CHAPTER 4

WHAT'S BAD ABOUT MASS ACTIONS

Let's see, where to start?

Okay, bad joke. Class actions can be and are a useful procedural device when they are used properly and for their intended purpose. But they also have inherent problems. For a business executive interested in reducing the risk of these lawsuits, it is important to understand some of these problems.

The Biggest Problem - Jackpot Justice

Jackpot Justice is one of the biggest problems in mass-action and class-action litigation. The plaintiffs' lawyers who bring these types of cases are strongly motivated by the massive financial incentives these cases offer. And because of the nature of these cases, there generally is little or no client oversight or control over what the plaintiffs' lawyers are doing. All of this can lead to massive abuses of the system.

Now, I have many good friends who are plaintiffs' class-action lawyers. They insist that they would never abuse the class-action tool. And most of them would swear on the Bible that they truly believe

what they are doing is ethical, productive, and incredibly important in keeping corporations from running roughshod over the rights of consumers and the public.

These are noble and laudable goals. But at the same time, it is difficult to ignore the structural incentives at work in class-action litigation.

There is a basic formula I like to keep in mind that provides insight into the motivations of plaintiffs' counsel in identifying and selecting class actions to file—and that can be a tool for understanding how to help your company avoid these cases:

Potential Recovery (PR) x Likelihood of Success (LS)
x ~15-35% (the lawyer's take of any recovery)
= Lawyer's Financial Incentive to Pursue Case (FIPC)
FIPC > Estimated Investment (EI) » plaintiff's lawyer will pursue case

Let's look at this formula.

We start with the **Potential Recovery**—the amount the plaintiffs' lawyer believes is potentially recoverable in the case on behalf of the class or plaintiffs. Class actions and mass actions involve the aggregation of individual claims, so the Potential Recovery is the total amount recoverable on behalf of all the members of the class or all those that are part of the mass action.

The next variable is the **Likelihood of Success**, meaning the probability that the plaintiffs' lawyer will succeed in recovering the first number—the Potential Recovery. In looking at the case, the lawyer will assign some probability—based on his experience and evaluation of the facts and law—to being able to obtain the Potential Recovery.

As presented, the formula only provides for one Potential Recovery and one Likelihood of Success figure. This, of course, is too simplistic. In evaluating a case, a lawyer may assign different probabilities to differing levels of recovery. And other lawyers involved in the case may have their own evaluations. You also could assign numerous Potential Recovery and Likelihood of Success figures and use Monte Carlo or other simulation techniques to provide a more accurate and sophisticated assessment.

But no matter how sophisticated or simple a calculation you make, the important point remains the same. Plaintiffs' lawyers will make some estimate of the Potential Recovery and Likelihood of Success. These factors are the key drivers of most decisions about whether to file or continue pursuing a class action. Understand how to control these factors, and you will understand how to reduce your company's risk of becoming a class-action target.

The next figure is the **Percentage Recovery**. In class actions and mass actions, plaintiffs' lawyers typically are paid on a contingency basis, meaning that their compensation is tied directly to the ultimate recovery in the case. Sometimes it is a percentage of the recovery by the class and sometimes it is a percentage of the total recovery on top of the recovery by the class. Either way, the basic premise remains the same—the bigger the recovery, the more the plaintiffs' lawyers stand to recover.

There have been many studies on the attorneys' fees awarded in class-action settlements. Two basic points emerge. First, the percentage awarded to plaintiffs' lawyers most often falls in a range from about 15% to 35%. Yes, there are awards that are higher and lower, but most fall within this range. Second, the percentage recovered by plaintiffs' lawyers has a negative correlation to the size of the overall recovery. In other words,

the percentage falls when the total recovery is higher and increases when the total recovery is lower. Why? Likely because courts oversee the size of the attorneys' fee award and are trying to avoid a massive windfall to the lawyers when the total recovery is large, while honoring the "normal" contingency fee rate of about 30-40% when the total recovery is smaller.

So the basic formula ends up looking like this: total Potential Recovery multiplied by the percentage Likelihood of Success in obtaining that recovery, with that total multiplied by a percentage ranging from 15-35%. The resulting figure is the **Lawyer's Financial Incentive to Pursue the Case**.

The last factor is the **Estimated Investment**—the amount the plaintiffs' lawyer estimates he will have to put into the case. The number includes hard costs and expenses, such as filing fees, transcript costs, copying costs, etc., as well as expert witness and consultants' fees. The Estimated Investment also includes the value of the amount of time the plaintiffs' lawyer will have to invest in the case to obtain a successful outcome.

If the Financial Incentive to Pursue the Case is greater than the Estimated Investment, chances are good that the plaintiffs' lawyer will pursue the case.

Now, this formula is a basic representation of the financial incentives at work in class-action litigation for plaintiffs' lawyers. As I mentioned, there may be many different levels and likelihoods of recovery for the case, and some of the more sophisticated plaintiffs' firms take those differing levels and percentages into account when making the calculus as to whether to bring or continue pursuing a class-action case.

That said, there are several important insights that can be drawn from this formula.

The first and perhaps most important point is to understand the relationship between the Potential Recovery (i.e., the amount potentially at issue in the case) and the Likelihood of Success. As the magnitude of the Potential Recovery increases, you need only a relatively small Likelihood of Success to justify pursuing the case. So when a plaintiffs' firm sees a case with a Potential Recovery of $5 million and the merits are not very strong (maybe only 20% Likelihood of Success) and they do the calculus, they may decide it is not worth taking the case (because the Financial Incentive to Pursue the Case is less than $400,000).

But when you increase the Potential Recovery in the case from $5 million to, say, $100 million or $500 million, the calculus and likely decision completely changes. Even a relatively weak case, one with 20% or less chance of success on the merits, represents a potential payday for the lawyers of millions or tens of millions of dollars—maybe more.

This is the phenomenon that I like to refer to as "Jackpot Justice."

You have plaintiffs' lawyers looking at these cases and trying to understand the potential recovery and likelihood of success in the case, and they are doing these calculations that often lead them to the conclusion that even a very weak case is nonetheless worth bringing because of the potential magnitude of recovery. It is the same concept that leads people to play the lottery. The potential award is massive, while the investment is relatively small. So why not take a shot?

The phenomenon of Jackpot Justice is impacted by volume and scale. For example, if a plaintiffs' firm finds a case that has a modest Potential Recovery and a Likelihood of Success of only 20%, it still might be worth filing, provided they also file four other cases with similar or higher Potential Recoveries. If they win on just one of the five, that win will cover the costs of the other cases. Volume helps

plaintiffs' firms hedge against the risk of the inevitable losses.

This formula has several other important lessons for business executives interested in understanding how to limit and deal with class-action litigation, lessons we will discuss in the next part of the book. For present purposes, the important point to understand is that the structure of the class-action lawsuit leads to situations where it is economically rational for a plaintiffs' firm to bring a lawsuit that has relatively little merit, but that has a very large potential recovery if successful. This basic principle, combined with several other structural aspects of class-action litigation, can lead to abuses of the class-action process.

Absence of Client Control

There is a famous quote from notorious plaintiffs' lawyer William Lerach, who spent time in a federal prison for actions he took while pursuing class-action cases. The quote attributed to him is, "I have the greatest law practice in the world. I have no clients."[1]

For most class actions, what Mr. Lerach said is true. Although the plaintiffs' lawyer technically has a client in the named plaintiffs, at the end of the day those individuals often are legally unsophisticated and have neither the ability nor the interest to provide a real check on the actions of plaintiffs' counsel. The plaintiffs' firm is fronting all or most of the costs. The plaintiffs' lawyer developed the theory of the case and is involved in the day-to-day management of the litigation. The individual plaintiff has a relatively small interest in the case, in that his

1 Peter J. Henning, *Behind the Rise and Fall of a Class Action King,* available at http://dealbook.nytimes.com/2010/03/01/behind-the-rise-and-fall-of-a-class-action-king/

potential recovery will be a few dollars, while the plaintiffs' firm stands to receive millions.

Compare this to the defense side, where the companies and the in-house lawyers provide a powerful check on the actions of defense counsel. They understand the substantive legal issues at issue in the case, as well as the cost issues associated with pursuing various tactics of litigation. The company is paying all the costs and will be responsible for any settlement or judgment.

The result is a situation more similar to a prosecutorial proceeding than traditional commercial litigation. In most commercial cases, you have economically rational business people on both sides, each with the most significant financial interest in the management of the case and the outcome. In a class action, you have a defendant who, like the accused in a criminal case, faces massive risk and exposure. On the other side, you have a plaintiffs' lawyer who, like a government prosecutor, is operating essentially free of any client control, has complete discretion in terms of how to litigate the case, and has the most significant stake in the outcome. But unlike a prosecutor, there is no political check on the plaintiffs' lawyer, who is essentially free to do whatever he wishes, both in terms of which cases to pursue, how to pursue them and how to resolve those he does pursue.

As we shall see, the absence of any real check on plaintiffs' class action lawyers can lead to many types of abuse.

No Harm Mass Actions

The first area where you see massive abuse is the so-called "no harm" class action. These lawsuits are a somewhat recent phenomenon. They

allege that the company made some type of misrepresentation or nondisclosure in connection with the purchase of a product or service. The "harm" caused by the misrepresentation or nondisclosure is nonexistent—or at least very hard to identify. The consumer received the product or service, it performed essentially as expected, but the class action is nonetheless filed seeking to recover on behalf of all those subjected to the misrepresentation or nondisclosure.

Here is an example. Earlier, we discussed the litigation filed against the insurance industry alleging that a fee was disclosed on the wrong piece of paper. The basic theory was that under various state statutes, the fee should have been disclosed on the "policy." This fee, however, was disclosed on another piece of paper received and expressly agreed to by the customer, and the customer received the services associated with the fee. In that case, it was very hard to see how there could possibly have been any harm to the customers. Nonetheless, this type of litigation was allowed to proceed as a class action under the theory that, because of the alleged illegality, the defendant should be required to disgorge all of the money received.

Experienced defense counsel are starting to have success in defeating "no harm" class actions at an early stage of litigation by relying on legal principles such as standing and causation, something we will discuss later in more detail. But at this point, it is important to understand that this type of litigation is prevalent and presents a real risk to the company, even where—as I said—it is difficult to see any real harm to the customer.

Other examples include cases where there is some alleged nondisclosure or misleading statement by a company about its products or services. In these cases, the customers receive exactly what they

bargained for—namely the product or service they wanted at the agreed-upon and fully disclosed price. But the theory is that, because of some omission or misstatement, the product somehow is not worth as much as it should be. For example, there have been cases filed against the manufacturers of appliances like washing machines, where the theory is that the company engaged in false advertising by stating that the product was stainless steel. The product was, in fact, made of stainless steel—although there were some components that were not. The plaintiffs claimed that, by saying the appliance was made of stainless steel, they believed the entire machine was made of stainless steel. But it wasn't—and according to the lawsuits, consumers should be compensated because the non-stainless steel components exposed clothes to a potential source of rust.

Thankfully, most of these cases have been defeated, either through dismissal or through a denial of class certification. But at the same time, companies were forced to defend these cases and spend millions paying their lawyers to deal with these allegations. And they are cases where it is often very hard to see how anyone could have been hurt or suffered any harm.

The lesson is that, even where there is a business practice that does not appear to really hurt anyone, it still can be the subject of a mass action, creating massive risk and expense for a company, as long as there is some argument that the practice is misleading or illegal. Savvy business executives probably are asking themselves what they can do to try to place their company in a better position to prevent these lawsuits or at least minimize their impact. The good news is that there are steps a company can take to reduce the impact of these types of cases, as we will see in the next part of the book.

"Idiot Plaintiff" Mass Actions

Now that's not a very nice thing to say. But how many lawsuits have you heard about where you thought: what was that guy (the plaintiff) thinking?

Well, those types of cases are filed all the time—many of them as class actions. The allegations often share a common theme. The case alleges that a company's business practices or advertising somehow led consumers to believe that a product or activity was beneficial or good for them, when it really wasn't.

One example is the litigation recently filed against the fast food industry alleging that the advertising convinced people the food actually was good for them. Now, whatever you might think about food and fast food in particular, the basic concept behind these cases is that, because of the defendants' enticing advertisements, the plaintiff was unable to understand the true ramifications of consuming high-calorie, high-fat foods on an almost daily basis. These cases differ from the "no harm" litigation in that there does appear to be some detriment to the plaintiffs. Often the plaintiff has a massive weight problem and poor overall health and wants to blame the company that sold him the greasy burger he ate every other day for five years.

Or how about the case recently filed against video rental company, Redbox? The company offers "$1 per night" DVD rentals, with no late fees. But if you keep the video more than 24 hours, you are charged another $1 for the next 24-hour period. Seems simple enough. But an Illinois woman recently filed a consumer fraud class action claiming that, because of the company's "no late fees" representation, her understanding was that she would not be charged anything if she kept

the movie more than 24 hours. In her particular case, she kept the movie 25 days and claimed that Redbox could charge her only $1.

Are these isolated cases that can be written off to occasional instances of litigation stupidity?

Unfortunately, the answer is "no." Open your newspaper or web browser on any given day and you can find stories about seemingly ridiculous cases being filed as class actions. Consider the recent class action filed against the maker of the chocolate drink Yoo-Hoo, claiming that the company's "good for you" ad slogan was misleading because, as stated on the label, the drink actually contains partially hydrogenated oil, sugar and chemicals. As you sit there shaking your head, consider the class action filed against Nintendo, claiming the company's video game console called the "Wii" was defective because, if you swing the controller really hard *and let go of it*, the controller might fly out of your hand and damage nearby property or people. And that case was filed even though the company provided warnings about not letting go of the controller.

Many of these seemingly baseless cases have been dismissed or class certification rejected. But some haven't. And even for the ones that were dismissed, companies still spent millions in lawyers' fees and costs defending the allegations. Looking at these cases and the expense associated even with seemingly ridiculous litigation, the question becomes whether there are ways to try to minimize the risk of these types of claims being filed, or at least increase the company's chances of defeating them at the earliest stage possible if they are. That question is answered in the next part of the book.