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# "SWEETHEART" AND "BLACKMAIL" SETTLEMENTS IN CLASS ACTIONS: REALITY AND REMEDY

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## I. INTRODUCTION

Class action aggregation of mass tort, antitrust, securities and consumer fraud, employment discrimination, and other damage claims currently provokes more controversy than at any time since the creation of the modern class action procedure. Indeed, class actions are without doubt the most controversial subject in the civil process today.

The controversy revolves around the settlement of class actions. Class actions, like ordinary lawsuits between individuals, settle most of the time. Yet unlike ordinary actions, the class action frequently involves thousands or even millions of claims, often worth billions of dollars. With so much at stake, critics have argued that the class action settlement process will inevitably lend itself to corruption and abuse.

Critics have focused on two dangers associated with the settlement of class actions. One concerns the problem of "sweetheart" settlements, in which the class members' interests are compromised by class counsel. This complaint, which is nothing new,<sup>1</sup> arises when class counsel allegedly settles meritorious claims for far less than they are worth. A number of recent class action settlements have been crit-

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1 As Judge Henry Friendly observed long before class settlements reached today's astronomical proportions, the attorney has "every incentive to accept a settlement that runs into high six figures or more regardless of how strong the claims for much larger amounts may be. . . . [A] juicy bird in the hand is worth more than the vision of a much larger one in the bush." *Alleghany Corp. v. Kirby*, 333 F.2d 327, 347 (2d Cir. 1964). More recently, the Supreme Court has expressed a like concern. See *Ortiz v. Fibreboard Corp.*, 119 S. Ct. 2295, 2318 & n.30 (1999).

icized on the ground that class counsel had in effect "sold out" the class members.<sup>2</sup>

The other complaint concerns the problem of "blackmail" settlements, in which the defendant is bludgeoned into settling cases for more than they are worth.<sup>3</sup> This is the mirror image of the sweetheart settlement: here, the accusation is that the class recovers more than it should, because the class counsel is able to threaten the defendant with a costly and risky trial.<sup>4</sup> This charge has also been raised in connection with a number of recent cases.<sup>5</sup>

These two complaints—sweetheart settlements and blackmail settlements—conflict in their assessment of the problem associated with class actions. One concludes that class members collect too little; the other, that they collect too much. Yet for many, they offer complementary prescriptions: limiting the use of the class action. The critics seem to concur on the proposition that the corruption of class settlements is so pervasive and intractable that the only effective remedy is to curtail the use of the class action itself.<sup>6</sup>

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2 See, e.g., John C. Coffee, Jr., *Class Wars: The Dilemma of the Mass Tort Class Action*, 95 COLUM. L. REV. 1343 (1995); Susan P. Koniak, *Feasting While the Widows Weep: Georgine v. Amchem Products, Inc.*, 80 CORNELL L. REV. 1045 (1995); Susan P. Koniak & George M. Cohen, *Under Cloak of Settlement*, 82 VA. L. REV. 1051 (1996).

3 This concern has also been around for a long time. See HENRY J. FRIENDLY, *FEDERAL JURISDICTION: A GENERAL VIEW* 120 (1973) (referring to the possible use of class actions to extract "blackmail settlements"); Milton Handler, *The Shift from Substantive to Procedural Innovations in Antitrust Law—The Twenty Third Annual Anti-Trust Review*, 71 COLUM. L. REV. 1, 9 (1971) (calling certain class actions "legalized blackmail").

4 The blackmail effect of class actions involves "forcing . . . defendants," as Judge Richard Posner explained, "to stake their companies on the outcome of a single jury trial, or be forced by fear of the risk of bankruptcy to settle even if they have no legal liability." *In re Rhone-Poulenc Rorer Inc.*, 51 F.3d 1293, 1299 (7th Cir. 1995).

5 See, e.g., Sheila Birnbaum, *Class Certification—The Exception, Not the Rule*, 41 N.Y.L. SCH. L. REV. 347, 350 (1997); Mary J. Davis, *Toward the Proper Role for Mass Tort Class Actions*, 77 OR. L. REV. 157, 187 (1998); Peter A. Drucker, *Class Certification and Mass Torts: Are "Immature" Tort Claims Appropriate for Class Action Treatment?*, 29 SETON HALL L. REV. 213, 228 (1998); Barry F. McNeil & Beth L. Fancsali, *Mass Torts and Class Actions: Facing Increasing Scrutiny*, 167 F.R.D. 483, 489-90 (1996).

6 Thus, most of the critics cited in *supra* notes 2 and 5 have made various arguments for greater adherence to, or tightening of, the prerequisites to class certification. We do not review the details of their proposals here. For our purposes it is enough to observe that the concern over collusive and blackmail settlements has led many to urge greater restraint in the use of class actions. For a prominent example in the mass tort area, see Coffee, *supra* note 2 (urging less use of class actions in mass tort cases). Also, we note that these critics generally ground their concerns on anecdotes, not systematic empirical studies, and they give little or no attention to the risk

In this Article, we critically examine the problems of sweetheart and blackmail settlements in class actions. In essence, the questions we are concerned with are the following: Are sweetheart and blackmail settlements an inherent feature of the class action? To what extent can they be combated through proper design of the class action procedure? What types of reform of the class action procedure—short of abolishing or curtailing its use—would reduce the risk of these problems? Our central conclusion is that the risks of sweetheart and blackmail settlements have been overstated, in that these problems can effectively be handled by courts through appropriate class action safeguards, without resorting to the drastic remedy of eliminating or reducing the use of the damage class action. We can shed the risks of abusive class settlements without scuttling class actions and their considerable advantages.

Our starting point, developed in Part II of this Article, is that the class action has great potential value for the fair and efficient adjudication of large-scale damage actions. It potentially offers substantial advantages over the alternative of individually prosecuted actions. (We will use the term "separate action process" to refer to the standard mode of case-by-case adjudication.) In the separate action process, a defendant facing a large number of plaintiffs generally has an enormous, and unwarranted, upper hand over the plaintiffs. The defendant firm, but not the plaintiffs, can take advantage of economies of scale in case preparation, enabling it to invest far more cost-effectively in the litigation.<sup>7</sup> The upshot is that the plaintiffs—precisely because of their large number—will recover less at trial or in settlement than they would have if there had been fewer of them. In effect, the defendant is able to use the plaintiffs' numerosity against them, so that the value of their claims is reduced *for no reason other than the fact*

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of sweetheart and blackmail settlements in the conventional process of separate actions.

7 By economies of scale, we refer to the idea that the cost of litigating a claim goes down if it is bundled with other similar claims. This occurs because the investment on a common issue—that is, an issue (or type of proof such as statistical evidence) shared by or generally applicable to the claims—can be used to litigate all of the claims. So for example, in a product liability case, once the defendant has invested in a scientific study on the nature of a product, that study can be used for all claims concerning the product. Suppose that the study costs five million dollars. If there are 1000 claims, the per-claim cost of the study is \$5000; if there are 100,000 claims, the per-claim cost of the study is \$50. All else being equal, the more claims there are, the more worthwhile the study becomes. Accordingly, all else being equal, the more claims there are, the more the defendant will invest in the case.

that they are in large numbers.<sup>8</sup> This is an arbitrary and, from the standpoint of legal policy, undesirable result.<sup>9</sup>

The potential virtue of a class action is that it prevents the defendant from using the plaintiffs' numerosity against them. Once the plaintiffs' claims are aggregated and the task of representing them assigned to a single group of attorneys, the plaintiffs can exploit the same scale economies as the defendant when investing in the case. Because the plaintiffs' lawyers can spread their investment over all of the claims—just as the defendant does—it becomes possible to make investments in the litigation that the plaintiffs could not make if the

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8 This is an instance of the familiar problem of collective action. The plaintiffs as a group would be benefited by a substantial investment in the litigation, but no individual plaintiff (or his lawyer) finds it in his interest to make the investment. See *infra* Part II.B. We do not ignore the real world of mass tort litigation in which a relatively few corporately structured organizations of plaintiffs' attorneys compete both to increase their respective market shares of the claims that arise from a given mass tort event and to attract financial backing from various sources of venture capital. By aggregating large claim inventories, these "firms" exploit scale economies in preparing the common questions en masse. Often these competitors agree to share some information and costs and to an extent coordinate litigation strategy. As such, the market for mass tort claims somewhat redresses the imbalance in litigation power between the defendant and plaintiffs. But, as we discuss in Part II.B, obvious and basic market defects preclude plaintiffs from efficiently or indeed virtually ever achieving the scale economies from class-wide aggregation essential to support the optimal investment that maximizes aggregate and individual value of their claims. Chief among the market defects thwarting collective action are, as explained below, high organizational and other transaction costs and incessant opportunities for free-riding. It should be noted, however, that the market's near universal aggregation of mass tort claims (albeit divided among separate firm "inventories") expresses the preference of plaintiffs for "collective" rather than "individual" representation. If plaintiffs' preference rationally furthers their interest in maximizing their respective net recoveries, as we demonstrate even partial and costly collectivization does, then it follows they benefit from more not less aggregation. The vote in the marketplace is decidedly against the individual benefits of so-called "litigant autonomy," contradicting the supposition of the Supreme Court. Thus in decreeing that class actions are an "exception" to "our 'deep-rooted historic tradition that everyone should have his own day in court,'" *Ortiz*, 119 S. Ct. 2295, 2315, the Court is not merely engaging in harmless metaphysics; it establishes a conception of individualism that in operation will make all plaintiffs *individually* worse off.

9 That is, it frustrates the law's general goals of cost-effectively providing deterrence and compensation. For development of the deterrence, compensation, and administrative costs of this systemic bias against plaintiffs in mass tort cases, see David Rosenberg, *Mass Tort Class Actions: What Defendants Have and Plaintiffs Don't*, 37 HARV. J. LEG. (forthcoming Summer 2000).

claims were prosecuted separately.<sup>10</sup> This puts the plaintiffs in a position of parity with the defendant, who will exploit scale economies whether or not the case is brought as a class action. This state of affairs, if it can be realized, is preferable to the separate action process, in which the plaintiffs effectively have one hand tied behind their back when it comes to investing in case preparation.

The question then becomes whether it is possible to realize these potential benefits of the class action procedure. As we describe in Part III, critics of the procedure charge that, whatever its potential benefits in an ideal world, the class action in reality is an instrument of abuse and corruption. They assert that class settlements inevitably fall prey to either sweetheart deals that "sell out" plaintiffs for a fraction of the value of their claims, or blackmail pressures that extort payments from the defendant in excess of what the claims are really worth. Our analysis, however, persuades us that these problems are not an inherent feature of the class action device. It is true that these might be problems if the courts were powerless to deal with them. However, there are measures well within the courts' reach to guard against settlement dangers. Indeed, even without radically changing contemporary class action practice, the risk of sweetheart and blackmail settlements can be substantially reduced if not eliminated.

Part IV of the Article addresses the problem of sweetheart settlements. There we examine the regulation of class counsel's fee as a mechanism for discouraging him from settling for less than the plaintiffs' claims are worth. The danger of a sweetheart settlement only arises if the class counsel finds it profitable to settle for less than the claims are worth. By appropriately structuring the counsel's fee, the court can shape the attorney's incentives so that he will reject settlement offers that give the plaintiffs less than the value of their claims.

Significantly, the court can accomplish this result even without knowing the value of the claims. The solution we propose thus re-

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10 This point is implicit in the widely held view that class treatment should be available in the case of "small claims" that are not economically viable on their own. See *Amchem Products, Inc. v. Windsor*, 521 U.S. 591 (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.

*Id.* at 617 (quoting *Mace v. Van Ru Credit Corp.*, 109 F.3d 338, 344 (7th Cir. 1997)). However, the point also applies to cases involving "large claims" that *can* be brought separately. Even in such large claims, the defendant will outspend the plaintiffs on common issues, unless the claims are aggregated in a class action.

sponds to critics' concerns that effective judicial policing of settlements is impaired by the courts' inability to determine whether a given settlement accurately reflects the value of the plaintiffs' claims.<sup>11</sup> Moreover, the approach we advocate can solve the problem of sweetheart settlements in both ordinary trial class actions and the so-called settlement-only class action. It thus also responds to critics' concerns that settlement class actions are particularly prone to sweetheart settlements, because the defendant can in effect solicit rival bids from different plaintiffs' lawyers who hope to serve as class counsel. If the fee is properly structured, sweetheart settlements can be prevented even if the defendant solicits rival bids in this manner.

Part V turns to the problem of blackmail settlements, in which plaintiffs use trial class actions to extort settlements from defendants that exceed the value of the plaintiffs' claims. Critics argue that the threat of a single class trial on the issue of the defendants' liability to the plaintiffs systematically puts irresistible pressure on the defendant to settle, even if the evidence supporting liability is weak. The defendant, according to this argument, will not want to take the gamble of going to trial, because a plaintiff verdict could mean catastrophic damages and even bankruptcy. Indeed, critics ignore the fact that the prospect of a catastrophic loss from a single class trial exerts pressure on class counsel and class members to settle for less than the value of the class claim, even when the evidence supporting liability is strong. Our proposed solution to this problem is simple and comprehensive:<sup>12</sup> the court should hold multiple class trials and base its judgment on some suitably weighted combination of the different verdicts.<sup>13</sup> This multiple-trial process makes going to trial less risky, because the judgment does not depend on the result of a single all-or-nothing verdict. It should therefore prevent either side from using the riskiness of trial as leverage for extorting unwarranted settlement concessions from the other side.

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11 As an additional protection, we also propose that courts relax the preclusive effect of class settlements that turn out to be insufficient to cover future claims.

12 We accept for purposes of this argument that defendant firms are risk averse in their litigation decisions, which underlies the concern for blackmail settlements. The validity of the assumption has not, to our knowledge, been demonstrated empirically.

13 As we describe below, the court might take the "average" of the verdicts and compute damages accordingly. (Thus, if the court held 10 trials on liability, and these resulted in two verdicts for the plaintiff and eight for the defendant, the defendant would pay 20% of the plaintiffs' damages.) Alternatively, it might base its judgment on the majority of verdicts: for example, if more than half of the verdicts favor the plaintiffs, they collect their full damages; otherwise, they collect nothing.

In Part VI, we pull together the different threads of the analysis in some concluding remarks.

## II. THE GENERAL CASE FOR CLASS ACTIONS

We begin by setting forth the basic reason for classing large-scale damages actions, a reason we think has been too little appreciated in the debate over class actions. The central rationale for the class action aggregation—not merely in “small claims” cases, but in all cases involving numerous claims for damages—is this: it enables plaintiffs to exploit the “economies of scale” *the defendant already naturally enjoys* from treating separate claims as a single litigation unit. Enabling plaintiffs to exploit the same scale economies leads them to make more productive litigation investments—investments that determine both the likelihood and magnitude of recovery. Put crudely, the class action is desirable because it enables plaintiffs as a group to recover more than they could get in separately-prosecuted actions.<sup>14</sup>

Allowing plaintiffs the opportunity to exploit class action scale economies is desirable, we contend, because it simply amounts to removing an artificial and unjustified (socially detrimental) advantage that defendants have in separately-prosecuted actions. When claims are litigated separately, the defendant (but not the plaintiffs) takes advantage of litigation scale economies, giving the defendant an automatic “upper hand” in the litigation. The result is that the defendant’s litigation position is artificially strengthened—not because of anything having to do with the merits of the lawsuit, but solely because the plaintiffs are overburdened by litigation costs. Class action aggregation reduces this asymmetry, giving the plaintiffs the same scale economies in litigation that the defendant already possesses. Our purpose in what follows is to develop this point before turning to the problem of settlement abuses.

### A. *The Defendant’s Artificial Advantage in Separate Actions*

When facing a series of separate lawsuits presenting common questions of law or fact, the defendant will treat the plaintiffs as a *de facto* class, in the sense that the defendant will seek to minimize its liability to the plaintiffs as a group. The defendant can make a large investment in the litigation of the common questions, and then use the fruits of that investment in each of the individual cases. But no plaintiff has an incentive to match the defendant’s investment, if the

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14 The class device may also eliminate wasteful redundancy of expenditures, but we consider this of secondary importance.



cases are litigated separately (or in batches comprising a subset of the whole).<sup>15</sup>

To see the point, assume that the manufacturer of a product is faced with a series of separate claims for personal injuries suffered by the product's users. The claims present certain common questions, such as whether the product is defective. A lawyer, having invested in the litigation of this common question, may deploy that investment in *all* of the claims he is involved in. For example, once resources have been invested to acquire an expert opinion on the defectiveness issue, the lawyer may use the fruits of that work on all of the claims.

The possibility of spreading litigation investments and reaping the full aggregate return in this fashion creates a built-in advantage for defendants over plaintiffs who are bringing their claims separately. The defendant, being involved in all of the claims, will be able to spread across and reap the full return from its investment on the common questions *in the claims by all of the plaintiffs*. In contrast, on the plaintiff's side, different plaintiffs are likely to be represented by different lawyers; no one lawyer will be handling all the claims. Therefore, *no plaintiff's lawyer will be able to spread the costs of and reap the full return from his investment on the common questions in all the claims*.

Because of this asymmetry, the defendant will make investments in the litigation that no plaintiff's attorney can economically match. A litigant will invest up to the point at which the cost of additional investment exceeds the gain from additional investment. All else being equal, a given plaintiff's attorney (handling only a fraction of the claims) will reach that point before the defendant does.

A simple numerical example will make the point clearer. Suppose our hypothetical product liability case involves 10,000 plaintiffs, each of whom has suffered losses of \$10,000. The defendant then has a total of \$100 million "on the line" in the litigation. Suppose, however, that no individual lawyer represents more than 100 plaintiffs in the litigation. In this scenario, no lawyer's clients have more than one million dollars "on the line" in the litigation.<sup>16</sup>

All else being equal, the defendant will invest much more than any plaintiff's lawyer in the litigation of the common questions. Take

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15 Sometimes multiple plaintiffs in a case will hire a single lawyer. Unless he is hired by *all* of them (a practical impossibility), however, he will not come close to matching the defendant's investment. In sum, given that their incremental litigation investments continuously raise the probability of success at trial (albeit at a decreasing rate), plaintiffs will not optimally invest to maximize aggregate value from 100% of their claims unless they receive the full recovery from those claims.

16 Indeed, it will not even be one million dollars, assuming that the lawyer works on a contingent fee that gives him only a fraction of the recovery.

the issue of whether the product was defective. Suppose that by making, say, an investment of ten million dollars, the defendant could obtain an elaborate scientific study that could be used to its advantage on the defectiveness issue in all of the cases. The defendant will rationally make this investment, so long as the studies and testimony would more than "pay for itself" by reducing the likelihood that the product will be found defective.

In contrast, no plaintiff's lawyer would dream of investing ten million dollars on the defectiveness issue. That investment would swamp the hoped-for one million dollar recovery by the plaintiffs he represents. No matter how effective the investment would be in increasing the likelihood of recovery, it would be a waste of money for any plaintiff's lawyer to make the investment.

Thus, in this example, the defendant will have an elaborate scientific study to buttress his position on the defectiveness question. But no plaintiff will have a comparable study to support *his* position. As a result, the defendant will have a better chance of prevailing on the common question than it would have if the plaintiffs' attorney had equivalent investment incentives. In effect, the defendant is able to use his greater stake in the litigation (as compared to any individual plaintiff's lawyer) as leverage for increasing his chances of success.

This analysis holds for virtually any type of investment on the litigation of the questions common to the different plaintiffs' claims. It could be discovery, expert witnesses, legal research, or any of numerous other investments of time, effort, and money. Because the investment bears on an issue common to all the claims, the defendant can draw on the investment in litigating all the claims. As a result, the defendant will use the aggregate potential value of the claims—here, \$100 million—as the baseline for determining whether a given investment is worthwhile. He will accordingly be willing to make some investments on the common questions that no plaintiff's lawyer is willing to make. This will translate into a much greater chance of prevailing on the common questions than the defendant would otherwise have.

This problem is less pronounced if the plaintiffs' claims are aggregated into a class action. If a single team of attorneys has a stake in all \$100 million worth of claims, these attorneys will be willing to make a much greater investment than an attorney handling only a single claim for \$10,000. Class treatment does not make the asymmetry of investment go away altogether: even in a class action, the defendant has an incentive to outspend the plaintiffs' attorneys, if the class counsel are paid—as they often are—on a strict percentage-of-the-recovery basis. (The defendant has \$100 million to lose, whereas class counsel

usually has only twenty or thirty percent of that to gain.)<sup>17</sup> Compared to the separate-action alternative, however, the class action device at least moves plaintiffs in the direction of investment parity with the defendant.

### B. *The Basic Problem: Collective Action*

The key point to see in the foregoing analysis is that in separate actions, *the very fact that the plaintiffs are numerous puts them at a disadvantage*. That is, when claims are prosecuted separately, each plaintiff is worse off than he would have been if they were less numerous. In the example just used, if there had only been one plaintiff—that is, if the \$100 million in losses had been concentrated on a single plaintiff—then he would have matched the defendant's litigation investment in a scientific study. However, because the \$100 million in losses is dispersed over many plaintiffs, no plaintiff has an incentive to make the investment.<sup>18</sup>

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17 Here we assume the lawyer is given a fractional share of the recovery, usually in the 20 to 30% range. Of course, the court may calculate counsel's fee on some other basis, such as an hourly rate or a more complex percentage-of-the-recovery basis (e.g., 10% of the first \$20 million, 15% of the next \$20 million, etc.), which might improve counsel's incentives to match the defendant's investment. Frequently, however, a simple percentage-of-the-recovery formula is used.

Although beyond the scope of this Article, we note that motivating class counsel to invest optimally in maximizing the net aggregate value of the class claim requires pegging the fee award (percentage of recovery or hourly payment) to the optimal level of investment, neither more nor less. In addition, the court should multiply or increase the award by a factor that nullifies the contingent nature of the fee, which otherwise would induce class counsel to discount the investment by the probability of not achieving a successful outcome. To avoid the difficulty of determining fee-awards as well as the problems of sweetheart deals, courts could simply sell or auction the class claim to class counsel. See Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991). Better still, courts could promote an "ex ante" claims market by authorizing first-party commercial and governmental insurers to acquire by subrogation complete ownership control over the prosecution of their insured's prospective (including pre-risk) tort claims. See David Rosenberg, *Of End Games and Openings in Mass Tort Cases: Lessons from a Special Master*, 69 B.U. L. REV. 695, 729-30 (1989). In the absence of a contractual arrangement between insurers for aggregating the claims arising from a mass tort event, courts could certify class actions with one or more of the insurers being designated as class-representative. Cf. Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(a)(3)(B)(i) and (iii)(I) (creating "rebuttable presumption . . . that the most adequate plaintiff . . . is the person or group of persons that . . . in the determination of the court, has the largest financial interest in the relief sought by the class").

18 Indeed, if only one of many injured persons sues, there will be equivalency of litigation power between the plaintiff and defendant. More generally, this equiva-

It might be objected that the plaintiffs could voluntarily band together in order to match the defendant's investment. Each could make a contribution to a fund used for purposes of conducting a scientific study for their mutual benefit. More generally, they could all agree to be represented by a single team of lawyers who would then find it worthwhile to match the defendant's investment on all aspects of the common questions. However, there are two obvious obstacles to this type of collective action.

First, there are substantial transaction costs in assembling any voluntary collective effort of this sort. Plaintiffs may be difficult to locate, especially in mass exposure cases involving long latent risks. There will be disagreements over who should contribute how much. There will be bickering over who should control the litigation of the common questions. It would be surprising if all could put aside their differences and unanimously agree on resolution of these issues.

Second, any collective effort will be beset by free-riding. Each individual plaintiff will have an incentive to withhold his contribution to the effort, hoping to benefit from the collective effort without paying his share. It may be difficult for contributors to exclude non-contributors from the fruits of the collective effort. Consider the example of a scientific study—once finished, it is hard to prevent its dissemination to third parties.

The magnitude of these problems is obviously an empirical question. However, it would be folly to deny their existence. More precisely, it would be folly to suppose that when \$100 million in claims is dispersed over a large number of plaintiffs, they will be able to coordinate their activities and invest as productively as would a single party who owned (or faced) all \$100 million in claims. It is in that sense that the plaintiffs are hampered by their large numbers—the very fact that the \$100 million is dispersed over many people means that the plaintiffs will have less chance of success than they would have if the claims were not dispersed. And by the same token, their large numbers will put them at a disadvantage against a common defendant, because they cannot match the defendant's productivity in investment.

The class action device at least partially alleviates this problem, by concentrating control of the claims in the hands of a single team of attorneys, without the need for a negotiated voluntary collective effort. To be sure, as presently constituted the class action does not

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lence holds whenever a single attorney (or team of attorneys) on each side controls all of the filed claims, regardless of what percentage they represent of the total number of injured individuals who could file suit.

solve the problem of free-riding entirely, because class members may opt out of certain classed damages actions. In general, however, it is easier to secure aggregation of claims through the vehicle of class actions than through informal collective efforts; some plaintiffs will remain in the class even though they would not (for one reason or another) have participated in informal aggregation.<sup>19</sup>

### C. *The Normative Baseline*

In the separate-action process, then, dispersed plaintiffs are likely to be disadvantaged, by the very fact of their numerosity, when facing a common defendant. Barriers to collective action will prevent them from realizing the scale economies available to their opponent. The device of class action aggregation reduces this asymmetry and for that reason is *prima facie* desirable. By what criterion do we say this is desirable?

The normative baseline we use here is quite simple: *the outcome of a case should not depend on how dispersed the plaintiffs are*. A defendant's liability to a given plaintiff should not be lessened (or augmented) by virtue of the fact that many other plaintiffs were also harmed. Put otherwise, a plaintiff should not be disadvantaged simply because he is part of a large group.

The intuition here may be captured by the following example. Defendants *A* and *B* engage in identical behavior. Defendant *A* causes a total of \$100,000 in harm, spread over two plaintiffs. Defendant *B* causes a total \$100,000 in harm, spread over 2000 plaintiffs. Under our criterion, the victims of *A* should recover no more (and no less) from *A* than the victims of *B* recover from *B*. The fact that *B*'s victims are part of a large group should neither hurt nor help them.

If the actions are prosecuted separately, *B*'s victims will likely recover less on average than *A*'s victims. For the reasons we have identified, *B* (facing a large number of plaintiffs) will invest much more heavily than the plaintiffs on the common questions and have a correspondingly greater chance of prevailing. In contrast, *A*, facing only two plaintiffs, will not substantially outspend the plaintiffs. Thus, *A*'s victims will recover more, on average, than *B*'s victims, solely because of their smaller number.

This is an arbitrary and, from the standpoint of legal policy, undesirable result. The value of a plaintiff's claim should not depend on the number of other plaintiffs facing the same defendant. We think

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19 In addition, once the opt-out period has passed, class action plaintiffs cannot threaten to exit the collective effort. In contrast, under voluntary joinder, the constant risk of exit may hamper coordination.

most will agree to this common sense proposition. If a plaintiff has suffered a loss of \$100,000, the amount he recovers should not normally vary with the happenstance of how many others have suffered a similar loss. It should not be the case that he recovers \$100,000 if there are only a few other plaintiffs, but (say) only \$50,000 if there are many other plaintiffs.

Put the other way around, the amount a defendant is forced to pay a given plaintiff should not normally depend on the number of other plaintiffs who have claims. It should not be the case that a defendant who inflicts a \$100,000 loss on a small number of plaintiffs must pay them each \$100,000, while a defendant who inflicts an identical loss on a *large* number of plaintiffs only pays them each \$50,000.

Yet the separate action process invites these arbitrary results, because it gives a natural advantage to the defendant who faces a large number of plaintiffs. From the point of view of the conventional goals of civil liability—cost-effective deterrence and compensation, (whether viewed realistically as insurance or moralistically as corrective justice)—this is an undesirable state of affairs.<sup>20</sup>

The potential virtue of the class action is that it curtails, though it does not entirely eliminate, the defendant's natural incentive to outspend the plaintiffs on common questions. It puts the plaintiffs, as a group, on a more nearly equal footing with the defendant in the litigation. The result is that case outcomes are less likely to be skewed by collective action problems that have nothing to do with the merits.

### III. THE PROBLEM OF CLASS ACTION SETTLEMENTS

Critics of the class action, however, have raised two distinct arguments against the use of the class action procedure, focusing on the *settlement* of class actions. If valid, these concerns raised by the critics might weaken the basic case for class actions just sketched.<sup>21</sup> How-

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20 On the deterrence theory of tort liability, see GUIDO CALABRESI, *THE COSTS OF ACCIDENTS* (1970). For discussion of various theories of tort compensation, see DAVID ROSENBERG, *THE HIDDEN HOLMES: HIS THEORY OF TORTS IN HISTORY*, 136–138 (1995).

21 Even if the concerns were valid, there would remain the empirical question whether the class action procedure created benefits in excess of its costs. Such analysis should consider the net-benefit of class actions in relative as well as absolute terms. Incentives for sweetheart deals certainly exist in the separate action process, especially in the prevailing claims market dominated by corporately structured organizations of plaintiff attorneys acquiring, prosecuting, and settling large inventories of claims en masse. And, as we show, the potential for one-sided, systematic blackmail settlements (exclusively disadvantaging plaintiffs and their attorneys) exists only in the separate action process. In light of these costs of settlement abuse plus the costs of deficient deterrence and compensation resulting from sub-optimal investment incentives, class

ever, we deny the validity of critics' concerns; more precisely, we deny that class actions are irremediably susceptible to settlement abuse. We will try to demonstrate this in Parts IV and V below. Here we will simply describe the nature of the two problems with class settlement and our approach to analyzing them.

### A. *Two Problems with Class Settlement*

The two concerns raised by critics both relate to case outcomes—that is, the amount recovered by the class in settlement. The first concern is that class action settlements will give class members *too little*, because class counsel will be tempted to enter into a “sweetheart” or collusive deal with the defendant. The second, opposing, concern, is that class action settlements will give class members *too much*, because class counsel will “blackmail” the defendant into paying the class more than is warranted by the case’s merits.

#### 1. “Sweetheart” Settlements

Some critics have been troubled by the prospect that class counsel may “sell out” the class.<sup>22</sup> According to this argument, the defendant and the class counsel have a joint incentive to negotiate a settlement that gives the class counsel a generous attorney’s fee, but gives the class members less than the fair value of their claims. Proponents of this argument contend that courts are poorly equipped to detect such “sweetheart” deals, because the trial judge has limited information about the value of the class’s claims and therefore cannot easily verify whether a settlement provides an appropriate recovery.<sup>23</sup>

Critics identify two contemporary innovations in class action practice that compound the problem of sweetheart settlements. The first arises from recognition and class certification of mass tort claims based on the present increased risk of future ultimate injury.<sup>24</sup> The

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actions may well prove the superior mode of adjudication despite the possibility of abusive class settlement. We do not take that issue up here.

22 See, e.g., Coffee, *supra* note 2 at 1347–48; Koniak, *supra* note 2, at 1055–56; Koniak & Cohen, *supra* note 2, at 1053–57.

23 To some extent, the court depends for this information on class counsel, who according to this argument would have an incentive to understate the value of the claims in order to make the settlement look generous. For example, class counsel and the defendant might implicitly agree to understate the number of future claimants in a mass exposure tort case.

24 See, e.g., Todd W. Latz, Note, *Who Can Tell the Futures? Protecting Settlement Class Action Members Without Notice*, 85 VA. L. REV. 531 (1999); Alex Raskolnikov, Note, *Is There a Future for Future Claimants After Amchem Products, Inc. v. Windsor?*, 107 YALE L.J. 2545 (1998).

prime example is the mass exposure case involving workplace or environmental release of a toxic substance that places a large population at risk of contracting deadly disease years or decades later. Class actions composed largely of such "future injury claims" or other risk-based claims—of necessity, to make aggregating mass tort claims worthwhile—provide fertile ground for collusion, according to critics, because courts cannot reliably estimate the aggregate value of these claims.<sup>25</sup>

The second innovation is the so-called "settlement-only class action," where the class is certified solely for purposes of settling the case. In these actions, settlement negotiations often occur before the class is certified. The defendant, together with lawyers for one or more of the plaintiffs, negotiates a proposed classwide settlement, which is then presented to the court for approval. Critics have argued that this procedure enables the defendant to conduct a sort of "reverse auction," seeking bids from different plaintiffs' lawyers and settling with the one who offers to settle for the lowest figure.<sup>26</sup> According to the argument, individual plaintiffs' lawyers have an incentive to underbid one another, because the one who makes the winning bid is designated class counsel and earns class counsel fees. This makes it all but inevitable, the argument goes, that the resulting settlement will be unfair to the class members, giving them less than the value of their claims.

## 2. "Blackmail" Settlements

Other critics argue that the class action creates a systematic threat that defendants will be blackmailed into settling on overly generous terms, even when the class's claims are weak or marginal. This argument focuses on class actions that are certified for trial. According to the critics, such certification makes trial very risky for the defendant: its liability to the class is determined by a lone jury issuing a single all-or-nothing verdict—a single "toss of the coin." If the defendant is risk-averse, it will be willing to pay a handsome premium to avoid going to trial, even if its chances of winning at trial are strong. By threatening the defendant with a classwide trial on the common issues,<sup>27</sup> so

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25 See, e.g., Coffee, *supra* note 2, at 1373; Richard A. Nagareda, *Turning from Tort to Administration*, 94 MICH. L. REV. 899, 950–60 (1996); Brian Wolfman & Alan B. Morrison, *Representing the Unrepresented in Class Actions Seeking Monetary Relief*, 71 N.Y.U. L. REV. 439, 452 (1996).

26 See Coffee, *supra* note 2, at 1370–73; see also Nagareda, *supra* note 25, at 960.

27 That is, on issues common to all of the claims, such as whether the product in question was defective or whether the defendant was negligent.



goes the argument, plaintiffs may be able to extract a substantial settlement even for weak claims. Plaintiffs' recovery thus reflects not the merit of their claims, but rather the defendant's fear of staking everything on a single trial.

In contrast, this argument continues, if the claims are brought separately, the defendant does not face the same kind of risks. In separate actions, a trial only determines the defendant's liability to the individual plaintiff whose case is being tried.<sup>28</sup> The plaintiff cannot threaten the defendant with a single all-or-nothing trial that may result in liability to all of the plaintiffs. Thus, this argument concludes, class action treatment exposes the defendant to a form of extortion not present in the separate-action context.

This argument figured prominently in the widely discussed *Rhone-Poulenc* case,<sup>29</sup> in which the court of appeals overturned an order certifying a class of tort plaintiffs who alleged that they had contracted HIV as a result of the defendant's negligent handling of blood products used in transfusions. In the court of appeals' view, the plaintiffs' case must have been very weak, because twelve of thirteen individual trials involving non-class members had resulted in defense verdicts.<sup>30</sup> Nonetheless, if the defendant were to lose a class trial, it would face certain bankruptcy. That prospect, according to the court, might lead the defendant to pay a large settlement in order to avoid a class trial, even though the plaintiffs' claims apparently had little merit. Part of the reason for ordering the cases to proceed separately, the court explained, was to prevent the plaintiffs from using the threat of a class trial to extract a settlement to which they were not entitled.<sup>31</sup>

### B. Analytical Approach to Class Settlement Problems

In this Article we do not address the extent to which these settlement abuses have been present in past cases or pose a realistic risk in

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28 Here the argument assumes that there is no collateral estoppel or other preclusive effect that would bind the defendant in other plaintiffs' cases.

29 *In re Rhone-Poulenc Rorer, Inc.*, 51 F.3d 1293, 1299 (7th Cir. 1995).

30 *See id.* For reasons discussed in *supra* Part II, this is a non-sequitur; the plaintiffs' losses may reflect a weak case or may reflect the fact that they were outspent by the defendant. We express no view on the merits of the case.

31 Similar considerations were invoked by the court of appeals to decertify a class in the *Castano* cigarette litigation. *See Castano v. American Tobacco Co.*, 84 F.3d 737, 746 (5th Cir. 1996) (arguing that class certification "dramatically affects the stakes for defendants," "magnifies and strengthens the number of unmeritorious claims," "makes it more likely [that a jury will find a defendant liable]," and "creates insurmountable pressure on defendants to settle," leading to the risk of "judicial blackmail").

future cases. Rather, our purpose is to investigate whether the prospect of such abuses, however real, is an *inherent* and thus generally intractable feature of the class action. The class action's critics often appear to believe that the answer is yes; to these critics, the risks of collusion and extortion are built-in properties of the class action. For some of these critics, this defect necessarily makes the class action inferior to the alternative of separately prosecuted actions.

We take a different approach from these critics who would limit or otherwise sacrifice the scale economies of class actions to prevent class settlement abuse. We do not deny, for example, that increasing subclasses or opt-out opportunities for class members to create a milieu of competing interest groups might diminish the incidence of sweetheart deals. Our concern is that such proposals also would prevent plaintiffs from exploiting class-wide scale economies to make the optimal investment that maximizes the net recovery on the class claim. For this reason, our approach seeks to prevent abuse by designing rules to correct class counsel's litigation incentives *consistent with preserving the scale economies of class-wide aggregation*.

In what follows, we try to show that sweetheart and blackmail settlements are not at all inherent to the class action procedure. Courts have readily available means to minimize the danger. There is no need to jettison the class action and to forgo the potential benefits of class treatment. We will try to show, therefore, that the basic case for class actions outlined in Part II remains intact and is not undermined by the prospect of collusion or extortion in settlement.

Essentially, we argue that it is possible for the court to ensure that class action settlements generally give the class as a whole an amount approximately equal to the total value of its claims. Here we define the "value of the class's claims" as *the aggregate expected recovery at trial of the plaintiffs' claims*. This figure is given by the total amount the plaintiffs would win if their claims were tried, discounted by the possibility that they might lose at trial. We will assume that the legal system's objective is, all else being equal, to ensure that a settlement gives the plaintiffs a sum not more or less than this amount.<sup>32</sup> Thus, for example, suppose that the aggregate expected value at trial of the plaintiffs' claims is \$100 million. Then we shall assume that the objective of the legal system is to ensure that if the claims settle, the plaintiffs collect about \$100 million. Our hope is to show that judges can ensure this happens with reasonable probability.

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32 More specifically, we assume that assuring this level of recovery to plaintiffs furthers the deterrence, compensation, and administrative productivity goals of civil liability.

#### IV. PREVENTING "SWEETHEART" SETTLEMENTS

In this Part we will show how a combination of devices is available to the court to discourage class counsel from settling for less than the class's claims are worth. Significantly, the court can achieve this goal *even if it does not know the value of the class's claims*. Let us begin by discussing this point in connection with the settlement of classes that have been certified for trial; we then proceed to consider classes that are certified for settlement only.

##### A. Trial Class Actions

Class counsel's incentives in settlement depend on the *fractional share* of a settlement that he will receive relative to his fractional share of any trial recovery. If his fractional share of a settlement is no greater than the fractional share he would receive of the proceeds from going to trial, then in general—with qualifications to be noted below—he will have no incentive to settle for less than the class members' claims are worth. That is, he will find it in his interest to "hold out" for a settlement that gives the class members the full value of their claims. Accordingly, the court can eliminate any incentive to settle for too little by regulating the attorney's fee in such a way as to ensure that the attorney's fractional share of a settlement is no greater than his fractional share would have been of the recovery had the case gone to trial.<sup>33</sup>

The point may be illustrated with a simple numerical example. Assume that the class's claims as a group are worth \$100 million and that class counsel will receive a fee equal to ten percent of the class recovery if the case goes to trial. (For simplicity's sake, assume that class counsel is risk neutral and that going to trial and settling are equally costly for class counsel.)<sup>34</sup> Then the class counsel will refuse

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33 Further analysis of the appropriate fee structure is developed in Bruce Hay, *Asymmetric Rewards: Why Class Actions (May) Settle for Too Little*, 48 HASTINGS L.J. 479 (1997).

34 We drop these assumptions below, and they are not essential to our analysis.

However, we note our skepticism about suggestions that sweetheart deals stem from class counsel's aversion to placing a substantial pre-trial investment at risk by going to trial. See, e.g., Judge Friendly's observation in *Alleghany Corp.*, *supra* note 1. Experienced, adequately financed, and competent class counsel would not undertake these burdens unless, judged from the *ex ante* perspective, the anticipated fee-award exceeds the total expected litigation investment—pre-trial as well as trial—including the costs of bearing the risk of losing. In short, the actual expenditure of resources in preparation for class trial should not affect class counsel's calculation of costs and benefits respecting the choice to settle or go to trial. Indeed, in settlement negotiations on the eve of trial, class counsel would regard pre-trial expenditures as irretriev-

any settlement offer that gives the class less than \$100 million, provided that he collects no more than ten percent of the settlement amount. To see this, observe that in this example if he goes to trial, the class counsel will collect ten million dollars. If he is allowed only ten percent of the settlement recovery, then the settlement must be at least \$100 million for him to make as much as he would get by going to trial. Note, however, that if his allowed share of a settlement is greater than ten percent, he will perhaps be willing to settle for less than \$100 million.<sup>35</sup>

As this example suggests, the court can prevent class counsel from having an incentive to settle for less than the class's claims are worth by appropriately regulating counsel's distributive share of the settlement amount.<sup>36</sup> To do this, the court must estimate the fractional share that class counsel would receive in the event the case were tried and the class were to recover at trial and apply that share to any recovery from settlement. Notably, the court does not need to know the actual amount that the class would receive at trial; thus in this example, it is not important for the court to know that the value of the class's claims is \$100 million. All that the court needs to estimate is

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able, sunk costs. Consequently at this point the hazards of trial should concern the attorney even less than they did originally, before undertaking the case and making those expenditures. Having made the pre-trial investment, class counsel rationally compares the expected recovery from class trial to the *incremental* (even if substantial) costs of proceeding to trial rather than settling. That ratio is likely to yield an expected net-return from class trial that is far more favorable than the comparison of the expected trial recovery to *total* litigation costs that class counsel considered sufficiently profitable to commence the class action in the first place.

Of course, a sweetheart deal might seem attractive to "inadequate" class counsel—too thinly financed and risk-averse to bear the expense and uncertainties of a high-stakes class trial. But courts possess ample power and opportunity to scrutinize the adequacy of class counsel. And there is no dearth of adequately prepared lawyers. Whatever may have been true in Friendly's time or even a decade ago, today, class counsel usually is capable of marshalling the economic wherewithal for effective prosecution of large-scale class actions. These "entrepreneurial lawyers" amass the resources necessary for adequately funding and hedging the risks of litigating a complex class claim through trial in a litigation class action.

This is not to deny, however, that class counsel like the defendant might well be relatively risk averse to staking the entire class claim on a single, all-or-nothing class-wide trial. We consider this question in Part IV.

35 For example, if his allowed share of a settlement is 20%, then he will perhaps be willing to accept a settlement offer of \$50 million awarded to the class, because such a settlement offer would give him \$10 million and thus make him as well off as he would be by going to trial.

36 In other words, the appropriate regulation assures that the share of recovery from settlement does not substantially exceed the forgone share of recovery from trial (essentially the "opportunity cost" of settling).

the *fractional share* of the recovery that the counsel would receive of the proceeds from trial—in this example, ten percent.

Now, in this example we have assumed that the costs to the plaintiff's counsel of settling (time spent and so forth) are the same as the cost of going to trial. This assumption is unrealistic in many cases, because frequently going to trial will involve a much greater investment of time and other resources.<sup>37</sup> However, this complication is easily taken into account in the analysis.<sup>38</sup> The formula indicating the appropriate share that the counsel should receive of a settlement he negotiates is the following. We use the simplifying notation: let  $R$  be the fraction of the recovery that the counsel would get in the event the case went to trial; let  $X$  represent the additional cost to the counsel of going to trial, over and above the cost he would incur in settling; and let  $W$  represent the expected recovery by the class in the event the case goes to trial. Then the following expression indicates the appropriate fractional share of the settlement that the counsel should receive:

$$R - (X/W)$$

Thus, referring to our earlier example, suppose that the lawyer who, if the case were to go to trial, would generate an expected recovery for the class of \$100 million, would incur additional litigation costs of five million dollars, and would collect ten percent of the recovery as his fee. Simple calculation shows that he should collect five percent of the settlement recovery that he negotiates.<sup>39</sup> If the class counsel knows that his fee award will be capped at five percent of the settlement amount in this example, then he will reject any settlement offer of less than \$100 million.

Accurate judicial assessment of the terms in the above expression will doubtless be a difficult task. However, arriving at a result that approximates these terms will not be impossible. The court can use data from previous cases that have gone to trial to estimate both the attorney's fractional share of the trial recovery ( $R$ ) as well as the ratio of his costs to the class's recovery ( $X/W$ ). Thus even though the court

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37 To be sure, the court may compensate counsel for these costs by calculating his fee on a time-plus-expenses basis. Frequently, however, courts use a percentage-of-the-recovery approach, either explicitly or implicitly. Our assumption in this analysis is that the court is using a percentage-of-the-recovery approach.

38 In these cases, the opportunity cost of settling represents the counsel's share of recovery from trial *less* the costs of going to trial.

39 Five percent represents counsel's real (or net) return from trial after deducting costs and thus the share of trial recovery counsel forgoes to settle.

does not know the expected recovery in the case at hand, it may be able to arrive at a reasonable approximation of the above terms.

Moreover, a crucial point to recognize is that it is *not necessary for the court to accurately assess the above terms in individual cases*. Sometimes the court will overestimate their value; other times it will underestimate their value. All that matters is that the court's errors in this regard be *unbiased*, in the sense that the court is no more likely to underestimate than to overestimate their value, so that *on average*, the court's assessment is accurate. For in deciding how much to settle for, class counsel will be guided by the *expected* fee award in the case, which is to say the average fee award for similar cases. So long as the average fee award is accurate, the class counsel will have the correct incentives.

This point is worth emphasizing by reference to our previous example. Suppose that in our hypothetical case the correct fee award (as indicated by the above expression) is five percent. Suppose, however, that some courts might inaccurately set the fee at three percent while others might inaccurately set the fee at seven percent. Assume however that, at the time he negotiates the settlement, class counsel does not know which of these errors the court will make and that either error is equally likely. Then the *expected* fee award in the case is five percent and, accordingly, counsel will have the correct settlement incentive—that is, to accept a settlement if and only if it gives the class at least \$100 million.

### B. Settlement Class Actions

Let us now turn to the so-called settlement-only class action, in which a class is certified for purposes of settlement alone, meaning that if the case does not settle in class action format, then the plaintiffs' claims will revert to the separate action process for individual resolution. Commentators have viewed the settlement-only class action as being particularly susceptible to the risk of inadequate class recoveries, because in principle the defendant can solicit competing "bids" from different lawyers who seek to act as class counsel, and whose success in this regard depends on their reaching a settlement with the defendant.<sup>40</sup> However, the same fee regulation strategy dis-

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40 Critics are concerned that such "reverse auction" settlements will escape judicial notice. However, they present no evidence that courts are incapable of evaluating class settlements. Indeed, in *Amchem* and *Ortiz*, the purported major exemplars of the "reverse auction" problem, the presiding district courts made extensive findings of fact—never overruled on appeal—substantiating the fairness and adequacy of the substantive terms of class settlement. Moreover, critics tend to downplay the sources

cussed above in connection with trial class actions can also be employed to ensure that the class members recover the fair value of their claims in the context of settlement class actions. There is no necessary reason that settlement class actions must tend to give the class members less than the value of their claims.

The core task for the court here again is to regulate counsel's fee in such a way as to ensure that his fractional share of a class settlement he negotiates is no greater than his fractional share of what the plaintiffs would recover if he had not negotiated a class settlement. Under such a fee structure, a lawyer acting on behalf of the plaintiffs will not find it in his interest to enter into a class settlement unless the settlement amount is at least as great as the expected value of the plaintiff's claims. Any class settlement he negotiates that gives the plaintiffs less than the value of their claims will leave him worse off than he would be if he did not negotiate the class settlement at all. In this way, the proposed fee regulation approach protects the class from inadequate settlements while permitting or making possible settlements that give the members the full value of their claim.

To see how this approach to fee regulation works, consider the following variant on our earlier example. Assume there is a group of plaintiffs whose claims have an aggregate value of \$100 million and that these plaintiffs have not been certified as a class for purposes of a trial. Suppose the defendant in these actions<sup>41</sup> approaches one of the lawyers representing a subset of these plaintiffs and seeks to negotiate a settlement that would bind all of the plaintiffs as part of a settlement class action. Suppose that this lawyer represents one-tenth of the plaintiffs,<sup>42</sup> and that he would collect one-third of the recovery on these plaintiffs' claims if they were to be resolved individually (that is, outside the rubric of a settlement-only class action). This is equivalent

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of information that courts tap in evaluating the substance of class settlements. Thus, any non-negligible deviation of class settlement values from separate action settlement values, often well-established through years of test-case trials and inventory settlements, would immediately send up a "red flag" signaling possible "sell out." Moreover, losing bidders in the "reverse auction" would not hesitate to "blow the whistle" on a sweetheart deal to preserve their separate action fees or take over role of class counsel. Courts also receive knowledgeable estimates of the number as well as judgment values of future claims from a variety of sources. These include government agencies; unions, consumer groups, and other political organizations; academics; various layers of liability and subrogated insurers; non-settling defendants; and other parties with contribution, indemnity, or security interests affected by the scope and amount of settlement.

41 We assume here that the plaintiffs face a single, common defendant.

42 More precisely, he represents plaintiffs whose claims add up to one-tenth of the aggregate value of the plaintiffs' claims as a whole.

to saying that the lawyer stands to collect one-thirtieth of the amount recovered by the overall group of plaintiffs in the proposed class if there is no class settlement.

In this example, if the lawyer negotiates a class settlement with the defendant, the lawyer should receive one-thirtieth of the amount paid to the class. For if the lawyer knows that his share of the settlement will be capped at that fraction, then he will have no incentive to settle the case for less than \$100 million. Any settlement giving the plaintiffs less than that amount would make the lawyer worse off than he would be by refusing to enter into a class settlement at all. Only if the defendant offers at least \$100 million will this lawyer find it in his interest to accept the defendant's offer. Thus, capping the lawyer's fee at one-thirtieth of the class recovery in this example induces the lawyer to "hold out" in settlement bargaining for a settlement that gives the class the full value of its members' claims.

This basic result holds even if there are rival lawyers bidding with the defendant to negotiate a class settlement. So long as an individual lawyer's fractional share of a settlement he negotiates is no greater than his fractional share of the plaintiffs' recovery in the event he does not negotiate a class settlement, then he has no incentive to seek a settlement that gives the plaintiffs less than the value of their claims. This can easily be verified by considering what the lawyer will do if a rival has offered to settle for an amount less than \$100 million. Suppose for example that a rival has offered to settle for, say, ninety million dollars. If the original lawyer's fee in a class settlement is capped at one-thirtieth, then he has no incentive to undercut this rival's offer. For if he declines to undercut the offer, then he will receive one-thirtieth of ninety million dollars, assuming that offer is accepted by the defendant. In contrast, if he undercuts the offer with an offer to settle for a smaller amount, then he gets one-thirtieth of that smaller amount. No matter how many rival bidders there are, the attorney has no incentive to take a settlement for less than the value of the class's claims, so long as his fee is capped in the manner described.<sup>43</sup>

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43 This example assumes that the attorney will collect one-third of the recovery on each of his clients' claims if another lawyer negotiates a class settlement. That is, it assumes that his share of his clients' recoveries is the same as another lawyer who negotiates a class-wide settlement, as it would be if there were no class settlement at all. The analysis must be modified if this assumption is not true. In particular, suppose that if another lawyer negotiates a class-wide settlement, the original lawyer's share of his clients' recoveries is cut from one-third to some smaller amount. Then that smaller amount must be used as the baseline for calculating the lawyer's fee in the event he were to negotiate a class-wide settlement. Thus, for example, suppose that if another lawyer were to negotiate a class-wide settlement, the original lawyer's



Once again, the central task for the court is to assess what share of the plaintiff's recovery the class counsel would have received had he not negotiated a class settlement. Then when overseeing the settlement, the court must set counsel's fee in a way that ensures that he receives no more than that fraction. One important implication of this analysis is that the appropriate fee for class counsel in the context of settlement class actions will depend heavily on counsel's share of the claims comprising the plaintiff class. Thus, returning to our example, if the counsel who negotiates the class settlement represents one-tenth of the plaintiffs, he should (assuming a one-third contingent fee) collect one-thirtieth of the class recovery; if he represents one-twentieth of the plaintiff class, then he should only receive one-sixtieth of the class recovery. To determine the appropriate fee cap, the court must multiply the fraction of the class that the lawyer represents by the fraction of each plaintiff's recovery he would receive if he did not negotiate a class-wide settlement. This will entail careful inquiry into a counsel's share of the plaintiffs' claims and the fee arrangements he has with them.

We recognize that this requires an estimate of the size of the class, which may be difficult, particularly in the case of classes involving "future" claims. However, courts have information available to them on this question. Settlement-only class actions usually culminate years or even decades of separate action litigation of claims.<sup>44</sup> Court-appointed experts can use this track record as a basis for estimating the size of the class. Moreover, courts have another knowledgeable and highly motivated source of information about the class: disgruntled organizations of attorneys whose class settlement demands (bids) were rejected by the defendant. These organizations have strong economic motivation to demonstrate not only defects in estimates of the

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share of his clients' recoveries would be cut from one-third to one-sixth. Then his share of the class's claims drops from one-thirtieth to one-sixtieth. To ensure that the lawyer does not undercut his rival's offer and agree to a settlement of less than \$100 million, the court would have to cap the lawyer's fee at one-sixtieth of the class settlement. Of course, the court should avoid capping class counsel's fee at a level below the attorney's opportunity cost of serving in that capacity; fees capped below that level will discourage leading and generally competent counsel from accepting that role.

In restricting the fees non-class counsel receive on present cases, courts also run the risk of inhibiting the leaders among those counsel from making the investments that generated the separate action claim values that are incorporated in the class settlement. Indeed, to induce the most productive investment possible in the separate action process, it is often important to assure that these leading counsel receive fees reflecting the value their investments created for future claims.

44 See generally Peter H. Schuck, *Mass Torts: An Institutional Evolutionist Perspective*, 80 CORNELL L. REV. 941, 959 (1995).

future injury claims, but also any understatement of claim values.<sup>45</sup> Finally, as noted above in connection with trial class actions, effective fee regulation does not require the court to accurately estimate the size of the class in every case. All that matters is that the court's estimate not be systematically biased downwards. Provided that condition is met, settling attorneys will have the right incentives.

*C. Additional Considerations on Future Claims and  
Settlement-Only Classes*

We believe the approach outlined above is an effective safeguard against sweetheart settlements in all class actions, including those thought to be particularly susceptible to abuse—namely, cases involving future claims (such as latent disease injuries) and class actions that are certified for settlement only. Regarding these two categories of cases, a few additional observations are in order.

First, with respect to future claims: an additional safeguard against collusive settlements is to release future claimants from settlements that provide insufficient funding for their claims. Courts could achieve this through what might be called a "contingent res judicata rule." Under this approach, a court-approved settlement would have preclusive effect—i.e., bind future claimants—only to the extent that the settlement fund has sufficient assets to pay all qualified claims fully in accord with the terms of settlement. If the settlement fund were exhausted before paying all qualified claims, class members holding unpaid claims could prosecute separate actions (or, alternatively, bring a supplementary trial class action).<sup>46</sup> Contingent res judicata

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<sup>45</sup> Indeed, these attorneys have a more pronounced interest, because they will claim a share of the "future" claims and therefore a related share of the recovery from class settlement. Frequently, non-class counsel file or threaten objections to the class settlement for the purpose of forcing a side-settlement with class counsel that pays over their share of such future fees. Indeed, by holding out for the fee they would receive in the absence of class settlement, non-class counsel compel class counsel to hold out for the true value of the class claim from the defendant in order to satisfy their demands. Critics of settlement-only class actions reflexively brand these side-settlements "unethical," never considering the useful fee-sharing role played by these agreements. Indeed, eager to impugn the motives of class counsel, critics ignore a more plausible "unethical" (socially detrimental) explanation for these side-settlements, namely that the objectors are extracting nuisance-value settlements. On nuisance-value settlements, see David Rosenberg & Steven Shavell, *A Model in Which Suits Are Brought for Their Nuisance Value*, 5 INT. REV. L. & ECO. 3 (1985).

<sup>46</sup> The defendant could be given the option of replenishing the fund to pay these remaining claims, which would then be barred from further litigation.

would thus remove defendant's incentive to enter into a settlement that shortchanged future injury claims.<sup>47</sup>

Second, with respect to settlement-only class actions, we have argued that the court can use fee regulation to prevent the class from being "sold out" by class counsel—in the sense of ensuring that class counsel will not settle for less than the expected value of the class's claims.<sup>48</sup> However, we do not mean to imply by this that settlement and trial class actions are equally effective vehicles for resolving large-scale disputes. Settlement class actions display a notable weakness as compared to trial class actions: *the value of plaintiffs' claims is smaller in settlement class actions, because the defendant enjoys an artificial "upper hand" in the litigation.*

The reason is quite simple: if the class has been certified for trial, the alternative to a class settlement is a class trial. In a class trial, class counsel has an incentive—as we saw in Part II—to make a substantial litigation investment, as he enjoys the same economies of scale as the defendant. By contrast, in settlement class actions, *the class is certified for settlement purposes only*, meaning that if there is no class settlement the actions will proceed separately. Yet in separate actions, as we discussed in Part II, plaintiffs' counsel do not enjoy the same scale economies as the defendant and will therefore invest less effectively in the case.

The upshot is that claims have a greater value—that is, a greater expected trial recovery—in trial class actions than in settlement class actions. In settlement class actions, the value of the plaintiffs' claims is artificially depressed by the differential economies of scale enjoyed by plaintiffs and the defendant. For this reason, the trial class action (more precisely, class certification on common issues for all litigation purposes) is the preferable vehicle. Even though it is unlikely a trial will actually be held (class settlement is much more likely), trial class action certification is appropriate in order to eliminate the defendant's artificial advantage in litigation investment.

## V. PREVENTING "BLACKMAIL" SETTLEMENTS

Risk averse parties will pay a premium to avoid taking a gamble.<sup>49</sup> It is on this basis that critics have stated that, in trial class actions,

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47 Note, also, that risk-averse defendants could purchase insurance to cover the possibility that future claims will arise in numbers far above the predicted average.

48 The court may use this together with contingent res judicata, if the case involves future claims.

49 More precisely: a risk-neutral person is indifferent between a definite loss of one dollar and a one in one hundred chance of losing \$100; he therefore would pay

defendants may be subject to extortion on weak claims: even if the chance of losing a class trial is remote, the defendant will, it is said, pay a great deal to avoid that small risk. Thus, class actions, it is argued, pressure defendants to pay a premium for class settlement—more than the true value of the class claim—by forcing them to gamble a great deal of their wealth on an all-or-nothing basis in a single, class-wide jury trial.<sup>50</sup> We believe, however, that there is a straightforward safeguard against this danger.

Before describing this safeguard, we begin by noting that critics may well overstate the danger of blackmail against defendants<sup>51</sup> and ignore the danger of similar extortionate effects on class counsel and class members as well. The all-or-nothing gamble of a single, class-wide jury trial exerts pressure on risk-averse class counsel and class members to settle for less than the value of the class claim.<sup>52</sup> Moreover, regardless of which side bears the greater risk of blackmail settlement pressures in class actions, relegating claims to the separate action process is not an appropriate cure. An all-or-nothing gamble is

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no more than one dollar to avoid taking that chance. In contrast, a risk-averse person would pay more than one dollar—perhaps much more—to avoid a one in one hundred chance of losing \$100.

50 As noted previously, settlement class actions do not pose the risk of "blackmail" against defendants, because the alternative to class settlement of the class claim is not one but a series of separate action trials of the underlying classable claims. The defendant's option to demand separate action trials for all claims greatly increases the chance that the aggregate average of all verdicts will coincide with the true total value of all claims—that is, true value as separate compared to trial class action claims—while reducing the chance of suffering catastrophically excessive liability to an infinitesimal degree. Normally, the defendants and opposing plaintiffs' attorneys more or less cooperatively subject a small, representative sample of the claims to "test trial," average out the results, and incorporate them into a schedule of damages for settling the bulk of the remaining present and future claims.

51 There is some reason to doubt that defendants in class actions view the prospect of class trial with substantial risk aversion. Generally, class actions do not involve aggregate damages of high magnitude relative to the wealth of defendant firms. Some defendants, of course, are designed to become judgment-proof and bankrupt in the event of class action. But most are organized and operated to respond in a relatively risk-neutral fashion to all sorts of major business uncertainties, including those posed by civil litigation that often arises from the firm's generalized risk-taking and thus involves multiple claims of a classable nature. Many firms are owned by stockholders with widely diversified investment portfolios and limited liability for managerial wrongs; the firm's structure—parent-subsidiary and otherwise—also may confine the impact of liability; and compensation and indemnity arrangements address the risk aversion of executives and other employees. Liability insurance further spreads the risk of a litigation catastrophe.

52 There is little reason to suppose that class counsel and class members are less risk-averse than defendant firms.

precisely what each plaintiff—but no defendant—faces in the separate action process.<sup>53</sup> Thus, we should expect the defendant to be able to exploit plaintiff risk aversion in separate actions—by offering the plaintiff, who may have a meritorious case, less than his claim is worth. If it is inappropriate to face *both parties* with an all-or-nothing gamble (a single class trial), we do not see how it improves things to simply face *one party*—the plaintiff—with an all-or-nothing gamble (which is what occurs with separate actions).

There is, however, a clear solution to the problem of blackmail effects—on both sides, not just against defendants—from a single class trial. Courts supervising class actions could avoid the problem simply by adopting a policy of determining the class claim by multiple class trials. Under this policy, the court would conduct a set of jury (or bench) trials sufficient in number and representativeness to yield a reliable basis for estimating the true value of the class claim. The court would then take an average of the verdicts as the aggregate recovery for class-wide judgment. Multiple class trials would reduce the risks associated with going to trial for the simple reason that it is far less likely that either side will lose before *all* of the juries than that it will lose before a *single* jury.

To illustrate the point, suppose that the odds are fifty percent that a given jury will return a verdict for the defendant and fifty percent that it will return a verdict for the class; and suppose that if the verdict is for the class, the expected damages will be \$200 million. (Thus, the class's expected recovery at trial, taking into account the possibility of a defendant victory, is \$100 million.) In such a setting, a single class trial is a highly risky proposition for both sides. The class and class counsel ("class" for simplicity) have a fifty-percent chance of recovering nothing if the case goes to trial; defendant has a fifty-percent chance of losing \$200 million at trial.

Suppose, however, that the court's policy is to hold a series of trials and award the class an amount equal to the average of the amounts awarded by individual juries. Then the odds drop substantially that the class will recover nothing or that the defendant will lose everything; the greater the number of trials held or juries consulted, the lower these odds of an extreme outcome become. For example, if the court holds two trials (or, equivalently, holds a single trial but empanels two juries), the odds that the plaintiffs will recover nothing drop to one in four; if the court holds four trials, the odds drop to one

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53 In the separate action process, trial is an all-or-nothing event for the plaintiff; a loss may be catastrophic. But it is not an all-or-nothing event for the defendant firm; a loss means paying only one plaintiff.

in sixteen; if the court holds ten trials, the odds drop to roughly one in one thousand. In making it far more likely that the class will recover damages (most likely averaging to \$100 million), but less likely that the defendant will suffer a total loss (\$200 million), holding multiple class trials reduces the riskiness to both sides of forgoing settlement in favor of trial.

Several points are worth emphasizing about the policy of holding multiple trials. First, the policy is consistent with the distributive norm of civil liability. Multiple class trials neither increase nor decrease the overall liability exposure of defendants or recovery by classes. Assuming courts award a figure equal to the average verdict returned by different juries, the aggregate expected judgment from multiple class trials remains the same as it would be from a single trial. This is evident from the example just used. The class's expected recovery in any single trial is \$100 million (fifty percent of \$200 million). But this implies that the class's expected recovery from a *series* of trials in the case is simply the average expected recovery of each trial, namely, \$100 million. The policy of holding multiple trials and averaging the result has no effect on the true value of the class claim. It simply affects the variation (or variance) in the possible actual outcomes. In particular, it reduces this variance, making it more likely that the class's actual recovery after concluding the series of trials is approximately equal to the expected recovery of \$100 million.<sup>54</sup>

Second, the multiple class trials approach can be adapted for both general and special verdict trials. In the context of general verdict trials, where the jury is charged with deciding both liability and damages for the class as a whole, the court would take the average of different jury awards (with a verdict for the defendant on liability being equivalent to a damage award of zero). In special verdict trials, the procedure could easily be modified to yield equivalent results. For example, if the jury is charged with deciding the question of liability alone, the court could discount the ultimate damage award by the proportion of jury verdicts for the defendant. If three-fifths of the juries return a verdict against the defendant, the court could award

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54 We conjecture that this variance-reduction is desirable on grounds of individual justice, quite apart from its effect of reducing blackmail settlements. We do not pursue that point here. For discussion, see Bruce Hay and David Rosenberg, *The Individual Justice of Averaging* (March 1997) (unpublished manuscript on file with the authors), and see also David Rosenberg, *Individual Justice and Collectivizing Risk-Based Claims in Mass-Exposure Cases*, 71 N.Y.U. L. REV. 210, 245-48 & n.90 (1996).

the class three-fifths of the aggregate damages, and so forth.<sup>55</sup> Once again, this procedure reduces the risks associated with the trial process without affecting in any way the true value of the class claim.

Third, confronting the parties with the prospect of more than one, rather than a single, class trial would not necessarily increase their litigation costs nor dull appropriate incentives to settle. Although it would depend on the nature and complexity of the common questions, conducting repeat trials probably entails higher costs, for example, to pay for the reappearance of expert witnesses. But despite redundancy costs, multiple class trials might well reduce the parties' costs overall. The prospect of a single class trial would induce risk-averse parties to spend excessively on pre-trial preparation as a measure of insurance against the possible horrendous verdict. Courts could streamline the process to reduce redundant trial costs, for example by convening and averaging the judgments of more than one jury in a single trial, or employing video taped testimony in several trials. The parties might themselves increase efficiency by confining the scope of multiple trials to the contentious issues that stand in the way of settlement. In general, class settlement should occur about as often in the shadow of multiple class trials as a single class trial. Only the terms of settlement will change, and for the better—because neither side will be able to exploit the other's risk aversion toward a single all-or-nothing trial.

Finally, conducting multiple class action test-trials to derive average claim values for settling the bulk of the remaining present and future claims replicates prevailing practice in the separate action process, with one major difference. In contrast to the separate action process, trial class certification assures plaintiffs the same scale economy incentives defendants have to invest optimally in maximizing the average value from litigating multiple test-trials of the common questions.

One possible objection to this proposal is that the Seventh Amendment may be read to give a party the right to insist on a single all-or-nothing trial.<sup>56</sup> Perhaps, therefore, a court could not force a party, against his will, to submit to our proposed multiple-trial procedure. However, we believe courts can properly secure the consent of

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55 The discounting method could be used to tailor the aggregate award according to a series of special verdicts on causation, differences in governing law, and other elements and variables affecting the true value of the class claim.

56 See U.S. CONST. amend. VII ("No fact tried by a jury shall be otherwise reexamined in any court of the United States."). The question whether the Seventh Amendment limits the power of federal courts to hold a series of trials in this fashion is beyond the scope of this Article.

both plaintiffs and defendants to the procedure. If the defendant resists, the court can offer the alternative of a single class trial (which, by assumption, does not violate the defendant's right to a single trial). If the plaintiffs resist, the court can give them the alternative of separate individual trials (which, again, does not violate any plaintiff's right to a single trial). Such court-exerted pressure is, we think, a proper means to prevent either party from exploiting the other's risk aversion.<sup>57</sup>

## VI. CONCLUDING REMARKS

We can bring together the different strands of the argument by reverting to our earlier example of a large-scale product liability case. Assume that the plaintiffs have suffered a total of \$200 million in damages. If their claims are prosecuted separately, the defendant will have an artificial advantage in the litigation, born of the economies of scale it enjoys in litigating the common questions in the case (such as whether the product was defective). If, instead, the claims are unified in a class action certified for trial, then the plaintiffs' class counsel has an incentive to match the defendant's litigation investment. The plaintiffs' claims have more value as a group, therefore, if they are aggregated into a class action. For reasons developed in Part II, we think this value-enhancing effect of aggregation is quite appropriate. Put otherwise, we think that forcing the plaintiffs to proceed separately has the effect of inappropriately depressing the value of the plaintiffs' claims, by putting them at an artificial disadvantage in investment.

Suppose, then, that if the claims are brought as a class action, the plaintiffs would have a fifty percent chance of prevailing at trial, because reasonable juries may differ on the question of liability. In that case, the expected value of the plaintiffs' claims is \$100 million—which is therefore the amount the plaintiffs ought to recover in settlement, according to our proposed baseline. We have suggested that, with a combination of appropriate fee regulation and multiple trials, the court can ensure that the case settles for approximately that figure. As we have stressed, the court does not need to know the value of

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57 In response to the formal restrictions of the Seventh Amendment, courts could subdivide the class or certify a number of smaller class actions, and appoint the same team of class counsel to represent all subclasses or class actions. This process would achieve the effect of providing multiple trials while at the same time preserving the scale economies of a single-trial class action. It should also be noted that even if holding a series of trials in this fashion were not permitted, it might nonetheless be permissible to hold a single trial with several juries simultaneously impaneled to render judgment, with the court taking the average verdict to decide the case.



the class's claims in order to bring about that result, provided that it follows the guidelines in Parts IV and V.

We do not contend that our proposals will work perfectly. Even when implemented, there may be some residual risks of abuse in class action settlements. But perfection is not an appropriate standard by which to judge. The emphasis must be on a comparison between available alternatives. As we have tried to show, the separate-action alternative to class action treatment is itself highly imperfect—much more so, in our judgment, than class actions that proceed along the lines we have suggested.