Ethics and Innovation

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Introduction

The articles contributed to the panel on legal ethics describe many instances of improper behavior by lawyers in mass actions and offer various explanations for the misconduct. Usually, the authors identify the desire to collect fees as the culprit, perhaps combined with high settlement participation thresholds or underenforcement of state bar rules. These explanations are incomplete. They fail to explain why serious agency problems persist in the face of market forces that pressure agents to serve principals better. Because the market for legal services is highly competitive, lawyers wanting to attract clients should find ways to guarantee their reliability and trustworthiness. What impedes the development of innovations that would address the problems identified in the articles?

This Essay suggests that the law governing lawyers' professional responsibilities frustrates some desirable innovations. When lawyers try to use contracts to make mass tort representations more transparent and themselves more accountable, courts and legal ethicists respond negatively, locking claimants and attorneys into suboptimal relationships.

Part I of this Essay briefly describes the economics of principal-agent relationships. This Part aims to explain why lawyers should feel pressure to represent mass tort clients well. Part II develops the two tiers of agency problems that exist in group lawsuits. The first tier stems from client-lawyer relationships; the second from client-client relationships. Part II also chronicles the harsh treatment innovations designed to address both tiers of problems have received in the courts. Part III takes up certain examples of misconduct identified in the articles by other authors on the panel. A plausible case can be made that the problems arose, at least in part, because state bar rules stifled innovation. Given more freedom, lawyers would likely address the identified agency problems more effectively. In the Conclusion, this Essay suggests that legal ethicists should study up on the microeconomics of principal-agent relationships.

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I. Competition for Clients Generates Pressure to Improve

An agency problem exists whenever two persons' payoffs are interdependent, so that the outcome for one person (the principal) depends on the action selected by the other (the agent). The principal's problem is to motivate the agent to choose the best option for the principal, given that self-interest may incline the agent to follow a different course.[1]

Motivating the agent is difficult because no fee arrangement that enables the principal to benefit from the agent's work can align the interests of the principal and the agent perfectly. Unless the agent receives one hundred percent of the return on effort, the agent may encounter opportunities to benefit by shirking or otherwise acting to the principal's detriment. But, obviously, an arrangement entitling the agent to keep one hundred percent of the return would not benefit the principal at all; it would eliminate any reason for hiring the agent.

In mass tort litigation, plaintiffs use contingent percentage fees to compensate lawyers. These arrangements connect lawyers' and clients' fates—they sink or swim together—but even so, their marginal interests can diverge. For example, suppose a mass action has an expected value of $110 million at trial, reflecting damages of $220 million and a fifty percent probability of success. Now suppose the defendant offers $100 million to settle. Assuming risk neutrality, the claimants would want their lawyer to advise them to reject the proposal. The lawyer may nonetheless prefer to settle. To see why, make the following assumptions: The lawyer will receive forty percent of the recovery as fees; the lawyer has expended time worth $20 million and incurred $1 million in out-of-pocket costs as of the date of the settlement offer; and, finally, to take the case to trial the lawyer would have to expend an additional $10 million in time and incur an additional $1 million in expenses. Assuming costs are reimbursed from the recovery, the proposed settlement would pay the lawyer $41 million ($40 million in fees plus $1 million in expense reimbursements), enabling the lawyer to earn $20 million in profit on a $21 million investment. A trial would promise an expected $46 million in total compensation but would generate only $14 million in profit on sunk costs of $32 million. Although the clients would be better off rejecting the offer, a trial would require the lawyer to risk more in hope of winning less.

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1 *See* Henry Hansmann & Reinier Kraakman, *Agency Problems and Legal Strategies*, *in* Reinier Kraakman et al., The Anatomy of Corporate Law: A Comparative and Functional Approach 21 (2009) (discussing how agency problems arise from information asymmetry).

Because incentives cannot align the interests of principals and agents perfectly, principals must use contracts to specify how agents will act. Unfortunately, contracts have limited utility when agents' services require the application of professional judgment. "When one party hires the other's knowledge and expertise, there is not much they can write down," as Frank Easterbrook and Daniel Fischel observed.[2]

Because neither incentive arrangements nor contracts can motivate lawyers to serve clients faithfully in all situations, monitoring has a role to play. Unfortunately, claimants' ability to monitor attorneys is also limited. Mass tort lawyers are sophisticated professionals who possess a good deal of private information about the merits and values of claims. Claimants tend to be less sophisticated, meaning that they lack the skills needed to evaluate the performance of the attorneys they employ. The specialized assets that make it advantageous for claimants to hire attorneys also make it difficult for claimants to assess the quality of their work. Observable outcomes help claimants somewhat, but they signal lawyers' effort levels imperfectly because many factors affect them, not just lawyers' work product. Finally, because monitoring consumes resources, claimants find it rational to stop spending while a residual level of unpoliced opportunism remains.

Incentives to free-ride also exist. If one claimant monitors counsel and thereby causes the quality of counsel's effort to improve, all other claimants also benefit. Other claimants can thus enjoy the common benefits of monitoring without bearing the costs. Given this, the dominant strategy for all claimants is to let others do the work, in which event no monitoring occurs and all claimants forgo the common benefits that monitoring would have produced. Alternatively, claimants may seek exclusive returns on monitoring investments, such as allocation formulas skewed in their favor. Monitoring by some claimants may be as much a curse as a blessing.

The problems discussed to this point are well understood. Common law judges have known for centuries that the interests of principals and agents may diverge, and they have subjected agents to a host of familiar duties for this reason. Economists have framed the problem in general terms and have also observed that high agency costs should not persist when agents compete for business. Competition should encourage agents to find ways to guarantee their trustworthiness because principals should find honest agents especially appeal-

[2] Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & Econ. 425, 426 (1993).

ing.[3] If principals and agents have a common interest in ameliorating interest conflicts, agents should search for optimal solutions to agency problems; that is, solutions that maximize the aggregate welfare of principals and agents taken together by minimizing agency costs. Because principals should also welcome these solutions, cost-minimizing innovations should spread quickly, and agents who fail to use them should have difficulty attracting clients.

The market for legal services is highly competitive, including the segment of the market made up of lawyers who handle mass tort claims. Mass tort lawyers should therefore have incentives to assure clients of their honesty, ability, and trustworthiness. Yet, the conventional wisdom is that in mass tort cases, opportunistic behaviors abound.[4] The articles contributed to this panel describe arbitrary allocations of settlement recoveries, arm-twisting of clients, unacknowledged conflicts of interest, excessive fees, and thefts. Why do these problems persist? Part II considers the (perhaps heretical) notion that the law governing lawyers contributes to some of them by preventing lawyers and clients from adopting cost-minimizing innovations.

II. Two Tiers of Agency Problems

Members of litigation groups participate in principal-agent relationships with their lawyers and with other claimants.[5] Both sets of relationships harbor the potential for agency failures.[6] Consequently, in both relationships, the core problem is the one identified above: being at the mercy of others, i.e., their lawyers and other claimants, claimants must motivate others to act in ways that maximize the aggregate welfare of the group, thereby making the largest possible net

3 Hansmann & Kraakman, *supra* note 1, at 22; *see also* John W. Pratt & Richard J. Zeckhauser, *Principals and Agents: An Overview*, *in* Principals and Agents: The Structure of Business 1, 4 (John W. Pratt & Richard J. Zeckhauser eds., 1985) ("Our theme . . . is that businesses, workers, consumers, and indeed all participants in society at large regularly struggle to deal with the intractable problems that arise in agency relationships, that organizational forms evolve to deal with them, and that on average these forms perform reasonably well.").

4 *See, e.g.*, Nancy Morawitz, *Bargaining, Class Representation, and Fairness*, 54 Ohio St. L.J. 1, 4 n.10 (1993) (surveying discussions of lawyers' self-interest in the context of mass litigation).

5 A litigation group exists when clients use agreements to create legal rights and obligations between or among themselves. A group is thus distinct from a simple client aggregation, which exists whenever a lawyer separately represents multiple clients who possess related claims. *See, e.g.*, Elizabeth Chamblee Burch, *Litigating Groups*, 61 Ala. L. Rev. 1, 20–35 (2009) (discussing variable compositions of litigation groups). Although agency problems stemming from the concurrent representation of many clients arise in both contexts, only litigation groups meet the identified condition.

6 Hansmann & Kraakman, *supra* note 1, at 22.

expected recovery available. Incentives, contracts, and monitoring are the tools they can use to accomplish this.

I shall refer to agency problems arising out of client-lawyer relationships and client-client relations as first-tier and second-tier problems, respectively. In recent years, claimants and lawyers have sought to address first- and second-tier agency problems by using retainer agreements to structure their relationships.[7] Courts have frustrated their efforts.[8] Well-intentioned commentators have made matters worse by defending judges' decisions on traditional grounds.[9] They have let their desire to protect claimants cause them to prevent claimants from helping themselves.

Consider *Abbott v. Kidder Peabody & Co.*, a case in which over 200 disappointed investors hired a single law firm to prosecute a non-class fraud case.[10] Each claimant signed a Representation Contract that established the following structure for the group action:

- A steering committee of plaintiffs, the size and membership of which would be determined by majority vote of all jointly represented clients based on the net cash invested, would control the litigation. It would supervise the law firm, receive communications from the law firm, and make all day-to-day decisions.[11]
- The cases of plaintiffs not on the steering committee would be conducted identically with those of the committee members.[12]
- Communications by the lawyers with the steering committee would count as communications with all claimants.[13]
- The law firm would settle all clients' claims "on the same terms as those applicable to the personal claims of the steering committee members."[14] A formula reflecting each client's investment would determine each client's share of a groupwide settlement.[15] The steering committee could change the allocation formula, subject to certain constraints.[16]

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7 *See, e.g.*, Abbott v. Kidder Peabody & Co., 42 F. Supp. 2d 1046 (D. Colo. 1999).

8 *See, e.g.*, *id.*

9 Howard M. Erichson, *Beyond the Class Action: Lawyer Loyalty and Client Autonomy in Non-Class Collective Representation*, 2003 U. CHI. LEGAL F. 519, 569–74.

10 *Abbott*, 42 F. Supp. 2d at 1048.

11 *Id.*

12 *Id.*

13 *Id.*

14 *Id.*

15 *Id.* at 1048–49.

16 *Id.* at 1049.

- Any client who received a settlement payment outside of a groupwide deal would have to place the payment in escrow pending a groupwide resolution, following which the individual payment would be shared by the entire plaintiff group.[17] A client who settled individually would also bear a predetermined share of the litigation costs.
- Each client would pay the same contingent fee. Expenses would be shared pro rata.

These provisions served obvious functions. They recognized that to gain the benefits of collective action, which include economies of scale, cost spreading, increased bargaining leverage, and the possibility of gaining a settlement premium by offering the defendant global peace,[18] the claimants had to rely on each other. For example, they had to share the burdens of litigation and the benefits, so they adopted fair formulas to govern both.[19] They had to discourage group members from settling individually, so they made opting out unattractive.[20] They had to monitor their attorneys efficiently, so they assigned the responsibility to a steering committee staffed by individuals whose incentives were strong because their claims were large.[21] They then relied on the committee members to monitor the attorneys for everyone's benefit while also using the litigation and settlement formulas to minimize the risk of opportunism by their guardians. In effect, they used the common factual and legal bases of their claims to tie everyone's fortunes to those of the steering committee members. By doing so, they created a business model for collective litigation that was economically feasible, stable, and transparent.

Despite these obvious advantages, the trial court struck down the entire arrangement and disqualified the plaintiffs' attorneys for using it.[22] Why? The reason offered in the opinion is that the agreement violated the Colorado bar rules.[23] Considering the judge's motive, however, a different possibility emerges: the judge had a plan for settling the case, and the plaintiffs' chosen structure of representation frustrated his efforts.[24] Readers will have to decide for themselves whether to take the opinion at face value.

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17 *Id.* at 1048–49.
18 Erichson, *supra* note 9, at 576.
19 *Abbott*, 42 F. Supp. 2d at 1049.
20 *Id.*
21 *Id.* at 1048.
22 *Id.* at 1051.
23 *Id.*
24 *Id.* at 1049.

The judge hoped to settle the case by ordering the parties to court-annexed mediation.[25] Following the referral, the defendants attempted to pick the group apart by making settlement offers to individual claimants.[26] This strategy failed.[27] The plaintiffs consistently rejected the offers, preferring "to stay with the group."[28] Frustrated, the defendants asked the court to invalidate the Representation Contract and disqualify the plaintiffs' attorneys.[29]

The court granted the motion.[30] It began by observing that, although the claimants freely adopted the terms of the group lawsuit and were happy with them, their attorney had to "pursu[e] their . . . goals in a manner consistent with the ethical rules."[31] Under the Colorado bar rules, "any provision of an attorney-client agreement which deprives a client of the right to control their [sic] case is void as against public policy."[32] In the court's view, the Representation Contract was invalid for this reason.[33] It enabled counsel to enter into a settlement that would bind all claimants with the consent of only the steering committee.[34] Because the Contract did not require each client to consent individually, it "violate[d] the professional and ethical standards created to regulate the legal profession in the State of Colorado," and "a disinterested lawyer would have advised [the clients] against entering into [it]."[35]

The nature of the judge's argument is more important than the soundness of his logic, which is patently faulty. The court treated the Colorado bar rules as a fixed, one-size-fits-all template for attorney-client relationships. The plaintiffs' attorney ran afoul of the rules because she deviated from the standard form by tailoring her relationships with the clients (and their relationships with each other) to the clients' specific needs. It did not matter that the alterations addressed agency problems peculiar to mass tort representations, that the clients were sophisticated and had consented, or that the claimants' right to try their cases trumped the judge's desire for a settlement. Deviations for any purpose were forbidden.

25 *Id.*
26 *Id.*
27 *Id.*
28 *Id.*
29 *Id.*
30 *Id.* at 1051.
31 *Id.* at 1050.
32 *Id.* at 1051.
33 *Id.*
34 *Id.* at 1048.
35 *Id.* at 1051.

Insofar as the judge's unwillingness to permit innovations is concerned, *Abbott* is a typical decision. Its lineage runs to *Hayes v. Eagle-Picher Industries, Inc.*,[36] a 1975 decision in which the Tenth Circuit struck down a majority-rule settlement provision. The plaintiffs, who sued as a group, agreed that if the defendant offered to settle all their claims for a single sum, they would hold a vote and the majority would prevail.[37] In fact, the claimants received an all-or-none offer, and most claimants voted to settle.[38] A few dissenters challenged the settlement, arguing that the group's attorney lacked authority to settle their cases over their objection.[39] The Tenth Circuit agreed. It invalidated the majority-rule provision on the ground that "the basic fundamentals of the attorney-client relationship" required individual consent.[40]

Judges' disdain for innovations also held sway in *Tax Authority, Inc. v. Jackson Hewitt, Inc.*,[41] a post-*Abbott* decision. There, the plaintiffs' attorney represented 154 franchisees, each of whom signed an identical retainer agreement.[42] As in *Abbott*, the agreement created a steering committee to handle day-to-day affairs and imposed a formula for settlement allocation.[43] The agreement also provided that a weighted majority would decide whether to settle.[44] Eventually, a settlement proposal won approval.[45] A claimant who opposed the settlement did not want to be bound, however, and challenged the deal.[46] After losing in the trial court, the objectors' arguments prevailed on appeal.[47] Both appellate courts ruled that the *Model Rules of Professional Conduct* prohibited a lawyer from obtaining a client's advance consent to be bound by majority rule.[48] A lawyer can obtain binding consent to settle only after the terms of each client's proposed settlement are known.[49] The victory was pyrrhic, however. Because *Tax*

36 Hayes v. Eagle-Picher Indus., Inc., 513 F.2d 892, 894 (10th Cir. 1975).

37 *Id.* at 892.

38 *Id.* at 892–93.

39 *Id.* at 893.

40 *Id.* at 894–95.

41 Tax Auth., Inc. v. Jackson Hewitt, Inc. (*Tax Auth. II*), 898 A.2d 512 (N.J. 2006).

42 *Id.* at 514.

43 *Id.* at 515.

44 *Id.* at 514.

45 *Id.* at 516.

46 *Id.*

47 *Id.* at 517.

48 *See id.* at 522; Tax Auth., Inc. v. Jackson Hewitt, Inc. (*Tax Auth. I*), 873 A.2d 616, 623, 627, 630 (N.J. Super. Ct. App. Div. 2005).

49 *See Tax Auth. II*, 898 A.2d at 522.

Authority provided the first opportunity for the New Jersey Supreme Court to address the issue, the justices determined that fairness to the defendant precluded retroactive application of their ruling.[50] Going forward, however, majority rule was barred.[51]

Tax Authority clearly impeded innovation, and in that respect it resembles *Abbott* and *Hayes*. Even so, the opinion is less reflexively critical of departures from the state bar rules than its predecessors. Taking note of the debate among academics over the need for special procedures in aggregate representations, the New Jersey Supreme Court instructed that state's Commission on Ethics Reform to consider "permitting less than unanimous agreement in multi-plaintiff mass litigation."[52] Ultimately, however, the state's disciplinary rules remained unchanged.[53]

To this point, I have focused on judges' opposition to deviations from the template created by the disciplinary rules, but the rules themselves are the primary impediments to innovation. Unlike the rules of agency on which they are based, many disciplinary rules cannot be altered or waived. For example, the Aggregate Settlement Rule ("ASR") prohibits the use of majoritarian voting arrangements in mass tort representations.[54] The ASR contains no provision allowing clients to alter its requirements, even with informed consent. Innovation is prohibited, no matter how great the benefits for clients may be.

Scholars sometimes assert that the ASR is simply the natural application to multiple-client contexts of rules that apply to lawyers who represent solitary clients.[55] In a sense, this is correct. A lawyer with a

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50 *Id.* at 522–23.

51 *Id.*

52 *Id.*

53 The follow-up was not what the New Jersey Supreme Court might have expected. Although the Commission's Chair contacted Professor Nancy Moore, a prominent scholar known to favor preservation of the existing bar rules, the Commission's Chair failed to obtain the views of the authors whose writings convinced the court to entertain the possibility of liberalizing the rules. *See* Nancy J. Moore, *The American Law Institute's Draft Proposal to Bypass the Aggregate Settlement Rule: Do Mass Tort Clients Need (or Want) Group Decision Making?*, 57 DePaul L. Rev. 395, 397 n.16 (2008) (reporting that the chair of the Commission contacted Professor Moore, who "urg[ed] that the aggregate settlement rule be retained in its current form").

54 *See* Model Rules of Prof'l Conduct R. 1.8(g) (2004).

55 *See* Howard M. Erichson & Benjamin C. Zipursky, *Consent Versus Closure*, 96 Cornell L. Rev. 265, 304 (2011) (observing that "the disclosure and consent requirements of [the ASR] are best understood as a specialized application of informed consent to conflicts of interest," and arguing that conflicts arising under the ASR should be consentable); Howard M. Erichson, *A Typology of Aggregate Settlements*, 80 Notre Dame L. Rev. 1769, 1795 (2005) (observing that the ASR "can be understood as a particular application of the rule on concurrent conflicts

single client must obtain the client's informed consent before settling and cannot obtain irrevocable settlement authority.[56] The ASR embodies both doctrines. Even so, the wisdom of applying single-client doctrines to multiple-client representations can be questioned. In single-client representations, clients' behaviors affect only themselves and their attorneys. In multiple-client representations, clients' actions also affect other clients. Before extending single-client rules to multiple-client representations, the impact on clients' ability to handle second-tier agency problems must be considered.

When Professor Lynn A. Baker and I identified the ASR as a subject worthy of scholarly attention in 1997, we suggested that agreements authorizing attorneys to settle at the behest of a majority of clients should be irrevocable.[57] In reaching this conclusion, we relied on two facts. First, the social choice procedures built into the retainer agreements in cases like *Hayes* create legal relationships among the claimants that are designed to make litigation groups successful. Second, clients who join groups voluntarily accept the entire package of governance and cost-sharing provisions knowing that other claimants will rely on them to perform. In effect, each client authorizes the common attorney to settle the entire set of claims subsequent to a favorable majority vote *for the benefit of other claimants*, who, after performing their own obligations, would otherwise risk having the rug pulled out from underneath them by dissenting clients. Although most powers conferred on agents are revocable, powers designed to benefit other parties by securing the performance of principals' contractual obligations are not.

This Essay does not seek to persuade readers that the earlier argument for irrevocability is correct, although, to my knowledge, its merit has never been disputed. Rather, the objective is to attack the intuitively appealing but nonetheless mistaken notion that rules designed for single-client representations have natural applications in multiple-client situations. The danger with this way of thinking is that "natural" tends to mean linear. For example, the rule requiring client

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of interest," and that "[t]he comment to [the ASR] aptly describes it as a corollary to both [ABA Model] Rule [of Professional Conduct] 1.7, which addressed concurrent conflicts of interest, and Rule 1.2(a), which protects client autonomy to decide whether to accept a settlement").

56 RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 22 (2010).

57 Charles Silver & Lynn A. Baker, *Mass Lawsuits and the Aggregate Settlement Rule*, 32 WAKE FOREST L. REV. 733, 773 (1997). Our views are developed further in Charles Silver & Lynn A. Baker, *I Cut, You Choose: The Role of Plaintiffs' Counsel in Allocating Settlement Proceeds*, 84 VA. L. REV. 1465 (1998), and Lynn A. Baker & Charles Silver, *The Aggregate Settlement Rule and Ideals of Client Service*, 41 S. TEX. L. REV. 227 (1999).

control of single-client settlements is thought to imply individual control of multiple-client settlements. The implication is neither natural nor necessary, however. Individual control may work well in single-client representations, but it may exacerbate second-tier agency problems in litigation groups. If the purpose of individual control of settlements in single-client matters is to enhance welfare by reducing agency costs, the natural way to handle control of settlement decisions in claimant groups is by implementing welfare-enhancing social choice rules, whatever they may be. Individual control has no inherent claim to being the best way of handling second-tier agency problems.

III. Causes of Misconduct Identified by Others

In her contribution to this volume, Professor Nancy Moore upbraids the Reporters for the American Law Institute's *Principles of the Law of Aggregate Litigation* ("*Principles*") for "consistently tout[ing] the benefits of [litigation groups] . . . with no significant discussion of any of the accompanying risks."[58] She singles out the Reporters' discussion of referral fees for extended criticism:

> [R]eferral networks are described [in the *Principles*] as entirely beneficial because the referral market corrects the mismatch of clients and lawyers that results in deficient representation. There is no mention of the risks entailed in such referral markets. For example, some lawyers may refer cases to another lawyer because that lawyer offers a more favorable referral fee or because that lawyer's own marketing efforts have misled the referring lawyer to believe that he has more experience and expertise than is in fact the case. There is also no mention of the likely violation of rules that prohibit lawyers from false or misleading advertising when they market themselves to the public without any indication that their intention is to turn these cases over to other lawyers in return for a referral fee.[59]

In a footnote in this passage, Professor Moore emphasizes the "numerous opportunities for the referral market to fail, including the inability or lack of willingness of referring lawyers to discern precisely which other lawyers are best positioned to advance the clients' interests in maximizing recovery."[60]

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58 Nancy J. Moore, *The Absence of Legal Ethics in the ALI's* Principles of the Law of Aggregate Litigation*: A Missed Opportunity—and More*, 79 Geo. Wash. L. Rev. 719, 729 (2011).

59 *Id.* (footnotes omitted).

60 *Id.* at 729 n.73.

Referral arrangements resemble group lawsuits in having multiple agency relationships and, therefore, multiple tiers of potential agency problems. Clients' payoffs depend on their lawyers' actions. Each lawyer's payoff depends on the behavior of the other attorney and on that of the clients as well. One might therefore think, as Professor Moore does, that referrals are especially susceptible to agency failures. In fact, this fear appears to be unwarranted. The available empirical and anecdotal evidence suggests that referral arrangements work well. They help claimants maximize recoveries by moving high-value claims from generalists to specialists.[61]

Why do referrals work well? Because good behavior makes everyone better off, while poor performance, in addition to being unprofitable, is easily discovered and punished. Referral arrangements typically involve generalists and specialists who engage in repeat play and who gain by cultivating good reputations—the former for locating quality cases worth developing, the latter for possessing expertise and obtaining large payments from defendants or insurers. By failing to develop a case appropriately or settling too cheaply, a specialist would risk being denied future referrals, both from the referring lawyer involved in the particular case and from other generalists, who are certain to learn of the receiving lawyer's poor performance in short order. In effect, the generalist becomes the client's agent for the purpose of selecting and monitoring a superior lawyer who possesses the abilities and resources the client needs.[62]

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61 Many academics have noted the tendency of the referral market to move high-value cases from generalists to specialists. *See, e.g.*, Stephen Daniels & Joanne Martin, *It Was the Best of Times, It Was the Worst of Times: The Precarious Nature of Plaintiffs' Practice in Texas*, 80 TEX. L. REV. 1781, 1784 (2002); Catherine T. Harris, Ralph Peeples & Thomas Metzloff, *Who Are Those Guys? An Empirical Examination of Medical Malpractice Plaintiffs' Attorneys*, 58 SMU L. REV. 225, 235–36 (2005). The economist Stephen Spurr has provided the most rigorous evidence in support of this proposition. *See* Stephen J. Spurr, *The Impact of Advertising and Other Factors on Referral Practices, with Special Reference to Lawyers*, 21 RAND J. ECON. 235, 244 (1990); Stephen J. Spurr, *Referral Practices Among Lawyers: A Theoretical and Empirical Analysis*, 13 LAW & SOC. INQUIRY 87, 87 (1988) [hereinafter Spurr, *Referral Practices*]. Anecdotally, a task force, the members of which included prominent tort reform advocates, commissioned to recommend amendments to the State Bar of Texas's referral-fee and advertising rules, found no evidence that referral fees harm clients, despite scouring the state. REFERRAL FEE TASK FORCE, STATE BAR OF TEX., FINAL REPORT AND RECOMMENDATIONS 7 (2004). The number of reported malpractice cases involving lawyers who received cases by referral also appears to be small.

62 Spurr, *Referral Practices*, *supra* note 61, at 93 ("It is optimal to concentrate monitoring resources on the best attorneys, since there is a great potential loss to clients if a high-grade attorney shirks or underinvests his time because of the contingent fee arrangement . . . . [S]ince the specialist has the most human capital at stake, he is more concerned about his reputation

Referrals between lawyers at different firms work well, then, for the same reasons that intrafirm referrals usually do. In a firm, many lawyers may serve a client. One may solicit the client and land the business. Others may provide specialist-level advice in particular areas where the client needs assistance. Still others may do legal and factual research or speak for the client in court. The process of dividing work involves a series of internal referrals, each designed to match a particular task with a lawyer possessing appropriate skills. The client is likely to be served well, despite the potential for agency failure, because the firm gains by delivering quality service and because the lawyers are repeat players with reputational interests and good information who can easily monitor each other.

Referrals are common in mass tort representations, as are joint ventures among lawyers with groups of clients, which might be thought of as ad hoc law firms. These cooperative arrangements should work well for lawyers and clients, but as the other papers in the panel show, examples of improper behavior in mass tort lawsuits are legion. The persistence of misconduct forces one to ask why competitive pressure is failing to motivate lawyers to serve clients as well as they should.

No single explanation can account for all agency failures, but rule-induced rigidity may contribute to many of the troubling examples discussed in other papers. Consider fees in mass tort representations. Professor Lester Brickman thinks they are excessive, pointing out that lawyers with "hundreds and even thousands of clients" charge the same amount as other contingent fee lawyers even though they enjoy superior economies of scale.[63] Professor Brickman attributes "the lucrative nature of this area of practice" partly to "the lack of enforcement of ethics rules that purport to limit lawyers' fees to 'reasonable' amounts."[64]

Professor Brickman's explanation has an obvious shortcoming. It does not explain why market forces fail to pressure mass tort lawyers to pass on savings to clients. The market for legal services is highly competitive. Mass tort lawyers should therefore feel as much pressure to reduce prices as other purveyors of goods and services, yet other providers routinely pass savings along to customers without pressure

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than other attorneys and is not likely to underinvest his time in order to maximize his profit on a single case.").

63 Lester Brickman, *Anatomy of an Aggregate Settlement: The Triumph of Temptation over Ethics*, 79 GEO WASH. L. REV. 700, 706 (2011).

64 *Id.* at 702.

from law enforcement. Contingent fees are also highly transparent and, therefore, easy to compare. Yet, according to Professor Brickman, mass tort lawyers consistently overcharge.[65]

Obviously, Professor Brickman could be mistaken. One might reasonably demand more rigorous evidence of rent extraction than the observation that mass tort lawyers charge the same percentages as lawyers who work in different practice settings. Still, assuming he is right, one should not automatically conclude that fees should be capped or otherwise reduced. Limiting percentages to levels below prevailing market rates could harm claimants by discouraging lawyers from exerting the effort needed to maximize recoveries. This would happen if, owing to weakened incentives, plaintiffs' attorneys expended less effort, causing recoveries to tumble. This possibility worries some economists. After observing that agency problems would disappear if attorneys were allowed to buy claims from clients, McKee, Santore, and Shelton write:

> When the purchase of legal claims is prohibited, it has been shown that attorneys may earn economic rents even though they remain free to compete over the contingent fee. The intuition is that while a low contingent fee gives the client a larger share of the award, it induces less attorney effort and hence lower expected awards. *It is therefore possible for the client to be better off paying a larger contingent fee even if an attorney would have accepted a lower fee*.[66]

Professor Brickman does not mention the downside potential of low percentages in his essay in this volume, but he has recognized it before.[67]

For present purposes, the important point is not the impact lower percentages would have on lawyers' effort levels. It is that, despite the existence of competition, lawyers may profit excessively from mass tort cases, as Professor Brickman claims, because state bar rules and other laws prevent them from purchasing claims and from paying

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65 *Id.* at 706.

66 Michael McKee, Rudy Santore & Joel Shelton, *Contingent Fees, Moral Hazard, and Attorney Rents: A Laboratory Experiment*, 36 J. LEGAL STUD. 253, 254 (2007) (emphasis added) (citation omitted); *see also* Bruce L. Hay, *Contingent Fees and Agency Costs*, J. LEGAL STUD. 503, 530, 550 (1996); Rudy Santore & Alan D. Viard, *Legal Fee Restrictions, Moral Hazard, and Attorney Rents*, 44 J.L. & ECON. 549, 550, 559 (2001).

67 *See* Lester Brickman, *The Market for Contingent Fee-Financed Tort Litigation: Is It Price Competitive?*, 25 CARDOZO L. REV. 65, 101 (2003). Judges presiding over multidistrict litigations and other mass tort proceedings should take this point to heart. These judges have recently begun cutting fees to levels significantly below market rates, supposedly to help plaintiffs. The net effect on claimants could be negative, however.

clients for the opportunity to represent them. In other words, rent extraction in mass tort cases, assuming it exists, would likely disappear if the law governing lawyers were liberalized to permit certain fee-related innovations. Scholars who want to protect clients from excessive charges should therefore seek first to repeal these restrictions, which are relics of a prior age in which litigation was strongly discouraged.[68] Disciplinary actions and fee caps should be fallbacks kept in reserve until liberalization has a chance to succeed, reflecting the traditional preference for voluntary market transactions over coercive regulation.

Now consider a series of allocation-related problems discussed by Professor Howard Erichson.[69] In several mass tort settlements involving clients who used the fen-phen diet drug combination, the defendant paid a lump sum to settle a large number of related claims and left the task of allocating the money to the plaintiffs' attorneys.[70] By Professor Erichson's account, the lawyers then committed a variety of abuses. Some stole money.[71] Some shortchanged referred clients on whose cases fees had to be shared.[72] Some misled clients concerning the manner in which individual settlement payments were determined.[73] Some created slush funds to buy off clients who rejected their initial offers.[74] Some exerted undue pressure on clients to settle.[75]

Professor Erichson attributes many of these abuses to "all or nothing" participation requirements, which entitle defendants to walk away from deals when too few claimants agree to settle.[76] It seems clear, though, that several causes are at work. For example, theft of client funds is a problem that transcends practice areas. Its causes are greed, unscrupulousness, and deficient security measures. It seems odd to lay the blame for theft at the feet of minimum participation requirements.

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68 Marc J. Shukaitis, *A Market in Personal Injury Tort Claims*, 16 J. LEGAL STUD. 329, 330–31 (1987).

69 Howard Erichson, *The Trouble with All-or-Nothing Settlements*, 58 U. KAN. L. REV. 979, 982–95 (2010).

70 *Id.* at 984–85.

71 *Id.* at 986–87.

72 *Id.* at 994.

73 *Id.* at 986–87.

74 *Id.* at 988.

75 *Id.* at 987.

76 *Id.* at 1006.

Allocation conflicts also arise independently of participation thresholds and even of lump sum settlement offers. Even when a plaintiffs' attorney negotiates a series of individualized payments for clients with related claims, the demand for each claimant must be determined. The process of liquidating the demand and obtaining settlement authority can involve conflicts, expectation massaging, and arm twisting, especially when, as usually will be true, the plaintiffs' attorney knows how much insurance coverage is available or believes for other reasons that the defendant will pay only so much to settle all the claims. More for one claimant is likely to mean less for another no matter how the process of bargaining toward settlement is structured.

In a group lawsuit, the need to allocate settlement funds is a potentially serious impediment to wealth maximization. Plaintiffs with related claims can gain by suing together because the common aspects of their claims generate economies of scale, because they can obtain a premium by settling as a group, and because their lawyer can help everyone by maximizing the total recovery. Allocation, by contrast, focuses on who gets what rather than on how much everyone recovers. Because the shift from "our good" to "my good" brings differences among claimants to the fore, it will predictably cause squabbling and may undermine a group's solidarity.

Allocation is also difficult to deal with on a principled basis when money is on the table. The reasonableness of a settlement payment depends on a mix of objective and subjective factors, such as the size of claimants' stakes and claimants' tolerance for risk. Because subjective considerations matter, plaintiffs with similar objective characteristics may reasonably demand different amounts, and consensus may be difficult to achieve. Strategic behavior may also occur, as clients seek to increase their shares by threatening to veto settlements others desperately want. Predictably, such jockeying will benefit clients with small losses and harm clients whose injuries are more severe.

In view of the preceding, it is unsurprising that plaintiffs and their lawyers have sought to deal with allocation problems by agreeing on their resolution at the start of litigation. Sometimes, as in *Abbott*[77] and *Tax Authority*,[78] they have built allocation formulas into retainer agreements. In other cases, they have agreed on fair procedures for fixing shares in a groupwide recovery without specifying how much each client will receive. One plaintiffs' attorney uses a retainer agreement that authorizes him to represent multiple clients injured by the

77 Abbott v. Kidder Peabody & Co., 42 F. Supp. 2d 1046, 1048 (D. Colo. 1999).

78 *Tax Auth. I*, 873 A.2d 616, 619 (N.J. Super. Ct. App. Div. 2005).

same product, to litigate and attempt to settle all the clients' claims as a group, to demand a lump sum in settlement of all claims, and to employ an economic damages expert to determine each client's share. The clients agree up front that the expert's allocation decisions will bind everyone.

It is unclear whether the agreement just described would stand up if a disgruntled client were to challenge it in court. Judges have qualms about allocation agreements entered into at the start of litigation, as explained. Applying rules developed in single-client representations, judges have found that clients must be free to revoke agreements made before the terms of settlements are known.[79] The possibility therefore exists that the agreement to use a neutral damages expert could be invalidated, in which event the attorney would have to improvise. He would have to devise a new allocation procedure none of the clients expected him to apply and to which none of the clients agreed. Judicial invalidation would frustrate the common objective of reducing agency costs by preventing clients from addressing allocation issues up front.

Judges' disdain for ex ante allocation agreements likely contributes to a number of the agency problems Professor Erichson describes. When lawyers and clients are prevented from addressing allocation problems in principled ways ex ante, they can only wind up dealing with them in ad hoc ways ex post. Lacking a formula or method to which all clients can agree and be bound before a lump sum settlement offer is received, a plaintiffs' attorney must jump into the allocation morass when the need arises. Allocation plans do not create themselves, after all. Lawyers must negotiate them with clients, and, absent ex ante agreements, they must do so in circumstances where the conflicts could hardly be more pronounced. With life-changing amounts of money up for grabs, clients feel strong pressure to get as much as they can.

Lawyers feel pressure to satisfy clients' demands. Slush funds and disparate payments are common because they facilitate this process. Lawyers can also shortchange referred clients only when allocation formulas are left open. When allocations are ad hoc and unprincipled, can anyone really be surprised that clients who wind up with less money than others feel cheated? Unfairness stings.

Participation thresholds add pressure to the ex post allocation process. A plaintiffs' attorney will always be mindful of the possibility

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[79] *See, e.g.*, Quintero v. Jim Walter Homes, Inc., 654 S.W.2d 442, 444 (Tex. 1983).

that, unless the required number of claimants settles, a defendant will exercise its right to kill a deal. But the influence of these provisions may not be all that great. Plaintiffs' attorneys often want high participation rates for other reasons. First, high takeup rates maximize their returns on sunk litigation investments. Second, many individual claims are not worth litigating apart from a group. Attorneys would rather help these clients by settling their claims than set them adrift. Third, when the lump sum offer to a group exhausts a defendant's assets or insurance coverage, there is simply no more blood to squeeze out. Fourth, most plaintiffs' attorneys care about their clients and want to do right by them. A lawyer who genuinely believes that a settlement is reasonable will usually exert significant pressure on a client to settle, and the client will usually comply.

CONCLUSION

Legal ethicists want to protect clients from attorneys' wrongdoing. Sometimes, they can do this straightforwardly, by exposing and condemning acts that are *malum in se*, such as thefts and deceptions. But the actions by mass tort lawyers that divide academic commentators are *malum prohibitum*. They entail risks but may also generate gains. Taking agency law as a guide, most conduct of this type can be legitimated with clients' consent. In this realm, well-meaning interventions by academics are more likely to backfire, especially when paternalistic interventions prevent clients and lawyers with good incentives from innovating.

I would have more confidence in paternalistic recommendations if legal ethicists grounded them in the microeconomics of principal-agent relationships, for two reasons. First, the belief that clients and lawyers need fixed rules because they cannot reasonably be expected to solve problems on their own requires more support than it currently enjoys. A new opportunity to innovate arises every time a new litigation group forms, and the joint interest in minimizing agency costs should encourage lawyers and clients to experiment with new representational structures and forms. Ethics rules should permit these experiments to proceed. Second, the study of economics encourages modesty about the possibility of crafting macro-level solutions to micro-level problems. "The curious task of economics is to demonstrate to men how little they really know about what they imagine they can design."[80]

[80] F. A. HAYEK, *The Fatal Conceit*, *in* 1 THE FATAL CONCEIT: THE ERRORS OF SOCIALISM 66, 76 (W. W. Bartley III, ed., 1989).

Informed consent requirements especially require deeper justifications. A rule that conditions the enforceability of an agreement made at Time *1* on a client's possession of information that cannot be available until Time *2* is really a paternalistic prohibition on agreements of that type. The informed consent requirement in the ASR fits this description.[81] Because it establishes a disclosure requirement that cannot be met ex ante, it necessarily assumes that clients cannot decide for themselves how much information is enough. In cases like *Abbott* and *Tax Authority*, the assumption is certainly false. Whether it is true and helpful in other cases remains to be seen.

81 *See, e.g.*, ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 438, 6 (2006) (arguing that because the "detailed disclosures" required by the ASR "must be made in the context of a specific offer or demand[,] . . . the informed consent required by the rule generally cannot be obtained in advance of the formulation of such an offer or demand"); *see also* Erichson & Zipursky, *supra* note 55, at 313, 321 (arguing that clients' upfront consent to limitations on individual control of settlement decisions would be inauthentic because they would be underinformed).