Plaintiffs' Attorneys' Fees in Stockholder Class Actions and Derivative Suits
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The subject of the awarding of fees by courts to plaintiffs' lawyers in stockholder class actions and derivative suits has become very important during the last forty years or so because class actions and derivative suits are increasingly being used by the courts and in federal legislation as an instrument of social policy. Size of the fees awarded to plaintiffs' lawyers in such cases determines how many cases are brought. The method by which the fees are calculated determines what cases are brought, how such cases are conducted by the plaintiffs' lawyers in charge of them, and also how many cases are brought. The principal purpose in this paper is to show that, despite the appearance of fairness, the policy now being pursued by the courts of awarding fees to plaintiffs' lawyers on the basis of the fair value of the hours spent by them is contrary to the social interest.

Beginning with *Lindy Bros. Builders, Inc. v. American Radiator & Standard Sanitary Corp.*, the federal courts have begun to award attorneys' fees primarily on the basis of the number of hours spent rather than on the basis of the benefit conferred. Almost all of the recent writing on the subject supports the shift in emphasis to hours. In the *Lindy* case, which involved the settlement of an antitrust class action, the court said that a judge who is fixing attorneys' fees should award only reasonable compensation which should be determined primarily by multiplying the number of hours spent by a reasonable hourly rate and then making adjustments for several factors such as the contingent nature and complexity of the case and the amount of legal innovation required. (Under the federal antitrust laws, the lawyer for a plaintiff is entitled to a fee from the defendant if he wins a judgment after trial, but in a settlement, the fee must be awarded by the court from the same sources as in other cases, usually out of the recovery.) Since the *Lindy* case, most of the federal court opinions which have discussed the subject have expressly applied formulas in which the number of hours spent by the lawyers multiplied by appropriate hourly rates is the primary factor ("lodestar" is the term usually used). Moreover, a formula for awarding plaintiffs' attorneys' fees based primarily on their hours spent was included in the original draft of the new Justice Department proposals on class actions submitted to Congress, although the most recent Justice Department draft has eliminated the provisions for determining how to calculate plaintiffs' attorneys' fees.

The problem with awarding fees to lawyers primarily on the basis of the number of hours spent is that it gives the lawyers a strong incentive to increase their hours. When fees are awarded primarily on the basis of a percentage of the recovery, there is a direct and simple incentive for the lawyers to maximize the amount of the recovery and also to minimize the cost, including lawyers' hours.

A simple example will illustrate the problem. If a lawyer has a choice of settling a class action for two million dollars or taking a one-out-of-two chance of recovering four million dollars after trial and appeal approximately three years later, the class would be clearly better off with a settlement. The mathematical expectation for the two outcomes is the same, except for the difference in the time when the money is paid, which clearly

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favors settlement. However, the lawyer does not have the same interest as the class, because on a time basis he would receive a much larger fee if he spends a large amount of time litigating over the three-year period.

In fact, the problem is even worse than this simple example suggests. Very often, a defendant's settlement offer takes into account factors such as the money and other costs of litigation to the defendant which makes the settlement offer higher than the present discounted value of any judgment which can reasonably be anticipated. In addition, defendants and their lawyers, when making settlement offers, sometimes overvalue the plaintiff's case through mistake or because of an unusual bias against risk taking or sensitivity with regard to litigation, which would also contribute to making the settlement worth more than the mathematically expected value of the case. By awarding attorneys' fees based on the number of hours spent, however, the courts have given plaintiffs' attorneys a strong incentive to ignore these considerations and continue litigating even though the class would be better off with the settlement. As a result, the involuntary class clients are in a less advantageous position, and the effectiveness of plaintiffs' lawyers as an instrument of social policy is seriously impaired because of lawyers' lost time. Moreover, and just as important, awarding attorneys' fees on the basis of hours also adds additional social costs by imposing time and other expense burdens on the courts and defendants which early settlement or more expeditious litigation could avoid.

Observation bears out this analysis. Personal experience has shown that during the last several years, stockholder suits have become much more difficult to settle at an early stage in the litigation. The notion that reluctance to settle is evidence of harder and more moral plaintiffs' lawyers is naive. The refusal by a plaintiff's lawyer to accept a settlement may be the height of wisdom or irrational stubbornness. The fact that he receives a larger settlement or judgment later throws no light on the question. The cost or risk incurred may or may not have been justified at the time of the first settlement offer. For example, a lawyer may refuse a million-dollar settlement and recover a judgment for two million dollars several years later on a case which at the time of settlement had a one-out-of-three chance of success. If this is the general policy of the lawyer, his involuntary class clients, on the average, will be losers, although in particular instances the clients would gain when the lawyer happens to be successful. Dawson, despite his advocacy of awarding fees on the basis of hours, recognizes that inhibiting settlements and forcing litigation to the bitter end could have extremely negative consequences.7

The problems connected with awarding fees to lawyers on the basis of hours are the same as those associated with cost-plus contracts. In a cost-plus contract, there is no incentive for the person required to perform the work to keep down the costs and to improve the efficiency with which the work is done. Consequently, the costs can be expected to be much higher, on the average, than if there is a fixed contract price. The following is an evaluation of the use of cost-plus contracts by the British Government in World War II:

The "cost plus" contract obviously relieves the contractor of [the risk of the actual cost being higher than was expected at the time the order was received.] In its effects, however, the system has been unfortunate; it offers no incentive whatsoever to efficiency; under the peculiar type of "cost plus percentage profit" system efficiency is, on the contrary, strongly discouraged, because profits increase with cost. That the system has, in fact, led to waste and inefficiency is shown by the Reports of the Select Committee. They show that most complaints of waste and inefficiency directed to the Committee were connected with work ordered on a cost plus basis.8

The difficulties associated with cost-plus arrangements are one aspect of an important basic characteristic of human nature which the psychologist B. F. Skinner has described in terms of what he calls "non-contingent reinforcers": "That behavior is extraordinarily sensitive to the consequences contingent upon it is beginning to be recognized wherever decisions are made. The tragedy of the non-contingent reinforcer in welfare payments (not to mention the welfare state) is being examined."9

The same argument does not apply to lawyers for sophisticated voluntary clients (a fair approximation of defendants in stockholder litigation) because voluntary clients are free to terminate their lawyers' services whenever they are dissatisfied. The justification for this statement is a corollary of the economic theory that the allocation of resources in a perfectly competitive economy would be optimum for any given distribution of income. In a world of voluntary contracts, nobody has to buy particular goods or services. If he chooses to buy, it must be because he is getting a benefit measured by the price he pays. Competition among suppliers of goods and services prevents excessive
mean that mistakes. It is possible usually Crick cis on intellectual consequence of evaluating for since all determination which would be abandoned or for duplicating effort in the solution of a problem. By far, the best discipline is self-interest. Plaintiffs’ lawyers should bear the cost of all hours they spend, and they are already required to share their fees with any coworkers.

It may be feasible in some situations for courts when awarding attorneys’ fees to determine in rough fashion whether some time has been wasted. For example, it may be possible to determine (or, sometimes, to maintain a plausible illusion that one is determining) if different lawyers representing the same class have duplicated each other’s efforts or if time was wasted on claims that were ultimately denied. Beyond such rough attempts, however, it is not realistic to expect judges to make determinations whether plaintiffs’ lawyers spent their time in the most efficient manner. For example, it can hardly be expected that a judge would disallow hours because the plaintiffs’ lawyers did not make a motion for summary judgment or refused to agree to a particular settlement or a stipulation of facts which would have reduced the hours the lawyers devoted to the litigation. Decisions to take such actions are necessarily subjective, and judges cannot be expected to attempt to substitute their own judgments for the lawyers in charge of the cases except possibly in the most extreme situations.

Moreover, even crude judicial attempts to solve the problem of misallocation of lawyers’ time can be misdirected since duplication of effort, or effort exerted by a lawyer on a legal or factual theory which is ultimately fruitless, does not necessarily mean that time was wasted. On projects of any intellectual consequence there is no effective way to determine whether time was wasted or effort duplicated unnecessarily. There are no general rules for problem solving which could serve as a standard against which to measure the effectiveness of lawyers since all knowledge is built on a combination of successive guesses (hypotheses) and corrected mistakes.10 (There are, however, techniques for evaluating the correctness of solutions and it is usually possible to reach some tentative agreement on the importance of solutions.) Some people accomplish very little of importance and make few mistakes. Others make many mistakes but achieve outstanding results. Should J. D. Watson and Francis Crick have been refused a Nobel Prize for their extraordinarily important discovery of the structure of DNA because they followed so many leads which turned out to be wrong and duplicated effort by working together?11 It is probably just as useless to attempt to penalize lawyers for following up legal and factual theories which have to be abandoned or for duplicating effort in the solution of a problem. By far, the best discipline is self-interest. Plaintiffs’ lawyers should bear the cost of all hours they spend, and they are already required to share their fees with any coworkers.

A review of recent cases awarding attorneys’ fees on the basis of hours spent confirms the observation that, as a practical matter, judges do not usually substitute their own judgments for those of lawyers by disallowing hours for managing cases inefficiently. In the Lindy case itself, the only time that was ultimately disallowed by the court was time spent by the lawyers in negotiating fee agreements and preparing claim forms for those claimants who had actually retained the lawyers and time spent by them on the attorneys’ fees application, including the appeal on that issue.12 In general, cases subsequent to the Lindy decision have only disallowed hours which could not be compensated for under the general fund theory or under statutes awarding attorneys’ fees or which appeared to duplicate the time spent by other lawyers.13

Occasionally, courts have noted that certain work was done inefficiently14 or by partners instead of associates at a higher hourly rate than was justified,15 and have reduced hours or hourly rates for such reasons.16 No case, however, has been uncovered where a court has penalized plaintiffs’ lawyers because the court disagreed with their legal judgment on matters involving legal strategy, such as making or failing to make a motion for summary judgment or agreeing to or failing to agree to a settlement.17 Nor have courts usually disallowed hours because they thought lawyers adopted a legal strategy which resulted in too much work, such as engaging in protracted discovery or motion practice, although occasionally courts have rejected some of the hours spent on matters such as a brief because the court thought the hours were excessive.18

The decisions awarding attorneys’ fees on the basis of an hourly lodestar make another adjustment which also has very undesirable side effects. The courts have said that while hours, multiplied by appropriate hourly rates, are the “lodestar,” there must be adjustments for several factors, one of the most important of which is the risk and uncertainty involved in the litigation. This policy is based on
the fact that normally a lawyer would charge more than his normal billing rate if he were not sure that he would be successful and his fee were dependent on the outcome of the litigation.\textsuperscript{19} The amount of the adjustment varies in accordance with the amount of risk and uncertainty. An adjustment of this type was mentioned in the \textit{Linday} case itself\textsuperscript{20} and has been taken into consideration in subsequent cases which have used an hourly basis for awarding attorneys' fees.\textsuperscript{21} Unfortunately, this adjustment encourages plaintiffs' lawyers to bring cases with less merit. Taking a very simple example, it is not a wise social policy to make it just as attractive for lawyers to bring cases with a one-out-of-four chance of recovering a million dollars for the class as it is to take cases with a one-out-of-two chance of recovering the same amount by adjusting upward the expected fee for the more risky and uncertain cases. Ideally, lawyers should be encouraged to bring those cases with respect to which the law is most clear and where the violations are the most certain since, in those cases, society is least likely to waste its resources, such as courts', lawyers', and defendants' time and expenses, in useless efforts. Increasing attorneys' fees for the risk and uncertainty involved encourages lawyers to bring cases with regard to which the law and the facts are less certain. In the example, the fees should be the same for both sets of cases if the recoveries are the same. Plaintiffs' lawyers would still take very risky cases but only if the absolute amount of the recovery expected is correspondingly high or the cost of recovery can be kept low. If it is desirable to encourage legal innovation by plaintiffs' lawyers, a much better approach which would avoid any bias toward excessive risk taking would be to increase their compensation in all cases and not just in marginal, risky cases.

Increasing the propensity of plaintiffs' lawyers to take risks by giving them special incentive fees for risk taking aggravates an already serious problem since the incentives toward risk taking for plaintiffs' lawyers in derivative suits and class actions is already too high when fee awards are made on an hourly basis. There are two causes of this bias toward risk taking: separation of ownership and control between client and lawyer respectively (the involuntary client problem) and a system of payment which rewards successes and does not penalize failures.

A comparison with an ideal \textit{theoretical} procedure (used to illuminate the problem and not as a practical proposal) should make the nature of this bias clearer. A public auction of all class action and derivative suits to the highest bidder could be used to eliminate the separation of ownership and control. Such an auction could be conducted by the Securities and Exchange Commission or some other governmental agency after public notice describing the case. Lawyers and laymen would be permitted to bid, but the layman would be required to obtain a lawyer of his own choice to handle the case. The purchase price bid at the auction would be paid to the class in class actions and to the corporation in derivative suits, and the class or the corporation would have no further economic interest in the case. The purchaser would own the claim.

If, for example, a lawyer (or his client) has successfully bid $400,000 for a claim, he would have to consider the protection of his $400,000 investment in the case as well as any expense in conducting the case when he is evaluating a settlement. The result would be that the lawyer would be forced to behave like any other private litigant. His willingness to take risks would be tempered by his desire to protect his investment, which is the way the class or the corporation in a derivative suit would behave if it could hire, control, and pay its own lawyers.

If, in the example, defendants were permitted to bid on the cases filed against them, they would be willing to bid at least the nuisance value of the suit and possibly much more depending on the defendants' attitudes toward risks and litigation. A plaintiff's lawyer (or his client) who wanted to invest in the suit would be forced to invest more than the nuisance value of the suit and would, therefore, be much less likely to make the investment and to bring a nuisance value suit. If he did make the investment, he would be under pressure to settle for less than he paid in order to protect his investment against total loss, and the plaintiffs' lawyer and defendant would share the costs resulting from the lawyer's bad decision. In general, if defendants are permitted to bid, then, to the extent that they are the successful bidders, there has been a very efficient settlement of the case.

The auction model has one intriguing additional advantage over existing haphazard methods of allocating volunteer lawyers to involuntary clients in class actions and derivative suits. The best qualified lawyers would bid the highest prices at the auction because they could reasonably anticipate the largest recoveries which would increase the amount recovered by plaintiffs in meritorious class and derivative suits. The model in the example could be made
more effective by not holding the auction until after discovery is completed and awarding the lawyers who were in charge of the preliminary stage of the case before the auction a percentage of the amount paid at the auction as a fee.

Another adjustment made by the courts in the award of attorneys' fees is for the quality of the work involved; the higher the quality of the lawyers' work the greater fee. This adjustment was also discussed in the Lindy case and has been accepted in subsequent cases. While the courts look to a number of factors in determining the quality of the work, the primary factors appear to be the result obtained and the amount of innovation involved. The court in the Lindy case noted that the result is especially important when there has been a settlement. Making the quality of work a factor in the formula for determining the amount of the fee would probably improve the efficiency with which class and derivative litigation is managed but only by reintroducing in a roundabout manner the concept of percentage of recovery. Consequently, such an adjustment would improve efficiency but only to a marginal extent, since the lawyers would know that the lodestar is still based on the number of hours they record. To the extent that innovation is a factor in determining quality, there is an undesirable bias toward risk taking. Also, by taking into consideration the benefit produced, the courts have not escaped one of the problems associated with awarding attorneys' fees on the basis of a percentage of the recovery—how to value the recovery when it is not readily measurable in monetary terms. Nevertheless, while measuring the benefit produced may be difficult in some special situations, it is substantially easier than determining whether that benefit was efficiently produced.

In summary, basing plaintiffs' attorneys' fees on the number of hours worked has probably not produced any significant advantages but has produced serious disadvantages when compared with awarding attorneys' fees on the basis of a percentage of the recovery. Awarding attorneys' fees on the basis of hours spent has removed a very important incentive to plaintiffs' lawyers to choose and to manage cases in the most efficient manner. Moreover, the rationale behind using the number of hours spent as a basis for awarding fees has led the courts to increase fees where the likelihood of recovery is small, or the amount of innovation required is great; lawyers are thus encouraged to pursue more risky and uncertain cases, which is antisocial in its effects because it increases the propensity to initiate suits and to litigate instead of settling marginal cases. On the other hand, the courts still look to the benefit produced, especially where there is a settlement, which, to some extent, probably reintroduces a percentage-of-recovery factor without eliminating the bias against efficiency in an hourly basis formula.

The most desirable basis for compensating lawyers in class actions and derivative suits is a percentage-of-recovery formula. This was the method commonly employed by courts before the present, overwhelming success of the hourly "lodestar" method. In the past, when courts used the percentage-of-recovery method, no particular percentage of recovery was applied to all cases. The percentages applied by the courts ranged from approximately 10% to 50%. Plaintiffs' lawyers had no method of predicting in advance what percentage would be applied in a particular instance, except for the very rough generalization that usually the percentage applied varied approximately inversely with the size of the recovery. The most important characteristic of any successful procedure for determining plaintiffs' lawyers' fees is that a lawyer's best strategy for obtaining the highest possible fee should be to do his best, i.e., to bring the cases which have the highest present net expected value and to litigate them in the most efficient manner possible. A percentage-of-recovery method, using a flexible schedule of percentages, comes closest to accomplishing this goal. There is no incentive to work extra hours or to avoid settlement because extra hours are at the lawyer's expense. The incentive to take risks is exactly correct, because the only risks that are rewarded are those that are successful and only as a function of the amount of the success.

The most important criticism which has been leveled against awarding plaintiffs' lawyers' fees on the basis of a percentage of recovery is that it appears unseemly and brings the courts and bar into disrepute because of the large incomes earned by some plaintiffs' lawyers. Once society, through the courts, has made a decision to use private lawyers for the achievement of social goals through class actions and derivative suits, the most important consideration should be the efficient implementation of the policy. If the policy itself leads to undesirable results, then there should be a re-evaluation of the policy. The worst possible solution is to keep the policy and entangle it in rules which make it operate perversely. If the underlying problem with a percentage-of-recovery method of compensating plaintiffs' lawyers is that the fees awarded are often
too high, the courts can solve this problem by lowering the schedule of percentages they use. The effect of such a change would be to decrease the number of cases brought, but there would be no bias against efficiency.

Notes
1. 487 F. 2d 161 (3rd Cir. 1973).
2. Prior to the Lindy case, the courts had generally awarded attorneys’ fees primarily on the basis of a percentage of the recovery, with the percentage, on the average, declining inversely with the size of the recovery. See Hornstein, Legal Therapeutics: The “Salvage” Factor in Counsel Fee Awards, 69 Harv. L. Rev. 658 (1956).
4. See, e.g., Donnarumma v. Barracluda Tanker Corp., 77 F.R.D. 455, 462-463 (C.D. Calif. 1978). The principals set forth in the Lindy case have also been adopted in cases where the defendants are required to pay the plaintiffs’ attorneys’ fees because of a statute or for some other reason. See, e.g., Pete v. UMW Welfare and Retirement Fund of 1950, 117 F. 2d 1275 (D.C. Cir. 1941) (en banc). The Lindy case has also been commented upon favorably by various writers. See, e.g., Development in the Law-Class Actions, 89 Harv. L. Rev. 1318, 1611-1612 (1976); Hammond, Stringent New Standards for Awards of Attorneys’ Fees, 32 Bus. Law. 523 (1977); Dawson, supra, 88 Harv. L. Rev. at 921.
7. Dawson, supra, note 4, 88 Harv. L. Rev. at 838.
10. “To a philosopher with a somewhat open mind, all intelligent acquisition of knowledge would appear sometimes as a guessing game. I think. In science as in everyday life, when faced by a new situation, we start out with some guess. Our first guess may fail wide of the mark, but we try it and, according to the degree of success, we modify it more or less. Eventually, after several trials and several modifications, pushed by observations and led by analogy, we may arrive at a more satisfactory guess. The layman does not find it surprising that the naturalist works in this way... It may appear a little more surprising to the layman that the mathematician is also guessing. The result of the mathematician’s creative work is demonstrative reasoning, a proof, but the proof is discovered by plausible reasoning, by guessing,” G. Poly, Mathematics and Plausible Reasoning, Vol. II, Patterns of Plausible Inference, 118 (1968). See also Medawar, Anglo-Saxon Attitudes, Encounter, August, 1965, at 52, 54: “Unfortunately, we in England have been brought up to believe that scientific discovery turns upon the use of a method analogous to, and of the same logical stature as deduction, namely the method of Induction—a logically mechanized process of thought which, starting from simple declarations of fact striving out of evidence of the senses, can lead us with certainty to the truth of general laws.”
17. Courts, however, have occasionally required plaintiffs’ lawyers to share control of a case with objectors after a proposed settlement has been successfully attacked by the objectors at a hearing on the fairness of the settlement. See, e.g., Chalkler v. Burks, 55 F.R.D. 168, 172 (S.D.N.Y., 1972).
19. Dawson, supra, 88 Harv. L. Rev. at 926.
20. 487 F. 2d 168.
21. See, e.g., City of Detroit v. Grinnell Corporation, 495 F. 2d 448 (2d Cir. 1974).
22. 487 F. 2d 168.
24. 487 F. 2d at 108.
25. Dawson, supra, 88 Harv. L. Rev. at 878.