

PREVENTING CLASS ACTION SELLOUTS

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When class actions settle, the defendant and class counsel have a strong joint incentive to appropriate part of the class's entitlement. The problem is long recognized, but neither existing mechanisms nor those suggested in the literature address it effectively.

The current article proposes a market-based solution to the problem: Once a settlement is struck, any attorney of the plaintiffs' bar may replace original class counsel, nullify the settlement, and litigate the case. This is done by paying original class counsel the fees stipulated in the settlement. When litigation concludes, new class counsel is rewarded based on the percentage-increase in the class's remuneration. The mechanism deters the formation of any settlement that is detrimental to the class, while preserving the incentives to reach all socially desirable settlements.

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I. INTRODUCTION

Class action settlements present a straightforward agency problem. Class counsel and the defendant have both the incentive and the opportunity to increase class counsel’s fees in return for a decreased payment to the class compared to the payment that would have been received in a fair settlement (Coffee 1987 Hay and Rosenberg 2000; Leslie 2007; Chen and Legg 2022).¹

As the vast majority of class actions settle (Klerman 2019, p. 1103; Lahav 2019, p. 1397; Consumer Financial Protection Bureau 2015; U.S. Chamber Institute 2017), this problem results in systematic under-compensation of class members, and concomitantly in systematic under-deterrence of wrongdoers (Hay and Rosenberg 2000; Chen and Legg 2022).

Legal doctrine has constructed several procedures aiming to tackle the problem. Most prominently, Rule 23(e) of the Federal Rules of Civil Procedure requires court approval for class settlements, and conditions such approval on the settlement being “fair, reasonable, and adequate” (Fed. R. Civ. P. 23; *Hefler v. Wells Fargo & Co.*, N.D. Cal. Dec. 17, 2018). This procedure is largely ineffective, however, because in an adversarial system the court’s ability to scrutinize the parties’ contentions depends on the parties’ rivalry. But when both parties are aligned in seeking approval of a settlement, this rivalry is lost. There are also two additional mechanisms currently in place that could seemingly rectify the problem – awarding class counsel a fee that is a fixed percentage of the class’s recovery, and allowing class members to file objections to the proposed settlement. For reasons surveyed below, these mechanisms are also deficient.

We propose a new, simple market-based mechanism to address the problem – a post-settlement option to acquire the right to represent the class. After a settlement is reached and before it is consummated, any attorney may acquire the right to represent the class by paying original class counsel the fees stipulated in the settlement. If such a purchase occurs, the settlement is

¹ Class action settlements also include a third party – class representative – who receives nominal remuneration within the framework of the settlement. We do not consider the award to class representative separately from class counsel’s fees, because class actions are normally motivated by attorneys, and class representative is often a mere eponym, whose name “graces the marquee” (Miller, 2003, p. 634). The distinction between class counsel’s fees and class representative’s award becomes more meaningful under a fee-shifting regime. We discuss such a regime in Section V.

nullified, the acquiring attorney is appointed as new class counsel and litigation resumes. At the end of trial new class counsel's fees are calculated based on her impact on the class's award. Particularly, new class counsel receives a fee that is equal to her overall expenses (including the amount paid to original class counsel and the cost of litigation) multiplied by the *percentage change in the class's award relative to its proposed recovery under the settlement*. Thus, for example, if under the settlement the class was to receive \$100 and ultimately receives \$150 – new class counsel's fees will equal her expenses multiplied by 1.5. The excess in the cost of representation stemming from the mechanism is borne by the defendant.

If the parties reach a sellout settlement – that is, if under the settlement the class nets less than its expected award in litigation – purchasing the right to represent the class becomes a lucrative investment for any attorney. The class's recovery can be increased because the recovery was, by construction, under-compensatory. And since the class's award is expected to grow, new class counsel expects to profit from entering. The mechanism thus incentivizes law firms of the plaintiffs' bar to monitor class settlements and nullify any settlement that shortchanges the class. The mechanism also penalizes the defendant for a sellout settlement, by holding her liable for any increase in fees resulting from incoming counsel's entry. By incentivizing entry and penalizing the defendant when such entry occurs, the mechanism ensures that a sellout settlement will always be a losing prospect for the defendant. Such settlements will thus be deterred *ex ante*. And if such settlements are nevertheless struck, the mechanism induces potential entrants to nullify them *ex post*. At the same time, the mechanism does not deter socially valuable settlements, which save on litigation costs without shortchanging the class. The proposed mechanism thus overcomes the system's deficiencies given the parties' absent rivalry.

As an instrument at the court's disposal, this mechanism expands the courts' decision-making arsenal. When a settlement is brought for approval under conditions of limited information, the court will not be confined to a simple approve-or-reject decision. It will have a third alternative: conditional approval with an avenue for entry of new class counsel. This third option, particularly valuable when information is scant, allows the court to leverage the market to scrutinize the settlement's adequacy.

We show that the proposed mechanism can be implemented under both types of cost-allocation rules – the American rule, according to which each party bears its own costs of litigation,

and the English rule, under which the losing party pays the vindicated party's costs. Although the mechanism will operate differently in each of these two regimes, the same underlying principles will ensure its efficacy in both.

This article unfolds as follows: In **Part II**, we review the procedures currently available under law and those proposed in the literature. We explain their shortcomings and explain why the problem of sellout settlements persists despite being long recognized (Parkinson 2016). In **Part III** we present the proposed mechanism in a nutshell, using a simple numerical example. **Part IV** develops a formal model, demonstrating the rule's effect of deterring sellout settlements without hindering socially desirable ones. **Part V** addresses the concern associated with negative-expected-value (NEV) acquisitions – the possibility that an attorney will acquire the right to represent the class only to extract a private payoff from the defendant or from original class counsel. This could ostensibly occur even if the settlement is beneficial to the class and litigating it carries a negative expected value for the acquiring attorney. We show that the proposed mechanism includes safeguards to deter such NEV acquisitions. **Part VI** provides concluding remarks. Finally, an **Appendix** outlines how the mechanism can be modified to fit jurisdictions employing a fee-shifting regime (under which the loser pays the winner's litigation costs).

II. LITERATURE REVIEW

When class actions settle, both class counsel and the defendant will find it profitable to increase class counsel's fees and decrease the defendant's payment at the expense of the class. As class members are largely uninvolved and rationally apathetic to the process in its entirety (Coffee 2000), class counsel's 'clients' cannot be expected to effectively monitor her actions (Coffee 1987). Class counsel and the defendant are thus largely free to self-enrich by shortchanging the class (Coffee 1987; Macey and Miller 1991, pp. 25-26; Nagareda 1996, p. 933; Leslie 2007, pp. 79-80; *Eubank v. Pella Corp.*, 753 F.3d 718, 720 (7th Cir. 2014); Xu 2020, p. 1585-86; Kidd and Whitehead 2021, pp. 589-90).²

Three existing mechanisms may seemingly address this concern: court supervision over

² Such settlements are also colloquially referred to as "sweetheart settlements" – see Coffee 1987, p. 883; Hay and Rosenberg 2000.

settlement terms; awarding class counsel a fee that is a fixed percentage of the class's recovery; and class members' objections to settlements. As the literature has shown, however, all suffer from fundamental flaws.

Court review of the fairness of settlement terms is notoriously ineffective because the parties arguing before the court are no longer in an adversarial relationship. To decide whether a settlement is fair, the court must gauge, among other factors, the *probability* that the class would prevail and the claim's *value*. For example, the court must know what evidence the parties have in their possession and would have presented but for the settlement, what objections to the submission of such evidence could have been raised, what the response to the objections would have been, etc. But the court is entirely dependent on the parties' willingness to provide this information. And given the non-adversarial position the parties hold after a settlement is agreed on, they have no incentive to present that information if it suggests that their settlement is inappropriate. The court's ability to question the parties' representations regarding the fairness and adequacy of the settlement is thus severely limited (*Eubank v. Pella Corp.*, 753 F.3d 718, 720 (7th Cir. 2014)). An additional concern raised in the literature is that courts may be predisposed to approving settlements, because doing so helps clear their overloaded dockets (Posner 1973; Helland and Klick 2007; Fitzpatrick 2020). Ultimately, as the 7th Circuit astutely put it, "the trial court's approval is a weak reed on which to rely once the adversaries have linked arms and approached the court in a solid phalanx seeking its approval" (*Creative Montessori Learning Ctrs. V. Ashford Gear L.L.C.*, 662 F.3d 913, 917 (7th Cir. 2011); see also *Devlin v. Scardelletti*, 536 U.S. 1 (2002); *Greenberg v. Procter & Gamble Co. (In re Dry Max Pampers Litig.)*, 724 F.3d 713 (6th Cir. 2013)).

Finally, the requirement for court approval does not penalize the settling parties for attempting to have an inappropriate settlement approved. Consequently, parties are incentivized to pursue the approval of inadequate settlements, knowing that some may survive court scrutiny.

A second approach to ensuring the adequacy of settlements involves granting class counsel a fee that is a fixed percentage of the class's recovery, regardless of whether the case is resolved through litigation or settlement. This seemingly obviates the need for court scrutiny of the settlement, as it aligns class counsel's interests with those of the class. To maximize her fees in settlement, class counsel must secure the highest possible recovery for the class; any compromise made on the class's behalf reduces her own compensation in direct proportion (Hay and Rosenberg

2000; Chen and Legg 2022). But this introduces a different problem. The amount of work required to realize a given recovery varies from case to case. Naturally, some cases are more complicated than others, and therefore a fixed percentage applied across the board is sure to be excessive in some cases and insufficient in others (e.g., in PLSRA class actions – see Shapira 2019; *Makor Issues and Rights, Ltd. v. Tellabs Inc.*, 437 F.3d 588 (7th Cir. 2008)). When the amount of work required is smaller than average, a fixed-percentage-of-recovery fee may overcompensate the attorney at the expense of class members. Conversely, cases requiring more work than justified by the expected fees (e.g., because in-depth investigations and solicitation of whistleblowers are required) would not be filed. Similarly, different cases have different prospects of success. If class counsel is not compensated for the risk that litigation will yield an unfavorable outcome, riskier class actions will become unviable. And indeed, acknowledging the variance across cases, courts often supplement the percentage-of-recovery system with a “lodestar method”, which offers added flexibility. This more adaptable method enables courts to calibrate the fee to class counsel’s reasonable efforts, the level of risk assumed, and in some cases the quality of work performed (Eisenberg and Miller 2010, 2013; Eisenberg et al. 2017; *Perdue v. Kenny, A.*, 559 U.S. 542 (2010)). But allowing the parties to argue for a different rate reintroduces the problems associated with court discretion in a non-adversarial setting. The settling parties can easily present the case as more labor-intensive than it actually is, thereby justifying a greater fee for class counsel. The courts have little ability (and perhaps limited incentive) to scrutinize such representations effectively.

Objections to settlements are a third mechanism that may seemingly address the problem. When class actions settle, class members are notified of the settlement, and are afforded a time-window during which they can file objections with the court (Fed. R. Civ. P. 23(e)(5)). Objectors alert the court to inadequacies in settlements and fill the adversarial void. But objections too suffer from significant shortcomings.

First, the court may not be quick to strike down a settlement that spares judicial resources (Helland and Klick 2007). Importantly in this context, the court cannot *force* the settling parties to adopt an alternative settlement that it considers justified in view of the objection. The court can

only strike down the settlement proposed by the parties, forcing them to renegotiate or litigate.³ Striking down a settlement thus introduces an immediate risk of protracted litigation. A court may thus deny justified objections, which in turn disincentivizes would-be objectors to invest in substantiating an objection. This problem is exacerbated by the fact that an objector is only rewarded if the objection results in a better *settlement*. Under the current regime, if an objection is upheld and the parties consequently litigate, the objector is not rewarded for this improvement even if litigation ultimately produces a better outcome for the class (see Klonoff, 2020, pp. 480-482). Thus, objectors are under-incentivized to file meritorious objections, knowing that such objections may result in litigation.

Second, even if the existing regime can be altered so that objectors are rewarded for all improved outcomes (which, in turn, requires evaluating which part of the improvement is attributable to the objection, and which to class counsel's efforts in litigation), another problem still persists: rewarding objectors based on the value added to the settlement does not penalize objectors for objections that were not upheld (Klonoff 2020).⁴ Therefore, objectors have an incentive to file frivolous objections. Even if such objections have a slim chance of being upheld (Bebchuk 1988, 1996; Bebchuk and Klement 2011, Hubbard 2015), they may still be filed as a lever to extract a private payoff from the settling parties (see, e.g., Lopatka and Smith 2012; Cabraser and Steinman 2020). Objectors can impose significant costs on the settling parties, as adjudicating objections takes time and consumes resources (Klonoff 2020; *In re Cardinal Health, Inc. Sec. Litig.*, 550 F. Supp. 2d 751 (S.D. Ohio 2008); *In re Petrobras Securities Litigation*, 317 F. Supp. 3d 858 (S.D.N.Y. 2018)). Moreover, when a trial court denies an objection for lack of merit, an objector may still appeal the decision (*Devlin*, 536 U.S. 1 (2002) at 14; Rubenstein, 2022), thereby significantly delaying the execution of the settlement and imposing additional costs on the settling parties. Caselaw and the literature suggest that objections typically impose more costs on the settling parties than the objector incurs. The objector can file a conclusory or routine

³ This is not only a matter of prevailing doctrine that can be changed. Either settling party may prefer to litigate than to agree to an alternative settlement, so courts cannot be authorized to impose a different settlement on the parties.

⁴ Of course, objectors must incur the costs of filing and litigating the objection. But the settling parties must also incur such costs (Rosenberg & Shavell, 1985). Importantly, objectors are not penalized for frivolous objections in any way that assures that they will find such objections unprofitable *ex ante*.

objection (e.g., by arguing that class counsel’s fees are too high or that the class’s recovery is insufficient – Lopatka and Smith 2012, 879; Klonoff 2020), whereas the settling parties are forced to justify the settlement in detail (Fitzpatrick 2020; Klonoff 2020). The settling parties may thus agree to pay an objector even if they perceive the objection to be meritless.

Not surprisingly, in practice objectors normally receive their remuneration as payment from class counsel in return for withdrawing their appeal (Greenberg 2010; Fitzpatrick 2020; Klonoff 2020; Frankel 2022). As one court put it (quoting Prof. Samuel Issacharof), “[T]he unfortunate game is to lodge *pro forma* objections at the trial stage, then negotiate a private resolution in order to drop the invariable notice of appeal.” (*Torres v. Bank of Am. (In re Checking Account)*, 830 F. Supp. 2d 1330 (S.D. Fla. 2011). Professional objectors have been characterized as “pariah[s] to the functionality of class action lawsuits” (*Snell v. Allianz Life Ins. Co. of N. Am.*, Civ. No. 97-2784 RLE, 2000 WL 1336640 (D. Minn. Sept. 8, 2000)); and their involvement has been described as “effectively a tax on class action settlements” (*Barnes v. Fleetboston Financial Corp.*, C.A. No. 01-10395-NG (D. Mass. Aug. 22, 2006)).⁵

A third problem with objections as a mechanism for preventing sellout settlements is that they lack a deterrent effect on the settling parties. Much like court supervision, objections – even when upheld by the court – do not penalize the settling parties for attempting to have a sellout settlement approved. The parties’ incentive to strike such settlements in the first place remains intact.

Thus, existing mechanisms do little to deter sellout settlements from the outset, and none of them offers a satisfactory solution to the problem.

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In addition to the procedures currently available under law, the literature has proposed

⁵ Congress has recently enacted an amendment attempting to make it more difficult to extract payments in return for forgoing or withdrawing objections, by requiring court approval for such payments (Fed. R. Civ. P. 23(e)(5)(b)). An article reviewing very preliminary results suggests that the practice has not been curtailed (Fitzpatrick, 2020), possibly because courts are still incentivized to sanction settlements that clear the docket. More importantly, even if this new amendment is successful in making it more difficult to extract such payments, it does not penalize objectors for filing such objections, and therefore does not disincentivize the practice of filing a myriad of objections, with a view to collecting a fee for those objections that are ultimately upheld.

several alternative mechanisms that warrant discussion.

First, Macey and Miller (1991) propose to eliminate class counsel's agency problem by auctioning the claim at a preliminary stage. The highest bidder pays her bid to class members and becomes the owner of the right of action. Once ownership of the claim in its entirety has been transferred, the divergence between the class's interests and those of its counsel is eliminated.

The mechanism, however, suffers from a severe practical shortcoming – the lack of sufficient funding. For the divergence of interests to be eliminated, the claim must actually be purchased. Any class action that is not purchased will remain open to abuse by class counsel and the defendant. This, in turn, raises two closely-related issues. First, as Macey and Miller acknowledge, financing is a problem for the larger claims (Macey and Miller 1991, p. 113). Some class actions are valued at hundreds of millions, if not billions, of dollars. Second, for the mechanism to function, *all* class actions that appear *prima facie* appropriate for certification must be auctioned. The funding necessary for the application of the mechanism on a large scale is thus the total value of all class actions. Even disregarding the largest claims, this cost is likely prohibitive.⁶

As we subsequently demonstrate, the mechanism proposed in this article does not rely on the ability to finance the value of an entire claim, but merely on the ability to pay original class counsel's fees. Moreover, even this payment is not actually required. The mere *threat* of acquisition is sufficient to deter sellout settlements. In equilibrium, acquisitions should rarely occur.

Polinsky and Rubinfeld (2003) develop a method addressing a closely-related problem – the misalignment of attorneys' and clients' interests with respect to class counsel's investment in the case. When an attorney is compensated on an hourly basis, she may be inclined to work too much (i.e., more than is justified from the client's perspective). Conversely, when she is compensated on a contingency basis, her incentive is to work too little, because she incurs the full cost of every working hour, but reaps only a fraction of the benefit that the hour yields. Polinsky and Rubinfeld suggest a modified contingency-fee system, which aligns the attorney's interests with those of her

⁶ A tweak of Macey and Miller's proposal might be suggested, whereby the class's claim is purchased post-settlement (a similar mechanism has been suggested in the context of *Parens Patria* claims (Beach, 2016)). This would reduce the total number of actions to which the mechanism would need to be applied. But it would not alleviate the problem: the full value of the claim would still need to be paid, and this would need to be done for all settling claims (including the largest ones). The funding necessary—the total value of all settling class actions—would likely remain prohibitive.

client: A Third-Party-Administrator (TPA) receives an up-front fee from the attorney, and in return compensates the attorney for part of her costs, irrespective of the outcome of the case. The part of the attorney's costs borne by the TPA is equal to the client's share of the reward. Thus, for example, if the attorney is to receive 25% of any amount awarded, the TPA would compensate her for 75% of her time, based on her regular hourly rate (irrespective of the trial's outcome). Consequently, for every additional hour worked, the attorney would bear 25% of the cost, while internalizing 25% of its value in promoting the client's case. This would align her incentives with those of the client, and induce her to work the same number of hours that an informed, knowledgeable, client would have her work. Although Polinsky and Rubinfeld's method is developed in the context of private lawsuits, it can be employed in the context of class actions as well.

But while Polinsky and Rubinfeld's mechanism may effectively align the attorney's incentives with those of the client with respect to the *amount of work* invested, it does not prevent sellout settlements in class actions. The method corrects class counsel's incentive to over- (and under-) invest in litigation, not her incentive to sell out the class. If the mechanism were adopted, class counsel would still find it beneficial to increase her own remuneration at the class's expense. And importantly, so would the TPA. As Polinsky and Rubinfeld acknowledge, the attorney and the TPA share a common interest vis-à-vis the client – they jointly bear the cost of the attorney's time and obtain the share of the award or settlement not collected by the client. Polinsky and Rubinfeld's model abstracts from this problem by assuming that the attorney's remuneration is given by a fixed percentage of the class's reward, whether the case settles or goes to trial. Such a compensation method indeed prevents sellout settlements. But in the context of class actions, it introduces new problems, as discussed above.⁷

Finally, Klement, Neeman and Ofir (2022) develop an extension to Polinsky and Rubinfeld's mechanism in the context of class actions. Klement et al.'s aim is to ensure that the attorney

⁷ Polinsky and Rubinfeld also point out that collusion between the TPA and the attorney may be prohibited by law, and that the TPA may suffer reputational costs. But while these safeguards may ameliorate the problem in the case of individual actions, they will be less effective in the context of class actions, where no actor is incentivized to monitor attorneys (and TPAs). If class counsel could be monitored effectively, the problem of sellout settlements would not arise in the first place.

initially appointed as class counsel is the one offering the class the maximum net payoff. They suggest a two-stage auction, whereby insurers initially bid for the percentage of the attorney's hourly fee for which they will pay, and attorneys then bid for the price they will pay to represent the class. Klement et al.'s proposal thus works to ensure that the class receives optimal representation at a minimal cost. But as Klement et al.'s proposal is based on Polinsky and Rubinfeld's mechanism, it too assumes that class counsel's fees (as ultimately set by the court) are based on a fixed percentage of the class's reward. This reintroduces the problems associated with such a mechanism.

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Existing solutions – both those employed by courts and those proposed in the literature – thus fall short as means of identifying sellout settlements and deterring them. Sellout settlements remain a largely unresolved problem in class actions (Lahav 2019; Xu 2020).

We next turn to outline our proposed mechanism. Before laying out the details of the model, we present the mechanism in a nutshell, and provide a simple numerical example.

III. THE PROPOSED MECHANISM IN A NUTSHELL

The goal of the proposed mechanism is to prevent sellout settlements without impairing the parties' ability to strike ones that benefit the class. The mechanism does so by incentivizing attorneys of the plaintiffs' bar to replace original class counsel whenever a settlement shortchanges the class, and by penalizing the defendant when that occurs.

A major advantage of the proposed mechanism lies in its low cost of implementation. Under the proposed mechanism, actual acquisitions rarely occur in equilibrium.⁸ Hence, deterrence is primarily achieved not through acquisition itself, but through the looming *threat* of doing so. Even when acquisition does occur, the cost of doing so is limited to class counsel's fees. Thus, achieving deterrence does not require the availability of funds in the tune of the *total* value of claims in *all*

⁸ This assumes that the market for class attorneys functions without major friction. In Section IV.C below (Proposition 2), we show that as the cost of monitoring settlements approaches zero, the rate of actual acquisitions approaches zero as well.

class actions (as in the option suggested by Macey and Miller); rather, funds must only cover class counsel's fees, and even that – only rarely.

Another significant advantage lies in the mechanism's reliance on a competitive market. The mechanism does not merely leverage the specialized expertise of class action attorneys as monitors of the adequacy of settlements, but also aligns their incentives with the social goal through competition. If only expertise were at issue, the sellout problem could be addressed by simply appointing class action attorneys as experts who are vested with the task of reviewing settlements. However, employing attorneys in this capacity would introduce major incentive concerns. First, as experts, attorneys would have limited motivation to conduct a rigorous evaluation of the settlement, as their compensation would not be tied to the accuracy of their assessments. By contrast, the proposed mechanism ensures that attorneys have a financial stake in the precision of their evaluations. Second, attorneys seeking to secure future appointments might be incentivized to approve sellout settlements if they believe that courts prefer such approvals – perhaps to ease congested dockets (Posner 1973; Helland and Klick 2007; Fitzpatrick 2020). Lastly, relying on attorneys as experts would not deter sellout settlements. If the only consequence of proposing such settlements is the risk of rejection, settling parties might still attempt to have them approved, banking on the possibility that some detrimental settlements will be upheld. The proposed mechanism offers a more robust safeguard, as it not only establishes a monitoring framework, but also penalizes parties for attempted transgressions.

In line with this framework, the proposed mechanism is structured around the following elements.

- (1) When a class action settles, the settlement and its terms are made publicly known *before* its final approval by the court (as under the current regime – Fed. R. Civ. P. 23(e)(1)). During this time window any attorney may purchase the right to represent the class by paying original class counsel the fees stipulated in the settlement. Once the right is acquired, original class counsel exits, the settlement is nullified (defendant makes no payment), and litigation resumes with the acquiring attorney acting as new class counsel.
- (2) If, following acquisition, the court rules in favor of the defendant, new class counsel is paid nothing. If it rules in favor of the class, new class counsel is paid a fee, the value

of which depends on the benefit litigation conferred on the class. More concretely, new counsel's fee is given by her expenses multiplied by the ratio of the class's net award in litigation to the amount it was to net under the settlement.

- (3) If the class prevails, liability for new class counsel's fee is divided between the class and the defendant. The class pays the amount it would have paid for the same outcome had new class counsel represented the class from the outset. The defendant pays any residual amount to which class counsel is entitled as a markup.

To illustrate the rule's operation, consider the following numerical example. A class action is filed; the probability of success is 0.5, and if successful, the class will be awarded \$200. The expected cost of litigation for the class (borne by class counsel) is \$5, as is the expected cost of litigation for the defendant. Given all relevant factors, class counsel's fair share of the recovery should be set at, say, 10%. Thus, if litigation proceeds to judgment, the class's net expected payoff is **\$90** ($= 0.5 \cdot (\$200 - 0.1 \cdot \$200)$), whereas the net expected profit for class counsel is **\$5** ($= 0.5 \cdot 0.1 \cdot \$200 - \5).

Suppose that class counsel and the defendant reach a settlement stipulating that the defendant will pay an overall sum of **\$60**, of which the class will receive **\$45**, and class counsel a fee of **\$15**. This settlement benefits the settling parties not merely by saving litigation costs of **\$10** ($= \$5 + \5), which is a socially desirable element of the settlement, but also by appropriating **\$45** ($= \$90 - \45) from the class. Relative to the no-settlement position, class counsel increased her payoff by **\$10** (obtaining a net profit of \$15 instead of \$5), and the defendant by **\$45** (bearing an ultimate cost of \$60 instead of \$105 ($= 0.5 \cdot \$200 + \5)).

Because the class's entitlement was appropriated, the proposed mechanism induces an attorney of the plaintiffs' bar to purchase the right to represent the class. If a new attorney enters, her overall cost will be **\$20** – consisting of \$15 payable to original class counsel and \$5 in litigation costs. But if she prevails at trial, she would raise the class's net award by **\$135**, from **\$45** to **\$180** ($= \$200 - 0.1 \cdot \200), or by 400%. If this scenario materializes, she will be paid **\$80** ($400\% \cdot \20). This scenario has a probability of 0.5 of materializing, so her expected fee is **\$40**. This exceeds the cost of purchasing the right to represent the class and litigating the case (\$20), so the new attorney would be induced to enter.

In case of success, liability for new class counsel's fee (\$80) would be divided between the class and the defendant. The class would be liable for \$20 – the same liability it would carry had incoming counsel represented the class from the outset. The remaining part of the fee (\$60) would be borne by the defendant. Hence, once the right to represent the class is acquired (following a sellout settlement), the defendant would not only bear the full expected liability ($0.5 \cdot \$200$) and its own litigation costs (\$5), but also a positive share of new class counsel's expected fee ($\$30 = 0.5 \cdot \60). Put differently, the sellout settlement would cost the defendant \$30 more (in expected terms) than litigating the case without attempting a sellout settlement. The more detrimental the settlement is to the class, the greater the defendant's liability for new class counsel's fee. Entering a sellout settlement thus imposes a loss on the defendant. She is better off not settling at all.

As new class counsel's fee is effectively a reimbursement of her costs plus a markup reflecting the benefit conferred on the class relative to the settlement, her incentive is to enter *if and only if* the settlement is detrimental to the class. If the settlement indeed appropriates some of the class's expected award, entry will benefit both the new attorney and the class. But if the settlement is beneficial to the class, entry will be a losing prospect for a new attorney. This ensures that the threat of acquisition will not deter socially valuable settlements. Settling parties incur no sanction if the sole effect of the settlement is to save litigation costs and the settlement appropriates none of the class's entitlement.

A major advantage of the proposed mechanism is its cost. Under the proposed mechanism, actual acquisitions rarely occur in equilibrium.⁹ Hence, deterrence is primarily achieved not through acquisition itself, but through the looming *threat* of doing so. Even when acquisition does occur, the funds required for the operation of the mechanism are limited to class counsel's fees. Thus, achieving deterrence does not require the availability of funds in the tune of the *total* value of claims in *all* class actions (as in the option suggested by Macey and Miller); rather, funds must only cover class counsel's fees, and even that – only rarely.

⁹ This assumes that the market for class attorneys functions without major friction. In Section IV.C below (Proposition 2), we show that as the cost of monitoring settlements approaches zero, the rate of actual acquisitions approaches zero as well.

Another significant advantage of the mechanism lies in its reliance on a competitive market. The mechanism does not merely leverage the specialized expertise of class action attorneys as monitors of the adequacy of settlements, but also aligns their incentives with the social goal through competition. If only expertise were at issue, the sellout problem could be addressed by simply appointing class action attorneys as experts who are vested with the task of reviewing settlements. However, employing attorneys in this capacity would introduce major incentive concerns. First, as experts, attorneys would have limited motivation to conduct a rigorous evaluation of the settlement, as their compensation would not be tied to the accuracy of their assessments. By contrast, the proposed mechanism ensures that attorneys have a financial stake in the precision of their evaluations. Second, attorneys seeking to secure future appointments might be incentivized to approve sellout settlements if they believe that courts prefer such approvals – perhaps to ease congested dockets (Posner 1973; Helland and Klick 2007; Fitzpatrick 2020). Lastly, relying on attorneys as experts would not deter sellout settlements. If the only consequence of proposing such settlements is the risk of rejection, settling parties might still attempt to have such settlements approved, banking on the possibility that some settlements will be upheld. The proposed mechanism offers a more robust safeguard, as it not only establishes a monitoring framework, but also penalizes parties for attempted transgressions.

IV. THE MODEL

A. The Basic Setup

Consider a class action interaction including $n + 2$ players: a class counsel C , a defendant D , and n attorneys C_A^i , all of whom are risk neutral. The class is widely dispersed, and therefore exerts no influence or impact on the overall interaction.

At time t_0 , (prospective) class counsel C and the defendant D monitor the potential merits of the action, incurring costs M_C and M_D , respectively.¹⁰ Monitoring reveals five key parameters:

- p – the probability of the class prevailing in court.
- v – the value of the award to the class if it prevails.

¹⁰ These costs are sunk prior to the implementation of the mechanism.

- ϕv – class counsel’s fee if the class prevails, where $\phi \in (0,1)$. In line with the American Rule governing cost allocation, the fee is deducted from the class’s award.¹¹
- c – litigation cost for class counsel.
- d – litigation cost for the defendant.

Class counsel can gain from filing an action if and only if $p\phi v \geq c$. If a claim is filed, the trial commences at t_1 . Still at t_1 , class counsel can offer a settlement to the defendant on a take-it-or-leave-it basis. A settlement is defined by a pair $\{s, f\}$, where s denotes the defendant’s overall payment, and $f \in (0,1)$ denotes the payment’s division, such that class counsel is awarded fs , and the class $(1 - f)s$. If the parties fail to reach a settlement, the case proceeds to litigation and the court renders a judgment at t_2 .

We distinguish between “detrimental” and “beneficial” settlements according to their impact on the class. A settlement is deemed detrimental if it leaves the class with less than its net award expected in litigation, $(1 - f)s < pv(1 - \phi)$. Conversely, it is deemed beneficial if it leaves the class with at least the net award expected in litigation, $(1 - f)s \geq pv(1 - \phi)$. Let $R \equiv \frac{(1-\phi)v}{(1-f)s}$ denote the ratio between the class’s net award if it prevails in litigation and its net award under the settlement. A settlement is thus detrimental to the class if $pR > 1$ and beneficial otherwise.

B. The Agency Problem

Before detailing our proposed mechanism, we utilize the framework of our model to delineate the agency problem impacting class action settlements.

Settlements can bring social value by saving the costs of litigation $c + d$. Yet, class counsel can exploit a settlement to seize not only that value, but also to appropriate the class’s expected

¹¹ The American rule provides that each party bears her own litigation costs, regardless of the outcome of trial. In Appendix 2 we consider a variation of our proposal within the context of the English rule, according to which the loser bears the winner’s costs.

award, $pv(1 - \phi)$. In an extreme scenario, class counsel might propose a settlement $\{s, f\} = \{pv + d, 1\}$, where defendant pays the expected cost she would have incurred in litigation, the class obtains nothing, and the entire award is diverted to class counsel.¹²

Recognizing this agency problem, current laws mandate court approval for class action settlements. Accordingly, one might presume that if class counsel brings a detrimental settlement for approval, the court will strike it down. Yet, discerning the biased nature of a settlement is not an easy task. Suppose, for instance, that class counsel asserts that her projected cost of litigation approaches the value of defendant's expected liability (i.e., c approaches pv). Should the court accept this factual premise, it may be compelled to approve a settlement where ϕ nears 1, to ensure satisfaction of class counsel's participation constraint ($p\phi v \geq c$). In other words, the court will approve a settlement allocating the entire award to class counsel, based on the assumption that no other allocation would preserve class counsel's incentive to pursue the action.¹³

It follows that if a court is to *effectively* scrutinize the settlement, it must be able to observe the relationship between pv and c . However, gauging the precise values of these variables may pose a significant verification challenge. The settlement approval proceeding typically occurs early in litigation, when the court is not yet familiar with the details of the lawsuit and cannot form an independent assessment of its essential variables. The challenge is further compounded by the fact that the proceeding is non-adversarial. Once a settlement is reached, both class counsel and the defendant are united in their pursuit of approval, and are both motivated to downplay any elements that could be seen as detrimental to the class.¹⁴ With the court's limited access to impartial data

¹² The take-it-or-leave-it-offer format, allowing class counsel to reap the entire surplus from a settlement, is assumed here for simplicity. Note that if class counsel and the defendant share the proceeds of a settlement, the defendant will ultimately pay less than her full expected liability in litigation. Such a settlement could then compromise the goals of the liability system not only by appropriating the class's award, but also by under-detering the defendant's primary activity (Kidd and Whitehead 2021, p. 590).

¹³ Recall that the condition for a beneficial settlement is $(1 - f)s \geq p(1 - \phi)v$. Consequently, if $\phi = 1$, then a settlement allocating no compensation to the class (i.e., $(1 - f)s = 0$), is still deemed beneficial. This is because, the premise that $pv = c$ implies that even in the absence of a settlement, the class's share of the award would be zero.

¹⁴ While objectors might voice the class's concerns to some extent, their incentives are far from aligned with the interests of the class. For a discussion see notes 3 – 5 *supra* and accompanying text.

and inability to utilize the adversarial process to solicit credible information, class counsel is left with ample opportunity to claim an award that rightfully belongs to the class.¹⁵ We therefore assume that the case's parameters (p , v , ϕ , c and d) are not immediately verifiable to the court. The court will only be able to observe these values at the trial's conclusion, and only if the parties opt for litigation over settlement.¹⁶

If the court is to curb detrimental settlements without verifying the precise relationship between pv and c , it might consider establishing a benchmark parameter $\hat{f} \in (0,1)$ such that a settlement $\{s, f\}$ would be sanctioned only if $f \leq \hat{f}$. For instance, the court might determine \hat{f} based on the average value of ϕ typically granted in fully litigated cases (Hay and Rosenberg 2000). However, this approach has its limitations, being both under-inclusive and over-inclusive. The relationship between c and pv can vary significantly across cases, affecting the ideal allocation of an award between the class and class counsel. If the actual relation between c and pv merits a percentage fee that is lower than \hat{f} , then this approach will lead to the approval of detrimental settlements. Conversely, if the appropriate percentage fee in a specific case is higher than \hat{f} , it will lead to the violation of class counsel's participation constraint, thus deterring class actions that are socially beneficial. The proposed mechanism, to which we turn next, seeks a more refined outcome. It aims to harness market participants' information and expertise to achieve a more tailored and effective resolution.

¹⁵ Accordingly, the problem has been widely recognized in the general legal literature. See Part II *supra*.

¹⁶ The premise that information cannot be verified in the trial's early phases, yet becomes verifiable upon full litigation, is in line with the reasoning underlying the 'lodestar method,' commonly applied in determining class counsel's fee. According to this method, judicial assessment of the appropriate fee is predicated upon a series of factors (including the reasonable hours worked, the quality of the work, and the risk undertaken by the attorney), but the court's determination of these factors is deferred until the conclusion of the litigation process. For a discussion, see, e.g., Fitzpatrick (2021, p. 1157); *Goldberger v. Integrated Resources, Inc.*, 209 F.3d 43 (2d Cir. 2000), pp. 46-47, 50.

C. *The Proposed Mechanism*

An ideal solution to the problem must concurrently attain two goals: first, it must deter detrimental settlements in which the class's entitlement is appropriated; and second, it must not hinder beneficial settlements that save litigation costs without shortchanging the class. The proposed mechanism, which strives to meet both these ends, is structured as follows.

Upon settlement, each of the n attorneys C_A^i observes the settlement terms $\{s, f\}$, and can apply to acquire the right to represent the class. These attorneys are initially uninformed about the parameters of the class action (namely p , ϕ , v , c and d), but they hold the same prior beliefs about their values.¹⁷ These beliefs, along with the terms of the settlement, allow them to form a probability distribution over pR , which we denote by F . Each attorney C_A^i can reveal the lawsuit's parameters by investing M_i in monitoring. Without loss of generality, we assume that $0 \leq M_1 \leq M_2 \leq \dots \leq M_n$. Any attorney litigating the case must acquire this information, and the cost of doing so must be incurred in addition to the cost of litigation, c .¹⁸

Each C_A^i must choose among the following three options:

- (1) Refrain from both monitoring and acquisition.
- (2) Apply for acquisition without prior monitoring.
- (3) Invest M_i in monitoring and determine whether to apply for acquisition based on the information obtained.

Note that strategy (2) is dominated by strategy (3). As an attorney cannot litigate the action unless she incurs both M_i and c , she might as well incur M_i first and use the information revealed to guide the decision on whether to pursue acquisition. Strategy (2) can therefore never lie along the game's equilibrium path.

We assume that if no C_A^i applies for the right to represent the class, the settlement is executed as agreed. If a single attorney applies, the right is granted to that attorney. If multiple attorneys

¹⁷ In the interest of preserving notation, we refrain from specifying these beliefs formally.

¹⁸ One could alternatively conceptualize the overall cost of litigation as consisting of two components: (a) the cost of learning the core features of the case; and (b) the cost of arguing the case in court. An attorney cannot escape either component of the cost when taking a case to court. However, if an attorney monitors the case before assuming the role of counsel (thereby learning its core features), she need not incur the same cost again when becoming counsel.

apply, the right is randomly granted to one of them. If a C_A^i is indifferent between acquiring the right or not, she does not apply for acquisition. Denote by C_A an attorney who is ultimately granted the right.

Once the right is acquired, the settlement is rendered void (resulting in no payment from defendant) and the following conditions apply:

- Litigation resumes and C_A and D are barred from striking a second settlement.¹⁹
- C_A pays original counsel the fee stipulated in the settlement, fs , and bears the class's litigation cost c . If the class loses at trial, C_A receives no compensation. If the class prevails, C_A is entitled to a fee of $R(fs + c)$.
- If the class prevails, it contributes up to ϕv towards C_A 's fee. If $R(fs + c) > \phi v$ then any remainder is borne by the defendant.

Note that, in principle, the defendant's expected share of C_A 's fee, $pR(fs + c) - p\phi v$, is not necessarily positive. However, as demonstrated in Proposition 1, it is invariably positive if the settlement was detrimental to the class. This ensures that, given acquisition, forming a detrimental settlement is a losing prospect for defendant.

Further note that if the class prevails, its payment towards new counsel's fee remains ϕv , i.e., the same fee it would have incurred had C_A represented the class from the outset, and no settlement had been reached. The proposed mechanism thus insulates the class from any additional cost stemming from the markup on acquiring attorney's fees ($R(fs + c) - \phi v$). The cost of that markup is borne fully by the defendant.

* * *

Like any market-driven solution, the mechanism's performance can be diminished by frictions originating from transaction costs, which in this case manifest as the cost of monitoring

¹⁹ As we discuss in Part VI below, the prohibition on a second settlement ensures that acquisition will always be deterred if the settlement is beneficial.

settlements. Should monitoring costs prove prohibitively high for all potential entrants, then the market's capacity to regulate behavior would naturally weaken. The Proposed Mechanism might be finely tuned to assist in alleviating these costs. One viable strategy is to impose specific discovery obligations on the settling parties.²⁰ Furthermore, for some potential entrants the cost of monitoring might be nonexistent or negligible. Attorneys often compete for appointment as class counsel at the initial phases of class action litigation. In the course of doing so, they obtain substantial information about the parameters of the case and its prospects of success. Consequently, attorneys who were denied the role of original class counsel will often be in a position to scrutinize the settlement at minimal cost.

The forthcoming analysis thus differentiates between two scenarios: one where monitoring costs are absent post-settlement, and another where they are present. The first scenario applies to cases where at least one potential entrant is already informed about the case's parameters at the time of settlement. The second scenario pertains to cases in which all potential entrants can acquire information only post-settlement, and at a positive cost. In the former case, the Proposed Mechanism yields an equilibrium in pure strategies, which is both optimal and unique. In the latter case, it yields an equilibrium in mixed strategies, the efficiency properties of which depend on the degree of friction. We demonstrate that as monitoring costs approach 0, the probability of achieving an optimal outcome approaches 1.

Scenario 1: No Monitoring Costs for at Least One Potential Entrant

As monitoring costs are assumed to be sequentially ordered, this scenario corresponds to the case in which $M_1 = 0$ and $M_i \geq 0$ for all $i \neq 1$. Given this premise, the following Proposition establishes that the Proposed Mechanism deters all detrimental settlements while facilitating beneficial ones.

²⁰ The legal infrastructure needed to avail third parties of information is already established under existing law within the realm of objections. Caselaw facilitates the transfer of information by making objectors eligible for discovery, and by allowing access to information depositories that the settling parties are required to set up (*In re Prudential Ins. Co. America Sales Practice Litigation*, 962 F. Supp. 450 (N.J., 1997); Rubenstein 2021 at §13.32; Greenberg 2010, p. 966). Analogous procedures can be employed to enhance the accessibility of information to attorneys considering an acquisition.

Proposition 1

Assuming that $M_1 = 0$ and $M_i \geq 0$ for all $i \neq 1$, the Proposed Mechanism yields a unique subgame perfect equilibrium in pure strategies, in which C and D strike a beneficial settlement, no C_A^i enters, and the settlement is executed as agreed.

Proof:

As $M_1 = 0$, the lawsuit's parameters are revealed by at least one potential entrant, C_A^1 . Accordingly, any C_A^i who engaged in monitoring will seek acquisition if and only if the expected fee exceeds the cost of acquisition and litigation:

$$pR(fs + c) > fs + c \quad (1)$$

Post-monitoring, acquisition will therefore be pursued if and only if $pR > 1$, i.e., the settlement is detrimental to the class. Note that no C_A^i will seek acquisition without prior monitoring, as this would not save C_A^i the cost of M_i , yet it would commit her to litigation even if condition (1) is not satisfied.²¹

The mechanism therefore guarantees that all detrimental settlements will trigger acquisition and all beneficial settlements will be executed as agreed. We next demonstrate that defendant will reject any offer of a detrimental settlement, as accepting it would place her in a worse position than if litigation proceeds without settlement. Recall that defendant's expected cost absent a settlement is $pv + d$. In contrast, if she accepts a detrimental settlement and C_A enters, her cost would include not only $pv + d$ but also liability towards C_A 's fee, $\max(0, pR(fs + c) - p\phi v)$. It

²¹ See *supra* note 18 and accompanying text.

is easily verified that when the settlement is detrimental, the expression $pR(fs + c) - p\phi v$ is greater than zero, implying that defendant's expected cost will strictly increase.²² It follows that under the proposed mechanism defendant will reject offers of detrimental settlements, and class counsel will therefore offer only beneficial ones. ■

Scenario 2: Positive Monitoring Costs for All Potential Entrants

In this scenario we consider the case in which every potential entrant must incur a positive cost to ascertain the parameters of the action. Specifically, we now assume that $0 < M_1 < M_2 < \dots < M_n$. Within this framework, an equilibrium in pure strategies will typically not exist. The reason is that if a beneficial settlement is reached, the optimal strategy for C_A^i s is to refrain from monitoring. However, if C_A^i s fail to monitor, C and D are better off striking a detrimental settlement. Likewise, if a detrimental settlement is reached, the optimal strategy for C_A^i s is to engage in monitoring, provided that monitoring costs are not prohibitive. However, if monitoring occurs, D is better off rejecting an offer of a detrimental settlement, prompting C to propose a beneficial settlement instead.

Consequently, we focus on a mixed strategy equilibrium with the following properties: C alternates between beneficial and detrimental offers according to some probability; D accepts the offer; C_A^1 's monitoring decision is similarly determined probabilistically; and all other C_A^i s abstain from monitoring. As C_A^1 's monitoring cost draws closer zero, the probability of reaching an efficient outcome approaches 1.

Proposition 2

- (a) Assuming that $0 < M_1 < M_2 < \dots < M_n$, the Proposed Mechanism induces a sub-game perfect equilibrium in which players act as follows:

²² Recall that class counsel will offer a settlement only if $fs \geq p\phi v - c$, or equivalently, if $fs + c \geq p\phi v$. Multiplying both sides by pR and then deducting $p\phi v$ from both sides, we obtain: $pR(fs + c) - p\phi v > pR \cdot p\phi v - p\phi v$. Note that if the settlement is detrimental to the class (i.e., $pR > 1$), the right-hand side is positive: $pR \cdot p\phi v - p\phi v > 0$. As the left-hand side is larger, it follows that $pR(fs + c) - p\phi v > 0$ as well.

- C employs a mixed strategy θ , proposing a beneficial settlement with probability θ and a detrimental one with probability $1 - \theta$.
- D employs a pure strategy of accepting a settlement offer as long as its overall magnitude, s , does not exceed $pv + d$ (her expected cost absent a settlement).
- Every C_A^i employs a (possibly) mixed strategy $q_i \in [0,1]$ denoting i 's probability of monitoring. In equilibrium:
 - C_A^1 employs an actual mixed strategy ($q_1 \in (0,1)$).
 - All other C_A^i s abstain from monitoring ($q_i = 0$ for all $i \neq 1$).

(b) For an M_1 sufficiently close to zero, there is no equilibrium in which C and C_A^1 employ pure strategies.

(c) The Proposed Mechanism guarantees that, as M_1 approaches zero, the probability of a beneficial settlement approaches 1.

Proof. See Appendix 1.

The intuition underlying the proof can be explained as follows. In a mixed-strategy equilibrium, class counsel must be indifferent between proposing beneficial and detrimental settlements, meaning that both strategies must yield her the same payoff. In a beneficial settlement, the defendant's total payment equals its full expected cost of pursuing litigation, $pv + d$, while class counsel's recovery equals $p\phi v + d$ – the maximum she can capture while keeping the settlement beneficial.

However, in the case of a detrimental settlement, class counsel cannot demand the defendant's full expected payment $pv + d$, as such settlements expose defendant to additional liability in the event of acquisition. To compensate for this risk, the defendant will only accept the detrimental settlement if the total payment is reduced. This reduction must come entirely at the class's expense to maintain class counsel's indifference between the two strategies.

The size of the required reduction depends on the probability of monitoring and acquisition. The higher the likelihood of monitoring, the greater the reduction needed to ensure the defendant's acceptance of a detrimental settlement. However, this reduction has a natural limit—namely, the class's award cannot fall below zero. Once this threshold is reached, detrimental settlements become infeasible, as defendant would require a reduction that the class cannot bear.

As the cost of monitoring declines, making it easier to pursue, this limit is reached sooner. Ultimately, when it approaches zero, a mixed-strategy equilibrium can only be sustained if the probability of offering a detrimental settlement approaches zero as well.

V. PREVENTING NEGATIVE VALUE ACQUISITIONS

The analysis above demonstrates that litigation yields a positive value for an incoming attorney only if the settlement is detrimental to the class. However, as a substantial body of literature observes (Bebchuk 1988, 1996; Bebchuk and Klement 2011, Hubbard 2015), a party may sometimes initiate litigation even when it carries a negative expected value (a phenomenon known as a 'NEV suit'). The general motivation underlying NEV suits is the hope of extracting a payment from the counterparty in a future settlement. Indeed, if a plaintiff can credibly commit to litigate the case (despite its NEV character), she can expect the defendant to settle, as settlement allows the defendant to save litigation costs. If settlement can be reached early enough, committing to pursue a NEV suit can thus be a profitable strategy for a rational plaintiff.

The possibility of profitable NEV suits could seemingly carry over to the current setting, potentially challenging the efficacy of the proposed mechanism. An attorney could seemingly leverage the threat of entry even when a settlement is beneficial, aiming to extract payment from either settling party (or from both). Indeed, when settlement negotiations are not confined to a take-it-or-leave-it format, both class counsel and the defendant derive a positive profit from settlement, making them both inclined to prevent entry that would render it void. In that sense, the concern for NEV acquisitions may be viewed as a straightforward extension of the previously-discussed phenomenon of "blackmail objections", or "extortionate objections" (Lopatka and Smith 2012, pp. 880–882; *In re Petrobras Securities Litigation*, 317 F. Supp. 3d 858 (S.D.N.Y. 2018)). While such objections are unlikely to succeed on their merits, they can still inflict significant losses on settling parties by prolonging litigation and by delaying the execution of the settlement. Thus,

they serve as a bargaining tool for objectors to extract a payout in exchange for dropping the legal challenge (see Lopatka and Smith 2012, pp. 876–879; Rubenstein 2021 at §13:21).

If NEV acquisitions can occur, they are likely to hinder the parties' ability to strike beneficial settlements in the first place. The need to pay off an entering attorney (and perhaps a series of attorneys appearing in sequence thereafter), will obviously raise the cost of entering a beneficial settlement relative to continued litigation. The proposed mechanism therefore includes elements designed to counter the threat of NEV acquisitions, by preventing a new attorney's extortionary power both vis-à-vis original class counsel and vis-à-vis the defendant. We next discuss both elements in turn.

A. Extracting a Payment from Original Class Counsel

To safeguard original class counsel from the threat of NEV acquisitions, the proposed mechanism requires that an entering attorney pay class counsel fs – the fee she was to receive under the terms of the settlement. This requirement immunizes original class counsel from extortion: As the entering attorney must pay her exactly what she was to receive under the terms of the settlement, she is indifferent to entry. She is also not threatened by the prospect of future litigation, as she will bear no cost if such litigation occurs. Once an acquiring attorney enters, she is not involved in the case in any way.

This is, in fact, the justification for requiring that an acquiring attorney pay original class counsel's fees. Absent a concern for NEV acquisitions, this payment would be unnecessary. As new class counsel incurs the costs of litigation (c), the rule could ostensibly police the parties' incentives by simply granting an acquiring attorney a markup on c . Setting the acquiring attorney's expected fee to pRc , entry would be lucrative whenever the settlement is detrimental to the class ($pR > 1$), but not otherwise ($pR \leq 1$). But doing so would open the gates to NEV acquisitions designed to extract a payment from original class counsel. A new attorney could then commit to enter even when a settlement is beneficial to the class, knowing that original class counsel would pay up to fs to secure the original settlement's execution. Conditioning the new attorney's entry on payment of fs removes the vulnerability of original class counsel.

B. Extracting a Payment from the Defendant

In order to curb NEV acquisitions aimed at extracting a payment from the defendant, the rule must regulate the terms of a second settlement, after the right to represent the class is acquired. To illustrate why a second settlement must be regulated, consider the following example. Suppose that original class counsel and the defendant strike a *beneficial* settlement in which $pR = 0.8$, and class counsel's award under the settlement is \$5. Further suppose that if a new attorney acquires the right to represent the class and the case is litigated, each of the litigating parties will incur a cost of \$10. As $pR < 1$, acquiring the right and litigating the case would carry a negative expected value for new class counsel. The overall cost of acquisition and litigation is \$15 ($= \$5 + \10) while the return is only \$12 ($= 0.8 \cdot \15). But an attorney may benefit from acquisition if she expects to settle. Once the right to represent the class is acquired, the cost of \$5 paid to original class counsel becomes sunk. The acquiring attorney's residual cost of pursuing litigation is then only \$10, while the expected return remains \$12. As the threat of litigation is now credible, the defendant would be willing to enter a settlement where acquiring attorney is paid up to \$10 (in addition to the suit's net expected value, payable to the class). If acquiring attorney receives at least \$5 in a second settlement, she will have profited from entry. Thus, even though the original settlement was beneficial to the class, and therefore acquisition produced a negative expected value for acquiring attorney (conditional on litigation) – a new attorney is not deterred from making the acquisition.²³

The proposed mechanism offers a straightforward solution to this concern by prohibiting a second settlement (Shavell and Rosenberg 2006).²⁴ If the prospects of a second settlement are removed, an acquiring attorney cannot hope to profit from a NEV acquisition. A threat to pursue it is no longer credible, and its capacity to deter beneficial settlements is eliminated.

²³ For a general model exploring the interplay between early investments in litigation and settlement patterns in NEV suits, see Hubbard (2015).

²⁴ Shavell and Rosenberg do not propose a blanket prohibition on settlements. Rather, they propose a rule under which a defendant may preclude the enforceability of any future settlement (through a court declaration to that effect). This allows the defendant to credibly commit *not* to settle, thereby deterring plaintiffs from filing a NEV lawsuit. The logic underlying our proposed restriction is parallel to the scheme proposed by Shavell and Rosenberg.

VI. CONCLUSION

The phenomenon of sellout settlements is, as of yet, inadequately resolved. Neither the mechanisms suggested in the literature nor those currently available under law offer a satisfactory solution to the problem. Judicial oversight of settlements is notably compromised by the absence of an adversarial relationship, and by the court's unfamiliarity with the case at the early phases of litigation. This leaves courts with limited options, such as imposing arbitrary caps on class counsel's fees – a strategy that can either discourage labor-intensive and high-risk class actions, or compensate attorneys excessively, at the class's expense. While auctioning the entire claim to a single plaintiff could offer a theoretically sound solution, it depends on the availability of funding for the aggregate expected value of *all* class actions, which renders it impractical.

The mechanism proposed in this article takes an alternative approach. It suggests leveraging the market for class action attorneys as a means of regulating settling parties' incentives. The mechanism is comprised of a post-settlement option to acquire the right to represent the class, paired with a reward scheme, making the purchase worthwhile if and only if the class's recovery can be increased. This induces attorneys of the plaintiffs' bar to monitor class settlements, prompting acquisition if and only if a settlement is detrimental to the class. By making the defendant bear the markup on incoming counsel's fees, the mechanism deters any settlement that sells out class members.

The mechanism thus offers an additional option that courts can utilize when evaluating settlements, moving beyond the binary choice of approval or rejection (or the imposition of arbitrary caps). Instead, courts can expose the settlement to the scrutiny of the market. This option can serve as a valuable instrument in the judicial toolkit, and is particularly advantageous when a court faces substantial informational limitations.

APPENDIX 1: PROOF OF PROPOSITION 2

Part (a): The reasoning presented in Proposition 1 remains applicable in relation to two preliminary points. First, if a settlement is struck, and at least one C_A^i engages in monitoring, the

right to represent the class will be acquired if and only if the settlement is detrimental ($pR > 1$). Second, acquisition is pursued only after monitoring, as seeking acquisition without prior monitoring is a dominated strategy for C_A^i s.

Given these observations, we proceed to establish the existence of the stated equilibrium. For C to employ a mixed strategy between a beneficial and detrimental settlement offer, she must be indifferent towards the (pure) strategies being mixed. Denote by $\{s_B, f_B\}$ a settlement that C will propose if it is beneficial. C will maximize her designated reward $f_B \cdot s_B$ by setting $s_B = pv + d$ (the maximum amount D will pay to avoid litigation), under the constraint that the settlement must be beneficial, $(1 - f_B)s_B = p(1 - \phi)v$. Hence, C 's reward under the settlement is:

$$f_B \cdot s_B = s_B - (1 - f_B)s_B = p\phi v + d \quad (2)$$

Note that $f_B \cdot s_B$ equals the benefit C would attain absent a settlement ($p\phi v - c$) plus the settlement's entire social value ($c + d$).

Next consider a detrimental settlement, $\{s_D, f_D\}$, that C might contemplate as an alternative for $\{s_B, f_B\}$. For C to be indifferent between the beneficial and detrimental settlements, her reward $f_D \cdot s_D$ must also equal $p\phi v + d$. The overall payment s_D , however, will be lower than s_B : As a detrimental settlement triggers a potential acquisition, D 's willingness to accept the offer will reflect her heightened exposure to liability. Let q denote the beliefs of C and D that at least one C_A^i will engage in monitoring (which, in equilibrium, must be the true probability of this event). As the settlement considered is detrimental, q also represents the probability of acquisition. D will thus require that her added liability (incurred with probability q) be offset by a corresponding reduction in s (a reduction that will benefit D only if no monitoring occurs, an event realized with probability $1 - q$). Hence, $s_B - s_D$ must satisfy the following condition:

$$(1 - q)(s_B - s_D) = q(pR_{\{s_D, f_D\}}(f_D \cdot s_D + c) - p\phi v) \quad (3)$$

where $R_{\{s_D, f_D\}}$ denotes the value of R under settlement $\{s_D, f_D\}$, and $pR_{\{s_D, f_D\}}(f_D \cdot s_D + c) - p\phi v$ states the increase in D 's expected liability in case of acquisition.²⁵

Let $y \equiv (1 - f_D)s_D$ denote the class's award under $\{s_D, f_D\}$. As $f_D \cdot s_D = f_B \cdot s_B$, the entire reduction in D 's payment ($s_B - s_D$) must come at the expense of the class. Consequently, we have:

$$y = (1 - f_B)s_B - (s_B - s_D)$$

Or, using (3):

²⁵ Recall that $pR_{\{s_D, f_D\}}(f_D s_D + c)$ is the acquiring attorney's expected compensation, but as the class covers $p\phi v$ of this award, D 's liability remains $pR_{\{s_D, f_D\}}(f_D s_D + c) - p\phi v$. As demonstrated in the proof of Proposition 1, D 's residual liability is strictly positive whenever the settlement is detrimental. See *supra* note 22 and accompanying text.

$$y = (1 - f_B)s_B - \frac{q}{1-q} \left(pR_{\{s_D, f_D\}}(f_D \cdot s_D + c) - p\phi v \right) \quad (4)$$

Since $(1 - f_B)s_B = p(1 - \phi)v$, $R_{\{s_D, f_D\}} = \frac{(1-\phi)v}{y}$ and $f_D \cdot s_D = p\phi v + d$, we can re-formulate (4) as:

$$y = p(1 - \phi)v - \frac{q}{1-q} \left(p \frac{(1-\phi)v}{y} (p\phi v + d + c) - p\phi v \right) \quad (5)$$

Observe that (5) can be expressed as a quadratic equation in y :

$$y^2 - \left(p(1 - \phi)v + \frac{q}{1-q} p\phi v \right) y + \frac{q}{1-q} (p(1 - \phi)v(p\phi v + d + c)) = 0 \quad (6)$$

The solutions to this equation are given by:

$$y_{1,2} = \frac{p(1-\phi)v + \frac{q}{1-q} p\phi v \pm \sqrt{\left(p(1-\phi)v + \frac{q}{1-q} p\phi v \right)^2 - 4 \frac{q}{1-q} (p(1-\phi)v(p\phi v + d + c))}}{2} \quad (7)$$

Note that a solution to (7) always exists for a value of q sufficiently close to zero.

We next characterize the monitoring decisions for C_A^i s. Initially observe that monitoring cannot occur with probability 1 in equilibrium. This stems from the fact that, with $q = 1$, D cannot be induced to accept a detrimental settlement (see condition (3)). Second, if any C_A^i with $i > 1$ chooses to monitor, or exhibits indifference in relation to monitoring, then any C_A^i with a lower i must hold a strict preference for monitoring, thereby setting $q = 1$. It follows that in equilibrium all C_A^i s with $i > 1$ must hold a strict preference against monitoring, whereas C_A^1 must be indifferent. To ensure C_A^1 's indifference, her monitoring cost M_1 must equal her potential gain from acquisition:

$$M_1 = (fs + c)(1 - F_\theta(1))(E_\theta(pR/pR > 1) - 1) \quad (8)$$

where θ denotes the probability of a beneficial settlement. F_θ and E_θ refer to C_A^i 's beliefs given by the cumulative distribution of pR and its expected value, respectively. $E_\theta(pR/pR > 1)$ is their belief about the expected value of pR conditional on a detrimental settlement offer. These beliefs are influenced by both external uncertainty (concerning the parameters of the legal action) and by strategic uncertainty (pertaining to the actions taken by C and D , i.e., C 's offer and D 's response).

As beliefs about C and D 's strategies must be correct in equilibrium, we can replace $1 - F_\theta(1)$ with $1 - \theta$, the actual probability of a detrimental settlement. Additionally, we can substitute fs with $p\phi v + d$ and $E_\theta(pR/pR > 1)$ with $\frac{p(1-\phi)v}{y}$. Also recall that y is a function of q and can therefore be written as $y(q)$. With these substitutions, (8) can be rewritten as follows:

$$M_1 = (p\phi v + d + c)(1 - \theta) \left(\frac{p(1-\phi)v}{y(q)} - 1 \right) \quad (9)$$

Rearranging (9) to isolate θ , we obtain:

$$\theta = 1 - M_1 \cdot \frac{y(q)}{(p\phi v + d + c)(p(1-\phi)v - y(q))} \quad (10)$$

Condition (10) expresses the relation between the two mixed strategies θ and q as a function of the primitives alone. Note that (7) determines y as a function of q and (10) determines θ as a function of $y(q)$. Hence, (7) and (10) jointly establish the relationship between θ and q as equilibrium strategies for C and C_A^1 .

Part (b): We initially demonstrate that for an M_1 sufficiently close to zero, C_A^1 will not employ a pure strategy, i.e., she will choose neither $q_1 = 0$ nor $q_1 = 1$ in equilibrium. Note first that if C_A^1 never monitors ($q_1 = 0$), then it must be optimal for all other C_A^i s to do the same (as $M_i > M_1$ for all $i \neq 1$). Moreover, with a sufficiently low M_1 , choosing $q_1 = 0$ can only be optimal for C_A^1 if settlements are beneficial with probability 1.²⁶ But if $q_i = 0$ for all i , C 's optimal strategy is to offer a detrimental settlement, knowing that D will accept it.²⁷ Conversely, choosing $q_1 = 1$ can only be optimal for C_A^1 if a detrimental settlement is reached with positive probability.²⁸ But if $q_1 = 1$, a detrimental settlement is never reached, as D cannot be induced to accept such a settlement (see (3)).

We next demonstrate that class counsel will not employ a pure strategy, i.e., will choose neither $\theta = 0$ or $\theta = 1$ in equilibrium. Offering only a detrimental settlement ($\theta = 0$) can only be optimal for C if D accepts the settlement offer.²⁹ But if $\theta = 0$ and M_1 is sufficiently close to zero, C_A^1 's best

²⁶ C_A^1 can benefit from monitoring as long as $M_1 < (fs + c)(1 - F_\theta(1))(E_\theta(pR/pR > 1) - 1)$. Thus, if a detrimental settlement is reached with positive probability (i.e., $1 - F_\theta(1) > 0$), and M_1 is sufficiently close to zero, choosing $q_1 = 0$ will not be optimal for C_A^1 .

²⁷ Recall that if $q = 0$, D accepts any offer in which $s \leq pv + d$. Hence, offering a detrimental settlement can yield C a payoff of $pv + d$, which exceeds the payoff of $p\phi v + d$ attained in a beneficial settlement.

²⁸ If a detrimental settlement is never reached (i.e., $1 - F_\theta(1) = 0$), then C_A^1 cannot benefit from monitoring as $M_1 > (fs + c)(1 - F_\theta(1))[(E_\theta(pR/pR > 1) - 1)]$ will hold for any $M_1 > 0$.

²⁹ Recall that if D declines the offer, the parties proceed to litigation. In that event C forfeits the opportunity to realize

response is to monitor with certainty ($q_1 = 1$). Hence, D uniformly rejects C 's offer, rendering $\theta = 0$ a sub-optimal strategy for C . Conversely, offering only a beneficial settlement ($\theta = 1$) can only be optimal for C if $q_i > 0$ for some i .³⁰ However, when $\theta = 1$, C_A^i 's best response is to refrain from monitoring for any $M_i > 0$.

Part (c): The result follows directly from condition (10). ■

APPENDIX 2: LITIGATION WITH FEE SHIFTING

In many jurisdictions, the norm governing the allocation of litigation costs is not the American rule, but rather the English rule, providing that the losing party is liable for the vindicated party's litigation costs. The English rule is the norm in most jurisdictions, with the exception of the United States and Japan (Terhar 2019, pp. 68-69). Even within the United States, there are numerous statutes applying the English rule in particular settings (Pacold 2001, pp. 1010, 1012 – 1014). Fee-shifting does not alter the principal problem underlying class action settlements, i.e., the concern that settlements will be used to appropriate the class's expected entitlement. However, as fee-shifting alters the litigation regime, the rule required to correct the parties' incentives takes a different form.

First, under the English rule, if the defendant loses, her liability consists not only of the class's award v , but also of class counsel's fee, ϕv . On the flip side, if the defendant wins, she is entitled to reimbursement of her litigation costs, d .

Second, considering that the class consists of a dispersed group of plaintiffs, it is impractical to apportion the defendant's costs among class members, as this would entail collecting trivial sums from a vast number of individuals. Therefore, to implement a fee-shifting regime, we consider a version of the English rule where a class representative, denoted CR , assumes the class's fee liability (Watson 2001, pp. 274-277; Chen and Legg 2022, pp. 9-10). Specifically, if the class action fails, CR pays d to the defendant; if it succeeds, she collects a share of rv from the class award, where $r \in (0,1)$. To ensure that CR is willing to act in that capacity, we assume that $prv > (1 - p)d$.

Third, a settlement benefits the class if and only if $(1 - f)s \geq p(1 - r)v$. Let $R^{ER} \equiv \frac{(1-r)v}{(1-f)s}$ denote the ratio between the class's net award if it prevails and its net award under the settlement. A settlement is thus detrimental to the class if $pR^{ER} > 1$ and beneficial otherwise. The factor R^{ER} replaces the factor $R \equiv \frac{(1-\phi)v}{(1-f)s}$, used in the context of the American rule.

Finally, if a new attorney assumes the role of class counsel and the class prevails, her fee is no longer divided between the class and the defendant, but rather borne exclusively by the defendant. This transition accounts for the fact that absent a settlement, the class pays nothing towards the fee of its attorney: if the action fails, the attorney is paid nothing; and if it succeeds, the fee is paid fully by the defendant (as prescribed by the fee-shifting regime). The modified

a profit of $p\phi v + d$ from a beneficial settlement, as opposed to a profit of $p\phi v - c$ in litigation.

³⁰ See note 27 *supra*.

mechanism follows the same scheme in case of acquisition, by imposing no liability on the class for the fees of its own attorney.

Note that in a fee-shifting framework, the benefit of settlement extends beyond the saving of litigation costs; it also encompasses the saving in class representative's (net) remuneration. This additional factor implies that class counsel can secure a higher profit from offering a beneficial settlement. Specifically, her profit will now consist not only of $c + d$ (as under the American Rule), but also of the saving in class representative's net expected compensation, $prv - (1 - p)d$.

The modified mechanism is formally defined as follows.

The Modified Mechanism. If C and D reach a settlement, the right to represent the class is offered for acquisition. If a C_A enters, the settlement is nullified (defendant makes no payment), litigation resumes, and the following conditions apply:

- (a) C_A pays original class counsel the fee stipulated in the settlement, fs , and bears the class's litigation costs, c .
- (b) If the class prevails, defendant pays v to the class and $R^{ER}(fs + c)$ to C_A . The class pays vr to CR .
- (c) If defendant prevails, C_A and the class are paid nothing and CR pays defendant d .
- (d) If C and D reach a settlement that is ultimately executed, CR pays nothing and receives nothing.

Similar to the analysis concerning the American Rule, we distinguish between the case in which monitoring costs are zero for at least one C_A^i , and the case in which monitoring costs are positive for all. In both cases, results are analogous to those obtained in the context of the American Rule. We next state the modified propositions.

Proposition 3

Assuming that $M_1 = 0$ and $M_i \geq 0$ for all $i \neq 1$, the Modified Mechanism yields a unique sub-game perfect equilibrium in pure strategies, in which C and D strike a beneficial settlement, no C_A^i enters, and the settlement is executed as agreed.

Proof. The proof proceeds analogously to that of Proposition 1, with pR^{ER} substituting for pR . The same arguments establish that all settlements are monitored; all detrimental settlements trigger acquisition; and all beneficial settlements are executed as agreed.

It remains to be shown that if a detrimental settlement is reached, and a C_A assumes the right to represent the class, defendant will be in a less favorable position than if she had rejected the settlement offer. Recall that if no settlement is reached and defendant loses at trial, she bears liability of v to the class and ϕv to class counsel, on top of her own litigation cost d . Conversely, if defendant wins at trial, her cost is 0 (recalling that her litigation cost d is borne by class representative). Her overall expected cost is thus $p(v(1 + \phi) + d)$. In contrast, in case of a detrimental settlement and subsequent acquisition, her expected cost shifts to $p(v + d) +$

$pR^{ER}(fs + c)$, where liability to class counsel $p\phi v$ is replaced with $pR^{ER}(fs + c)$. It is easily verified that $p\phi v < pR^{ER}(fs + c)$, implying that a detrimental settlement results in a higher cost for defendant.³¹ Consequently, D rejects any offer of a detrimental settlement, which induces C to propose only beneficial settlements. ■

Proposition 4

- (a) Assuming that $0 < M_1 < M_2 < \dots < M_n$, the Modified Mechanism induces a sub-game perfect equilibrium in which players act as follows:
- C employs a mixed strategy θ , proposing a beneficial settlement with probability θ and a detrimental one with probability $1 - \theta$.
 - D employs a pure strategy of accepting a settlement offer as long as its overall magnitude, s , does not exceed $p(v(1 + \phi) + d)$ (her expected cost absent a settlement).
 - Every C_A^i employs a (possibly) mixed strategy $q_i \in [0,1]$ denoting i 's probability of monitoring. In equilibrium:
 - C_A^1 employs an actual mixed strategy ($q_1 \in (0,1)$).
 - All other C_A^i s abstain from monitoring ($q_i = 0$ for all $i \neq 1$).
- (b) For an M_1 sufficiently close to zero, there is no equilibrium in which C and C_A^1 employ pure strategies.
- (c) The Modified Mechanism guarantees that, as M_1 approaches 0, the probability of a beneficial settlement approaches 1.

Proof.

Part (a): The proof for this part closely mirrors the arguments laid out in Proposition 2, with some modifications needed to accommodate the English Rule. We next present the argument concisely, emphasizing the junctures where adjustments are required.

As established in Propositions 1 and 2, a C_A^i will pursue acquisition only after engaging in monitoring, and only if it is revealed that the settlement is detrimental (which, under the English rule, translates to $pR^{ER} > 1$).

If C offers a beneficial settlement $\{s_B, f_B\}$, she maximizes her payoff $f_B \cdot s_B$ by setting $s_B = p(v(1 + \phi) + d)$ (the maximum amount D will pay to avert litigation), and $(1 - f_B)s_B = pv(1 - r)$ (the minimum payment to the class required to qualify the settlement as beneficial). From these conditions we can deduce that:

³¹ Note that $fs \geq p\phi v - c$ (because the settlement must increase C 's gain relative to the alternative of litigation) and $pR^{ER} > 1$ (because the settlement is detrimental). It follows that $pR^{ER}(fs + c) > p\phi v$, which yields the result.

$$f_B \cdot s_B = s_B - (1 - f_B)s_B = pv(\phi + r) + pd \quad (2A)$$

This sum is equivalent to the benefit that C would capture in litigation ($p\phi v - c$) supplemented by the entire aggregate value of the settlement, which includes the saving in litigation costs ($c + d$) and the saving of CR 's expected compensation ($prv - (1 - p)d$).

If C proposes a detrimental settlement, $\{s_D, f_D\}$, her award $f_D \cdot s_D$ must remain $pv(\phi + r) + pd$ to maintain her indifference between a beneficial and detrimental settlements. However, the overall payment from D , s_D , must be less than s_B to compensate for her additional exposure to liability. This relationship can be expressed as:

$$(1 - q)(s_B - s_D) = q \left(pR_{\{s_D, f_D\}}^{ER} (f_D \cdot s_D + c) \right) \quad (3A)$$

where $R_{\{s_D, f_D\}}^{ER}$ denotes the value of R^{ER} under the English Rule for the settlement $\{s_D, f_D\}$.³² Given that the entire reduction in D 's payment ($s_B - s_D$) is borne by the class, we can express the class's award under $\{s_D, f_D\}$ as:

$$y = (1 - f_B)s_B - \frac{q}{1-q} \left(pR_{\{s_D, f_D\}}^{ER} (f_D \cdot s_D + c) \right) \quad (4A)$$

Since $(1 - f_B)s_B = p(1 - r)v$, $R_{\{s_D, f_D\}}^{ER} = \frac{(1-r)v}{y}$ and $f_D \cdot s_D = pv(\phi + r) + pd$, we can reformulate (4A) as follows:

$$y = p(1 - r)v - \frac{q}{1-q} \left(p \frac{(1-r)v}{y} (pv(\phi + r) + pd + c) \right) \quad (5A)$$

Notice that (5A) can be rearranged to form a quadratic equation in y :

$$y^2 - pv(1 - r)y + \frac{q}{1-q} (p(1 - r)v(pv(\phi + r) + pd + c)) \quad (6A)$$

The solutions to this quadratic equation are given by:

³² Recall that $pR_{\{s_D, f_D\}}^{ER} (f_D s_D + c) > 0$ whenever the settlement is detrimental. See *Ibid*.

$$y_{1,2} = \frac{pv(1-r) \pm \sqrt{(pv(1-r))^2 - 4 \frac{q}{1-q} (p(1-r)v(pv(\phi+r) + pd + c))}}{2} \quad (7A)$$

Note that for a value of q sufficiently close to zero, a solution to (7A) always exists.

For reasons analogous to those presented in the proof of Proposition 2, an equilibrium requires that all C_A^i s with $i > 1$ abstain from monitoring, while C_A^1 remains indifferent towards monitoring. To maintain C_A^1 's indifference, her monitoring cost M_1 must equal her potential gain from acquisition:

$$M_1 = (fs + c)(1 - F_\theta(1))(E_\theta(pR^{ER}/pR^{ER} > 1) - 1) \quad (8A)$$

Given that beliefs about C and D 's strategies must be accurate in equilibrium, we can substitute $1 - F_\theta(1)$ with $1 - \theta$; fs with $pv(\phi + r) + pd$; and $E_\theta(R^{ER}p/R^{ER}p > 1)$ with $\frac{p(1-r)v}{y}$. Consequently, condition (8A) can be rewritten as:

$$M_1 = (pv(\phi + r) + pd + c)(1 - \theta) \left(\frac{pv(1-r)}{y(q)} - 1 \right) \quad (9A)$$

Rearranging (9A) to solve for θ , we obtain:

$$\theta = 1 - M_1 \cdot \frac{y(q)}{(pv(\phi+r) + pd + c)(pv(1-r) - y(q))} \quad (10A)$$

Similar to the result obtained in Proposition 2, (10A) expresses the relationship between θ and q solely in terms of the primitives. While (7A) specifies y as a function of q , (10A) determines θ as a function of $y(q)$. Consequently, (7A) and (10A) jointly establish the equilibrium strategies for C and C_A^1 in terms of θ and q .

Parts (b) and (c): The proof follows the same reasoning stated in the corresponding parts of Proposition 2. ■

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