PROFIT FOR COSTS

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Courts reward attorneys for investing time in class action lawsuits more generously than they reward them for investing money in the costs of those suits. Class counsel may directly profit on time investments in two ways: by billing lawyers at market rates though paying those lawyers less and by receiving multiplied fee awards. Those same attorneys in those same situations may also recover their costs but courts may not—or at least do not—permit the attorneys either to mark up their costs or to receive cost multipliers. As cost profits are rarely even debated, there is no good defense of why they are unavailable, but one assumes that courts are less comfortable awarding attorneys a markup on their copying machine than they are for their legal work.

The assumption that costs cannot be directly profitable appears therefore to belittle costs, relegating them to a secondary position in the fee and cost award analysis and treating them as something of a tagalong or afterthought. Our goal in this Article is to give costs their due. We describe current jurisprudence, demonstrating how, given a choice between investing profitable time or reimbursable costs, profit-maximizing attorneys will find time investment more attractive than cost investment. We then explore the effects of this bias, showing that because cost investments are not directly rewarded, profit-maximizing attorneys will predictably (1) avoid certain cases; (2) select suboptimal modes of proceeding within cases they do bring; and then (3) settle those cases prematurely. Assuming that conclusion is unfortunate, we consider and propose mechanisms for remedying it.

While our proposals are initial and therefore tentative, our commitment to the project of centering costs is not: it is grounded in the belief that the legal system's anti-cost-investment bias impedes access to justice for individuals whose claims can be established only with substantial cost investments by entrepreneurial lawyers. Centering costs—and considering measures as conventionally discouraged as permitting third parties to profit from cost investments—has the potential to serve a larger public good.

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INTRODUCTION

Courts reward attorneys for investing time in class action lawsuits more generously than they reward attorneys for investing money in the costs of those suits. Class counsel may recover fees from an adversary via a fee-shifting statute or from their clients under the common-fund doctrine. In both instances, the firm may profit in two ways: (1) like any private firm, a class action firm can bill its attorneys' time investments at market rates that are likely higher than what it costs the firm to pay and staff attorneys, meaning that the firm's basic "lodestar"[1] embodies some profit for the firm's partners; and (2) a class action firm may also receive a multiplier on its lodestar to reward it for the risk it took in pursuing a contingent fee case. Those same firms in those same situations may also recover their costs from the same adversary or common fund, but courts may not—or at least *do* not—permit the firms either to mark up their costs or to receive cost multipliers. As cost profits are rarely even debated, there is no good defense of why they are unavailable, but one assumes that courts are less comfortable awarding attorneys a markup on their copying machine than they are for their legal work.

The assumption that costs cannot be directly profitable appears therefore to belittle costs, relegating them to a secondary position in the fee- and cost-award analysis and treating them as something of a tagalong or afterthought. That approach usually comports with the numbers, as costs are typically but a small fraction of fees.[2] Perhaps for these reasons, firms have rarely sought cost profits, and costs are rarely a significant topic in fee jurisprudence or scholarship.

Our goal in this Article is to give costs their due. Part II explains how current jurisprudence defines and rewards costs and how those rewards differ for fees, thus making time investment more attractive than cost investment. Part III explores the effects of this bias. It demonstrates that because cost investments are not directly rewarded, profit-maximizing firms will predictably (1) avoid certain cases, (2) select suboptimal modes of proceeding within cases they do bring, and then (3) settle those cases prematurely. Part III thereby shows that the current regime for reimbursing costs does not well serve the inter-

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1. An attorney's lodestar is the product of his reasonable hourly rate multiplied by the number of hours invested in a matter. A firm's lodestar is the sum of its attorneys' lodestars attributable to a case.

2. *See* Theodore Eisenberg & Geoffrey P. Miller, *Attorney Fees and Expenses in Class Action Settlements: 1993–2008*, 7 J. EMPIRICAL LEGAL STUD. 248, 274 (2010) ("[In] 232 cases from 1993 to 2002 for which cost data were available, mean costs were 2.8 percent of the recovery and median costs were 1.7 percent.").

ests of class members or the public in certain types of (high cost) cases; plaintiffs are less likely to be compensated and defendants less likely to be deterred in high-recovery-cost, as opposed to low-recovery-cost, situations.

Part IV assumes that Part III's conclusion is unfortunate and thus considers mechanisms for remedying it—that is, ways to encourage private attorneys general to invest in cost-intensive cases. We explore the strengths and weaknesses of four distinct approaches to cost profits: mark-to-market, cost-plus contracts, cost multipliers, and fee multipliers for cost investments. Part IV demonstrates that devising a reward regime for costs is more complicated than might be immediately apparent. Nonetheless, enabling *any* profit on cost investments will at least serve to dampen firms' current disincentive to invest in costs. We therefore begin that process in Part V by suggesting a range of possible first steps and by identifying and discussing some potential negative consequences of such efforts.

One of those first steps posits that if costs could be profitable, the legal system might permit nonlawyers to invest in them. This is not an Article about third-party financing per se, but we want to make two gestures in that direction. First, enabling firms to make a profit on costs *is* a form of litigation financing, indeed a new one. If cost profits come out of a common fund, the funder would be the clients themselves; if cost profits were shifted, the funder would be the losing adversary. Whatever the mechanism for delivering the cost profit, that profit alone would alter the class action litigation financing landscape. Second, cost profits could also alter how third parties might be able to invest in and profit from class action litigation. Currently, the "profit" a plaintiff's attorney makes in a lawsuit is her marked-up and multiplied fee, and that profit cannot, consistent with ethical proscriptions, be shared with nonlawyers.[3] By contrast, if costs yielded profits, the rule against fee-sharing might, arguably, not be violated were that profit shared with a nonlawyer investor. Even if cost profits were considered nonshareable "fees," the reasons for not permitting an attorney to share fees—the threat to her independence—might be outweighed in these circumstances by the relatively small function costs play compared to fees and the relative value to the class that higher cost investments might engender. In future work, we plan to examine some of the ramifications that would follow from the opportunity for nonlawyers to invest money in the *costs* of cases and be

3. MODEL RULES OF PROF'L CONDUCT R. 5.4(a) (2013) ("A lawyer or law firm shall not share legal fees with a nonlawyer . . . .").

rewarded for successful investments. For now, focusing on law firm investments, we explore how enabling cost profits might funnel resources to cases that are meritorious but presently underfunded, thereby increasing access to justice.

II. Defining and Situating Costs

A. How Courts Define Costs

ABA Formal Opinion 93-379 (Opinion)[4] divides attorney costs into three categories: general overhead (e.g., office and utilities),[5] disbursements (e.g., expert fees and other payments to third parties),[6] and in-house provision of services (e.g., copying and delivering).[7] Interpreting ABA Model Rule of Professional Conduct 1.5,[8] the Opinion discourages attorneys from directly profiting on these costs, absent express agreement by the client to the contrary. According to the Opinion, clients appropriately assume that overhead is part of the lawyer's hourly rate and thus that it will not be billed separately.[9] Similarly, the Opinion states that clients reasonably expect disbursements to be billed at no more than the amount the lawyer actually pays to a third party, meaning that the lawyer should not mark up the cost and should pass any discounts on to the client.[10] Finally, the Opinion holds that in-house services should, absent client consent, be billed at actual cost plus a reasonable estimate of overhead directly attributable to the provision of the service.[11] The majority of jurisdictions to

4. ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 93-379 (1993) elucidates ABA Model Rule of Professional Conduct 1.5 ("Fees"), which has been widely adopted.

5. *Id.* at 7 (defining as "cost in maintaining a library, securing malpractice insurance, renting of office space, purchasing utilities and the like").

6. *Id.* (defining as items such as stenographer fees and travel expenses).

7. *Id.* at 8 (defining as items such as copy costs, in-house meals, and delivery services).

8. Model Rules of Prof'l Conduct R. 1.5(a) ("A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses.").

9. ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 93-379, at 7 ("When a client has engaged a lawyer to provide professional services for a fee . . . the client would be justifiably disturbed if the lawyer submitted a bill to the client which included, beyond the professional fee, additional charges for general office overhead.").

10. *Id.* ("[C]lients justifiably should expect that the lawyer will be passing on to the client those actual payments of funds made by the lawyer on the client's behalf.").

11. *Id.* at 8 ("[T]he lawyer is obligated to charge the client no more than the direct cost associated with the service (i.e., the actual cost of making a copy on the photocopy machine) plus a reasonable allocation of overhead expenses directly associated with the provision of the service (e.g., the salary of a photocopy machine operator). . . . The lawyer's stock in trade is the sale of legal services, not photocopy paper, tuna fish sandwiches, computer time or messenger services.").

have considered the ethics of cost profits track the ABA Opinion's categories and contractual approach.[12]

In a normal lawyer-client relationship, the contracting approach is easy to effectuate: a retainer agreement typically sets forth the client's obligations with regard to payment of costs. In a class action suit, such *ex ante* contracting is usually impossible because the clients are primarily absent class members, most of whom will be unaware of the existence of the suit prior to receiving notice of the certification of a plaintiff class long after commencement of the proceedings.[13] A court must therefore approve the attorney's fees and costs. Though the class action rule permits courts to include "provisions about the award of attorney's fees or nontaxable costs"[14] in the order appointing class counsel, courts more typically award fees and costs at the conclusion of the lawsuit.[15] In overseeing class action cost awards, courts have developed a jurisprudence identifying reimbursable costs. Specifically, reimbursable costs include all reasonable expenditures paid to advance a successful class case,[16] except for a firm's overhead[17] and its

12. Most jurisdictions have not issued ethics opinions traversing the same territory as ABA Formal Op. 93-379, but have a tradition of looking to ABA ethics opinions for guidance in the absence of local authority. *See* Lawrence K. Hellman, *When "Ethics Rules" Don't Mean What They Say: The Implications of Strained ABA Ethics Opinions*, 10 GEO. J. LEGAL ETHICS 317, 324–25 (1996) (noting that state bars look to ABA ethics opinions for guidance). Of the jurisdictions that have issued relevant ethics opinions, most have followed the ABA's contract approach. *See, e.g.*, State Bar of Ariz. Comm. on the Rules of Prof'l Conduct, Formal Op. 94-10 (1994) (permitting an attorney to contract with a client to charge a percentage of the fee as a proxy for costs and in lieu of merely obtaining reimbursement for costs); State Bar of Mich. Standing Comm. on Prof'l Ethics, Op. RI-241 (1995) (permitting cost "surcharges" with client consent); Prof'l Ethics Comm. for the State Bar of Tex., Op. No. 594 (2010) (permitting cost profits with disclosure and consent); S.C. Bar Ethics Advisory Comm., Ethics Advisory Op. 06-02 (2006) (finding surcharge on particular expenses charged to client permissible with disclosure and consent).

13. Securities class actions pursued under the Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.), are an exception; it would be interesting to review the extent to which lead plaintiffs (typically institutional investors) in those cases bargain with lead counsel over costs *ex ante*, but that project exceeds the scope of this Article.

14. FED. R. CIV. P. 23(g)(1)(D).

15. *See* FED. R. CIV. P. 23(h).

16. While Rule 23(h) authorizes an award of fees and "nontaxable" costs in a successful class action, *id.*, Rule 54(d)(1) authorizes courts to award "taxable" costs to a prevailing party in any case—class action or not. FED. R. CIV. P. 54(d)(1). A federal statute defines such costs to encompass items such as (1) fees of the clerk and marshal; (2) fees of the court reporter; (3) fees and disbursements for printing and witnesses; (4) fees for exemplification and copies of papers necessarily obtained for use in the case; (5) docket fees; and (6) compensation of court appointed experts and interpreters. 28 U.S.C. § 1920 (2006).

17. Overhead costs are presumed to be covered in any fee award. *See In re* Bausch & Lomb, Inc. Sec. Litig., 183 F.R.D. 78, 90 (W.D.N.Y. 1998) ("The request for 'word processing' costs is not only completely vague as to the nature or reason for those costs, but such costs are presumed

professionals' time.[18] The remaining costs can be categorized using ABA Formal Opinion 93-379's taxonomy as either disbursements or in-house services. Typically, it is the former category of costs—payments made to third parties—that dominate class action counsel's cost submission. That category picks up all of the major expenses in a class suit, including the costs of electronic discovery, experts, special masters or mediators, class notice,[19] and even litigation financing.[20]

B. How Courts Reward Costs

Courts are authorized to reimburse class counsel's cost outlays in one of two ways. Some statutes entitle a prevailing party to payment of its costs by its losing adversary; these statutes normally authorize payment of all costs reasonably incurred to advance or resolve the plaintiffs' case, not just simple taxable costs.[21] In cases in which counsel's effort has established a common fund, fees and costs are paid from the fund to ensure that the fund beneficiaries are not unjustly enriched by receiving counsel's services without paying for them.[22] The animating principle with regard to the award of costs in both fee-

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to be included in counsel's overhead expenses, and are thus properly included in the award of attorneys' fees.").

18. Legal professionals' time is excluded from costs because it is separately recoverable as fees, but which legal professionals' time may be included in the fee petition varies according to the specific facts of the case, the relevant market, and task. *See, e.g.*, Missouri v. Jenkins, 491 U.S. 274, 285, 287–88 (1989) (recognizing that law clerk and paralegal time should be included in any fee award under 42 U.S.C. § 1988 at market rates, rather than at the cost to the lawyer of employing such persons, where it is the practice to bill in that manner to paying clients in the relevant market); *In re* Superior Beverage/Glass Container Consol. Pretrial, 133 F.R.D. 119, 131 (N.D. Ill. 1990) ("We have eliminated hours to the extent that paralegal time appeared to represent clerical work, such as messengering documents, opening mail, filing documents (in court or out), etc.").

19. Plaintiffs' counsel must pay for notice programs, *see* Eisen v. Carlisle & Jacquelin, 417 U.S. 156, 178 (1974), though if a case settles before the class is certified and provided certification notice, the defendant typically pays the costs of settlement notice. *See* 3 WILLIAM B. RUBENSTEIN, NEWBERG ON CLASS ACTIONS § 8:34, at 335 (5th ed. 2013).

20. *See* Nora Freeman Engstrom, *Lawyer Lending: Costs and Consequences*, 63 DEPAUL L. REV. 377 (2014) (discussing the treatment of litigation financing costs).

21. *See* 1 ALBA CONTE, ATTORNEY FEE AWARDS § 4:41, at 645–46 (3d ed. 2004) ("[I]t is generally recognized that awards for litigation costs under a statutory fee authorization provision are not limited to taxable costs for suits generally, but include all reasonable expenses incurred in furnishing effective and competent representation.").

22. *See, e.g.*, Boeing Co. v. Van Gemert, 444 U.S. 472, 478 (1980) (stating that "[t]he doctrine rests on the perception that persons who obtain the benefit of a lawsuit without contributing to its cost are unjustly enriched at the successful litigant's expense"); Mills v. Elec. Auto-Lite Co., 396 U.S. 375, 393–94 (1970) (authorizing federal courts to award attorneys' fees to prevent unjust enrichment when litigation confers "a substantial benefit on the members of an ascertainable class, and where the court's jurisdiction over the subject matter of the suit makes possible an award that will operate to spread the costs proportionately among them"); Sprague v. Ticonic Nat'l Bank, 307 U.S. 161, 166 (1939) ("Plainly the foundation for the historic practice of granting

shifting and common-fund cases is reasonableness, informed in part by market principles (i.e., what fee-paying clients normally pay).[23] Courts are rarely asked to approve, and even more rarely do approve, any profit on costs, as discussed more fully below.

For our purposes, reimbursement of costs must be contrasted with the manner in which courts award class counsel fees. As with costs, courts are authorized to award counsel fees either by a fee-shifting statute[24] or under the common-fund doctrine.[25] In fee-shifting cases, courts generally employ a lodestar method, awarding counsel an hourly fee for all hours reasonably expended on the litigation;[26] the hourly rate is usually that of the local market.[27] Courts have the discretion to multiply the fee, either upward or downward, but the Supreme Court's interpretation of the federal fee-shifting statutes has severely restricted the ability of lawyers to recover a fee multiplier in fee-shifting cases.[28] In common-fund cases, fees are typically calculated using the percentage-of-fund method,[29] with class counsel typi-

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reimbursement for the costs of litigation other than the conventional taxable costs is part of the original authority of the chancellor to do equity in a particular situation.").

23. *See* LeBlanc-Sternberg v. Fletcher, 143 F.3d 748, 763 (2d Cir. 1998) ("'[A]ttorney's fees awards include those reasonable out-of-pocket expenses incurred by attorneys and ordinarily charged to their clients.'" (alteration in original) (quoting U.S. Football League v. Nat'l Football League, 887 F.2d 408, 416 (2d Cir. 1989))); *see also* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 34 cmt. a (2000) ("The prohibition on unreasonable payment arrangements is not limited to fees in a narrow sense. It applies also to excessive disbursement or interest charges or improper security interests." (citation omitted)); CONTE, *supra* note 21, § 2:19, at 190–91 (noting that "[t]he prevailing view is that expenses are awarded in addition to the fee percentage" in common-fund cases); *id.* § 4:42, at 663 ("Recoveries of reasonable litigation costs not limited to taxable costs are treated using the same standards for cost reimbursement in both statutory and common fund fee award proceedings.").

24. *See, e.g.*, 42 U.S.C. § 1988(b) (2006) (stating that in cases enforcing certain federal statutory rights, "the court, in its discretion, may allow the prevailing party, other than the United States, a reasonable attorney's fee as part of the costs").

25. *See supra* note 22.

26. *See* Perdue v. Kenny A. *ex rel.* Winn, 130 S. Ct. 1662, 1672 (2010) (noting that the "'lodestar' figure has, as its name suggests, become the guiding light of our fee-shifting jurisprudence" (quoting City of Burlington v. Dague, 505 U.S. 557, 562 (1992)) (internal quotation marks omitted)).

27. *See* ALAN HIRSCH & DIANE SHEEHEY, FED. JUDICIAL CTR., AWARDING ATTORNEYS' FEES AND MANAGING FEE LITIGATION 20–21 (2d ed. 2005) ("Most courts consider the forum community the proper yardstick, so an award for out-of-town counsel will not be based on the rates in their usual place of work.").

28. *See, e.g.*, *Perdue*, 130 S. Ct. at 1669 (noting the "strong presumption" that lodestar is the reasonable fee in fee-shifting cases).

29. *See, e.g.*, MANUAL FOR COMPLEX LITIGATION (FOURTH) § 14.121, at 187 (2004) ("After a period of experimentation with the lodestar method . . . the vast majority of courts of appeals now permit or direct district courts to use the percentage-fee method in common-fund cases." (footnotes omitted)); Brian T. Fitzpatrick, *An Empirical Study of Class Action Settlements and Their Fee Awards*, 7 J. EMPIRICAL LEGAL STUD. 811, 832 (2010) (finding that 69% of courts

cally recovering roughly 20%–30% of the fund,[30] mimicking the familiar 33% contingency fee of individual plaintiffs' counsel. That percentage need not have a relationship to the actual time the attorneys put into the case, but in roughly half the cases in which courts use the percentage method, they undertake a "lodestar cross-check" of the percentage award[31] whereby they evaluate the fee in terms of the hours the lawyers invested in the case and their hourly rate. Through the cross-check, a court can determine whether, and to what extent, the requested percentage is a positive or negative multiple of the lodestar. In both settings, courts attempt to keep fees reasonable by testing them against a series of factors that are derived from, and parallel, the indicia for reasonable fees found in ethics rules.[32]

It may not be immediately obvious how costs and fees are treated differently in that costs are reimbursed and fees are generally paid at their market rate. But the courts' approach embodies two distinct layers of profits in fees but not costs. First, a firm typically pays its lawyers less than the market rate, such that the firm's lodestar embodies a profit for the firm's partners. This mimics the private market; indeed the market rates in class action cases are generally borrowed from the rates large firms bill their clients. The partners at such firms bill their

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utilize the percentage-of-fund method in some fashion, either with or without the lodestar cross-check).

30. *See* THOMAS E. WILLGING ET AL., FED. JUDICIAL CTR., EMPIRICAL STUDY OF CLASS ACTIONS IN FOUR FEDERAL DISTRICT COURTS: FINAL REPORT TO THE ADVISORY COMMITTEE ON CIVIL RULES 69 (1996) (reporting median fee awards in class actions "rang[ing] from 27% to 30%"); *see also* Eisenberg & Miller, *supra* note 2, at 260 tbl.4 (mean award 24%; median award 25%); Fitzpatrick, *supra* note 29, at 835 tbl.8 (mean award 25.7%; median award 25%).

31. *See* Eisenberg & Miller, *supra* note 2, at 267 tbl.10 (showing that from 2003–2008, 42.8% of courts used both the percentage and lodestar methods in the same case, suggesting that these courts are undertaking a lodestar cross-check).

32. *Compare, e.g.*, Johnson v. Ga. Highway Express, Inc., 488 F.2d 714, 717–19 (5th Cir. 1974) (articulating a twelve-factor test for fee reasonableness: "(1) The time and labor required;"; "(2) The novelty and difficulty of the questions"; "(3) The skill requisite to perform the legal service properly"; "(4) The preclusion of other employment by the attorney due to the acceptance of the case"; "(5) The customary fee"; "(6) Whether the fee is fixed or contingent"; "(7) Time limitations imposed by the client or the circumstances"; "(8) The amount involved and the results obtained"; "(9) The experience, reputation, and ability of the attorneys"; "(10) The [political] 'undesirability' of the case"; "(11) The nature and length of the professional relationship with the client"; and "(12) Awards in similar cases"), *with, e.g.*, MODEL RULES OF PROF'L CONDUCT R. 1.5(a) (2013) ("The factors to be considered in determining the reasonableness of a fee include the following: (1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly; (2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer; (3) the fee customarily charged in the locality for similar legal services; (4) the amount involved and the results obtained; (5) the time limitations imposed by the client or by the circumstances; (6) the nature and length of the professional relationship with the client; (7) the experience, reputation, and ability of the lawyer or lawyers performing the services; and (8) whether the fee is fixed or contingent.").

clients market rates, pay their associates at lower than market rates, and pocket the difference. So too can a partner at a class action firm awarded the firm's lodestar. Second, as noted above, court-awarded fees may include a positive multiplier, particularly in common-fund cases. Fee multipliers acknowledge the risk that contingent fee plaintiffs' counsel undertook. If contingent fee counsel were merely reimbursed at market rates, few would undertake such work because they could get paid market rates in noncontingent fee cases without such risk.[33] By rewarding the risk that counsel took, the multiplier incentivizes the lawyer to pursue a contingent practice.

Neither of these profit centers is available on the cost side, at least not directly. As discussed earlier, ABA Model Rule 1.5 and a related ethics Opinion discourage lawyers from profiting on costs, though some reasonable profit on disbursements and in-house service charges may be negotiated as part of an *ex ante* representation and fee agreement.[34] Courts overseeing class actions have generally refused to permit cost markups, typically relying on the fact that the class does not have the opportunity to negotiate the charges *ex ante*.[35] Not surprisingly, therefore, there is no such thing as a "cost multiplier"; no re-

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33. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 21.9, at 567 (4th ed. 1992) ("A contingent fee must be higher than a fee for the same legal services paid as they are performed. The contingent fee compensates the lawyer not only for the legal services he renders but for the loan of those services. The implicit interest rate on such a loan is high because the risk of default (the loss of the case, which cancels the debt of the client to the lawyer) is much higher than that of conventional loans . . . ."); *see also* John Leubsdorf, *The Contingency Factor in Attorney Fee Awards*, 90 YALE L.J. 473, 480 (1981) ("A lawyer who both bears the risk of not being paid and provides legal services is not receiving the fair market value of his work if he is paid only for the second of these functions. If he is paid no more, competent counsel will be reluctant to accept fee award cases.").

34. *See supra* Part II.A.

35. *See, e.g.*, *In re* San Juan Dupont Plaza Hotel Fire Litig., 111 F.3d 220, 237 (1st Cir. 1997) ("Unlike the PSC, the IRPAs [individually retained plaintiffs' attorneys] are free to assess their own clients for photocopying in accordance with their respective contingent fee agreements and any applicable ethical-code provision. On the other hand, the PSC is a creature of the district court, whose mission is to promote more efficient litigation. In a 'common benefit' case of this sort, therefore, the court must ensure that PSC members recover only their *actual* costs, with no 'profit' margin." (citation omitted)); *In re* Wash. Pub. Power Supply Sys. Sec. Litig., 779 F. Supp. 1063, 1111–12 (D. Ariz. 1990) ("A further deduction will be made to the amounts reported by Bernstein Litowitz, as it will be made for most other firms, for the expense of photocopying. Initially, the firm imposed a charge of 15 cents per page for in-house copies. The charge increased in January 1987 to 20 cents, and again in March 1989 to 25 cents. The Court considers the per-page charges, and the resulting $44,200 assessment to Class members, excessive. That this amount may be charged to regular clients by the firm, or that it is 'standard' in the firm's area of practice, is not controlling. Class members will not be assessed an amount that produces a clear and unwarranted profit for the firm. While it is not possible—either for the Court or counsel—to establish a 'true' cost for photocopying in this action, a reasonable allowance of approximately $26,500 for in-house copying expense of Bernstein Litowitz will be permitted." (footnote omitted)), *vacated in part*, 19 F.3d 1291 (9th Cir. 1994).

ported court decision has ever awarded counsel a cost that was directly multiplied.

It is true, as noted above, that *fees* may be multiplied based on the risks counsel took in pursuing a case, and such profit-making risk may include risks arising from *cost* investments: courts have held in both statutory fee-shifting[36] and common-fund cases[37] that attorneys can demonstrate risk by, *inter alia,* showing an extraordinary outlay of costs. In this sense, cost outlays may be a factor in fee profits, but this indirect reward for cost investments is clumsy, at best, and detracts little from the conclusion that costs are reimbursed but not rewarded.

Similarly, firms working together to pursue a case sometimes contract to reward cost investments in ways that the courts do not by reallocating fee payments to cost investors.[38] For instance, an agreement that surfaced in one case stated that "35% of any class fees would be allocated according to costs advanced and 65% would be allocated based on work performed."[39] Such an agreement may be penned *ex ante*,[40] or at the time that counsel negotiate adding new firms or cost investments,[41] or even *ex post*, after a court awards an aggregate fee.[42] This type of private ordering demonstrates the in-

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36. *See, e.g.*, Perdue v. Kenny A. *ex rel.* Winn, 130 S. Ct. 1662, 1674 (2010) (holding, in interpreting federal fee statute, that where expense outlays are "extraordinary" and the litigation is "exceptionally protracted," a fee multiplier may be appropriate).

37. *See, e.g.*, Edelman & Combs v. Law, 663 So. 2d 957, 959–60 (Ala. 1995) (listing "the reasonable expenses incurred by the attorney" as one of the relevant fee factors in common-fund fee situations); Ladewig v. Ariz. Dept. of Revenue, 63 P.3d 1089, 1094 (Ariz. Tax Ct. 2003) (stating, in a common fund case, that "the risk undertaken by counsel, the fact that they advanced approximately $246,815.00 in costs on behalf of the class, and the fact that their award of attorneys' fees has been delayed for almost twelve (12) years warrants that they be given a reasonable incentive for their efforts").

38. *See* Vincent Robert Johnson, *Ethical Limitations on Creative Financing of Mass Tort Class Actions*, 54 BROOKLYN L. REV. 539, 579 (1988) (identifying intra-class counsel fee reallocation agreements as one flawed but "plausible means of minimizing the risk of undercompensation of the cost of advancing class action expenses").

39. Dunn v. Dart, No. 09 CVS 02600, 2011 WL 2749569, at *4 n.14 (N.C. Super. Ct. July 14, 2011).

40. *See, e.g.*, *Ex parte* Burr & Forman, LLP., 5 So. 3d 557, 559 (Ala. 2008) (reciting fee and cost sharing agreement terms reached by participating counsel at outset of litigation, requiring counsel to bear common costs in proportion to anticipated fee split, though with a cap on cost contributions to be made by firms receiving the smaller percentage fees); Daniel v. Aon Corp., 952 N.E.2d 638 (Ill. App. Ct. 2011) (dispute arising out of alleged fee allocation agreement among cooperating class counsel discussed at the outset of the litigation, prior to any fee award).

41. *See, e.g.*, *In re* "Agent Orange" Prod. Liab. Litig., 818 F.2d 216, 218 (2d Cir. 1987) ("In December of 1983, as a means of raising the capital necessary for the maintenance and continuation of the lawsuit, the nine PMC members entered into a written fee sharing agreement whereby six of the members each promised to advance the class $200,000 for general litigation expenses.").

42. *See, e.g.*, *In re* Initial Pub. Offering Sec. Litig., No. 21 MC 92(SAS), 2011 WL 2732563, at *4 (S.D.N.Y. July 8, 2011) (counsel tasked with recommending an allocation of an aggregate fee

stinct to reward cost investments, but standing alone it does not actually do so; the court has not awarded any extra money for the cost investment—the attorneys have simply reallocated the fixed fee award among themselves in a manner not purely based on their time investments. Worse, such private reordering is useful only in cases that attract multiple law firms with varying preferences or capacities regarding the investment of time and costs, and moreover is useful only to the extent that courts will enforce these agreements, but they need not and often do not do so.[43] Courts generally do not like these inter-firm agreements because they run afoul of the default preference for allocating according to the services rendered (i.e., the attorneys' relative lodestars)[44] and raise other ethical concerns. For example, in the seminal case on point—*In re "Agent Orange" Product Liability Litigation*[45]—the Second Circuit, while not finding such a contract per se unenforceable, identified three interrelated concerns rendering such contracts effectively unusable: (1) that the contract deviated substantially from the lodestar,[46] (2) that it created a conflict of interest

award post-settlement considered, among other factors, "whether the firm met its litigation fund obligations," as well as factors pertaining more to investment of attorney time, such as whether the attorneys assumed "supervisory responsibilities or other leadership roles").

43. *See, e.g.*, *In re* High Sulfur Content Gasoline Prods. Liab. Litig., 517 F.3d 220, 230 (5th Cir. 2008) ("This circuit . . . does not forbid a district court to rely on fee allocation proposals submitted by attorneys. The proposals must, however, be factually supportable and consistent with the Johnson [*v. Georgia Highway Express*, 488 F.2d 714 (5th Cir. 1974)] factors."); *In re* FPI/Agretech Sec. Litig., 105 F.3d 469, 474 (9th Cir. 1997) ("We decline to curb the district courts' broad discretion in exercising their equitable power to award attorneys' fees in common fund class actions by requiring that fee allocation proposals be treated as enforceable contracts."); Allapattah Servs., Inc. v. Exxon Corp., 454 F. Supp. 2d 1185, 1225 (S.D. Fla. 2006) ("[A] federal court always has authority to reject agreements allocating fees among class counsel whenever there is cause to do so.").

44. *See, e.g.*, *In re FPI/Agretech Sec. Litig.*, 105 F.3d at 473 ("[A] court may reject a fee allocation agreement where it finds that the agreement rewards an attorney in disproportion to the benefits that attorney conferred upon the class—even if the allocation in fact has no impact on the class."); Prandini v. Nat'l Tea Co., 557 F.2d 1015, 1019 (3d Cir. 1977) ("A division of fees [by agreement among counsel] based on a percentage without regard to work performed or responsibility assumed is not in compliance with the standard. Consequently, when he was asked to approve a fee based only upon the percentage agreement, the trial judge properly refused to approve the arrangement."); Kronfeld v. Transworld Airlines, Inc., 129 F.R.D. 598, 612 (S.D.N.Y. 1990) ("To the extent that counsel's fee-sharing agreement differs significantly from the lodestar or from the amount that the court determines is equitable after adjusting each attorney's lodestar, the court may refuse to enforce the attorney's arrangement.").

45. *In re "Agent Orange" Prod. Liab. Litig.*, 818 F.2d 216. For an overview of the circumstances leading to the funding crisis in *Agent Orange*, see PETER H. SCHUCK, AGENT ORANGE ON TRIAL: MASS TOXIC DISASTERS IN THE COURTS 107–09 (1986); Paula Batt Wilson, Note, *Attorney Investment in Class Action Litigation: The* Agent Orange *Example*, 45 CASE W. RES. L. REV. 291, 311–13 (1994).

46. *See In re "Agent Orange" Prod. Liab. Litig.*, 818 F.2d at 223 ("[W]hile the practice of allowing class counsel to distribute a general fee award in an equitable fund case among themselves pursuant to a fee sharing agreement is unexceptional, we find that any such agreement

between class counsel and the class,[47] and (3) that it undermined the court's role as the class's fiduciary.[48] While fees law has developed significantly in the quarter century since the Second Circuit's *Agent Orange* decision, and in ways that might be more receptive to the enforcement of contracts rewarding cost investments,[49] neither class counsel nor courts have pursued this agenda. What this review has demonstrated is that fees can generate partner profits while costs generally cannot, or at least do not, perform the same magic.

C. How Firms Approach Costs

Given a jurisprudence that enables profit on time but not costs, one would expect firms to prefer time over cost investment, just as a consumer would, all else being equal, prefer an interest-bearing checking account over a non-interest-bearing checking account. That proposition and our exploration of cost effects in the succeeding sections rest on three key assumptions. First, consistent with a classic model of attorney case investment decision making,[50] we assume law firms and

must comport essentially with those principles of fee distribution set forth in *Grinnell I* and *Grinnell II*.").

47. *Id.* at 223–24 ("In our view, fees that include a return on investment present the clear potential for a conflict of interest between class counsel and those whom they have undertaken to represent," due to the "incentive provided to an investor-attorney to settle early and thereby avoid work for which full payment may not be authorized by the district court."). In rejecting the idea that the lawyers of the PMC could be equated with an ad hoc firm for purposes of applying ethics rules, the court seemed, too, to implicitly accept arguments regarding ethics-based limits on divisions of fees among lawyers from distinct firms. *Id.* at 226.

48. *Id.* at 223 ("There is authority for a court, under certain circumstances, to award a lump sum fee to class counsel in an equitable fund action under the lodestar approach and then to permit counsel to divide this lodestar-based fee among themselves under the terms of a private fee sharing agreement. We reject this authority, however, to the extent it allows counsel to divide the award among themselves in *any* manner they deem satisfactory under a private fee sharing agreement. Such a division overlooks the district court's role as protector of class interests . . . and its role of assuring reasonableness in the awarding of fees in equitable fund cases." (citations omitted)).

49. The most significant development since *Agent Orange* is the shift across jurisdictions from a strong preference for the lodestar method to acceptance of the percentage method in common-fund cases. *See* MANUAL FOR COMPLEX LITIGATION (FOURTH) § 14.121, at 187 (2004) ("After a period of experimentation with the lodestar method . . . , the vast majority of courts of appeals now permit or direct district courts to use the percentage-fee method in common-fund cases." (footnotes omitted)). As fees law is now less firmly fixated with lodestar awards, courts might be more understanding of contracts that deviate from lodestar-based allocations among counsel.

50. *See generally* Murray L. Schwartz & Daniel J. B. Mitchell, *An Economic Analysis of the Contingent Fee in Personal-Injury Litigation*, 22 STAN. L. REV. 1125 (1970). The Schwartz and Mitchell article provided the basis of the modeling done in another classic work, Kevin M. Clermont & John D. Currivan, *Improving on the Contingent Fee*, 63 CORNELL L. REV. 529, 534 n.10, 537–46 (1978). A variation of that same model grounded Professor John Coffee's early scholarship regarding the case investment and settlement strategies of private attorneys general. John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Pri-*

the individual lawyers associated with them are cohesively and rationally profit maximizing[51] and function as "risk-taking entrepreneurs."[52] Second, we assume that when choosing whether to pursue litigation, firms can discern, at the outset, the extent to which a case will involve the investment of time and costs, as well as the reward the firm is likely to reap from that investment.[53] Third, we assume law firms are indifferent between the investment of time and money in litigation, if time and money investments yield the same reward.

None of these assumptions perfectly captures real firm behavior. Firms often honor a host of values other than profit maximization;[54] firms can often only make crude estimates of litigation costs at the outset of a case; and not all firms are indifferent as to investment of time and costs, given constraints such as limited access to capital or the time demands of the firm's existing case portfolio. Nevertheless, our assumptions are helpful for modeling purposes.[55] The hypotheti-

vate Enforcement of Law Through Class and Derivative Actions, 86 COLUM. L. REV. 669, 687 n.55 (1986). None of these analyses specifically focused on cost rewards or investment.

51. To simplify our analysis, we assume, further, that if multiple firms join forces to litigate a class action, they act as a single firm pursuing the same case to maximize the rewards to the participating firms as a whole. This assumption, like the assumption of intra-firm cohesiveness, allows us to avoid accounting for the effects of group dynamics on firms' case investment decisions. While those dynamics are important, *see* Morris Ratner, *A New Model of Plaintiffs' Class Action Attorneys*, 31 REV. LITIG. 757 (2012) (examining incentive effects of firm organizational structure on case investment and settlement decisions by individual lawyers within firms), we bracket them here to enable this initial analysis of cost profits. This same cluster of assumptions enables us to use the terms "attorneys" and "firms" interchangeably in this Article when referring to class counsel's case investment incentives and choices.

52. *See* Coffee, *supra* note 50, at 676 ("Once we understand that the plaintiff's attorney in these actions behaves as a risk-taking entrepreneur, there are reasons to believe that the private incentives for much litigation may be inadequate from a social cost perspective."); *see also* Kenneth W. Dam, *Class Actions: Efficiency, Compensation, Deterrence, and Conflict of Interest*, 4 J. LEGAL STUD. 47, 60 (1975) ("The [class action] attorney is an entrepreneur.").

53. Relatedly, we assume that firms treat their time investments as if they were to be rewarded on a lodestar basis, even if in fact a court will use a straight percentage fee award. If counsel could rely on a pure percentage fee (without a lodestar cross-check) in every case some of the disparity between time and capital investments would be muted, as any investment would centrally contribute to recoupment of the percentage award in this or another case. Our assumption that attorneys focus on lodestar is generally warranted, however, in that attorneys making *ex ante* investment decisions often do not know if the court will use a pure percentage-of-fund method or will instead utilize a lodestar approach, or a lodestar cross-check, given that courts generally make such decisions *ex post*, at the time of any settlement or judgment.

54. *See* Herbert M. Kritzer et al., *The Impact of Fee Arrangement on Lawyer Effort*, 19 LAW & SOC'Y REV. 251 (1985) (using empirical data to cast doubt on the explanatory power of economic models that attempt to predict or explain lawyer case investment choices on the assumption that lawyers are profit-maximizing).

55. *Cf.* Schwartz & Mitchell, *supra* note 50, at 1127 ("This Article assumes throughout that both lawyer and client are rational, economic men. No account is taken of professional pride, ethics, or a desire 'to keep the insurance company honest.' No one can know to what extent

cal case investment scenarios we explore in the following Part tell us something useful, even if real life is more complicated.

III. Exploring Cost Effects

Having defined costs and fees and described how courts treat them differently, we are ready to model the distortions created by that differential treatment. Specifically, the differential rewards flowing from time and cost outlays distort attorney case selection, management, and settlement decisions in predictable ways.[56]

A. High-Cost Cases Are Less Likely to Be Pursued

A typical class action firm will have limited resources—given its current caseload and access to both attorney time and capital—to invest in new cases. Assume the firm is considering involvement in two cases with similar risks (in terms of success), each of which involves the same *total* outlay (combined outlay of lodestar plus costs) but in different quantities.

> Case 1: Total Outlay $1 million
>
> At the outset of the case, the firm estimates it will spend $400,000 on causation experts and $400,000 on mailed notice in the event a litigation class is certified. The remaining $200,000 of the expected outlay is attorney time, measured in lodestar (which translates into 500 hours of attorney time—or roughly 1/4 of a year's total billing for one busy lawyer—at $400 per hour).
>
> Case 2: Total Outlay $1 million
>
> At the outset of the case, the firm estimates it will spend $800,000 in lodestar (which translates into 2,000 hours of attorney time—or roughly one full year's billings for one busy lawyer) on a case with complex briefing and fact discovery. The firm estimates it will spend an additional $200,000 covering costs like expert fees and notice.

As should be obvious, all other things being equal, a firm looking to maximize its profit will pursue Case 2 rather than Case 1, as the bulk of its investment may yield a profitable and potentially multiplied recovery. Below, Table 1 shows that the firm's yield is 50% greater in Case 2 ($1,800,000) than in Case 1 ($1,200,000).

This comparison actually likely underestimates the benefit of Case 2 to the firm for another reason. The hypothetical assumed a single law-

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such factors affect lawyers' behavior. Their presence does not, however, negate the consideration treated in the text—the lawyer's behavior as an economic man.").

56. In some sense, these are all variants of the same problem—namely, that an attorney will always weigh investing her next dollar in a cost against the other available opportunities—though they occur at different points in the litigation spectrum.

TABLE 1: A COMPARISON OF INVESTMENT RETURNS IN TWO SIMPLE CASES

	Case 1		Case 2	
	Investment	Return	Investment	Return
Fees (2 multiplier)	$200,000	$400,000	$800,000	$1,600,000
Costs	$800,000	$800,000	$200,000	$200,000
Total	$1,000,000	$1,200,000	$1,000,000	$1,800,000

yer billed at $400 per hour. In 2,000 hours—or one year—of billing this lawyer to the class, the firm generates an unmultiplied lodestar of $800,000. However, the firm is likely paying that lawyer less than that amount,[57] even assuming that the fee encompasses the lawyer's overhead and benefits.

Table 1A shows that if the firm bills its attorneys at 33% more than it costs the firm to hire, train, pay, and house those attorneys, its actual investment is less than that shown in Table 1, and yet the return on that investment remains that which is shown in Table 1 and is therefore a greater actual return. Moreover, the disparity between the cost-heavy case and fee-heavy case widens: the cost-heavy case now requires an investment of $950,000 (rather than $1,000,000), yet the fee-heavy case requires an investment of only $800,000 (rather than $1,000,000), with the returns remaining the same. The cost-heavy case had a 20% return on investment absent the lodestar profit and has a 26% return with it; the fee-heavy case had an 80% return on investment absent the lodestar profit and has a 125% return with it.

TABLE 1A: A COMPARISON OF INVESTMENT RETURNS IN TWO SIMPLE CASES

	Case 1		Case 2	
	Investment	Return	Investment	Return
Fees (2 multiplier)	$150,000 (actual) $200,000 (billed)	$400,000	$600,000 (actual) $800,000 (billed)	$1,600,000
Costs	$800,000	$800,000	$200,000	$200,000
Total	$950,000	**$1,200,000**	$800,000	**$1,800,000**

In short, investments in fees may be profitable at lodestar alone, and hence the profit in the multiplier is simply gravy.

57. $400 per hour is roughly the billing rate of a fifth-year associate in the Los Angeles market and the cost of paying and staffing a fifth-year associate is likely less than $800,000 per year.

The discussion to this point has assumed that the firm was equally likely to prevail in either case. However, given the bonus for prevailing in a fee-heavy case, a rational firm would pursue a riskier fee-heavy case rather than a low risk cost-heavy case. In the hypothetical above, if the fee-heavy case had a 67% chance of winning, but a 2 multiplier if the plaintiffs did succeed, its net expected value at the outset (.67 × $1,800,000) would be precisely the same as the cost-heavy case with an assured victory and a 2 multiplier.[58]

It is, of course, easy to devise a hypothetical case that shows the dramatic effect of fees but not costs being multiplied. The tougher question is whether any real cases actually have these characteristics. The matched sets of cases in Table 2 demonstrate some of the ways these effects might play out in a variety of substantive law settings, assuming again that the cases in each row have the same expected value and differ only in the mix of time and cost investment necessary to prosecute them.

TABLE 2: THE ACTUAL CASE-SELECTION EFFECTS OF NOT MULTIPLYING COSTS

	Case 2 – High Costs	Case 1 – Low Costs
Property Damage	A property damage case requiring plume studies and expert analysis to trace the source of contamination from possible point sources to a particular parcel or grouping of properties.	A property damage environmental case involving a single, known point source (e.g., a factory that is the only entity within a particular distance known to have used or produced a particular contaminant).
Personal Injury	A personal injury cancer-cluster case involving a community exposed to multiple known and suspected carcinogens from a variety of possible defendants.	A case involving less severe personal injuries on behalf of long-term workers at a single plant or factory exposed to a single known contaminant.
Fraud	A case alleging fraud in the billing of uninsured patients against a hospital chain that includes recently acquired hospitals with disparate billing systems and practices, and a range of alleged illicit charges requiring a review of a broader array of medical records to document the charges.	A case alleging fraud in the billing of uninsured patients against a hospital chain that has a single billing system and that consistently engaged in fraud as to only one category of billing.

58. In fact, the argument for a 2 multiplier would be greater in the riskier case than in the safe case, skewing the analysis further.

Invasion of Privacy	A case alleging that a national bank errantly released its electronic records of past customers' safe deposit information; any court-required notice in the case would need to be done by first-class mail, perhaps augmented with a national advertising campaign.	A case alleging that an Internet company errantly released information in electronic records about current e-mail users; any court-required notice in the case could be accomplished via e-mail.

In sum, a firm considering investing in two cases, one involving high costs and low attorney time and the other involving relatively low costs and high attorney time, will invest in the latter case because the possibilities of fee profits and fee multipliers—with no possibility of profiting from costs—makes the investment much more attractive. This means that a set of high-costs cases will likely not be pursued, even if the odds of prevailing are similar.[59] Moreover, given the disparity in returns, it is likely that a firm would invest in many less worthy fee-heavy cases.

B. Cases That Are Pursued May Be Pursued Suboptimally

Once the case is filed, investment of attorney time will logically be more attractive than investment of cash for costs because time is multipliable while costs are not. Litigation incentives may thus be distorted. A critical example of this is the use of legal process outsourcing vendors (LPOs).[60] There are certain functions that nonlawyers under the supervision of a lawyer may perform in a class suit, such as work coding and searching discovery documents. A cost-conscious firm could outsource these tasks to an LPO, perhaps even one in another country where the labor costs are lower than in the

59. There may be additional benefits to pursuing high cost cases that our analysis does not capture. For example, we do not account for the effects of competition among law firms for position in cases, which may prompt firms able to fund higher cost litigation to pursue it, knowing such cases will present less crowded fields of plaintiffs' firms jockeying for position (and thus for the opportunity to control the allocation of work and the fees that flow from leadership and work).

60. *See* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 08-451, at 1–2 (2008) ("Many lawyers engage other lawyers or nonlawyers, as independent contractors, directly or through intermediaries, on a temporary or an ongoing basis, to provide various legal and nonlegal support services. Outsourced tasks range from the use of a local photocopy shop for the reproduction of documents, to the retention of a document management company for the creation and maintenance of a database for complex litigation, to the use of a third-party vendor to provide and maintain a law firm's computer system, to the hiring of a legal research service to prepare a 50-state survey of the law on an issue of importance to a client, or even to the engagement of a group of foreign lawyers to draft patent applications or develop legal strategies and prepare motion papers in U.S. litigation. The outsourcing trend is a salutary one for our globalized economy. Labor costs vary greatly across the United States and throughout the rest of the world. Outsourcing affords lawyers the ability to reduce their costs and often the cost to the client . . . .").

United States. Yet the disparate treatment of fees and costs rewards the use of attorney time and provides a disincentive to choose nonlawyer providers of services. Table 3 demonstrates this by comparing the costs and returns of three options: (1) outsourcing the work to an LPO, paying for it on a flat fee basis, and using a small amount of attorney time to supervise the LPO; (2) hiring contract lawyers to perform the work with negligible supervision; and (3) having a staff attorney perform the work.

TABLE 3: COSTS AND RETURNS ON LAWYERS VS. LPOS

	Option 1 – LPO	Option 2 – Contract Attorney	Option 3 – Staff Attorney
Cost to Firm	$25,000 flat fee + $5,000 attorney time (100 hours at $50 per hour) = $30,000	$25,000 (1,000 hours at $25 per hour)	$50,000 (1,000 hours at $50 per hour)
Costs Billed to Class	$25,000	$0	$0
Lawyer Billed to Class (2 multiplier)	$32,500 fees (100 hours at $325 per hour) × 2 = $65,000	$225,000 (1,000 hours at $225 per hour) × 2 = $450,000	$325,000 (1,000 hours at $325 per hour) × 2 = $650,000
Total Paid by Class	$90,000	$450,000	$650,000
Net Profit	$60,000	$425,000	$600,000

Table 3 shows that class action firms have little incentive to outsource work to less costly LPOs; the firm will realize a profit utilizing either contract attorneys or staff attorneys, while the only profit available in the use of LPOs is that of the time of the attorney supervising the LPO. This hurts the class in two ways, one micro and one macro. In a particular case, it drives the class's recovery down, as the attorneys' extra lodestar justifies a higher fee; with each dollar of the fee coming out of the class's returns, the class's recovery is thereby diminished. More globally, it skews resources toward cases where lawyers can run up their time and away from cases that could be easily handled by nonlawyers. This effect may be diminished by counsel's risk factor—if the case is a risky one, a risk-averse lawyer may take the cheaper route, even if her return is less, so as to hedge her bets. However, for that very reason, attorneys are likely to gravitate towards less risky cases—for example, following government enforcement actions or investing in pharmaceutical cases after the FDA has removed a drug from the market—and then run up their time in those cases.

The LPO example is not an isolated one. The incentive to steer nonlawyer work to lawyers affects a variety of litigation investment choices. For example, the disparity in rewards on time and cost investment may prompt lawyers to:

- Review medical records that would be better screened by medical professionals in the first instance;
- Handle routine client contacts that nonlawyer professionals could cost-effectively handle; or
- Respond to routine questions arising out of class notice programs that third-party notice vendors could more efficiently handle.[61]

C. Cases May Be Settled Prematurely

Because attorneys receive relatively little reward for their cost investments, they may be tempted to settle cases on the eve of such investment points. For example, a firm may:

- Work a case through motion practice, but settle before investing significantly in outside experts;
- Avoid or defer moving for class certification, although such certification would give it settlement leverage, if it were going to be required to pay the costs of notice of a litigation class—costs that would normally be shouldered by the defendant in the event of a settlement; or
- Pursue a case to the point of trial but settle before investing significantly in such a trial.

A rich literature demonstrates how *fee* structures create incentives for class counsel to settle prematurely.[62] This well-chronicled agency

61. To some extent, courts may guard against efforts by counsel to pad their lodestar by having lawyers perform administrative or other "nonlawyer" tasks by reducing the billing rate or number of hours billed, especially in lodestar cases where the attorney hours are more carefully scrutinized. *See, e.g.*, Ryan v. Allied Interstate, Inc., 882 F. Supp. 2d 628, 635–37 (S.D.N.Y. 2012) (reducing lodestar in a fee-shifting case on ground that attorneys engaged in less skilled work that could have been performed by nonlawyers). However, such oversight taxes limited court resources, and for that reason may not be particularly effective. *See* Court Awarded Attorney Fees, Report of the Third Circuit Task Force, 108 F.R.D. 237 (1985) (identifying as two of several deficiencies of the lodestar method first, that it consumes limited judicial resources by imposing a time-intensive gatekeeping function, and second, that it encourages various forms of padding). See also John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff As Monitor in Shareholder Litigation*, LAW & CONTEMP. PROBS., Summer 1985, at 5, 35 ("If the defendant agrees not to object to the plaintiff's fee request, there is little prospect that the court will engage in an elaborate inquiry into the reasonableness of the hours expended by the plaintiff's attorney.").

62. *See, e.g.*, Coffee, *supra* note 50, at 684–90; 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, 22 (1991) ("Finally, consider incentive effects in class and derivative litigation. The lack of monitoring and the relative inefficacy of bonding in these settings would not be especially problematic if the interests of plaintiffs' counsel were closely aligned with those of their clients. Unfortunately, there is a substantial deviation of inter-

problem has two principal facets, both flowing from the asymmetry between the interests of class counsel and the class members. First, the lawyer has an incentive to invest too little in class litigation. The lawyer advances her time, but is entitled to only part of the class's return (i.e., whatever amount a court ultimately awards class counsel as part of the fee award).[63] Because fees are only a fraction of the overall award, attorneys will predictably be inspired to invest time only to the point where each additional hour of time produces a fee that is equal to or greater than what the attorney can earn investing her time in another venture.[64] By contrast, the client prefers attorney investment until the later point at which the marginal cost to the client of additional investment (i.e., the lawyer's fee) is no longer less than the corresponding gain in settlement amount.[65] Second, class actions present an opportunity for plaintiffs' and defendants' counsel to collude, trading settlement benefits for fees. For example, if counsel's investment to date has produced a case value of $100 million, counsel may be tempted to settle for a fraction of that amount in exchange for

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ests between attorney and client. The nature of the conflict varies depending on the type of litigation involved and the procedure used in the jurisdiction for determining the attorney's fee. But at least under the existing regulatory system, the conflict remains significant in all cases.").

63. *See* Clermont & Currivan, *supra* note 50, at 544–45 ("The lawyer once again has economic interests very different from his client's. For each hour the lawyer devotes to the case, he receives 1/3 of any increase in the settlement resulting from that hour's work. However, for that hour he must forgo working an hour on some other matter, at an opportunity cost of $50. His interests suggest that he should continue to devote hours to this case only so long as each additional hour increases his fee by at least as much as his opportunity cost. When the hourly increase in his fee drops below his opportunity cost, he would do better to settle and then to shift his efforts to other matters."); *see also* Coffee, *supra* note 50, at 686 ("The key point is that the litigation stakes are asymmetric, with the defendant focusing on the judgment or settlement and the plaintiff's attorney focusing on the fee, which is typically a declining percentage of the recovery."); Dam, *supra* note 52, at 57 ("The plaintiff's financial interest is in his share of the total recovery less what may be awarded to counsel, *simpliciter*; counsel's financial interest is in the amount of the award to him less the time and effort needed to produce it." (quoting Saylor v. Lindsley, 456 F.2d 896, 900 (2d Cir. 1972))); Bruce L. Hay, *Contingent Fees and Agency Costs*, 25 J. LEGAL STUD. 503, 509 (1996) ("As is well known, the lawyer who owns only a fractional interest in the claim will invest less in the claim than someone who owns the entire claim.").

64. *See* Coffee, *supra* note 50, at 688–89 (mapping attorneys' investment incentives); *see also* Macey & Miller, *supra* note 62, at 25 ("Attorneys compensated on a percentage method have an incentive to settle early for an amount lower than what might be obtained by further efforts. The attorney who puts in relatively few hours to obtain an early settlement is likely to earn a much greater compensation per hour of effort than an attorney who expends greater efforts and litigates a case to the point where the plaintiffs' recovery is maximized." (footnote omitted)).

65. *See* Coffee, *supra* note 50, at 687 n.55, 689 fig.A (citing and discussing Clermont & Currivan, *supra* note 50, at 544). The socially optimal investment point is somewhere between the attorney's and client's preferred investment points. *See id.* at 689–90 (explaining that at the socially optimal investment point, "any further expenditure of effort will involve marginal costs greater than the marginal increment in the settlement's size and hence will normally result in social inefficiency (even if it is still in the client's interest to continue the action, because the client receives the marginal gains but does not incur the marginal costs)").

defendant's explicit or tacit agreement to support (or at least not object to) a higher fee.[66]

Cost investments suffer the same agency problems, but the effect is even more pronounced. First, because costs are not directly profitable, and because the relationship of cost investment to any fee award is unclear and muted, firms lose the incentive to pursue additional cost investment at an earlier point than with regard to time investment. That is so because the additional cost investment—which is unable to generate direct profits—more quickly reaches the point where the next unit of investment produces less of a return than could be earned in another venture. Second, class counsel is never more susceptible to inducements to accept a sweetheart deal at the expense of class members than when faced with a looming and substantial cost investment, given that the return on money investment in litigation is so unappealing to the investing firm.

D. Summarizing Cost Effects

In sum, our current jurisprudence concerning fees and costs incentivizes firms to invest in time but not costs. This means that cost-intensive cases are not pursued, that cost-effective measures are not taken in pursuing the cases that are brought, and that counsel is likely to settle a case on the eve of a large cost investment. These three outcomes are suboptimal from the class's perspective—some classes are never even formed because their claims are too cost heavy to pursue, and other classes' claims are litigated at too high a fee (or price) or settled at too low a recovery.

IV. CORRECTING COST EFFECTS: COST PROFITS

A jurisprudence that rewards cost investments would begin to ameliorate the problems identified in the previous Part, thereby encouraging firms to pursue cost-heavy cases and to do so in a manner that better aligns with class members' interests. To achieve those goals, courts would first have to identify mechanisms for enabling profits on costs. Toward this end, we identify four approaches to cost profits—

66. *See, e.g.*, John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877, 883 (1987) ("The classic agency cost problem in class actions involves the 'sweetheart' settlement, in which the plaintiff's attorney trades a high fee award for a low recovery."); Hay, *supra* note 63, at 1436 ("The central agency problem in class action settlements may be stated simply. There is some amount of money that the class members will recover, in expected terms, from the defendant if the case goes to trial. The defendant and the class counsel have a financial incentive *to split that amount between themselves* by settling the case and giving the class members as little as possible.").

mark-to-market, cost-plus contracts, cost multipliers, and fee multipliers for cost investments—and analyze their relative strengths and weaknesses.

A. Mark-to-Market

A mark-to-market approach would provide firms with a market rate for their cost investments, regardless of their actual costs. The category of cost investment where class counsel are most likely to experience a gap between their own costs and market rates is those costs categorized as in-house services, such as copying. If it costs a firm, for example, three cents per page for copying, but the market rate at Kinko's is ten cents per page, the firm could charge ten cents per page.

This approach bridges some of the differential in fees and costs in some situations (notably, with regard to in-house services), but does little to address the problems with respect to investment in a more significant cost category, disbursements to third parties. Thus, as to cases that are not brought because of their cost-heavy nature,[67] the mark-to-market approach provides little further incentive for investing in, say, an expert's plume study because the "market rate" for plume studies is likely to be precisely whatever class counsel already pays and is reimbursed for in these cases. Similarly, a mark-to-market approach is unlikely to counter incentives to settle prematurely or suboptimally as, on the eve of a large cost investment, a firm will not alter its behavior if the investment (e.g., in experts for trial) will just return the market rate paid to these experts. Mark-to-market alone is therefore insufficient to generate optimal cost investments in the most troubling situations.

B. Cost-Plus

A fixed markup approach would enable firms to recover a fixed profit, such as 10%, above their costs, through an *ex ante* arrangement with the court made, for example, at the time interim class counsel is appointed.[68] This approximates a "cost-plus" approach to sales contracts generally.

Like the mark-to-market approach, this bridges some of the differential between fees and costs in some situations by making cost investment at least competitive with nonlitigation investment. However, the cost-plus approach does not fully address the current regime's disproportionate rewarding of time versus cost investment. That is, a 10%

67. *See supra* Part III.A.
68. *See* FED. R. CIV. P. 23(g)(3).

across-the-board cost return makes cost investment more alluring than, say, parking cash in a savings account, but it does not come close to the direct profit available on time investment. The cost-plus approach is thus unlikely to make cost-effective money investments—for example, steering work to LPOs—more attractive than relatively cost-ineffective (but profitable) investments of attorney time, as the markup on the firm's lodestar and the possibility of a multiplier will likely outweigh the plus in the "cost-plus." Similarly, the cost-plus approach may move class counsel's and class members' preferred case-investment points closer together, but will not fully bridge the gap, because even with a direct cost profit, counsel's stake in the litigation outcome remains a fraction of the class's stake. Of course, in the cost-plus approach, a lot turns on the quantity of the plus. We return to this point below, as it suffuses the following option as well.

C. Cost Multipliers

Courts could apply multipliers to cost investments that parallel multipliers currently awarded on time investment (lodestar)—if attorneys are deserving of a 2 multiplier for their fees (that is, double their lodestar), they would receive a 2 multiplier for their costs. Cost multipliers are just a version of cost-plus contracts with two distinctions. First, a cost-plus contract may be enacted *ex ante* while a cost multiplier is awarded by a court *ex post*; this creates a greater risk for the investor and hence requires a greater reward.[69] Second, multipliers (in fee jurisprudence) tend to hover in the 1.5 range,[70] whereas the term "cost-plus" rarely imagines the plus being as high as 50%.

Cost multipliers appear at first glance to level the playing field between cost and time investments: if the multiplier were set at the same level, one might think an investor should be indifferent between the choices. But looks may be deceiving. This is so for two reasons: first, because costs are often relatively small, a firm sensing a strong case might want to invest heavily in that case and fees enable this in ways costs do not; and second, as argued throughout this Article, fee multipliers are often icing in that the lodestar itself embodies a profit.[71]

69. That is, 100% certainty of a 10% markup equals 1.1 (1×1.1), while to generate that return with only a 60% chance of recovery, the promised markup/multiplier would need to be 83% or 1.83 ($.6 \times 1.83$).

70. *See* Eisenberg & Miller, *supra* note 2, at 272 tbl.14 (mean multiplier 1.81); *see also* Fitzpatrick, *supra* note 29, at 833–34 (mean multiplier 1.65).

71. The first of these two factors—the higher numbers on the fee side—is somewhat of a fudge as it does not describe any differential treatment of costs and fees; however, it captures the fact that there is generally more opportunity to profit from fees in a given case than there are opportunities to profit from costs. This privileging of fee investments should be offset by the

Cost multipliers cannot level the field unless they, too, employ both a markup and a multiplier. Table 4 demonstrates the point by using the same hypothetical data from Table 3 but adding in a cost multiplier equal to the fee multiplier.

TABLE 4: COSTS AND RETURNS ON LAWYERS VS. LPOS
(WITH COST AND FEE MULTIPLIERS SET AT 2)

	Option 1 – LPO	Option 2 – Contract Attorney	Option 3 – Staff Attorney
Cost to Firm	$25,000 Flat fee + $5,000 attorney time (100 hours at $50 per hour) = $30,000	$25,000 (1,000 hours at $25 per hour)	$50,000 (1,000 hours at $50 per hour)
Costs Billed to Class (2 multiplier)	$25,000 × 2 = $50,000	$0	$0
Lawyer Billed to Class (2 multiplier)	$65,000 (100 × $325 × 2)	$450,000 (1000 × $225 × 2)	$650,000 (1000 × $325 × 2)
Total Paid by Class	$115,000	$450,000	$650,000
Net Profit	$85,000	$425,000	$600,000

Table 4 shows that with a cost multiplier, the profit in using the LPO goes from the $60,000 it was in Table 3 (with no cost multiplier) to $85,000 (with the cost multiplier). While that is a 42% increase in profit, the LPO profit still pales in comparison to the firm's profit were it to use a contract or in-house attorney because of (1) the higher numbers on the fee side and (2) the profit already built into the lodestar. While it is true that the firm has to risk more money to make the fee profit, its risks are muted by the lodestar-profit effect—a risk-averse firm can invest in contract attorneys and for a lower investment ($25,000 as opposed to $30,000) realize a far greater return ($450,000 rather than $65,000) than the firm investing in an LPO. A firm willing to put $50,000 into a staff attorney—which may have collateral benefits, or else firms would always hire contract attorneys—could up the total of its return to $650,000. Our model therefore predicts that even with direct cost profits, firms may not invest in more cost-effective LPOs but may instead move toward contract or staff attorneys. This intuition tracks current practice pretty well. To get firms to invest in

risk—the more a firm invests in the case, the greater its downside should it lose. But the lodestar markup counters that risk rather significantly in how it doubly rewards the fee investments.

costs, something beyond cost multipliers themselves may be necessary.

As with the other forms of cost profits we have examined, a cost multiplier also goes part of the way to more closely aligning the interests of class counsel and the class in terms of the level of case investment and the timing of settlement; however, because the combined fee and cost award is still always a fraction of the overall recovery for the class, class counsel's and the class members' asymmetric litigation stakes will still require courts to guard against self-seeking behavior by class counsel regarding the timing and amount of settlements.

D. Fee Multipliers for Cost Investments

A fourth approach to rewarding cost investments would be to enable *fees* to be multiplied if a firm could demonstrate a significant investment in *costs*. This approach would harness the lodestar-profit effect that privileges time investments in the first place and attach that effect to cost investments.

Interestingly, practice slouches in this direction in two ways. First, lawyers in private practice who negotiate arrangements for jointly pursuing cases often build into their contracts a fee reward to the investor firm that outstrips the size of the investment itself and reflects the intuition that a higher share of the fee is the only way to reward the cost investment.[72] Second, as discussed above,[73] fee jurisprudence identifies risk—which can often be cost investment—as a factor in reward, including a multiplied reward. Both of these practices are currently fairly marginalized, however. Rewarding cost investors with fees immediately runs into two ethical hurdles: (1) fees can only be shared among lawyers, so the market of potential cost investors is limited; and (2) in many jurisdictions, fees can only be shared relative to the services rendered, with few ethics rules or allocating courts considering or giving much weight to the cost investment itself as a service. Rewarding a single firm's cost investments by augmenting its multiplier is but a crude current practice because there is scant jurisprudence on what it means to make a meaningful cost investment. Moreover, this approach would, hand-in-hand with encouraging cost investments, simultaneously encourage firms to run up their lodestar, as the latter is the basis for what will be multiplied due to the former.

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72. *See supra* notes 39–49 and accompanying text.

73. *See supra* notes 36–37 and accompanying text.

V. Getting Started Correcting Cost Effects

While none of the methods described in the preceding Part will eradicate the bias against cost investments in class action lawsuits, effectuation of any of them would begin to soften the negative effects of that bias. In the following subparts, we recommend steps that courts could begin to consider and examine some of the potential downsides of those effects.

A. First Steps

We recommend that courts consider some or all of the following measures, all of which are doctrinally feasible under current fee and cost doctrine:

- At the outset of class action lawsuits, if courts are discussing fee structures with class counsel, they should explicitly advise counsel that investment in costs that benefit the class will be rewarded.
- As fee multipliers currently reward risks, including the risk of cost investments, there is already a toehold in current doctrine for cost profits, albeit indirectly. To strengthen this practice, courts should develop a fee jurisprudence that focuses more intently on the risk factor for fee multipliers and takes seriously the extent to which cost investments ought to trigger fee multipliers. Counsel that can demonstrate to courts that particular cost investments benefited the class ought to be presumptively rewarded for that with some fee multiplier. If courts extract this part of the fee equation and discuss it more explicitly, a jurisprudence will develop that begins to explicate particular types of cost investments warranting fee multipliers, and that will in turn have a more meaningful impact on attorney case investment decisions.
- Alternatively, courts should consider rewarding costs directly with cost markups and multipliers. Such rewards would be more defensible under current ethics doctrine if counsel advises the class representatives and court of the need for them in particular cases at the outset of those cases and secures that approval *ex ante*. And of course any cost reward would have to be reasonable in size and ensure that the class's total payout for fees *and* costs does not become unreasonable. Thus, for example, if a cost is rewarded directly, there might be no reason to award a fee multiplier for the same cost investment—and the same risk.
- Ethics rules on fee sharing among lawyers should more clearly and expressly permit the division among counsel to rely on both time and cost investment, without privileging time investment. Relatedly, courts should understand the value of private arrangements among counsel that reward costs and deem such contracts presumptively enforceable—or at least not presumptively unenforceable.

- Courts and ethics counsel should consider easing the restrictions, if any, that might prohibit counsel from sharing cost profits with nonlawyers. If any of our proposals for directly rewarding costs were put into practice, such cost profits ought to attract investors. There is no strong reason for limiting investment in costs to lawyers alone given that cost investors would likely not control a significant enough piece of a case to skew counsel's incentives away from the class's best interests.

These steps are culled from our initial overview of the available mechanisms to reward costs. As such, they are a first thought experiment in need of refinement and development over time. Nonetheless, they identify ways in which the legal system might provide access to more justice for litigants in high-cost situations.

B. Potential Problems

As with all new ideas, effectuating changes in fee and cost structures runs the risk of creating perverse incentives, incentives that weaken the strength of the suggestions we make in this Article. We preliminarily note several potential concerns our suggestions raise and identify some ways that these negative consequences might be contained.

First, we argued above that the most effective means of rewarding cost investments is to enable a fee multiplier for such investments. Yet this recommendation immediately has a perverse effect: counsel, aware that their cost investments will trigger a fee multiplier, now have yet another incentive to run up their lodestar. Courts using costs as a basis for fee multipliers need to guard against this outcome, perhaps by checking the total lodestar more closely and comparing it to similar cases. That said, we are aware that courts often lack the time or ability to engage in this level of lodestar micro managing. It might therefore require more of a long-term, scholarly, empirical analysis to see if the introduction of fee multipliers for cost investments leads to significant upticks in lodestars.

Second, if courts were to penalize cost investments that were poorly made using a *negative* cost multiplier—as they occasionally apply negative fee multipliers—this might discourage investment in costs and counter our efforts to encourage such investments in certain cases. This is not to say that negative cost multipliers would never be warranted, simply that they provide a complicating factor to this analysis.

Third, by creating a new investment center for lawsuits, our proposals trigger two conventional ethical and policy concerns: (1) that such investment opportunities will not create a more optimal array of case types but will create over-litigation and (2) that cost investors will wield too much control of individual litigation decisions. There is a rich literature on both of these points that we need not replay here,[74] but courts will obviously need to be wary of these problems should they start down the paths we propose.

Fourth, as with all new ideas—particularly those involving lawyers' incentives—there will surely be a range of unintended consequences of our proposals, consequences we cannot therefore identify.[75] That of course suggests that there be periodic reassessments of any moves in this direction or possibly time-limited trial runs with various suggestions in particular jurisdictions to see how they work in practice.

VI. Conclusion

Law firm partners make a profit by charging their associates' time at higher rates than they pay their associates and, in class action cases, by occasionally realizing a multiple of their lodestar to reward the risk they took in pursuing the case on a contingent fee basis. It is these profits that attract lawyers to pursue plaintiff-side law practices. Legal doctrine enables these rewards precisely to encourage lawyers to do just that, as such lawyers supplement public law enforcement as private attorneys general.

Our current jurisprudence, however, skews the incentives of private attorneys general by rewarding their time investments more directly and generously than their cost investments. That disparity discourages private attorneys general from investing in cost-intensive cases, from staffing cases most efficiently, and from settling cases at optimal points.

This Article has described those skewed effects and provided a series of initial recommendations to attempt to correct them. Our goal

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74. *See, e.g.*, Steven Garber, RAND Corp., Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns 28 (2010), *available at* http://www.rand.org/content/dam/rand/pubs/occasional_papers/2010/RAND_OP306.pdf ("[S]ome have argued that availability of ALF will increase the number of lawsuits filed or, synonymously, increase the 'quantity' or 'volume' of litigation."); *id.* at 18 ("[S]ome have raised concerns that ALF will lead ALF suppliers to influence decisions by claimants and their lawyers in inappropriate ways."); ABA Comm'n on Ethics 20/20, Informational Report to the House of Delegates 17–26 (2011), *available at* http://www.americanbar.org/content/dam/aba/administrative/ethics_2020/20111212_ethics_20_20_alf_white_paper_final_hod_informational_report.authcheckdam.pdf (reviewing potential ethical problems associated with ALF, including conflicts and interference with the attorney's independent judgment).

75. For example, the Private Securities Litigation Reform Act of 1995 was widely seen as aimed at breaking the grip of certain firms, including most notably Milberg Weiss, but had as one unintended consequence the effect of increasing the position of that very firm in securities litigation. *See, e.g.*, A. A. Sommer, Jr., *Preempting Unintended Consequences*, Law & Contemp. Probs., Summer 1997, at 231, 231.

has been not just to describe and prescribe, but to suggest that our justice system is falling short of its ideals to the extent that its costs jurisprudence discourages the filing and optimal pursuit of meritorious, but high-cost, lawsuits.