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ARTICLES

AUCTIONING CLASS ACTION AND DERIVATIVE LAWSUITS: A CRITICAL ANALYSIS

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I. INTRODUCTION

Numerous legal academics and practitioners have criticized the handling by plaintiffs' attorneys of large-scale class action and derivative lawsuits.¹ These critiques point out attorneys' abuse of the legal system, ranging from purported collusion among plaintiffs' and defendants'

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¹ See Janet C. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991); John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877 (1987) [hereinafter Coffee, *Entrepreneurial Litigation*]; John C. Coffee, Jr., *Rethinking the Class Action: A Policy Primer on Reform*, 62 IND. L.J. 625 (1987); John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669 (1986) [hereinafter Coffee, *The Plaintiff's Attorney*]; John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 NO. 3 LAW & CONTEMP. PROBS. 5 (1985) [hereinafter Coffee, *The Unfaithful Champion*]; John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter is Not Working*, 42 MD. L. REV. 215 (1983) [hereinafter Coffee, *Rescuing the Private Attorney General*]; Leo Herzel & Robert K. Hagan, *Plaintiffs' Attorneys' Fees in Derivative and Class Actions*, 7 NO. 2 LITIG. 25 (1981); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORGANIZATION 55 (1991) [hereinafter Romano, *The Shareholder Suit*]; Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155 (1990); Roberta Romano, *What Went Wrong With Directors' and Officers' Liability Insurance?*, 14 DEL. J. CORP. L. 1 (1989).

counsel in settling cases to excessive charges by attorneys for prosecuting these cases.² Plaintiffs, with little stake in the litigation, collectively face tremendous problems policing the actions of their attorneys. Effective legal reform, several commentators have argued, requires joining the interests of plaintiffs and their attorneys.³

Judicial auctioning of lawsuits has been suggested as a means of more closely connecting the ownership and control of class action and derivative litigation.⁴ The benefits from auctioning lawsuits to the highest bidder are significant: combining the agent and the principal will result in focused ownership of the case and lead to the use of more efficient litigation techniques.

A recent article by Professors Jonathan Macey and Geoffrey Miller⁵ develops this nascent auction idea. Macey and Miller suggest that a judge should auction suitable class action or derivative claims to the highest bidder. The proceeds from the auction would be distributed among the plaintiff class, and the winning bidder would be free to conduct the litigation in the manner it believed most appropriate.

In this Article, we apply auction theory to examine two issues raised by this proposal. First, we analyze the question of who should conduct the auction, asking whether judges are the preferred auctioneers for these claims. We conclude that judges would make good auctioneers. In particular, judicial immunity to suit and judges' ability to enforce auction rules strictly will result in relatively greater auction proceeds for the injured parties than if other third-party auctioneers are employed.⁶

Second, we examine the costs of an auction system, finding them to be much greater than Macey and Miller recognize.⁷ In particular, we focus on three aspects of the cost equation. One, we observe that bidders

² See Coffee, *The Unfaithful Champion*, *supra* note 1, at 24 (discussing problems of collusion in the settlement of derivative actions); Coffee, *Rescuing the Private Attorney General*, *supra* note 1, at 232-33 (same); Macey & Miller, *supra* note 1, at 111. The prevalence of these abuses is reflected in the amount of time and effort that courts invest ensuring that settlements in collective actions are not tainted by fraud or collusion. See, e.g., *Malchman v. Davis*, 588 F. Supp. 1047, 1059 (S.D.N.Y. 1984) (conducting exhaustive review of settlement proposal to determine if there was any fraud or collusion), *modified*, 761 F.2d 893 (2d Cir. 1985); *Alleghany Corp. v. Kirby*, 218 F. Supp. 164 (S.D.N.Y. 1963) (same); 6A FEDERAL PROCEDURE, LAWYERS ED. § 12:124, at 22 (1989) (stating that a judicial finding of collusion defeats certification).

³ See Coffee, *The Unfaithful Champion*, *supra* note 1, at 77-79; Herzel & Hagan, *supra* note 1, at 27; Macey & Miller, *supra* note 1, at 6; Geoffrey P. Miller, *Some Agency Problems in Settlement*, 16 J. LEGAL STUD. 189, 209-15 (1987) [hereinafter Miller, *Some Agency Problems in Settlement*].

⁴ See *infra* note 66-69 and accompanying text for a discussion of these proposals.

⁵ Macey & Miller, *supra* note 1.

⁶ See *infra* notes 107-09, 114-15 and accompanying text.

⁷ On this point, we note that Macey and Miller do point out that there are significant costs to the auction method. Macey & Miller, *supra* note 1, at 110-16. They, however, are "confident" that the benefits of an auction technique will outweigh the costs. *Id.* at 110. We are less confident that an auction system would be an improvement over the existing system, except in those cases where the initial discovery costs for bidders are very low. See *infra* notes 146-49 and accompanying text.

in an auction have imperfect information about the value of the lawsuit being auctioned. Applying auction theory, we find that bidders' uncertainty about the value of a lawsuit lowers their bids in the auction. As a result, injured parties would not receive the expected value of their claim.⁸ Bidders could engage in discovery to lessen their uncertainty, but as we note below, increased discovery could reduce the value of the auction process.

Two, bidders' information problems are compounded if, as Macey and Miller suggest, we allow defendants to bid in the auction of the lawsuit brought against them.⁹ Defendants typically would have significant informational advantages over other bidders because of their ability to conduct their own rapid internal investigations of the circumstances surrounding a lawsuit. Outside parties, and even the injured parties themselves, would normally need to resort to the legal system's more cumbersome formal discovery process before they could even begin to obtain similar information. Bids received at an auction would reflect the effects of this informational asymmetry. Whatever the defendant bid for the claims being auctioned, other bidders would be reluctant to bid higher for fear that they would only win auctions where they overpaid for the case. This "winner's curse" problem implies that the auction price always falls short of the expected value of the case. Consequently, we conclude that defendants should be precluded from bidding in the auction.

Three, even if we exclude the defendant from the bidding, and permit bidders to engage in some form of discovery as to the merits of the claim, the auction process may be prohibitively expensive. Under an auction system, each bidder will need information about the case to establish the value of the claim being sold. This information can only be gathered, under the existing rules, through the discovery process. A fundamental result of auction theory is that the value of the bid received in the auction will, on average, be reduced by the aggregate sum of *all* bidders' discovery costs.¹⁰ The injured parties will therefore bear the burden of paying for this discovery through lowered auction proceeds. This problem seems inevitable with the auction mechanism. With the defendants excluded from the auction, settlement, if it happens, will probably have to occur after the auction takes place. At this point, the bidders will have already engaged in substantial discovery. As discovery costs will be subtracted from the winning bid, little, if any, increased efficiency seems likely to result from auctioning claims where bidders need to engage in extensive discovery to determine the value of the claim.

⁸ See *infra* notes 128-34 and accompanying text.

⁹ Macey & Miller, *supra* note 1, at 108.

¹⁰ See Kenneth R. French & Robert E. McCormick, *Sealed Bids, Sunk Costs, and the Process of Competition*, 57 J. BUS. 417, 424-25 (1984) (deriving general result); Jonathan R. Macey, *Auction Theory, MBOs and Property Rights in Corporate Assets*, 25 WAKE FOREST L. REV. 85, 88-90 (1990).

In light of these implications of auction theory, we conclude that auctions of class action and derivative lawsuits should have a place, albeit a restricted one, in our legal system. For that class of cases where the bidders' costs in determining the value of the claim are low, we believe that the benefits of eliminating agency costs exceed the costs of the auction process. Within this limited set of cases, we agree with Macey and Miller's conclusion that "the auction idea has sufficient merit to warrant at least a limited experiment to determine whether such a system would indeed be workable on a larger scale."¹¹

In the remainder of this Article, we expand on these arguments as follows: Part II looks at class action and derivative litigation from the perspective of the agency cost model. After describing current judicial practice in dealing with such lawsuits, this part examines the benefits of joining together ownership and control of class action and derivative lawsuits. Part III considers judges as auctioneers, analyzing the traditional legal rules for auctioneers and comparing this to the legal regime that would apply to judges as auctioneers. Part IV applies auction theory to look at the costs of auctioning class action and derivative lawsuits. Finally, in Part V, we discuss the conditions under which an auction system would work.

II. AGENCY COSTS IN CLASS ACTIONS AND DERIVATIVE LITIGATION

A. *Class Actions: Solving a Collective Action Problem*

Litigation is an expensive process. For parties with small dollar claims, the cost of filing and prosecuting a lawsuit may outweigh any potential recovery, even though society often picks up part of the litigation costs.¹² Where a large number of parties have suffered a similar

¹¹ Macey & Miller, *supra* note 1, at 118. Our recommendation assumes as an objective the maximizing of the plaintiffs' recovery. This objective might conflict with maximizing economic efficiency. For example, it is conceivable that an auction system would increase the plaintiff class's recovery but lead to more inefficient settlements if, for instance, settlements did not generally occur until after the auctions had been conducted.

¹² Where the injury suffered is slight in dollar terms or nonpecuniary, this private cost-benefit analysis can break down, and society can incur substantial costs for a private party's vindication of its rights. See Louis Kaplow, *Private Versus Social Costs in Bringing Suit*, 15 J. LEGAL STUD. 371, 371 (1986) (costs of operating the legal system create a divergence between actual private incentives to sue and socially optimal results); Steven Shavell, *The Social Versus the Private Incentive to Bring Suit in a Costly Legal System*, 11 J. LEGAL STUD. 333, 334 (1982) (same). For example, a California attorney recently won an appeal in his suit against the federal government's use of metal detectors in the federal courthouse in downtown Los Angeles. The attorney's shoes contained a metal shank which set off the metal detector, and he was required to take off the shoes and enter the courthouse in his socks. This, the attorney claimed, was humiliating. The Ninth Circuit agreed that the attorney should be allowed to bring this action and reversed the district court's dismissal of the action. The filing fee for the appeal was \$100. The estimated cost to the public of this suit was over \$5,600 for the appellate court's time alone. See Amy Stevens, *Lawyer Gets Chance To Appeal The Case Of Alarming Shoes*, WALL ST. J., Sept. 18, 1991, at B6.

injury, however, American law provides a device that enables the injured parties to band together to pursue their claims: the class action. The class action aims to overcome the collective action problems inherent in any effort to organize a large group of individuals' into one common project.¹³

Under the class action rules, a representative plaintiff can file an action and ask the court to certify her as the class representative. If the plaintiff and her attorney can satisfy the procedural prerequisites for certification, the court can certify the case as a class action that will bind all members in the defined class.¹⁴ The case will then proceed in the same manner as other litigation. The principal difference, for our purposes, is that the named plaintiff has little, if any, control over the conduct of class action litigation.¹⁵

B. Derivative Lawsuits: Shareholders Monitoring Management?

Corporations have standing to bring suit to remedy wrongs done them by third parties. As with any corporate action, the initial responsibility for bringing this action lies with the corporation's management. However, management may choose for self-interested reasons or otherwise not to file an action to enforce the corporation's rights.

The derivative lawsuit empowers a representative shareholder to step in for management and bring suit on behalf of the corporation.¹⁶ The suit is brought in the corporation's name to enforce its rights against parties that injured it. Recovery, if obtained, is on behalf of the corporation, although only after an award of attorney's fees is deducted from it.

In theory, these suits function as a mechanism for shareholders to monitor managerial misconduct.¹⁷ As many others have noted, when corporate managers have a small ownership stake in the corporation they run, the potential exists for them to enrich themselves at the expense of other shareholders.¹⁸ Using the derivative action, shareholders can in theory police management's diversion of resources to management's own personal uses.

¹³ Macey & Miller, *supra* note 1, at 8 (noting that the class action is "a tool for overcoming the free-rider and other collective action problems that impair any attempt to organize a large number of discrete individuals into any common project").

¹⁴ See generally FED. R. CIV. P. 23.

¹⁵ See *infra* notes 55-57 and accompanying text.

¹⁶ See generally FED. R. CIV. P. 23.1.

¹⁷ These liability rules are called into play when primary governance mechanisms—such as the board of directors, outside stock holders, and executive compensation—fail to monitor managerial misconduct, but the misconduct is not sufficiently great to cause a change of control. See Romano, *The Shareholder Suit*, *supra* note 1, at 55.

¹⁸ In this situation, the interests of the agent are likely to diverge from those of the principal. For a detailed discussion of this problem, see generally, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

However, a recent empirical study argues that "shareholder litigation is a weak, if not ineffective, instrument of corporate governance."¹⁹ Additionally, some critics have claimed that the device is frequently abused, with multiple lawsuits being filed by entrepreneurial attorneys at the announcement of any extraordinary transaction by a corporation.²⁰ The courts, perhaps attempting to rein in this alleged misconduct, have set strict procedural requirements that govern the bringing of derivative suits²¹ and require greater court supervision of the conduct of derivative litigation.²² The fundamental problem, however, lies in the inability of named plaintiffs to control effectively their attorneys' conduct.

C. *Inefficiencies Created by Attorney Selection and Compensation in the Existing System of Class Action and Derivative Litigation*

In class action and derivative lawsuits, the court has the power to appoint counsel for the litigation under the rules of civil procedure.²³ For example, the court approves the appointment of class lead counsel, and will reject the named plaintiff's chosen counsel in certain circumstances.²⁴ In most class action suits, however, the court simply appoints

¹⁹ Romano, *The Shareholder Suit*, *supra* note 1, at 84. In making these remarks, we do not intend to imply that shareholders' counsel do not make important contributions to the law through their actions. Any good corporate law casebook contains numerous decisions in which shareholder litigation has yielded very large recoveries and where shareholders' counsel has uncovered and effectively prosecuted corporate misconduct. In fact, our analysis suggests that in an auction system, shareholders' counsel are likely to be the (high) winning bidders.

²⁰ See *Piambino v. Bailey*, 757 F.2d 1112, 1143-44 (11th Cir. 1985); *Kahn v. Occidental Petroleum Corp.*, No. 10808, 1989 Del. Ch. LEXIS 92, at *8-*9 (Del. Ch. July 19, 1989). See also Alexander, *supra* note 1, at 528; R. Franklin Balotti & Mark J. Gentile, *Elimination or Limitation of Director Liability for Delaware Corporations*, 12 DEL. J. CORP. L. 5, 6-7 (1987); Roswell B. Perkins, *Avoiding Director Liability*, HARV. BUS. REV., May-June 1986, at 8; Joseph Flom, "Home Court" is Best Advantage, FIN. TIMES, June 27, 1991, § I, at 10.

²¹ See, e.g., FED. R. CIV. P. 23.1; *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 263 (1st Cir.) (stating that the complaint must allege with particularity the reasons for not making demand), *cert. denied*, 414 U.S. 857 (1973); *Grobow v. Perot*, 539 A.2d 180, 186-87 (Del. 1988) (same); *Aronson v. Lewis*, 473 A.2d 805, 814-15 (Del. 1983) (same).

²² See ROBERT CLARK, *CORPORATE LAW* 656-59 (1986) for a discussion of the court's role in the settlement process.

²³ See, e.g., FED. R. CIV. P. 23(d), which allows the trial court to make appropriate orders (1) determining the course of proceedings or prescribing measures to prevent undue repetition or complication in the presentation of evidence or argument; (2) requiring, for the protection of the members of the class . . . that notice be given . . . to some or all members of any step in the action, or of the proposed extent of the judgment, or of the opportunity of members to . . . intervene and present claims or defenses; . . . (3) imposing conditions on the representative parties or on intervenors; . . . and (5) dealing with similar procedural matters.

Id.

²⁴ The federal courts derive this power from FED. R. CIV. P. 23(d)(1). *Percodani v. Riker-Maxson Corp.*, 51 F.R.D. 263, 265 (S.D.N.Y. 1970), *aff'd sub nom.*, *Farber v. Riker-Maxson Corp.*, 442 F.2d 457 (2d Cir. 1971). Where the plaintiff's suggested counsel does not demonstrate the necessary experience or resources to prosecute an action, the courts have refused to appoint them as lead counsel. See, e.g., *Cullen v. New York State Civil Serv. Comm'n*, 566 F.2d 846, 847 (2d Cir. 1977).

the attorney who was first to file the action, rather than others who seek to intervene later.²⁵

The court's authority extends to naming counsel where several class or derivative actions are consolidated.²⁶ Judicial attempts to ensure efficient prosecution of these actions can also take the form of the designation of a "Plaintiffs' Committee" whose members are compensated for their work for the class.²⁷ Intense negotiations are often conducted amongst plaintiffs' counsel for positions on these committees.²⁸

Lead counsel, or the Plaintiffs' Committee, can be given substantial authority to conduct the litigation, even to the exclusion of other counsel.²⁹ For example, in *In re Ivan Boesky Securities Litigation*,³⁰ the Second Circuit vested the lead counsel with virtually all the responsibilities listed in the *Manual for Complex Litigation*.³¹

Discovery efforts of the plaintiffs' counsel are generally coordinated by the lead counsel.³² Discovery can include several forms of informal and formal fact-finding: document review and document production requests, witness interviews and depositions of witnesses, drafting multiple rounds of interrogatories and working with expert witnesses.³³ This discovery can be very costly and time consuming, both for the parties and

²⁵ See, e.g., *Schatte v. International Alliance of Theatrical Stage Employees*, 183 F.2d 685, 687 (9th Cir. 1950). This practice has the effect of rewarding attorney search activity. See *infra* note 39 for further discussion of this point.

²⁶ See, e.g., *Feldman v. Hanley*, 49 F.R.D. 48 (S.D.N.Y. 1969). In this case, the court granted the defendant's request to appoint a lead counsel, despite some of the plaintiff's objections, stating that lead counsel would "merely supervise and coordinate the conduct of plaintiffs' cases." *Id.* at 51 (quoting *MacAlister v. Guterma*, 263 F.2d 65, 68-69 (2d Cir. 1958)).

²⁷ See, e.g., *In re Air Crash Disaster v. Eastern Airlines, Inc.*, 549 F.2d 1006 (5th Cir. 1977). In this consolidated action involving more than 150 claims for death and injuries arising out of the crash of an Eastern Airlines passenger plane, the court appointed a "Plaintiffs' Committee" as "lead counsel" for the plaintiffs. The court awarded compensation to the Committee for its work as lead counsel by ordering each attorney, save those who had actively participated in pretrial activities, to pay the Committee part of the fee she was entitled to receive from her client. *Id.* at 1008. For discussions of the creation of plaintiffs' committees, see *MANUAL FOR COMPLEX LITIGATION* 2D § 20.221 (5th ed. 1982) and 2 H. NEWBERG, *NEWBERG ON CLASS ACTIONS* 284 (2d ed. 1985).

²⁸ See *Coffee, Entrepreneurial Litigation*, *supra* note 1, at 909; *Coffee, Rescuing The Private Attorney General*, *supra* note 1, at 274-78.

²⁹ *In re Air Crash*, 549 F.2d at 1015.

³⁰ 948 F.2d 1358 (2d Cir. 1991).

³¹ *Id.* at 1360.

The *Manual for Complex Litigation* summarizes the responsibilities of lead counsel as follows:

Lead counsel ordinarily have major responsibility for formulating and presenting positions on substantive and procedural issues during the litigation. Typically they act for the group—either personally or by coordinating the efforts of others—in presenting written and oral arguments and suggestions to the court, working with opposing counsel in developing and implementing plans for conduct of the litigation, initiating and organizing discovery requests and responses, conducting the principal examination of deponents, employing experts, arranging for support services, and seeing that schedules are met.

MANUAL FOR COMPLEX LITIGATION 2D § 20.221 (1985).

³² See *MANUAL FOR COMPLEX LITIGATION* 2D § 20.221 (1985).

³³ See generally 2 JAMES W. MOORE ET AL., *MOORE'S MANUAL FOR FEDERAL PRACTICE AND*

for the court, because both sides frequently resist the opposing attorneys' discovery requests.³⁴ For consolidated actions, all of the plaintiffs' discovery requests are generally grouped together so that the defendant has to respond to only one request and unnecessary duplication of effort can be avoided.³⁵

Lead counsel also plays a significant role in the settlement of class actions and derivative lawsuits. The lead attorney must give notice of a settlement to the class members and the other attorneys. However, the lead attorney has authority to negotiate and propose a settlement to the court without obtaining the approval of every plaintiffs' attorney involved in the matter.³⁶ If the court approves the settlement, a requirement in any class action or derivative suit for the settlement to become effective,³⁷ the court must still determine the amount of attorneys' fees it will award to the plaintiffs' attorneys.³⁸

Significant costs arise from the selection of inefficient attorneys to act as lead counsel. The current practice for selecting the plaintiffs' attorney seems to be concerned more with awarding the control of the litigation to the first attorney who files, or to those attorneys who can negotiate strong positions in the Plaintiffs' Committee, than with the efficient prosecution of the case.³⁹ Efficiency would require that some method be used to ascertain the comparative effectiveness and cost of the different attorneys handling the case. The case should then be assigned to that attorney offering the best combination of these two factors.⁴⁰

Under the current system, once selected, the plaintiffs' attorneys'

PROCEDURE, §§ 15.01-14 (1992) [hereinafter MOORE ET AL.] for discovery purposes and techniques.

³⁴ See 2 CARL R. ARON ET AL., CLASS ACTIONS: LAW AND PRACTICE, § 25:02 (1987) for a discussion of discovery costs and delays in class action and derivative suits. For a discussion of abuses of the discovery process and possible objections to excessive discovery requests, see 2 MOORE ET AL., *supra* note 33, at § 15.02[1][a] nn.4, 5 & 14. For a review of costs imposed by discovery on the courts, see MANUAL FOR COMPLEX LITIGATION 2D § 21.42 (1985).

³⁵ See MANUAL FOR COMPLEX LITIGATION 2D § 21.42 (1985).

³⁶ See *In re Ivan Boesky Sec. Litig.*, 948 F.2d 1358, 1365 (2d Cir. 1991) (noting, however, that "the failure to communicate and consult with other plaintiffs' counsel is grounds for rejection of the settlement").

³⁷ 7B CHARLES A. WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE §§ 1797, 1797.1 (1990).

³⁸ See, e.g., *Magana v. Platzer Shipyard, Inc.*, 74 F.R.D. 61, 66-78 (S.D. Tex. 1977).

³⁹ In part, courts are rewarding search activity by appointing the first filing attorney as lead counsel. As Macey and Miller point out, an auction system must make specific provisions to reward search activity if we believe that these search activities are beneficial. See Macey & Miller, *supra* note 1, at 106. However, the net impact on search activity of directly compensating the first filing attorney is unclear. If existing incentives are adequate, and the revised system increases the rewards for being the first to file, it could provide even greater incentives to file cases without adequate investigation of their merits. Likewise, if the change in the compensation system reduces the incentives to engage in search, suboptimal search activities could result.

⁴⁰ It is, however, still possible that an efficient mix of legal resources for prosecuting any given suit will involve a syndicate of various law firms. See Robert G. Hansen, *Firms and Syndicates:*

incentives are governed by the method of their compensation.⁴¹ Attorney compensation in common fund cases, where the plaintiffs' attorneys can point to a fund that they have generated through the litigation for the benefit of the class,⁴² is presently calculated by one of two basic methods: the lodestar method⁴³ or the percentage method.⁴⁴ The different compensation methods produce different inefficiencies.

The lodestar method of determining attorneys' fees requires the judge to take a reasonable number of hours expended by the plaintiffs' attorneys and multiply it by a reasonable hourly rate to compute a "lodestar" amount.⁴⁵ This amount is then adjusted, where needed, to take account of certain factors, including such things as the risk of losing the case.

The lodestar method's obvious problem is that it gives attorneys little incentive to control hours and costs; as long as fees are less than any settlement, the attorney can be reasonably sure of having most of his costs paid for.⁴⁶ Attempts by judges to investigate critically the reasonableness of certain activities undertaken by the attorney are unlikely to be successful.⁴⁷ Indeed, judicial supervision could worsen the situation by making certain classes of activities especially prone to judicial review and therefore risky to undertake, from the point of view of the attorney. Consequently, there would be a tendency to avoid these activities even in cases where they would benefit the plaintiffs.

The lodestar compensation method can also generate incentives for inefficient settlements. If the attorney is confident that additional hours will be paid for, then there is really no incentive to accept a settlement at any time: the attorney should continue to prosecute the case as long as possible.⁴⁸ On the other hand, if the attorney is uncertain whether a judge will allow additional hours to be paid for, then the incentive will be

Efficient Structure For Transactions Oriented Industry (Sept. 1986) (unpublished manuscript, on file with the *Northwestern University Law Review*).

⁴¹ See Alexander, *supra* note 1, at 527-57; Coffee, *The Plaintiff's Attorney*, *supra* note 1, at 670; Miller, *Some Agency Problems in Settlement*, *supra* note 3, at 193.

⁴² The common fund doctrine is an exception to the general American rule that each party bears its own attorneys' fees. See Dan B. Dobbs, *Awarding Attorney Fees Against Adversaries: Introducing the Problem*, 1986 DUKE L.J. 435, 435.

⁴³ The lodestar method was first formulated in *Lindy Bros. Builders, Inc. v. American Radiator & Standard Sanitary Corp.*, 487 F.2d 161, 165 (3d Cir. 1973).

⁴⁴ See, e.g., *In re Oracle Sec. Litig.*, 131 F.R.D. 688, 695 (N.D. Cal. 1990).

⁴⁵ Macey & Miller, *supra* note 1, at 22, 50.

⁴⁶ See Herzog & Hagan, *supra* note 1, at 25.

⁴⁷ See Macey & Miller, *supra* note 1, at 12-27, 44-50 (discussing the general problem of one, monitoring the activities of attorneys—especially in derivative suits—and two, judicial review of settlement negotiations and fee requests).

⁴⁸ See Alexander, *supra* note 1, at 535-48 (discussing the effects of the lodestar method, *inter alia*, on the plaintiffs' counsel); Miller, *Some Agency Problems in Settlement*, *supra* note 3, at 202-03 (discussing generally the nonoptimal settlement effects when a plaintiff's attorney controls the settlement and is paid under an hourly compensation method).

for the attorney to settle immediately, rather than incur additional hours for which he will not be compensated. This would be the case even if additional work would increase the likely settlement value of the case to the plaintiffs by a significant amount. Thus, it is unclear whether the application of the lodestar method generally causes settlements to be reached too early or too late.

Additionally, the lodestar method gives little economic incentive for efficient prosecution of the case. For example, there is little incentive under the lodestar compensation method for the plaintiffs' attorneys to monitor their overall efforts to ensure that the case is proceeding so as to maximize the value of the settlement. The overall prosecutorial effort should be expected to be mediocre, for more effective prosecution would only result in more money for the plaintiffs and, if anything, fewer billable hours for the attorney.

The percentage method in class actions and derivative litigation, which has become more popular in recent years, resembles the contingent fee award in ordinary litigation. Under this method, fees are awarded based on a fixed percentage of the fund created by the litigation.

Percentage compensation methods will generally give attorneys the proper incentive to control legal costs, for there is no direct compensation for additional hours billed. Payments to the attorney will increase with additional effort only if that additional effort results in a higher settlement. But therein lies the problem with percentage compensation: if the attorney spends resources to increase the settlement, she can look forward only to receiving a fraction of the increase. This means that the attorney will generally devote *too little* effort to increasing the settlement. For example, if an additional hour of effort increases the expected proceeds by \$500, that effort will not be undertaken if the attorney's hourly cost is \$200 and her anticipated additional compensation is twenty percent of the increase in the settlement (\$100 in this case).

For this reason, we will expect to see too-early settlement for too-low of an amount. Of course, attorney compensation could be adjusted using a progressive percentage structure, where the attorney's contingent fees would increase with the size of the recovery, or the stage of the litigation.⁴⁹ If such a system could be properly constructed, it would more closely align the attorney's and the client's interests. It would not, how-

⁴⁹ For a discussion of attempts to circumvent this effect using a sliding-scale method, see Miller, *Some Agency Problems in Settlement*, *supra* note 3, at 201-02. Miller discusses the potential benefits of providing a sliding scale for contingent fees "based on a rough proxy for the amount of work the attorney has performed." *Id.* at 201. Miller gives as an example an agreement where the attorney gets a 20% fee if the case settles before pretrial motions are decided, a 25% fee if the case is settled before trial, a 30% fee if the case is tried and won but not appealed, and a 35% fee if the case is appealed by the defendant. He concludes that this approach has merit in that it equalizes the returns to attorneys from settling cases at different stages of the litigation, but that it is at best a rough corrective measure. *Id.*

ever, guarantee “that the settlement figure that the attorney would accept would give the client a return equal to the client’s return from trial.”⁵⁰

Our analysis of the agency costs inherent in class action and derivative lawsuits conflicts with the received legal model of the attorney-client relationship. This model presumes that the attorney is the agent of the client. Under the legal profession’s ethical rules, the attorney has a duty to advance the client’s interests to the furthest extent permissible.⁵¹ Clients are said to keep watch over their attorneys using monitoring devices,⁵² bonding mechanisms,⁵³ and incentive structures.⁵⁴

Reality is a dim reflection of this model. Despite the strictures of the received legal model of the attorney-client relationship, the plaintiffs’ attorney, not the plaintiffs, in these actions controls the conduct of every important aspect of the litigation.⁵⁵ Bonding mechanisms are weak and ineffective.⁵⁶ The divergence of attorney and client interests may be so wide as to render it almost impossible to create strong incentives for plaintiffs’ attorneys to act in their clients’ best interests.⁵⁷ Individual plaintiffs cannot, by themselves, effectively control the agency costs that arise from the attorney-client relationship in these cases.

Nor do judges, in the existing legal system, provide a reasonable proxy for effective client involvement in the lawsuit. For example, judicial review of settlements does not adequately protect the injured parties’ interests, for judges have a strong interest in approving the settlement,

⁵⁰ *Id.* at 201-02. Clermont and Currivan suggest that these problems could be eliminated through the use of a fee structure that included both hourly and contingent fees. Kevin M. Clermont & John D. Currivan, *Improving on the Contingent Fee*, 63 CORNELL L. REV. 529, 578-85 (1978).

⁵¹ Macey & Miller, *supra* note 1, at 12.

⁵² *Id.* at 13-15. Clients have some methods of monitoring an attorney’s conduct. Some examples of client monitoring include assessing attorneys’ reputation before hiring them and getting second opinions from other lawyers. The legal regulatory system also has a number of features designed to reduce these monitoring costs, such as bar admissions requirements and retention of good standing in the bar. *Id.*

⁵³ *Id.* at 16-17. Several bonding mechanisms exist for lawyers. For instance, the lawyer will not engage in egregious misconduct for fear of both losing her right to practice law and suffering harm to her reputation. *Id.*

⁵⁴ *Id.* at 17-19. Incentive structures that reduce the disparity between the client’s and the attorney’s interests can act as partial, but incomplete, methods of aligning the interests of the two. Incentive devices include compensation methods for attorneys and the lawyer’s basic ethical obligations under the Model Code of Professional Responsibility. *Id.* For further discussion of the problems caused by existing compensation methods in class actions and derivative lawsuits, see *supra* notes 41-50 and accompanying text.

⁵⁵ Macey & Miller, *supra* note 1, at 19-20. Client monitoring in derivative and class action lawsuits fails to effectively align the clients’ and attorneys’ interests for several reasons. The main reason is that the class members often have relatively small claims so that the conduct of the litigation is a matter of little consequence for them. Even clients that might choose to monitor actively the litigation will have difficulty in doing so because they frequently do not know about the litigation until they have received the official notice of settlement. *Id.*

⁵⁶ *Id.* at 20-22.

⁵⁷ *Id.* at 22-27.

lack sufficient information to make informed judgments about the fairness of settlements, and cannot rely on the adversary system to provide them with a balanced view of the proposed settlement.⁵⁸ Similarly, judges face tremendous obstacles in trying to review critically attorney fee applications under the existing formulas.⁵⁹

D. Auctions of Lawsuits: The Costs and Benefits of Reuniting Ownership and Control

Numerous critics of the existing system have pointed out these costs and made proposals to reform the system. Recently, a number of proposals have surfaced for auctioning lawsuits as a method of improving the legal system's handling of large-scale, small dollar value claims.⁶⁰ The leading proponents of the auction model, Professors Macey and Miller, have described the mechanics of such an auction system as follows.⁶¹

Whenever a complaint with class action or derivative claims is filed with the court, a judge would make an initial determination of whether an auction procedure should be employed. The judge would need to answer several questions, including whether the case was large-scale, small claim litigation; how many complaints had been filed; how the claims in the case are defined; and whether there are any other factors that generally mitigate against auctioning off the claim.⁶² If the judge determined that auction treatment was appropriate, she would define the claim being sold, post notice of the auction to invite bidders to participate, and select a bidding procedure for the auction. Interested bidders, including the defendant(s), would have the opportunity to investigate the claim through discovery.

The auction would then be held, and the claim awarded to the highest bidder.⁶³ The winning bidder would pay the amount of its bid to the court, and the judge would deduct all expenses she determined appropriate, including some amount as compensation for the attorneys that first filed the suit. Finally, the judge would distribute the net proceeds of the

⁵⁸ *Id.* at 45-47.

⁵⁹ *Id.* at 48-61.

⁶⁰ See Herzel & Hagan, *supra* note 1, at 27; Macey & Miller, *supra* note 1, at 105-16. See also Coffee, *The Plaintiff's Attorney*, *supra* note 1, at 691-93 (raising but rejecting idea because of potential to chill search activity); Coffee, *The Unfaithful Champion*, *supra* note 1, at 77-79 (1985) (same).

⁶¹ We make no attempt to defend all facets of Macey and Miller's proposal. Instead, we focus in this paper on several economic issues raised by their proposed auction system. Macey and Miller's paper addresses many of the obvious difficulties with implementing an auction system, including the existing legal obstacles to creating an auction system embodied in the doctrines of champerty and maintenance. See Macey & Miller, *supra* note 1, at 97-105. We refer the interested reader to their article for further discussion of those points.

⁶² Macey & Miller, *supra* note 1, at 106.

⁶³ *Id.* at 107.

auction to the injured parties.⁶⁴

The winning bidder would be free to prosecute the claim in whatever manner she chose. If the defendant(s) won the auction, they could cause the suit to be dismissed with prejudice immediately.⁶⁵ Otherwise, the litigation would proceed in a manner similar to that of any other claim.

1. Benefits of Auctions.—Auctioning lawsuits to the highest bidder unites ownership and control of the lawsuit in one party. The main benefit of such an auction is plain: if the party controlling the prosecution of the claim owns the claim, agency costs are minimized.⁶⁶ Winning bidders would have incentives to prosecute their claims in an economically efficient manner.

The collective action problems considered inherent in class actions and derivative lawsuits would be wiped out. For example, no incentives would exist for collusive settlements between defendants and plaintiffs, and the courts would not need to spend their time monitoring such settlements to protect the class's interests.⁶⁷

Additionally, focused ownership of the suit would improve the conduct of the litigation. Winning bidders would reduce the costs of pursuing the claim to maximize their net recovery.⁶⁸ The incentives under the current system to increase attorney hours spent in litigation and to pad expenses would be eliminated.

Finally, the auction mechanism has the added advantage of allocating the suit being sold to the highest valued bidder.⁶⁹ The most skilled law firms who can maximize the net recovery on the claim should, on average, win the auction. The overall quality of the plaintiff's bar will benefit from this process, and this effect should spill over to injured parties and corporations.

2. Costs of an Auction System.—An auction system would be difficult to implement. Macey and Miller identify several problems with an auction system, including the judge's ability to define the scope of the claim to be auctioned, the potential for collusion among the bidders, the possibility of too few or too many bidders emerging at the auction, the difficulty of arranging financing for bidders, the need to insure the coop-

⁶⁴ *Id.*

⁶⁵ *Id.* at 108.

⁶⁶ *Id.* at 108-09. Agency costs could be completely eliminated if the winning bidder turns out to be the lawyer who ultimately prosecutes the claim. In any other case, the winning bidder will need to retain counsel, and consequently, there will remain the agency costs inevitably present between lawyers and clients in ordinary litigation.

⁶⁷ *Id.* at 109.

⁶⁸ *Id.*

⁶⁹ *Id.* at 109-10.

eration of the plaintiff class in the case,⁷⁰ and the necessity of compensating those attorneys who are the first to file in the litigation for their search costs.⁷¹ We agree with their analysis and conclusion that these problems, while serious, can be overcome.

We focus on two important aspects of implementing an auction system for lawsuits that Macey and Miller do not address. First, who should be the auctioneer for lawsuits? Macey and Miller assume that judges will act as auctioneers, but never ask whether judges would be good auctioneers. We compare judicial auctioneers to common-law auctioneers to determine whether judicial auctioneers will have the proper incentives to maximize revenues for injured parties.

Next, we ask how should the bidders be informed about the value of the lawsuit they are bidding for, and what are the implications of this information-collecting process for auction bidding levels. Macey and Miller assume that allowing bidders to engage in discovery before the auction of the lawsuit will increase auction revenues. Using auction theory, we show that allowing uncontrolled bidder discovery will lead to lower auction revenues. In fact, we propose that auctioneers permit only one, relatively thorough, discovery process to take place and that the results of this discovery be made publicly available to all potential bidders.

III. SHOULD JUDGES ACT AS AUCTIONEERS?

Courts have experience in auctioning things: companies, manufac-

⁷⁰ Once the individual plaintiff has received payment after the auction, there would be little reason for them to cooperate in the conduct of the litigation should testimony or other proof be needed to establish the claim or the amount of damages. See Macey & Miller, *supra* note 1, at 114. These witnesses could be compelled to give testimony through the usual subpoena procedure. Those plaintiffs not otherwise subject to the court's jurisdiction could be required to agree to give evidence as a condition of receiving their share of the auction proceeds. Alternatively, we could allow bidders to offer to pay part of the consideration in the auction in securities whose value depends on the outcome of the litigation. Contingent payment rights have been used as a method of payment to shareholders in a corporate buyout. See, e.g., *Braunschweiger v. American Home Shield Corp.*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,799, at 94,190-191 (Del. Ch. Oct. 26, 1989) (merger consideration included contingent payment right securities where the value of the security depended on the company's future earnings). The use of noncash methods of payment in an auction can be desirable from both the buyer and the seller's points of view. See Randall S. Thomas & Robert G. Hansen, *A Theoretic Analysis of Corporate Auctioneer Liability Regimes*, 1992 WIS. L. REV. 1147. As Professor Miller has pointed out, however, the use of these securities does raise several other issues, including the reintroduction of an agency cost by requiring the owner of the claims to share the fruits of her labor, thereby reducing her incentives to prosecute the claim vigorously. Letter from Geoffrey P. Miller, Professor, *University of Chicago Law School*, to Randall S. Thomas, Professor, *University of Iowa Law School*, 2 (Apr. 20, 1992) (on file with the *Northwestern University Law Review*).

⁷¹ For a general discussion of each of these problems, see Macey & Miller, *supra* note 1, at 111-15.

ured goods, even the role of lead counsel in class action litigation.⁷² In our current litigation system, if we choose to auction lawsuits, making the judge the auctioneer of lawsuits seems natural: the trial courts will have to hear the case if it does not settle, they have broad discretion to appoint counsel for the class,⁷³ they have the power to replace class counsel for inadequate representation of the class,⁷⁴ and they can determine the amount of attorney fees that class counsel are entitled to receive.⁷⁵ Drawing on these powers, and their "fiduciary duty" to protect the interests of the class, the trial courts already have asserted that they have the power to conduct auctions of the lead counsel role in class action litigation.⁷⁶ From here it is a short step to assert that the courts could be empowered to act as class action and derivative suit auctioneers.

Yet, the fact that judges are well positioned to act as auctioneers does not necessarily mean that they are the best party to assume that role. For one thing, judges have no economic incentive to insure that the auction is conducted properly. Under the Code of Judicial Conduct, judges can have no economic interest in the outcome of a case, and therefore cannot be given monetary incentives to sell to the highest bidder.⁷⁷ Hence, no market mechanism is in place that will act to enforce efficient judicial auctioneer behavior.

Nor is it clear how the seller can monitor the auction process by bringing suit against a judicial auctioneer if the auction is not conducted properly. Judges enjoy immunity from suit for actions they take in furtherance of their judicial responsibilities.⁷⁸ At first blush, there appears to be little that a disgruntled injured plaintiff, particularly one with a small dollar interest in the case, can do to identify or object to a poorly conducted judicial auction.⁷⁹

⁷² See *infra* Part III.B for further discussion of judges' role as auctioneers in the existing legal system.

⁷³ See *In re Agent Orange Prod. Liab. Litig.*, 818 F.2d 179, 187 (2d Cir. 1987); *County of Suffolk v. Long Island Lighting Co.*, 710 F. Supp. 1422, 1425 (E.D.N.Y. 1989), *aff'd*, 907 F.2d 1295 (2d Cir. 1990).

⁷⁴ See *In re Agent Orange Prod. Liab. Litig.*, 818 F.2d 179, 187 (2d Cir. 1987); *Cullen v. New York State Civil Serv. Comm'n*, 435 F. Supp. 546, 563-64 (E.D.N.Y.), *appeal dismissed*, 566 F.2d 846, 848-49 (2d Cir. 1977).

⁷⁵ The trial court has discretion to determine the amount of attorney fees awarded in a class action, subject to a general standard of reasonableness. See, e.g., *Angoff v. Goldfine*, 270 F.2d 185, 186 (1st Cir. 1959); *Wewoka v. Banker*, 117 F.2d 839, 840 (10th Cir. 1941).

⁷⁶ See *In re Oracle Sec. Litig.*, 136 F.R.D. 639, 641 (N.D. Cal. 1991).

⁷⁷ See CODE OF JUDICIAL CONDUCT Canon 3C(1)(c) (1972); see also 28 U.S.C. § 455(b)(4) (1988); MODEL CODE OF JUDICIAL CONDUCT Canon 3E(1)(c) (1990).

⁷⁸ See generally *Mireles v. Waco*, 112 S. Ct. 286 (1991).

⁷⁹ When the parties' personal stakes in the outcome of the auction are high, they have stronger incentives to police judicial auctions. For example, in the judicial auction of the Financial News Network (FNN), the bankruptcy court initially refused to consider a higher bid by Dow Jones Group W (Dow) because it did not appear to satisfy one of the conditions that the court had imposed for bids. *In re Financial News Network, Inc.*, 126 B.R. 152, 154 (S.D.N.Y. 1991) [hereinafter *FNN I*]. Dow promptly appealed this decision to the district court and succeeded in getting the

In the remainder of this Part, we look more closely at the question of whether judges should be lawsuit auctioneers. We begin by examining common-law auctioneers, and identifying the important legal features of the relationship between the auctioneer and the seller. We then discuss how a judicial auctioneer would differ from the common-law auctioneer and whether the injured party is likely to be as well off in an auction conducted by a judge as in an auction conducted by a common-law auctioneer.

A. *The Common-Law Auctioneer: The Seller's Fiduciary*

An auctioneer's job is to get bidders to pay as much as possible for what she sells.⁸⁰ The auctioneer is charged with getting the best price possible for the goods⁸¹ subject to a minimum reservation price.⁸² If the bidding does not reach the reservation price set by the seller, or the buyer fails to pay the purchase price at the required time, then the goods are not sold, or as an auctioneer would say, "bought in."⁸³

The law views auctioneers as agents of the seller. They must follow the seller's instructions, seek the highest price, and act consistently with their fiduciary duties toward their principal.⁸⁴ Furthermore, as the principal's agent, the auctioneer cannot purchase or otherwise have an interest in the property which it is employed to sell.⁸⁵ If the auctioneer conducts the auction in a negligent manner, the principal has a cause of

bankruptcy court's order reversed and the auction reopened. *Id.* at 157. Undoubtedly, this appeal was expensive and would not be cost-justified for any single injured party in the small-claim class actions we are discussing here.

⁸⁰ Auctions may take many forms. One important distinction is whether other bidders will know what others have bid. Open, or oral, auctions result in other bidders learning what the other bidders have bid. Sealed-bid auctions require the bidders to submit their bids without knowing what other bidders will do. Bidders' ability to learn what others have bid, as we shall show below, has important implications for what each bidder will bid. For a general description of the different types of auctions and their characteristics, see R. Preston McAfee & John McMillan, *Auctions and Bidding*, 25 J. ECON. LITERATURE 699, 702-03 (1987).

⁸¹ If bidders know the value to themselves of the goods being sold, that is, their value does not depend on what other persons believe they are worth, then in an oral auction, bidders will bid up to the price that reflects their willingness to pay. Paul Milgrom, *Auctions and Bidding: A Primer*, 3 No. 3 J. ECON. PERSP. 3, 8 (1989). If bidders behave in this way, the item will be awarded to the bidder who values it most highly for a price equal to the second-highest valuation. *Id.*

⁸² Reservation prices keep items from selling at prices below a certain minimum level. For rare paintings from the Impressionist period, it has been estimated that about one-third of the paintings put up for auction in the early 1980s were left unsold when the bids made at auction failed to exceed their reservation price. Orley Ashenfelter, *How Auctions Work For Wine and Art*, 3 No. 3 J. ECON. PERSP. 23, 24 (1989).

⁸³ *Id.*

⁸⁴ See, e.g., *Elco Shoe Mfg., Inc. v. Sisk*, 260 N.Y. 100, 103 (1932); *Cristallina S.A. v. Christie, Manson & Woods Int'l (Inc.)*, 502 N.Y.S.2d 165, 171 (App. Div. 1986).

⁸⁵ *Moore v. Moore*, 5 N.Y. 256, 261 (1851); *Holston v. Pennington*, 304 S.E.2d 287, 291 (Va. 1983).

action under agency principles against the auctioneer.⁸⁶

In most auctions, auctioneers have no duties to third parties, such as disappointed bidders.⁸⁷ An auctioneer's duties to a buyer are also quite limited⁸⁸ unless the auctioneer charges a commission to both the seller and the buyer.⁸⁹ Where both the seller and the buyer are paying the auctioneer a commission, the auctioneer can have legal obligations to the buyer.⁹⁰

Sophisticated and large auctioneers will carry liability coverage against suits by bidders and other third parties for actions they took in the course of their auctioneering duties. If the items sold are sufficiently valuable, the auctioneer may require the seller to agree to indemnify it for any risk involved in the sale.⁹¹

In most auctions, auctioneers are prohibited from bidding on the goods that they are auctioning. Because the auctioneer cannot compete with the bidders, and the auctioneer's reputation and (usually) compensation are tied to obtaining the best possible price for the goods auctioned,⁹² the auctioneer has strong incentives to design the auction to maximize the seller's expected revenues.

Fixing unchangeable rules for the auction before the auction begins

⁸⁶ See, e.g., *Cristallina*, 502 N.Y.S.2d at 171.

⁸⁷ *Slaughter v. Guinn*, 571 So. 2d 876, 878 (La. Ct. App. 1990). For an excellent discussion of the development of the common law of auctions, see *Anderson v. Wisconsin Cent. Ry.*, 120 N.W. 39 (Minn. 1909).

⁸⁸ The general rule is that the auctioneer is the agent of the buyer only after "the hammer falls" and only for the limited purpose of presenting written evidence at the time of sale. See Paul L. Reynolds, Note, *Chernick v. Fasig-Tipton: A Caveat to the Horse Trader*, 74 KY. L.J. 889, 909-10 n.140 (1985). Upon the acceptance of the bid, the auctioneer becomes the agent of both the principal and the purchaser for the purpose of executing the memorandum that takes the transaction out of the operation of the statute of frauds. *United States v. Conrad*, 619 F. Supp. 1319, 1323 (M.D. Fla. 1985).

⁸⁹ Although the law treats the auctioneer as the agent of the seller, the large auction houses typically receive compensation from both the buyer and the seller. DANIEL J. LEAB & KATHARINE K. LEAB, *THE AUCTION COMPANION* 32-33 (1981); Ashenfelter, *supra* note 82, at 27.

⁹⁰ When an auctioneer is an agent for both the buyer and the seller, this dual agency imposes a duty on that auctioneer to act fairly to both principals and to disclose all facts which the agent knows, or should know, would affect the principals' decisions. See *RESTATEMENT (SECOND) OF AGENCY* § 392 (1957); Reynolds, *supra* note 88, at 908 n.132.

⁹¹ This is commonly observed in corporate auctions, where the company being sold will agree to indemnify the investment bankers retained to handle the sale. Thomas & Hansen, *supra* note 70, at 1181-82.

⁹² Take the example of the English auction where the bidding begins low and is driven higher by escalating bids. If the final bid received exceeds the reservation price of the seller, the buyer pays a percentage of the sale price to the auctioneer, usually a nonnegotiable 10%. Ashenfelter, *supra* note 82, at 27. The seller also pays a commission equal to a percentage of the sale price, varying between 5% and 15% depending on the type of item being sold. *Id.* If an item goes unsold because the bidding (or lack thereof) does not exceed the reservation price, the seller still pays the auctioneer a fee based on a percentage of the reservation price to cover some of the auctioneers' costs of attempting to auction the item. *Id.*

is important if the auction is to maximize revenues.⁹³ For example, in a first-price sealed-bid auction,⁹⁴ if buyers know that the auctioneer will not change the rules of the auction after receiving their bids, they will make their highest bids in the initial (and only) round of bidding. Auction house auctioneers have the power to guarantee bidders there will be no sudden rule changes, unlike their corporate counterparts who may change the rules in midstream because of the dictates of corporate law.⁹⁵

The rules of the common-law auction normally require the auctioneer to award the goods to the highest bidder, subject to the condition that the price bid is paid promptly. If this condition is satisfied, there is no need for third-party review of the auctioneer's decision. If, however, there is some question about whether the highest bidder was awarded the goods, the seller of the goods could demand a review of the award.⁹⁶ It is less certain whether the high bidder could get the award reversed before the title to the goods passed to the lower bidder, but reputable auctioneers would undoubtedly try to insure that such an event did not occur. If the disappointed bidder could bring the matter before a judge, as is often the case with corporate auctions, the courts might intervene on behalf of the high bidder.⁹⁷

B. Judges as Auctioneers: How Do They Compare With Common-Law Auctioneers?

In the past, judges have acted as auctioneers in two different settings. The more common setting is when the assets of a bankrupt company or individual are auctioned to raise money to satisfy the debtor's obligations. Some recent examples of this type of auction are the bankruptcy courts' auctions of the assets of the Financial News Network (FNN),⁹⁸ the sale of Eastern Air Lines slots, gates, and other assets,⁹⁹

⁹³ The advantage of commitment is that procedures can be adopted that induce the bidders to bid in desirable ways. McAfee & McMillan, *supra* note 80, at 703. For example, in sealed-bid auctions for government contracts, the government agrees that it will award the contract to the lowest qualified bidder after a single round of sealed bids. This commitment induces bidders to make their best bids initially. If the government failed to follow this policy in an auction, the cost to it would be that bidders would not believe it would honor its own rules in the future. This would mean a loss of future bargaining power. *Id.*

⁹⁴ In a first-price sealed-bid auction, the seller solicits sealed bids and awards the item being auctioned to the highest bidder, who in turn pays the amount of his bid. This can be contrasted to a second-price sealed-bid auction, where the highest bidder wins but pays the amount of the second highest bid. See *supra* note 80 for definition of a sealed-bid auction.

⁹⁵ Corporate auctioneers of public corporations cannot stop an auction at any particular point in time because the directors' fiduciary duties require them to consider any higher bid that is received. See Thomas & Hansen, *supra* note 70, at 1156-57.

⁹⁶ See *In re RJR Nabisco Shareholders Litig.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194 (Del. Ch. Jan. 31, 1989).

⁹⁷ See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173 (Del. 1986).

⁹⁸ Consumer News and Business Channel Partnership (CNB) acquired the assets of FNN for \$154.3 million in an auction conducted by the Bankruptcy Court for the Southern District of New

Harris Trust & Savings Bank's acquisition of Elgin Clock,¹⁰⁰ and Maxtor Corporation's successful bid for MiniScribe Corporation.¹⁰¹ A second and unique form of judicial auction is Judge Walker's innovative decision to conduct an auction of the right to represent a class of securities law plaintiffs in *In re Oracle Securities Litigation*.¹⁰²

In the proposed auction system, judges would conduct auctions of lawsuits in the same way as any other auctioneer. For instance, judicial auctioneers, like their common-law counterparts, will seek to maximize the price received for the goods they are auctioning. The bidding procedures employed, such as an English auction or first-price sealed-bid auc-

York after a long and complex series of maneuvers. *Courtroom Auction*, COMM. DAILY, May 8, 1991, at 2 (describing the parties' courtroom actions); see also *Appeal Called Certain*, COMM. DAILY, May 10, 1991, at 6. The background of this fascinating story and its twists and turns are set forth in opinions by the District Court for the Southern District of New York and the Second Circuit. See *FNN I*, 126 B.R. 152, 153-54 (S.D.N.Y. 1991); *In re Financial News Network, Inc.*, 931 F.2d 217, 219-20 (2d Cir. 1991), *dismissing appeal from*, *FNN I*, 126 B.R. 152.

⁹⁹ On February 15, 1991, Chief Judge Burton R. Lifland of the United States Bankruptcy Court for the Southern District of New York approved the sale of 67 slots, five gates, and other assets of bankrupt Eastern Air Lines, Inc. at Washington D.C.'s National Airport to Northwest Airlines, Inc. for \$35.5 million. Other assets sold included five jetways, ticket counters, office space, and a clubroom. *Judge Approves Eastern Sale to Northwest After Antitrust Divisions Threatens Attack*, 60 Antitrust & Trade Reg. Rep. (BNA) No. 1504, at 272 (Feb. 21, 1991).

¹⁰⁰ On May 6, 1991, Harris Savings & Trust Bank acquired Elgin Clock & Home Products in an auction conducted by the United States Bankruptcy Court for the Northern District of Illinois. See Terry Troy, *Bank Gets Elgin Assets in Liquidation*, WKLY. HOME FURNISHINGS, May 20, 1991, at 62.

¹⁰¹ On April 4, 1990, Maxtor Corp., a California-based company, outbid Wearnes Brothers, Ltd., a Singapore electronics firm, at the bankruptcy court auction of MiniScribe Corp. Adriel Bettelheim, *MiniScribe Turmoil Ends with Sale to San Jose Firm*, DENVER POST, Apr. 5, 1990, at C1.

¹⁰² 131 F.R.D. 688 (N.D. Cal. 1990) [hereinafter *Oracle I*]. In that case, Judge Walker instructed all of the law firms that were competing for the position of lead counsel for the stockholder class to submit sealed litigation budgets, with reimbursable litigation expenses and percentage of judgment that counsel would require to take the case. See *id.* at 690-91. In *Oracle I*, Judge Walker discussed his reasons for adopting a competitive bid auction and ordered the various plaintiffs' law firms to submit bids for the right to represent the class. *Id. passim*. Subsequently, in *In re Oracle Sec. Litig.*, 132 F.R.D. 538, 548 (N.D. Cal. 1990) [hereinafter *Oracle II*], Judge Walker awarded lead counsel rights to one of four bidders. Finally, in a post-auction challenge brought by one of the disappointed law firm bidders, Judge Walker provided some economic and legal justifications for his decision to use the competitive bid process to determine the lead counsel position. *In re Oracle Sec. Litig.*, 136 F.R.D. 639, 642-51 (N.D. Cal. 1991) [hereinafter *Oracle III*].

The principal advantage of Judge Walker's proposal for auctioning the lead counsel position is that it increases the winning attorney's incentives to invest in case preparation because she will not have to share the expected profit of prosecuting the action with other attorneys. Coffee, *The Unfaithful Champion*, *supra* note 1, at 77. However, this procedure has serious drawbacks. For example, if the court awards the case to the lowest cost attorney, the unintended consequence may be that the least competent counsel, who had the lowest costs, wins the bid. To the extent that lawyers' fees reflect their demand by the market, it seems an undesirable consequence of this method that it could allocate these cases to the worst attorneys. *Id.* Furthermore, as Macey and Miller note, this technique reintroduces significant agency costs because the winning attorney will have incentives to settle early to obtain a larger profit on the fee. Macey & Miller, *supra* note 1, at 113; see also Coffee, *The Unfaithful Champion*, *supra* note 1, at 77-78.

tion,¹⁰³ are likely to be identical.

Several features of this type of judicial auction, however, stand in sharp contrast with the common-law auction. For example, unlike the common-law auctioneer who gains reputational and frequently direct financial benefits for maximizing the price received in an auction, judges cannot have any financial interest in an auction.¹⁰⁴ Nor is a judge's appointment as an auctioneer likely to be the result of a competitive bidding process between various judges or auction houses; the parties have little say in how their bankruptcy proceeding or lawsuit is assigned by the court system, and only one forum is generally available for the conduct of the auction.¹⁰⁵ Without these incentives, judges, it could be argued, may not push the bidders to offer the best price possible.¹⁰⁶

The effect of judges' lack of economic incentives is exacerbated by the parties' inability to police directly the auction process to stop unfair conduct. Judges are immune from suit by the parties to the auction—both the bidders and the seller—for actions taken in their judicial capacity in conducting the auction.¹⁰⁷ There is no equivalent to the common-law cause of action available to a seller for negligence committed by an auctioneer in the conduct of an auction.

However, the seller's inability to bring suit against the judicial auctioneer can have a positive effect on auction revenues. Judges will not need to purchase liability insurance to protect themselves against claims of misconduct in the auction. In turn, the seller will not need to worry about indemnification costs.

Furthermore, reducing the threat that an auctioneer will be exposed to liability in an auction will reduce the bidders' uncertainty over the

¹⁰³ An English auction, also known as an open or oral auction, is the form of auction frequently used for selling artwork, antiques, and estates. In such an auction, bidding is done orally or by signal, and the price rises as bidding ensues. When nobody is willing to bid higher, the last bidder wins and pays the amount of his bid. See *supra* notes 80 and 92 for definition of a sealed-bid auction.

¹⁰⁴ A judge is disqualified from presiding over any matter in which she has a financial or property interest that could be affected by the outcome of the matter. See 28 U.S.C. § 455(b)(4) (1988); *Tumey v. Ohio*, 273 U.S. 510 (1927); MODEL CODE OF JUDICIAL CONDUCT Canon 3E(1) (1990). Thus, for instance, a judge is disqualified from presiding over a case if the judge's fees will be paid from court costs assessed by the judge. *Taylor v. Public Convalescent Serv.*, 267 S.E.2d 242 (Ga. 1980).

¹⁰⁵ Of course, companies often have a choice between filing for bankruptcy or trying to sell the company before entering bankruptcy. Events may, however, overtake a company that waits too long to sell itself. Apparently, this is what happened to FNN. It had already negotiated its sale to CNB prior to filing for bankruptcy, but another potential bidder objected to the agreement and forced an auction by the bankruptcy court. *In re Financial News Network, Inc.*, 931 F.2d 217, 218-19 (2d Cir. 1991).

Sellers may also have the ability to engage in forum-shopping in deciding where they file their bankruptcy proceedings.

¹⁰⁶ Cf. Douglas G. Baird, *The Uneasy Case For Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 136-37 (1986) (judges may be unable to value accurately firms in bankruptcy because they "enjoy no benefit and suffer no cost" if they overvalue or undervalue firms).

¹⁰⁷ See generally *Mireles v. Waco*, 112 S. Ct. 286 (1991).

value of the item being auctioned. This could result in lower charges for auctioneer services and higher net revenues for the seller of the goods.¹⁰⁸ Judicial auctioneers would have no potential liability, even if the auctioneer function were delegated to a master, minimizing the real cost of auctioneer services. Where the value of the goods being auctioned is substantial, as it would be in a multimillion dollar lawsuit, these cost savings are also likely to be very substantial.¹⁰⁹

Nor are the parties to the auction left unprotected from judicial abuses. The auctioneer judge has a duty to act to maximize revenues for the seller,¹¹⁰ and a fiduciary duty to protect the class's interests.¹¹¹ Where the judge acts as an auctioneer without referring the matter to a master, the seller may save on the costs of employing an auctioneer.¹¹² Finally, the parties can always appeal from the court's or the master's final orders.¹¹³

There are some other important advantages to using judges as auctioneers. One fundamental result of auction theory is that auction revenues will be maximized, on average, if the auctioneer commits herself in advance to the rules of the auction and then enforces those rules.¹¹⁴ Judges can fix hard and fast rules for auctions, subject of course to appellate review for abuse of discretion, thereby insuring that bidders put their best bids forward instead of holding back in hopes of getting the lawsuit

¹⁰⁸ Cf. Thomas & Hansen, *supra* note 70, at 1183-84. Briefly put, corporate auctioneers are normally indemnified by the seller for any liability they may incur in conducting the auction. The cost of this indemnification to the seller is uncertain because the purchaser will ultimately have to assume the indemnification obligation, which, therefore, makes the value of the company being sold uncertain. Bidders, therefore, will lower their valuations by more than the expected value of the loss. *Id.* For a general discussion of the role of director insurance and indemnification in the context of class action and derivative settlements, see Alexander, *supra* note 1, at 550-57.

¹⁰⁹ Since the American legal system generally provides judges' services at a low cost to private parties, private litigants may already realize little additional benefit from reducing the costs of using judges. See *supra* note 12 for an example of this subsidy. Thus, any savings realized from judicial immunity from suit would largely be enjoyed by society. The cost of auctioneer services to the seller would, however, be positive if the court chose to delegate the auctioneer function to a master because the costs of the master could be assessed against the monies obtained in the auction.

¹¹⁰ See *In re Todem Homes, Inc.*, 51 B.R. 883, 887-88 (Bankr. S.D.N.Y. 1985) (in a bankruptcy auction, the governing principle of judicial approval is obtaining "the best price for the bankruptcy estate").

¹¹¹ See *Oracle I*, 131 F.R.D. 688, 691 (N.D. Cal. 1990).

¹¹² If the injured plaintiff does not bear these costs, society will need to expend its judicial resources in performing these services.

¹¹³ Appellate review can be an effective means of insuring that the auction is not prematurely terminated. In the FNN auction, Dow Jones, a disappointed bidder in the first round of bids, appealed from the bankruptcy court's decision to award FNN to CNB, despite Dow's higher bid, because of Dow's failure to match the conditions imposed by the court on all bids. *FNN I*, 126 B.R. 152, 154-55 (Bankr. S.D.N.Y. 1991). The district court reversed the Bankruptcy Court's order, finding that the lower court ruling "failed to further the interests of creditors, equity holders, and the debtor". *Id.* at 156.

¹¹⁴ McAfee & McMillan, *supra* note 80, at 703. See also *supra* note 93.

for very little.¹¹⁵

Macey and Miller recognize that collusion among the relatively small number of plaintiff's law firms is a real danger to the auction procedure.¹¹⁶ Collusion can take the form either of explicit agreements about which bidder will win the auction or the form of implicit understandings among the bidders to exercise restraint in bidding.¹¹⁷ However, sellers can offset the potential effects of such a cartel by setting secret and undisclosed reservation prices for their goods.¹¹⁸

Further, judges are well-positioned to fight collusion among the auction bidders.¹¹⁹ Many trial court judges are former litigators and have the experience needed to set reservation prices for lawsuits.¹²⁰ Also, the bidders in the auction are well aware that the judge who is auctioning the case is the same judge who will be trying the case, if necessary. This provides them ample incentive to avoid even the appearance of participating in collusion in the bidding process.¹²¹

The existing judicial framework for handling regular cases provides another reason why judges are good auctioneers. Judges can use the current rules for discovery and pretrial procedure to control the bidders' initial discovery about the value of the lawsuit. Alternatively, the judge, or a party designated by the judge, might be charged with conducting all of the preauction discovery.¹²²

¹¹⁵ The possibility of appellate review of the auction result insures that courts do not create overly restrictive rules for the auction (or apply those rules unfairly). For example, in *FNN I* the district court admonished the bankruptcy court for disqualifying a higher bid from consideration by being overly restrictive in its application of the auction rules. Court-imposed rules, the Court stated, are to "ensure fair comparability between competing bids or to protect other bidders who have limited their bids to the announced terms." *FNN I*, 126 B.R. at 156. The disqualified bid was \$10 million more than the bid that was accepted. "[T]he interests of the creditors, equity holders and the debtor" required the bankruptcy court to consider the higher bid. *Id.*

¹¹⁶ Macey & Miller, *supra* note 1, at 111. Macey and Miller believe that this danger is relatively slight because of the threat of disbarment or criminal prosecution of the attorneys involved in price fixing. *Id.*

¹¹⁷ McAfee & McMillan, *supra* note 80, at 724-25.

¹¹⁸ Auction theory predicts that this reservation price should be set by taking into account the seller's own optimal valuation of the goods and the number of cartel members. *Id.* at 724-25. As the number of cartel members increases, the seller's anticartel price should increase. Thus the effect of collusion is to raise the reservation price to a higher level than would be the case if there were no collusion. *Id.* at 725.

¹¹⁹ See *supra* note 2. Courts have monitored potentially collusive conduct between parties in many different contexts. See, e.g., *In re Abbotts Dairies, Inc.*, 788 F.2d 143, 148 (3d Cir. 1986) (finding that allegations of collusion between buyer and seller, if proved, would destroy a purchaser's good faith status).

¹²⁰ Judges who do not feel confident in their abilities to set a minimum price for the lawsuit might choose to appoint a special master who is sufficiently knowledgeable about the subject matter of the lawsuit to do so.

¹²¹ Of course, the use of the auction process for lawsuits should also eliminate collusion in any settlements negotiated between defendants and plaintiffs' counsel. See *Oracle III*, 136 F.R.D. 639, 647 (N.D. Cal. 1991).

¹²² See *infra* Part V.

Masters would appear to enjoy most of the same advantages as judges. For instance, they have immunity from suit for actions taken within the scope of their judicial activities and they can conduct discovery. Masters, however, create two problems that judges do not. First, who will bear the costs of their services? The court could charge bidders an auction entry fee to defray these costs. In the end though, these costs probably will be passed through by the bidders in the form of lower bids.

Second, and more importantly, when masters are employed as auctioneers a question arises as to whether the bidders, knowing that the master will not be trying the case, will be more likely to engage in obstructionist behavior. For example, bidders could file frequent appeals of the master's procedural rulings on the conduct of the auction thereby delaying the proceeding. In part, this problem may become less important over time as the bidders become more familiar with the bidding process and the rules for conducting these auctions become generally accepted. However, the master will have a difficult job and will need the court's support to keep the bidders from contesting her every decision.

In summary, we believe that the benefits of using judges as auctioneers outweigh the costs. While the lack of a market incentive for judges to perform their auctioneer duties is of concern, there are several mechanisms in place that encourage judges to act in the seller's best interests. For these reasons, we believe judges would make good auctioneers for lawsuits.

IV. WHEN SHOULD CLASS-ACTION AND DERIVATIVE LAWSUITS BE AUCTIONED?

A. Are Auctions the Answer?

Scholars have been fascinated with the conduct of auctions for many centuries.¹²³ A wide array of goods are sold at auctions: artwork, books, antiques, mineral rights, treasury bills and gold, are a few current examples; wives and slaves are historical examples.¹²⁴ In recent years, corporations have been sold by auction; this procedure has sparked considerable academic debate.¹²⁵ The main attraction of auctions is that they allocate goods to the user that attaches the highest value to them and maximize revenue for the seller.

As the large theoretical and empirical literature on auctions demon-

¹²³ Martin Shubik, *On Auctions, Bidding, and Contracting*, in AUCTIONS, BIDDING AND CONTRACTING: USES AND THEORY 3-4, (Engelbrecht-Wiggans, et al. eds., 1983). See generally, David W. Leebron, *Games Corporations Play: A Theory of Tender Offers*, 61 N.Y.U. L. REV. 153, 192 (1986); Macey, *supra* note 10, at 85.

¹²⁴ McAfee & McMillan, *supra* note 80, at 701; Paul R. Milgrom & Robert J. Weber, *A Theory of Auctions and Competitive Bidding*, 50 ECONOMETRICA 1089 (1982); see also LEAB & LEAB, *supra* note 89, at vii-viii.

¹²⁵ See, e.g., Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597 (1990); Leebron, *supra* note 123; Macey, *supra* note 10.

strates, however, auctions are not a costless market mechanism. Auctions involve transaction costs for a variety of reasons, but the most important of these for our purposes stems from the uncertainty and costs of collecting and analyzing information. We discuss the nature of these costs below. We conclude this Part of the Article with a discussion of the conditions under which auctions will tend to operate as an efficient mechanism for transferring the legal rights of claimants.

B. Common Value Auctions Imply that Expected Auction Proceeds Are Less than Expected Settlement

Under conditions likely to hold in auctions of lawsuits, the average price received through an auction process will necessarily be less than the average value of the lawsuit to the winning bidder. This inequality reflects the transaction costs of conducting an auction. To understand when an auction will be better than the current practice therefore requires a good understanding of these transaction costs.

To begin developing such an understanding, suppose that a lawsuit is being considered for auction, and for ease of exposition initially, suppose that all potential prosecuting attorneys would be equally adept at conducting the case. Then there is no allocation problem, in an economic sense, in deciding which attorney to give the case to; whichever attorney gets the case, the expected outcome will be the same. In auction theory, this is referred to as a *common-value* auction.¹²⁶

Although the final decision as to which attorney gets the case does not matter in this situation, there is still the crucial problem of determining how much the assigned attorney will pay for the case and, of course, how much the plaintiffs will therefore receive. Uncertainty over the value of the lawsuit—that is, what the costs of litigation and any settlement amounts will be—makes the determination of this price a difficult one. Auctioning the lawsuit to the highest bidder is a natural way to determine the price, and in fact an auction is probably the best way to

¹²⁶ Thus, we are for now ignoring one agency cost that is commonly recognized in current practice: that associated with inefficiency in the selection of the plaintiff's attorney. We feel that this inefficiency is important and that an auction will attenuate the inefficiency (for an auction will find the low-cost attorney). But in order to discuss the major transaction cost associated with auctions, it is easiest to deal with a common-value model. However, this assumption could be relaxed. Auction theory currently includes two polar models, the common-value model and another known as the independent private values model. In the former, the value of the item being sold is uncertain but is the same to all bidders; in the latter, each bidder knows the value of the item to himself but each bidder's value will be different (hence the term independent private values). Most real auctions will have both common-value and independent private values characteristics; auctions of lawsuits undoubtedly will. A model that deals with such auctions has been developed, *see* Milgrom & Weber, *supra* note 124, but it is considerably more complex than a simple common-value model. Since the major transaction cost we focus on arises from common-value characteristics, we choose to conduct the discussion solely in a common-value context. Adapting the discussion along Milgrom and Weber's lines would not change any of our conclusions.

determine price, if a price must be determined.¹²⁷

But this does not mean that the auction is perfect. Let $E(v)$ be the expected value of the lawsuit (expected settlement proceeds less expected costs to any of the potential attorneys). We assume here that v , the true value of the lawsuit, will only be known *ex post* so that *ex ante* there is uncertainty over v . A basic result from common-value auction theory is that $E(p) < E(v)$, where $E(p)$ is the expected price in the auction.¹²⁸

There are two related explanations for this important result. First, common-value auctions potentially involve what is known as the “winner’s curse” phenomenon.¹²⁹ Put simply, this refers to the fact that the winning bidder in a common-value auction will tend to be the bidder who thinks the item for sale is worth the most, and this means that he has a value estimate that is *biased high*.¹³⁰ Recognizing that auctions select the high-valued bidder, rational bidders will bid *lower* so that if they win the auction they will not overpay and suffer the winner’s curse. This low bidding on the part of all bidders puts downward pressure on the auction price; the result is that $E(p) < E(v)$.

A second explanation for this result also arises out of the uncertainty over the true value of the item being sold. Uncertainty means that individual bidders will have different estimates of the item’s true value. In thinking about an optimal bid, a bidder will therefore have incentive to bid low, for there will be a good chance that the next-highest value estimate will be significantly beneath his own. This difference between bidders’ value estimates is key in determining how much beneath their value estimates profit-maximizing bidders will bid; if the difference is small, then bids will be relatively close to value estimates because otherwise they will be likely to lose the auction to the next-highest bidder. If the difference in value estimates is large, then bidders can strategically “shave” their bids by a significant amount, for the risk of losing to the next-highest bidder is relatively low. These arguments imply that plaintiffs cannot expect to get the true value of the lawsuit via an auction. Instead, the winning bidder retains some of the value, for the simple reason that bidders expect to profit by participating in lawsuit auctions.¹³¹

¹²⁷ Note however, that the current system of litigating lawsuits does not determine an *ex ante* price.

¹²⁸ For a formal proof of this result, see Douglas K. Reece, *Competitive Bidding for Offshore Petroleum Leases*, 9 *BELL J. ECON.* 369, 380 (1978).

¹²⁹ The winner’s curse has been raised as a possible explanation for bidder overpayment for take-over targets. See Black, *supra* note 125, at 625; Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 *J. BUS.* 197, 197-200 (1986); Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 *YALE L.J.* 1235, 1274 (1990).

¹³⁰ A bidder’s value estimate can be thought of as the average value that the bidder estimates the item to have, given the information that the bidder then possesses.

¹³¹ This profit is economic profit. Because of uncertainty, competition with a fixed number of bidders does not fully compete away all profit. The assumption that there are a fixed number of bidders is relaxed below.

The difference $E(v) - E(p)$ is therefore the transaction cost to the plaintiffs of using the auction.

Of course, the auction yields significant benefits as well. Denote the expected settlement proceeds to plaintiffs under the current, nonauction system as $E(s)$. We must have $E(v) > E(s)$, for v is just the settlement when the case is run efficiently under one owner; s will be less than v if there are any agency costs at all associated with many plaintiffs and one attorney. Unfortunately, theory alone cannot tell us whether $E(s)$ exceeds $E(p)$, or vice versa. We return to this important issue below,¹³² but for now, we note two results from auction theory that suggest the conditions under which an auction will be the best choice for plaintiffs:

- (1) As the number of bidders goes up, $E(p)$ increases.¹³³
- (2) As bidders' uncertainty over the item's value decreases, $E(p)$ increases.¹³⁴

Thus, an auction should perform better when either the number of bidders is large or uncertainty over the lawsuit's outcome is low.

It may appear that uncertainty and the number of bidders could be controlled by a judge so as to ensure low auction transaction costs, that is, to ensure that $E(p)$ is close to $E(v)$. Uncertainty could be reduced by having open and full discovery before the auction, and the number of bidders could be increased via wide dissemination of an auction prospectus. As it turns out, however, it is probably more correct to think about the number of bidders in an auction as an *endogenous* variable,¹³⁵ with potential bidders selecting whether or not to participate in the auction on the basis of expected profit from participation.¹³⁶ But first, we must dispense with the issue of having the *defendant* as a bidder.

C. *Having the Defendant as a Bidder Reduces the Expected Price*

One intriguing aspect of auctioning lawsuits is that the defendant could also participate as a bidder. If the defendant wins the auction, he is in effect settling the case at the amount of his winning bid. It would seem desirable to have the defendant as a bidder, for otherwise one would foreclose this possibility of obtaining a settlement.

Our analysis, however, points to the opposite conclusion. By allowing the defendant to bid, the possibility exists for settlement via the

¹³² See *infra* notes 144-45 and accompanying text.

¹³³ See French & McCormick, *supra* note 10, at 439.

¹³⁴ This result was proved in Milgrom & Weber, *supra* note 124, at 1102. See also McAfee & McMillan, *supra* note 80, at 722 (also giving a restatement of this result).

¹³⁵ An endogenous variable is a variable that cannot logically be taken as a constant in the analysis and instead must be considered as one of the implications of the analysis. In the case at hand, the number of bidders is endogenous because it will vary depending upon the specifics of the auction being considered.

¹³⁶ Part IV.D below addresses this issue in depth.

auction, but the price at which settlement will occur can be expected to be relatively low. Indeed, even if settlement does not occur in the auction (that is, the defendant does not win), the expected price will still be relatively low. These conclusions follow from what appears to be a very reasonable assumption: that the defendant has better information than other bidders on the probable outcome of the case.

Asymmetric information—where one bidder knows more than others—is anathema to auction prices, for it exacerbates the “winner’s curse” problem described earlier.¹³⁷ Intuitively, as a nondefendant bidder, one can understand the fear associated with winning an auction where a knowledgeable defendant is bidding: a win means that the defendant bid less than you, and that probably means that he does not fear a lawsuit very much—or, at least, that he thinks the lawsuit will cost him less than the winning bid. Nondefendant bidders then face an adverse selection problem, with their probability of winning being greater when the defendant thinks the lawsuit will cost him little. Recognizing this, rational bidders will bid low, and the result is that the plaintiffs will receive relatively less for their case: that is, $E(p)$ will be significantly less than $E(v)$.

Since plaintiffs are hurt by including the defendant as an auction participant, defendants should be prohibited from bidding. This does not adversely affect settlement, however, for settlement between the winning bidder and the defendant can occur anytime after the auction is over.¹³⁸ Indeed, one would expect that immediately after an auction the first step of the winning bidder would be to pay a visit to the defendant and see if a settlement could not be quickly reached. But importantly, after the auction is over, settlement does not *have* to occur at any specific point in time. Instead, the winning bidder can be flexible, employing an optimal strategy of further discovery and negotiation to maximize his expected payoff. By forcing bidders to consider settlement with a more knowledgeable defendant at the time of the auction, plaintiffs lose flexibility and necessarily also lose revenue.¹³⁹

¹³⁷ See Milgrom, *supra* note 81, at 5-6 for a discussion of this problem.

¹³⁸ This raises an important issue: Can settlement occur before the auction? This might be desirable from an efficiency point of view, as well as from the plaintiffs’ profit-maximizing perspective, for it circumvents a costly discovery process. We do not, however, see how it can occur without the court making a determination of who will represent the class in the same manner that the current system works. The purpose of the auction is to reduce the agency costs incurred in the current system by selecting an attorney who has the proper incentives to accept a settlement or litigate the case; early settlement stops that from occurring.

¹³⁹ Another interesting question is would the plaintiffs want the auction price to be revealed to the defendant (assuming that the defendant does not bid)? Negotiation strategy suggests that the answer is “no”: the auction price reveals considerable information to the defendant about what the winning bidder thinks the lawsuit is worth. Bidders would be willing to pay more in the auction if they had the freedom to choose whether to reveal or not reveal their winning bid. Practical considerations, such as the need to pay the plaintiffs, would, however, probably require this information to be revealed. In the final analysis, revealing this information may not provide the defendant with

D. Amount of Discovery and the Number of Bidders

Having resolved the issue of defendant as bidders, we can now return to the issues concerning discovery and the number of bidders. We showed above that, with uncertainty over the value of the lawsuit, $E(p) < E(v)$. One would think that this inequality could be improved upon by either reducing uncertainty or increasing the number of bidders. Unfortunately for plaintiffs, increasing auction revenue is not as simple as that.

Consider first the idea of reducing bidders' uncertainty by providing a more complete preauction discovery process. Macey and Miller would authorize the judge to make an initial "limited" examination of the defendant to gather the information necessary to evaluate the claim.¹⁴⁰ This information would then be made available to potential bidders.¹⁴¹

There are at least two costs to this discovery, one which the plaintiffs probably bear and one which they will certainly bear. The first cost of discovery we shall label the *administrative cost*. By this we mean such common costs as deciding what materials and witnesses to obtain, and providing for physical facilities and experts for depositions. These costs would likely be borne initially by the court, and it would seem reasonable to subtract them from the auction proceeds. The larger these common administrative costs are, the smaller the recovery will be to the plaintiff class.¹⁴²

The second component will be referred to as the *analysis costs*. By

much more information than a plaintiff's attorneys' early settlement offers do under the existing system.

¹⁴⁰ Macey & Miller, *supra* note 1, at 106. They would also have the court ask the filing attorney to conduct further inquiry into the merits of the suit and appoint a master to further investigate the facts. The potential pitfalls of having judicially-conducted discovery have been noted by several commentators. See Geoffrey C. Hazard, Jr., *Discovery Vices and Trans-substantive Virtues in the Federal Rules of Civil Procedure*, 137 U. PA. L. REV. 2237, 2240-41 (1989) (pointing to possible civil liberty concerns); John C. Reitz, *Why We Probably Cannot Adopt the German Advantage in Civil Procedure*, 75 IOWA L. REV. 987, 1004 (1990) (arguing that judicially led discovery creates danger of "crusading judges"). If, however, such a proposal is not adopted, then each bidder would have to determine what level of initial discovery to engage in, the defendant would likely resist these inquiries into its affairs, and the court would become embroiled in numerous discovery disputes at a very early stage in the litigation.

¹⁴¹ A two-step procedure similar to that employed by corporate auctioneers could be employed. Corporate auctioneers distribute selected public information about the company they are selling to potential bidders in the first step of the corporate auction process. This sales memorandum serves to inform potential bidders about the basic facts of the suit so that they can determine whether they wish to invest the resources needed to learn more about the company. In the second step of the auction process, serious bidders are given more detailed, nonpublic information about the company on which to base their bids. Thomas & Hansen, *supra* note 70, at 1152-56.

¹⁴² These costs may be offset by the value to the parties of accelerating the process of determining the value of the claim. Presumably, the defendants would be forced in such a system to respond to the court's inquiries promptly and thereby quickly form their own (preliminary) estimates of the value of the claims involved much earlier than they do under the current discovery system. Plaintiffs would also obtain access to defendants' evaluations of the claim's value at an earlier stage than they

this we mean the costs incurred by bidders in analyzing discovery data in order to arrive at an estimate of value of the lawsuit. This evaluation process must necessarily be an intensive, complicated process. Potential bidders must arrive at estimates of either (1) the likely settlement value of the case, or (2), and obviously related, a combination of the likelihood of winning a suit at trial and the likely damages forthcoming if the suit is won. Arriving at these estimates will require potential bidders to examine both depositions and all available evidence, and to evaluate the data. Most important, the whole process of analysis must be repeated by every potential bidder. Thus, while *administrative costs* are only incurred once, *analysis costs* are incurred as many times as there are bidders.

How will these costs affect the auction process? Take first the *analysis costs*. Assume that the level of preauction discovery can be varied by the judge, and denote the chosen level by D . Since it is reasonable to assume that *analysis costs* will vary with the level of discovery, we will denote the costs by $A(D)$. In deciding whether or not to participate in the auction—and this is certainly a decision which every potential bidder will address—a potential bidder must assess the likelihood that any profits from winning the auction will cover $A(D)$, his *analysis costs*. But a potential bidder's expected profit from participating in the auction depends upon the number of bidders in the auction: with more bidders, the higher the expected price and the lower the bidders' expected profits. These relationships imply that the number of bidders in an auction will be endogenously determined.¹⁴³

do presently. As a result, suits may settle quicker after the auction than they do under the system currently in place.

¹⁴³ This analysis is presented in French & McCormick, *supra* note 10; see also Ronald N. Johnson, *Auction Markets, Bid Preparation Costs and Entrance Fees*, 55 LAND ECON. 313, 313-17 (1979).

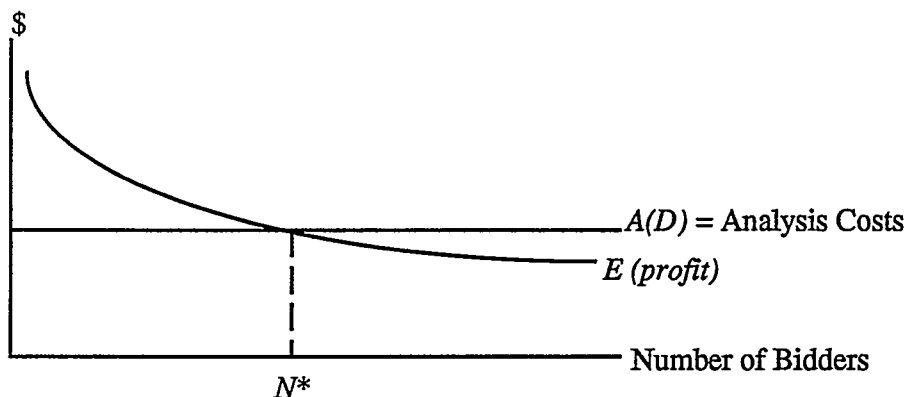


Diagram 1
Equilibrium Number of Bidders

Diagram 1 illustrates the equilibrium.¹⁴⁴

In Diagram 1, the curve labeled $E(\text{profit})$ depicts the declining profits of any one bidder as the number of bidders increases. The line $A(D)$ simply shows the constant analysis costs incurred by any one bidder. Bidders should enter the auction until $A(D) = E(\text{profit})$, so that N^* is the equilibrium number of bidders.

The main point of this analysis is that the number of bidders cannot naively be thought of as freely variable by an auctioneer/judge. This supports the argument that auction performance cannot be simply improved via broader solicitation of interest.

The equilibrium of Diagram 1 can be interpreted in a way that sheds additional light on why $E(p) < E(v)$, and on how great the difference between these two amounts will be. With N^* homogeneous bidders in the auction, it must be that each has a probability of winning equal to $1/N^*$. Thus, we can write any one bidder's expected profit as

$$E(\text{profit}) = 1/N^* (E(v) - E(p)) \quad (1)$$

and since $E(\text{profit}) = A(D)$ in equilibrium, it follows that

$$E(v) - E(p) = N^* A(D) \quad (2)$$

Equation (2) says that $E(p)$ will be less than $E(v)$ by the *analysis costs times* the number of bidders in the auction. Or, in other words, the plaintiffs end up bearing the *analysis costs* incurred by all the bidders. This interpretation of the auction equilibrium shows how important *analysis costs* are to the plaintiffs' revenues.¹⁴⁵

¹⁴⁴ An equilibrium in relation to the number of bidders occurs when, given the number of bidders planning to enter an auction, (a) no more bidders would find it profitable to enter, and (b) all of those planning to enter would find it profitable to stay by their decision to do so.

¹⁴⁵ Intuitively, the auction market must provide enough profit in total to cover the "industry's" (the bidding firms') total costs. If profits are not large enough to cover costs, firms will exit as they would in any industrial setting when losses are being made.

Taking the analysis one step further, we should consider that D , the level of discovery, is a variable that can be determined by the auctioneer/judge. Allowing more discovery preauction will reduce bidders' uncertainty, but it also implies a higher *analysis cost*. There are therefore potential offsetting effects on plaintiffs' revenues: although reducing uncertainty raises the expected price for any given number of bidders, if $A(D)$ were to increase, N^* could potentially decrease and that would reduce expected auction revenue. Furthermore, there is the additional *administrative cost* of more discovery.

In summary then, while there will generally be an optimal level of discovery, it is difficult to describe analytically the nature of that optimum. Qualitatively, it would seem safe to say that discovery should be limited to material that can significantly lower bidders' uncertainty as to damages and likelihood of winning at trial. Information that is costly to analyze and that is unlikely to have a material impact on lawsuit valuation should not be produced by discovery.

V. AUCTIONING LAWSUITS: WHERE DO WE GO FROM HERE?

A. When Would An Auction System Work?

When will an auction produce more revenue for plaintiffs than current procedure? At a broad level, this is easy to answer. An auction will be preferable when:

- (a) Costs of the current system for the lawsuit in question are large; and
- (b) For the lawsuit in question, $E(p)$ is close to $E(v)$.

It is possible to further define these conditions so as to give at least qualitative advice to judges in deciding whether or not to auction a lawsuit.

We believe that the main variables to be considered when determining whether to employ an auction are (1) the level of uncertainty over the lawsuit's value and (2) a related variable, the cost of resolving the uncertainty through a process of discovery and analysis, preauction. Overall, we can refer to these variables as constituting the *auction information cost*. When the *auction information cost* is high, current practice will likely be the better option, for $E(p)$ will be much less than $E(v)$.

If auctions are to be used to allocate class action and derivative lawsuits, we need, one, to identify auction mechanisms that reduce bidders' uncertainty without prohibitively high *administrative* and *analysis costs*, and two, to provide the courts with some guidelines to help them identify classes of cases where the uncertainty over the value of the lawsuits being auctioned is likely to be low. We turn now to the first part of this inquiry.

B. Discovery Restrictions: Containing Analysis Costs and the Auction Information Cost

For an auction to constitute an improvement over the existing litigation process, *all* bidders must have their uncertainty over the claim's value reduced significantly, but without incurring either large *administrative* or *analysis costs*. It is important to treat all bidders equally in regard to information disclosure; if some bidders are relatively uninformed, then they will have to reduce their bids just the same as if a well-informed defendant were participating.

The auctioneer judge can control the amount of discovery that bidders are allowed to obtain from the defendant. The first rule of an efficient discovery process should be that bidders are prohibited from pursuing discovery on their own. Instead, there should be one court-sanctioned discovery process with the results common to all interested bidders. Specifically, bidders should not be allowed to interview defendants or witnesses without notifying the court and, if permission were given to conduct the additional discovery, the resulting evidence should be made publicly available.

For the first rule to be effective, another rule must also be followed: no evidence that could significantly impact a bidder's view of the case should be withheld. Put simply, the single, public discovery record must be complete enough to allow bidders to come to reasonably certain estimates of the case's value. If this record is complete enough, it will also serve to reduce bidders' incentives to unilaterally attempt additional discovery (as described above) for the value of any new information would be low.

The goal of discovery should not be, however, to eliminate uncertainty completely. If that were accomplished, then most likely too much effort would have been spent on discovery. With all uncertainty removed, settlement should occur immediately after the auction, for both the defendant and the winner would agree on the outcome of any further litigation. But mutually agreeable settlement can also occur without perfect information, so it is efficient to conduct the auction while some uncertainty remains and then see if the winner and the defendant can come to terms without any more costly litigation.

The second rule, or principle, of efficient discovery therefore requires the auctioneer judge to evaluate each step of discovery in terms of its cost and its potential contribution to reducing uncertainty. Under the existing rules of civil procedure, judges already engage in a similar exercise when evaluating discovery requests.¹⁴⁶ The auction process would require judges to balance the costs of obtaining additional information against its potential to reduce the bidders' uncertainty about the value of the claim. If the additional evidence being considered would most likely

¹⁴⁶ See FED. R. CIV. P. 26(b)(1).

have little impact on bidders' value estimates, and would only come at considerable cost, then it should be excluded.

Balancing the cost of additional discovery against the reduction of uncertainty about the value of the lawsuit in this way will help to increase net revenues from the auction process. However, a more direct route to this result would be to auction cases where bidders can form a good assessment of the value of the case without much discovery. For that reason, we next attempt to identify classes of cases where the auction mechanism will be particularly appropriate because the level of uncertainty about the value of the lawsuits is likely to be low.

C. Suits Where the Auction Information Costs Might Be Initially Low

What types of class and derivative actions might be relatively easy for bidders to value? We believe that three classes of cases are likely candidates: (1) cases where there has been prior factual or legal determinations establishing the defendant's probable liability and damages; (2) cases where the facts bearing on liability and damages are very clear cut; and (3) strike suits where the facts pleaded in the complaint fail to allege a cause of action.¹⁴⁷

A large number of class actions and derivative lawsuits are filed after a government regulatory or criminal action is made public. These governmental prosecutions can result in factual findings that form the basis for subsequent private litigation. For example, an SEC action against a company, or an FTC price fixing investigation, may provide significant evidence on the merits of a private claim for damages. This evidence could give potential bidders accurate information about the expected value of the underlying legal claim and insure that $E(p)$ is close to $E(v)$.

Cases where the facts bearing on liability and damages are very clear represent a second category of cases where bidders may be more certain about the value of the underlying claim. For example, in securities litigation, private claims under section 16(b) for short swing profits from corporate insiders may be easy for bidders to value: if the insider has held the securities for less than the statutory period and sold them for a profit, then the corporation is entitled to recover an easily measurable amount of damages.¹⁴⁸ Claims that a prospectus contained false and misleading statements brought under section 12(2) of the 1933 Act may be suscepti-

¹⁴⁷ While these cases, we argue, will be easy to value, it is not necessarily true that they are also cases where agency costs under the existing litigation process will be low. For example, if the plaintiff's attorney is compensated by the lodestar method, then that attorney still has incentive to bill as many hours as possible in the conduct of the litigation. Thus, the cases we identify below are cases where the auction information cost is probably low but the agency cost of the existing process might be relatively high.

¹⁴⁸ See 15 U.S.C. § 78p(b) (1988).

ble to similar treatment.¹⁴⁹

Finally, suits that fail to state a claim on the face of the complaint are likely to be susceptible to auction treatment. In these cases, filed often on the basis of a press release announcing a major transaction, the auction process would result in their sale for a nominal amount, less than or equal to their nuisance value to the defendants. Auctioning these cases would quantify their nuisance value which could hasten the settlement process.

This list is intended to be suggestive of the types of cases that could be beneficially handled using the auction process. Trial judges are usually experienced former trial lawyers who will have their own insights into what cases will be best handled by an auction procedure. Furthermore, we would expect that if the auction procedure was utilized by the courts, certain courts and judges would develop an expertise in deciding when to apply it. For instance, the Delaware Chancery Court would be a logical choice to test the usefulness of auctioning derivative lawsuits. A specialized court could adopt routine procedures for determining what cases to auction, how to conduct the auction and whom to allow to bid that would greatly increase the efficacy of employing the auction process.

VI. CONCLUSION

The idea of auctioning class action and derivative lawsuits is provocative. Our analysis indicates that, from an economic perspective, an auction system has several serious limitations which could limit its usefulness to a relatively small number of types of cases. However, within these categories of cases, an auction mechanism has the potential of eliminating serious agency problems and increasing recoveries to injured plaintiffs.

For these cases, there are other significant benefits to an auction process, in addition to the reduction in agency costs. For example, auction proponents have shown that the auction process is likely to have the following results: (1) lowering transaction costs by eliminating the need for courts to review the substance of many settlements and attorney fee requests; (2) increasing efficiency in the deployment of plaintiffs' law firms' resources because of the consolidation of the litigation in one entity rather than the loose consortiums currently deployed; and (3) allocating the resource—the legal claim—to the highest valued user, who is likely to be the most qualified attorney.¹⁵⁰

As a final note, we recognize that our analysis has focused only on

¹⁴⁹ See 15 U.S.C. § 77f(2) (1988). These claims may be more complex because the defendants may be able to show that they conducted proper due diligence in supplying these documents.

¹⁵⁰ These benefits are more fully explored in Macey & Miller, *supra* note 1, at 108-10. These authors also develop more fully several problems with the auction process that we do not explore here. See *id.* at 110-16.

the efficiency of auctions in yielding revenues for plaintiffs *given* that a case has been brought. We have not examined in any depth the impact that auctions would have on the number and type of cases that would be brought forward. Yet, from an overall public policy perspective, this is clearly an important question. The answer to this question—and the social welfare implications of the answer—does not seem obvious. Although plaintiffs may end up with greater proceeds under an auction process, the openly competitive nature of the auction should put downward pressure on lawyers' fees. Coupled with this point is the issue of how the attorney who first files the suit will recover her costs.¹⁵¹ Thus, there may now be more cases that could potentially yield a positive financial return to plaintiffs, but the class of plaintiffs may find no attorneys rushing to file suit on the plaintiffs' behalf. From a normative, or social welfare, point of view, there would probably be many who would argue that there are already too many class action and derivative lawsuits. If auctions were to result in yet more, then the overall impact on welfare would be negative. The current process could then be viewed as a second-best solution. Although it creates additional costs in prosecuting cases, these costs keep the number of cases brought in check.

Even given this last caveat, we remain optimistic that the auction process is worthy of judicial experimentation and further development for those cases where auction information costs are low.

¹⁵¹ See *supra* note 39 and accompanying text.