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FINANCIAL ARRANGEMENTS IN CLASS ACTIONS, AND THE CODE OF PROFESSIONAL RESPONSIBILITY

Committee on Professional Responsibility, Association of the Bar of the City of New York †

I. Introduction

The ABA Model Rules of Professional Conduct[1] (the "Model Rules") and its precursors, the ABA Code of Professional Responsibility[2] (the "Code") and the Canons of Professional Ethics[3] (the "Canons"), evolved in the context of a lawyer, probably a sole practitioner, advocating the cause of an individual client, generally in a litigated dispute, for a fee.[4] The New York Code of Professional Responsibility[5] (the "New York Code"), based as it is on the Code and the Canons, reflects a similar vision. The various codes developed a series of guidelines covering the payment of fees and disbursements designed to preserve the role of the lawyer as a zealous, though somewhat disinterested, advocate of his or her client's positions.[6] These rules have generally been carried through to the present. Thus, the New York Code retains rules that prohibit a lawyer from having a financial interest in a matter,[7] that prohibit contingent fees in some situations,[8] and that require a client to be responsible for court costs and other fees.[9] Parallel developments regulate fee-splitting among

† December 1992. The members of the Committee at the time this Report was written are listed in Appendix A.

1. MODEL RULES OF PROFESSIONAL CONDUCT (1983).

2. MODEL CODE OF PROFESSIONAL RESPONSIBILITY (1969).

3. CANONS OF PROFESSIONAL ETHICS (1908).

4. Vincent R. Johnson, *Ethical Limitations on Creative Financing of Mass Tort Class Actions*, 54 BROOK. L. REV. 539, 541 n.3 (1988) (citing GEOFFREY HAZARD, ETHICS IN THE PRACTICE OF LAW XV (1978)); *see also* CHARLES W. WOLFRAM, MODERN LEGAL ETHICS § 2.6.2, at 54-55 (1986).

5. N.Y. COMP. CODES R. & REGS. tit. 22, § 1200 (1992) [hereinafter N.Y. CODE OF PROFESSIONAL RESPONSIBILITY].

6. But see Thomas D. Morgan, *The Evolving Concept of Professional Responsibility*, 90 HARV. L. REV. 702 (1977), in which Professor Morgan argues that the codes are not so much expressions of high ideals as they are perhaps a self-serving device promulgated by the legal profession. Thus, he views the ban on contingent fees in criminal cases as a device to protect lawyers from being pressured by clients to bear such risks. *Id.* at 734.

7. N.Y. CODE OF PROFESSIONAL RESPONSIBILITY, *supra* note 5, DR 5-103(a).

8. *Id.*

9. *See id.* DR 5-103(b).

lawyers,[10] prohibit fee-splitting between lawyers and non-lawyers,[11] and mandate that fees bear a reasonable relationship to the services performed.[12]

Lawyers representing plaintiffs in class actions are increasingly finding that the needs of the class action—particularly as to funding and other financial arrangements—are in conflict with the Code. Unlike the paradigm on which the various codes are based, plaintiffs in class actions are usually remote, often nameless and have no meaningful economic interest in pursuing individual claims. Furthermore, class actions can be extremely expensive to carry to the point where recovery of costs can be realized from a settlement fund or judgment. In recent years, federal courts have begun to favor the public policy considerations supporting class actions when the financial needs of the class action have come in conflict with the Code.

The evolution of the modern class action began with the adoption of the Federal Rules of Civil Procedure in the late 1930's and accelerated dramatically after the amendments were promulgated in 1966, particularly the adoption of Rule 23(b)(3).[13] The basic theory behind Rule 23, and the old Equity Rule 38 from which it was drawn, was that it allowed more efficient adjudication in situations where a large number of claimants sought relief based on the same facts. Secondarily, class actions held the promise of permitting vindication of claims that, assessed individually, might not be economically justified in light of the costs of litigation. Thus, class action lawsuits serve broad remedial goals and also promote efficiency by avoiding multiplicitous lawsuits over the same issue.[14]

The prosecution of a class action raises conflicts between a broad, remedial approach to civil justice and the simple model from which the Code evolved.[15] As the demands of administering large complex class action litigation come in conflict with the paradigm, traditional concepts need to be rethought or amended in the interests of furthering the social benefits of class actions.

Although the early skirmishes between the needs of class actions

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10. *Id.* DR 2-107.

11. *Id.* DR 3-102.

12. N.Y. CODE OF PROFESSIONAL RESPONSIBILITY, *supra* note 5, DR 2-106.

13. FED. R. CIV. P. 23. *But see* Arthur R. Miller, Comment, *Of Frankenstein Monsters and Shining Knights: Myth, Reality, and the "Class Action Problem"*, 92 HARV. L. REV. 664 (1979) (arguing that the proliferation of class actions following the 1966 amendments was basically unrelated to the amendments to Rule 23).

14. *See generally* Stephen C. Yeazell, *Collective Litigation as Collective Action*, 1989 UNIV. ILL. L. REV. 43.

15. David Rosenberg, *Class Actions for Mass Torts: Doing Individual Justice by Collective Means*, 62 IND. L.J. 561 (1987).

and the Code were generally decided in favor of the Code,[16] the Code is increasingly seen as creating unwarranted roadblocks to the financing and maintenance of class actions. Thus, in a line of cases concerning financial incentives to class representatives, the federal courts have permitted such payments when class representatives take more risks than other members of the class or when they put more effort into the prosecution of class actions than the usual class representative could be expected to provide. Similarly, in a line of cases culminating in *Rand v. Monsanto Co.*,[17] federal courts have found the Code's prohibition against advancing costs on behalf of clients inapplicable if it serves as an impediment to prosecuting the case as a class action. Finally, in the *Agent Orange* case,[18] a federal district court and the Second Circuit Court of Appeals considered the propriety of "creative financing by the attorneys" whereby attorneys could be allowed to "invest" in the action and receive a rate of return on their investment apart from the time and effort the attorney put into the litigation.[19]

The following three sections of this report address these issues raised by the conflicts between the need to finance and maintain a class action and the restrictive provisions of the Code.[20]

II. Ethical Considerations of Plaintiff Incentive Awards

Incentive awards for named class representatives have attracted increasing attention and some criticism.[21] Incentive awards are allot-

16. *See, e.g.*, *In re* Mid-Atlantic Toyota Antitrust Litig., 93 F.R.D. 485 (D. Md. 1982).

17. 926 F.2d 596 (7th Cir. 1991).

18. *In re* "Agent Orange" Prod. Liab. Litig., 611 F. Supp. 1452 (E.D.N.Y. 1985), *rev'd*, 818 F.2d 216 (2d Cir.), *cert. denied*, 484 U.S. 926 (1987).

19. *Id.* at 1462; *see* Johnson, *supra* note 4, at 552-53.

20. This report does not discuss the effect that the Code may have on non-financial aspects of prosecuting a class action, such as issues of solicitation of class members, and disqualification on grounds of conflict of interest. Class actions raise other ethical issues that are not discussed in this report. *See, e.g.*, Gulf Oil Co. v. Bernard, 452 U.S. 89 (1981) (upholding reversal of district court order, which had completely banned all communications between plaintiffs' attorneys and potential class members without prior judicial approval, as a violation of First Amendment); *In re* "Agent Orange" Prod. Liab. Litig., 800 F.2d 14, 19 (2d Cir. 1986) (stating that, in the context of class action litigation, the traditional rule of disqualifying an attorney from representing one of two or more former joint clients whose interests subsequently become adverse must give way to a balancing test for resolving questions of disqualification; a strict disqualification rule "would substantially diminish the efficacy of class actions as a method of dispute resolution").

21. *See* Andrew Blum, *Class Actions' New Wrinkle: Bonus Awards*, NAT'L L. J., Oct. 7, 1991, at 1; *Categories of Incentives*, NAT'L L. J., Oct. 7, 1991, at 38; Clinton A. Krislov, *Scrutiny of the Bounty: Incentive Awards for Plaintiffs in Class Litigation*, 78 ILL. B. J. 286 (1990), *available in* Westlaw, ILJB Database; Jerold S. Solovy et al., *The Head of the Class*, NAT'L L. J., Aug. 27, 1990, at 13; *see also* Jonathan R. Macey and Geoffrey P.

ments to named plaintiffs in class actions over and above the amount of any judgment received by the other members of the class. Courts which have awarded such bonuses have done so for three reasons: 1) to compensate for the initiation and maintenance of the lawsuit and as a means to encourage a particular type of litigation; 2) to compensate for consultative services rendered in the litigation—services which require something greater than the regular obligations of a class representative; and 3) to compensate for stronger individual claims on the merits.

This Committee believes that while incentive awards can serve laudable purposes, such awards may in some cases encourage meritless litigation or raise possible conflicts between named plaintiffs and their fellow class members as well as their lawyers. The challenge is to work out guidelines that will permit such awards only in appropriate cases.

A. Compensation for Being a Plaintiff

1. The Cases

The most frequent rationales for approving incentive awards to class action plaintiffs are: 1) to compensate them for the time and effort spent preparing for the litigation; and 2) to compensate them for assuming the financial risk of the costs of the litigation.[22]

Courts have been particularly willing to award such compensation to reward individual plaintiffs for accepting personal risks and to encourage particular types of litigation. In civil rights cases, for example, courts typically cite as a reason for incentive awards the significant benefits afforded the class members of having their rights protected, and the courage exhibited by the named plaintiff in bringing the action in the face of possible personal repercussions.[23]

Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 65 n.194 (1991).

22. *See, e.g.*, Enterprise Energy Corp. v. Columbia Gas Transmission Corp., 137 F.R.D. 240, 251 (S.D. Ohio 1991); *In re* Dun & Bradstreet Credit Servs. Customer Litig., 130 F.R.D. 366, 374 (S.D. Ohio 1990); Golden v. Shulman, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,060, at 90,954 (E.D.N.Y. 1988).

However, the need to provide an incentive for a plaintiff to assume the cost of litigation has been minimized by recent authority allowing plaintiffs' attorneys to advance expenses of the litigation with the expectation that the lawyer will be reimbursed only if the plaintiff is successful. *See* Rand v. Monsanto Co., 926 F.2d 596, 600 (7th Cir. 1991). For example, the Court of Appeals for the Seventh Circuit recently affirmed the denial of an incentive award because, among other reasons, the named plaintiff "bore [only] a slight risk of being made liable for sanctions, costs, or other fees . . . ." *In re* Continental Ill. Secs. Litig., 962 F.2d 566, 571-72 (7th Cir. 1992)(citing *Rand*, 926 F.2d 596).

23. *See In re* Jackson Lockdown, 107 F.R.D. 703, 710 (E.D. Mich. 1985) (awarding

The named plaintiffs in *In re Jackson Lockdown*[24] and *Women's Committee for Equal Employment Opportunity v. National Broadcasting Co.*[25] are typical of the class representatives who have been awarded incentive compensation. In *Jackson Lockdown*, state prison inmates initiated a complaint against prison officials for unjust treatment during a "lockdown" in response to a prison riot. The class action was brought despite the named plaintiffs' valid fear of retaliation. The court described the named plaintiffs as "active protesters [as] contrasted to [plaintiffs who later joined the suit] who were merely passive and indicated no particular desire to bring an end to a discriminatory policy."[26] In *Women's Committee*, the named plaintiffs risked losing their jobs by creating and funding the organization that commenced the employment discrimination action.[27]

Courts have also been willing to award bonuses to representative plaintiffs in securities and antitrust cases to encourage such suits. For example, in *Sherin v. Smith*[28] and *In re Continental/Midatlantic Shareholders Litigation*,[29] the courts found that the plaintiffs had helped enforce the federal securities laws by bringing the suits. In *In re First Jersey Securities, Inc. Securities Litigation*,[30] the court gave as one of its reasons for approving an incentive award the fact that the plaintiff had braved personal risk; the defendant had threatened him with a sizable counter-suit.

The reason most frequently given for incentive awards in this category of cases is the effort required of the named plaintiff in an action which ultimately benefits the entire class. For example, in *Huguley v.*

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bonus to "reward[] members of a class who protested and helped bring rights to a group who had been victims of discrimination" in suit for violation of prisoners' rights); Women's Comm. for Equal Employment Opportunity v. National Broadcasting Co., 76 F.R.D. 173, 181 (S.D.N.Y. 1977) ("[T]he prospect of a substantial personal recovery will encourage aggrieved persons to bring lawsuits which are likely to advance the national policy of eliminating discrimination in employment.") (Title VII action); Krislov, *supra* note 21, at 15 of 23 ("[T]hey are the reward for those who put themselves at risk on the class' behalf, sometimes when no one else knew, cared, or was courageous enough to assume the risk.").

24. 107 F.R.D. 703.

25. 76 F.R.D. 173.

26. 107 F.R.D. at 710.

27. 76 F.R.D. at 181; *see also* Lo Re v. Chase Manhattan Corp., 19 Fair Empl. Prac. Cas. (BNA) 1366 (1979) (granting separate award where plaintiff-employees "initiated this action at some risk to their own job security and to the good will of their co-workers").

28. [Transfer Binder 1987-1988] Fed. Sec. L. Rep. (CCH) ¶ 93,582, at 97,609 (E.D. Pa. 1987).

29. No. CIV.A.86-6872, 1987 WL 16678, at *7 (E.D. Pa. Sept. 1, 1987).

30. No. MDL 681, 1989 WL 69901, at *7 (E.D. Pa. June 23, 1989).

General Motors Corp.,[31] the court approved a bonus comprised of a pooled fund of over $300,000 to be shared by the eighty-eight named plaintiffs and plaintiffs prepared to act as witnesses in a Title VII case. The court reasoned that they were "entitled to more consideration . . . because of the onerous burden of litigation that they have borne."[32] Many other class members in that case—incumbent employees—received nothing but the potential benefits from future affirmative relief set out in the consent decree. The only other class members to receive any monetary compensation were ex-employees who were to share in a settlement fund for back pay.

Other, more specific reasons given for awarding compensation to the class representative are: responding to discovery requests;[33] being the first to come forward with a complaint;[34] disruption of a personal business caused by the substantial amount of time the plaintiff had to devote to the litigation;[35] and taking on class representation when an individual claim could have been more quickly and easily settled.[36]

Although incentive awards are often approved when they are requested,[37] such awards have not been unanimously and unquestionably granted. Many courts have required a named plaintiff to exert special effort—beyond that ordinarily expected of a litigant—to warrant an incentive award. For example, in *Weseley v. Spear, Leeds & Kellogg*,[38] the court noted that "[a]lthough it is laudable that plaintiff undertook to prosecute this litigation, the court perceives no circumstances warranting a special award."[39] There are also cases that have expressed reservations about the practice of awarding financial incen-

31. 128 F.R.D. 81, 85 (E.D. Mich. 1989), *aff'd*, 925 F.2d 1464 (6th Cir.), *cert. denied*, 112 S. Ct. 304 (1991).

32. *Id.*

33. *See* Golden v. Shulman, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,060, at 90,954 (E.D.N.Y. 1988); Bogosian v. Gulf Oil Corp., 621 F. Supp. 27, 32 (E.D. Pa. 1985).

34. *See In re* Dun & Bradstreet Credit Servs. Customer Litig., 130 F.R.D. 366, 374 (S.D. Ohio 1990).

35. *See id.*

36. *See* Luevano v. Campbell, 93 F.R.D. 68, 90 (D.D.C. 1981) ("A plaintiff should not be penalized for having agreed to take on the mantle of class representation. An individual settlement could most likely have been reached in this case far more quickly than the twenty-three month period it took to hammer out the class relief, and a class representative's willingness to delay individual relief in order to obtain relief for the class should not be made the occasion for requiring the representation to waive individual consideration of his or her claims.").

37. This is not so in cases where the motion for a bonus is perceived as a request by the named plaintiff for a disproportionate share of the class settlement based on a stronger individual claim.

38. 711 F. Supp. 713 (E.D.N.Y. 1989).

39. *Id.* at 720; *see also In re* Gould Secs. Litig., 727 F. Supp. 1201 (N.D. Ill. 1989)

tives, while at the same time approving a bonus in the particular case.[40] For example, the court in *Enterprise Energy Corp. v. Columbia Gas Transmission Corp.*,[41] approved the award but expressed concern with granting such bonuses arbitrarily. To allay its concern, the court set out guidelines for determining whether the class representatives had really "earned" the award. Specifically, the court noted three factors to consider: 1) whether the action led to a substantial benefit for the class; 2) whether the named plaintiff assumed a substantial financial risk; and 3) whether the amount of time and effort spent by the representative preparing for the litigation was beyond that ordinarily expected of a litigant.[42]

The Court of Appeals for the Seventh Circuit affirmed the denial of a $10,000 incentive fee to a named plaintiff in a securities class action based on an economic risk analysis.[43] The court reasoned that recovery from a common fund for expenses is usually limited to necessary expenses, such as attorney's fees.[44] The court found no need to compensate the named plaintiff because, given the minimal risk for any named plaintiff and the limited burden undertaken by the named plaintiff in the specific case (a deposition which took a few hours), the market would have produced another plaintiff willing to proceed without seeking compensation.[45]

The analysis used by the Seventh Circuit does not, of course, foreclose the possibility of an incentive award for cases in which, because of their difficult or sensitive nature, the market would not be likely to produce another named plaintiff. Since the rationale for incentive awards is to encourage named plaintiffs to prosecute class actions, the economic incentive analysis of the Seventh Circuit is eminently sound, presuming it is fairly applied. A financial incentive is a windfall to a named plaintiff in cases where other plaintiffs are equally capable and equally willing to serve. On the other hand, an incentive is needed in

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(stating that, by bringing litigation, named plaintiffs disclaim any right to preferred treatment even though they undertake extra responsibilities).

40. *See Women's Comm. for Equal Employment Opportunity*, 76 F.R.D. at 181 (stating that practice could "run afoul of the named plaintiff's duty to negotiate fairly on behalf of *all* members of the class").

41. 137 F.R.D. 240 (S.D. Ohio 1991).

42. *Id.* at 250; *see also* Harris v. Pernsley, 654 F. Supp. 1042, 1053 (E.D. Pa.) ("[T]he named plaintiff's contribution to the progress of the litigation has been especially meritorious and has justified such an award."), *appeal dismissed*, 820 F.2d 592 (3d Cir.), *cert. denied*, 484 U.S. 947 (1987).

43. *In re* Continental Ill. Secs. Litig., 962 F.2d 566, 571-72 (7th Cir. 1992)(citing *Rand*, 926 F.2d 596).

44. *Id.* at 571.

45. *Id.* at 572.

cases where a meritorious class action may otherwise never be brought.

2. *Concerns*

There are a number of possible ethical problems arising from the grant of an incentive award to named plaintiffs. However, the Committee finds these problems generally more theoretical than real. One possibility is that the prospect of a financial incentive may encourage meritless litigation. The Committee believes that this possibility is remote, for several reasons. First, there are currently rules in place which deter meritless litigation, such as Rule 11 of the Federal Rules of Civil Procedure,[46] and DR 7-102, which states that a lawyer shall not "knowingly advance a claim or defense that is unwarranted under existing law."[47] Second, as stated above, the grant of a financial incentive award is far from a certainty. The Committee does not believe that the mere possibility of a financial incentive will cause clients, or their attorneys, to ignore the sanctions against frivolous litigation.

Another possible danger is that in the hope of obtaining an incentive award, attorneys may be tempted to solicit named representatives and split the award with them. This raises the further prospect of bidding wars among attorneys for named representatives.

Solicitation using the promise of an incentive award to encourage plaintiffs to bring a lawsuit, however, would violate DR 2-103(a): "A lawyer shall not, directly or indirectly, seek professional employment . . . from a person who has not sought advice regarding employment of the lawyer in violation of any statute or existing court rule in the judicial department in which the lawyer practices."[48] Indirect solici-

46. *See generally* Committee on Professional Responsibility, *Proposed Amendments to Federal Rule of Civil Procedure 11*, 47 REC. ASS'N B. CITY N.Y. 65 (1992).

47. N.Y. CODE OF PROFESSIONAL RESPONSIBILITY, *supra* note 5, DR 7-102.

48. N.Y. CODE OF PROFESSIONAL RESPONSIBILITY, *supra* note 5, DR 2-103(a). Several New York statutes and court rules may be implicated by a promise of an incentive award. *See* N.Y. JUD. LAW §§ 479, 485 (McKinney 1983) (prohibiting attorneys from directly or indirectly "solicit[ing] . . . legal business"). In addition, each of the four Appellate Division departments makes it a violation of its rules to violate any of the provisions of the Canons of Professional Responsibility. *See* N.Y. COMP. CODES R. & REGS. tit. 22, §§ 603.2, 691.2, 806.2, 1022.17 (1992). The First Department further adds a rule that prohibits an attorney from directly or indirectly "promis[ing], giv[ing], or procur[ing] . . . any valuable consideration to any person as an inducement to placing in his hands . . . any claim for the purpose of making a claim or bringing an action . . . ." N.Y. COMP. CODES R. & REGS., tit. 22, § 603.2 (1990). An ethics opinion by the New York State Bar Association cited each of these rules as being implicated in the context of DR 2-103(a) where an attorney attempted to contact potential class members. N.Y. ST. B. ASS'N COMM. ON PROFESSIONAL ETHICS, Op. 499, 1978 WL 14162 at *2-3 (1978).

tation through another attorney would also be unethical.[49] Again the Committee is unconvinced that the contingent possibility of a limited financial incentive would encourage attorneys to violate the Disciplinary Rules concerning solicitation.

As to the possibility that financial incentives to named plaintiffs could lead to fee-splitting with non-lawyers, again the rule prohibiting such a practice is clear.[50] It is true that one court has described incentive awards as "border[ing] on permitting a lay plaintiff to share in the attorney's fees."[51] This would indeed be an arguable point if the incentive award were taken out of the amount set for attorneys' fees. In fact, however, the incentive award and the award for attorneys' fees are generally applied for and provided for separately, and hence do not run afoul of the limitation on fee-splitting.[52] Again, to the extent that there is a concern that the possibility of a financial incentive could lead the lawyer to violate a clear disciplinary rule and split the incentive award specifically granted to the plaintiff, we find this concern unfounded: an attorney is unlikely to risk an ethical violation in the hope of sharing an award that is far from a certainty and modest even if granted.

Another potential undesirable consequence of incentives is the possibility that they will lead to bidding wars to attract plaintiffs. Once lawyers begin to promise bonuses, plaintiffs could be prompted to sign up with those who promise the highest amount. As one court has stated:

> The real danger [of incentive awards] is a potentially undesirable precedent where every named plaintiff would expect a 'fee' or 'bounty' for the use of his or her name to create a class action. It is not difficult to envision a scenario . . . of prospective named plaintiffs becoming involved in a bidding war . . . with prospective class counsel.[53]

49. *See* MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 2-103(b) (1981); N.Y. CODE OF PROFESSIONAL RESPONSIBILITY, *supra* note 5, DR 2-103(b). In fact, DR 2-103(b) is even more directly on point if incentive awards for named plaintiffs are construed as fees for obtaining class clients for attorneys. DR 2-103(b) states that "[a] lawyer shall not compensate or give anything of value to a person or organization to recommend or obtain employment by a client . . . ."

50. *See* N.Y. CODE OF PROFESSIONAL RESPONSIBILITY, *supra* note 5, DR 3-102.

51. *In re* Gould Secs. Litig., 727 F. Supp. 1201, 1209 (N.D. Ill. 1989).

52. *See, e.g., id.*; Genden v. Merrill Lynch, Pierce, Fenner & Smith, 700 F. Supp. 208 (S.D.N.Y. 1988); Weseley v. Spear, Leeds & Kellogg, 711 F. Supp. 713 (E.D.N.Y. 1989); Bogosian v. Gulf Oil Corp., 621 F. Supp. 27 (E.D. Pa. 1985).

53. *Gould Secs. Litig.*, 727 F. Supp. at 1209. One commentator has argued that bidding wars are actually more harmful to attorneys than to clients, and that an ethical prohibition may be necessary to protect lawyers who would be pressured to grant a

While the possibility of bidding wars is a concern, the Committee does not believe that such a risk is serious enough to warrant a total ban on incentive awards. Since the incentive award is not granted until the class action has neared or reached completion, the trial court can at that point assess whether any improprieties have occurred in the retention of the attorney by the named plaintiff (or vice versa). The court's denial of incentive awards in cases where it appears that bidding wars have occurred should provide sufficient disincentive to clients and attorneys who may be tempted to engage in such a practice.[54]

Finally, it has been argued that incentive awards may create a conflict between the class representatives and the other class members. Incentive awards could encourage collusion and "suboptimal" class settlements, because plaintiffs with something extra to gain are not motivated to hold out for higher awards for the rest of the class.[55] However, the Committee believes that existing procedural requirements of notice to the class and judicial approval of a settlement provide sufficient safeguards against conflicts of interest and unreasonable settlements. Because of the safeguards inherent in the class action device, a ban on incentive awards is unwarranted.

B. Consultant Fees

1. *The Cases*

Consultant fees are generally intended to compensate a plaintiff for some special expertise which aided in a successful suit. For example, in *AAMCO Automatic Transmissions, Inc. v. Tayloe*,[56] the court awarded the class representative a bonus because of his expertise on the subject of AAMCO parts, which were at issue in the litigation. The court noted that the duties performed by the plaintiff went be-

higher financial incentive if they wanted to represent that client. *See* Thomas D. Morgan, *The Evolving Concept of Professional Responsibility*, 90 HARV. L. REV. 702 (1977).

54. The attorney-client privilege would not prevent the court from determining the propriety of the financial arrangement between the attorney and the named plaintiff. *See In re* Grand Jury Subpoena Served Upon Doe, 781 F.2d 238, 248 (2d Cir. 1985) (en banc) (attorney-client privilege does not protect fee arrangements).

55. *Weseley*, 711 F. Supp. at 720; Franks v. Kroger Co., 649 F.2d 1216, 1227 (6th Cir. 1981) (Merritt, J., concurring) ("We should not allow a class action device to be used as a hammer at the head of the defendant for the purpose of extracting benefits for the named plaintiffs at the expense of members of the class."); Jerold S. Solovy et al., *The Head of the Class*, NAT'L LAW JOURNAL, Aug. 27, 1990, at 13 ("The primary difficulty with incentive awards is that they raise the specter that named plaintiffs may 'sell out' the interest of the class they purport to represent.").

56. 82 F.R.D. 405 (E.D. Pa. 1979).

yond those normally assumed by a class representative.[57]

Similarly, in *Genden v. Merrill Lynch, Pierce, Fenner & Smith*,[58] the court allowed the named plaintiff in a securities fraud class action to recover for "consultative services." The court found that the plaintiff, who was also an attorney, had, by drawing upon his legal background, "played a valuable role for the . . . class . . . and should be remunerated for his efforts."[59]

However, in at least one case where the court purported to compensate plaintiffs for consultative services, it failed to distinguish between services requiring some sort of expertise and ordinary participation in the litigation. In *Bogosian v. Gulf Oil Corp.*,[60] the court claimed that the named plaintiffs "provided valuable consultative assistance," but described such assistance as "preparing for pretrial discovery" and being "subject to extensive oral depositions,"[61]—responsibilities that any representative plaintiff would have to bear. If such ordinary services warranted compensation, then every class representative would be entitled to compensation. The Committee believes that compensation to named plaintiffs for consultative assistance should be limited to those cases in which the plaintiff performs services above and beyond those provided by the ordinary class representative.

2. *Concerns*

Awards are justified in cases like *AAMCO* where the representative plaintiff actually provided valuable services over and above what named plaintiffs would ordinarily be required to provide. In a case like *Bogosian*, the court may have disguised a plaintiff's bonus by describing it as payment for consultative services when in fact the plaintiff had only performed those services any representative plaintiff would have to contribute. It may be that the court granted a bonus because it felt that such an incentive was necessary to produce a plaintiff to prosecute the class action. If that was so, it should have been specifically stated by the court. Otherwise, it appears that the court gave the plaintiff a windfall, perhaps at the expense of the rest of the class.

A more particular problem that could arise exists in cases like *Genden* where the named plaintiff is an attorney. In fact, at least one

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57. *Id.* at 409 (noting that plaintiff "personally performed extensive services in preparing the proofs of damages" in an antitrust action).

58. 700 F. Supp. 208 (S.D.N.Y. 1988).

59. *Id.* at 210.

60. 621 F. Supp. 27 (E.D. Pa. 1985).

61. *Id.* at 32.

court has already noted the possibility of the appearance of impropriety in such a situation. In *Lowenschuss v. C.G. Bluhdorn*,[62] the court disqualified a class representative because he initiated the suit in a dual capacity as both class counsel and class representative. Although the plaintiff subsequently withdrew as counsel and arranged for a substitute, he also contracted to be paid attorney's fees for his continuing legal assistance in the case. The court found a conflict of interest created by the fact that " 'the financial recovery for reasonable attorneys' fees would dwarf the individual's recovery as a member of the class.' "[63]

C. Disproportionate Share of Class Settlement

1. *The Cases*

There are cases in which the named plaintiff receives a disproportionate judgment compared to the rest of the class because the plaintiff has a better claim on the merits or has shown a greater injury. However, courts are typically more reluctant to award bonuses in the form of disproportionate shares of the class settlement than they are to award "ordinary" incentive bonuses. In *Women's Committee*, for example, the plaintiffs asserted that they had stronger claims than the rest of the class, but the court's reasons for granting the higher award were the same as those typically given for ordinary incentive awards: the plaintiffs "earned" the award because the class was going to receive significant relief and because "plaintiffs . . . instituted significant measures and undertook significant obligations . . . [including] organizing and funding [the plaintiff organization], retention of counsel, filing and prosecution of administrative complaints, and eventually compliance with defendants' discovery requests."[64]

2. *Concerns*

It is apparent from the number of cases which have criticized the award of a disproportionate share of recovery to named plaintiffs, that

62. 78 F.R.D. 675 (S.D.N.Y. 1978).

63. *Id.* at 678 (quoting Turoff v. May Co., 531 F.2d 1357 (6th Cir. 1976)); *see also* Cotchett v. Avis Rent-A-Car, 56 F.R.D. 549, 554 (S.D.N.Y. 1973) (stating that partner of lawyer for class could not be an adequate representative of class, because that would create a conflict of interest for class representative, who would benefit financially from increased attorneys' fees, which would not be in the interest of the class). Close connections between class counsel and the named plaintiff are often accepted, however. *See* Lewis v. Goldsmith, 95 F.R.D. 15 (D.N.J. 1982) (class counsel is uncle of named plaintiff); *see generally* Ronan E. Degnan, *Adequacy of Representation in Class Actions*, 60 CALIF. L. REV. 705 (1972).

64. *Women's Comm. for Equal Employment Opportunity*, 76 F.R.D. at 181-82.

courts seem to find this type of award much more problematic than "ordinary" incentive awards. The practice is usually criticized as creating conflicts between the representative plaintiff and the class members. As one court stated, "the possibility of an antagonism in interests as between plaintiffs and other class members seeking advancement could not be ignored."[65]

Courts reason that if the plaintiff wanted to pursue individual claims disproportionate to those of the class, then he or she should have brought an individual action. The plaintiff "may very well have had stronger claims than most class members, but he joined in bringing this action as a class action and, by so doing, he had disclaimed any right to a preferred position in the settlement."[66] As a fiduciary, the class representative has an obligation to protect the interests of the class with scrupulous fairness and not to prefer his or her recovery above that of all other members of the class.

D. Conclusions

The most egregious ethical violations that could arise from incentive awards are already causes for disciplinary action or other sanctions against an attorney (e.g., frivolous lawsuits, unbidden solicitation, and fee splitting). Generally speaking, the Committee believes that these existing rules sufficiently regulate the problems that may arise from incentive awards, and that any rule of law prohibiting incentive awards would unduly inhibit the prosecution of class actions.

One method of balancing the benefits of incentive awards against their possible danger is for courts to assure that such awards are modest, and thus do not create an incentive so great that an attorney may be tempted to risk the violation of an existing disciplinary rule.[67] In addition, such awards should only be made when the court supervising the award concludes, after taking all factors into account, that such an award is appropriate because of the special circumstances of the individual case. Awards should not be made as a matter of course. They should be granted only when the court finds unusual

65. Plummer v. Chemical Bank, 668 F.2d 654, 659 (2d Cir. 1982).

66. Officers for Justice v. Civil Serv. Comm'n, 688 F.2d 615, 632 (9th Cir. 1982), *cert. denied*, 459 U.S. 1217 (1983); *see* Holmes v. Continental Can Co., 706 F.2d 1144, 1147 (11th Cir. 1983); Flinn v. FMC Corp., 528 F.2d 1169, 1176 (4th Cir. 1975), *cert. denied*, 424 U.S. 967 (1976).

67. *See* Sofia C. Hubscher, *Making It Worth Plaintiffs' While: Extra Incentive Awards to Named Plaintiffs in Class Action Employment Discrimination Suits*, 23 COLUM. HUM. RTS. L. REV. 463, 464 (1992) ("[P]rudent use of incentive awards can nullify concerns regarding collusive activity and sheer mercenary behavior").

factors such as that the named plaintiff made an unusual contribution to the case (e.g., particular expertise or extraordinary time commitments), or that it was unlikely that other plaintiffs would have brought or continued the class action. Courts should also take into account whether there was unusual personal risk and whether the statutory scheme suggests that Congress intended to encourage private class actions. These principles would allow some compensation in cases where it is justified by the particular facts of the case. When used prudently, a financial award to named plaintiffs can serve a positive good: it can create a proper incentive to render active assistance during the investigative stage and at trial, and thereby promote strong case preparation and increase the chances for the class action's success.

III. The *Rand* Case: Plaintiffs' Responsibility for the Costs of Litigation

Under the common law, the offense called "maintenance" was committed when a lawyer provided the money to prosecute or defend an action. Maintenance was viewed as a lawyer's "scheme" to stir up litigation and, at various times, was considered a crime.[68] Disciplinary Rule 5-103(b) of the New York Code carries forward the prohibition of maintenance with one qualification: an attorney can advance costs on behalf of a client if the client remains responsible for the expenses.[69] DR 5-103(b)(2) provides a further exception that a lawyer representing an indigent client on a *pro bono* basis may pay court costs and reasonable expenses of litigation on behalf of the client, without any expectation of reimbursement. Model Rule 1.8(E) goes one step further by permitting attorneys to advance costs in all cases, with repayment contingent on the outcome of the litigation. New York has not yet adopted Model Rule 1.8(E).[70]

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68. BLACK'S LAW DICTIONARY 1106 (4th ed. 1957).

69. GEOFFREY C. HAZARD, JR. & W. WILLIAM HODES, THE LAW OF LAWYERING §§ 1.8:602, 1.8:1101 (2d ed. 1990).

70. New York's DR 5-103(b) now reads:

> While representing a client in connection with contemplated or pending litigation, a lawyer shall not advance or guarantee financial assistance to the client, except that:
>
> 1) A lawyer may advance or guarantee the expenses of litigation, including court costs, expenses of investigation, expenses of medical examination, and costs of obtaining and presenting evidence, provided the client remains ultimately liable for such expenses.
>
> 2) Unless prohibited by law or rule of court, a lawyer representing an indigent client on a *pro bono* basis may pay court costs and reasonable expenses of litigation on behalf of the client.

In *County of Suffolk v. Long Island Lighting Co.*,[71] a district court held that a federal court could ignore DR 5-103(b) in a class action, thus allowing the attorney for the plaintiff class to advance the costs of litigation, without the client being responsible for repayment if the suit is unsuccessful.[72] In *Lilco*, the court held that New York could be enjoined under the Supremacy Clause of the United States Constitution from attempting to enforce DR 5-103(b) against a New York lawyer who represented class plaintiffs in federal court.[73] The court stated that the ethical standards imposed upon attorneys in federal court are a matter of federal law.[74] The court recognized that the "reality of class litigation" is that it is unusual for class lawyers to seek to recover legal fees from named representatives in the event that the suit is unsuccessful.[75] The court criticized DR 5-103(b) as an "outmoded and unrealistic concept of ethics" and concluded that the application of DR 5-103(b) would unduly inhibit the prosecution of class actions, because it would make it almost impossible to find named plaintiffs willing to prosecute the action.[76] Consequently, the court found DR 5-103(b) to be contrary to the policy of Federal Rule of Civil Procedure 23, which was to encourage the prosecution of meritorious class actions.

In *Rand v. Monsanto Co.*,[77] the Seventh Circuit Court of Appeals held, consistent with *Lilco*, that DR 5-103(b) was inapplicable to a class action. Rand, the named plaintiff, thought he had a securities fraud claim for $100,000. He had apparently agreed with his lawyers to be responsible for a maximum of $25,000 in expenses. During a deposition, defense counsel pointed out that Rand's individual claim could not exceed $1,135 and that Rand's attorneys had so stated in answering an interrogatory. Following defense counsel's statement, Rand expressed his unwillingness to be responsible for the litigation expenses. The district court found Rand an inadequate class representative because his unwillingness to be responsible for litigation costs indicated to the court that he was not committed to vigorously prosecuting the claim.[78]

N.Y. CODE OF PROFESSIONAL RESPONSIBILITY, *supra* note 5, DR 5-103(b).

71. 710 F. Supp. 1407 (E.D.N.Y. 1989), *aff'd*, 907 F.2d 1295 (2d Cir. 1990).

72. *Id.* at 1414-15.

73. *Id.*

74. *Id.* at 1413 (citing *In re* Snyder, 472 U.S. 634, 643-45 & n.6 (1985)).

75. *Id.*

76. *County of Suffolk v. Long Island Lighting Co.*, 710 F. Supp at 1414.

77. 926 F.2d 596, 600 (7th Cir. 1991).

78. Rand v. Monsanto, No. 85-C9087, 1989 WL 27458 (N.D. Ill. Mar. 23, 1989), *rev'd*, 926 F.2d 596 (7th Cir. 1991).

As shown by *Rand*, the question of whether attorneys are permitted to bear the costs of

In reversing the district court, the court of appeals asserted that Rand may have been an unsuitable representative if he was unwilling to pay anything, but that the lower court had erred in finding him unsuitable simply because he was unwilling to pay everything.[79] The court stated that "no person need be willing to stake his entire fortune for the benefit of strangers", and that "no (sane) person would pay the entire costs of a securities class action in exchange for a maximum benefit of $1,135."[80] The court reasoned that since class actions typically assemble claims too small to be worth separate litigation, it would be impossible in most cases to find a plaintiff willing to risk the entire litigation cost for the chance to obtain a small recovery.[81] It therefore concluded that DR 5-103(b) was unworkable in the class action context.[82] The court characterized DR 5-103(b) as "long in the tooth", and unduly restrictive in comparison with Model Rule 1.8(E), which permits lawyers to "advance court costs and expenses of litigation, the repayment of which may be contingent on the outcome of the matter."[83] Thus, the court found DR 5-103(b) "inconsistent with Rule 23" and stated that it "may not be applied to class actions."[84]

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a class action has relevance beyond an ethical context. In order to certify the class, the court must find that the named plaintiff is an adequate representative. *See* FED. R. CIV. P. 23(a)(4). One aspect of adequacy is the ability to fund the litigation. *See* Judith L. Maute, Comment, *Class Certification: Relevance of Plaintiff's Finances and Fee Arrangements with Counsel*, 40 U. PITT. L. REV. 70 (1978). If the attorney is allowed to fund the litigation, then the attorney's finances can be considered in determining whether the class is adequately represented. *See* Cannon v. Equitable Life Assurance Soc'y, 433 N.Y.S.2d 378 (N.Y. Sup. Ct. 1980), *vacated on other grounds*, 451 N.Y.S.2d 817 (App. Div. 1982) (stating that, where counsel is permitted to fund the litigation, "whether . . . counsel can and will pay the expenses of this suit, rather than whether plaintiffs can individually afford this litigation, becomes the relevant question"). Obviously, if the finances of an attorney or law firm can be considered, it is much easier to satisfy the requirement of adequate representation, which is crucial to class certification. *See generally* 2 WEINSTEIN ET AL., NEW YORK CIVIL PRACTICE ¶901.16 (1988).

79. *Rand*, 926 F.2d at 601; *see also* Kirkpatrick v. J.C. Bradford & Co., 827 F.2d 718, 728 (11th Cir. 1987).

> Where the class is represented by competent and zealous counsel, class certification should not be denied simply because of a perceived lack of subjective interest on the part of the named plaintiffs, unless their participation is so minimal that they virtually have abdicated to their attorneys the conduct of the case. To require less would permit attorneys essentially to serve as class representatives; to require more could well prevent the vindication of the legal rights of the absent class members under the guise of protecting those rights.

Id.

80. *Rand*, 926 F.2d at 599.

81. *Id.*

82. *Id.* at 600.

83. *Id.*

84. *Id.* at 600.

Although the court's holding in *Rand* was based on the conflict between a local ethics rule and a federal rule, the outcome may have been influenced by the court's apparent disapproval of DR 5-103(b): "Indeed, so far as we can tell, DR 5-103(b) itself serves no good purpose. The ABA has jettisoned, and the states are in the process of replacing, this relic of the rules against champerty and barratry."[85] In a concurring opinion, Judge Kanne disagreed with the majority's view of DR 5-103(b):

> I do not see this relic as worthless for I do not believe that the legal profession, or the American public which it serves, is better off when lawyers are first given authority to foment litigation and then are permitted to carry on that litigation at their own cost and risk.[86]

Judge Kanne nonetheless concurred with the majority because he agreed that DR 5-103(b) was inconsistent with the policies behind Federal Rule of Civil Procedure 23, and hence that the Supremacy Clause prevented the application of the Disciplinary Rule to a Federal class action.[87]

The Third Circuit, in *Vanderbilt v. Geo-Energy Limited*,[88] held, consistent with *Rand* and *Lilco*, that there was no impropriety in an attorney's financing a class action. The court relied on a different analysis, however. It noted that DR 5-103(b) provided an exception for *pro bono* cases, and argued that it was unfair and unreasonable to allow attorneys to finance *pro bono* class actions but not other class actions. The court concluded that "while functioning as class plaintiffs the rich are entitled to the same privileges as the poor."[89]

At least one court has held, however, that DR 5-103(b) is enforceable within the federal class action context, though the decision predates the recent trend of cases relying on the policies of Rule 23 and the Supremacy Clause. In *In re Mid-Atlantic Toyota Antitrust Litiga-*

85. *Rand*, 926 F.2d at 600.

86. *Id.* at 603 (Kanne, J., concurring).

87. For an excellent commentary on the conflict between state ethical codes and the practice of lawyers in Federal courts, see Stephen B. Burbank, *State Ethical Codes and Federal Practice: Emerging Conflicts and Suggestions for Reform*, 19 FORDHAM URB. L.J. 969 (1992).

88. 725 F.2d 204 (3d Cir. 1983).

89. *Id.* at 210; *see also In re* Oracle Sec., 136 F.R.D. 639 (N.D. Cal. 1991) (permitting class attorneys to incur out-of-pocket expenses); Cannon v. Equitable Life Assurance Soc'y, 433 N.Y.S.2d 378 (N.Y. Sup. Ct. 1980) ("In this case the plaintiffs' counsel has stated for the record that the legal fees are being borne by him on a contingent fee basis. Such an arrangement has been held appropriate in a class action context."), *vacated on other grounds*, 451 N.Y.S.2d 817 (App. Div. 1982).

tion,[90] the court held that an arrangement between class representatives and their lawyers, whereby the representatives formally agreed to be responsible for costs but were told informally that the attorneys would not seek to recover costs if they were unsuccessful, was sufficient grounds to deny class certification. The court characterized the purposes behind DR 5-103(b) as "to prevent the attorney from acquiring a financial interest in the litigation which might interfere with his/her exercise of independent professional judgment, especially when it comes to deciding whether to settle the case."[91]

It thus appears that the resolution of the apparent conflict between DR 5-103(b) and Rule 23 of the Federal Rules of Civil Procedure depends, to an extent, upon how one feels about large class action litigation. Clearly, the recent trend in the courts is to support these suits and to do away with traditional barriers such as DR 5-103(b). States, as well, are increasingly adopting the Model Rules, effectively eliminating DR 5-103(b). The rule appears to be incompatible with the modern class action. Insisting on ultimate client responsibility would render many class action suits impracticable and have the effect of limiting the access of legitimate claims, particularly those where losses to individual claimants are very small.

The Committee therefore agrees with the recent trend in court decisions that DR 5-103(b) should be inapplicable to class actions. Indeed, while these opinions have dealt mainly with federal class actions brought under Rule 23, the Committee believes that DR 5-103(b) is equally inconsistent with the liberal spirit of the New York State class action provision, CPLR 901.[92] At least one state court has so held.[93] We conclude that the restrictions imposed by DR 5-103(b) should not be applied to any class action. We therefore suggest that DR 5-103(b), to the extent it is retained at all, be amended to include an exception for class actions.

It could be argued that DR 5-103(b) is necessary to prevent an attorney from incurring excessive expenses that would then be assessed from the award to the class. DR 5-103(b) is not necessary to guard against such a risk, however; judicial scrutiny of class action expenses is currently required, independent of DR 5-103(b). To the extent there may be a risk that an attorney's expenses may be excessive, the court can reduce them pursuant to the provisions of Rule 23 and relevant state rules, which mandate that any fees and expenses awarded

90. 93 F.R.D. 485 (D. Md. 1982).

91. *Id.* at 490.

92. N.Y. CIV. PRAC. L. & R. 901 (McKinney 1993).

93. *Cannon*, 433 N.Y.S.2d at 378.

in a class action must be approved by the court after notice to all class members and a hearing. To the extent that there is a perceived, theoretical risk that some plaintiff's attorney will settle a class action simply because the expenses are too high, the requirement of judicial approval for any class action settlement eliminates any such hypothetical risk.

IV. Plaintiffs' Management Committees — *Attorney-Investors and Creative Financing of Class Actions*

The *Agent Orange* class action involved claims on behalf of several hundred thousand Vietnam veterans who were allegedly injured by the use of defoliants by the U.S. military in Vietnam. A Plaintiffs Management Committee ("PMC") had been established early in the case, but budget problems almost immediately threatened the continued prosecution of the action.[94] An agreement was reached among the members of the PMC that allowed some attorneys to advance funds necessary to prosecute the litigation, in return for a promise that they would receive three times their investment out of any fund approved for payment of attorneys' fees.[95] The effect of the treble repayment was that those attorneys who invested money rather than time in the case were relatively well-compensated, while those who invested time and effort rather than money were relatively poorly compensated.[96] For example, under the agreement, one investor was entitled to an award twelve times greater than that which the district judge ultimately determined to be reasonable, while one non-investor's award would have been almost a million dollars less than he would have received in the absence of an agreement.[97]

The district court judge[98] was not informed of the written agreement of the members of the PMC until the fee application was submitted after settlement of the action. The court, following a challenge of the agreement by a member of the PMC who stood to get a much smaller fee than he otherwise would have, approved the agreement as a necessary part of a flexible approach to applying ethical standards to class action litigation.[99] Thus, Judge Weinstein wrote:

94. Johnson, *supra* note 4, at 549 n.35.

95. *"Agent Orange" Prod. Liab. Litig.*, 611 F. Supp. at 1454.

96. *Id.* at 1455.

97. *Id.*

98. The district court judge was Judge Weinstein, the same judge who held in *Lilco* that ethical standards in federal courts are a matter of federal law. County of Suffolk v. Long Island Lighting Co., 710 F. Supp. 1407 (E.D.N.Y. 1989).

99. *In re* "Agent Orange" Prod. Liab. Litig., 611 F. Supp. 1452 (E.D.N.Y. 1985), *rev'd*, 818 F.2d 216 (2d Cir.), *cert. denied*, 484 U.S. 926 (1987).

> [The] ethical principles [contained in the Code and the Model Rules] are not dispositive. The focus of Rule 23(e) [the provision providing for court approval of settlements on notice to the class] is prevention of harm to the rights of the class, a consideration that is independent of, albeit usually consistent with, the Code and Model Rule standards. In addition, general professional ethics guidelines may require interpretation in the class action setting because of the special problems posed by this kind of litigation.[100]

Judge Weinstein relied on the reasoning of Judge Adams in the *Corn Securities* litigation, wherein Judge Adams stated:

> Courts confronting an ethical problem in the class action setting must focus on two points. First, courts cannot mechanically transpose to class actions the rules developed in the traditional lawyer-client setting context; and second, a resolution of such issues would appear to call for a balancing process that in most cases should be undertaken initially by the district court.[101]

Judge Weinstein went on to analyze the problems raised by the PMC's expense agreement on two bases: (1) whether the allocation of funds in the fee agreement reflected unethical fee splitting among attorneys not in the same firm; and (2) whether the agreement created an impermissible stake in the lawsuit giving rise to a conflict of interest between the attorneys and the members of the class.

Judge Weinstein determined that DR 2-107, which then prohibited fee-splitting outside a law firm, was not violated by the agreement.[102] He reasoned that the PMC was an *ad hoc* law firm, so allocations among PMC members involved only those risks associated with any law partnership agreement which might allocate fees among members of the firm.[103]

On the conflict of interest question, Judge Weinstein found that the promised return to the attorney-investors probably involved the ac-

100. *Id.* at 1457.

101. *Id.* (quoting *In re* Corn Derivatives Antitrust Litig., 748 F.2d 157, 163 (3d. Cir. 1984) (Adams, J., concurring)).

102. *Id.* at 1459.

103. *Id.* at 1458. Disciplinary Rule 2-107 of the New York Code of Professional Responsibility was amended as of September 1, 1990, to change the requirement of DR 2-107(a)(2) that any permitted division of fees must be in proportion to the services performed by each lawyer. The rule now permits division of fees without regard to actual services performed if both lawyers, by a writing to the client, assume joint responsibility for the representation. Thus, DR 2-107(a) now reads in its entirety:

> (a) A lawyer shall not divide a fee for legal services with another lawyer who is not a partner in or associate of the lawyer's law firm or law office, unless:
>
> (1) The client consents to employment of the other lawyer after a full disclosure that a division of fees will be made.
>
> (2) The division is in proportion to the services performed by each lawyer or,

quisition of an interest in the lawsuit in contravention of DR 5-103 (and Rule 1.8 of the Model Rules). However he found it necessary to approve the agreement, in order to avoid the "creation of disincentives that in individual instances may unnecessarily discourage counsel from undertaking the expensive and protracted complex multiparty litigation often needed to vindicate the rights of a class."[104] Judge Weinstein noted that, based on his observations, he had no reason to believe the fee sharing agreement had any effect on the decision to settle the case.[105] He also remarked that he doubted whether the money could have been obtained from the attorney-investors on more favorable terms.[106]

Judge Weinstein's decision was appealed to the Second Circuit Court of Appeals, which reversed,[107] finding the fee sharing agreement unenforceable. The court of appeals stated:

> The ultimate inquiry, therefore, in examining fee agreements and setting fee awards under the equitable fund doctrine and Fed. R. Civ. P. 23(e), is the effect an agreement could have on the rights of a class. Because we find that the agreement here conflicts substantially with the principles of reasonable compensation in common fund actions . . ., and that it places class counsel in a potentially conflicting position in relation to the interests of the class, we reverse.[108]

The court expressed a concern that the fee sharing agreement was inconsistent with the lodestar guidelines established for fee allocations in class actions.[109] The court reasoned that the lodestar approach was necessary to "protect the interests of the class by tying fees to the

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by a writing given to the client, each lawyer assumes joint responsibility for the representation.

(3) The total fee of the lawyers does not exceed reasonable compensation for all legal services they rendered the client.

N.Y. CODE OF PROFESSIONAL RESPONSIBILITY, *supra* note 5, DR 2-107(a). For a discussion of this amendment, see *Proposed Amendments to the Lawyer's Code of Professional Responsibility*, 42 REC. ASS'N B. CITY N.Y. 323, 335-37 (1987) (Executive Committee Statement). Under the amended DR 2-107, the fee allocation arrangement in *Agent Orange* would have been permissible, even assuming that the ethical provision in the New York Code could be applicable to a federal class action. *Cf. "Agent Orange" Prod. Liab. Litig.*, 611 F. Supp. at 1459.

104. 611 F. Supp. at 1460.

105. *Id.* at 1461.

106. *Id.*

107. *In re* "Agent Orange" Prod. Liab. Litig., 818 F.2d 216 (2d Cir.), *cert. denied*, 484 U.S. 926 (1987).

108. *Id.* at 222.

109. *Id.*

actual effort made by the attorney to benefit the class."[110] The lodestar guidelines have been described as follows:

> Under the lodestar approach, a court engages in a two-step fee-setting process. The first step is to establish the lodestar figure, by multiplying the number of hours worked by the attorney times the rate normally charged by an attorney of like skill. The second step is to increase (or decrease) the lodestar amount by application of an appropriate multiplier, if any, based upon such factors as the quality of counsel's work, the risk of the litigation, and the complexity of the issues involved. None of the factors deemed relevant under the lodestar approach directly prove the issue of whether the attorney has advanced large amounts of money needed to finance the litigation for substantial periods of time. While expenses incurred by an attorney on behalf of a class are reimbursed under the common or equitable fund doctrine as an element of compensation separate from fees, they typically are paid at a flat out-of-pocket rate. No allowance is made, in the usual case, for the fact that advances have long been outstanding and have therefore given rise to an opportunity cost or borrowing cost.[111]

The Second Circuit in *Agent Orange* rejected relevant precedent in the Southern District of New York and elsewhere, that permitted counsel to divide lodestar fee allocations, to the extent these cases sanctioned a fee sharing agreement that does not generally comport with lodestar principles.[112] Read strictly, the Second Circuit's decision would permit some fee sharing agreements, but would prohibit one that promised a "return on investment," such as the *Agent Orange* arrangement.

Further, the court specifically rejected the district court's concern about creating disincentives to class attorneys, and noted that the risk to the interests of the class as to timing of settlements was particularly egregious in the *Agent Orange* case.[113] The court concluded that, in the context of a settlement not particularly favorable to the class, it was unseemly to permit an attorney to get twelve times what the district court had determined was the fair value of his services.[114] Finally, in a conclusory manner and without citation to authority, the court rejected the district court's assertion that the PMC constituted

110. *Id.*

111. Johnson, *supra* note 4, at 571-73 (citations omitted). *See also* City of Detroit v. Grinnell Corp., 575 F.2d 1009 (2d Cir. 1977) (amending 560 F.2d 1093 (2d Cir. 1977)).

112. *"Agent Orange" Prod. Liab. Litig.*, 818 F.2d at 223.

113. *Id.* at 224.

114. *Id.* at 225.

an *ad hoc* law firm.[115]

An argument can be made that the Second Circuit's rejection of the *Agent Orange* financing scheme was driven by the following facts: (1) the settlement was generally unfavorable for the plaintiffs; (2) the settlement had been reached at a relatively early stage in the litigation making the treble multiplier unduly favorable to the attorney-investors; and (3) the attorneys entered into the agreement without the knowledge and prior approval of the courts.[116] In other words, the Second Circuit's decision may be limited to its peculiar facts, and may not have been intended to thwart all creative financing arrangements in class actions. The court of appeals seemed to contemplate fee sharing agreements that might be acceptable when it stated:

> We do agree with the district court's ruling that in all future class actions counsel must inform the court of the existence of a fee sharing agreement at the time it is formulated. This holding may well diminish many of the dangers posed to the rights of the class. Only by reviewing the agreement prospectively will the district courts be able to prevent potential conflicts from arising, either by disapproving improper agreements or by reshaping them with the assistance of counsel to conform more closely with the principles of *Grinnell I* and *Grinnell II* [the cases establishing the lodestar guidelines]. In the present case, however, where the district court was not made aware of the agreement, and the potential for a conflict of interest arising was substantial, the adoption of a rule for future cases in no way alleviates the fatal flaws of this agreement and does not offset the need for its invalidation.[117]

The court of appeals also expressed sympathy with class counsel "regarding the business decisions they must make in operating an efficient and manageable practice," and acknowledged that "a certain flexibility on the court's part is essential."[118]

We hope that the Second Circuit's decision in *Agent Orange* will not be read as the "death knell" for creative financing of class ac-

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115. *Id.* at 226.

116. As discussed in Judge Weinstein's opinion in the *Agent Orange* case, the judges of the Eastern District of New York now interpret Local Civil Rule 5(a) to require all fee sharing arrangements to be filed with the court as soon as they are agreed to by counsel. 611 F. Supp. at 1464.

117. *"Agent Orange" Prod. Liab. Litig.*, 818 F.2d at 226. *Grinnell I* and *Grinnell II* are City of Detroit v. Grinnell Corp., 495 F.2d 448 (2d Cir. 1974), and City of Detroit v. Grinnell Corp., 560 F.2d 1093 (2d Cir. 1977), respectively. *Grinnell I* and *Grinnell II* adopted the lodestar formula for fee computations in class actions.

118. *"Agent Orange" Prod. Liab. Litig.*, 818 F.2d at 225.

tions.[119] Rather, we think that the opinion should stand for the salutary proposition that not all risks from unethical practices will be overlooked in the interest of encouraging class actions. The term "class action" is not a talisman which can be used to permit all manner of questionable conduct by class attorneys. In our view, the most objectionable aspects of the agreement in *Agent Orange* were: (1) the failure to obtain prior court approval for the fee allocation agreement;[120] and (2) the fact that attorney-investors would have been compensated far beyond the value of their investment to the litigation, and far beyond the opportunity cost of the money they invested. We do not believe that the *Agent Orange* opinion should be read to prohibit all forms of creative financing of class actions simply because such arrangements may not be in lockstep with the lodestar guidelines. Where an agreement, viewed prospectively, provides for reasonable reimbursement of the time-value of monetary advances, the approval of such an agreement will serve the important social policy of promoting the prosecution of a class action (which may not otherwise be financed), with little or no risk that the class or any class counsel will suffer prejudice. It is this type of agreement which should not be foreclosed by the *Agent Orange* litigation.[121]

119. *See* Johnson, *supra* note 4, at 585 (expressing concerns on this point and quoting from *In re "Agent Orange" Prod. Liab. Litig.*, 818 F.2d at 223-34).

120. *See "Agent Orange" Prod. Liab. Litig.*, 611 F. Supp. at 1454 (stating that a "sunshine rule is essential to protect the interests of the public, the class, and the honor of the legal profession.").

121. *See* Johnson, *supra* note 4, at 587.

> The type of fee allocation agreement most likely to pass scrutiny is one that links the payment of interest on advanced expenses to a reasonable market standard, and that preserves, as far as possible, the correlation between the fee received and the work performed. Among other things, an agreement in conformance with these limitations will minimize the risk of public misunderstanding as to the interests of class counsel.

Appendix A
The Committee on Professional Responsibility

Daniel J. Capra, *Chair***
Julia K. Cowles, *Secretary*

Maria Helen Bainor
Nancy Batterman
Richard J. Bauerfeld
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