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Class Counsel as Litigation Funders

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I. INTRODUCTION

Class actions facilitate private law enforcement by manipulating the financial incentives of entrepreneurial class counsel,[1] prompting them to act as litigation funders by advancing their time and litigation costs. First, by aggregating claims and permitting a fee and cost award to be assessed as to the class as a whole, the class device makes it feasible for counsel to pursue claims that are economically viable to investing class counsel only when joined.[2] Second, by providing criteria for courts to use when awarding fees and costs once the class action is successfully resolved,[3] fee and cost award doctrine signals to class counsel how they may eventually profit from case investment, which, in turn, affects not only the level of private enforcement, but, also, its quality. By aligning the interests of class counsel and the class members—that is, by making right choices profitable—fee and cost award doctrine has the potential to inspire loyal representation.

Unfortunately, current fee and cost award doctrine sends the wrong signals and thus misaligns the interests of class counsel and the class by making the

1. *See* John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 5, 12 (1985) ("[A]ny attempt to rehabilitate the private attorney general concept can succeed only if we move from viewing the plaintiffs' attorney in exclusively normative terms as a fiduciary who must faithfully serve his clients and instead analyze him from an ex ante perspective as a risk-taking entrepreneur who predictably will act to maximize his return and to minimize his risk.").

2. *See* Amchem Prods., Inc. v. Windsor, 521 U.S. 591, 617 (1997) ("The policy at the very core of the class action mechanism is to overcome the problem that small recoveries do not provide the incentive for any individual to bring a solo action prosecuting his or her rights. A class action solves this problem by aggregating the relatively paltry potential recoveries into something worth someone's (usually an attorney's) labor." (quoting Mace v. Van Ru Credit Corp., 109 F.3d 338, 344 (7th Cir. 1997))).

3. *See* FED. R. CIV. P. 23(h) ("In a certified class action, the court may award reasonable attorney's fees and nontaxable costs that are authorized by law or by the parties' agreement.").

investment of attorney time more profitable than investment in case costs. Unlike time investment, which may contain a markup in the hourly rate and may also be multiplied in the fee award, a class action lawyer's advancement of litigation costs—including filing fees, expert fees, notice costs and other disbursements—is merely reimbursed.[4] This uneven treatment of time and cost investment in class action litigation distorts attorney case investment incentives. Predictably, profit-maximizing attorneys will be less inclined to pursue high cost cases; will favor time over cost-intensive approaches to case investment, even where cost investment would ultimately work to the advantage of class members; and will settle prematurely to avoid relatively unprofitable cost investment points. These perverse incentive effects inhibit justice in high-cost cases. A solution—one William Rubenstein[5] and I recently proposed—is to enable direct cost profits in class actions, by, for example, not just reimbursing costs, but applying a multiplier to cost investment.[6]

A precursor to and variant of this idea was rejected in the *Agent Orange* litigation in the late 1980s when the Second Circuit reversed Judge Weinstein's decision for awarding a form of indirect cost profits—the reallocation of a court-awarded fee by agreement of class counsel in order to recognize the value of cost investment.[7] The Second Circuit asserted ethical[8] impediments to cost profits, including, for example, that they created conflicts between class counsel and the class.[9] These impediments have remained largely unexamined by courts since the 1980s.[10] Since *Agent Orange*, no court has championed the award of direct cost profits in class actions.

Times have changed, suggesting that courts may or at least should now be open to more completely harnessing class counsel's incentives to fund class actions,

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4. *See generally infra* Section II.

5. *Faculty: William B. Rubenstein*, HARVARD L. SCH., http://hls.harvard.edu/faculty/directory/10742/Rubenstein/ (last visited Nov. 21, 2014).

6. *See* Morris A. Ratner & William B. Rubenstein, *Profit for Costs*, 63 DEPAUL L. REV. 587, 612–13 (2014).

7. *In re* Agent Orange Prod. Liab. Litig., 818 F.2d 216 (2d Cir. 1987). An agreement by class counsel to reallocate a fee in order to reward cost investment is an "indirect" path to cost profits because the court makes an overall fee award in the first instance in which costs are merely reimbursed. Any reallocation via contract among counsel does not serve to enlarge the overall award of fees and costs, and instead only redistributes a shrunken pie. This kind of indirect re-routing of fees to compensate for cost investment is available only in the limited circumstance where multiple firms prosecute the same case, and where the court is willing to enforce an agreement among the firms to reallocate fees. *See, e.g.*, *In re* FPI/Agretech Sec. Litig., 105 F.3d 469, 472–74 (9th Cir. 1997) (rejecting agreement among counsel regarding allocation of fees that was not in proportion to work performed); Prandini v. Nat'l Tea Co., 557 F.2d 1015, 1019 (3d Cir. 1977) (fee agreement that allocated fees without regard to work performed was properly rejected by trial court), *disapproved on other grounds by* Evans v. Jeff D., 475 U.S. 717 (1986).

8. The term "ethics" is used in this Article in the broadest sense, to include all relevant law governing lawyers' fee and cost awards; such law includes not only the law codified in rules of professional responsibility, but, also, relevant procedural rules and common law doctrines. *See, e.g.*, FED. R. CIV. P. 23 and decisions interpreting it.

9. *Agent Orange*, 818 F.2d at 223–24.

10. *See infra* note 72 and accompanying text.

and to doing so directly in the initial fee and cost award. First, a rich academic literature has matured since the 1980s that provides a theoretical framework for evaluating fee and cost award doctrine's effects on class counsel's incentives.[11] Second, judges handling complex and large-scale multidistrict litigations have grown increasingly accustomed to addressing the financing function of the plaintiffs' attorneys in preliminary case management orders, especially in large multidistrict litigation proceedings.[12] Third, *alternative* litigation financing has received attention from courts,[13] academics,[14] bar associations,[15] research centers,[16] and the popular media,[17] exposing litigation financing as an area undergoing dramatic transformation at the margins, whether or not courts choose to guide it. Courts may or at least should be more willing in this environment to look at change not only at the margins, where alternative funders fill (some of)

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11. The framework for considering class action fee and cost award doctrine involves two conceptual moves, popularized by Professor John C. Coffee, Jr. in the mid-1980s. First, the language and assumptions of classical liberal economic theory are used to describe class counsel as a self-interested, profit-maximizing entrepreneur. *See, e.g.*, 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, 676 (1986) (characterizing class counsel as a self-interested and risk-taking entrepreneur); 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, 3 (1991) ("[P]laintiffs' class and derivative attorneys function essentially as entrepreneurs"). Second, agency cost theory is marshaled to explain why profit-maximizing class counsel may be unfaithful to the class, given class counsel's and the class members' asymmetric stakes and access to information. *See, e.g.*, Coffee, *supra*, at 680–690 (applying agency cost theory to explain dynamics between class counsel and class members); Macey & Miller, *supra*, at 19–27 (similarly applying agency cost theory). This framework is now so pervasive as to have been described as "canonical." *See* Myriam Gilles & Gary B. Friedman, *Exploding the Class Action Agency Cost Myth: The Social Utility of Entrepreneurial Lawyers*, 155 U. PA. L. REV. 103, 104 (2006).

12. *See, e.g.*, *In re* Pradaxa (Dabigatran Etexilate) Prod. Liab. Litig., No. 3:12–md–02385–DRH–SCW, 2012 U.S. Dist. LEXIS 162110, at *2 (S.D. Ill. Nov. 13, 2012) ("This Order is entered to provide for the fair and equitable sharing among plaintiffs, and their counsel, of the burden of services performed and expenses incurred by attorneys acting for the common benefit of all plaintiffs in this complex litigation."); *In re* San Juan Dupont Plaza Hotel Fire Litig., 111 F.3d 220, 223–25 (1st Cir. 1997) (describing trial court's early case management orders addressing MDL common benefit expenditures, including required procedures for reporting and claiming costs).

13. *See, e.g.*, Miller UK Ltd. v. Caterpillar, Inc., No. 10C3770, 2014 U.S. Dist. LEXIS 779 (N.D. Ill. Jan. 6, 2014) (discovery dispute regarding alternative funding documents).

14. *See, e.g.*, Jonathan T. Molot, *The Feasibility of Litigation Markets*, 89 IND. L. J. 171, 172–73 (2014) (describing scholarly attention directed to alternative litigation financing) (emphasis added); Nora Freeman Engstrom, *Lawyer Lending: Costs and Consequences*, 63 DEPAUL L. REV. 377 (2014) (examining the lawyer lending industry).

15. *See, e.g.*, *White Paper on Alternative Litigation Finance*, A.B.A. COMM'N ON ETHICS 20/20 6 (2011), *available at* http://www.americanbar.org/content/dam/aba/administrative/ethics_2020/20111019_draft_alf_white_paper_posting.authcheckdam.pdf (defined most generally, alternative litigation financing refers to mechanisms that give a third-party (other than the lawyer in the case) a financial stake in the outcome in exchange for money paid to a party in the case).

16. *See, e.g.*, Steven Garber, *Alternative Litigation Financing in the United States: Issues, Known, and Unknowns*, RAND INST. FOR CIVIL JUSTICE: LAW, FINANCE, AND CAPITAL MARKETS (2010), *available at* http://www.rand.org/content/dam/rand/pubs/occasional_papers/2010/RAND_OP306.pdf.

17. *See, e.g.*, Vanessa O'Connell, *Litigation Funding Market Heats Up*, WALL ST. J. BLOG (Oct. 3, 2011, 2:26 PM), http://blogs.wsj.com/law/2011/10/03/litigation-funding-market-heats-up/.

the litigation financing gaps, but at the center of traditional case financing,[18] where plaintiffs' counsel act as litigation funders of first resort. Fourth, class action fee and cost award doctrine itself has made major strides since *Agent Orange* away from an exclusive focus on time as the yardstick for fees, creating via the percentage method, the opportunity to value other contributions class counsel make, including as litigation funders. And, finally, ethics doctrine has evolved in the individual (non-class, non-aggregate) setting since *Agent Orange* to chart a path to permitting direct cost profits, one that simply has not yet been adapted to the special circumstances of the class action.[19]

Against this backdrop, this Article reexamines the ethics of cost profits in class actions, as well as the extent to which existing doctrine points towards a measure. The Second Circuit's decision in *Agent Orange* has previously been contextualized[20] and criticized for failing to recognize the need for and permissibility of a wider scope of agreements among counsel to reallocate a court's fee award.[21] This Article grapples with the more fundamental question of whether trial courts paying successful class counsel may make cost investment directly profitable, by, for example, awarding a multiplier on cost investment. That inquiry traverses three doctrinal boundary lines which, as currently drawn, fail to fully acknowledge the distinct role played by plaintiffs' counsel in class actions as litigation financiers and court-appointed fiduciaries: the lines between "professional services" and other charges; consent and its absence; and permissible and impermissible conflicts.

First, when class counsel acts as litigation funder, directly advancing case costs, is he providing a professional service on which he can reasonably make a direct profit, or is he merely paying a disbursement that is ancillary to the

18. Plaintiffs' contingency fee lawyers are typically direct litigation funders, using their own capital buttressed by traditional bank loans to the firm. *See* MICHAEL J. SWANSON, HOW DAVID BEATS GOLIATH: ACCESS TO CAPITAL FOR CONTINGENT-FEE LAW FIRMS 89 (2011).

19. *See* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 93-379 (1993) [hereinafter ABA Formal Op. 93-379] (permitting cost profits by agreement between lawyer and client).

20. PETER H. SCHUCK, AGENT ORANGE ON TRIAL: MASS TOXIC DISASTERS IN THE COURTS 73, 94–95, 108–09, 120–22, 202–04 (1986) (describing conflicts among counsel over leadership and the related question of case financing, and the eventual agreement among counsel for a leadership and fee allocation structure that induced new case financing by select co-counsel); Paula Batt Wilson, *Attorney Investment in Class Action Litigation: The Agent Orange Example*, 45 CASE W. RES. L. REV. 291, 311–13 (1994).

21. *See, e.g.*, Vincent Robert Johnson, *The Second Circuit Review—1986–1987 Term: Ethics: Ethical Limitations on Creative Financing of Mass Tort Class Actions*, 54 BROOK. L. REV. 539, 578–79 (1988) (recognizing that *Agent Orange* highlighted the problem of how to reward cost investment in class actions, but focusing on the ethics of agreements among counsel to *reallocate* fees under ethics rules prohibiting fee splitting, rather than on the permissibility of direct cost profits); Sarah Northway, *Non-Traditional Class Action Financing and Traditional Rules of Ethics: Time for a Compromise*, 14 GEO. J. LEGAL ETHICS 241, 248–53 (2000) (characterizing agreements among counsel to reallocate fee awards to indirectly account for cost profits as a form of non-traditional case financing, and critically evaluating the ethics of such agreements); David J. Capra, Thomas W. Jackson & John Koeltl, *Financial Arrangements in Class Actions, and the Code of Professional Responsibility*, 20 FORDHAM URB. L.J. 830, 849–54 (1993) (same).

professional service he renders? The answer to this question largely determines whether costs can be a profit center because ethics and class action fee and cost award doctrine assume counsel's professional services in the form of labor are presumptively capable of producing direct profit, but that actions that merely support the labor function are not. While attorneys in other practice settings may not be expected to include litigation funding as part of the package of professional services they offer, contingent fee class counsel must, both as a practical condition of being retained by representative plaintiffs and as a formal matter pursuant to the criteria Rule 23 provides for appointment of class counsel.[22] The distinctiveness of contingent fee class action practice can be recognized either by moving the boundary line between professional and other services, or by discarding it altogether as a heuristic for defining permissible cost profits in that setting.

Second, to what extent is client consent a necessary precursor to the award of cost profits? Under ABA Model Rule 1.5, as interpreted by ABA Formal Opinion 93-379, cost investment may be directly profitable as long as the bases of cost charges are disclosed to the client, preferably at the outset of litigation, and typically in the representation agreement that commences the relationship.[23] The problem is that both Rule 1.5 and the ABA Opinion interpreting it rest on an assumption that the lawyer-client relationship is contractual, whereas the lawyer-client relationship in class actions is created by court order.[24] In the class setting, there is usually no opportunity to disclose cost profits at the outset of the lawyer-client relationship because fee and cost awards are made *ex post*, after a favorable judgment for the class has been obtained. The question is thus whether it is possible to substitute for or simulate consent in class actions to create a space between express individual consent and its absence. Substituting for express consent involves shifting from a market approach to structuring the lawyer-client relationship to a fiduciary one, a familiar move in class action jurisprudence that is accomplished by designating the judge as guardian of the class and by giving the court power to appoint and approve any fee and cost award to class counsel. Simulated consent is also accomplished by the adoption of procedures to enable class member participation, including notice, the opportunity to object to any fee and cost award, and the right to opt out. The need for consent—or at least a facsimile of consent—thus need not be a barrier to cost profits in class actions.

Third, do direct cost profits create conflicts between lawyer and client? The Second Circuit expressed skepticism about directly rewarding cost investment on that ground in *Agent Orange*. But the relevant question when selecting a fee and cost award methodology is not whether the award of cost profits creates conflicts

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22. FED. R. CIV. P. 23(g)(iv).

23. *See* MODEL RULES OF PROF'L CONDUCT R. 1.5(b) (2012) [hereinafter MODEL RULES]; ABA Formal Op. 93-379, *supra* note 19.

24. *See* FED. R. CIV. P. 23(g).

between class counsel and the class—it surely does. The relevant question is whether, on balance, a regime that permits direct cost profits is more or less likely to align the interests of class counsel and class members than does a regime which does not. That analysis should consider, among other things, the probability of conflict actually arising, the resulting costs to class members associated with counsel's disloyalty, and the ability of courts to manage those costs. Such a comparison of likely agency costs flowing from alternative fee and cost award regimes indicates that the agency costs associated with direct cost profits should be tolerated within a fee and cost award methodology.

Once over the hurdle of the propriety of cost profits in any amount, existing doctrine points towards a measure. Courts have authority to award "reasonable" fees and costs to successful class counsel.[25] A key determinant of reasonableness is the relevant "market" for legal services. Thus, the project when calculating cost profits is to define the market. At least five options exist, explored below: lawyer-client contracts in individual, non-class cases; rates charged by third-party litigation funders; the market reflected by private contracts with cost-investing counsel; the market mimicked by judges acting a consumers of legal services; and the market for time investment. These market measures are capable of equalizing the reward on time and cost investment to varying degrees. The following sections explore each of these points in turn.

II. THE DISPARATE TREATMENT OF TIME AND COST INVESTMENT IN CLASS ACTION JURISPRUDENCE; PREDICTABLE EFFECTS ON ACCESS TO JUSTICE

Entrepreneurial plaintiffs' counsel make two types of investments in class action litigation—time and money.[26] Time investment includes, literally, the allocation of time—measured in hours—by attorneys employed by or who are members of the firm. Most tasks cognizable as traditional "lawyering" are accomplished via time investment, including, for example, when a lawyer interviews clients, conducts fact discovery, drafts legal memoranda, argues in court, conducts a trial, or settles a case.

Case-specific cost investment includes two types—in-house services and disbursements to third parties.[27] The cost investment necessary to advance class

25. *See* Fed. R. Civ. P. 23(h).

26. The boundary between time and cost investment varies across jurisdictions and practice settings. *See* Dennis E. Curtis & Judith Resnik, *Contingency Fees in Mass Torts: Access, Risk, and the Provision of Legal Services When Layers of Lawyers Work for Individuals and Collectives of Clients*, 47 DEPAUL L. REV. 425, 438–39 (1998) (identifying type of work (e.g., attorney versus paralegal labor) and fee calculation method as factors impacting the boundary between "costs" and "fees").

27. ABA Formal Op. 93-379 breaks down cost investment into three categories: Overhead is by definition not case-specific, and instead is part of the cost of operating the business, including such items as expenses associated with leasing office space, paying attorneys and other employees of the firm, etc. Presumptively, overhead is recovered as part of the fee. ABA Formal Op. 93-379, *supra* note 19. Case-specific investments in the form of in-house services include photocopying and messenger services provided by the firm. *Id.*

actions varies by type of case, but it is the magnitude of disbursements to third parties that distinguish these cases.[28] A kind of disbursement that is unique to class actions is the cost of notice of class certification, which can be substantial, especially where notice must be delivered by mail or publication to a large, geographically dispersed class.[29] Class actions can also entail extraordinary expert costs, for example, in cases involving complex aggregate damage models, such as antitrust suits.[30]

Some tasks necessary to advance a litigation matter are nearly always accomplished via time investment. Cases raising novel legal questions, for example, are likely to be time-intensive, because of the amount of research, briefing, and argument they entail. Other tasks necessary to advance class litigation can be accomplished either via time or cost investment, including projects where technology offers alternatives to the use of attorney labor, such as in the area of electronic discovery, which allows firms receiving productions of electronic data to select more or less labor-intensive review methods; where non-lawyer legal process outsourcing companies (LPOs) are available to do the work that would otherwise be done in the first instance by the firm's lawyers;[31]

Disbursements are costs paid to third parties (outside the firm), including experts and vendors. *Id.* Disbursements may also include interest charges on loans necessary to fund litigation expenses. *See, e.g.*, Chittenden v. State Farm Mut. Auto. Ins. Co., 788 So. 2d 1140, 1150 (La. 2001) (citing ethics opinions from Florida, Maryland, Illinois, and Virginia for the proposition that interests charges may be assessed if (1) the client agrees in writing, and (2) the rate of interest is "lawful and reasonable").

28. Recent Supreme Court decisions will increase the cost of class litigation by requiring a more rigorous showing at the time of the motion for certification, one that in several key practice settings will front-load merits and expert discovery and associated costs. *See, e.g.*, Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2414–15 (2014) (finding that defendants in securities fraud cases may rebut alleged price impact on market at class certification stage); Comcast v. Behrend, 133 S. Ct. 1426, 1432–33 (2013) (criticizing lower court for failing to recognize the importance in the class certification determination of permitting challenges to and scrutinizing expert testimony regarding class damages); Wal-Mart Stores, Inc. v. Dukes, 131 S. Ct. 2541, 2551 (2011) (requiring a "rigorous analysis" of whether Rule 23's requirements have been met). *See also* Linda S. Mullenix, *Putting Proponents to Their Proof: Evidentiary Rules at Class Certification*, 82 GEO. WASH. L. REV. 606 (2014) (suggesting pushing doctrine further, by requiring application of federal rules of evidence at the class certification stage).

29. *See* Eisen v. Carlisle, 417 U.S. 156, 178 (1974) ("The usual rule is that a plaintiff must initially bear the cost of notice to the class."); Hunt v. Imperial Merch. Servs., Inc., 560 F.3d 1137, 1143 (9th Cir. 2009) ("[C]ourts must not stray too far from the principle underlying [*Eisen*] that the representative plaintiff should bear all costs relating to the sending of notice because it is he who seeks to maintain the suit as a class action." (quoting Oppenheimer Fund, Inc. v. Sanders, 437 U.S. 340, 359 (1978))).

30. *See, e.g.*, Am. Express Co. v. Italian Colors Rest., 133 S. Ct. 2304, 2316 (2013) (Kagan, J., dissenting) ("As the case comes to us, the evidence shows that Italian Colors cannot prevail in arbitration without an economic analysis defining the relevant markets, establishing Amex's monopoly power, showing anticompetitive effects, and measuring damages. And that expert report would cost between several hundred thousand and one million dollars."); *In re* Fanny Mae Sec., Derivative, and ERISA Litig., No. 04-1639 (RJL), 2013 U.S. Dist. LEXIS 172231, at *61 (D.D.C. 2013) ("The most significant expense category relates to plaintiffs' experts and consultants. Of the total reimbursement sought, $10,027,188.94, or nearly 66%, is for expert and consultant fees and expenses.").

31. *See* ABA Standing Comm. on Ethics and Prof'l Responsibility, Formal Op. 08-451 (2008) (outsourced work performed off-site without the need for law firm structural support should be billed at cost). *See also*

and where either a lawyer or a non-lawyer specialist could do the same work, such as reviewing client medical records.

Logically, it is all money investment, from the perspective of the firm serving as class counsel on a contingent fee basis. To the owners of the firm, it costs money to provide overhead for the firm's lawyers to be available to invest time, and that cost can be quantified, e.g., as a cost per lawyer, per hour billed.[32] The firm typically dips into the same well of capital to pay for both overhead (which may be recaptured only via a fee award) and case-specific cost investment including disbursements (which are separately reimbursed as costs). But the fee and cost award jurisprudence treats time and other cost investments differently, and thus prompts lawyers to see the two types of investments as producing unequal rewards.

Time investment produces two layers of direct profit. First, the lodestar (a direct measure of lawyer time described below) is profitable because firms typically bill their attorneys out at market rates that exceed the cost to the firm of maintaining the lawyer whose time is being invested. Second, if the court awards an actual or effective multiplier on lodestar, the firm realizes an additional direct profit (the multiplied fee).[33]

The extent to which time investment is directly profitable depends in part on the fee methodology used. There are two methods by which courts calculate fees in class actions. The first method is the lodestar method, which most directly rewards time investment. The lodestar method uses time investment as the primary basis for calculating a fee and measuring its reasonableness. Under this fee-calculation methodology, courts award attorneys' fees by multiplying the number of hours the prevailing party reasonably expended on the litigation by a reasonable hourly rate for the region and for the experience of the lawyer.[34] Courts awarding fees pursuant to the lodestar method have discretion to award a

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Thomas S. Clay & Eric A. Seeger, *2012 Law Firms in Transition: An Altman Weil Flash Survey*, ALTMAN WEIL ii (2012), *available at* http://www.altmanweil.com/dir_docs/resource/1667e5c8-b99e-4557-93ac-73174118ea29_document.pdf (forty-five and a half percent of law firm leaders surveyed in 2012 see the shift to outsourcing of legal work as a "permanent trend," a four-fold increase over 2009 survey responses).

32. *See, e.g.*, William F. Brennan, *New Survey Focuses on Law Firm Economics*, 36 REP. TO LEGAL MGMT. 1 (Nov./Dec. 2008), *available at* http://www.altmanweil.com/dir_docs/resource/41ff6ad2-da67-406e-9999-ca2aaae63539_document.pdf (reporting average per lawyer overhead expenses of $170,363 per year, based on information provided by 265 firms contributing to the annual Altman Weil survey of law firm economics); *id.* at 9 (identifying staff, occupancy (e.g., leases) and paralegal expenses as the three largest cost categories contributing to overhead); *id.* at 9–10 ("Note the significantly greater expense level reported by plaintiffs firms. These firms spend more on a per lawyer basis than all other categories of firms, and their increased level of spending applies to all expense items, but especially to paralegal, equipment, reference and promotional expenses. The total overhead expense per lawyer for plaintiff firms is $260,761 which is a 53% premium over the average reported by all law firms in the *Survey*.").

33. *See In re* Bluetooth Headset Prod. Liab. Litig., 654 F.3d 935, 942–43 (9th Cir. 2011) (defining lodestar method and reversing trial court's award of a fee using the lodestar method where the trial court made no explicit calculation of the lodestar amount, among other problems).

34. *See id.*

multiplier on the lodestar in appropriate circumstances.[35]

The second method is the percentage method, whereby the court selects a percentage of an ascertainable[36] common fund or common benefit to award as a fee.[37] The fee ultimately awarded in a common fund case where the percentage method is employed turns largely on the size of the fund, because any percentage is applied to that fund. If, for example, the court awards class counsel twenty percent of the common fund, the value of that award will depend on the size of the fund; the question is always, "twenty percent of what?" But the selection of the percentage figure to be applied to the common fund may depend in part on the firm's lodestar, i.e., the firm's time investment, which courts may consider when setting the percentage[38] or, more commonly, when cross-checking any percentage fee award against the lodestar to assure its reasonableness.[39] As a result,

35. The Supreme Court has expressed antagonism toward contingency multipliers in statutory fee-shifting cases. *See* Burlington v. Dague, 505 U.S. 557, 562 (1992) ("We note at the outset that an enhancement for contingency would likely duplicate in substantial part factors already subsumed in the lodestar."). Multipliers are appropriate under fee-shifting statutes only in rare and exceptional cases. *See* Perdue v. Kenny A. *ex rel.* Winn, 559 U.S. 542, 553–54 (2010) ("[T]here is a 'strong presumption' that the lodestar figure is reasonable, but that presumption may be overcome in those rare circumstances in which the lodestar does not adequately take into account a factor that may properly be considered in determining a reasonable fee."). When the lodestar method is used to award a fee in a common fund case, the trial court generally has more discretion to award a multiplier. *See* Vizcaino v. Microsoft Corp., 290 F.3d 1043, 1052 (9th Cir. 2002) ("[M]ultipliers ranging from one to four are frequently awarded in common fund cases when the lodestar method is applied.").

36. *See* Hanlon v. Chrysler Corp., 150 F.3d 1011, 1029 (9th Cir. 1998) (The lodestar method should be applied where "there is no way to gauge the net value of the settlement or any percentage thereof."); Nwabueze v. AT&T Inc., No. C 09-01529 SI, 2014 U.S. Dist. LEXIS 11766, at *5–6 (N.D. Cal. Jan. 29, 2014) (citing *Hanlon*, 150 F.3d at 1029 and using lodestar method where settlement involves a claims-made program, the ultimate value of which is not known at the time of the fee application, because the fee application predated the conclusion of the claims program).

37. *See generally In re* Diet Drugs Prod. Liab. Litig., 582 F.3d 524, 540 (3d Cir. 2009) (The federal circuit courts have adopted varying approaches to the selection of the appropriate percentage, from relying on "benchmarks" where the project for the fee awarding court is to assess whether and on what grounds deviation from the benchmark is warranted, to the selection of a percentage figure that depends on the circumstances of each case, often using multifactor tests). *Compare* Torisi v. Tuscon Elec. Power Co., 8 F.3d 1370, 1376 (9th Cir. 1993) ("In common fund cases such as this, we have established 25% of the common fund as the 'benchmark' award for attorney fees . . . . This 'benchmark percentage should be adjusted, or replaced by a lodestar calculation, when special circumstances indicate that the percentage recovery would be either too small or too large in light of the hours devoted to the case or other relevant factors.'" (citing Six Mexican Workers v. Ariz. Citrus Growers, 904 F.2d 1301, 1311 (9th Cir. 1990)) *with In re Diet Drugs*, 582 F.3d at 541) (not specifying a benchmark, but listing ten factors to be considered by courts when selecting a percentage to apply to a common fund).

38. *See, e.g.*, *In re Diet Drugs*, 582 F.3d at 541 (identifying as one factor in the selection of the percentage to be applied to a fund "the amount of time devoted to the case by plaintiffs' counsel"). *See generally* Brian T. Fitzpatrick, *Do Class Action Lawyers Make Too Little?* 158 U. PA. L. REV. 2043, 2053 (2000) ("[C]ourts typically use an indeterminate multifactor test—often with the lodestar as one of the factors—to select a 'reasonable' fee percentage.").

39. *See In re* Bluetooth Headset Prod. Liab. Litig., 654 F.3d 935, 944 (9th Cir. 2011) (the Ninth Circuit has "encouraged courts to guard against an unreasonable result by cross-checking their [percentage of fund] calculations against a second method."); *In re* Rite Aid Corp. Sec. Litig., 396 F.3d 294, 301 ("The purpose of the lodestar cross-check is to determine whether a proposed fee award is excessive relative to the hours reportedly worked by counsel . . . . "); Dick v. Sprint Commc'ns Co., L.P., 297 F.R.D. 283, 300 (W.D. Ky. 2014) ("Courts

courts and class counsel in common fund cases where the percentage method is to be applied to determine the fee are acutely aware of the lawyers' time investment, and of the extent to which that time represents an effective multiplier.[40]

Time investment presents the possibility of being directly profitable in any case in which the lodestar method will or may be used to calculate the fee. The lodestar method must be used in statutory fee shifting cases litigated to judgment (though a settlement, even in a statutory fee shifting case, can involve the creation of a common fund that generates a fee using the percentage method). Courts also regularly use the lodestar where the value of a class settlement is difficult to ascertain, e.g., because it involves non-monetary relief or an unfinished claims program.[41] The lodestar method may be used in most jurisdictions even in common fund cases and is regularly used in such cases as a cross-check even when the percentage method sets the fee.[42]

Cost investment, on the other hand, though it can be substantial,[43] is merely reimbursed, and produces no direct profit, regardless of the methodology used to calculate the fee award.[44] The standard format of an order awarding fees calculates the fee award separately from the award of costs, noting expressly that costs are reimbursed.[45] While some courts have awarded *less* than the amount of

adopting the percentage approach generally conduct a lodestar crosscheck to ensure that counsel does not receive a windfall."); *see also* Brian T. Fitzpatrick, *An Empirical Study of Class Action Settlements and Their Fee Awards*, 7 J. EMPIRICAL LEGAL STUD. 811, 833 (2010) ("It should be noted that in 218 of these 444 settlements (49%), district courts said they considered the lodestar calculation as a factor in assessing the reasonableness of the fee percentages awarded."); Theodore Eisenberg & Geoffrey Miller, *Attorney Fees and Expenses in Class Action Settlements*, 1993–2008, 7 J. EMPIRICAL LEGAL STUD. 248, 267 (2010) (from 2003–2008, 42.8 percent of courts used both the percentage and lodestar methods in the same case, indicating that these courts are undertaking a lodestar cross-check).

40. *See generally infra* Section II.

41. *In re Bluetooth*, 654 F.3d at 942.

42. *See infra* note 39. When the lodestar method is used as a cross-check, the value of class counsel's time investment can drive or at least cabin the fee award made under the percentage method. *See, e.g.*, *In re Rite Aid*, 396 F.3d at 306 ("The lodestar cross-check serves the purpose of alerting the trial judge that when the multiplier is too great, the court should reconsider its calculation under the percentage-of-recovery method, with an eye toward reducing the award.").

43. *See supra* note 31 and accompanying text. *See also* Elizabeth Chamblee Burch, *Financiers as Monitors in Aggregate Litigation*, 87 N.Y.U. L. REV. 1273, 1286–87 (2012) (discussing high cost and financial risks of aggregate litigation).

44. *See, e.g.*, MANUAL FOR COMPLEX LITIGATION § 14.216 (4th ed. 2004) (addressing "reimbursement of expenses" as a stand-alone issue, separate and apart from questions of the fee calculation methodology).

45. *See, e.g.*, Order Granting Award of Attorney's Fees, Reimbursement of Expenses and for Class Representative Incentive Payments, *In re* Static Random Access Memory (SRAM) Antitrust Litig. (N.D. Cal. October 14, 2011) (No. 4:07-md-1819-CW) ("IP Class Counsel are awarded attorneys' fees in the amount of $13,744,000, which is one-third (1/3) of the settlement fund of $41,322,000 . . . . IP Class Counsel are awarded reimbursement of their unreimbursed costs and expenses in the amount of $711,756.76."), at 2–3; Order Awarding Attorneys' Fees and Expenses, *In re* Bank of Am. Corp. Secs., Derivative, and Emp. Ret. Income Sec. Act (ERISA) Litig., No. 09 MDL 2058(PKC), (S.D.N.Y. Apr. 8, 2013) ("Co-Lead Counsel are hereby awarded attorneys' fees in the amount of $152,414,235.89, plus interest on such amount at the same rate as earned by the Settlement Fund from the date the Settlement Fund was funded to the date of payment, which sum the Court finds to be fair and reasonable, and $8,069,985.04 in reimbursement of Litigation Expenses, which fees and

reimbursement sought, e.g., on the ground that the costs submitted were insufficiently documented,[46] or were otherwise excessive,[47] courts do not award a direct mark-up on costs, either by permitting counsel to charge more than the costs actually incurred, or by awarding a multiplier on such costs.

Cost-investment may be *indirectly* profitable. While in the typical case, cost-investment is not determinative of the fee, it is indirectly profitable to the extent it makes a favorable judgment more likely, and some courts identify it as one, indeterminately weighted factor characterizing the contingency risk counsel undertook.[48] The degree of that risk may have an effect on the fee via a lodestar multiplier when the lodestar method is used,[49] or when the court selects a contingency percentage under the percentage of fund method.[50] Court decisions do not explain the precise connection between cost investment and any fee, and, in any event, merely reimburse such cost investment.[51] Moreover, courts

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expenses shall be paid to Co-Lead Counsel from the Settlement Fund."), *available at* http://www.blbglaw.com/cases/00120_data/OrderAwardingFees.

46. *See, e.g.*, Physician of Winter Haven LLC v. Steris Corp., No. 1:10 CV 264, 2012 WL 406966, at *9 (N.D. Ohio Feb. 6, 2012) (denying copy and computer charges due to lack of adequate information about the charges); *In re* Austrian and German Bank Holocaust Litig., No. 98 Civ. 3938(SWK), 2003 WL 402795 (S.D.N.Y. Feb. 21, 2003) (denying costs for historical research due to lack of information establishing necessity of the research).

47. *See, e.g.*, *In re* Agent Orange Prod. Liab. Litig., 611 F. Supp. 1296, 1359 (E.D.N.Y. 1985) (denying as excessive charges for unreasonably expensive hotel accommodations and meals).

48. *See* Macey & Miller, *supra* note 11, at 52–53 ("Most jurisdictions accept risk as a factor for consideration, but the determination of the level of risk is done exceedingly impressionistically.").

49. DeHoyos v. Allstate Corp., 240 F.R.D. 269, 330 (W.D. Tex. 2007) ("Given the complex legal and factual issues confronting counsel, as discussed throughout this opinion, class counsel undertook a considerable risk with no guarantee any fees or expenses would be recovered."); *In re* Sumitomo Copper Litig., 74 F. Supp. 2d 393, 399–400 (S.D.N.Y. 1999) (grounding 2.5 multiplier on time in part on counsel's contingency risk associated with $1.8 million in case-specific cost investment over a ten year period).

50. *See, e.g.*, *In re* Toyota Motor Corp. Unintended Acceleration Mktg., Sales Practices, & Prod. Liab. Litig., No. 8:10ML 02151 JVS (FMOx), 2013 US Dist. LEXIS 123298, at *306,*308–09 (C.D. Cal. July 24, 2013) (tentatively approving $200 million fee request on class settlement valued by settlement proponents at $1.6 billion, examining fee request using percentage of fund with a lodestar cross-check, and noting that with the lodestar of $69,706,936, the multiplier on time was 2.87; the court mentioned class counsel's contingent cost investment of $30,606,117, noting that plaintiffs' expert had found only one case in a survey of 688 cases with a higher absolute dollar amount of costs advanced); *see* Kifafi v. Hilton Hotels Ret. Plan, 999 F. Supp. 2d 88, 100–103 (D.D.C. 2013) (noting costs advanced as a factor contributing to class counsel's contingency risk, one factor affecting the selection of the percentage to be applied to a common fund to calculate class counsel's fee; reimbursing costs).

51. If the court uses a pure percentage-of-recovery method for calculating the fee, then time investment and cost investment are on more equal footing in that both have the potential to be only indirectly profitable. *See* MANUAL FOR COMPLEX LITIGATION, *supra* note 44, at 193 ("Unlike a statutory-fee analysis, where the lodestar is generally determinative, a percentage-fee award sometimes gives little weight to the amount of time expended."). But even in that setting, cost investment, though mentioned in passing, is rarely if ever given the kind of attention time investment receives in percentage-of-fund fee orders. *See, e.g.*, *In re* Colgate-Palmolive Co. ERISA Litig., No. 07-cv-9515, 2014 U.S. Dist. LEXIS 93379 (S.D.N.Y. July 8, 2014) (in a $45.9 million class action settlement, in which class counsel successfully moved for a twenty-five percent fee and for cost reimbursement in the amount of $591,011.17, including approximately $490,000 in expert fees paid out of pocket, the court, considering counsel's contingency risk, mentioned only the risk of not being compensated or

considering the contingency risk do not typically highlight cost investment and instead focus on the riskiness of the *claims*, i.e., the possibility of not prevailing.[52]

Review of a recent fee and cost award serves to crystalize the foregoing analysis: In *In re Payment Card Interchange Fee & Merch. Disc. Antitrust Litig.*,[53] Judge Gleeson, of the Eastern District of New York, oversaw a settlement of claims by merchants that Visa, MasterCard and a number of banks conspired to fix credit card fees and rules in violation of the antitrust statutes. The class action settlement's two key features were a $7.25 billion fund and additional injunctive relief in the form of credit card network rules changes.[54] At the outset of its opinion awarding $544.8 million in attorneys' fees and $27,037,716.97 in costs, the trial court held:

> Class Counsel took on serious risks in prosecuting the case. They now represent that, taking together all of the hours that they and other plaintiffs' counsel billed on this case, the lodestar figure for attorneys' fees is approximately $160 million, reflecting almost 500,000 hours of attorney and paralegal work conducted through November 30, 2012.[55]

The court thus grounded its fee award on class counsel's *time* investment, even though the award was made using the percentage of fund method, with the lodestar method used merely as a cross-check on the reasonableness of the award.[56] The court could have justified that time-centric focus using the first-listed criterion for establishing a percentage fee under the relevant Second

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paid a fee, without specifically mentioning counsel's cost investment other than to note, in a separate section of the order that costs were being reimbursed); Boyd v. Coventry Health Care Inc., 299 F.R.D. 451, 462–464, 468 (D. Md. 2014) (considering "the risk of nonpayment" as a factor in determining the percentage fee award, but omitting reference to costs advanced as part of the analysis of that factor, even though cost investment in this one case was approximately ten percent of time investment, i.e., approximately $137,000). That inequality can be explained in part by the fact that time investment dwarfs cost investment in the typical class case. *See* Eisenberg & Miller, *supra* note 42, at 274 ("Costs and expenses (collectively 'costs') tended to be a small percentage of the class recovery and have remained a fairly constant percentage over time. For the 232 cases from 1993 to 2002 for which cost data were available, mean costs were 2.8 percent of the recovery and median costs were 1.7 percent.").

52. *See, e.g.*, Thayer v. Wells Fargo Bank, 92 Cal. App. 4th 819, 834 (2001) (defining the contingency risk in a lodestar case as "the contingent nature of the fee award, both from the point of view of eventual victory on the merits and the point of view of establishing eligibility for an award" (quoting Serrano v. Priest, 20 Cal.3d 25, 49 (Cal. 1977))). *But see* Iorio v. Allianz Life Ins. Co. of N. Am., No. 05-CV-0633-JLS (CAB), 2011 U.S. Dist. LEXIS 21824, at *34 (S.D. Ca. Mar. 3, 2011) (awarding an $18 million fee and $1.3 million in costs, the court noted: "Class counsel's ability to recover fees and expenses in this action was purely contingent upon a successful outcome or settlement").

53. *See In re* Payment Card Interchange Fee & Merch. Disc. Antitrust Litig., 991 F. Supp. 2d 437 (E.D.N.Y.2014).

54. *Id.* at 439 (opt-outs reduced the cash fund to $5.7 billion).

55. *Id.*

56. *Id.* at 440.

Circuit precedent, i.e., "the time and labor expended by counsel."[57] Instead, the trial court focused primarily on another one of the listed criteria, i.e., "the risk of the litigation." In a case involving such substantial cost investment by class counsel, one would think that an assessment of the risk counsel undertook would emphasize that category of investment. Instead, the court held:

> This case was unusually risky for a number of reasons . . . . Those risks could have meant the end of the litigation with no recovery for class members and no *fee* for counsel. Counsel should be rewarded for undertaking them and for achieving substantial value for the class. If not for the attorneys' willingness to endure for many years the risk that their extraordinary efforts would go uncompensated, the settlement would not exist.[58]

While the court noted in passing that the litigation was "expensive,"[59] the expense with which it appears to have been most concerned for purposes of analyzing class counsel's contingency risk was time advanced. The trial court used the lodestar cross-check to find that the percentage fee award amounted to an effective multiplier on time of 3.41, which it held was "comparable to multipliers in other large, complex cases." As to counsel's roughly $27 million in cost investment, the court held, in a short section of the fee and cost award order titled "Expenses," that "[a]s a general rule, counsel are entitled to reimbursement for reasonable out-of-pocket expenses incurred over the course of litigating the case."[60] The disproportionate focus on time versus cost investment as a justification for the fee award renders this decision typical.[61]

Professor Rubenstein and I have shown that disproportionately rewarding time relative to cost investment distorts attorney case investment decisions in a manner that can dramatically affect whether persons with high cost claims have

57. *Id.* (citing Goldberger v. Integrated Res., Inc., 209 F.3d 43, 50 (2d Cir. 2000)).

58. *Id.* at 441 (emphasis added).

59. *Id.* ("My award of attorneys' fees must recognize that, from an *ex ante* perspective, counsel no doubt had serious doubts about taking on such a risky and expensive litigation.").

60. *Id.* at 448.

61. *See, e.g.*, *In re* Citigroup Inc. Bond Litig., 988 F. Supp. 2d 371, 373–376, 378–381 (S.D.N.Y. 2013) (In connection with the settlement of a securities fraud class action, the trial court awarded $116.8 million in fees and reimbursed litigation expenses in the amount of $7,286,868; using the percentage of fund method with a lodestar cross-check, the court assessed the reasonableness of the fee award by reference to time invested, without emphasizing cost investment as a determinant of the award, instead, merely noting that costs are to be reimbursed); *In re* Schering-Plough Corp. Enhance Secs. Litig., No. 08-397 (DMC) (JAD), 2013 U.S. Dist LEXIS 147981, at *74–115 (D. N.J. Aug. 28, 2013) (In connection with settlement of a securities fraud class action, awarding $80,021,600 in fees and $3,620,049.63 in costs, using a blended percentage and lodestar method, noting substantial cost investment, but disproportionately emphasizing time investment, both in connection with the percentage to be applied to the settlement fund and via the lodestar cross-check); *In re* Flonase Antitrust Litig., 951 F. Supp. 2d 739, 746–51 (E.D. Pa. 2013) (In connection with settlement involving creation of a $150 million settlement fund, court awarded fees of $50 million and reimbursed costs in the amount of $2,069,433, focusing in the order on fees almost exclusively on time investment using both the percentage and lodestar methods).

access to quality representation.[62] If we assume that class counsel are profit-maximizing, then mapping the distortions is a matter of following the money. While a plaintiffs' class action law firm may be indifferent to the distinction between time and cost investment, it can experience direct profits only on time, not costs. As a result, the firm will favor time-intensive over cost-intensive cases when choosing which cases to pursue; when given a choice, will invest attorney time rather than costs in a case, even if paying a third-party to perform a necessary litigation task would be cheaper for the class; and will face relatively more pressure to settle prematurely, especially around major cost-investment points, e.g., just before having to invest in high cost testifying experts. The distortion in class counsel's investment incentives caused by the current bias against direct cost profits thus produces agency costs, including the loss in welfare experienced by the principal as a result of counsel's disloyalty.[63]

The disparate treatment of time and cost investment in class action fee doctrine is rarely challenged. Class counsel do not normally seek direct cost profits from the court. This state of affairs is widely and uncritically accepted. The strain of mismatched rewards on time and cost investment is mostly under the surface, invisible to outside observers, except where investing counsel disagree on the allocation of any fee and cost award. In many cases, counsel's investment of time and cost are roughly proportional, so that the fee awarded gets allocated in roughly the same percentage as the overall contribution of time and money. However, in some cases, counsel invest time and costs disproportionately. It is in those cases that the uneven treatment of time and cost investment is most likely to erupt in the kind of conflict that will bubble up to a published decision that reveals the ethical concerns animating the uneven treatment of time and cost investment.

Agent Orange is the most famous case.[64] There, at a critical juncture in the litigation, existing counsel had depleted their resources and needed additional cost investment to continue the litigation.[65] To induce such investment, Plaintiffs' Management Committee (PMC) members agreed that cash-investing counsel would receive a three-fold return on their cost investment in the event of a

62. Ratner & Rubenstein, *supra* note 6, at 600–07. In this analysis, we assumed the lawyers are profit maximizing on behalf of their firms, that they can predict case costs and case expected values with some accuracy, and that they are indifferent between time and cost investment but for the way courts reward those categories of investment. *See id.* at 598–99.

63. For a classic definition of agency costs, see Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

64. Interfirm agreements regarding case financing are common. *See* Nora Freeman Engstrom, *Re-Re-Financing Civil Litigation: How Lawyer Lending Might Remake the American Litigation Landscape, Again*, 61 UCLA L. REV. DISC. 110, 115 (2013) ("Nor has interfirm coordination been confined to marquee cases. Even in routine cases, a practice has developed whereby, when PI law firms become over-extended, they forge co-counsel relationships with better financed and more experienced lawyers, together shepherding difficult cases to trial.").

65. SCHUCK, *supra* note 20, at 102–09 (describing the plaintiffs' lawyers' financial crisis).

successful resolution of the case.[66] Fees remaining in the pool (the combined fee and cost award made by the court) after the investment payouts would be split in accordance with counsel's relative time investments.[67] Judge Weinstein, recognizing the need to properly reward cost investing counsel, was willing to tolerate this reallocation of his fee and cost award.[68] The Second Circuit reversed on grounds sounding in ethics and procedure:[69] Class counsel's contractual end-run around the court's fee and cost award conflicted with the "principles of reasonable compensation in common fund actions" set forth in Second Circuit cases, which at that time centered on counsel's relative time investment via the lodestar method.[70] Moreover, the agreement among counsel to reward cost-investment created impermissible conflicts between class counsel and the class because cost-investing counsel were focused primarily on their three-fold return rather than on maximizing the recovery for the class.[71] Not only was the particular allocation agreement among counsel in that case unenforceable, but, the court suggested that *all* agreements designed to generate cost profits categorically created unacceptable risks of disloyalty:

> In our view, fees that include a return on investment present the clear potential for a conflict of interest between class counsel and those whom they have undertaken to represent . . . . The conflict obviously lies in the incentive provided to an investor-attorney to settle early and thereby avoid work for which full payment may not be authorized by the district court. Moreover, as soon as an offer of settlement to cover the promised return on investment [i.e., cost investment] is made, the investor-attorney will be disinclined to undertake the risks associated with continuing the litigation.[72]

66. *In re* Agent Orange Prod. Liab. Litig., 818 F.2d 216, 218 (2d Cir. 1987).

67. *Id.* at 219.

68. *Id.* at 220–21.

69. *Id.* at 222 (When reviewing a fee issue, "courts should look to the various codes of ethics as guidelines for judging the conduct of counsel . . . . The ultimate inquiry, therefore, in examining fee agreements and setting fee awards under the equitable fund doctrine and FED. R. CIV. P. 23(e) is the effect an agreement could have on the rights of a class.").

70. *Id.* at 223 ("A careful examination of those decisions permitting internal fee sharing agreements to govern the distribution of fees reveals no case where return on investment was a factor. More important, in a number of those cases the courts apparently assumed that the internal fee sharing agreement would be based substantially on services rendered by individual counsel . . . . Obviously, the needs of large class litigation may at times require class counsel in assessing the relative value of an individual attorney's contribution to turn to factors more subjective than a mere hourly fee analysis. It does mean that the distribution of fees must bear some relationship to services rendered.").

71. *Id.* at 224 ("The district court recognized that the agreement provided an incentive for the PMC to accept an early settlement offer not in the best interests of the class, because 'an attorney who is promised a multiple of funds advanced will receive the same return whether the case is settled today or five years from now,'" (quoting *In re* Agent Orange Prod. Liab. Litig., 611 F.Supp. 1296, 1460 (E.D.N.Y. 1985))).

72. *Id.* at 223–24 (citations omitted).

Though academic commentators criticized the *Agent Orange* decision in the few years following its issuance,[73] it remains good law.[74]

III. THE ETHICS OF COST PROFITS

Agent Orange should not be the last word on the ethics of cost profits. Because of the way the relevant doctrine is structured, a modern inquiry into the ethical propriety of direct cost profits requires us to map three boundary lines—the lines between professional and other services, between consent and its absence, and between permissible and impermissible conflicts. Traditionally, these lines have been drawn as a barrier to cost profits, due largely to a failure to fully account for class counsel's unique role as litigation funder and as a court-appointed fiduciary.

A. THE LINE BETWEEN PROFESSIONAL AND "OTHER" SERVICES

Ethics rules, contract law (as applied to attorney fee and cost agreements), and class action fee and cost award doctrine all presume that attorney "services" may be directly profitable, but that cost investment may not, absent notice or agreement to the contrary at the outset of the attorney-client relationship. These doctrines constitute a line between "professional" (attorney labor) and other services, one that has been used to bar direct cost profits in class actions. Direct cost profits can be enabled in part by updating our vision of the professional service that lawyers provide in practice settings where they act as litigation funders of first resort.

1. THE BOUNDARY LINE'S CONSTITUTIVE DOCTRINE

Under Rule 1.5 of the ABA Model Rules of Professional Conduct, time investment is presumptively profitable, but cost investment is not. Rule 1.5 imposes the same *general* limits on fees and costs, i.e., both must be reasonable.[75] The Rule also requires similarly timed disclosures to the client of both fees and costs, i.e., at the outset of an attorney-client relationship.[76] The similarities end there. While Rule 1.5(a) provides a detailed multi-factor test for assessing the

73. *See supra* note 21.

74. *See, e.g.*, *In re* TFT-LCD (Flat Panel) Antitrust Litig., No. M 07-1827 SI, 2013 U.S. Dist. LEXIS 49885, at *84 (N.D. Cal. April 1, 2013) ("Both federal law and California law require that any fee allocation agreement among attorneys that are not members of the same firm be in writing and signed by the clients, and be made in proportion to the services performed and responsibilities assumed," (citing *Agent Orange*, 818 F.2d at 220)); Allapattah Servs. v. Exxon Corp., 454 F. Supp. 2d 1185, 1225–26 (S.D. Fla. 2006) (rejecting fee allocation agreement among class counsel and citing *Agent Orange*).

75. MODEL RULES R. 1.5(a) ("A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses.").

76. MODEL RULES R. 1.5(b) ("The scope of the representation and the basis or rate of the fee and expenses for which the client will be responsible shall be communicated to the client, preferably in writing, before or within a reasonable time after commencing the representation . . . .").

reasonableness of a fee,[77] neither the rule nor the comments to it explain what constitutes a "reasonable" cost charge, except that Comment 1 suggests that absent agreement to the contrary, the cost of "services performed in-house" must reflect the *actual* "cost incurred by the lawyer," meaning there can be no markup or profit on such cost investment.[78] The leading ethics opinion on billing practices extends Comment 1's presumption to the other key category of case-specific costs, i.e., disbursements: "It is the view of the Committee that, in the absence of disclosure to the contrary, it would be improper if the lawyer assessed a surcharge on these disbursements over and above the amount actually incurred unless the lawyer herself incurred additional expenses beyond the actual cost of the disbursement item."[79] Only cost investment is subject to this presumptive preclusion of profits.

This differential treatment of time and cost investment under the ethics rules reflects a particular understanding of the line between "professional" and "other" services. The line is revealed in ABA Formal Op. 93-379, which treats attorney time and "professional services" as synonymous,[80] and, moreover, assumes that attorney cost investment is not part of the "professional" service rendered.[81] The justification for this boundary line is based on a vision of the professional role grounded in *labor*:

> "[I]n the absence of agreement to the contrary, it is impermissible for a lawyer to create an additional source of profit for the law firm beyond that which is contained in the provision of professional services themselves. *The lawyer's stock in trade is the sale of legal services, not photocopy paper, tuna fish sandwiches, computer time or messenger services.*"[82]

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77. MODEL RULES R. 1.5(a) lists eight non-exclusive factors for determining the reasonableness of a "fee," including, first, the "time and labor required," as well as the lawyer's opportunity costs; customary fees in the locality; the amount involved and results obtained; time limits imposed by the client or circumstances; the nature of the lawyer's prior relationship with the client; the lawyer's experience or reputation; and whether the fee is fixed or contingent.

78. ABA Formal Op. 93-379 explains how actual costs of in-house services may be calculated: "We conclude that under those circumstances the lawyer is obliged to charge the client no more than the direct cost associated with the service (i.e., the actual cost of making a copy on the photocopy machine) plus a reasonable allocation of overhead expenses directly associated with the provision of the service (e.g., the salary of the machine operator)." ABA Formal Op. 93-379, *supra* note 19.

79. *Id.* (commenting that law firm overhead is subsumed within the charge for professional services, and, absent agreement to the contrary, cannot be billed separately at all; case-specific cost investment (either in the form of disbursements or charges for in-house services can be recouped, but only at cost)).

80. *Id.* ("Consistent with the Model Rules of Professional Conduct, a lawyer must disclose to a client the basis on which the client is to be billed for both professional time and any other charges. Absent a contrary understanding, any invoice for professional services should fairly reflect the basis on which the client's charges have been determined.").

81. *Id.* ("In addition to charging clients fees for professional services, lawyers typically charge their clients for certain additional items which are often referred to as disbursements, out-of-pocket expenses or additional charges.").

82. *Id.* (emphasis added). The ABA's interpretation of Rule 1.5 as it applies to the billing of time by contract lawyers is similarly revealing. A firm employing contract lawyers may elect to treat them either as a

The boundary between professional and other services corresponds with a differential treatment of time and cost investment under contract law as well. A lawyer may earn a profit on time investment in litigation *even if* the lawyer and client never reach agreement on the proper basis for calculating that fee, or, put differently, even if the lawyer and client never agree on the amount of profit the lawyer can earn on time investment.[83] In the absence of an agreement regarding fees, courts will typically award fees on a *quantum meruit* basis,[84] at the lower range of what would be a reasonable negotiated fee,[85] which can be determined based on an hourly rate that would be charged by lawyers of similar experience in comparable cases.[86] Thus, the fee awarded may not be as profitable as the fee the attorney would have liked to have negotiated, but may nevertheless incorporate some level of profit, i.e., a markup on the actual cost to the lawyer of providing the time investment.[87] The same is not true of costs. Paralleling ethics doctrine, cost investment by a lawyer cannot be directly profitable absent agreement to the contrary.

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disbursement, in which case the cost is not presumptively profitable, or as the provision of a legal service, in which case it is presumptively profitable. *See* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 00-420 (2000) [hereinafter ABA Formal Op. 00-420].

83. GEOFFREY C. HAZARD, JR., W. WILLIAM HODES & PETER R. JARVIS, THE LAW OF LAWYERING 8–24, § 8.10 (3d ed. 2012), ("[I]t is rare that a client-lawyer relationship comes into being, let alone continues, without some agreement—even if only an implicit one—about the fees that the lawyer will charge. However, the matter may have been left so vague that for practical purposes there is no 'agreement' that is capable of being enforced according to its 'terms.' Also, there are situations in which the parties thought they had an agreement, but the agreement is unenforceable because of some technical impediment.").

84. *See* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS, § 39 [hereinafter RESTATEMENT] ("If a client and lawyer have not made a valid contract providing for another measure of compensation, a client owes a lawyer who has performed legal services for the client the fair value of the lawyer's services."); Joseph M. Perillo, *The Law of Lawyers' Contracts is Different*, 67 FORDHAM L. REV. 443, 452 (1998) ("Putting disciplinary consequences aside, the lawyer who fails to comply with this requirement [of Model Rule 1.5(b)] will be relegated to compensation on the basis of *quantum meruit*.") (bracketed text added).

85. RESTATEMENT § 39 cmt. c ("A conservative evaluation is usually appropriate in assessing fees under this Section. When a lawyer fails to agree with the client in advance on the fee to be charged, the client should not have to pay as much as some clients might have agreed to pay.").

86. RESTATEMENT § 39 cmt. c ("The hourly fee would be that charged by lawyers of similar experience and other credentials in comparable cases, but not more than the standard rate of the lawyer in question for that type of work."); Mardirossian & Assocs., Inc. v. Ersoff, 153 Cal. App. 4th 257, 272 (2007) ("It is well settled that a contingency fee lawyer discharged prior to settlement may recover in quantum meruit for the reasonable value of services rendered up to the time of discharge. 'The most useful starting point for determining the amount of a reasonable fee is the number of hours reasonably expended on the litigation multiplied by a reasonable hourly rate.'") (internal citations omitted); Potts v. Hines, 534 N.Y.S.2d 507, 508 (N.Y. App. Div. 1988) ("A suspended attorney is entitled to recover on a quantum meruit basis for services performed prior to suspension (22 NYCRR 806.9[b]). Generally, an attorney seeking counsel fees must establish the value of his services . . . by showing such factors as the time and skill required, the matter's complexity, his experience, ability and reputation, the client's benefit from the services and the fee usually charged by other attorneys for similar services.").

87. *See* HAZARD ET AL., *supra* note 83, at 8–25 ("[I]n measuring the fair value, a court should take into account the market price for like service"); RESTATEMENT § 39 cmt. c ("A lawyer who proves that a standard fee exists in the area should ordinarily be entitled to receive it . . . ").

Class action fee and cost awards also track the ethics rules' distinction between professional services that presumptively may generate profit and other services (including cost investment) that may not. As noted, most fee and cost awards state that cost advances are merely reimbursed, without explanation.[88] But a few decisions do discuss their refusal to permit direct cost profits, and those decisions either cite ethics doctrine (as in *Agent Orange*), or use language that tracks the key boundary line between professional and other services.[89]

2. WHY COST INVESTMENT IS EXCLUDED FROM THE DEFINITION OF "PROFESSIONAL SERVICES"

The current boundary line between "professional" and other services reflects a particular understanding of client expectations. ABA Formal Op. 93-379 ("the Opinion") states that surcharges or direct profits on disbursements beyond the actual cost advanced by the lawyer are impermissible, absent agreement to the contrary because "[c]lients quite properly could view these practices as an attempt to create additional undisclosed profit centers when the client has been told he would be billed for disbursements."[90] This view of client expectations results in part from the assumption in the Opinion that the lawyer has committed in advance to "bill" for disbursements.[91] But the same set of default assumptions is not applied to labor or time; a lawyer who promises, *ex ante*, to "bill" for time is not assumed to be billing only at the lawyer's cost of providing the legal service, without room for profit.[92]

The source of this understanding of client expectations regarding the profitability of professional versus "other" services like advancing costs is unclear.[93] It is likely that the drafters of the Opinion simply did not have contingency fee lawyers in mind when describing client expectations.[94] For

88. *See In re* Payment Card Interchange Fee & Merch. Disc. Antitrust Litig., 991 F. Supp. 2d 437, 448 (E.D.N.Y.2014).

89. *See, e.g.*, *In re* San Juan Dupont Plaza Hotel Fire Litig., 111 F.3d 220, 237 n.19 (1st Cir. 1997) (citing and discussing ABA Formal Op. 93-379 when refusing to permit copy charges to become a profit center for common benefit counsel in an aggregate MDL proceeding); *In re* AMF Bowling Sec. Litig., 334 F. Supp. 2d 462, 469–70 (S.D.N.Y. 2004) (citing and discussing ABA Formal Op. 93-379 when rejecting cost submission in class action that contained insufficient detail for the court to determine if it included impermissible profits on costs).

90. ABA Formal Op. 93-379, *supra* note 19.

91. *Id.*

92. *See* ABA Formal Op. 00-420, *supra* note 82 ("It is implicit in Formal Op. 93-379 that profit from providing legal services is expected and appropriate, as long as the total fee is reasonable.").

93. The Opinion's view of client expectations is somewhat circular, given that ethics rules (and their interpretation) shape those same expectations.

94. It is possible, too, that the exclusion of cost investment from the definition of professional services that may presumptively be profitable results from the fact that, in some jurisdictions, funds advanced for case costs are ultimately the client's responsibility. *See* Geoffrey P. Miller, *Payment of Expenses in Securities Class Actions: Ethical Dilemmas, Class Counsel, and Congressional Intent*, 22 REV. LITIG. 557, 565–73 (2003) (reviewing increasingly permissive approaches in ethics rules toward attorney advances to clients, and describing jurisdictions' varying approaches to the question of whether clients must ultimately be responsible

purposes of identifying and drawing the boundary line between professional and other services, the Opinion imagines the lawyer as billing for time and costs on a pay-as-you-go basis. The first sentence of the Opinion reiterates the requirement that a lawyer disclose the basis on which the client is to be "billed for both professional time and any other charges."[95] The second sentence of the Opinion assumes that such billing occurs in the form of "invoices for professional services."[96] Despite the increasing prevalence of alternative fee arrangements (e.g., flat fees), this traditional vision of the lawyer who regularly invoices and collects time and cost charges from the client accurately reflects a large segment of the legal services market.[97]

Contingent fee lawyers in general, and plaintiffs' class action lawyers in particular, are different. In lieu of billing or invoicing clients for time and costs on a pay-as-you-go basis, such lawyers invest time and costs in their clients' claims in exchange for payment out of any recovery only in the event that the litigation is successful.[98] The Opinion mentions contingent fee lawyers in passing, when quoting the text of Rule 1.5,[99] and when limiting the lawyer's ability to charge for overhead costs which are deemed part of the fee and are thus different from case-specific costs like in-house charges or disbursements to third parties.[100] But the Opinion omits any meaningful description of the case investment that contingency fee lawyers make.

Historical bias may also explain the current border between professional and other services. Disdain for or at least minimization of the centrality of litigation funding as a component of the array of professional services lawyers may provide has deep historical roots. It was expressed most clearly in common law prohibitions against that function—maintenance, champerty, and barratry, doctrines that have been traced back to feudal England.[101] "Put simply, maintenance

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for costs advanced). That means the lawyer is not seen as taking a risk there equivalent to the risk associated with the lawyer's advance of time, recovery of which may, in all jurisdictions, be purely contingent on the case outcome.

95. ABA Formal Op. 93-379, *supra* note 19.

96. *Id.*

97. David Brown & Jennifer Tonti, *Executive Summary: Survey of Law Firm Economics*, MANAGING PARTNER FORUM 3 (2012), *available at* http://www.managingpartnerforum.org/tasks/sites/mpf/assets/image/MPF%20-%202012%20Survey%20of%20LF%20Economics%20-%20Exec%20Summary%20-%209-20-12.pdf_("[W]hile it's clear that alternative fee arrangements are part of the arsenal of the vast majority of firms (ninety-six percent said one or more of their billings came from alternative fees), that doesn't mean firms are fast replacing the billable hour. Last year, thirty percent of firms said alternative fees represented more than ten percent of their billings. This year, thirty-four percent said so. The needle is moving—but slowly.").

98. HERBERT M. KRITZER, RISKS, REPUTATIONS AND REWARDS: CONTINGENCY FEE LEGAL PRACTICE IN THE UNITED STATES 9 (2004) (defining contingency fee agreements).

99. *Id.* at 7.

100. *Id.* at 5.

101. Max Radin, *Maintenance by Champerty*, 24 CALIF. L. REV. 48, 63–64 (1935); *see also* Deborah L. Rhode, *Institutionalizing Ethics*, 44 CASE W. RES. L. REV. 665, 722–23 (1994) (linking restrictions on case financing—both by lawyers and by parties—to medieval prohibitions on champerty and maintenance); Miller,

is helping another prosecute a suit; champerty is maintaining a suit in return for a financial interest in the outcome; and barratry is a continuing practice of maintenance or champerty."[102] These doctrines arose out of a cultural background in which litigation was viewed not as an essential mode of (private) enforcement of law, but, instead, as a "necessary evil,"[103] such that the lawyer's legitimate role was not framed to include creating the conditions necessary for litigation to be most conveniently, widely, or fairly financed. The role of the lawyer was instead to be an advisor and counselor, with the value of the service measured in units of time.

That vision was challenged in the nineteenth and twentieth centuries by competing conceptions of contingency fee lawyers as performing a social good—enabling private enforcement of law.[104] In the United States, champerty and maintenance are now relatively weak doctrines.[105] They were never universally adopted in this country, and have increasingly fallen into disfavor.[106] With regard to contingency fees in particular, maintenance, champerty, and barratry have ceded ground to ethics rules[107] that regulate[108] but permit such fees in every jurisdiction.[109] But the anxiety regarding litigation financing expressed

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supra note 94, at 560–61 (linking ethics rules regarding advancement of litigation costs to "traditional concerns about maintenance and champerty").

102. *In re* Edna Smith Primus, 436 U.S. 412, 424 n.15 (1978) (citing 4 WILLIAM BLACKSTONE, COMMENTARIES, *134–36).

103. Radin, *supra* note 101, at 68.

104. *See* Peter Karsten, *Enabling the Poor to Have Their Day in Court: The Sanctioning of Contingency Fee Contracts, a History to 1940*, 47 DEPAUL L. REV. 231, 241–42 (1998); *In re* Abrams & Abrams, P.A., 605 F.3d 238, 245 (4th Cir. 2010) ("[C]ontingeny fees provide access to counsel for individuals who would otherwise have difficulty obtaining representation."). *But see* Anthony J. Sebok, *The Inauthentic Claim*, 64 VAND. L. REV. 61, 125 (2011) (challenging the historical account of a "straight line of hostility" to maintenance and champerty extending "from Rome until the late twentieth century").

105. *See* Del Webb Cmtys., Inc. v. Partington, 652 F.3d 1145, 1156 (9th Cir. 2011) (recognizing the decline of champerty as a tort).

106. *See* Saladini v. Righellis, 687 N.E.2d 1224, 1225–26 (Mass. 1997) (The doctrine of Champerty "has a long and, in this country, checkered history. . . . The extent to which courts, here, accepted the doctrine has varied . . . . In some States, champerty was never adopted, or has been abandoned . . . . In others, the doctrine was given narrow application. *See, e.g.*, Brown v. Bigne, 28 P. 11,13 (Or. 1891) (doctrine should apply only when 'contracts are made for the purpose of stirring up strife and litigation, harassing others, inducing suits to be begun which otherwise would not have been commenced, or for speculation.'").

107. *See* Sebok, *supra* note 104, at 100 (the contingency fee is a form of maintenance now regulated by "each state's rules regarding the regulation of lawyers").

108. *See* MODEL RULES R. 1.5 (prohibiting contingency fees in particular categories of suits); Monica Hughes, Note, *Applying State Contingency Fee Caps in Multidistrict Litigation (MDL) Settlements*, 91 TEX. L. REV. 961, 963 (2013) ("Several state laws broadly cap contingency fees in most kinds of tort suits."); Richard W. Painter, *Litigating on a Contingency: A Monopoly of Champions or a Market for Champterty?*, 71 CHI.-KENT L. REV. 625, 648 (1995) ("In addition to determining reasonableness on a case-by-case basis, some jurisdictions limit contingent-fee percentages by rules of court. A few federal statutes impose similar limits.").

109. *See* MODEL RULES R. 1.5(a)(8) & R. 1.8(e) (2013); MODEL CODE OF PROF'L RESPONSIBILITY DR 2-106(B)(8) (1980) [hereinafter MODEL CODE]; CANONS OF PROF'L ETHICS Canon 12 (1908) [hereinafter 1908 CANONS]; Lester Brickman, *Contingent Fees Without Contingencies: Hamlet Without the Prince of Denmark?*, 37 UCLA L. REV. 29, 38–39 (1989) ("Today, all fifty states allow attorneys to enter into contingent fee

in the doctrines of maintenance, champerty, and barratry still exists[110] and shapes the law governing lawyers. For example, that fear still animates limits on third-party financing in some jurisdictions,[111] and shapes Model Rules 1.8(e), limiting the ability of lawyers to provide financial assistance to clients, and 1.8(i), preventing lawyers from acquiring property interests in a cause of action other than a contingent fee or cost recovery.[112]

It is only by ignoring or downplaying the distinct role class counsel plays as litigation funder that an expectations-based bifurcation of services into "professional" (time) and "other" (costs) makes sense. The client who pays by the hour reasonably sees herself as buying a professional service in the form of the attorney's labor. The plaintiff in a class action is buying much more.

3. RECOGNIZING COST INVESTMENT AS A PROFESSIONAL SERVICE CLASS COUNSEL PROVIDE

The academic literature describes the role class counsel and other contingency fee plaintiffs' lawyers play as including litigation funding and insurance against the possibility of non-recovery.[113] But is that a "*professional*" service? Three vantage points suggest an affirmative answer. As noted, ABA Formal Op. 93-379 looks at the client's expectations when distinguishing professional and other services. From that vantage point, litigation funding is an essential professional

contracts."); *see also* HAZARD ET AL., *supra* note 83, at 8–14.1 ("[L]egal fees that are contingent on the outcome of a matter are common in the United States, although they are prohibited in many other countries and were formerly prohibited in this country.").

110. *See* Marc Galanter, *Anyone Can Fall Down a Manhole: The Contingency Fee and Its Discontents*, 47 DEPAUL L. REV. 457, 457 (1998) ("Denigration of the contingency fee has figured prominently in the contemporary assault on the civil justice system that started in the late 1970s. Critics who behold a litigation explosion, excessive litigiousness, runaway juries, too many lawyers and other evils, identify the contingency fee as an important ingredient of the mess.").

111. *See, e.g.*, Johnson v. Wright, 682 N.W.2d 671, 678–79 (Minn. Ct. App. 2004); Rancman v. Interim Settlement Funding Corp., 789 N.E.2d 217, 221 (Ohio 2003) (voiding a third-party funding agreement as champertous); *see also* Sebok, *supra* note 104, at 107–20 (canvassing the different ways states regulate maintenance by third parties along the following dimensions: type of suit; investment mechanism; and whether the investment caused the lawsuit).

112. *See* MODEL RULES R. 1.8 cmt. 16.

113. *See* Brickman, *supra* note 109, at 43–44 (characterizing the contingency fee as a means of financing litigation and thereby creating access; characterizing contingency fee lawyers with diverse portfolios as equivalent to insurers pooling litigation risks); Engstrom, *supra* note 14, at 411 (arguing that the contingency fee "has always been understood to compensate plaintiffs' lawyers for a trio of services," including "actual lawyering," banking services and "insurance services"); John Leubsdorf, *The Contingency Factor in Attorney Fee Awards*, 90 YALE L.J. 473, 480 (1981) ("A lawyer who both bears the risk of not being paid and provides legal services is not receiving fair market value of his work if he is paid only for the second of these functions."); Jonathan T. Molot, *A Market in Litigation Risk*, 76 U. CHI L. REV. 367, 377 (2009) ("When a plaintiff's lawyer accepts a case on a contingent fee basis, he absorbs from his client the risk that the recovery will not be enough to cover litigation expenses.").

service contingent fee counsel provide.[114] Injured persons retain contingent fee counsel because they are unable or unwilling to finance litigation on their own. While individual, non-class contingent fee agreements regularly require the client to pay for litigation costs,[115] the typical class representative in a class action is unable to fund case costs on behalf of the entire class. This is especially true in small claims class actions, where it would be illogical for a named plaintiff to agree to fund case costs when her expected recovery is only a small fraction of those costs. Class action plaintiffs therefore reasonably expect class counsel to advance both time and costs of litigation as a necessary part of the service they provide, without which the class action could not proceed.[116]

From the perspective of the contingent fee lawyer, case filing and management decisions—quintessential professional services—*are* case investment decisions. A decision to represent a contingent fee plaintiff is a decision to invest in her claim. Each case management choice made upon commencement of the action has a price tag, in terms of both time and costs advanced by counsel. For example, a motion to compel can easily cost several thousand dollars in attorney time.[117] Similarly, the decision to retain a particular kind or quality of expert necessarily entails disbursements for that expert's time. The lawyer making case management decisions is simultaneously both a financier and an advocate, the former professional role enabling and shaping the latter.

Finally, from the perspective of the court appointing class counsel, litigation financing is a key professional service counsel must be able to competently provide. Pursuant to Rule 23(g), the court appointing class counsel must consider not only counsel's experience and knowledge, but, also, "the resources that counsel will commit to representing the class"[118] A trial court may be found to have abused its discretion if it appoints class counsel who are incapable of

114. *See* Herbert M. Kritzer, *The Wages of Risk: The Returns of Contingency Fee Legal Practice*, 47 DEPAUL L. REV. 267, 270 (1998) ("The normal hourly fee or flat fee simply purchases the services of a lawyer. Under a contingency fee arrangement, the client also purchases additional services. The first is financing.").

115. Sample individual, non-class contingent fee agreements from both the American Bar Association and various state bar associations have the lawyers advancing time but requiring clients to fund the cost of litigation. *See, e.g.*, P.A. Henrichsen, *Sample Engagement Letters and Fee Agreements: Compensation Agreement (Contingent Fee)*, ABA GPSOLO MAG. (Jan./Feb. 2007), *available at* http://www.americanbar.org/newsletter/publications/gp_solo_magazine_home/gp_solo_magazine_index/sampleengageletters.html#letter-7; *Sample Written Fee Agreement Forms*, STATE BAR OF CAL. 22–27 (2005), *available at* http://www.calbar.ca.gov/Portals/0/documents/mfa/Sample-Fee-Agreement-Forms.pdf.

116. *See* Capra et al., *supra* note 21, at 844–49 (noting the trend toward recognition by courts of the practical need for class counsel to bear the risk of advancing case costs, and thus to exempt class actions from DR 5-103(b), which made the client ultimately liable for case costs).

117. *See, e.g.*, Limu Co., LLC v. Burling, No. 6:12-cv-347-Orl-TBS, 2013 U.S. Dist. LEXIS 108848, at *8 (M.D. Fla. Aug. 2, 2013) (awarding $2,170 in attorneys' fees as part of sanction on a motion to compel); I.R. v. City of Fresno, No. 1:12–CV–00558 AWI GS, 2013 U.S. Dist. LEXIS 76969, at *23 (E.D. Ca. May 31, 2013) (awarding $6,430.10 in attorney and paralegal time on a motions to compel and for sanctions).

118. FED. R CIV. P. 23(g)(iv).

funding the litigation.[119] Rule 23's text thus requires courts to appreciate class counsel's role as litigation funder.

To match the experiences and expectations of clients, counsel and courts in class actions, the boundary line between "professional" and "other" services should be moved to acknowledge class counsel's role as litigation funder. In the alternative, one could simply discard the boundary line between "professional" and "other" services as a meaningful heuristic to define permissible profits in the class setting. The end result is the same: cost investment is presumptively capable of producing direct profits.

B. THE LINE BETWEEN CONSENT AND ITS ABSENCE; SIMULATED CONSENT

Absent disclosure at the outset of the attorney client relationship, typically as a term in the fee agreement, attorneys in individual, non-class cases may not earn direct cost profits. Instead, absent such *ex ante* disclosure, cost investment may only be reimbursed.[120] The solution in individual cases is a relatively straightforward one: to reap direct cost profits, attorneys can disclose and ask clients to agree to cost profits at the outset of the attorney-client relationship as a term in the representation agreement.

In class actions, such *ex ante* contracting regarding the reward of cost investment is impracticable.[121] Class members do not even find out about the pendency of a class suit or the identity of class counsel until relatively late in the litigation timeline, upon notice of class certification. While courts once routinely certified litigation classes early in the proceedings, without requiring substantial discovery, and often based only on the allegations in the complaint, the certification decision now normally takes place in later stages of proceedings, often after class counsel have made significant investments of both time and

119. *See, e.g.*, Kimber v. Tallon, 556 Fed. App'x 27, 28 (2d Cir. 2014) (finding it was an abuse of discretion for the district court to appoint as class counsel the Prisoner Rights Office of the Vermont Defender General because that entity lacked sufficient resources).

120. ABA Formal Op. 93-379, *supra* note 19; San Diego Cnty. Bar Ass'n Legal Ethics Comm., Op. 2013-3 (2013).

121. *See* Samuel Issacharoff, *The Governance Problem in Aggregate Litigation*, 81 FORDHAM L. REV. 3165, 3167 (2013) ("There is no telling act by class members that would look like the realized buy-in of the capital markets, or any other mechanism that would allow a clear signal of consent to representation. Instead, class action law has to look for substitutes for the legally constructed rights of representation."). The PSLRA is one attempt to restore the power of a client in class actions, one that has had mixed results. *See* James D. Cox & Randall S. Thomas with Dana Kiku, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587, 1515, 1623, 1628–29 (2006) (finding that a stable cluster of firms continue to dominate class counsel appointments; that individuals rather than institutions continue to comprise a plurality of the named plaintiffs; and that case outcomes in securities cases post-dating the PSLRA have not improved). Moreover, this kind of reform does not address the more fundamental issue, for our purposes, of a lack of opportunity for *ex ante* contracting between class counsel and *absent* class members.

costs.[122] In many cases, no litigation class is certified, and the class members instead discover the pendency of the class case only after it has settled, when nearly all of the work for which class counsel can bill time or costs has been done.

The problem is that the laws structuring all of the basic features of the lawyer-client relationship—from its formation to its termination—are grounded in an individual, non-class setting on contract principles pursuant to which disclosure or client consent create the conditions of the agency relationship, on the assumption that there is a client who is present to receive disclosures and give consent. That contract approach simply does not work in class actions because absent class members have no opportunity to negotiate with class counsel. For example, contrary to law governing lawyers in non-class litigation, the formation of the attorney client relationship in class actions is not one that involves absent class member consent,[123] except through the artifice of the implied consent that arises when a class member declines to opt out in Rule 23(b)(3) (voluntary) classes;[124] even that artifice is unavailable in mandatory classes. Nor can class members fire class counsel,[125] though they may seek to appear through counsel or to attempt to intervene under Rule 24;[126] instead, class counsel are appointed and serve at the pleasure of the court. Class members do not determine the scope of the representation;[127] decisions regarding how to frame the dispute and regarding which claims and remedies to pursue are made by class counsel and the representative plaintiffs in the first instance when they file the motion for class certification, and by the court when deciding it. Nor do class members control or

122. *See* Mullenix, *supra* note 28, at 612–15.

123. The *Model Rules* do not establish the point of formation of the attorney client relationship, and instead refer to other law. *See* MODEL RULES scope, ¶17. That law typically determines the commencement point of the relationship from the perspective of the reasonable client. *See, e.g.*, Togstad v. Vesely, 291 N.W.2d 686 (Minn. 1980) (applying tort and contract principles to identify commencement point of a relationship between lawyer and potential client sufficient to give rise to malpractice liability).

124. *See* Phillips Petroleum Co. v. Shutts, 472 U.S. 797, 812–13 (1985) ("We reject petitioner's contention that the Due Process Clause of the Fourteenth Amendment requires that absent plaintiffs affirmatively 'opt in' to the class, rather than be deemed members of the class if they do not 'opt out.'"); STEPHEN C. YEAZELL, FROM MEDIEVAL GROUP LITIGATION TO THE MODERN CLASS ACTION 256 (1987) (Rule 23 "presumes acquiescence by requiring the class member to step forward to withdraw, instead of requiring members to volunteer").

125. Model Rule 1.16 gives clients the right to terminate the lawyer-client relationship. Class representatives, on the other hand, may not. *See* FED. R. CIV. P. 23(g)(4) advisory committee's notes ("The class representatives do not have an unfettered right to 'fire' class counsel.").

126. FED. R. CIV. P. 23(D)(1)(B)(iii) acknowledges their right to intervene and present claims or defenses, or to otherwise come into the action, and thus acknowledges a route, cabined by the dictates of FED. R. CIV. P. 24, by which class members may convert from absent to named parties. *See generally* WILLIAM B. RUBENSTEIN, NEWBERG ON CLASS ACTIONS §§ 9:30-36, at 481–521 (5th ed. 2013).

127. Model Rule 1.2, regarding the scope of representation and the allocation of authority between lawyer and client, states that "a lawyer shall abide by a client's decisions concerning the objectives of representation," giving authority to a client regarding the very purpose of the representation that an absent class member cannot exercise except through the class representative.

even consent to the fact, timing, or terms of settlement;[128] instead, they learn of settlement only after it is reached and granted preliminary approval by the court, whereupon they may but need not actually receive notice of it.[129] Nor does or can a class member consent in advance to fee arrangements, despite the clear language of Rule 1.5;[130] instead, the court sets attorney's fees.

While consent to cost profits cannot be elicited in a class action in the same way it can be in an individual representation, consent can nevertheless be simulated. In fact, simulated consent is the procedural path that legitimizes the appointment of class counsel, class settlement, and class counsel's fee award, despite the absence of express client consent. Traditionally, a facsimile of consent is manufactured by three interrelated mechanisms: trial court intervention in the proceedings in a fiduciary capacity,[131] e.g., to appoint and pay counsel[132] and to evaluate proposed settlements;[133] the requirement of adequate representation by counsel and the class representatives; and the creation of opportunities for class members to participate (via notice, and the right to intervene or comment) or, in voluntary classes, to exit by opting out.[134] In this way, there is a shift from a

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128. Model Rule 1.2 gives the client authority to determine whether to settle a case, stating that a "lawyer shall abide by a client's decision whether to settle a matter." *See also* Geoffrey P. Miller, *Conflicts of Interest in Class Action Litigation: An Inquiry into the Appropriate Standard*, 2003 U. CHI. LEGAL F. 581, 587 (2003) ("[T]he ordinary ethics rules protecting against conflicts of interest cannot apply in class actions without substantial modification. Consent is the lynchpin of these rules, and consent is impossible in class actions, either to waive conflicts or to authorize aggregate settlements.").

129. Juris v. Inamed Corp., 685 F.3d 1294, 1321 (11th Cir. 2012) ("Courts have consistently recognized that, even in Rule 23(b)(3) class actions, due process does not require that class members actually receive notice.").

130. *See* MODEL RULES R. 1.5(b) ("The scope of the representation and the basis or rate of the fee and expenses for which the client will be responsible shall be communicated to the client, preferably in writing, before or within a reasonable time after commencing the representation. . . . ."); MODEL RULES R. 1.5(c) ("A contingent fee agreement shall be in writing signed by the client and shall state the method by which the fee is to be determined, including the percentage or percentages that shall accrue to the lawyer in the event of settlement, trial or appeal; litigation and other expenses to be deducted from the recovery; and whether such expenses are to be deducted before or after the contingent fee is calculated.").

131. *See, e.g.*, FED. R. CIV. P. 23(d) (giving the court authority to issue orders for the benefit of the class, including orders requiring notice "to protect class members and fairly conduct the action"); *In re* Cendant Corp. Litig., 404 F.3d 173, 187 (3d Cir. 2005) ("The court's scrutiny is, in essence, a substitute for active client involvement, which is so often difficult to obtain in class actions. In traditional common fund cases, the court acts almost as a fiduciary for the class, performing some of the roles—i.e., monitoring and compensating class counsel—that clients in individual suits normally take on themselves."); Reynolds v. Beneficial Nat'l Bank, 288 F.3d 277, 279–80 (7th Cir. 2001) ("We and other courts have gone so far as to term the district judge in the settlement phase of a class action suit a fiduciary of the class, who is subject therefore to the high duty of care that the law requires of fiduciaries.").

132. *See* FED. R. CIV. P. 23(g)–(h). More recently, via the addition by amendment of Rule 23(g)(3), we can add another mechanism, the appointment of interim class counsel in the early phases of litigation, which more closely approximates the timing of consent required in individual litigation. However, Rule 23(g)(3) is permissive; courts are not required to appoint interim class counsel in the early phases of class litigation.

133. FED. R. CIV. P. 23(e).

134. *See* Phillips Petroleum Co. v. Shutts, 472 U.S. 797, 811–12 (1985) ("If the forum State wishes to bind an absent plaintiff concerning a claim for money damages or similar relief at law, it must provide minimal procedural due process protection. The plaintiff must receive notice plus an opportunity to be heard and

contractual[135] approach to structuring the lawyer-client relationship to a fiduciary and participatory one, where—at least in theory[136]—the court secures the class members' interests and the class members are given opportunities to participate.

These conceptual and doctrinal shifts create a space in class actions between consent and its absence, one that recognizes the court's role in creating and structuring the lawyer-client relationship in such actions. In class actions, court supervision throughout the proceeding and the opportunity for absent class member participation at key procedural moments (e.g., to opt out of a certified class or object to a proposed settlement) substitute for and simulate *ex ante* consent. In that space, we can ground simulated consent to cost profits, just as we do for consent to participate in the proceeding as a class member, settle a claim, or pay counsel a fee.

C. THE LINE BETWEEN ACCEPTABLE AND UNACCEPTABLE CONFLICTS

Agent Orange can be read broadly to suggest that direct cost profits are always impermissible because they create conflicts between class counsel and the class,[137] or narrowly, to hold only that the agreement among counsel to reallocate fees in that case created such conflicts. The broad reading—that cost profits are

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participate in the litigation, whether in person or through counsel . . . . Additionally, we hold that due process requires at a minimum that an absent plaintiff be provided with an opportunity to remove himself from the class by executing and returning an 'opt out' or 'request for exclusion' form to the court. Finally, the Due Process Clause of course requires that the named plaintiff at all times adequately represent the interests of absent class members."). *But see* Carrie Menkel-Meadow, *Ethics and the Settlements of Mass Torts: When the Rules Meet the Road*, 80 CORNELL L. REV. 1159, 1193–94 (1995) (questioning whether these kinds of procedural mechanisms are authorized by the ethics rules).

135. *See, e.g.*, C.K. Indus. Corp. v. C.M. Indus. Corp., 623 N.Y.S.2d 410, 411 (N.Y. App. Div. 1995) (An attorney-client relationship "arises when a contract is formed between attorney and client for the performance of legal services or the rendition of legal advice"); Burns v. Valene, 214 N.W.2d 686, 688–89 (Minn. 1974) (applying general contract principles to the fee agreement between attorney and client, despite the fiduciary nature of the relationship).

136. The efficacy of these devices to substitute for or simulate consent is open to question. For example, the right to opt out of a class action can be experienced by class members as an illusory one, especially in "negative value" suits that are not as economically viable as non-class claims. *See* Jay Tidmarsh, *Rethinking Adequacy of Representation*, 87 TEX. L. REV. 1137, 1167–68 (2009) ("The paradigmatic case is 'large-scale, small-stakes' litigation, also known as 'negative-value' suits. Assume that a credit-card company has illegally overcharged ten million customers $2 apiece. It is unlikely that very many, if any, individual cases will be filed; the costs of litigating each case exceeds the expected recovery (thus giving the suit a negative net value)."). Similarly, the meaningfulness of the right to object has been questioned. *See, e.g.*, Theodore Eisenberg & Geoffrey Miller, *The Role of Opt-Outs and Objectors in Class Action Litigation: Theoretical and Empirical Issues*, 57 VAND. L. REV. 1529, 1560 (2004) (questioning whether class members value the opportunity to object); Christopher R. Leslie, *The Significance of Silence: Collective Action Problems and Class Action Settlements*, 59 FLA. L. REV. 71, 90 (2007) ("Courts have been far too quick to treat class member silence as universal support for a proposed settlement . . . [C]ourts have systematically misinterpreted the silence of the class by ignoring more plausible explanations for class members' failure to object to a proposed settlement.").

137. *See* Capra et al, *supra* note 21, at 852 ("Read strictly, the Second Circuit's decision would permit some fee sharing agreements, but would prohibit one that promised a 'return on investment,' such as the *Agent Orange* arrangement.").

categorically improper on conflicts grounds—goes to the method by which a trial court may calculate fees and costs, and is analogous to the choice between use of the lodestar or percentage of fund methods for calculating fees. The narrow reading—that this particular agreement among counsel was improper—goes to the distinct issue of whether counsel's contractual commitments regarding the allocation of fees rendered them impermissibly conflicted. The broad and narrow readings implicate different concerns and doctrinal frameworks. The court could have held that as a general rule trial courts may or should award direct cost profits in appropriate circumstances as part of a fee and cost award method, but could nevertheless have found that the contract among counsel to create such profits *in this case* was improper. That is, the process of drawing a boundary line between permissible and impermissible conflicts varies depending on whether a court is choosing a fee and cost award methodology or is instead examining the conduct of counsel in a specific case. In either circumstance, the conflicts analysis should be tailored to the class action's distinctive procedural contours, which the Second Circuit in *Agent Orange* failed to do.

1. CHOOSING A FEE AND COST AWARD METHODOLOGY

Should a method for awarding of fees or costs to class counsel be rejected because it creates conflicts between class counsel and the class? The answer is surely "no." Lawyers and clients are inherently conflicted regarding fees and costs: lawyers want to maximize their profits while clients want to maximize their own net gains. With regard to fees, the choice is *never* between a method for calculating fees that generates conflict and one that does not. Building on the same economic theory discussed above,[138] courts recognize that all existing[139] fee calculation methods create conflicts of interest.[140] The lodestar approach rewards counsel for being inefficient and for taking too long to resolve a

138. *See* Coffee, *supra* note 11.

139. Commentators have made adventuresome and creative proposals to minimize agency costs in class actions. *See, e.g.*, Jay Tidmarsh, *Auctioning Class Settlements*, 56 WM. & MARY L. REV. 227 (2014) (canvassing various proposals, and adding a new one, to wit: courts should put proposed class settlements up for auction, in connection with which third parties can purchase the class claims, with purchase proceeds going to the class); Jay Tidmarsh, *Cy Pres and the Optimal Class Action*, 82 GEO. WASH. L. REV. 767, 787 (2014) (citing Kevin M. Clermont & John D. Currivan, *Improving on the Contingent Fee*, 63 CORNELL L. REV. 529, 546–47 (1978)); Macey & Miller, *supra* note 11, at 105–16 (proposing auctioning class claims to the highest bidder) (reviving and applying to class actions a little-noticed proposal to combine an hourly and percentage approach to better align the interests of lawyer and client).

140. Professor Nancy Moore has argued that this conflict is not normally addressed via conflicts of interest doctrine because it is not unique to any particular lawyer, and is instead an agency problem endemic to legal practice. *See* Nancy J. Moore, *What Doctors Can Learn from Lawyers About Conflicts of Interest*, 81 B.U. L. REV. 445, 451 (2001) (stating that conflict of interest rules do "not purport to regulate circumstances that are common to all lawyers, but only circumstances that are unique to specific lawyers.").

matter.[141] Conversely, the percentage of fund approach creates the incentive for class counsel to settle prematurely.[142] No court has yet adopted a fee method in class actions that avoids conflicts altogether.

As a result, the boundary line between tolerable and intolerable conflicts of interest with regard to the method of awarding class counsel's fees is not at the point that conflicts arise. Instead, it is a relative point; though other policy concerns come into play,[143] when deciding which fee award methods to enable or require, jurisdictions tend to promote the fee award method that best allows them to *manage* rather than eliminate agency costs. That is why the familiar refrain adopted by courts permitting or requiring the percentage method in common fund cases is that it better aligns the interests of class counsel and class members by rewarding counsel for success and penalizing them for failure.[144] Courts so holding do not claim that the percentage method eliminates conflicts between class counsel and the class. Instead, they are making a comparison of relative conflicts, asserting that the percentage method generally leaves counsel relatively less conflicted than does the lodestar method.[145]

Similarly, with regard to a method for rewarding cost investment, the question is how a regime in which cost profits are prohibited compares to one in which they are allowed in terms of the conflicts they create between class counsel and

141. *See* McDaniel v. Cnty. of Schenectady, 595 F.3d 411, 418 (2d Cir. 2010) (the lodestar method inspires class counsel "to bill as many hours as possible to do unnecessary work, and for these reasons also can create a disincentive to early settlement"); *In re* Activision Sec. Litig., 723 F. Supp. 1373, 1378 (N.D. Cal. 1989) (concluding that the lodestar method can encourage unjustified work and delay).

142. *See In re* Synthroid Mktg. Litig., 264 F.3d 712, 721 (7th Cir. 2001) ("This is not to say that systems with declining marginal percentages are always best. They also create declining marginal returns to legal work, ensuring that at some point attorneys' opportunity costs will exceed the benefits of pushing for a larger recovery, even though extra work could benefit the client. This feature exacerbates the agency costs inherent in any percentage-of-recovery system, just as the lodestar approach creates the opposite incentive to run up the billable hours."); *In re* GMC Pick-Up Truck Fuel Tank Prod. Liab. Litig., 55 F.3d 768, 801 (3d Cir. 1995) ("Economic models have shown how conventional methods of calculating class action fee awards give class counsel incentives to act earlier than their clients would deem optimal." (citing Coffee, *supra* note 11, at 688)); *see also* Macey & Miller, *supra* note 11, at 25 ("Attorneys compensated on a percentage method have an incentive to settle early for an amount lower than what might be obtained by further effort.").

143. For example, the lodestar method is preferred in fee-shifting cases to inspire the correct level of private enforcement of the law, rather than to tether the interests of class counsel and the class with regard to case outcomes. *See, e.g.*, Drazin v. Horizon Blue Cross Blue Shield of N.J., Inc., 832 F. Supp. 2d 432, 440 (D. N.J. 2012) ("Because the lodestar award is de-coupled from the class recovery, the lodestar assures counsel undertaking socially beneficial litigation (as legislatively identified by the statutory fee shifting provision) an adequate fee irrespective of the monetary value of the final relief achieved for the class. . . . .") (quoting *In re* GMC, 55 F.3d at 821)).

144. *See, e.g.*, Union Asset Mgmt. Holding A.G. v. Dell, Inc., 669 F.3d 632 (5th Cir. 2012) ("The percentage method also brings certain advantages. The district court in this case selected it over the lodestar method in part because it allows for easy computation, it aligns the interests of class counsel with those of the class members, and it was the method Union chose in the retainer agreement.").

145. *See, e.g.*, Swedish Hosp. Corp. v. Shalala, 1 F.3d 1261, 1269 (D.C. Cir. 1993) ("That is, in the common fund case, if a percentage-of-the-fund calculation controls, inefficiently expended hours only serve to reduce the per hour compensation of the attorney expending them.").

the class. As the Second Circuit pointed out in *Agent Orange*, direct cost profits create conflicts between class counsel and the class:[146] investor attorneys may have the incentive to settle prematurely, e.g., accepting an offer of settlement that allows them to obtain their return on cost investment regardless of whether investing additional time would be to the advantage of class members.[147]

But to decide whether a fee and cost award method should enable direct cost profits, one needs a *comparator*, i.e., the agency costs flowing from a regime in which direct cost profits are prohibited. That kind of comparison suggests that enabling cost profits entails lower agency costs than prohibiting them. Prohibiting direct cost profits creates potential agency costs in *all* cases in which the lodestar method will or may be used to calculate the fee and cost award.[148] These costs include the loss in welfare consistently experienced by class members as a result of class counsel's disincentive to make the level of cost investment that best serves class members' interests.[149]

Whereas, if cost profits are enabled, conflicts of the kind noted by the Second Circuit are likely to arise only in limited settings. If the same firm is making both time and cost investment, and if time and cost investment are equally rewarded, then there is no incentive to underinvest in litigation based on the fact that cost investment is directly profitable.[150] The benefit to counsel of premature settlement as a result of the availability of direct cost profits arises only if the reward on time and cost investment is experienced as unequal, either because multiple firms investing in a class action have varying mixes of cost and time investment or because time and cost investment are both potentially profitable but to different degrees.

Both conditions existed in *Agent Orange*. Via contract, counsel agreed to reallocate any fee so that cost-investment was rewarded first at a 3.0 multiplier, with time investment being rewarded only after cost-investors were paid.[151] As a result of this agreement among counsel, the usual bias in favor of time investment was inverted. Cost investment was profitable, but time investment was rewarded far less generously. By way of example, David Dean, lead counsel for the plaintiff class, was a "noninvestor" attorney whose time investment dwarfed his cost investment. The court awarded him a fee of $1,424,283 under the lodestar method, but, as a result of the fee allocation agreement among counsel, he was paid only $542,310.[152] On the other hand, as a result of the reallocation

146. *In re* Agent Orange Prod. Liab. Litig., 818 F.2d 216, 224 (2d Cir. 1987).

147. *Id.*

148. *See* Ratner & Rubenstein, *supra* note 6, at 600–07.

149. *See id.*

150. *See id.* at 609–11.

151. *See Agent Orange*, 818 F.2d at 219 n.1 ("The agreement, in pertinent part, provided as follows: 'When and if funds are received . . . the first priority distribution will be to distribute to [cost investing counsel] an amount equivalent to the actual monies expended . . . with a multiplier of three.").

152. *Id.* at 220.

agreement, cost-investing counsel received far more than the court awarded to them using the lodestar method; in one extreme example, Newton Schwartz, a cost-investing attorney, was awarded only $41,886 in fees by the trial court under the lodestar method, but received $513,026 as a result of the allocation agreement that awarded direct cost profits.[153]

It is this peculiar favoring of cost investment, both in terms of the guaranteed multiplier and in terms of its priority of payment out of any court-awarded fee, that created the conflict in *Agent Orange* between class counsel and the class regarding settlement, because, the Second Circuit held, cost-investing counsel had no incentive to litigate once they received their return on investment.[154] This effect was exacerbated because a majority of lead counsel were predominantly cost-investors; so those lawyers were in a position to determine the timing of a premature settlement. That perfect storm of skewed incentives is unlikely to arise in the normal course, where courts set the fee and cost awards at the back end of a successful class action, without favoring cost investment. Instead, on balance, enabling direct cost profits as part of the fee and cost award methodology is likely to better align the interests of class counsel and class members than does a regime in which such profits are flatly prohibited.[155]

2. WHEN AN AGREEMENT TO REALLOCATE FEES AMONG CLASS COUNSEL GENERATES IMPERMISSIBLE CONFLICTS

Agent Orange also asked whether the particular agreement among counsel to reallocate fees to create cost profits was unenforceable because it created impermissible conflicts between class counsel and the class.[156] Resolving that question involves a different kind of boundary line drawing than courts use when fashioning or selecting a fee and cost award method.[157] Instead of comparing alternative cost-investment reward methods potentially available in class actions generally, a court distinguishes tolerable and intolerable conflicts of interest

153. *Id.*

154. The court's comments regarding the incentive for premature settlement are at odds with the actual timing of settlement in that case, just a few hours before jury selection was scheduled to commence. *See id.* at 166 (the settlement was reached "just before dawn on the day of trial after sleepless hours of bargaining").

155. *See* Ratner & Rubenstein, *supra* note 6, at 600–07.

156. *Agent Orange*, 818 F.2d at 223–24. The court also expressed concern that cost profits in that case, accomplished via a transfer of fees among firms, might constitute impermissible fee sharing among lawyers in different firms. *Id.* at 220, 226. That ethical concern arose only as a result of the fact that counsel attempted to accomplish cost profits via private ordering, and would not arise in the normal course, where cost profits are awarded by the trial court. *Id.* at 226 ("Finally, we do not find class counsel to have formed an ad hoc partnership. They merely are a group of individual lawyers and law firms associated in the prosecution of a single lawsuit, and they lack the ongoing relationship that is the essential element of attorneys practicing as partners.").

157. One need not go down this analytical path in order to evaluate the ethics of cost profits as part of a fee and cost award methodology. But because *Agent Orange* is the leading case, and, in it, the Second Circuit conflated the two issues, I separately evaluate conflicts flowing from counsel's fee allocation contracts.

flowing from counsel's peculiar commitments in a particular case by undertaking a risk assessment to determine if the contractually-created conflict is sufficiently problematic to warrant categorizing it as impermissible. While conflicts inherent in the payment of fees may be common to all for-profit lawyers in class and non-class settings, conflicts associated with agreements among lawyers to share or reallocate fees are not; thus, depending on the outcome of a risk-assessment, there may be relatively little or no tolerance for resulting conflicts.

In *Agent Orange*, the question arose in the procedural context of a motion to set aside a fee sharing agreement among counsel, and thus focused on whether the conflicts the agreement created rendered it unenforceable. But the court could have framed the conflicts question differently, as a question of class counsel's adequacy.[158] If class counsel are impermissibly conflicted, then they are, by definition, inadequate.[159] The requirement of adequate representation is codified in Rule 23,[160] but finds deeper roots in the Due Process Clause, which has been read to demand adequate representation as the most basic *quid pro quo* justifying the class action as an exception to the general rule against non-party preclusion.[161] One suspects that the Second Circuit was unwilling to enforce the agreement among counsel in *Agent Orange*, but had no desire to go further and to upset the entire apple cart of the class action settlement—though it could have.

a. Identifying Conflicts

Though a test is not yet fully articulated, doctrinally, three factors should be particularly relevant to any assessment of whether a fee allocation contract among counsel designed to create cost profits generates conflicts of interest:[162]

158. *See, e.g.*, Amchem Prods., Inc. v. Windsor, 521 U.S. 591, 626 n.20 (1997) (the adequacy of representation requirement is concerned with the "competency and conflicts of class counsel."); Wininger v. SI Mgmt. L.P., 301 F.3d 1115, 1122 (9th Cir. 2002) ("[T]he question of whether there is an ethical conflict forms part of the class certification question."); Sandoval v. Ali, No. C -13-03230(EDL), 2014 U.S. Dist. LEXIS 42630, at *28–35 (N.D. Cal. Mar. 28, 2014) (defendants' motion to disqualify class counsel analyzed as implicating the "adequacy of representation" requirement).

159. *See* Ortiz v. Fibreboard Corp., 527 U.S. 815, 856 (1999) (requiring sub-classes with sufficiently competing interests to have separate counsel); Radcliffe v. Experian Info. Solutions, Inc., No. 11-56376, 2013 U.S. App. LEXIS 7932, *24 (9th Cir. 2013) ("As soon as the conditional-incentive-awards provision divorced the interests of the class representatives from those of the absent class members, class counsel was simultaneously representing clients with conflicting interests . . . . Class counsel thus was not adequate. . . . ."). *See also* Linda S. Mullenix, *Taking Adequacy Seriously: The Inadequate Assessment of Adequacy in Litigation and Settlement Classes*, 57 VAND. L. REV. 1687, 1715 (2004) (noting that the message of *Ortiz* was, in part, that "class counsel may be found to be inadequate if counsel is not competent and has conflicts of interest").

160. FED. R. CIV. P. 23(a)(4) and 23(g).

161. *See* Phillips Petroleum Co. v. Shutts, 472 U.S. 797, 812 (1985) ("[T]he Due Process Clause of course requires that the named plaintiff at all times adequately represent the interests of the absent class members."); Hansberry v. Lee, 311 U.S. 32, 42–43 (1940) ("[M]embers of a class not present as parties to the litigation may be bound by the judgment where they are in fact adequately represented by parties who are present . . . .").

162. These factors are consistent with current case law, even if they are not part of a clearly-defined doctrinal test for conflicts in this setting.

the timing of the agreement; the extent to which cost profits are fixed; and the degree to and purposes for which time and cost investment are disproportionately rewarded. In terms of timing, courts are more likely to be concerned about conflicts associated with agreements reached in early phases of litigation, as was the case in *Agent Orange*, via contracts among co-counsel to reallocate fee and cost awards. It is typical for settlement class counsel to allocate a fee and cost award made by the court post-judgment, *after* the work necessary to resolve a class case has been done, with lead or a committee of counsel using knowledge of the benefits conferred by all counsel to guide the division of any award.[163] Any agreements reached at that point in the litigation typically do not raise conflicts concerns, because counsel's case management decisions have already been made, and because all such allocations are typically subject to court review in the event counsel disagree. Instead, conflicts concerns arise when the lawyers serving as class counsel reach agreements before a case is resolved because the terms of such agreements have the chance to influence counsel's decisions regarding litigation or settlement of the class action and thus may cause counsel's and the class members' interests to diverge. Not all *ex ante* agreements create conflicts. Courts must consider additional factors.

Agreements that establish disproportionate profits on time and cost investment without regard to the benefit conferred on the class are more likely to create conflicts of interest than are agreements to either normalize[164] the profits on time and cost investment or to permit disparities only to the extent doing so rewards class counsel for being efficient. In *Agent Orange*, the agreement among counsel to ensure a 3.0 multiplier on costs, paid before any time investment was rewarded, may have reflected the relative difficulty of securing cost investment in that case and thus may have captured the relative benefit to class members of that category of case investment, at least as of the point it was made. But the reallocation agreement in that case was the mirror image of the distortions in investment incentives chronicled in Section II, biasing cost rather than time investment, and thus created new wedges between counsel and the class.[165] The court noted one of these distortions, i.e., the incentive to settle prematurely as soon as a settlement amount was offered that could guarantee the 3.0 multiplier on costs. The court could also have found that the agreement created conflicts by making cost investment more attractive than time investment, even if time investment was better for the class.

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163. *See* Milliron v. T-Mobile, USA, Inc., 423 F. App'x 131, 134 (3d Cir. 2011) ("Generally, a district court may rely on lead counsel to distribute attorneys' fees among those involved.").

164. To "normalize" rewards on time and cost investment is to eliminate the disparity in reward, i.e., to make time and cost investment equally profitable.

165. A fourth feature of the agreement in *Agent Orange* was cause for alarm—it was reached in secret. *In re* Agent Orange Prod. Liab. Litig. 818 F.2d 145, 218 (2d Cir. 1987). The Advisory Committee note to Rule 23(h), added in 2003, suggests that such agreements should be disclosed in the normal course.

b. Assessing Whether the Conflicts Are Impermissible

Even if the Second Circuit reasonably concluded that the agreement to reallocate fees in *Agent Orange* created conflicts, the court's conclusion that those conflicts were *impermissible* rested, as this Section demonstrates, on a truncated analysis by modern standards, one that failed to fully account for the differences between class and non-class actions. Although the case law is muddled on this point, there is a reading of it that demonstrates how conflicts can and should be evaluated so as to recognize the distinctive roles of courts and plaintiffs' counsel in class actions.

Two lines of cases expose a tension within modern conflicts-of-interest analysis in class actions. First, the Supreme Court's decisions in *Amchem Prods. Inc. v. Windsor*[166] and *Ortiz v. Fibreboard*[167] amplify the conflicts-of-interests concerns embedded in the adequacy of representation requirement. Second, a line of high profile intermediate appellate court cases including *Lazy Oil Co. v. Wito Corp.*[168] has consistently reiterated over the years that professional conflicts rules applicable to individual cases cannot be mechanically applied in class actions because doing so would undermine the class device.[169] At first blush, the two lines of cases appear to pull in different directions. The suggestion in *Amchem* and *Ortiz* that subclasses with distinct interests need separate, unconflicted counsel tugs against the idea that conflicts-of-interest concerns must be relaxed or at least applied pragmatically in class cases to account for the unique nature of the class action and to avoid depriving class members of knowledgeable counsel.

Post-*Amchem* and *Ortiz* decisions by intermediate federal courts—though cacophonous—show how the two lines of cases can be read to converge on a single cluster of factors to distinguish tolerable and intolerable conflicts in class

166. Amchem Prods., Inc. v. Windsor, 521 U.S. 591, 626 (1997). In this case, the conflict arose from the presence in the same class, with the same representation, of persons with diametrically opposed interests with regard to settlement fund allocation. Persons with present asbestos-related injuries were interested in generous and immediate payments, whereas persons with exposure-only claims were interested in assuring the existence of an adequate fund to pay future claims. The Court held that separate classes were required under the circumstances, with separate representation. *Id.*

167. Ortiz v. Fibreboard Corp., 527 U.S. 815, 854–59 (1999).

168. Lazy Oil Co. v. Witco Corp., 166 F.3d 581, 589 (3d Cir. 1999) ("[T]he conflict rules do not appear to be drafted with class action procedures in mind and may be at odds with the policies underlying the class action rules.").

169. *See, e.g.*, Eubank v. Pella Corp., 753 F.3d 718, 722 (7th Cir. 2014) ("A lawyer's switching sides in the same lawsuit would normally be considered a fatal conflict of interest, but the courts are lenient when it is a class action lawyer."); *In re* Agent Orange Prod. Liab. Litig., 800 F.2d 14, 18–19 (2d Cir. 1986) ("When an action has continued over the course of many years, the prospect of having those most familiar with its course and status be automatically disqualified whenever class members have conflicting interests would substantially diminish the efficacy of the class action as a method of dispute resolution."); Parker v. Anderson, 667 F.2d 1204, 1211 (5th Cir. 1982) ("Courts have recognized that the duty owed by class counsel is to the entire class and is not dependent on the special desires of the named plaintiffs.").

actions,[170] in a way that tends to limit the extent to which *Amhem* and *Ortiz* render class counsel impermissibly conflicted:[171] First, courts look at the degree of conflict, i.e., the extent to which interests are completely oppositional or merely misaligned.[172] Second, courts consider the probability that a possible conflict will manifest; if the probability is too low, the conflict is deemed theoretical and thus not disabling.[173] Relatedly, and third, courts look to the ability of courts in class actions to provide other structural assurances of fairness besides entirely eliminating the conflict.[174] Fourth, courts assess the likely cost of any conflict if it arises, in terms of the loss in welfare experienced by the class members due to class counsel's disloyalty; logically, that cost should be a *net* figure, i.e., net of the cost in terms of class member welfare of eliminating the disloyalty.[175] For example, some circumstances have the potential to both align

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170. A number of prominent commentators have argued against an unduly strict reading of *Amchem* and *Ortiz* as adopting a zero tolerance rule for conflicts. *See, e.g.*, Samuel Issacharoff & Richard A. Nagareda, *Class Settlements Under Attack*, 156 U. PA. L. REV. 1649, 1683 (2008) ("No class action can account for all conceivable differences among its members."); Charles Silver & Lynn Baker, *I Cut, You Choose: The Role of Plaintiffs' Counsel in Allocating Settlement Proceeds*, 84 VA. L. REV. 1465, 1468 (1998) ("[W]e think that *Amchem*, if it in fact establishes a strict 'no conflicts' rule for class actions, is unworkable and wrong. Conflicts of interest and associated tradeoffs among plaintiffs are an unavoidable part of all group lawsuits and all group settlements."). A sentence fragment in *Ortiz* suggests that this commentary likely aligns with the Court's intentions. *See Ortiz*, 527 U.S. at 857 ("[A]t some point there has to be an end to reclassification with separate counsel. . . . .").

171. *See, e.g.*, Wallace v. Powell, No. 3:09-cv-286, 2013 U.S. Dist. LEXIS 69001, *54–55 (M.D. Pa. May 14, 2013) (citing *Lazy Oil Co.* in support of a reading of *Ortiz* that does not render class counsel who represent individual clients as well as the class impermissibly conflicted in all circumstances).

172. *See, e.g.*, Prof'l Firefighters Ass'n of Omaha, Local 385 v. Zalewski, 678 F.3d 640, 647 (8th Cir. 2012) (finding class counsel to be adequate, despite representing both active and retired employees in the same class, because the conflicts between them, though present, were less "stark" than the conflicts between present and future injury plaintiffs in *Amchem*); Allen v. Holiday Universal, 249 F.R.D. 166, 182 (E.D. Pa. 2008) ("Conflicts between class members based on their respective relationships to the defendant are relevant only when the class representatives' economic interests and objectives *substantially* conflict with those of absent class members."). *But see* Wolfert v. Transamerica Home First, Inc., 439 F.3d 165, 173 (2d Cir. 2006) (suggesting that even though "[t]here is no litmus test for determining when interests of one or more absent class members are sufficiently distinct from those of the class representatives to render those representatives inadequate," that mere variations in the law applicable to class claims could, if sufficiently different, require separate representation).

173. *See, e.g.*, *Prof'l Firefighters*, 678 F.3d at 646 (stating that merely theoretical conflicts do not require subclassing or disqualification of counsel, (citing Reynolds v. Nat'l Football League, 584 F.2d 280, 286 (8th Cir. 1978))); *In re* Chicken Antitrust Litig. Am. Poultry, 669 F.2d 228, 237 (5th Cir. 1982) (same).

174. *See, e.g.*, *Prof'l Firefighters*, 678 F.3d at 647 (recognizing a conflict among active and retired employee class members, but finding that separate classes with separate counsel were unnecessary where the court provided other structural assurances of fairness, including permitting five retired firefighters to intervene with separate counsel and participate in settlement negotiations).

175. Professor Tidmarsh has helpfully characterized *Amchem* as involving a "nonconsequentialist" approach to conflicts that does not weigh "the benefits of settlement against the costs of less than ideal representation." Tidmarsh, *supra* note 136, at 1157. That is true. The majority in *Amchem* was clearly underwhelmed by the utilitarian approach Justice Breyer outlined in his dissent, which would have balanced the costs of alleged conflicts against the costs of deeming counsel to be conflicted, i.e., the loss of an opportunity to resolve the asbestos litigation morass. Amchem Prods., Inc. v. Windsor, 521 U.S. 591, 622–23, 625–28 (1997). As the Court explained again in *Ortiz*, the fact of settlement cannot override the requirements of Rule 23, one of which is adequacy of representation. Put differently, Rule 23(e) cannot swallow Rule 23(a) or (b), regarding certification,

and misalign the incentives of class counsel and class members—e.g., the allocation of a fee among counsel. Courts consider all of the foregoing factors in light of the unique nature and purposes of the class action as a procedural device.[176]

Under this reading, *Amchem* and *Ortiz* did not express a zero tolerance policy regarding conflicts. Instead, their seeming strictness results from the fact that the conflicts were unusually severe, highly probable, difficult to manage, and needlessly manufactured. They were severe in that the competing interests counsel concurrently pursued were diametrically opposed;[177] that places them in the same category as the conflicts in *Hansberry v. Lee*.[178] It was highly probable that the conflicts would manifest, because they were central to the issues in the case. They were needlessly manufactured by the settling parties as part of a settlement agreement, rather than as an integral part of the operation of Rule 23, because the settling parties chose the breadth of the settlement classes, the separate treatment of class and non-class clients, and, in *Ortiz*, the limited fund framework, so they could not persuasively argue that tolerance of the conflicts was somehow necessary to the operation of the class action as a procedural device.[179]

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or 23(g), regarding appointment of class counsel. But, even so, courts may and do still consider the loss in welfare associated with eliminating conflicts, other than the loss of a particular settlement. *See* Lazy Oil Co. v. Witco Corp., 166 F.3d 581, 590 (3d Cir. 1999) ("We therefore hold that, in the class action context, once some class representatives object to a settlement negotiated on their behalf, class counsel may continue to represent the remaining class representatives and the class, as long as the interest of the class in continued representation by experienced counsel is not outweighed by the actual prejudice to the objectors of being opposed by their former counsel.").

176. *See* Wininger v. SI Mgmt. L.P., 301 F.3d 1115, 1122 (9th Cir. 2002) (interpreting an alleged conflict as not necessarily requiring disqualification of class counsel and citing both *Amchem* and *Lazy Oil Co.*); *Lazy Oil Co.*, 166 F.3d at 589–90 (refusing to deem class counsel impermissibly conflicted by virtue of promoting a class settlement over the objection of class representatives or other class members because otherwise such class members would have undue leverage over class counsel and the rest of the class).

177. Ortiz v. Fibreboard Corp., 527 U.S. 815, 857 (1999) (noting two types of conflicts among class members that were sufficiently severe to require sub-classing and separate counsel: (1) conflicts between both currently injured and exposure-only plaintiffs, who had oppositional interests with regard to structuring and allocation of any settlement fund; and (2) conflicts between class members who had pre-1959 claims as to which there was insurance coverage, and those who did not, a severe and direct conflict with regard to allocation in a case involving a limited fund created by insurance); *Amchem*, 521 U.S. at 626 ("In significant respects, the interests of those within the single class are not aligned. Most saliently, for the currently injured, the critical goal is generous immediate payments. That goal tugs against the interest of exposure-only plaintiffs in ensuring an ample, inflation-protected fund for the future.").

178. Hansberry v. Lee, 311 U.S. 32, 45–46 (1940) ("In seeking to enforce the agreement the plaintiffs in [the class action] suit were not representing the [collaterally attacking absent class members] whose substantial interest is in resisting performance.") (bracketed text added).

179. *Ortiz*, 527 U.S. at 858 ("'[T]he benefits asbestos-exposed persons might gain from the establishment of a grand-scale compensation scheme is a matter fit for legislative consideration,' but the determination whether 'proposed classes are sufficiently cohesive to warrant adjudication' must focus on 'questions that preexist any settlement,'" (citing and quoting *Amchem*, 521 U.S. at 625–28)).

Some agreements to contractually reallocate fee awards among counsel to enable cost profits may similarly be deemed to create intolerable rather than tolerable conflicts; but others should be able to pass muster. The nuanced, multi-factored risk-assessment that courts have used to determine if class members' divergent interests render class counsel impermissibly conflicted has not been consistently and overtly applied to evaluate class counsel's conflicts flowing from fee allocation contracts among counsel. But there is no reason to believe that counsel's loyalty should be assessed differently in the two settings.[180]

In *Agent Orange*, the Second Circuit noted but did not share Judge Weinstein's confidence in the existence of other structural assurances of fairness to counteract the pull toward early settlement, including both the lodestar method's tendency to inspire delay (to generate more hours for a higher fee)[181] and the trial court's role as fiduciary for the class.[182] Such pessimism about the trial court undoubtedly reflects in part the examples of judges behaving badly, approving manifestly defective settlements, something some intermediate appellate judges, including, most vividly and colorfully, Judge Posner, have exposed in recent decades.[183] But it ignores the contrary examples of trial court judges who carefully scrutinize settlements and provide a meaningful bulwark against self-seeking by class counsel.[184] Moreover, it does not consider how structural fairness can be achieved without dependence upon the judge as gatekeeper at the time of settlement. For example, had the agreement among counsel been disclosed earlier, the court could have built in other structural assurances of fairness, including a requirement that all class counsel agree to any proposed settlement, which, in that case, would have prevented cost-investing counsel who had a

180. In the non-class setting, Rule 1.7 is the general concurrent conflicts rule, while Rule 1.8 addresses specific conflicts that may arise between lawyer and client (with fees and costs are covered Rule 1.5). But as Professor Moore has argued, Rule 1.8 supplements (and does not supplant) Rule 1.7. Nancy J. Moore, *Ethical Issues in Mass Tort Plaintiffs' Representation: Beyond the Aggregate Settlement Rule*, 81 FORDHAM L. REV. 3233, 3238 (2013). Thus, in at least some circumstances—e.g., where a lawyer's disparate fee arrangements with distinct clients in a mass tort make it reasonably obvious at the outset of litigation that the lawyer will be conflicted on allocation issues—it may be appropriate to consider fee-related conflicts using the Model Rule 1.7 frame. *Id.* at 3246.

181. *In re* Agent Orange Prod. Liab. Litig., 818 F.2d 216, 225 (2d Cir. 1987) ("Equally unpersuasive is the district court's determination that the potential incentive to settle early is offset by an incentive, fostered by the lodestar formula, to prolong the litigation.").

182. *Id.* at 224 ("We also reject the district court's finding that its authority to approve settlement offers under FED. R. CIV. P. 23(e) acts to limit the threat to the class from a potential conflict of interest.").

183. *See, e.g.*, Reynolds v. Beneficial Nat'l Bank, 288 F.3d 277, 283 (7th Cir. 2002) ("Although there is no proof that the settlement was actually collusive in the reverse-auction sense, the circumstances demanded closer scrutiny than the district judge gave it.").

184. *See, e.g.*, Custom LED, LLC v. eBay, Inc., No. 12-vc-00350-JST, 2013 U.S. Dist. LEXIS 122022, at *18–22 (N.D. Cal. Aug. 27, 2013) (Judge Tigar rejected this proposed class settlement as inadequate due to, among other things, inadequate notice and overbroad release provisions.); Authors Guild v. Google Inc., 770 F. Supp. 2d 666, 669 (S.D.N.Y. 2011) (Judge Chin rejected a proposed class action settlement agreement as giving Google an unfair advantage over competitors and containing an overbroad release).

majority of the leadership positions from forcing a premature settlement on time-investing counsel.

Also, the Second Circuit considered the likely cost associated with a conflict manifesting, but did not balance conflicts flowing from the reallocation agreement against the agreement's propensity to *enhance* the alignment of class counsel's and class members' interests. At the time the agreement by counsel was made, class members' paramount interest was in finding deep pockets to fund the litigation. Failure to induce that kind of investment would have left them with nothing, surely a worse outcome, from their vantage point, than a premature settlement. Put differently, it is not enough to know if counsel's incentives will be misaligned with cost profits created by a particular agreement among counsel; instead, one needs to also consider the misalignment of incentives in the absence of the agreement. In *Agent Orange*, arguably, counsel's incentive in the absence of the cost profits they attempted to achieve via contract was to fold the proverbial tent, i.e., to abandon or cheaply settle plaintiffs' claims for lack of funding. Class members would arguably have been worse off without the agreement, because they would have been left with counsel who were even more likely to be disloyal than were cost-investing counsel.[185]

Nor did the court properly conduct this risk assessment in light of the unique features of the class action as a procedural device, one that requires class counsel to serve as litigation funders of first resort. Instead, the court suggested in a conclusory fashion that if cost investment required a 3.0 multiplier as a return to induce it, the case must have been a weak one.[186] The court had no basis for this conclusion other than its bald assertion that a 3.0 multiplier seemed like a higher rate of return than what non-litigation investors might expect.[187] The strength of the plaintiffs' claims in *Agent Orange* is debatable, but—at the time the court wrote of its weakness—the matter had just settled for $180 million. Moreover, a case is not weak merely because it requires substantial cost investment, though limited access to capital can make the firms prosecuting such cases relatively weak compared to defense counsel with deep pocket clients. The significance of the 3.0 return contractually guaranteed to cost investing counsel in *Agent Orange* cannot be appreciated without some understanding of the market for return on capital investment in class actions, a topic explored more fully below.

To decide if a particular conflict—e.g., the conflict generated by the award of cost profits by agreement of counsel at the front end of a particular case—renders class counsel impermissibly conflicted, the agreement should be run through the full gauntlet of factors impacting that determination, something the Second

185. Instead of balancing the reallocation agreement's tendency to align counsel's and the class members' interests against its tendency to cause them to diverge, the court simply dismissed the beneficial incentive effects as speculative. *In re* Agent Orange Prod. Liab. Litig., 818 F.2d 216, 225 (2d Cir. 1987).

186. *Id.* at 225–26.

187. *Id.* at 226.

Circuit did incompletely in *Agent Orange*. A more nuanced assessment may have changed the outcome. The Second Circuit would have considered the net costs and benefits in terms of the effect of the fee reallocation agreement on counsel's loyalty. Moreover, the court might have given greater weight to Judge Weinstein's holdings regarding both the need to facilitate litigation financing in expensive mass actions and the ability of courts to assure structural fairness to counteract any conflicts arising from funding agreements.

Whether or not the outcome in *Agent Orange* would have been different had the Second Circuit conducted a more thorough and open-minded risk-assessment, future agreements to reallocate fee awards to reward costs should be able to overcome some of the difficulties counsel in that case created for themselves. That is, even in the absence of the kind of doctrinal change regarding fee and cost reward methodology advocated as a policy matter in this Article, class counsel may be able to ethically negotiate fee reallocation agreements to reward cost investment, particularly if the agreement is disclosed to the court and the agreement's terms are reasonable, a subject addressed in greater detail in the following section.

IV. CALCULATING "REASONABLE" COST PROFITS—MARKET MEASURES

Once we acknowledge that cost profits may be awarded in class actions, the question shifts from their permissibility to their measure. The most obvious mechanisms for delivering direct cost profits would be, as with fees, an initial markup from actual cost to market rate (to the extent any gap exists), and an actual or effective multiplier on costs.[188] The question this Section addresses is not *how* such cost profits might be awarded but whether our existing doctrinal framework gives courts guidance as to the *amount* of such profits in a given case.

A useful starting point is Rule 23(h), which authorizes a court overseeing a class action to award "reasonable attorney's fees and nontaxable costs." In class actions fee and cost award jurisprudence, the "market" provides a central touchstone for determining a reasonable fee, though jurisdictions' understanding of and commitment to market principles varies.[189] When determining the fee to

188. *See* Ratner & Rubenstein, *supra* note 6, at 607–11 (canvassing vehicles for the award of cost profits).

189. All jurisdictions adopt a market approach to the lodestar by reference to rates charged in the relevant market (usually the community, e.g., the district). *See, e.g.*, Missouri v. Jenkins, 491 U.S. 274, 285 (1989) ("We have consistently looked to the marketplace as our guide to what is 'reasonable.'"); Blum v. Stenson, 465 U.S. 886, 895 (1984) (The hourly rate used in lodestar calculations in Section 1988 cases should be a market rate determined by reference to "prevailing market rates in the relevant community."). Variability regarding the centrality of the market measure is most evident when the percentage-of-fund method is used, and courts are called upon to select a percentage to apply to the fund. *Compare* Vizcaino v. Microsoft Corp., 290 F.3d 1043, 1049 (9th Cir. 2002) ("[W]e do not adopt the Seventh Circuit's approach in percentage fee award cases, as set forth in *In re* Continental Illinois Secs. Litig., 962 F.2d 566, 568 (7th Cir. 1992). There, that court stated that in awarding fees in common fund cases, courts should determine a reasonable fee by attempting to replicate the market. While an exclusively market-based approach may have superficial appeal, in the context of class action

award under the lodestar method, courts assess lawyers' hourly rates[190] by reference to the rates charged by lawyers of similar skill, experience, and reputation doing similar work in the relevant market.[191] With regard to percentage fee awards, some courts have looked to percentage awards in similar categories of litigation to establish a market measure of reasonableness.[192] What is the market for cost investment in litigation against which the reasonableness of direct cost profits could be assessed? This section considers five options: lawyer-client contracts in individual, non-class cases; the rates charged by third-party litigation funders; the market reflected by private contracts among class counsel; the market mimicked by judges acting as would sophisticated and informed consumers of legal services; and the market for time investment. The last two market measures (judges as client surrogates and the market for time) most naturally lend themselves to the project of normalizing of rewards on time and cost investment by class counsel.

A. LAWYER-CLIENT CONTRACTS IN NON-CLASS CONTINGENT FEE CASES

Information regarding lawyer-client contracts in non-class contingent fee matters is unlikely to provide much insight into the market for direct cost profits. With client consent, lawyers may mark up their actual costs to market rates;[193] charge interest on costs advanced calculated from the date the cost is advanced,

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litigation in which attorney's fees are determined post hoc by the court (without regard to any private arrangement), it may in many cases be illusory."), *with In re* Synthroid Mktg. Litig., 264 F.3d 712, 718 (7th Cir. 2001) ("We have held repeatedly that, when deciding on appropriate fee levels in common-fund cases, courts must do their best to award counsel the market price for legal services, in light of the risk of nonpayments and the normal rate of compensation in the market at the time.").

190. *See Jenkins*, 491 U.S. at 285 ("we have consistently looked to the marketplace as our guide to what is 'reasonable.'"); *Blum*, 465 U.S. at 895 (the hourly rate used in lodestar calculations in Section 1988 cases should be a market rate determined by reference to "prevailing market rates in the relevant community"); Alan Hirsch & Diane Sheehey, *Awarding Attorneys' Fees and Managing Fee Litigation*, FED. JUDICIAL CTR. 23 (1994) *available at* http://www.fjc.gov/public/pdf.nsf/lookup/attyfees.pdf/$File/attyfees.pdf ("The reasonable rate is determined by reference to the marketplace.").

191. *See, e.g.*, Jordan v. Multnomah County, 815 F.2d 1258, 1262 (9th Cir. 1987) ("The fee applicant has the burden of producing satisfactory evidence, in addition to the affidavits of its counsel, that the requested rates are in line with those prevailing in the community for similar services of lawyers of reasonably comparable skill and reputation.").

192. *See, e.g.*, Wolff v. Cash, No. 03-33778-CIV-COHN/TORRES, 2012 U.S. Dist. LEXIS 153786, at *13 (S.D. Fla. 2012) ("The requested fee of 33% is at the market rate which the Class could have negotiated at the beginning of this matter."); Nilsen v. York Cnty., 400 F. Supp. 2d 266, 279 (D. Me. 2005) ("Unfortunately, in this case I do not have direct data on the market price for civil rights class action lawyers, or for strip search class action cases inside or outside of Maine . . . . But there should be contextual market information available, such as what lawyers charge as percentage fees for various types of litigation."). In securities cases under the PSLRA, the fee negotiated by the class representative may be the best evidence of the market fee.

193. ABA Formal Op. 93-379, at 5 ("Thus, in the view of the Committee, the lawyer and the client may agree in advance that, for example, photocopying will be charged at $.15 per page, or messenger services will be provided at $5 per mile.").

or from the date on which the client's bill is due;[194] or use a flat percentage of fees to cover case costs in lieu of seeking reimbursement for actual costs.[195] But the idea of clients paying a direct cost profit is a relatively new one, and thus is not a standard feature of fee agreements. One could infer—not that direct cost multipliers are merely novel—but that the market rate for cost profits is close to zero, a conclusion that additional descriptive market data contradict, as described in the following paragraphs. One might also conclude that lawyers are generally satisfied with the kinds of *indirect* cost profits that flow from agreeing to invest both time and costs in exchange for a percentage of the client's recovery, without distinguishing profits on time and cost investment. That may be true, but in that instance, lawyers are individually negotiating fee agreements with clients with features that distinguish them from the class action fee awards: there is no possibility that the lodestar method will be used, even as a cross-check on the reasonableness of the fee; and there is no court selecting a percentage figure to calculate the fee award after the fact using criteria that privilege time over cost investment. That means that time and cost investment are equally capable of producing an indirect cost profit in the typical non-class case, where the contingent fee contract sets a percentage at the outset that is used to generate a fee ex post, after the matter is successfully resolved. As a result, fee agreements in such cases are not particularly instructive regarding the market rate for cost investment.

B. THIRD-PARTY LITIGATION FUNDERS

Lawyers who use third-party financing and pass those costs on to their clients are negotiating contracts with lenders that reveal direct profits on cost investment. In the third-party (alternative) litigation financing market, specialized lenders providing funds as cost investment in particular cases publish information regarding the direct cost profits they expect.[196] For example, Excalibur Programs Funding, Inc. ("Excalibur"),[197] one of the leading third-party litigation funders, provides "non-recourse" loans, meaning that repayment with interest from any attorneys' fees ultimately obtained is contingent on a successful resolution of the matter. The lender thus puts itself in a position similar to that occupied by plaintiffs' counsel as litigation funder of first resort. Because the

194. *See, e.g.*, L.A. Cnty. Bar Ass'n Prof'l Responsibility & Ethics Comm., Formal Ethics Op. No. 499 (1999), *available at* http://www.lacba.org/showpage.cfm?pageid=434 (finding cost interest charges ethical under California ethics rules if properly specified in contract).

195. *See, e.g.*, State Bar of Arizona, Opinion No. 94-10 (July 20, 1994) ("So long as the billing practice is clearly disclosed to the client, the amount charged is reasonable and approximates the actual expenses associated with such costs and the client consents in writing at the outset of the representation, the Committee is of the opinion that charging a percentage of the fee to cover disbursements is permissible.").

196. *See* Engstrom, *supra* note 14, at 394–96.

197. *Litigation Funding*, EXCALIBUR FUNDING PROGRAMS, http://www.excaliburlegal.com/index.html (last visited Nov. 11, 2014).

lender bears the risk that the loan will not be repaid, such lending is "more expensive than other avenues for capital."[198] Excalibur provides examples of its pricing in the form of multipliers ranging from 1.4 to 2.6, depending on the time it takes to successfully resolve the litigation.[199] The cost multipliers listed on the Excalibur website do not show multipliers applicable to case-specific loans that require more than two years to repay, but logically more extended repayment periods would justify higher multipliers.

The market for class counsel and other contingent fee lawyers is arguably different from the market for third-party funders. Though they may be more diversified than some law firms, third-party funders have only one source of return on their non-recourse loans, the multipliers. If courts were to award class counsel cost profits, however, class counsel would earn not only direct cost profits in the form of a multiplier on cost investment, but, also indirect profits associated with cost investment, including the fee that cost investment makes possible. Because third-party funders do not enjoy these indirect benefits to the same extent that class counsel would, their market rates may be higher than what class counsel would earn in a world in which direct cost profits in class actions were enabled. In addition, third-party lenders may charge a premium for the risk associated with the agency costs that inhere in the lender-attorney relationship; lenders, like principals in the attorney-client relationship, suffer information asymmetries and monitoring costs, and, especially where loans are non-recourse, may experience the disloyalty that stems from counsel's favoring of cases where counsel acts as a funder of first resort. Nevertheless, the rates charged by third-party lenders do reveal the direct profit levels necessary to attract the kind of case investment that the award of such profits in class actions would be designed to inspire.

C. AGREEMENTS AMONG COUNSEL TO REALLOCATE FEE AND COST AWARDS

Agreements among lawyers regarding the rewards for cost investment in jointly prosecuted litigation may provide yet another basis for characterizing the market rate of direct cost profits. Interestingly, the pricing on cost investment publicized by third-party lenders approximates the 3.0 multiplier on cost investment the PMC members attempted to achieve by contract in *Agent Orange*. The rewards for cost investment will be most apparent in cases like *Agent Orange* where counsel invest costs and time unequally, so the disparate rewards flowing from the two categories of investment are exposed. In cases where counsel agree to contribute time and money investment in roughly equivalent proportions, the

198. *Attorney Funding*, EXACALIBUR FUNDING PROGRAMS, http://www.excaliburlegal.com/AttorneyPricing.html (last visited Nov. 11, 2014).

199. *Id.*

profits associated specially with cost investment may not be revealed.

The timing of such agreements may have some bearing on the extent to which they evidence a general market measure of profits on cost investment. For example, cost-investing counsel in *Agent Orange* appeared at a crisis moment in the litigation, when time-investing counsel were financially depleted, suggesting that they may have bargained for rewards on cost investment that reflected existing counsel's desperation. Existing *Agent Orange* counsel who needed additional funds to continue the litigation were heavily invested in that case, having already advanced substantial time and costs, such that failure to obtain new investment would have exposed them to significant losses. As a result, the 3.0 multiplier on cost investment to which counsel agreed may not fairly represent the market's general approach to rewarding cost investment in class actions. Agreements regarding the reward of time and cost investment reached among participating counsel at the outset of a litigation matter may better capture the way lawyers organizing to finance litigation treat time and cost investment.

D. THE "MARKET" CREATED BY JUDGES AS CONSUMERS OF LEGAL SERVICES ON BEHALF OF CLASSES

Assuming courts start awarding direct cost profits, the most relevant "market" may be the awards made by judges in other cases.[200] Judges may mimic the market by positing themselves as sophisticated and informed consumers of legal services negotiating rewards on time and cost investment at the outset of litigation. Faced with a fee and cost award petition from successful class counsel at the end of a class action, a judge would hew to the agreement a sophisticated client would likely have negotiated at the front end.

A sophisticated client would want to reward counsel in a way that minimizes agency costs, or, put differently, best aligns the interests of class counsel and the class. As a result, the client would be inclined to eliminate the bias in favor of time investment.[201] Judges could move toward this goal by equalizing the direct reward on time and cost investment. For example, in a case where the court is awarding a percentage fee using a lodestar cross-check, the lodestar crosscheck could include both marked up time and similarly marked-up costs, with the same multiplier applied to both. Judges acting as sophisticated consumers might go further, not only normalizing the treatment of time and cost investment, but rewarding counsel for getting the right *mix* of time and cost investment, by, for example, putting the burden on counsel to demonstrate they made the kind of

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200. *See* Nilsen v. York Cnty., 400 F. Supp. 2d 266, 279 (D. Me. 2005) ("[T]he class action 'market' is controlled by judges. That is why this is a market 'mimicking' approach . . . . In the meantime, I look to such evidence as is available to suggest what hypothetical negotiation would have produced at the outset as an agreed-to fee for a case such as this.").

201. *See* Ratner & Rubenstein, *supra* note 6, at 607–13.

case investment that produced the greatest net award for the class members.[202] As fiduciaries for the class, judges should particularly press this issue with regard to categories of investment where, for example, cost investment tends to save clients money, e.g., with regard to the use of LPOs for document reviews.

E. THE MARKET FOR TIME INVESTMENT

Finally, the market for attorney labor may suggest a market measure for cost profits. From the investing law firm's vantage point, time and cost investment both involve dollar outlays, time calculated as the firm's overhead per lawyer for each hour of lawyer time available to invest, and case-specific cost investment as dollars paid out. From the contingent fee client's perspective, time and cost investment are both necessary. For example, the plaintiff in a product defect lawsuit may need both her attorney's labor and the testimony of a paid expert to establish the defect, causation, or other issues in the case. Both types of investment are equally necessary to establish her claim and are part of the package of services she expects her lawyer to provide or procure on her behalf.

As noted, lawyers enjoy two layers of profit on time investment. The first is the gap between the cost to the firm of supplying attorney labor and the price per hour charged for that labor. A firm might mark up the costs of supplying attorney time by, say, 100 percent; if clients are willing to pay that markup, then it could be argued that the firm's market rate includes a 100 percent profit on outlays in general—a rule of thumb that could be applied to all outlays, including cost investment.

The second source of direct profit on time is the multiplier. Professor Brian Fitzpatrick's comprehensive survey of federal class action settlements and fee awards reveals that multipliers on lodestar "ranged from 0.07 to 10.3, with a mean of 1.65 and a median of 1.34."[203] Under current practice, only time investment is multipliable. In a regime where both time and cost investment are multipliable, courts may end up awarding lower multipliers to keep the combined amount of fee and cost awards under the new regime in line with current norms. That likely downward trend in average multipliers can be taken into account as a factor in applying the data on rewards on time investment to characterize the market for cost investment.

202. Trial courts routinely perform a similar task with regard to time investment under the lodestar method, reviewing it to ensure that it was made efficiently, e.g., without excessive duplication. *See, e.g.*, Wolph v. Acer Am. Corp., No. C 09-01314 JSW, 2013 U.S. Dist. LEXIS 151180, at *6–12 (N.D. Cal. Oct. 21, 2013) (carefully scrutinizing counsel's time investment to avoid rewarding inefficiency and duplication).

203. Fitzpatrick, *supra* note 42, at 834.

F. THE MARKET MEASURES THAT BEST NORMALIZE THE REWARDS ON TIME AND COST INVESTMENT

The first three market measures identified above are inferior from the perspective of harnessing class counsel's profit motive in the service of the goals of loyal and adequate private law enforcement, because those measures perpetuate or exacerbate the differential in the reward on time and cost investment. Treating the cost rewards negotiated by contracting parties in non-class cases as the relevant market can lead to the incorrect inference that direct cost-investment rewards should remain at zero. Third-party funder contracts may overstate the market profits on cost investment due to the unique position of such funders and may also produce a number that varies from the reward on time investment. And both third-party funders and cost-investing counsel who negotiate reallocated fee awards may enter into litigation investment agreements at points where existing counsel are particularly vulnerable and desperate, such that their contracts may reflect peculiar problems with the cases in which investment is being made rather than a more generalizable value of cost investment.

The last of the two market measures considered above—the market created by judges and the market for time investment—most squarely address the case investment distortions described in Section II. That is because they counteract the basic cause of those distortions, i.e., the unequal reward on time and cost investment. A market measure that considers either the cost profits awarded by judges acting as sophisticated client surrogates or the profits on time can lead to the same place—equal treatment of time and cost investment. Both market measures have the potential to eliminate or reduce the bias in favor of time investment in class actions.

V. CONCLUSION

Cost profits have traditionally foundered on ethical shoals. But they need not. A proper reading of the applicable ethics rules would move (or stop drawing) the boundary lines that have prevented parties and courts from more fully exploring opportunities to better align the interests of class counsel and class members. Those poorly drawn boundaries fail to fully recognize the professional role played by class counsel as court-appointed litigation funders. Reasonable profits to compensate class counsel for properly performing that distinctive role may be grounded in market measures, as to which there are ample data.