to raise, the lawyers then draw up an in-depth offering memorandum containing all the basic economic and logistical information any third-party financier would want to consider before deciding whether to invest. This memorandum would include a theory of the case, estimates of the size and shape of the plaintiff class, an estimate of the potential award, an outline of litigation expenses, and an explanation of the financier's expected economic involvement in the case (such as a schedule for cash disbursements and an outline of any other expected financial obligations). In presenting estimates of award sizes and litigation expenses, the memorandum would provide figures under a range of possible scenarios, and would rely on benchmarks from previous cases.

b. Step Two: Solicitation of Bids and Due Diligence

The lawyers send notification of their intention to auction equity in the case to a group of potential investors, to whom they provide a summary prospectus outlining the highlights of their offer memorandum. Interested recipients sign a confidentiality agreement and receive the offer memorandum.

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82. We can think of the entrepreneurial function of claim discovery, discussed supra Part II, and the formation of a prospective class counsel coalition, discussed supra note 37 and accompanying text, as step zero.

83. Compensating attorneys for the time and initiative they have already invested in the claim is important, as it preserves the incentive to pursue and develop novel claims.

84. Judges and financiers may also look upon partial, as opposed to full, divestment favorably, as fees at risk give class counsel a performance incentive.
The bidders then begin their due diligence, consulting with their own lawyers and experts and devising their bidding strategy. During their diligence, they make their own estimates of the amount of time it will take to realize a recovery, the level of risk associated with the lawsuit, and the yield they demand for that level of risk. These estimates may be guided by the bidders' views on the strength of the claim, their assessments of the lawyers' theories and strategies, their evaluations of the lawyers' skill and track record, and their reading of the court's tendencies.

c. Step Three: The Auction

The auction commences. The bidders deliver sealed bids, denominated as a percentage of the final judgment that they are willing to take in exchange for the financing obligations outlined in the offer memo. The bid with the lowest percentage wins. With funding secured, the lawyers are now prepared to apply to the court for appointment as interim class counsel. As part of their application, they can present the court with the details of their financing arrangement and documentation of the robustness of the auction procedure. Critically, the attorneys are able to present the court with the percentage of the potential plaintiff fund that will go toward compensating the investors and attorneys—the auction has effectively set the contingency fee percentage.

To calculate the percentage of the fund that will go toward fees, the lawyers will scale the equity share purchased by the investors according to the proportion of the total financing commitment the investors have made. For example, if the investors agreed to take half of the financial responsibility in exchange for a bid of ten percent of the final fee award, the overall fee level would amount to twenty percent of the final fee award. The financiers, covering half of the expenses, take ten percent of the final award; the lawyers, who have retained responsibility for the other half of the expenses, also take ten percent. The plaintiffs receive the remainder.

This equity auction procedure may be more feasible in cases involving primarily money damages rather than injunctive relief, as the percentage-of-fund method of calculating fees is generally not available where there is no monetary common fund out of which fees can be awarded. This proposal would therefore be inappropriate in a case such as a civil rights suit seeking

85. Fees in such cases, which may be awardable under an applicable fee-shifting statute, must be calculated by the lodestar method. See Perdue v. Kenny A. ex rel. Winn, 559 U.S. 542, 550-51 (2010) (describing the virtues of the lodestar method and finding it appropriate for cases seeking injunctive and declaratory relief); MANUAL FOR COMPLEX LITIGATION (FOURTH), supra note 29, § 14.11. However, some courts have considered putting a value on injunctive relief and adding that value to the common fund. See supra note 61 and accompanying text.
Moreover, to set an accurate price at the beginning of the lawsuit, litigation costs and the potential recovery will have to be at least somewhat estimable on the basis of prefiling research into the claims.

The hypothetical case of In re Widget, an antitrust suit based on a claim of horizontal price fixing against defendants X, Y, and Z, illustrates the ideal conditions for equity auction treatment. Fees in antitrust class actions, which almost always seek monetary damages, are frequently awarded under the common fund doctrine. Predicting potential economic damages will be relatively straightforward: one need only estimate the difference between the prices the direct purchasers paid for widgets and the market price absent X, Y, and Z's collusion, scaled according to the size of the overall market over the period of alleged collusion.

Suppose Lawyer A, lead counsel in In re Widget, estimates that going forward with the lawsuit will cost four million dollars. He has derived this figure by taking the present value of the total number of attorney hours that he

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86. Perdue, a recent case involving the calculation of fees under a fee-shifting statute, is an example of a class action that would be inappropriate for the auction method I propose. Plaintiff Kenny A. sought a structural injunction under 42 U.S.C. § 1983 against the State of Georgia to improve foster child services. See Kenny A. ex rel. Winn v. Perdue, 454 F. Supp. 2d 1260 (N.D. Ga. 2006), aff'd, 532 F.3d 1209 (11th Cir. 2008), rev'd, 559 U.S. 542 (2010). Despite class counsel's Rule 23(h) motion for a common fund fee award, the district court held that "the common fund doctrine is inapplicable because no fund was created by the parties' settlement. Instead, the settlement is one in which State Defendants have agreed to undertake certain actions to benefit foster children." Id. at 1271.

87. See, e.g., In re Coordinated Pretrial Proceedings in Petrol. Prods. Antitrust Litig., 109 F.3d 602, 607 (9th Cir. 1997); In re Cardizem CD Antitrust Litig., 218 F.R.D. 508, 531-32 (E.D. Mich. 2003); In re NASDAQ Market-Makers Antitrust Litig., 187 F.R.D. 465 (S.D.N.Y. 1998). While the Clayton Act, which provides a private right of action under the federal antitrust laws, does provide for fee shifting, see 15 U.S.C. § 15(a) (2012), the common fund doctrine applies universally to class actions that establish a settlement common fund, see infra text accompanying notes 100-118. Furthermore, in some circuits, the common fund doctrine can apply in hybrid cases implicating both a fee-shifting statute and a common fund. See, e.g., Staton v. Boeing Co., 327 F.3d 938, 945 (9th Cir. 2003); Brytus v. Spang & Co., 203 F.3d 238, 247 (3d Cir. 2000) (holding that the common fund doctrine applies in hybrid cases "when the defendant responsible for the statutory fee has . . . insufficient funds" or "when there has been a showing that competent counsel could not have been obtained for that case or that line of cases"); see also Martha Pacold, Comment, Attorneys' Fees in Class Actions Governed by Fee-Shifting Statutes, 68 U. Chi. L. Rev. 1007, 1026-29 (2001).

88. See ABA SECTION OF ANTITRUST LAW, ANTITRUST CLASS ACTIONS HANDBOOK 55 (2010) (describing the factors to be considered in calculating damages in price fixing cases).
estimates will be required multiplied by the hourly rate he charges his non-contingency-fee clients plus out-of-pocket expenses. This sum is equal to

$$\sum_{t=0}^{T} \frac{H_t * f_t + k_t}{(1 + i)^t}$$

Lawyer A has decided to seek two million dollars in outside capital. He conducts the equity procedure as described above.

At auction, Financier B and her partners submit the winning bid. After a full assessment of the potential payout and the risks associated with the case, Financier B estimates a recovery of around thirty million dollars and a litigation timeframe of about two years. Based on the level of risk she has assessed, she requires a return on her capital of twelve percent. This means that, if she commits to providing two million dollars today, she must expect to recover her two million dollars plus two years of compound interest—a total of $2.5 million. This $2.5 million amounts to 8.4% of the thirty million dollar expected award. She will therefore bid 8.4%. Assuming the bidding process was sufficiently competitive and the bidders each based their submissions on the best available information, the auction has set the percentage-of-fund award at an efficient minimum. Financier B and her competitors submitted bids that amounted to the lowest share of the recovery they would be willing to take given their assessment of the merits and risks of the lawsuit. B won because of a combination of her optimism about the risks of the case relative to the other bidders and the competitive price of her funding given her assessed level of risk. B’s stake suggests an overall fee award of 16.8% of the final recovery due to the plaintiffs.

2. Extensions of the Equity Sale Procedure

Three potential extensions to the equity sale procedure could further strengthen the class action: (1) allowing plaintiffs to sell their equity stakes to financiers, (2) allowing objectors to a settlement offer to buy out nonobjectors at the settlement price with the assistance of third-party financiers, and (3) syndicating financiers’ equity investment. Allowing plaintiffs to sell equity would give them the opportunity to realize for certain the risk-discounted

89. This may be a somewhat simplified picture, as the lawyer and the financier may assume different discount rates. Instead of (or in addition to) calculating the present value, the lawyer can present bidders with a schedule that details when they expect the investors will be responsible for cash payments to cover expenses. The bidders can then use their own discount rate to determine a present value.

90. Her bid will be equal to $2,000,000 * (1 + 12%)^2 = $30,000,000.
value of their claims—to recover some compensation for their harms regardless of litigation risk. Settlement buyouts could prevent lawsuits from ending with settlements below the true value of the claim, benefitting plaintiffs and enhancing the deterrence value of lawsuits. Finally, syndication would make the financier's equity investment in the lawsuit more liquid, potentially further reducing the cost of capital.

a. Extension One: Sale of Plaintiffs' Equity

This enhancement, which has the signature of the equity auction proposal advanced by Jonathan Macey and Geoffrey Miller, would bring plaintiffs into the equity sale process by allowing financiers to buy plaintiffs' claims at the price determined by the initial equity auction. Class members are already entitled to opt out of Rule 23(b)(3) classes and thus preserve their independent claims against the defendants. Under this proposal, instead of opting out, they could also cash out: they could take an upfront cash payment in exchange for their interest in the claim, perhaps before the class is even certified. This would allow plaintiffs to divest themselves of the risk of an adverse judgment. It would also allow them to receive a payout before the case is resolved and a payout fund is established, which often takes years.

Plaintiffs' shares would be priced by reference to the original equity auction, which puts a present dollar value on each percentage point of equity in the final judgment. Let \( P_f \) represent the present dollar value of the investor's equity share and \( E_f \) represent the percentage of equity purchased by the investor at the auction. The present dollar value of every percentage point of equity in the final judgment will equal

\[
P_f \times \frac{1}{100 \times E_f}
\]

91. The Macey and Miller proposal would divest plaintiffs of their equity in the claim as a default. See Macey & Miller, supra note 62, at 105-16. Having bought the claim, the claim purchaser would then prosecute the lawsuit on her own behalf. Id. In contrast, under my proposal, plaintiffs would retain their equity as a default rule and would themselves have to take the initiative to divest. The mandatory opt-out nature of Macey and Miller's proposal may not be problematic in suits in which individual claims are not worth very much, but it may substantially prejudice the interest of plaintiffs whose claims are valuable to them. In contrast, under the procedure I propose, plaintiffs would only be separated from their claims if they so choose.


93. \( P_f \) is equal to the present value of the financier's expected cash contribution.
Multiplying this by the number of percentage points of equity held by the plaintiff (that is, the plaintiff’s equity share, $E_p$, multiplied by 100) will give the present dollar value of the plaintiff’s equity.\(^9^4\) Investors can therefore purchase the plaintiff’s equity share for a sum equal to $P_f \times (E_p / E_f)$.

We can see how this might play out in the context of *In re Widget*. Imagine that Plaintiff $P$ owns a small business that is a direct purchaser of widgets. She reads about the lawsuit in *Widgets Today*, a trade publication in which class counsel and Financier $B$ have advertised the lawsuit and the early cash out offer. She determines that if class counsel’s economic predictions are correct, her damages from overpaying for widgets amount to a total of fifteen thousand dollars. The equity auction has already established a fair, competitive price for $P$’s claim: in this scenario, $P_f = 2,000,000$, $E_f = 8.4\%$, and $E_p = (15,000 / 30,000,000) \times (1 - 16.8\%) = 0.04\%$. Based on Financier $B$’s winning bid, the present value of one percentage point of equity in the final judgment is $2,000,000 \times (1 / 8.4) = 240,000$. As Plaintiff $P$’s claim amounts to 0.04 percentage points of equity, her stake is worth about $9,500 in cash today. Financier $B$ offers her this sum, payable immediately. $P$ believes this cash will give her the opportunity to make a significant profitable investment in her business, so she takes the offer. In exchange, Financier $B$ gets an additional 0.04\% share in the eventual judgment.

### b. Extension Two: Settlement Bonding

Another potential extension of the equity auction procedure has been suggested as a standalone proposal by Jay Tidmarsh.\(^9^5\) This proposal would enable class members that object to a settlement proposal to pursue their objections without undermining the interests of class members that may be better served by accepting the settlement. Imagine, for example, that an objector believes the settlement leaves money on the table, but continuing litigation would be risky and could delay recovery for the class. Such an objector could bring in third-party investors to pay off class counsel and create a recovery fund for the class. This would allow him to pursue a larger payout for himself and for the class while protecting his fellow plaintiffs against any recovery less favorable than the terms of the settlement.

A recent derivative suit in the Delaware Court of Chancery shows that Burford Capital, a British litigation financier that touts itself as “the world’s

\(^{94}\) $E_p = (D_p / D) \times (1 - E_f + E_t)$, where $D$ is the expected damages award for the class as a whole, $D_p$ is the plaintiff’s individual damages, and $E_f$ and $E_t$ are the equity percentages of the financiers and the lawyers, respectively.

\(^{95}\) See Tidmarsh, *supra* note 2.
largest provider of investment capital and risk solutions for litigation, is trying to open the door to such practices in the United States. In that case, objectors offered to engage Burford to secure the settlement terms for the rest of the class while continuing to pursue litigation. Although the court seriously entertained the proposal—and acknowledged that the deal would make the class better off—the court ultimately turned down the objectors on the grounds that no market auction had taken place to establish the reasonableness of Burford’s expected returns.

Conducting a second auction could solve this problem. Interested investors (perhaps including the original investor) would bid on the opportunity to take a percentage of the upside of continuing litigation in exchange for providing a recovery fund for the plaintiffs and funding the marginal effort. Their bids would be priced as a percentage of the marginal amount of the final judgment above the settlement offer. Such a procedure would allow for settlements to be tested by the market for their sufficiency without putting plaintiffs at risk.

c. Extension Three: Syndication

Syndication allows financial investors to divvy up a large investment in order to pool the risks and rewards. In particularly resource-intensive class action suits requiring large amounts of capital, syndicating the financiers’ equity investment could enhance the benefits of the equity sale by increasing the amount of capital available and facilitating the liquidity of the investment. This would further lower the cost of capital and enhance the equity sale’s risk-sharing potential.

Syndication could be executed by allowing individual financial firms to compete in the auction and then sell portions of their equity stake to other


98. See *Forsythe*, 2013 WL 458373, at *1.

99. *Id.* at *4* (ruling that Burford and the objectors had not established that “the percentage of the upside extracted by [Burford] is a market rate that falls within a range of reasonableness”).

100. If \( A \) is the final award and \( S \) is the settlement offer currently on the table, the bid would be priced as a percentage of \( (A - S) \).
investors in secondary transactions. Alternatively, groups of investors could enter the bidding together as a unit. Under a third method, prospective class counsel could slice the present value of the expected cash financing into nominal units and sell off those nominal units to interested investors in a Dutch auction.\(^1\) (This option, however, may have more limited liquidity benefits as these shares may not be as easily transferable.) Whichever method is used, syndication has the potential to increase the liquidity of the investment and enhance the spreading of risk, thereby attracting more investors. These benefits could enlarge the pool of capital available to class action lawsuits, further lowering the cost of capital.

3. **What Happens When Investors’ Cost Predictions Are Wrong?**

The initial estimate of the cost of the lawsuit is unlikely to be exactly accurate. It is therefore essential that the terms of the equity investment agreement leave room for eventualities in which litigation costs depart significantly from initial estimates. Where litigation costs significantly undershoot actual expenditures—perhaps because defendants, knowing that class counsel was well-funded and unlikely to back down, capitulated more quickly than anticipated—investors should be awarded the same percentage of fund rate set at the auction stage, and the remainder of the unspent capital should go to the plaintiffs’ share of the recovery (or, put another way, the total unspent costs should be deducted from the fee awarded).

More difficult is a scenario in which class counsel have significantly underestimated the amount of capital needed to prosecute the lawsuit. Adequate provision for such circumstances should be among the key terms of the financing agreement, and an important factor for judicial scrutiny when the lawyers present the funding agreement as part of their application for appointment as class counsel. Such provisions may require financiers to contribute additional capital up to a certain threshold above which they can continue to provide capital at their discretion. Additional capital could come directly out of class counsel’s pockets, or they could jointly arrange terms with a second string of investors, offering those investors a share of the fee they established at auction. The risk that the investors will have to cover the additional capital will be reflected in their auction bids. What if even this

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\(^{10}\) In a Dutch auction, the price is set at the highest price at which there are investors willing to accept all of the shares on offer. See James Bergin, Microeconomic Theory: A Concise Course 101 (2005) (ebook). In the case of an equity sale of a class action lawsuit, a Dutch auction would set the lowest percentage per nominal financing share the investors participating in the auction would be willing to accept in exchange for the financing commitment associated with that share.

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threshold is exceeded, and the financiers are not willing to provide more capital? If there are no other investors willing to buy out the equity of the financiers and contribute more capital, the situation is ripe for settlement bonding.\textsuperscript{102}

B. Rule 23 and the Role of the Judge

The auction procedure does not require a change in the judge’s responsibilities or authority under Rule 23 with respect to appointing class counsel\textsuperscript{103} and awarding attorney fees and costs\textsuperscript{104} under the common fund doctrine. Moreover, the equity sale would not change the procedure for the appointment of class counsel, who would still be appointed by the judge according to their qualifications. The judge would retain extensive supervisory responsibilities under the equity auction procedure, so we should not expect the equity auction to significantly reduce the amount of judicial resources that go into litigating attorney fees.\textsuperscript{105}

Under the auction procedure, the judge retains her role as the critical guarantor of the fairness of fee arrangements. She will need to vet the auction and the resulting fee arrangement for fairness at two points: when she appoints class counsel and when she enters a final judgment or approves a settlement. In vetting the auction procedure at the appointment stage, she will require class counsel to show that the auction was conducted fairly and at arm’s length, without collusion or foul play on the part of the financiers or attorneys, and that the bids were based on reasonable projections and assumptions about the conduct of the lawsuit.

Having established at the outset that the fee set through the equity auction was fair, this presumption should have a heavy weight in any ex-post review of the fee award. A judge might reduce an award on an ex-post review where, for example, she finds that class counsel were incompetent or did not act in the best interests of the class, or that the investors exerted undue influence on class counsel during the course of the litigation. A judge may also reduce an award where some unforeseen eventuality results in a significant deviation from

\textsuperscript{102} See supra notes 95-100 and accompanying text.
\textsuperscript{103} FED. R. CIV. P. 23(g).
\textsuperscript{104} FED. R. CIV. P. 23(h).
\textsuperscript{105} It is no secret that Rule 23(h) is already the source of extensive litigation, as fee applications are subject to “thorough judicial review” by the district court, and are also closely reviewed on appeal. See \textit{In re Rite Aid Corp. Sec. Litig.}, 396 F.3d 294, 299-300 (3d Cir. 2005) (quoting \textit{In re Prudential Ins. Co. of Am. Sales Practice Litig. Agent Actions}, 148 F.3d 283, 333 (3d Cir. 1998)).
initial projections. Financiers and class counsel may want to stipulate terms around such an eventuality during the bidding process.

C. Required Changes in the Law

In order for the equity auction to be viable, two sets of legal roadblocks must be overcome. First, state legislatures, courts, and bars would have to roll back restrictions on third-party lawsuit financing. Second, courts may need to modify attorney-client privilege doctrine. Prospective funders may need access to privileged attorney-client communications in cases like mass torts that require plaintiff-specific discovery and verification. Such a modification could take the form of an expansion of the common interest exception, under which communications between multiple parties and an attorney are jointly privileged where the parties share a common interest. No change in work-product doctrine would be required.

These roadblocks to third-party financing arrangements notwithstanding, district court judges in most federal circuits would possess the authority to allow a fee to be set through an equity auction procedure in common fund cases. Awarding attorney fees under the common fund doctrine (rather than

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106. This is in line with ex-post judicial review of ex-ante fee arrangements between lead plaintiffs and attorneys in securities litigation subject to the Private Securities Litigation Reform Act (PSLRA). See, e.g., In re Cedant Corp. Litig., 264 F.3d 201, 282-84 (3d Cir. 2001) (holding that while a presumption of reasonableness attaches to fee arrangements between lead plaintiffs and class counsel under the PSLRA, this presumption can be rebutted by a change in circumstances during the course of litigation).

107. See supra notes 40-43 and accompanying text.


109. See Maya Steinitz, Whose Claim Is This Anyway? Third-Party Litigation Funding, 95 MINN. L. REV. 1268, 1328 (2011); see also Cavallaro v. United States, 284 F.3d 236, 249-50 (1st Cir. 2002) (providing a definition of the common interest exception).

110. In sharing such documents with third-party financiers under a strict seal of confidence, class counsel would not be waiving protection under the work-product doctrine. See Blanchard v. EdgeMark Fin. Corp., 192 F.R.D. 233, 237 (N.D. Ill. 2000) (holding that the protection of work product is waived by a disclosure to a third party only where “the particular disclosure was of such a nature as to enable an adversary to gain access to the information”); 8 CHARLES ALAN WRIGHT ET AL., FEDERAL PRACTICE & PROCEDURE § 2024 (3d ed. 2015) (“[D]isclosure of a document to third persons does not waive the work product immunity unless it has substantially increased the opportunities for potential adversaries to obtain the information.”).
under a fee-shifting statute) is an exercise of equity power. As such, district courts generally have "significant flexibility in setting attorneys' fees" subject only to review on an abuse of discretion standard. For example, as discussed below, some judges have experimented with appointing lead counsel through an auction based in part on bids to accept the lowest percentage of the recovery as a fee award. The authority that empowers judges to conduct these "lead counsel auctions" would authorize judges to allow equity auctions.

However, while federal district court judges maintain the discretion to institute an auction procedure to set a reasonable attorney fee ex-ante, some exceptions may apply. The Third Circuit, for example, has held that fees set through lead counsel auctions must undergo a searching ex-post review looking at the same factors that govern review of common fund awards in the absence of a bidding process, including the size of the fund, the presence of objectors, the lodestar, and benchmarks from similar cases. Such a searching review at least partially undermines the advantages of an ex-ante bidding procedure. The Third Circuit has also held that the lead counsel provision of the PSLRA preempts the judge's discretion to institute a competitive bidding procedure in securities cases where a viable lead plaintiff exists.

While judges do have the power to implement novel market-based procedures for setting attorney fees in most common fund cases, the law puts more restrictions on judges' ability to award fees under fee-shifting statutes. Awards made pursuant to statutory fee shifting are governed exclusively by the lodestar method, and there is a strong presumption against enhancements to or

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13. Id. at 186.
14. See infra notes 125-132 and accompanying text.
15. In In re Cendant Corp. PRIDES Litigation, the Third Circuit vacated a fee award set through a lead counsel auction because the judge's ex-post review of the award was "too cursory for [the court] to have a sufficient basis to review for abuse of discretion." 243 F.3d 722, 733 (3d Cir. 2001) (quoting Gunter v. Ridgewood Energy Corp., 223 F.3d 190, 196 (3d Cir. 2000)). The Third Circuit held that the court must evaluate the fee award against at least seven specific factors governing all ex-post fee determinations in common fund cases. Id.
17. See In re Cendant Corp. Sec. Litig., 404 F.3d at 192-93 (holding that a lead counsel auction is authorized "only in the unusual situation in which no sophisticated lead plaintiff can be trusted to fulfill its duties to the class under the PSLRA").
modifications of that method.\textsuperscript{118} The lodestar method is only intended to compensate an attorney with “an award that roughly approximates the fee that the prevailing attorney would have received if he or she had been representing a paying client who was billed by the hour in a comparable case.”\textsuperscript{119} Absent unusual or unforeseen circumstances, fee awards must be equal to the number of hours class counsel spent on the case multiplied by the prevailing market rate. While there may be some flexibility in cases where there has been an “extraordinary outlay of expenses and the litigation is exceptionally protracted,” or where payout of the fee has been significantly delayed, fee enhancements in such circumstances are limited to a strict, objective application of a “standard” rate of interest.\textsuperscript{120} Indeed, the Supreme Court has explicitly forbidden accounting for risk in the lodestar method applied in a fee-shifting case.\textsuperscript{121} Unless the law changes, no competitive method of setting fees can apply in fee-shifting cases.

D. Distinguishing the Equity Auction

The equity auction approach offers advantages over two other notable auction-based proposals: the lead counsel auction introduced into practice in 1990 by Judge Walker of the United States District Court for the Northern District of California and the auction procedure proposed by Macey and Miller. The former does not enjoy the benefits of third-party investment. The latter, which forcibly separates individual class action plaintiffs from their claims, is intended only for “large-scale, small-claim” suits, and would offend basic notions of the rights of plaintiffs if extended to cases where class members may have meaningful interests in the case.\textsuperscript{122}

1. The Lead Counsel Auction

While the lead counsel auction has substantial potential to reduce attorney fees by introducing a competitive bidding process, it has several defects. The

\textsuperscript{118} Perdue v. Kenny A. ex rel. Winn, 559 U.S. 542, 552-53 (2010); see also Pennsylvania v. Del. Valley Citizens' Council for Clean Air, 478 U.S. 546, 565 (1986) (“A strong presumption that the lodestar figure . . . represents a ‘reasonable’ fee is wholly consistent with the rationale behind the usual fee-shifting statute . . . .”).

\textsuperscript{119} Perdue, 559 U.S. at 551.

\textsuperscript{120} Id. at 555-56.

\textsuperscript{121} City of Burlington v. Dague, 505 U.S. 557, 561, 567 (1992) (holding that fees calculated under the lodestar method in statutory fee-shifting cases cannot be enhanced for the “contingent risk of nonpayment”).

\textsuperscript{122} Macey & Miller, supra note 62, at 105-06.
auction procedure begins with law firms submitting bids “specifying the percentage of any recovery such firm will charge as fees and costs in the event that a recovery for the class is achieved,” as well as details related to counsel’s qualifications. The judge will award the role of class counsel on the basis of both estimated price and qualifications.

This procedure does not produce any of the benefits of opening the class action to third-party financing. The lack of an open and competitive market for capital financing has its own effects on attorney fee levels and whether certain lawsuits are brought or maintained through inadequate settlement offers. Without allowing support from outside financiers, the lead counsel auction can only partially address the issues that result from inefficient financing. It is true that the auction does put the better-financed lawyer at an advantage: that attorney will be able to make a lower bid, and the judge will be able to take into consideration the health of his firm’s balance sheet when evaluating offers. Major problems, however, are left unaddressed. Better-financed attorneys aren’t necessarily better attorneys. Moreover, without the option of outside investment, financing will ultimately remain cordoned off from broader capital markets, raising the cost of capital and leaving attorneys limited in their decision making by their ability to bear risk and manage cash flow.

The lead counsel auction has other shortcomings not directly connected to the lack of third-party financing. Just over a decade after Judge Walker first introduced the method, the Third Circuit Task Force Report on Selection of Class Counsel pointed out several such defects in a comprehensive evaluation of lead counsel auctions, relying on empirical studies and extensive testimony from academics, judges, and lawyers. Despite initial indications that the method successfully reduces attorney fees, the task force pointed out several potential problems, including

whether the class is best served by selecting the counsel who offers the lowest bid (even if the court includes qualitative factors in its determination); whether a court can replicate a client’s choice without becoming unduly involved in the selection and negotiation process; and whether a meaningful fee agreement can be reached in advance of the

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123. In re Oracle Sec. Litig., 131 F.R.D. 688, 697 (N.D. Cal. 1990); see also Third Circuit Task Force Report, supra note 79, at 708 & n.44.

124. Though commonly referred to as an “auction,” the term may be a misnomer. Judges assessing bids for lead counsel generally have not made such determinations solely on the price of the bid—like Judge Walker, they also take counsel’s qualifications into consideration. As such, the procedure is not an auction in the technical sense of the term. See In re Synthroid Mktg Litig., 264 F.3d 712, 720 (7th Cir. 2001).

125. Third Circuit Task Force Report, supra note 79.
case, when the judge remains bound under Rule 23 to review the fee at
the end of the case.126

Additional problems include the potential for an auction to misprice the
attorney fees in actions with an uncertain outcome, as well as the potentially
damaging systemic effects of undercompensating, and therefore
underincentivizing, the work firms do before filing to find viable claims to
bring to court in the first place.127

The task force ultimately recommended that private ordering should
remain the favored class counsel selection method, and that courts should
conduct lead counsel auctions only in exceptional situations.128 The task force
concluded that “traditional criteria for appointing class counsel are preferable,
in most cases, to the use of an auction” despite the fact that the potential
downsides of auctions could be minimized in certain kinds of cases (for
example, those where liability and damages are clear cut, the litigation will be
relatively straightforward, and no particular attorney has undertaken extensive
prefiling investigatory work).129 Perhaps as a result of the task force’s cautious
evaluation, lead counsel auctions remain rare.130

Whether or not the task force’s cautiousness is justified, the equity auction
procedure proposed in this Note reduces or eliminates most of these purported
disadvantages. Under the equity auction procedure, the judge’s choice of class
counsel is independent of the market forces that set the attorney fees. The
procedure therefore does not increase the likelihood that less qualified counsel
will be appointed—indeed, quite the opposite. Investors will only contribute
their capital when they have confidence in the attorneys involved in the
lawsuit. Moreover, the procedure does not require judges to “unduly” involve
themselves in the counsel selection or financing process. Although they must
scrutinize the auction process for fairness, they do not conduct the process.
Equity auctions also preserve, and even enhance, the incentive for attorneys to
do the entrepreneurial prefiling legwork required to bring class action claims to
court: attorneys who may be uncomfortable with bearing the full risk of
bringing the action to completion can extract compensation at the auction
stage. The procedure could therefore lead to an even more robust industry of
entrepreneurial claim seekers.

126. Id. at 708.
127. Id. at 741-45.
128. Id. at 740-41.
129. Id. at 740-45.
130. RUBENSTEIN, supra note 1, § 10:14.
An additional concern about the lead counsel auction is that, by pushing down attorney compensation, it decreases the incentives for counsel to litigate the class action robustly. This is a particular concern in the class action context, as class counsel’s efforts are typically not closely supervised by any member of the plaintiff class. The equity auction does not suffer from this problem because, unlike in the case of the lead counsel auction, competence and reputation at bar will be critical components of the financier’s decision to invest in the case in the first place. While courts rarely question class counsel’s competence in their determinations of class counsel’s adequacy under Rule 23(g), part of any financier’s due diligence will involve assessing the attorney’s track record. Attorneys that are repeat players will therefore have every incentive to preserve their reputation by litigating zealously and competently. Moreover, to the extent that counsel retain some equity in the fee award, their compensation will remain directly tied to their efforts.

2. Macey and Miller’s Auction

The auction Macey and Miller propose, which would allow judges to auction certain claims in their entirety to third parties to litigate, is a compelling alternative for class actions involving large volumes of small claims. Under their proposal, the judge would make an initial determination as to whether the case warrants auction treatment by considering, among other factors, whether the case falls into the “large-scale, small-claim” category and whether the claims are definite enough to make a reasonable estimation of the damages. If the case fits the criteria, the judge directs notice to class members allowing individuals to opt out; subject to this opt-out, the court auctions the bundle of claims to the highest bidder and disburses the proceeds to the plaintiffs. Notably, defendants themselves are entitled to participate in the auction, essentially allowing them to settle the lawsuit at a competitive price without any litigation.

132. For example, Burford Capital makes clear on its website that it “seek[s] to insure that the highest quality counsel is involved in [its] cases.” Working with Burford, BURFORD CAP. (2014), http://www.burfordcapital.com/how-we-help-uk/working-with-burford [http://perma.cc/43G5-8RU5].
133. See Macey & Miller, supra note 62, at 106.
134. See id. at 107-08.
135. See id. at 108.
The administrative simplicity of Macey and Miller's proposal makes it an attractive alternative to the equity auction in many consumer and shareholder class actions (or derivative suits) where it is unlikely that individual plaintiffs would be able to collect more than a few dollars or a coupon. However, as Macey and Miller themselves note, their approach is not appropriate for cases where the plaintiffs' claims are not "small." Where plaintiffs' claims are meaningful, either in their monetary value or in their qualitative value to plaintiffs, alienating plaintiffs from their claims would violate the fundamental duty of the class action to make plaintiffs whole. The proposal would preserve plaintiffs' right to opt out; however, they may not receive notice in time. And even if they do, the auction deprives them of the ability to participate in the class action, forcing them to choose between litigating alone—which could be prohibitively expensive—and forfeiting any potential to collect more than the auction participants estimated their claims were worth before litigation. The equity auction is therefore more appropriate for cases in which the meaningful interest of the plaintiffs in the litigation must be preserved.

IV. ASSESSING THE RESTRICTIONS ON OUTSIDE FINANCING

Restrictions on outside financing pose the largest obstacle to the equity auction proposal. These restrictions are sustained by concerted opposition from large corporations—many of which are able to use their balance sheets to enjoy the very benefits they oppose giving to plaintiffs. The opposition has been vociferous, and is especially shrill when mentioned in the same breath as the class action. Critics resolutely resist enabling litigation financing on the grounds that it will provide overly litigious plaintiffs' lawyers with yet another unfair tactic with which to harass corporate defendants. It is perhaps

136. Cf. id. at 106 (mentioning that suitability for auction turns, in part, on the smallness of the claims).
137. Cf. id. at 30 (noting that the Supreme Court has generally required actual notice as a matter of due process in cases where the property right at issue is "substantial in size or importance" to the claimant).
138. See Hensler, supra note 6, at 499-500 (noting the "strident" advocacy of "corporate interest groups" against litigation financing).
139. See supra note 48 and accompanying text.
140. In the words of Deborah Hensler, "[N]o area of legal practice has been more clearly targeted for prohibition of [third-party] financing than class action litigation." Hensler, supra note 6, at 500.
141. The U.S. Chamber of Commerce, for example, features a website, updated on a near-weekly basis, dedicated to advancing the cause against litigation financing. U.S. Chamber Inst. for Legal Reform, Third Party Litigation Funding, U.S.
of little surprise, then, that ancient laws and professional standards barring many financing practices remain largely intact despite enthusiasm within the academy and successes abroad. This opposition has attached a social stigma to the practice, relegating it “to the dark corners of the capital markets and the legal profession.” Perhaps as a result, reputable lawyers are reluctant to push the law in a more sympathetic direction. Meanwhile, litigation financiers are content, at least in public, to disavow any interest in class actions and focus their attention on corporate clients.

Will the adoption of litigation financing in the class action arena have undesirable effects on the efficient and fair administration of civil justice? Opponents of financing cite two classes of negative consequences of its widespread adoption. The first relates to agency costs. The argument is that investors may interpose their interests, which could be adverse to those of the plaintiffs. The second, weightier objection relates to a perennial class action bogeyman: the negative-value lawsuit, which costs more to litigate than the underlying claim is worth. The fear is that, with more cash to spare, unscrupulous financiers and lawyers could be emboldened to go after deep-pocketed defendants in such cases with the goal of terrorizing them into an unfair settlement. This Part addresses each argument in turn.

A. Agency Costs Arguments

Litigation financing gives a third party without an independent interest in a lawsuit a direct financial stake in its outcome. This could be problematic where the financier’s interest conflicts with the interests of the plaintiff. Would the financier push the lawyer to advance the financier’s own best interests over

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142. Molot, supra note 6, at 102.
143. Id.
144. See Hensler, supra note 6, at 507-08 (parsing public statements of litigation financiers Burford and Juridica and concluding that “[i]t is difficult to avoid the inference that litigation investors who see their market as comprising large corporations believe that it is politic to give class actions a wide berth”).
145. See id. at 515-16.
146. Id. at 510-15; see also infra notes 150-151 and accompanying text.
those of the plaintiff? This could be particularly dangerous in the class action context, where plaintiffs are not present to call the shots and supervise the financier-attorney relationship. A judge-enforced requirement that investors remain on the sidelines would not be sufficient. After all, class counsel, repeat players in the market for financing, could feel compelled to tacitly acquiesce to the financier’s interests. It would be difficult for any court to completely enforce the independence of class counsel from the financier.

The danger that financiers will push to settle early is a real one—but not one created by the existence of the third-party financier. The underlying financial interests of investors are indistinguishable from the basic interests of the lawyers under the current regime. There is no reason to think that judicial oversight would be sufficient to ameliorate existing class action agency problems but would somehow fail to protect against agency conflicts with financiers. Indeed, opening the financing market could reduce the risk that the interests of a particular investor will be realized at the expense of the plaintiff class.

Equity holders in an open financing market can divest themselves of their equity without affecting the conduct of the lawsuit. As long as litigating remains financially viable, someone else will have the incentive to step in and allow the antsy investor to exit. Another advantage of an open financing market is alleviating conflicts of interest, both between attorneys-cum-financiers and within the plaintiff class itself. Alternative financing arrangements can allow objectors who would be better served by continuing litigation despite an attractive settlement offer to do so without harming the interests of the rest of the class. They also allow plaintiffs who would be better served by cashing out at a point earlier than final judgment or settlement to do so on transparent and market-priced terms.

And what of potential agency problems arising from the tension between monetary and nonmonetary forms of relief? The plaintiff class may desire to benefit from some measure of declaratory or injunctive relief in addition to its monetary claims. While it may be in the plaintiffs’ interest to sacrifice some of the latter to achieve the former, the financier would likely not be interested in doing so—especially if it required delaying settlement or putting more capital

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147. Examples of situations where financiers’ and plaintiffs’ interests compete include cases where the financier wants to settle early for a smaller sum in order to alleviate risk or cash flow concerns; where the plaintiff class would be better served by collecting immediately, but the financier wants to continue litigation; where there is some tension between expending resources and achieving some nonmonetary remedy important to the plaintiffs; or where the funder has an independent agenda unrelated to the size of recovery (for example, establishing a rule that could benefit recovery in other cases in the financier’s portfolio).
at risk. This potential for conflict exists in the normal contingency fee context, but to a lesser extent. Where class counsel are financing the lawsuit, any work they undertake to pursue declaratory or injunctive relief would at least be reflected in the lodestar calculation the judge ultimately uses to set or cross-check the fee.

Agency problems relating to nonmonetary relief either will not arise at all because such lawsuits won't be amenable to treatment under the equity auction procedure, or else can be mostly addressed through judicial oversight. Attorney fees in a class action seeking significant declaratory or injunctive relief—which will likely be certified under Rule 23(b)(2)—will generally be calculated using the lodestar method, which, as I have noted, is incompatible with the approach I have proposed. For those class actions certified under Rule 23(b)(3) where declaratory or injunctive relief are at issue to some degree, the agency problem can be remedied through judicial supervision. Judges will have to ensure that the nonmonetary issues are given adequate attention. In some circumstances, judges may even be able to incorporate the value of the injunctive relief into the common fund.\textsuperscript{148} Class counsel and financiers should make sure they take the nonmonetary issues into consideration when estimating how much the litigation will cost.

B. Lawsuit Abuse Arguments

In medieval times, individuals with grievances enlisted the help of the powerful, who used their resources and influence to manipulate the outcome of a case in exchange for some of the proceeds, usually in the form of land.\textsuperscript{149} According to litigation-financing critics, the modern version of this practice involves bringing shaky claims against a defendant who is forced to settle due to the uneconomical (or potentially ruinous) costs of putting on a defense.\textsuperscript{150}

Alternative litigation finance is not the root cause of this issue: critics claim that such abuse already takes place, enabled by the pocketbooks of plaintiffs themselves or perfidious contingency fee attorneys.\textsuperscript{151} (Other scholars refute

\begin{footnotesize}
\begin{enumerate}
\item[148.] See supra note 61 and accompanying text.
\item[149.] See Steinitz, supra note 109, at 1286–87.
\item[150.] See U.S. Chamber Inst. for Legal Reform, Class Actions, U.S. CHAMBER OF COM., http://www.instituteforlegalreform.com/issues/class-actions [http://perma.cc/ALA2-G62P] ("The large size of some classes, and the resulting large potential payouts, make these cases very risky for businesses. As a result, most business defendants seek to settle class actions before going to trial.").
\end{enumerate}
\end{footnotesize}
that such negative value suits take place.\textsuperscript{157}) Opponents of alternative litigation finance claim that an open financing market would aggravate this supposed problem by enabling deep-pocketed outsiders to engage in abusive litigation.\textsuperscript{193} They point to one notorious example, a corruption-riddled Ecuadorian class action against Chevron partially funded by Burford,\textsuperscript{154} to highlight the dangers of the potentially noxious combination of third-party finance and class action lawsuits. How justifiable are their fears?

1. \textit{The Theoretical Possibility of Negative Value Suits}

A theoretical possibility of negative value suits—meritless suits brought to cow defendants into settlement—does exist. The Chevron case, which involved a foreign venue, is perhaps not a persuasive example for critics of third-party financing to class actions litigated in American courts; however, many supporters of alternative litigation finance have perhaps too summarily dismissed the possibility that the practice could enable negative value suits. One standard response is that it would be unacceptably risky, and therefore a poor business decision, for a financier to back a lawsuit that would not hold up on the merits.\textsuperscript{155} While this may be true to an extent, it is not hard to imagine

\begin{itemize}
\item\textsuperscript{152} Macey & Miller, supra note 62, at 77-78.
\item\textsuperscript{153} See, e.g., Beisner & Rubin, supra note 141, at 4.
\item\textsuperscript{155} See Steinitz, supra note 109, at 1327 (“A commercial funder needs to make a rational economic decision to invest in a claim. It would not do so if the claim does not have merit and is unlikely to succeed.”); see also Hensler, supra note 6, at 513 (“At worst, bringing a frivolous claim would result in an expensive pretrial battle and a defense victory, with a financial loss for class counsel, who will neither recover expenses nor win fees for time spent on the case.”); Molot, supra note 6, at 106 (“Why an investor would purposely invest money in a case that is weak on the merits and likely to lose is hard to understand.”). In addition to these theoretical arguments, Hensler in particular has also pointed to the fact that the sky has not fallen in Australia, where third-party financing of class action suits has developed into an essential component of that country’s Rule 23(b)(3)-inspired class action procedure. Hensler, supra note 6, at 517-18, 524. But the Australian example is not quite apropos, as fees are assessed against the plaintiffs if the case fails, providing defendants with additional protection. See id. at 518-19. As a result of this fee shifting, the involvement of financiers, and other aspects of the legal fee regime, the Australian procedure now resembles more of a glorified joinder device than a true Rule 23(b)(3) class action. See id. at 519 (“[T]he result in Australia has been that the formal opt-out regime has become, in practice, an opt-in regime.”).
\end{itemize}
financiers with capital at their fingertips, few scruples, and a high risk tolerance. Moreover, at least theoretically speaking, it is possible that such a strategy could be profitable.

To see how this could occur, consider a hypothetical in which Lawyer A’s unscrupulous doppelgänger, Lawyer E, enlists the help of outside financiers and brings a widget price fixing suit against defendants X, Y, and Z even though he believes that such claims would likely prove to be meritless after extensive discovery. Lawyer E estimates that a full-throated prosecution of his claims would cost about five million dollars; however, given the dubiousness of the claims he is bringing, the expected value of the plaintiff award is low—also about five million dollars, with an expected fee award of around $1.5 million. If Lawyer E brings suit, and the suit is fully litigated, he can expect to lose around $3.5 million.

Assuming that the defendants will fight to the end, it makes little sense for Lawyer E to bring suit; he and his financiers will, after all, probably lose a great deal of money. But what if he can be relatively confident that the defendants will not put up a vigorous defense? Consider the position of X, Y, and Z. It will cost them collectively about five million dollars to defend the case vigorously. And even after putting on a full defense, they could lose: the expected value of their payout is, as mentioned above, five million dollars. Therefore the overall expected value of the lawsuit for them, if they litigate to the fullest extent, is a loss of ten million dollars. Does it make sense for them to capitulate and settle for some sum less than ten million dollars, or should X, Y, and Z put on a defense?

The answer to this question depends on an iterative, step-by-step dance between the parties as they alternately litigate and negotiate. We can see how this might unfold by considering a simplified world in which parties have only two choices: settle at the outset, or litigate through to a final judgment. In this situation, both parties lose if they litigate to completion. It is rational for Lawyer E to accept any settlement amount whatsoever. Meanwhile, it is rational for X, Y, and Z to accept any settlement under ten million dollars. Assuming that the outcome of their negotiations will not have consequences for future lawsuits, their interaction will resemble an ultimatum game, and the parties will likely reach some sort of settlement. Adversaries’ knowledge about the merits of the case and the costs that the opposing party would incur if they rejected settlement and insisted on litigating will influence the outcome.

156. See generally Molot, supra note 6, at 106 n.130 (describing scholarship on both sides of this debate).

157. See generally Werner Güth et al., An Experimental Analysis of Ultimatum Bargaining, 3 J. ECON. BEHAV. & ORG. 367 (1982), for background on the ultimatum game.
The scenario above makes two strong assumptions that are often false in the real world. When we consider each of these assumptions, it becomes clear that the availability of a litigation finance market can give the plaintiffs' lawyer a significant advantage in settlement negotiations in a lawsuit with a low chance of success. The first of these assumptions is that both parties will be playing toward the expected value, which is calculated by taking the probability-weighted mean of all potential outcomes, instead of playing toward a median value that more accurately reflects their risk preferences.\textsuperscript{158} Consider the following two scenarios, as assessed from an ex-ante perspective. In scenario one, if the lawsuit goes to judgment at trial, X, Y, and Z will be liable for thirty million dollars in damages; however, the lawsuit only has a seventeen percent chance of success. In scenario two, if the lawsuit goes to judgment at trial, X, Y, and Z will be liable for ten million dollars, and the lawsuit has a fifty percent chance of success.

For the defendants, each of these scenarios has an expected negative value of about five million dollars. Yet the defendants' attitudes toward each scenario may be very different. Suppose that X, Y, and Z would essentially be put out of business if assessed a thirty million dollar judgment (on top of the costs of their defense), but would be able to afford a judgment of up to ten million dollars plus five million dollars in legal fees. Scenario one puts them in a worse bargaining position than scenario two, as in the former scenario they cannot risk going to trial and losing. Therefore, in scenario one, the defendants' strategy requires settlement, whereas in scenario two they may be willing to put up a fight.

Scenario one may not present the defendants with a disadvantage if Lawyer E is similarly risk constrained. In scenario one, he has an eighty-three percent chance of losing five million dollars with a litigation strategy, odds that could be unacceptable to him. But if Lawyer E has the backing of a financier that can hedge the risk, he would be comfortable with the risk of a litigation strategy in scenario one; Lawyer E and his financier have a good chance of at least breaking even if they spread their risk over five other lawsuits with similar odds. Especially if he knows that the defendants are in the weaker position, Lawyer E has the ability to drive a hard bargain, potentially extracting an unmerited settlement up to the defendants' ability to pay—in this case, fifteen million dollars. That leaves Lawyer E with a windfall far above his expected value, and the defendants with a loss far below theirs.

The second assumption is that the litigation takes place in a vacuum: that settlement negotiations will not be influenced by the implications of each

\textsuperscript{158}. For a full discussion of playing toward the mean versus playing toward the median, see Molot, supra note 6, at 83-90.
party's behavior on future lawsuits. This assumption often will not hold. In deciding on a settlement threshold, defendants must consider the implications of settlement on future lawsuits. Entering into a settlement could, for example, embolden future plaintiffs by signaling a willingness to capitulate to less-than-meritorious lawsuits. The plaintiffs’ lawyer may make similar calculations: settlement under a certain amount may give him a reputation as weak, and therefore harm him in future negotiations. It is very clear, though, that a well-capitalized financier’s backing could put Lawyer E at a tremendous advantage by inoculating him against the risks of an aggressive litigation strategy. The financier would happily enable him to do that in order to signal to future defendants that her involvement means plaintiffs’ counsel will be aggressive. The financier would rather Lawyer E litigate, and thereby burnish the credibility of future lawyers she backs, than compromise her credibility by accepting a less-than-attractive settlement.

2. Litigation Finance Solves Its Own Problem

As we have seen, the fairness of a settlement can be skewed by an asymmetry in the parties' abilities to distribute litigation risk. Litigation financing has the potential to introduce or exacerbate these asymmetries, putting the plaintiffs’ lawyer at an advantage in negotiating settlements in lawsuits of dubious merit. Does this present a fatal blow to litigation financing?

Far from it. Litigation financing only presents this danger if there is an asymmetry of access to it. If both parties have the ability to insure their litigation risk, the asymmetry vanishes. A truly robust litigation financing market would make available resources to spread litigation risk equally to plaintiffs and defendants. Consider our discussion of how a defendant's expectations of future lawsuits will bear on his settlement behaviors. Clever lawyers and financiers will prey on the weak defendants that have shown they would rather settle than litigate a full defense, either because they are not repeat defendants, or because they are otherwise unable to protect themselves against litigation risk. But any corporation that can manage its litigation risk will not be a weak defendant. On the contrary, like Lawyer E and his financier, the defendant will be able to pursue an aggressive strategy that signals the ability to manage the risks of making a full defense rather than capitulating.

159. For a broader discussion of how litigation financing allows corporate defendants to manage their litigation risk, see Jonathan T. Molot, A Market in Litigation Risk, 76 U. CHI. L. REV. 367 (2009).
CONCLUSION

Over the last few decades, the class action lawsuit has been on its back foot. Legislative interventions like the Class Action Fairness Act of 2005\textsuperscript{160} and the PSLRA\textsuperscript{161} have made it easier to remove class actions to federal court and have raised pleading requirements in securities litigation. Meanwhile, in cases like \textit{Wal-Mart Stores, Inc. v. Dukes}\textsuperscript{162} and \textit{Comcast Corp. v. Behrend},\textsuperscript{163} the Supreme Court has made it increasingly difficult for plaintiff classes to obtain certification.

Given this clear trend, a proposal to liberalize financing restrictions and change the way class action contingency fees are set may face headwinds. But, as discussed above, the current financing and fee regime undermines the class action's goals. As a result, the class action device simply does not work as well as it could.

We can do better. The equity sale method, a competitive auction open to nonlawyer financiers, would enhance the welfare of plaintiffs and further the enforcement function of the class action. The proposal would comply with Rule 23 and current doctrine on attorney fee awards. It would, however, require us to become comfortable with the prospect of nonlawyers financing lawsuits. The dialogue must begin with a full acknowledgement of the critical role that profit, capital, and risk already play in setting the terms of justice. But as long as the class action remains a tool of American civil procedure, we would do well to focus on maximizing its ability to deliver on its mandate to facilitate justice for certain plaintiffs and to promote public welfare through private rights of action.

\textsuperscript{162} 131 S. Ct. 2541 (2011).
\textsuperscript{163} 133 S. Ct. 1426 (2013).