A Matter of Interpretation
Appointing Class Counsel Through
Competitive Auctions Under the
Securities Reform Act

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An “emerging trend” in Securities Reform Act cases — over which the courts are split — is the use of fee-based competitive auctions to select counsel to represent plaintiff class members. In selecting class counsel from among bidders, courts seek to minimize the portion of any subsequent settlement or damages award diverted from class members in the form of attorneys’ fees. The use of auctions represents a substantial break from traditional practice, in which courts select a lead plaintiff, and the lead plaintiff selects counsel for the class. All of which raises the question: Under the Securities Reform Act, who should be charged with looking out for the interests of the absent class members — lead plaintiffs or the courts?
Much attention is being paid to what one court has called the “emerging trend” of using fee-based competitive auctions to select class counsel in securities class action litigation. This attention is, in large part, attributable to the magnitude of the attorneys’ fees at issue, the possibility that auctions will reduce these fees, and the split of authority concerning whether auctions are permitted under the Private Securities Litigation Reform Act of 1995 (Reform Act). The Third Circuit has indicated that this split “is a question of statutory interpretation [of the Reform Act], rather than one of judicial policy.” While this issue plainly turns on the interpretation of the Reform Act, the division of authority reflects an underlying tension among courts concerning what is very much a policy question: In selecting and retaining class counsel, who should be charged with identifying and protecting the interests of the absent class members — the lead plaintiff or the court? At the moment, that question has no clear answer.

The Score and the Stakes

Based on a count of published post-Reform Act district court decisions in which the auction issue was litigated, as of this writing the score is eight to two in favor of cases using auctions. Only one circuit court of appeals, the Third Circuit, has addressed the issue, and it rejected the district court’s use of an auction. Another circuit, the Ninth Circuit, currently has this question before it, and some have suggested that it may follow the Third Circuit on this issue.

The stakes are high. Fees awarded to class counsel can be enormous. In Cendant, for example, following a $3.2 billion settlement, the district court awarded a then-record $262 million in attorneys’ fees to class counsel. One of the principal motivations behind the use of auctions, however, is to reduce the portion of recoveries that is siphoned off as class counsel fees (though, ironically, the Cendant fee award was the product of an auction). Reducing such awards through the use of auctions may mean the transfer of tens of millions of dollars between class counsel and the class in a given case, and far more than that on an aggregate basis. And these stakes may get even higher. As the Third Circuit noted in Cendant, “[t]he enormous size of both the settlement and the fee award presages a new generation of ‘mega cases’ that will test our previously developed jurisprudence.” Such “mega cases” may have arrived already. As others have observed, with the burst in the technology bubble, the magnitude of the drop in market capitalization of certain technology companies — Cisco Systems, for example, shed more than $400 billion at one point — may lead to fee awards that are multiples
greater than the *Cendant* award.\textsuperscript{13} Plaintiffs and their lawyers therefore care a great deal about whether auctions are permissible under the Reform Act. In fact, Milberg Weiss Bershad Hynes & Lerach, perhaps the best-known plaintiffs’ firm of all — having lost an auction — is now challenging their use in the Ninth Circuit, seeking to overturn the district court’s appointment of another firm as class counsel.\textsuperscript{14}

**The Selection and Compensation of Class Counsel**

Prior to the Reform Act, “[c]ourts traditionally appoint[ed] lead plaintiff and lead counsel in class action lawsuits on a first come, first serve basis.”\textsuperscript{15} This practice fostered a “race to the courthouse” among parties seeking lead plaintiff status and spawned a cottage industry of law firms devoted to researching and identifying potential targets for these lawsuits, locating and enlisting plaintiffs, and acting as the driving force behind the litigations.\textsuperscript{16}

The Reform Act sought to change this situation. The act was intended, among other things, to minimize lawyer-driven litigation and to assure that plaintiffs “would control the litigation, not lawyers.”\textsuperscript{17} The Reform Act sought to accomplish this by selecting as lead plaintiff the party most capable of representing the interests of the class. The act therefore establishes a presumption that, among the parties seeking to lead the class, the person or group of persons with “the largest financial interest in the relief sought by the class” is “the most adequate plaintiff” to do so.\textsuperscript{18} It was thought that such a plaintiff — most likely a large institutional investor — would have the motivation and sophistication to control the litigation and to represent the interests of the absent class members.\textsuperscript{19} The Reform Act specifies that the “most adequate plaintiff” then “select[s] and retain[s]” class counsel, “subject to the approval of the court.”\textsuperscript{20} As discussed below, the use of auctions places directly at issue the interpretation of this provision of the Reform Act and the respective interests — and who should be charged with looking out for the interests — of the lead plaintiff and the absent class members in the process of selecting class counsel.

In both pre- and post-Reform Act cases, class counsel traditionally have been compensated for their work at the end of a class action litigation according to one of two methods. The “lodestar” method involves a determination of the reasonable hourly rate for work on a case and a calculation of the total fee by multiplying the hourly rate by the number of hours that counsel reasonably devoted to the case.\textsuperscript{21} The other traditional method of calculating class counsel’s fees is the “percentage-of-recovery” method. Under this approach, a court first calculates the percentage of the total recovery that the proposal would allocate to attorneys fees (that is, the fee sought by counsel divided by the total class recovery) and then assesses whether that amount is appropriate under the circumstances of the case.\textsuperscript{22}

The auction method — which was first employed in securities litigation in 1990,\textsuperscript{23} prior to the Reform Act and has also been used in nonsecurities cases\textsuperscript{24} — is much different. Although several variations have been utilized, an auction typically requires law firms to submit their qualifications and sealed fee proposals to the court in camera, and the court then chooses the counsel who it believes is qualified to represent the class and whose proposed fee is in the interest of the class.\textsuperscript{25} As a result, the use of an auction has at least two dramatic effects: (1) it places the choice of counsel in the hands of the court, not lead plaintiff’s; and (2) it sets the fee structure at the outset of the case — unlike the ex post fee evaluations traditionally undertaken by courts — when much about the case is necessarily unknown.

Auctions are intended to remedy certain shortcomings perceived in the lodestar and percentage-of-recovery methods. Some courts were frustrated with the prevailing methods of setting attorneys fees in class actions, which frequently left judges with the unsatisfying choice of rubber-stamping fee proposals or second guessing class counsel’s litigation performance after the fact.\textsuperscript{26} Other courts have noted that auctions seek to address the gap between the economic interests of lawyers and their clients in the class action context.\textsuperscript{27} As the Third Circuit observed in *Cendant*:

[A] rational, self-interested client seeks to maximize net recovery; he or she wants the representation to terminate when his or her gross recovery minus his or her counsel’s fee is greatest. In contrast, … a rational self-interested lawyer looks to maximize his or her net fee, and thus wants the representation to end at the moment where the difference between his or her fee and costs … is greatest. These two points rarely converge.\textsuperscript{28}

By setting counsel’s fees at the outset of the case, auctions seek to eliminate this potential conflict of interest. In addition, the use of auctions, unlike the other methods of compensating class counsel, benefits the class by injecting market efficiencies into the fee-setting process.\textsuperscript{29}

Regardless of the precise objectives of auctions — and whether those objectives have been met — a serious question remains concerning whether auctions are permitted under the Reform Act at all.

**The Split of Authority Concerning Auctions Under the Reform Act**

The fault line dividing the cases approving and disapproving of the use of auctions in Reform Act cases largely comes down to the interpretation of a single, 20-word sentence: “The most adequate plaintiff shall, subject to the approval of the court, select and retain counsel to represent the class.”\textsuperscript{30} This sentence seems to contain something for everyone. The decisions favoring auctions focus on the clause providing that counsel selection is “subject to the approval of the court,” while the decisions rejecting the auction procedure rely on the statutory mandate that the “most adequate plaintiff shall … select and retain counsel.” This difference in interpretation of this sentence reflects an underlying disagreement among courts concerning (1) the deference to be given to the class repre-
sentative’s choice of (and fee arrangement with) counsel; and (2) the need to protect the absent class members who have no input into the selection and compensation of counsel.

**Cases Employing Auctions**

The cases supporting the use of auctions tend to emphasize the obligations of the court and lead plaintiff to advance and protect the interests of the absent members of the putative class. These obligations have been characterized as, among other things, a lead plaintiff’s “fiduciary duty” to the absent class member\(^{34}\) and the court’s role as a “surrogate client” in place of the absent class members\(^{32}\).

Because any recovery for the class is reduced by the fees awarded to class counsel, these courts appear to view their statutory role of approving the selection of counsel as requiring them to ensure the selection of the most qualified counsel, and, at the same time, to endeavor to minimize counsel’s fees. As stated by the Northern District of California’s Judge Vaughn R. Walker, the first judge to employ an auction in a securities class action in 1990,\(^{33}\) the court “is charged with ensuring that the class receives quality representation at a fair price, and cannot, therefore, simply defer to lead plaintiffs’ choice of counsel.”\(^{34}\) As support for this obligation, courts have looked to other provisions of the Reform Act (apart from the sentence quoted above), which require courts to ensure that attorneys’ fees are “not to exceed a reasonable percentage of the amount of any damages paid to the class.”\(^{35}\) Courts have also looked to Rule 23 of the Federal Rules of Civil Procedure, which governs the certification of class actions and provides that a class may not be certified unless the court “concludes that the [class representative] will fairly and adequately protect the interests of the class.”\(^{36}\) Still other courts have looked to legislative history, reasoning that “the legislative history of the Reform Act reveals that Congress wished to encourage the exercise of discretion in approving the selection of lead counsel.”\(^{37}\)

Auctions, according to these courts, are the most effective framework for meeting the obligation to appoint qualified counsel at a reasonable price. As Judge William H. Walls of the District of New Jersey reasoned:

The task of lead counsel carries substantial responsibility. Lead counsel must represent not only the interests of a lead plaintiff, but all members of the putative class. It follows then that such responsibility should be borne by counsel of the highest professional talent, accompanied by a similarly high degree of integrity. Such talents have been developed and manifested in this type of litigation. Such qualities, per force, have been hewn by the adversarial foundation of our trial system. To seek the requisite reasonableness of costs for such talent which are to be borne by the entire plaintiff group in the event of recovery, it is the Court’s judgment that legal fees also be the subject of adversarial competition.\(^{38}\)

Other courts, in approving the use of auctions, have cited as evidence “expert” testimony supporting this view. In Network Assocs., for example, the court observed that “[a]lthough by professor Joseph Grundfest of the Stanford Law School … demonstrates that competitive bidding for the lead plaintiff role tends to reduce substantially the amount of fees awarded and tends to increase the amount of recovery to the class.”\(^{39}\)

On the other hand, Judge Milton I. Shadur of the Northern District of Illinois, a “leading proponent of the auction method,”\(^{40}\) needs to look no further than his own docket for empirical evidence:

[It is surely startling to observe that in the two cases in which this Court has employed the bidding process, each of which generated a settlement in the $50 million range worked out by extremely able and experienced plaintiffs’ class action counsel, the bid-generated fee award came to only 6 percent of the recovery. And what that meant in each case was that the plaintiff class members ended up with fully $10 million or more in their pockets than if the court had used the average or median fee award of 31.71 percent of the recovery, a figure cited in an expert affidavit].\(^{41}\)

Similarly, in Bank One, another Reform Act case in which Judge Shadur employed an auction, he noted that “the competing law firms ultimately received something in the range of 6 percent of the total class recovery of well over $50 million” and that the plaintiff class “was somewhere between $5 million and $10 million better off … than would have been true in the typical … arrangement.”\(^{42}\)

The courts employing auctions, therefore, interpret quite explicitly the Reform Act’s directive that courts approve class counsel as requiring them to advance the absent class members’ interest in minimizing attorneys’ fees over the lead plaintiff’s interest in selecting the attorneys to represent the class.

**Cases Rejecting Auctions**

One recent case rejects, and another severely limits, the use of auctions under the Reform Act. In contrast to the cases discussed above, both of these cases focus on the lead plaintiff — not on the absent class members — and the lead plaintiffs’ statutory right to “select and retain counsel.”

In August 2001, in Cendant, the Third Circuit overruled as “inconsistent with the Reform Act” a district court’s use of an auction to select class counsel.\(^{43}\) In that case, in an effort to respect the lead plaintiff’s choice of counsel, the district court permitted the counsel selected by the appointed lead plaintiff to match the bid that the court had chosen, which the counsel did.\(^{44}\) As a result, while the law firm that the lead plaintiff had selected was, in fact, appointed to represent the class, it did not do so based on the fee that it had initially negotiated with the plaintiff.

The Third Circuit rejected this approach. The Cendant...
court stated that “the question is not whether the court believes that the lead plaintiff could have made a better choice or gotten a better deal. … If the court’s inquiry is appropriately limited to whether the lead plaintiff’s selection and agreement with counsel are reasonable on their own terms.”45 Later in its opinion, the court of appeals elaborated upon the test for the trial judge, stating it as follows: “[T]he ultimate inquiry is always whether the lead plaintiff’s choices were the result of a good faith selection and negotiation process and were arrived at via meaningful arms-length bargaining.”46 In forming this view, the court stated its interpretation of the Reform Act’s requirement that the court approve the counsel selected and retained by lead plaintiff:

This language makes two things clear. First, the lead plaintiff’s right to select and retain counsel is not absolute — the court retains the power and the duty to supervise counsel selection and counsel retention. But second, and just as importantly, the power to “select and retain” counsel belongs, at least in the first instance, to the lead plaintiff, and the court’s role is confined to deciding whether to “approve” that choice. Because a court-ordered auction involves the court rather than the lead plaintiff choosing lead counsel and determining the financial terms of its retention, this latter determination strongly implies that an auction is not generally permissible in a Reform Act case, at least as a matter of first resort.47

The court cited three bases for its interpretation of the statute. First, looking at the “overall structure of the Reform Act’s lead plaintiff section,” and observing that “[t]he only powers expressly given to the lead plaintiffs … are to ‘select and retain’ counsel,” the court reasoned that it would be “odd for Congress to have established such a specific means for choosing a lead plaintiff” if the courts were to turn around and limit that means.48 Second, the court stated that, because the Reform Act’s lead plaintiff provision was “clearly modeled” on a proposal that asserted that large investors are better suited than courts to selecting counsel,49 this goal would be “significantly undermined were we to interpret the Reform Act as permitting courts to take decisions involving counsel selection away from the lead plaintiff by ordering an auction.”50 Third, citing the Reform Act’s legislative history, the court found that the purpose of the legislation was to “encourage institutional investors to serve as lead plaintiff.”51 However, after concluding that the use of auctions could not be squared with the Reform Act in the typical case (and holding, on the facts before it, that the district court had erred in using an auction), the Third Circuit “did[ ] not rule out the possibility that [an auction] could be validly used.”52 The court noted, as an example, that “[i]f the court determines that the lead plaintiff’s initial choice of counsel or negotiation of a retainer agreement is inadequate” and the lead plaintiff’s response is inadequate, an auction might be appropriate.53

Judge Jed S. Rakoff of the Southern District of New York came to a stricter conclusion in Razorfish three months earlier, in May 2001.54 Examining the sentence of the Reform Act quoted above, Judge Rakoff concluded that

By no reasonable reading of this language can the Court’s right to disapprove lead plaintiff’s choice of counsel be transmogrified into a right to arrange a shot-gun marriage between strangers [lead plaintiff and class counsel selected by an auction].55

The Razorfish Court reached this conclusion largely by construing the sentence of the Reform Act quoted above “in light of the language and the purpose of the Reform Act as a whole” — in particular, the presumption that the “most adequate plaintiff” is the one with the largest financial stake in the litigation:

The theory of these provisions was that if an investor with a large financial stake in the litigation was lead plaintiff, such a plaintiff — frequently a large financial institution or an otherwise sophisticated investor — would be motivated to act like a “real” client, carefully choosing counsel and monitoring counsel’s performance to make sure that adequate representation was delivered at a reasonable price.56

Judge Rakoff did, however, recognize that courts may consider the economic implications of the lead counsel decision, “since an excessive compensation proposal can cast in doubt the ability of the proposed lead counsel to adequately represent the class.”57 However, “[u]nder the approach mandated by the Reform Act … the primary focus must always be, not on the selection of counsel, but on the selection of lead plaintiff … most likely to exercise genuine supervision over their counsel and the conduct of the litigation.”58 Judge Rakoff therefore concluded that the Reform Act does not condone auctions, though he goes even further than the Third Circuit, stating that auctions are never appropriate under the Reform Act.

The Cendant and Razorfish Courts have, therefore, chosen to focus on lead plaintiffs and to rely heavily on lead plaintiffs to look out for the interests of the absent class members in selecting and retaining class counsel.

Conclusion

In coming to precisely opposite interpretations of a single sentence of the Reform Act, courts on both sides of the auction issue have relied upon the act’s text, its purpose, and its legislative history. Their respective decisions, however, rest on substantially divergent policy preferences concerning the interests of lead plaintiffs and absent class members — and who will look out for those interests — in the selection and compensation of class counsel. Only one circuit court has addressed this issue, and another is considering it. Other circuits will likely soon confront these interpretive and policy questions.
Endnotes


10. See Cendant, 264 F.3d at 217–18.

11. See id.

12. Id. at 218.


16. See id. (citation omitted).

17. See Lucent, 194 F.R.D. at 145.


21. See Cendant, 264 F.3d at 255.

22. See id. at 256.


25. See, e.g., Oracle, 131 F.R.D. at 697.


27. See Cendant, 201 F.3d at 256.

28. Id.


32. See Bank One, 96 F. Supp. 2d at 784-85.

33. See Oracle, 131 F.R.D. at 697.

34. Wenderbold, 188 F.R.D. at 587; accord Sherleigh Assocs., 184 F.R.D. at 693.


39. 76 F. Supp. 2d at 1033.

40. Cendant, 264 F.3d at 260 n.45.

41. Comdisco, 150 F. Supp. 2d at 950.

42. Bank One, 96 F. Supp. 2d at 784-85 n.5.

43. See Cendant, 264 F.3d at 220.

44. See id. at 219-20.

45. Id. at 276.

46. Id.

47. 264 F.3d at 273 (brackets in opinion).

48. See id.


50. See id.

51. Id. at 273-74.

52. Id. at 277.

53. Id.

54. 143 F. Supp. 2d at 304.

55. Id. at 310.

56. Id. at 307 (citation omitted).

57. Id. at 311.

58. Id.