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Fees, Incentives and Deterrence:

A Reply to Professor Fitzpatrick

Linda Sandstrom Simard¹

Undaunted by the common refrain accusing class action lawyers of collecting astronomical fees while class members walk away with almost nothing, Professor Brian Fitzpatrick serves as provocateur in asserting that lawyers should receive higher fees and class members should receive less compensation in small-stakes class actions.² Although the proposal is seemingly outrageous in light of public opinion, it is theoretically appealing for several reasons. First, to the extent that the proposal seeks to prioritize deterrence, it is consistent with the enhancement of individual welfare.³ A system that deploys scarce resources to prevent, rather than insure, wrongful

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²Brian T. Fitzpatrick, Protection of Investors in the Wake of the 2008-2009 Financial Crisis: Do Class Actions Lawyers Make Too Little?, 158 U. Penn. L. Rev. 2043, 2047 (2010) ("the optimal award of fees to class action lawyers in small stakes actions is 100% of judgment.") The phrase "small-stakes class action" typically refers to a class action joining together claims that cannot be economically litigated on an individual basis. Tobias B. Wolf, Federal Jurisdiction and Due Process in the Era of the Nationwide Class Action, 156 U. Pa. L. Rev. 2035, 2088 (2008). Damages for the individual claims may range from almost nothing to several thousand dollars.

³ Class action litigation serves dual functions: minimization of accident costs through prevention of unreasonable risk (deterrence) and compensation for injuries caused by reasonable risk (insurance). David Rosenberg, Decoupling Deterrence and Compensation Functions in Mass Tort Class Actions for Future Loss, 88 U. Va. L. Rev. 1871, 1873 (2002). Fitzpatrick asserts that the insurance function is not relevant in small stakes class actions and therefore we should seek to maximize deterrence.

conduct is better for everyone.⁴ Second, Fitzpatrick's proposal significantly reduces agency costs associated with the attorney/class relationship, thus increasing the efficiency of adjudicatory regulation.⁵ Indeed, if the entire judgment is awarded as fees, agency costs are all but eliminated. Third, Fitzpatrick's proposal streamlines the process for class certification because typicality and adequacy of representation become irrelevant when class members have no skin in the game.⁶ Finally, the proposal is appealing because it offers a normative justification for the award of fees, something that is often absent under the existing fee setting regime. Notwithstanding these benefits, the proposal raises some serious questions.

Professor David Marcus identifies a number of problems that hinder any serious consideration of the proposal.⁷ Specifically, Marcus questions whether the proposal would pass muster under existing doctrinal constraints imposed by the Rules Enabling Act and the law of unjust enrichment.⁸ He also takes issue with Fitzpatrick's premise that full enforcement of substantive law necessarily increases social welfare, instead suggesting that procedural law may be an effective vehicle for fine tuning the regulatory force of substantive law.⁹ Overall, Marcus believes that the social legitimacy of the class

⁴ Id. at 1890 (the costs of preventing unreasonable risk are lower than the costs of compensating for the loss that arises from unreasonable risk.)

⁵ Agency costs arise in the context of class action litigation when class members lack the ability and incentive to monitor the lawyer's actions, thus creating a risk that class action attorneys will serve their own interests at the expense of the class. See Jonathan R. Macey, Geoffrey P. Miller, *The Plaintiffs Role in Class Actions and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. Chi. L. Rev. 1, 6 (1991)

⁶ See id. at 6 (when class action attorneys purchase class members' claims, typicality and adequacy of representation become irrelevant).

⁷ David Marcus, *Attorney's Fees and the Social Legitimacy of Class Actions*, 159 U. Penn. L. Rev. (PENumbra) 157 (2011).

⁸ Id. at 159-60.

⁹ Id. at 161-63.

action device will decline sharply if Fitzpatrick's proposal is adopted.¹⁰

While Professor Marcus persuasively presents each of his arguments, he overlooks two fundamental questions: (1) how much more deterrence can we expect to derive from an increase in fees to class action lawyers?¹¹ and (2) what are the costs associated with a significant increase in small-stakes class actions? The following analysis suggests that the increase in deterrence may be far outweighed by the increase in cost associated with the proposal.

Fitzpatrick's proposal rests upon an assertion that deterrence is the sole purpose of small-stakes class actions, at least from a social-welfarist utilitarian perspective.¹² In order to maximize deterrence, we should incentivize lawyers to file more small-stakes class actions by allocating a greater proportion of class awards to fees.¹³ An increase in the number of filings will result in more class awards and more deterrence.

To test the logic of the proposal, we must begin with the basic theory of deterrence: when an actor is threatened with liability for its harmful conduct in an amount that correlates to the extent of injury caused by the conduct, the actor will have an incentive to take

¹⁰ Id. at 163-66.

¹¹ Id. at 161 (Professor Marcus touches the issue only lightly when he raises the possibility that a risk averse plaintiff's lawyer might accept a settlement offer that is well below the amount of injury caused to the class, thus reducing the overall payout by the defendant and the deterrent effect of the litigation).

¹² Fitzpatrick, *supra* note 1, at 2067 ("Small-stakes class actions serve no insurance function because individuals are not risk averse with respect to small losses. ... In fact, when the administrative costs and profit margins of providing insurance are added to the equation, it is actually irrational for individuals to buy insurance against small losses for which they are not risk averse.").

¹³ Professor Fitzpatrick suggests that "every additional dollar given to plaintiffs instead of their attorneys will decrease the level of deterrence even further from the optimum." Fitzpatrick, *supra* note 1, at 2062.

precautions to avoid the injury.¹⁴ Thus, if an actor is faced with a choice between two actions, one that is socially optimal (such as investing in precautions to reduce the risk of injury) and another that is socially suboptimal (failing to take precautions), the actor will have an incentive to take the optimal action if the expected liability from taking the suboptimal action exceeds the cost of the optimal action.¹⁵ The deterrent value of threatened litigation, therefore, is equal to the expected loss from the litigation. Whether litigation is actually filed or not, the actor will be motivated to invest in precautions if it believes that a credible threat of litigation exists.¹⁶

The motivation to invest in deterrence hinges upon the credibility of the threat of litigation. If an actor believes that

¹⁴ Rosenberg, *supra* note 2, at 1912. Under this theory, the actor "aggregates all possible accident scenarios and all possible marginal investments in precautions. If appropriately motivated, the [actor] will take precautions to the point that maximizes aggregate welfare, that is, the point at which the aggregate cost of making an additional unit of investment in precautions would exceed the aggregate benefit from avoiding the corresponding aggregate unit of accident risk. The [actor] cannot know or predict how or to what degree contemplated conduct will benefit or harm any particular individual in the potentially affected population. The possibilities are infinite and are 'knowable' only as statistically weighted probabilities.")

¹⁵ For example, an actor may expect an aggregate injury of \$5,000,000 if it fails to invest in precautions, or zero if it invests in precautions. Assuming a class action will have an 80% chance of success for the plaintiff, the actor will expect a loss of \$4,000,000 if it fails to invest in precautions and zero if it invests in precautions. Thus, if the cost of the precaution is less than \$4,000,000 a rational actor would choose to invest in precautions to avoid the threat of litigation. As the probability of success by the class decreases, the actor's expected loss will decrease and the deterrent value of the threatened litigation will decrease.

¹⁶ The deterrent value of threatened litigation is dependent upon the ex ante calculation of expected loss, not the actual loss incurred when litigation is filed. Of course, if the actor finds that its estimates are materially wrong, subjecting it to more or less of a loss than expected, the actor may be motivated to refine its methods of calculation for future decisions regarding potential injury.

litigation is not likely to be filed or that the plaintiff is unlikely to succeed on the merits, the actor is less likely to invest in deterrence than if she believes that litigation is likely to be filed and the plaintiff is likely to succeed on the merits. To the extent that small-stakes litigation is not economically viable on an individual basis, these claims create no credible threat of litigation and no incentive to invest in deterrence. When a lawyer takes on a group of small-stakes claims and certifies a class action, however, these claims create a credible threat of litigation and a corresponding incentive to invest in deterrence. Thus, an actor choosing between socially optimal or socially suboptimal conduct will anticipate a lawyer's incentive to file a class action suit by calculating whether the expected return to the attorney will equal or exceed the expected costs of bringing suit.¹⁷

Under the existing fee regime, a credible threat of litigation exists for all class actions that offer an expected fee in excess of expected costs. If we assume a fee award of 25% of a judgment or settlement¹⁸ and costs in the range of \$500,000, economic viability is dependent upon the probability of success on the merits and the amount in controversy. For example, a class action seeking less than \$2,000,000 is unlikely to be economically viable; a class action

¹⁷ Assuming the attorney's fee is calculated as a percent of the fund, the incentive to file can be represented by the following formula:

$$c < f * p * l$$

where:

c = total costs (including opportunity costs to the attorney as measured by the value the attorney places on his or her time)

f = fee percentage awarded to attorney's fees

p = probability of success by the class

l = aggregate recovery

In an efficient market, the attorney's expected return should equal the expected costs; when the expected return exceeds the attorney's expected costs, the attorney receives excess profits. Macey and Miller, *supra* note 4, at 24.

¹⁸ Fitzpatrick, *supra* note 1, at 2046 (under the existing regime, fees have coalesced around 25%).

seeking \$2,500,000 will be viable if the probability of success is 80% or higher; and a class action seeking \$4,500,000 will be viable if the probability of success is 45% or higher. Class actions that offer a positive return under the existing fee setting regime pose a credible threat of litigation and a corresponding incentive to invest in deterrence. Increasing the fee awarded in these actions will not increase deterrence - it will merely increase the amount of excess profit to attorneys..¹⁹

To the extent that the Fitzpatrick proposal seeks to increase deterrence by increasing the number of small-stakes class actions filed, we must consider the deterrence derived from "new" class actions -- those that are not economically viable to a lawyer under the existing fee regime but will become economically viable with the added benefit of a larger fee..²⁰ If we assume a fee award of 100% of a judgment or settlement..²¹ and costs in the range of \$500,000, a class action seeking \$2,000,000 will become economically viable under the

¹⁹ Macey and Miller, *supra* note 4, at 59-60 ("the percentage of fund method [for calculating attorneys' fees] results in systematic excess profits for plaintiff's attorneys -- returns beyond what the attorney would earn in an efficiently functioning market.")

²⁰ This group of "new" class actions can be defined as class actions that offer: (1) an expected return that is less than the attorney's expected costs under the existing fee regime; and (2) an expected return that exceeds the attorney's expected costs under the proposed regime. This can be represented by the formula:

$$f_e * p_p * l < c < f_p * p_p * l$$

where:

f_e = fee percentage awarded to attorney's fees under the existing fee regime

p_p = probability of success by class

l = aggregate recovery

c = total costs

f_p = fee percentage awarded to attorney's fees under the Fitzpatrick proposal

²¹ Fitzpatrick, *supra* note 1, at 2046-47.

Fitzpatrick proposal when the probability of success is between 25% - 100%²²; a class action seeking \$2,500,000 will become viable under the proposal when the probability of success is between 20% - 80%²³; and a class action seeking \$4,500,000 will become viable under the proposal if the probability of success is between 12% - 45%²⁴. Overall, the Fitzpatrick proposal will create an incentive for lawyers to file new class actions, many of which will offer a lower probability of success than the class actions that are economically viable under the existing fee regime.

As the probability of success by the plaintiff class decreases, the expected loss from the threatened litigation decreases, and the ex ante deterrent value decreases.²⁵ To the extent that the Fitzpatrick proposal encourages lawyers to file new class actions that offer a relatively high probability of success to the class, we are likely to derive a correspondingly healthy increase in deterrence from the threat of these suits.²⁶ To the extent that the proposal encourages lawyers to file weak small-stakes class actions, however, we are likely to derive a correspondingly weak deterrent value from the threat of these suits.²⁷ While it is impossible to determine the precise increase in deterrence that will be derived from the threat of

²² Claims seeking less than \$2,000,000 are often not economically viable under the existing regime.

²³ Claims seeking \$2,500,000 are viable under the existing fee regime if the probability of success is 80% or higher and therefore they already pose a credible threat of litigation without the added benefit of an increase in fees.

²⁴ Claims seeking \$4,500,000 are viable under the existing fee regime if the probability of success is 45% or higher and therefore they already pose a credible threat of litigation without the added benefit of an increase in fees.

²⁵ See supra note 14 and accompanying text.

²⁶ For example, the Fitzpatrick proposal may encourage new class actions seeking between \$1,000,000 and \$2,000,000 that offer a 50% or greater probability of success.

²⁷ For example, the Fitzpatrick proposal may encourage new class actions seeking \$5,000,000 and offering a probability of success to the class of 15-20%.

new class actions, it is clear that we will derive diminishing returns on deterrence as weaker class actions are filed.

Assuming that some increase in deterrence will arise from the proposed increase in fees, we must weigh the value of the increase in deterrence against the costs associated with the proposal. On a systemic level, the increased return to plaintiffs lawyers in small-stakes class actions will result in a redistribution of legal services. Lawyers seeking to maximize the return on the investment of their time will divert legal services away from other types of cases in order to pursue small-stakes class actions. Indeed, in light of the dramatic disparity that will exist between small-stakes class actions and other types of legal services, the litigation explosion cliché may become a reality.²⁸ There is no evidence that our judicial system is prepared to absorb these extra demands. Moreover, class action lawyers motivated by the possibility of collecting 100% of a large award are likely to pursue a victory with intensity. In an effort to increase the probability of a successful outcome, lawyers are likely to invest extra time, depose more witnesses, hire more experts or investigators, or serve more discovery.²⁹ This increased intensity is likely to be most pronounced in the weakest cases. Defendants, faced with a formidable opponent, may dig their heels in and further intensify the battle, creating a cross current of effects.³⁰ Alternatively, defendants may choose to avoid the battle entirely by buying out the plaintiff class lawyer. Even very weak claims may offer a sizable return to the plaintiff class lawyer if the downside risk to the defendant could be catastrophic.³¹ Overall, the

²⁸ See Arthur Miller, *The Pretrial Rush to Judgment: Are the "Litigation Explosion," "Liability Crisis," and Efficiency Cliches Eroding Our Day in Court and Jury Trial Commitments?*, 78 N.Y.U. L. Rev. 982 (2003).

²⁹ Choi and Sanchirico, *Should Plaintiffs Win What Defendants Lose? Litigation Stakes, Litigation Effort, and the Benefits of Decoupling*, 33 J. Legal Studies 323, 325-26 (2004) (higher stakes are associated with higher intensity of litigation effort).

³⁰ *Id.* at 327.

³¹ See *In re Rhone-Poulenc Rorer Inc.*, 51 F.3d 1293, 1298-99 (7th Cir. 1995)(defendants "settle even if they have no legal liability," rather than "stake their companies on the outcome of a single jury trial").

systemic costs associated with the proposal are likely to exceed the increase in deterrence derived from new class actions.

Conclusion

The Fitzpatrick proposal is theoretically enticing because it is easy to apply, it reduces concerns about adequacy of representation, and it provides a normative rationale for the award of class action fees. Notwithstanding these benefits, the proposal has serious drawbacks. Although the threat of a large increase in the number of small-stakes class actions is likely to give rise to an increase in deterrence, the gains in deterrence will depend upon the strength of the cases that are filed. If the proposal allows weak class actions to become economically viable, the increase in deterrence may be much smaller than we hope. Indeed, the increase in deterrence may be dwarfed by the systemic costs associated with the proposal. Moreover, this proposal incentivizes lawyers to invest in small-stakes class actions over alternative legal services. Even if this proposal will increase deterrence to some degree, we must consider whether the redress of small-stakes injuries deserves such a tremendous investment of society's legal resources.