UNIVERSITY OF PENNSYLVANIA

LAW SCHOOL

MEMORANDUM

TO: Participants in the Meetings of the Civil Rules Advisory Committee, February 16-17, 1995

FROM: Stephen B. Burbank

DATE: January 30, 1995

RE: Agenda and Advance Materials

Enclosed are a Preliminary Agenda for, and a List of Participants in, the meetings of the Advisory Committee on Civil Rules at the University of Pennsylvania Law School on Thursday, February 16 and Friday, February 17. Also enclosed are materials that may be useful in preparation for the discussions. The materials are keyed to the agenda items to which they relate. The individuals whose names are noted in connection with the agenda topics have kindly agreed to lead the discussions. The Federal Judicial Center will forward a report on its empirical work (agenda item I(E)) under separate cover.

All of the substantive sessions will be held in Room 145 of Tanenbaum Hall, the Law School's new building. The entrance to the Law School is located on Sansom Street between 34th and 36th Streets. Sansom Street itself is located between Chestnut and Walnut Streets and is easily reached on foot or by taxi from 30th Street Station and by taxi from the airport.

Rooms have been reserved, and will be held, for those who requested them at the Four Seasons Hotel. In the event of cancellation, it is the individual's responsibility to notify the hotel, (215) 963-1500, 48 hours in advance.

I look forward to seeing you on February 16.

IV(A)

THE UNIVERSITY OF MICHIGAN
LAW SCHOOL
HUTCHINS HALL
ANN ARBOR, MICHIGAN 48109

ASSOCIATE DEAN

January 21, 1993

Dear Civil Procedure Buffs:

This letter about Civil Rule 23 is being sent to an array of people who have shown interest in recent proposals to revise the Federal Rules of Civil Procedure. Recipients are free to share these questions with anyone who comes to mind, so long as the tentative posture of the proposal is made clear.

The Advisory Committee on Civil Rules has had a draft revision of Civil Rule 23 slowly simmering on a back burner for some time. The most recent form of the draft is enclosed. I have not made any attempt to redraft this version. Matters of style, of substance addressed, and of substance not addressed, remain in inherited form. Robust comments can be made without fear of offending pride of authorship.

The purpose of this circulation is to invite comments on every aspect of Rule 23. The draft may provide a convenient focus for initial reactions, but I and the Committee hope for a completely uninhibited expression of experience with Rule 23 as it stands and for visions of a better Rule 23. It is important that we hear from as many different forms of experience and perspectives as may be found. Topics not addressed by the draft are more important for this purpose than the topics that are addressed. A comprehensive response now will enable the Committee to determine whether the time has come to draft a revised Rule 23 for public comment, and to draft a better revision if any is to be pursued.

Timing

Rule 23 was changed dramatically in 1966. Many of those involved in the drafting process state that they had no idea of the uses that would be made of the new rule. If the revision process is pursued now, some three decades would have run by the time any changes could take effect. That is a lot of time for appraising the effects of the 1966 amendments. Careful study of Rule 23 now does not suggest unseemly haste or petty tinkering.

The conclusion that it is appropriate to study Rule 23 does not lead inexorably to the conclusion that it is appropriate to amend Rule 23. It is possible that experience shows that the Rule is working so well than amendment is not wise. It also is possible that the Rule is not working as well as might be, but that changes are likely to make matters worse. Even if significant improvements could be made now, it might be better to wait a while longer in the

hope that much more significant changes will soon be within reach.

One question, then, is whether the time has come to revise Rule 23.

Style

Whatever else happens, Rule 23 will be rewritten in the style of the Style Subcommittee of the Standing Committee. Comments on style are welcome, particularly when they suggest ambiguities or opacities, but it should be remembered that this draft does not conform to current style conventions.

Draft

The major change made by the draft is the amalgamation of subdivisions (b)(1), (2), and (3). This amalgamation has at least three major consequences. First, it will not be necessary to decide which subdivision applies. Second, the provision for opting out of a (b)(3) class is changed to a provision that permits the court to determine whether class members may opt out -- the court may deny any opportunity to opt out of what would have been a (b)(3) class, or may allow an opportunity to opt out of what would have been a (b)(1) or (2) class. Instead, the court may certify a class that includes only those who elect to opt in. Conditions may be imposed on those who choose to opt out or in. Third, the provision for notice applies to all three in ways that may reduce the requirements for notice in former (b)(3) classes and increase the requirements in former (b)(1) and (2) classes.

There are several other significant changes. It is made clear that classes may be certified for resolution only of specific issues. This provision, and the opt-in alternative, are aimed in part at providing a framework better adapted to consolidated litigation of mass tort disputes. Subdivision (a)(4) is changed to focus directly on the ability of attorneys to represent the class, and requires that representatives be willing to fairly and adequately represent the class. The requirement that the representatives be willing is most likely to affect certification of classes defending against a claim. There is an oblique reference to fiduciary duty in (a)(4), calculated to emphasize the obligation of representatives and attorneys to put aside self-interest.

Rule 23(d) would be amended to make it clear that motions under Rules 12 or 56 can be decided before certification.

A more dramatic change is suggested by the Note to Rule 23(e). On its face, Rule 23(e) suggests that a proposal to dismiss or compromise a class action may be referred to a magistrate judge or other special master under Rule 53 without regard to the provisons

of Rule 53(b). The Note suggests that this provision would authorize investigation of a proposed settlement by independent counsel as a means of breaking the information monopoly of self-interested parties.

There is little need to point up the questions raised by these changes. The notice provisions may provoke dissent on the ground that there should be no room for relaxation in (b)(3) classes, or that increased burdens should not be imposed on (b)(1) or (2) class representatives. Instead, it might be argued that the draft does not go far enough in either direction.

The prospect that members of a (b)(3) class might not be allowed to opt out may seem dangerous, particularly if the forum lacks any contact with the class member. Denial of any opportunity to opt out might seem particularly dangerous with respect to members of a defendant class represented by an all-too-willing volunteer. The provisions for conditions deserve special attention. What should happen, for example, if opting out is allowed on condition the class member not bring a separate action, and a class judgment is entered that fails the tests for precluding relitigation by class members who did not opt out?

And so of other facets of the draft. A lengthy enumeration of questions that come to mind might tend to close out other questions, and perhaps more important ones. The more questions we can identify now, the better.

Detailed Questions Not Addressed

Many relatively small questions are not addressed by the draft. Some may be better left to development without guidance in the rule. Others may be unimportant in theory or in practice. A brief list of representative examples may provoke interesting reactions:

Should a party seeking class certification be required to make a motion for certification by a specified time?

Is any useful purpose served by the typicality requirement of Rule 23(a)(3)?

Is it possible to go beyond vague allusions to fiduciary duty to define the ways in which the class and all its members become clients of the attorney for the representative parties? Would more detailed principles of fiduciary duty to the class be useful? Should counsel be required, for example, to continue a course of vigorous advocacy after it has become apparent that the yield in fees is not likely to compensate the effort?

Should there be provisions regulating discovery and

counterclaims against nonrepresentative members of the class?

Would it help to adopt express provisions regulating the impact of filing, denial of certification, or decertification, on statutes of limitations?

Is it possible to include a provision allowing denial of certification on the ground that the value of a class recovery does not justify the burden of class adjudication? Can this concern be tied to provisions for "fluid" or "class" recovery? Would a provision written in neutral procedural terms invite the objection that this calculation would trespass on substantive matters?

Should anything be said about "personal jurisdiction" with respect to members of a plaintiff class or a defendant class? One possibility would be to provide jurisdiction as to any class member who has sufficient contact with the United States.

Is it desirable to provide authority for a class action court to supervise trial of individual issues in other courts after determination of common class issues? How would this be done?

Can some means of coordination be provided for situations in which potentially overlapping class actions are filed in different courts? Is transfer under present § 1407, or an amended § 1407, the only answer?

Should anything be done about the procedure for finding new representatives when mootness overtakes the original representatives?

Should the draft provision for investigation by a special master be expanded to require appointment of an independent representative for the class to evaluate any proposed dismissal or settlement?

Larger Questions

The most important questions surrounding Rule 23 probably are not suitable for present disposition. It seems likely that most reasonably detached observers would agree that some uses of Rule 23 are nefarious and some uses are highly desirable. It also seems likely that there would be wide differences among reasonably detached observers in guessing at the frequency of good and not-so-good uses. It seems even more likely that many of these judgments are bound up with deeper judgments about matters that are outside the Enabling Act process. Some may think it unwise to seek universal enforcement of substantive principles that involve uneasy and uncertain compromises between conflicting needs and policies. Others may have more direct disagreements with the substantive principles themselves. Yet others may doubt the need to encourage

entrepreneurial litigation that imposes substantial costs without producing significant benefits for anyone but the attorneys. It would be wonderful to be able to distill the wisdom from all these doubts and capture it in a procedural rule that does not trespass on substantive matters. Such wonders do not come ready to hand.

Other questions are more tractable, but clearly require legislation. Application of the amount-in-controversy requirement to each member of a class may deserve consideration, but cannot be changed by a rule of procedure. If some change were made that brought more diversity class actions, it would be necessary to consider the choice-of-law question. Again, legislation -- or perhaps a court decision -- would be needed.

Legislation also is needed, or almost surely is needed, to adopt other proposals that have been made in various forms. The theory that a class claim should be auctioned to the highest bidder, for example, would separate the owners from their claims by a procedure that deviates too far from traditional judicial procedures to permit enactment by rule. Proposals to regulate attorney fee incentives also raise grave questions of Enabling Act authority. Setting fees at a portion of the benefits gained for the class, auctioning the right to be attorneys for the class, or even tinkering with the lode star method are common examples. It may be possible to accomplish less ambitious changes by rule. Requiring disclosure and evaluation of fee arrangements as part of the determination whether the class representatives and their attorneys will fairly and adequately represent the class would be an example.

Other broad questions seem within the reach of Enabling Act processes. One question parallels the question of subclasses. Class members may have conflicting interests that are ignored in the desire to certify a broad class. Such conflicts may occur occasionally even among members of a plaintiff damages class, and easily could multiply if mass torts are brought into the class action fold. Conflicts are perhaps more likely in declaratory or injunction actions, particularly with regard to remedies. The plaintiff class in a school desegregation action, for example, may include people with widely different interests in, and views about, the remedies to be adopted. Procedures might be drafted to increase the attention given to these conflicts, as by increasing the number of representatives or creating more subclasses. Although such procedures would increase complication and expense, and likely would diminish the prospects of settlement, they might conduce to better results.

Some thought also might be devoted to the question whether there should be more than one class-action rule. It has been said, for example, that defendant class actions are important in suing large partnerships or large groups of underwriters. Mass torts

continue to be the subject of class action discussion. It may be better to draft separate rules for such cases than to attempt to fit them within a single comprehensive rule.

No doubt there are other matters, large and small, that should be considered in any effort to revise Rule 23. Let me close with the request made at the outset. Comments on the current draft proposal are welcome, and important to ensure that the draft is as good as can be if the process proceeds to the point of publishing a proposed revision for public comment. Even more important, however, will be comments on the wisdom of addressing Rule 23 at all and on the need to consider matters not addressed by the draft.

Although comments are welcome at any time, it would be helpful to have substantial reactions by Marcy 15. The Committee agenda for the May meeting is crowded, but it may prove possible to include preliminary discussion of Rule 23. Reactions from as many perspectives as possible can be most useful.

Thank-you for your help.

Sincerely,

EHC/lm
encls.

Edward H. Cooper
Reporter, Advisory Committee
on Civil Rules

IV(A)

PROPOSED AMENDMENTS TO RULES OF CIVIL PROCEDURE*

Rule 23. Class Actions

(a) **Prerequisites ~~to a Class Action~~.** One or more members of a class may sue or be sued as representative parties on behalf of all ~~only~~ if — with respect to the claims, defenses, or issues certified for class action treatment —

(1) the ~~class is~~ members are so numerous that joinder of all ~~members~~ is impracticable,

(2) ~~there are questions of law or fact~~ legal or factual questions are common to the class,

(3) ~~the claims or defenses of~~ the representative parties' positions typify those ~~are typical of the claims or defenses~~ of the class, ~~and~~

---

* New matter is underlined; matter to be omitted is lined through.

(4) the representative parties and their attorneys are willing and able to ~~will~~ fairly and adequately protect the interests of all persons while members of the class until relieved by the court from that fiduciary duty; and~~.~~

(5) a class action is superior to other available methods for the fair and efficient adjudication of the controversy.

(b) ~~When~~ Whether a Class Action~~s Maintainable~~ Is Superior. ~~An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition~~ The matters pertinent in deciding under (a)(5) whether a class action is superior to other available methods include:

(1) the extent to which ~~the prosecution of~~ separate actions by or against individual members ~~of the class would create a risk of~~ might result in

(A) inconsistent or varying adjudications ~~with respect to individual members of the class which~~ that would establish incompatible standards of conduct for the party opposing the class, or

(B) adjudications ~~with respect to individual members of the class which would~~ that, as a practical matter ~~be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede,~~ would dispose of the nonparty members' interests or reduce their ability to protect their interests; ~~or~~

~~(2) the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief~~ the extent to which the relief may take the form

of an injunction or ~~corresponding~~ declaratory ~~relief with respect to~~ judgment respecting the class as a whole; ~~or~~

(3) ~~the court finds that~~ the extent to which common questions of law or fact ~~common to the members of the class~~ predominate over any questions affecting only individual members~~, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include:~~;

(~~A~~4) the class members' interests ~~of members of the class~~ in individually controlling the prosecution or defense of separate actions;

(~~B~~5) the extent and nature of any related litigation ~~concerning the controversy~~ already ~~commenced~~ begun by or against members of the class;

(~~C~~6) the desirability or undesirability of concentrating the litigation ~~of the claims~~ in the particular forum; and

(~~D~~7) the likely difficulties ~~likely to be encountered~~ in ~~the management of~~ managing a class action which will be eliminated or significantly reduced if the controversy is adjudicated by other available means.

(c) Determination by Order Whether Class Action to Be ~~Maintained~~ Certified; Notice and Membership in Class; Judgment; ~~Actions Conducted Partially as Class Actions~~ Multiple Classes and Subclasses.

(1) As soon as practicable after ~~the commencement of an action brought as a class action~~ persons sue or are sued as representatives of a class, the court ~~shall~~ must determine by order whether and

with respect to what claims, defenses, or issues ~~it is to be so maintained~~ the action should be certified as a class action.

(A) An order certifying a class action must describe the class and determine whether, when, how, and under what conditions putative members may elect to be excluded from, or included in, the class. The matters pertinent to this determination will ordinarily include:

(i) the nature of the controversy and the relief sought;

(ii) the extent and nature of the members' injuries or liability;

(iii) potential conflicts of interest among members;

(iv) the interest of the party opposing the class in securing a final and

consistent resolution of the matters in controversy; and

(v) the inefficiency or impracticality of separate actions to resolve the controversy.

When appropriate, a putative member's election to be excluded may be conditioned upon a prohibition against its maintaining a separate action on some or all of the matters in controversy in the class action or a prohibition against its relying in a separate action upon any judgment rendered or factual finding in favor of the class, and a putative member's election to be included in a class may be conditioned upon its bearing a fair share of litigation expenses incurred by the representative parties.

(B) An order under this subdivision

may be conditional, and may be altered or amended before ~~the decision on the merits~~ final judgment.

(2) ~~In any class~~ When ordering that an action be ~~maintained~~ certified as a class action under ~~subdivision (b)(3)~~ this rule, the court ~~shall~~ must direct that appropriate notice be given to the ~~members of the~~ class under subdivision (d)(1)(C). The notice must concisely and clearly describe the nature of the action; the claims, defenses, or issues with respect to which the class has been certified; the persons who are members of the class; any conditions affecting exclusion from or inclusion in the class; and the potential consequences of class membership. In determining how, and to whom, notice will be given, the court may consider the matters listed in (b) and (c)(1)(A), the expense and difficulties of providing

actual notice to all class members, and the nature and extent of any adverse consequences that class members may suffer from a failure to receive actual notice. ~~the best notice practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort. The notice shall advise each member that (A) the court will exclude the member from the class if the member so requests by a specified date; (B) the judgment, whether favorable or not, will include all members who do not request exclusion; and (C) any member who does not request exclusion may, if the member desires, enter an appearance through counsel.~~

(3) The judgment in an action certified ~~maintained~~ as a class action ~~under subdivision (b)(1) or (b)(2), whether or not favorable to the class, shall~~

~~include and describe those whom the court finds to be members of the class. The judgment in an action maintained as a class action under subdivision (b)(3)~~, whether or not favorable to the class, ~~shall include and~~ must specify or describe those ~~to whom the notice provided in subdivision (c)(2) was directed, and who have not requested exclusion, and whom the court finds~~ who are ~~to be~~ members of the class or have elected to be excluded on conditions affecting any separate actions.

(4) When appropriate ~~(A)~~, an action may be ~~brought or maintained~~ certified as a class action with respect to particular claims, defenses, or issues~~, or (B)~~ by or against multiple classes or subclasses. Subclasses need not separately satisfy the requirements of subdivision (a)(1). ~~a class may be divided into subclasses and each subclass treated as~~

~~a class, and the provisions of this rule shall then be construed and applied accordingly.~~

(d) Orders in Conduct of Class Actions.

(1) In the conduct of actions to which this rule applies, the court may make appropriate orders that:

(~~1~~A) ~~determining~~ determine the course of proceedings or ~~prescribing~~ prescribe measures to prevent undue repetition or complication in the presentation of evidence or argument;

(B) decide a motion under Rule 12 or 56 before the certification determination if the court concludes that the decision will promote the fair and efficient adjudication of the controversy and will not cause undue delay;

(~~2~~C) ~~requiring, for the protection of the members of the class or otherwise for the fair~~

~~conduct of the action, that~~ require notice ~~be given in such manner as the court may direct~~ to some or all of the class members or putative members of:

(i) any step in the action, including certification, modification, or decertification of a class, or refusal to certify a class ~~or of~~;

(ii) the proposed extent of the judgment~~,~~; or ~~of~~

(iii) the members' opportunity ~~of members~~ to signify whether they consider the representation fair and adequate, to intervene and present claims or defenses, or otherwise to come into the action;

(~~3~~D) ~~imposing~~ impose conditions on the representative parties, class members, or ~~on~~

intervenors;

(4E) ~~requiring~~ require ~~that~~ the pleadings be amended to eliminate ~~therefrom~~ allegations ~~as to~~ about representation of absent persons, and that the action proceed accordingly; or

(5F) deal~~ing~~ with similar procedural matters.

(2) ~~The orders~~ An order under Rule 23(d)(1) may be combined with an order under Rule 16, and may be altered or amended ~~as may be desirable from time to time~~.

(e) **Dismissal or Compromise.** An ~~class~~ action in which persons sue or are sued as representatives of a class must ~~shall~~ not, before the court's ruling under subdivision (c)(1), be dismissed, be amended to delete the request for certification as a class action, or be compromised without ~~the~~ approval of the court~~, and notice of the proposed~~

~~dismissal or compromise shall be given to all members of the class in such manner as the court directs~~. An action certified as a class action must not be dismissed or compromised without approval of the court, and notice of a proposed voluntary dismissal or compromise must be given to some or all members of the class in such manner as the court directs. A proposal to dismiss or compromise an action certified as a class action may be referred to a magistrate judge or other special master under Rule 53 without regard to the provisions of Rule 53(b).

(f) **Appeals.** A court of appeals may permit an appeal from an order granting or denying a request for class action certification under this rule upon application to it within ten days after entry of the order. An appeal does not stay proceedings in the district court unless the district judge or the court of appeals so orders.

COMMITTEE NOTE

PURPOSE OF REVISION. As initially adopted, Rule 23 defined class actions as "true," "hybrid," or "spurious" according to the abstract nature of the rights involved. The 1966 revision created a new tripartite classification in subdivision (b), and then established different provisions relating to notice and exclusionary rights based on that classification. For (b)(3) class actions, the rule mandated "individual notice to all members who can be identified through reasonable effort" and a right by class members to "opt-out" of the class. For (b)(1) and (b)(2) class actions, however, the rule did not by its terms mandate any notice to class members, and was generally viewed as not permitting any exclusion of class members. This structure has frequently resulted in time-consuming procedural battles either because the operative facts did not fit neatly into any one of the three categories, or because more than one category could apply and the selection of the proper classification would have a major impact on whether and how the case should proceed as a class action.

In the revision the separate provisions of former subdivisions (b)(1), (b)(2), and (b)(3) are combined and treated as pertinent factors in deciding "whether a class action is superior to other available methods for the fair and efficient adjudication of the controversy," which is added to subdivision (a) as a prerequisite for any class action. The issue of superiority of class action resolution is made a critical question, without regard to whether, under the former language, the case would have been viewed as being brought under (b)(1), (b)(2), or (b)(3). Use of a unitary standard, once the prerequisites of subdivision (a) are satisfied, is the approach taken by the National Conference of Commissioners on Uniform State Laws and adopted in several states.

Questions regarding notice and exclusionary rights remain important in class actions — and, indeed, may be critical to due process. Under the revision, however, these questions are ones that should be addressed on their own merits, given the needs and circumstances of the case and without being tied artificially to the particular classification of the class action.

The revision emphasizes the need for the court, parties, and counsel to focus on the particular claims, defenses, or issues that are appropriate for adjudication in a class action. Too often, classes have been certified without recognition that separate controversies may exist between plaintiff class members and a defendant which should not be barred under the doctrine of claim preclusion. Also, the placement in subdivision (c)(4) of the provision permitting class actions for particular issues has tended to obscure the potential benefit of resolving certain claims and defenses on a class basis while leaving other controversies for resolution in separate actions.

As revised, the rule will afford some greater opportunity for use of class actions in appropriate cases notwithstanding the existence of claims for individual damages and injuries — at least for some issues, if not for the resolution of the individual damage claims themselves. The revision is not however an unqualified license for certification of a class whenever there are numerous injuries arising from a common or similar nucleus of facts. The rule does not attempt to authorize or establish a system for "fluid recovery" or "class recovery" of damages, nor does it attempt to expand or limit the claims that are subject to federal jurisdiction by or against class members.

The major impact of this revision will be on cases at the margin: most cases that previously were certified as class actions

will be certified under this rule, and most that were not certified will not be certified under the rule. There will be a limited number of cases, however, where the certification decision may differ from that under the prior rule, either because of the use of a unitary standard or the greater flexibility respecting notice and membership in the class.

Various non-substantive stylistic changes are made to conform to style conventions adopted by the Committee to simplify the present rules.

SUBDIVISION (a). Subdivision (a)(4) is revised to explicitly require that the proposed class representatives and their attorneys be both willing and able to undertake the fiduciary responsibilities inherent in representation of a class. The willingness to accept such responsibilities is a particular concern when the request for class treatment is not made by those who seek to be class representatives, as when a plaintiff requests certification of a defendant class. Once a class is certified, the class representatives and their attorneys will, until the class is decertified or they are otherwise relieved by the court, have an obligation to fairly and adequately represent the interests of the class, taking no action for their own benefit that would be inconsistent with the fiduciary responsibilities owed to the class.

Paragraph (5) — the superiority requirement — is taken from subdivision (b)(3) and becomes a critical element for all class actions.

The introductory language in subdivision (a) stresses that, in ascertaining whether the five prerequisites are met, the court and litigants should focus on the matters that are being considered for class action certification. The words "claims, defenses, or issues"

are used in a broad and non-legalistic sense. While there might be some cases in which a class action would be authorized respecting a specifically defined cause of action, more frequently the court would set forth a generalized statement of the matters for class action treatment, such as all claims by class members against the defendant arising from the sale of specified securities during a particular period of time.

SUBDIVISION (b). As noted, subdivision (b) has been substantially reorganized. One element, drawn from former subdivision (b)(3), is made a controlling issue for all class actions and moved to subdivision (a)(5); namely, whether a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The other provisions of former subdivision (b) then become factors to be considered in making this determination. Of course, there is no requirement that all of these factors be present before a class action may be ordered, nor is this list intended to exclude other factors that in a particular case may bear on the superiority of a class action when compared to other available methods for resolving the controversy.

Factor (7) — the consideration of the difficulties likely to be encountered in the management of a class action — is revised by adding a clause to emphasize that such difficulties should be assessed not in the abstract, but rather in comparison to those that would be encountered with individually prosecuted actions.

SUBDIVISION (c). Former paragraph (2) of this subdivision contained the provisions for notice and exclusion in (b)(3) class actions.

Under the revision, the provisions relating to exclusion are made applicable to all class actions, but with flexibility for the

court to determine whether, when, and how putative class members should be allowed to exclude themselves from the class. The court may also impose appropriate conditions on such "opt-outs" — or, in some cases, even require that a putative class member "opt-in" in order to be treated as a member of the class.

The potential for class members to exclude themselves from many class actions remains a primary consideration for the court in determining whether to allow a case to proceed as a class action, both to assure due process and in recognition of individual preferences. Even in the most compelling situation for not allowing exclusion — the fact pattern described in subdivision (b)(1)(A) — a person might nevertheless be allowed to be excluded from the class upon the condition that the person will not maintain any separate action and hence, as a practical matter, be bound by the outcome of the class action. The opportunity to elect exclusion from a class may also be useful, for example, in some employment discrimination actions in which certain employees otherwise part of the class may, because of their own positions, wish to align themselves with the employer's side of the litigation either to assist in the defense of the case or to oppose the relief sought for the class.

Ordinarily putative class members electing to be excluded from a plaintiff class will be free to bring their own individual actions, unhampered by factual findings adverse to the class, while potentially able, under the doctrine of issue preclusion, to benefit from factual findings favorable to the class. The revised rule permits the court, as a means to avoid this inequity, to impose a condition on "opting out" that will preclude an excluded member from relying in a separate action upon findings favorable to the class.

Rarely should a court impose an "opt-in" requirement for membership in a class. There are, however, situations in which such a requirement may be desirable to avoid potential due process problems, such as with some defendant classes or in cases where an opt-out right would be appropriate but it is impossible or impractical to give meaningful notice of the class action to all putative members of the class. With defendant classes it may be appropriate to impose a condition that requires the "opting-in" defendant class members to share in the litigation expenses of the representative party. Such a condition would be rarely needed with plaintiff classes since typically the claims on behalf of the class, if successful, would result in a common fund or benefit from which litigation expenses of the representative can be charged.

Under the revision, some notice of class certification is required for all types of class actions, but flexibility is provided respecting the type and extent of notice to be given to the class, consistent with constitutional requirements for due process. Actual notice to all putative class members should not, for example, be needed when the conditions of subdivision (b)(1) are met or when, under subdivision (c)(1)(A), membership in the class is limited to those who file an election to be members of the class. Problems have sometimes been encountered when the class members' individual interests, though meriting protection, were quite small when compared with the cost of providing notice to each member; the revision authorizes such factors to be taken into account by the court in determining, subject to due process requirements, what notice should be directed.

The revision to subdivision (c)(4) is intended to eliminate the problem when a class action with several subclasses should be certified, but one or more of the subclasses may not independently satisfy the "numerosity" requirement.

Under former paragraph (4), some issues could be certified for resolution as a class action, while other matters were not so certified. By adding similar language to other portions of the rule, the Committee intends to emphasize the potential utility of this procedure. For example, in some mass tort situations it might be appropriate to certify some issues relating to the defendants' culpability and — if the relevant scientific knowledge is sufficiently well developed — general causation for class action treatment, while leaving issues relating to specific causation, damages, and contributory negligence for potential resolution through individual lawsuits brought by members of the class.

SUBDIVISION (d). The former rule generated uncertainty concerning the appropriate order of proceeding when a motion addressed to the merits of claims or defenses is submitted prior to a decision on whether a class should be certified. The revision provides the court with discretion to address a Rule 12 or Rule 56 motion in advance of a certification decision if this will promote the fair and efficient adjudication of the controversy. See *Manual for Complex Litigation, Second,* § 30.11.

Inclusion in former subdivision (c)(2) of detailed requirements for notice in (b)(3) actions sometimes placed unnecessary barriers to formation of a class, as well as masked the desirability, if not need, for notice in (b)(1) and (b)(2) actions. Even if not required for due process, some form of notice to class members should be regarded as desirable in virtually all class actions. Subdivision (c)(2) requires that notice be given if a class is certified, though under subdivision (d)(1)(C) the particular form of notice is committed to the sound discretion of the court, keeping in mind the requirements of due process. Subdivision (d)(1)(C) contemplates that some form of notice may be desirable with respect to many other important rulings; subdivision (d)(1)(C)(i),

for example, calls the attention of the court and litigants to the possible need for some notice if the court declines to certify a class in an action filed as a class action or reduces the scope of a previously certified class. In such circumstances, particularly if putative class members have become aware of the case, some notice may be needed informing the class members that they can no longer rely on the action as a means for pursuing their rights.

SUBDIVISION (e). There are sound reasons for requiring judicial approval of proposals to voluntarily dismiss, eliminate class allegations, or compromise an action filed or ordered maintained as a class action. The reasons for requiring notice of such a proposal to members of a putative class are significantly less compelling. Despite the language of the former rule, courts have recognized the propriety of a judicially-supervised precertification dismissal or compromise without requiring notice to putative class members. *E.g., Shelton v. Pargo*, 582 F.2d 1298 (4th Cir. 1978). The revision adopts that approach. If circumstances warrant, the court has ample authority to direct notice to some or all putative class members pursuant to the provisions of subdivision (d). While the provisions of subdivision (e) do not apply if the court denies the request for class certification, there may be cases in which the court will direct under subdivision (d) that notice of the denial of class certification be given to those who were aware of the case.

Evaluations of proposals to dismiss or settle a class action sometimes involve highly sensitive issues, particularly should the proposal be ultimately disapproved. For example, the parties may be required to disclose weaknesses in their own positions, or to provide information needed to assure that the proposal does not directly or indirectly confer benefits upon class representatives or their counsel inconsistent with the fiduciary obligations owed to

members of the class or otherwise involve conflicts of interest. Accordingly, in some circumstances, investigation of the fairness of these proposals conducted by an independent master can be of great benefit to the court, particularly since the named parties and their counsel have ceased to be adversaries with respect to the proposed dismissal or settlement. The revision clarifies that the strictures of Rule 53(b) do not preclude the court from appointing under that Rule a special master to assist the court in evaluating a proposed dismissal or settlement. The master, if not a Magistrate Judge, would be compensated as provided in Rule 53(a).

SUBDIVISION (f). The certification ruling is often the crucial ruling in a case filed as a class action. The plaintiff, in order to obtain appellate review of a ruling denying certification, will have to proceed with the case to final judgment and may have to incur litigation expenses wholly disproportionate to any individual recovery; and, if the plaintiff ultimately prevails on an appeal of the certification decision, postponement of the appellate decision raises the specter of "one way intervention." Conversely, if class certification is erroneously granted, a defendant may be forced to settle rather than run the risk of potentially ruinous liability of a class-wide judgment in order to secure review of the certification decision. These consequences, as well as the unique public interest in properly certified class actions, justify a special procedure allowing early review of this critical ruling.

Recognizing the disruption that can be caused by piecemeal reviews, the revision contains provisions to minimize the risk of delay and abuse. Review will be available only by leave of the court of appeals promptly sought, and proceedings in the district court with respect to other aspects of the case are not stayed by the prosecution of such an appeal unless the district court or court of appeals so orders. The appellate procedure would be the same as

for appeals under 28 U.S.C. § 1292(c). The statutory authority for using the rule-making process to permit an appeal of interlocutory orders is contained in 28 U.S.C. § 1292(e), as amended in 1992.

It is anticipated that orders permitting immediate appellate review will be rare. Nevertheless, the potential for this review should encourage compliance with the certification procedures and afford an opportunity for prompt correction of error.

PROPOSED AMENDMENTS TO RULES OF CIVIL PROCEDURE

Rule 23. Class Actions

(a) **Prerequisites.** One or more members of a class may sue or be sued as representative parties on behalf of all if — with respect to the claims, defenses, or issues certified for class action treatment —

(1) the members are so numerous that joinder of all is impracticable,

(2) legal or factual questions are common to the class,

(3) the representative parties' positions typify those of the class,

(4) the representative parties and their attorneys are willing and able to fairly and adequately protect the interests of all persons while members of the class until relieved by the court from that fiduciary duty; and

(5) a class action is superior to other available methods for the fair and efficient adjudication of the controversy.

(b) **Whether a Class Action Is Superior.** The matters pertinent in deciding under (a)(5) whether a class action is superior to other available methods include:

(1) the extent to which separate actions by or against individual members might result in

(A) inconsistent or varying adjudications that would establish incompatible standards of conduct for

the party opposing the class, or

(B) adjudications that, as a practical matter, would dispose of the nonparty members' interests or reduce their ability to protect their interests;

(2) the extent to which the relief may take the form of an injunction or declaratory judgment respecting the class as a whole;

(3) the extent to which common questions of law or fact predominate over any questions affecting only individual members;

(4) the class members' interests in individually controlling the prosecution or defense of separate actions;

(5) the extent and nature of any related litigation already begun by or against members of the class;

(6) the desirability or undesirability of concentrating the litigation in the particular forum; and

(7) the likely difficulties in managing a class action which will be eliminated or significantly reduced if the controversy is adjudicated by other available means.

(c) Determination by Order Whether Class Action to Be Certified; Notice and Membership in Class; Judgment; Multiple Classes and Subclasses.

(1) As soon as practicable after persons sue or are sued as representatives of a class, the court must determine by order whether and with respect to what claims, defenses, or issues the action should be certified as a class action.

(A) An order certifying a class action must describe the class and determine whether, when, how,

and under what conditions putative members may elect to be excluded from, or included in, the class. The matters pertinent to this determination will ordinarily include:

(i) the nature of the controversy and the relief sought;

(ii) the extent and nature of the members' injuries or liability;

(iii) potential conflicts of interest among members;

(iv) the interest of the party opposing the class in securing a final and consistent resolution of the matters in controversy; and

(v) the inefficiency or impracticality of separate actions to resolve the controversy.

When appropriate, a putative member's election to be excluded may be conditioned upon a prohibition against its maintaining a separate action on some or all of the matters in controversy in the class action or a prohibition against its relying in a separate action upon any judgment rendered or factual finding in favor of the class, and a putative member's election to be included in a class may be conditioned upon its bearing a fair share of litigation expenses incurred by the representative parties.

(B) An order under this subdivision may be conditional, and may be altered or amended before final judgment.

(2) When ordering that an action be certified as a

class action under this rule, the court must direct that appropriate notice be given to the class under subdivision (d)(1)(C). The notice must concisely and clearly describe the nature of the action; the claims, defenses, or issues with respect to which the class has been certified; the persons who are members of the class; any conditions affecting exclusion from or inclusion in the class; and the potential consequences of class membership. In determining how, and to whom, notice will be given, the court may consider the matters listed in (b) and (c)(1)(A), the expense and difficulties of providing actual notice to all class members, and the nature and extent of any adverse consequences that class members may suffer from a failure to receive actual notice.

(3) The judgment in an action certified as a class action, whether or not favorable to the class, must specify or describe those who are members of the class or have elected to be excluded on conditions affecting any separate actions.

(4) When appropriate, an action may be certified as a class action with respect to particular claims, defenses, or issues by or against multiple classes or subclasses. Subclasses need not separately satisfy the requirements of subdivision (a)(1).

(d) Orders in Conduct of Class Actions.

(1) In the conduct of actions to which this rule applies, the court may make appropriate orders that:

> **(A)** determine the course of proceedings or prescribe measures to prevent undue repetition or complication in the presentation of evidence or argument;

(B) decide a motion under Rule 12 or 56 before the certification determination if the court concludes that the decision will promote the fair and efficient adjudication of the controversy and will not cause undue delay;

(C) require notice to some or all of the class members or putative members of:

(i) any step in the action, including certification, modification, or decertification of a class, or refusal to certify a class;

(ii) the proposed extent of the judgment; or

(iii) the members' opportunity to signify whether they consider the representation fair and adequate, to intervene and present claims or defenses, or otherwise to come into the action;

(D) impose conditions on the representative parties, class members, or intervenors;

(E) require the pleadings be amended to eliminate allegations about representation of absent persons, and that the action proceed accordingly; or

(F) deal with similar procedural matters.

(2) An order under Rule 23(d)(1) may be combined with an order under Rule 16, and may be altered or amended.

(e) **Dismissal or Compromise.** An action in which persons sue or are sued as representatives of a class must not, before the court's ruling under subdivision (c)(1), be dismissed, be amended to delete the request for certification as a class action, or

be compromised without approval of the court. An action certified as a class action must not be dismissed or compromised without approval of the court, and notice of a proposed voluntary dismissal or compromise must be given to some or all members of the class in such manner as the court directs. A proposal to dismiss or compromise an action certified as a class action may be referred to a magistrate judge or other special master under Rule 53 without regard to the provisions of Rule 53(b).

(f) Appeals. A court of appeals may permit an appeal from an order granting or denying a request for class action certification under this rule upon application to it within ten days after entry of the order. An appeal does not stay proceedings in the district court unless the district judge or the court of appeals so orders.

IV(c)

draft 10/25

SETTLEMENT OF MASS TORT CLASS ACTIONS: ORDER OUT OF CHAOS

William W Schwarzer*

Why do we worry so much about mass tort class actions? It is not simply that they involve many injuries and a lot of money, but rather that it seems to be extremely difficult to bring about a junction of those two, i.e. of the money to the injury, in rational ways. Of course mass torts arising out of single accidents or disasters have long been with us but the new variety of mass torts based on exposure to toxic or otherwise harmful products or substances presents a new and more difficult set of issues and problems in the context of class actions. These observations are directed primarily at those issues and problems, but they are not irrelevant to other kinds of class action litigation.

When I say rational ways, I have in mind four objectives that should characterize the resolution of mass tort litigation:

1) A fair determination—whether by agreement or adjudication—of liability and damages;

2) Reasonable assurance that parties entitled to it will obtain compensation;

3) Minimum adverse impact on enterprises and the related economy consistent with deterrence of objectionable conduct; and

4) Minimum transaction costs.

Why is it so difficult to achieve those objectives? The obstacles in the way flow largely from the defining characteristics of this kind of mass tort litigation. Aside from the sheer number of claims, they include at least the following:

1) Duplicative litigation activity: because claims to varying degrees share common issues of fact and law, much discovery and adjudication is duplicative;

2) Multiple trials: though claims share common issues, the individual issues of causation and damages coupled with the Seventh

* Senior United States District Judge, Northern District of California, and Director, Federal Judicial Center, Washington, D.C.

Amendment right to an individual jury trial require numerous separate adjudications, resulting not only in duplication, as noted, but in costs and delays that may as a practical matter deny relief to many;

3) Inconsistent outcomes: multiple jury trials in different jurisdictions, sometimes subject to different rules of law, lead to wildly inconsistent outcomes, complicating the evaluation of cases;

4) Punitive damages: the threat of punitive damages further complicates evaluation and distorts the settlement calculus;

5) Uncertainty of causation: the relationship between alleged causes and injuries is frequently incapable of being proved with any degree of certainty, both because of the uncertainty of the relevant science and because the causal relationship between exposure and a particular injury will often be speculative;

6) Impact of federalism: adjudication in national litigation is complicated by the applicability of multiple and often inconsistent state substantive and procedural law;

7) Uncertainty about identity of claimants: the full array of present and potential claimants may not be capable of identification, and potential claimants may themselves not be aware of their status and may not become aware of it for some years;

8) The magnitude of defendants' potential exposure: the full measure of claims against some defendants in some mass tort litigation may force them into bankruptcy;

9) Attorney control: by their nature, cases comprising mass tort litigation tend to be controlled by a small number of attorneys; and

10) The effects of vast amounts of money at stake: because damage claims tend to be large individually and enormous in the aggregate, they generate incentives that can undermine traditional foundations of the legal process.

The attempts to overcome these obstacles, or find ways to accommodate them, in the resolution of mass tort litigation have caused considerable debate and disagreement (reflected, among other places, in the papers included in this issue of the Cornell Law Review). While some welcome the mass tort class action as a savior, other see it as something like the sorcerer's apprentice which, once having been put to work, may be running amok.

* * * * *

It is clear enough that when Rule 23 was adopted in its present form in 1966, it was not intended to apply to mass tort litigation. The notes of the advisory committee state that "A 'mass accident' resulting in injuries to numerous persons is ordinarily not appropriate for a class action because of the likelihood that significant questions, not only of damages but of liability and defenses of liability, would be present, affecting the individuals in different ways." If that could be said of mass accidents, today's mass tort litigation, involving exposure under innumerable circumstances and often latent injuries, presents the *a fortiori* case. Moreover, as Professor Benjamin Kaplan, the reporter of the advisory committee on civil rules at the time, in writing about its work, observed, the purpose of the amended rule was to enable litigation when community or solidarity of interest was strong (Kaplan, Continuing Work of the Civil Rules Committee: 1966 Amendments of the Federal Rules of Civil Procedure (I), 81 Harv. L. Rev. 356, 376 (1967)). In mass tort litigation, individual claims generally are sufficiently large to sustain separate actions and community and solidarity of interest are not strong.

Thus the reasons for using Rule 23 in mass tort litigation are not those that were said to have motivated its adoption. Those reasons boil down to the conviction held by many attorneys, judges and informed parties that aggregation of claims is a logical, if not an indispensable method for overcoming the obstacles posed by the characteristics of mass tort litigation. To be sure, not all agree. Many judges recognize that aggregation extracts a price of its own: it can lead to insuperable management difficulties and to premature, unwise or just plain wrong dispositions. Some attorneys see a loss of individual autonomy and of the full realization of claimants' rights to compensation. Moreover alternatives may exist that could, when used with care and ingenuity, avoid some of the pitfalls of class actions, including consolidation, bellwether trials, and statistical sampling and adjudication. Nevertheless the pressures to adopt aggregation procedures are great and, short of bankruptcy, Rule 23 offers the most readily available tool.

The dangers of uncritical acceptance of the Rule 23 for the purpose of large-scale aggregation, however, warrant a hard look at the operation of the rule in mass tort litigation, and particularly in settlements. Putting aside, for the moment, the special cases that may fall under Rule 23(b)(1) or (2), class actions are authorized by subdivision (b)(3) when "the court finds that the questions of law or fact common to the members of the class *predominate* over any questions

affecting only individual members, and that a class action is *superior* to other available methods for the fair and efficient adjudication of the controversy."

Whether findings of predominance and superiority (or for that matter, of commonality and typicality) could be made in the typical mass exposure litigation, involving many claimants each offering his proof of individual causation and consequent damages and each having a right to an individual jury verdict (though not necessarily a separate trial), raises difficult questions. While the trials of individual claims comprising the class could be consolidated, there are practical limits to how many separate claims supported by different evidence can be given to a single jury to decide.

There may, of course, be some genuine common issues, most likely legal issues, in a mass tort class action. Rule 23(c)(4) provides that "[w]hen appropriate (A) an action may be brought or maintained as a class action with respect to particular issues . . ." But resolving the common issues in a class action does not eliminate the problem of how to deal with the claims of the individual class members.

Some effort has been made to find support for mass tort classes in Rule 23(b)(1). But it is quite clear now that the possibility of inconsistent damage verdicts in separate jury trials does not qualify under subdivision (1)(A) which permits a class action to be maintained where separate actions "would create a risk of inconsistent . . . adjudications . . . which would establish incompatible standards of conduct for the party opposing the class." A more difficult question is whether in a case where the claims are likely to exceed a defendant's assets, a class can be certified under subdivision (1)(B) on the theory that "adjudications with respect to . . .[some] members of the class would as a practical matter . . . substantially impair or impede . . . [other non-partymembers'] ability to protect their interests." The original concept of the limited fund class does not readily fit the situation where a large volume of claims might eventually generate judgments that in the aggregate could exceed the assets available to satisfy them, much less where the claimants have a right to individual jury trials, a right that is protected in a (b)(3) opt-out class but not in a (b)(1)(B) class. In effect, the use of subdivision (1)(B) might be seen as an end run around the bankruptcy law, giving the defendant some of the benefits of bankruptcy without its burdens (although even in bankruptcy the right to a jury trial would be preserved).

These observations suggest reasons to question the authority of courts to certify class actions in mass exposure cases, and the validity of orders certifying

such classes. One might speculate about other sources of authority for class actions in federal courts, perhaps inherent authority or some kind of common law class action. But strangely, the issue of judicial authority has not received much attention, perhaps because none of the participants has had the incentive to raise the question. The tendency seems to be to avoid it by simply not making findings on the prerequisites of Rule 23, or doing so perfunctorily at best.

These problems concerning the court's authority to proceed under Rule 23 in mass tort litigation are compounded where the class certified is what is known in the trade as a settlement class, though that term does not exist in Rule 23. A settlement class is one agreed to by the parties to the settlement as an essential part of their agreement. The court is asked to approve (or, more accurately, "certify") it in the same proceedings in which it approves the settlement under Rule 23(e). It is one thing for a court to certify a class in the course of adversary proceedings. If the issues are genuinely contested, the court may arrive at a bona fide ruling, even if it turns out to be erroneous. It is quite another for the court to certify a class at the request of the parties, essentially for their convenience in implementing the settlement and with little regard to the requirements of the rule since litigation is not in contemplation. It could of course be that, even in the absence of a controversy over certification, the parties could make a bona fide demonstration that the proposed class meets the prerequisites of the rule sufficient to enable the court to enter the appropriate findings, but that seems rarely to be the case. Since it is improbable that the court would be able to make the requisite findings of predominance and superiority (and perhaps of commonality and typicality) in these situations, the requirements of the rule tend to be ignored and findings are simply not made when settlement classes are certified.

In the mass tort settlement context, then, the class action is becoming a creature that resembles a cross between an equity receivership and a bill of peace. It has moved far from the text and from the purpose of Rule 23. One way to see this is as a commendable example of the law's adaptability to meet the needs of the time—in the best tradition of the Anglo-American common law. But another interpretation might be that it is an unprincipled subversion of the Federal Rules of Civil Procedure. True, if it is a subversion, it is done with good intentions to help courts cope with burgeoning dockets, to enable claimants at the end of the line of litigants to recover compensation, and to allow defendants to manage the staggering liabilities many face. But as experience seems to show, good

intentions are not always enough to ensure that all relevant private and public interests are protected. The siren song of Rule 23 can lead lawyers, parties and courts into rough waters where their ethical compass offers only uncertain guidance.

It is not only that settlement classes rest on shaky legal grounds, but also that they confront courts charged with passing on those settlements with issues for the resolution of which the law provides little if any guidance. This paper is not intended to address those issues other than to point out that to a large extent the issues revolve around questions of fairness, and in particular of professional ethics. If the key to judicial approval of a settlement turns on the outcome of a battle of ethicists, then the legal process is truly at sea.

In fact—and surprising as it may seem on reflection— Rule 23 contains no standards at all governing judicial approval of class action settlements. Appellate courts have invented a variety of formulations (mostly that it be "fair and equitable"), but the rule is silent. Subdivision (e) simply states that "a class action shall not be dismissed or compromised without the approval of the court." The advisors' notes shed no additional light. For all that one can tell from the text, it may have been intended only as protection against abuse or misuse of the rule by ensuring that the procedural requirements relating to the certification of the class and notice to the members have been met. If that were the correct interpretation, a class settlement could not be approved unless the class is entitled to certification. At the other extreme, the rule could permit a court to make approval turn on its own independent valuation of the claims and the settlement consideration. Even reading a "fair and equitable" standard into subdivision (e), that standard is measured by the length of the chancellor's foot.

As a result, the parties are left to operate in the dark and the court, lacking guidance, knows neither the measure of its responsibility nor the limit of its power. This is obviously an unsatisfactory situation: it replaces the rule of law with standardless administration, and it injects instability and unpredictability into legal proceedings of great moment.

* * * * *

For all the various reasons discussed, there is a compelling need to facilitate the settlement of mass tort litigation. As it is, the opposing parties often find themselves in the situation of two tarantulas in a bottle, each able to inflict fatal injury on the other: insistence on individual jury trials will deny many plaintiffs compensation while the aggregate compensatory and punitive damage

awards can bankrupt a defendant. As noted above, Rule 23 is not the only available vehicle for aggregation to facilitate settlement. That it may be the vehicle of choice for this purpose does not justify its subversion and acceptance of the evils that may follow. Legal standards for approval of settlements are essential to protect all of the interests involved and to preserve the integrity of the judicial process.

While the focus of this discussion has been on mass tort litigation, Rule 23 is transsubstantive and serves in other kinds of litigation as well. Settlement classes may be used in all of them, and some of the problems that arise in mass tort cases can arise there too, even if in less acute form. Potentially, any class action settlement could involve questions about the over- or under-inclusiveness of the class definition, fairness as between different categories of claimants, the adequacy of opt-out rights, and the protection of future claimants, to name a few. Thus the lack of standards to govern the approval of class action settlements is a Rule 23 problem cutting across all actions subject to the rule.

For these reasons, there is good reason to amend subdivision (e) to provide standards. Those standards should satisfy certain criteria: they should be transsubstantive, applicable to any action subject to Rule 23; they should be neutral and objective , avoiding substantive ethical rules and principles; they should not dictate terms of settlements or stifle creativity and adaptation to unique circumstances; they should be practical and flexible; they should be reasonably comprehensive but not so detailed that they lead to a failure to see the forest for the trees; and they should mandate a sufficiently close examination of settlements to bring serious defects to light in the approval process. To meet these criteria, standards should not be prescriptive. They could however take the form of guidelines for findings a court would be required to make to approve a settlement.

Relying on appellate decisions for such standards has the drawback that the precedential effect of a decision will be circumscribed by the unique facts of the case. Amendment of Rule 23(e) is therefore preferable. Such an amendment would require the court to make findings, and hence to consider, a number of factors relevant to the fairness and reasonableness of a settlement. The statement of such factors, of course, tends to invite elaboration to a degree that might defeat the utility of a rule. Nevertheless it may be worthwhile to explore the feasibility of this approach by an attempt at a concise statement, as follows:

Rule 23(e). Dismissal or Compromise. [add to existing text:] When ruling on an application for approval of a dismissal or compromise of a class action, the court shall make findings with respect to the following matters, so far as applicable to the action:

(1) The prerequisites set forth in subdivisions (a) and (b), and whether the settlement was made in contemplation of a realistic prospect of litigation of the settled claims;

(2) The appropriateness and fairness of the class definition, including whether it is consistent with the purpose for which the class is certified, whether it may be overinclusive or underinclusive, and whether division into subclasses may be necessary, taking into account any of the factors relevant to approval;

(3) The comparative treatment of persons having similar claims, whether included in the class or not, including the treatment of present and future claimants, and the justification for differences in treatment;

(4) The adequacy of notice to members of the class, including notice to persons who may be unaware or incapable of becoming aware of the existence of a potential claim;

(5) The adequacy of representation of members of the class, including the extent of separate representation of persons whose claims against the settling defendant differ in material respects from those of other claimants;

(6) The adequacy of protection of opt-out rights, including those of future claimants whose claims may not yet have matured;

(7) The reasonableness of attorneys' fees, including the relationship of compensation to the value and amount of services rendered and the risk assumed;

(8) The impact of the settlement on other pending actions, in state or federal courts;

(9) The impact of the settlement on potential claims of class members for injury or loss arising out the same or related occurrences not covered by the settlement;

(10) The reasonableness of the amounts provided by the settlement, including the comparative cost to defendant and benefits to class members, the impact of contribution and indemnity rights of

defendants, and the availability of other sources of compensation for class members; and

(11) The fairness and reasonableness of the claims process provided under the settlement.

An argument might be made that these specifications are too lengthy and detailed to be appropriate for inclusion in the Federal Rules of Civil Procedure. But the rules have been moving in that direction; Rule 16(c), for example, has an even more lenghty recitation of subjects for consideration at the pretrial conference. Alternatively, the listed factors could be included, perhaps on an experimental basis, in the notes of the advisory committee accompanying Rule 23.

But it is submitted that some action on Rule 23(e) ought to be considered now, to replace the exisiting chaos with a degree of order and stability and, by clarifying the procedure, reduce the cost and delay with which it is now plagued.

VI(A)

United States Court of Appeals
for the Fifth Circuit

November 3, 1994

PATRICK E. HIGGINBOTHAM
CIRCUIT JUDGE

UNITED STATES COURTHOUSE
1100 COMMERCE STREET
DALLAS, TEXAS 75242

Professor Stephen B. Burbank
University of Pennsylvania Law School
3400 Chestnut Street
Philadelphia, PA 19104-6204

Dear Steve:

In discussing class action reform at the University of Pennsylvania, we need constructs in mind, albeit loosely defined--akin to ye ole classroom hypothets. These can focus discussion. By February, some proposals may have surfaced, and they will meet the need, in part. I have two.

We would begin with the assertion that, particularly on the federal side, we have perversely created mass cases that defy case or controversy resolution. The superhighways of interdistrict transfers and consolidations, coupled with lawyer solicitation and media hype, are attended by risks of fostering litigation that would not have otherwise occurred. Whether or not we are creating cases that would never have been filed or are facilitating redress on a larger scale to large numbers of injured persons, the inescapable reality is that with a mass disaster such as a product failure in asbestos or, perhaps, breast implants (the science here is uncertain), we create large numbers of cases that, in their aggregate form, cannot be tried. The pressure to settle these cases taxes due process, Seventh Amendment, and Article III principles. A congressional solution to the asbestos cases has proved to be impossible. Certainly, it is more difficult politically to respond to a particular problem after interests have vested. It should be easier, at least politically, to solve the problems before they arise by creating a free-standing administrative apparatus.

In responding to the assertion, I would like for us to imagine a structure created by Congress to respond to defined mass disasters. What would it look like? The legislative model might offer an extra-judicial solution, in part, and the first image in mind is something like the Longshoremen's Act provisions treated in Crowell v. Benson, 285 U.S. 22 (1932). Sometimes such proposals are loosely described as "black lung" proposals. They seldom are further defined.

I would like to reach further in our discussions. Rather than depending upon Congress to respond ad hoc by, e.g., creating a claims system for asbestos cases, we need to probe the idea that Congress might create a freestanding structure, with defined triggers for its use. The triggers would be designed to identify masses that defy trial due to complexity, of size and numbers. Federal (or state?) courts confronted with a mass of such cases that realistically cannot be tried[1] could, if legislative prerequisites are met, deflect the entire mass into the administrative apparatus. Such an approach may demand that in these limited and defined circumstances, the controlling law would be federal and preemptive of state tort law. The applicable federal law might denominate some state law as federal law according to a prescribed choice of law rule.

It is not clear that Congress can constitutionally respond without preempting applicable state law under its commerce power and replacing it with a federal right, whether fault based or absolute. The absence of decisional force in the public rights/or-private rights dichotomy is now well recognized. Nonetheless, it remains an informing principle in examining the validity of a non-Article III tribunal. See, e.g., Commodity Futures Trading Commission v. Schor, 478 U.S. 833 (1986). Justice O'Connor's opinion the preceding term in Thomas v. Union Carbide Agricultural Products Co., 473 U.S. 568 (1985), was more than circumspect in its willingness to tolerate resolution of common law claims by non-Article III courts. While consent is also a significant, but not always determining, component in the validity of such non-Article III tribunals, any workable model probably should not rest on consent. Indeed, in a consensual arrangement, judicially approved settlements are usually effective.

Suppose Congress provided that when the triggers are judicially pulled, all claims including futures are routed to the Article I tribunal, sans state law claims (preempted) to be compensated according to grids created by the tribunal. The case before the Article III judge is now the United States versus industry participants. The question is their liability for an aggregate figure--the estimated sum the government will pay under its claims process. This determination of industry debt could include liability questions using state law (a choice) or federal common law. This trial of industry liability might look something like Judge Robert Parker's proposed trial that the Fifth Circuit rejected in In re: Fibreboard. It would be free of the strictures of discrete case focus.

---

[1] A defined term. Needless to say, the ALI's "Complex Litigation: Statutory Recommendations and Analysis" provides a rich resource.

A variant of this model, and a second hypothet, could be an opt-in structure for settlements that legislatively bridge chasms that private agreements alone have difficulty crossing.[2]

Well, you have the idea. We need suggestions such as these to guide the discussion. These ideas are crafted to expose difficulties with legislative solutions and are calculatedly provocative (wild may be the word). Specifically, in these discussions we sometimes bounce between judicial and legislative solutions, with an inadequate attention to limits upon legislative power that will shape the model. We need to look for the channel markers, realizing that any legislative response will travel dangerous waters. Of course, this is beyond the compass of the rules committees. Our rulemaking, however, must account for the range of solutions if we are to know our own appropriate response.

Sincerely yours,

Pat

Patrick E. Higginbotham

cc: Dean Edward H. Cooper

---

[2] Another intriguing idea drawing on Justice Jackson's famous opinion in National Mutual Insurance Company v. Tidewater Transfer Company, Inc., 337 U.S. 589 (1949). Perhaps Congress can move some of the administrative responsibility of its Article I created structure back to the courts. That is, Congress preempts and creates a claims process administered by an Article III court.

I(F)

SUBMISSION TO THE COUNCIL OF THE LITIGATION SECTION OF THE AMERICAN BAR ASSOCIATION PLAINTIFFS SECURITIES ATTORNEYS' PERSPECTIVE ON TITLE II OF H.R. 10-- "REFORM OF PRIVATE SECURITIES LITIGATION"

TABLE OF CONTENTS

GUARDIAN AD LITEM AND STEERING COMMITTEE PROPOSED PROVISION

SEC. 202. PREVENTION OF LAWYER-DRIVEN LITIGATION.

(a) PLAINTIFF STEERING COMMITTEES TO ENSURE CLIENT CONTROL OF LAWSUITS.--The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by adding at the end the following new section:

"SEC. 36. GUARDIAN AD LITEM AND CLASS ACTION STEERING COMMITTEES.

"(a) GUARDIAN AD LITEM.--Except as provided in subsection (b), not later than 10 days after certifying a plaintiff class in any private action brought under this title, the court shall appoint a guardian ad litem for the plaintiff class from a list or lists provided by the parties or their counsel. The guardian ad litem shall direct counsel for the class as set forth in this section and perform such other functions as the court may specify. The court shall apportion the reasonable fees and expenses of the guardian ad litem among the parties. Court appointment of a guardian ad litem shall not be subject to interlocutory review.

(b) Class ACTION STEERING COMMITTEE.--Sub-section (a) shall not apply if, not later than 10 days after certifying a plaintiff class, on its own motion or on motion of a member of the class, the court appoints a committee of class members to direct counsel for the class (hereafter in this section referred to as the 'plaintiff steering committee') and to perform such other functions as the court may specify. Court appointment of a plaintiff steering committee shall not be subject to interlocutory review.

"(c) MEMBERSHIP OF PLAINTIFF STEERING COMMITTEE.--

"(1) QUALIFICATIONS.--

"(A) NUMBER.--A plaintiff steering committee shall consist of not fewer than 5 class members, willing to serve, who the court believes will fairly represent the class.

"(B) OWNERSHIP INTERESTS.--Members of the plaintiff steering committee shall have cumulatively held during the class period not less than--

"(i) the lesser of 5 percent of the securities which are the subject matter of the litigation or securities which are the subject matter of the litigation with a market value of $10,000,000; or

"(ii) such smaller percentage or dollar amount as the court finds appropriate under the circumstances.

"(2) NAMED PLAINTIFFs.--Class members who are named plaintiffs in the Litigation may serve on the plaintiff steering committee, but shall not comprise a majority of the committee.

"(3) NONCOMPENSATION OF MEMBERS.--Members of the plaintiff steering committee shall serve without compensation, except that any member may apply to the court for reimbursement of reasonable out-of-pocket expenses from any common fund established for the class.

"(4) MEETINGS.--The plaintiff steering committee shall conduct its business at one or more previously scheduled meetings of the committee, of which - prior notice shall have been given and at which a majority of its members are present in person or by electronic communication. The plaintiff steering committee shall decide all matters within its authority by a majority vote of all members, except that the committee may determine that decisions other than to accept or reject a settlement offer or to employ or dismiss counsel for the class may be delegated to one or more members of the committee, or may be voted upon by committee members seriatim, without a meeting.

"(5) RIGHT OF NONMEMBERS TO BE HEARD.--

A class member who is not a member of the plaintiff steering committee may appear and be heard by the court on any issue in the action, to the same extent as any other party.

"(d) FUNCTIONS OF GUARDIAN AD LITEM AND PLAINTIFF STEERING COMMITTEE.--

"(1) DIRECT COUNSEL.--The authority of the guardian ad litem or the plaintiff steering committee to direct counsel for the class shall include all powers normally permitted to an attorney's client in litigation, including the authority to retain or dismiss counsel and to reject offers of settlement, and the preliminary authority to accept an offer of settlement, subject to the restrictions specified in paragraph (2). Dismissal of counsel other than for cause shall not limit the ability of counsel to enforce any contractual fee agreement or to apply to the court for a fee award from any common fund established for the class.

"(2) SETTLEMENT OFFERS.--If a guardian ad litem or a plaintiff steering committee gives preliminary approval to an offer of settlement, the guardian ad litem or the plaintiff steering committee may seek approval of the offer by a majority of class members if the committee determines that the benefit of seeking such approval outweighs the cost of soliciting the approval of class members.

"(e) IMMUNITY FROM CIVIL LIABILITY; REMOVAL.--

Any person serving as a guardian ad litem or as a member of a plaintiff steering committee shall be immune from any civil liability arising from such service. The court may remove a guardian ad litem or a member of a plaintiff steering committee for good cause shown.

"(f) EFFECT ON OTHER LAW.--This section does not affect any other provision of law concerning class actions or the authority of the court to give final approval to any offer of settlement.".

THE COUNCIL SHOULD OPPOSE THIS PROVISION.

Adoption of the guardian ad litem steering committee proposal will protract and complicate litigation that is already lengthy and complex; add new layers of lawyer bureaucracies; and, ultimately, reduce the recoveries of victims.

Under Rule 23 of the Federal Rules of Civil Procedure, the courts are required to closely supervise the efficient and fair prosecution of class actions. There has been no showing that the courts are not doing their job effectively. Yet, H.R. 10 fundamentally changes this rule by taking the responsibility from the court and transferring it to the guardian or steering committee.

Such a change is contrary to the driving thrust of modern litigation reform, which has been to simplify, streamline, and reduce the expense of litigation. The procedures in H.R. 10 will frustrate these objectives and only increase the expense and time necessary to conclude litigation. Questions of appointment of the steering committees, relationship with class counsel, and delegation of decisionmaking will undoubtedly lead to more litigation, additional delays, and smaller recoveries. Moreover, this provision permits defendants and their counsel to propose candidates for a guardian ad litem. Thus, the litigation could be controlled by a person sympathetic to the defendant's case.

As Arthur R. Miller, Bruce Bromley Professor of Law at Harvard Law School, testified at Congressional hearings last summer: "There are also many questions about the guardian ad litem concept. Isn't it predicated on the notion that the lawyers for the class, who are its guardians, are not doing their job? If so, where will the process of second-guessing end? Who will guard the guardians? Who will guard the guardians of guardians? What rationality is there to adding additional layers of lawyers to a case? Finally, we must remember that the court already has the power to appoint a guardian (or a special master) if necessary."

Moreover, because the membership of the proposed steering committees has high cumulative minimum ownership requirements ($10 million or 5% of the subject stock), the committees will undoubtedly be comprised mostly of large institutional investors with ties to the defendant company. This may well disadvantage small investors. Further, the steering committee would be comprised of class members who neither initiated the litigation, contribute to its cost and are immune from liability. Yet this group would control the litigation.

The Association of the Bar of the City of New York has strongly opposed this proposal.

SETTLEMENT DISCLOSURE STATEMENTS

"(b) FULL DISCLOSURE OF PROPOSED CLASS ACTION SETTLEMENTS.--Section 21 of the Securities Exchange Act of 1934 (15 U.S.C. 78u) is amended by adding at the end the following new subsection:

"(i) DISCLOSURE OF SETTLEMENT TERMS TO CLASS MEMBERS.--In any private action under this title that is certified as a class action pursuant to the Federal Rules of Civil Procedure, a proposed settlement agreement that is published or otherwise disseminated to the class shall include the following statements:

"(1) STATEMENT OF POTENTIAL OUTCOME OF CASE .--

"(A) AGREEMENT ON AMOUNT OF DAMAGES AND LIKELIHOOD OF PREVAILING.--If the settling parties agree on the amount of damages per share that would be recoverable if the plaintiff prevailed on each claim alleged under this title and the likelihood that the plaintiff would prevail--

"(i) a statement concerning the amount of such potential damages; and

"(ii) a statement concerning the probability that the plaintiff would prevail on the claims alleged under this title and a brief explanation of the reasons for that conclusion.

"(B) DISAGREEMENT ON AMOUNT OF DAMAGES OR LIKELIHOOD OF PREVAILING.--If the parties do not agree on the amount of damages per share that would be recoverable if the plaintiff prevailed on each claim alleged under this title or on the likelihood that the plaintiff would prevail on those claims, or both a statement from each settling party concerning the issue or issues on which the parties disagree.

"(C) INADMISSIBILITY FOR CERTAIN PURPOSES.--Statements made in accordance with subparagraphs (A) and (B) shall not be admissible for purposes of any Federal or State judicial or administrative proceeding."

"(2) STATEMENT OF ATTORNEYS' FEES OR COSTS SOUGHT.--If any of the settling parties or their counsel intend to apply to the court for an award of attorneys' fees or costs from any fund established as part of the settlement, a statement indicating which parties or counsel intend to make such an application the amount of fees and costs that will be sought (including the amount of such fees and costs determined on a per-share basis, together with the amount of the settlement proposed to be distributed to the parties to suit, determined on a per-share basis), and a brief explanation of the basis for the application. Such information shall be clearly summarized on the cover page of any notice to a party of a proposed or final settlement.

"(3) IDENTIFICATION OF LAWYERS' REPRESENTATIVES.--The name and address of one or more representatives of counsel for the plaintiff class who will be reasonably available to answer written questions from class members concerning any matter contained in any notice of settlement published or otherwise disseminated to class members.

"(4) OTHER INFORMATION. Such other information as may be required by the court, or by any guardian ad litem or plaintiff steering committee appointed by the court pursuant to this section.".

THE COUNCIL SHOULD SUPPORT THIS PROPOSAL.

PROHIBIT ATTORNEYS' FEES FROM SEC DISGORGEMENT FUNDS

PROHIBITION ON ATTORNEYS' FEES PAID FROM COMMISSION DISGORGEMENT FUNDS.--Section 21(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78u(d)) is amended by adding at the end the following new paragraph

"(4) PROHIBITION ON ATTORNEYS' FEES PAID FROM COMMISSION DISGORGEMENT FUNDS.--Except as otherwise ordered by the court, funds disgorged as the result of an action brought by the Commission in Federal court, or of any Commission administrative action, shall not be distributed as payment for attorneys' fees or expenses incurred by private parties seeking distribution of the disgorged funds."

THE COUNCIL SHOULD SUPPORT THIS PROVISION SUBJECT TO THE CLARIFICATION THAT WHILE ATTORNEYS' FEES CANNOT BE PAID DIRECTLY FROM THE SEC DISGORGEMENT FUND, A COURT CAN TAKE SUCH FUND INTO CONSIDERATION IN DETERMINING THE AMOUNT OF THE COMMON FUND IN AWARDING FEES IF THE ATTORNEYS' EFFORTS CONTRIBUTED TO THE CREATION OF SUCH A FUND. THIS PROCEDURE WAS AGREED TO BY THE SEC AND FOLLOWED IN THE DREXEL BURNHAM CASES.

SECTION 203 (SECTION 21(K) OF THE SECURITIES & EXCHANGE ACT OF 1934)
NAMED PLAINTIFF THRESHOLD

"(k) REQUIREMENT THAT NAMED PLAINTIFF HAVE MEANINGFUL INVESTMENT.--In any private action under this title, in order for a plaintiff or plaintiffs to obtain certification as representatives of a class of investors pursuant to the Federal Rules of Civil Procedure, the plaintiff or plaintiffs must show that they owned, in the aggregate, at the beginning of the time period in which violations of this title are alleged to have occurred, not less than the lesser of--

"(1) 1 percent of the class of securities which are the subject of the litigation; or

"(2) $10,000 (in market value) of such securities.

THE COUNCIL SHOULD OPPOSE THIS PROVISION AS DRAFTED.

The requirement of a "meaningful" investment of an aggregate of either 1% of the securities or $10,000 blatantly discriminates against the small investors. Access to the courts should not be so limited.

Equally troubling is the provision that requires a class plaintiff to own shares of stock on the first day of the class period. This is an unnecessary and anomalous requirement because it would prevent investors who purchased during the class period from being class representatives.

While it is important to ensure that litigants have a genuine interest in filing an action and pursuing the action in a manner that is consistent with the duties of a class representative, these numerical thresholds are too high and thus not the best approach. The Litigation Section and the ABA should work with Congress on constructive alternatives.

RESTRICTIONS ON PROFESSIONAL PLAINTIFFS

"(1) RESTRICTIONS ON PROFESSIONAL PLAINTIFFS.--A person may be a named plaintiff, or officer, director, fiduciary, or beneficiary of a named plaintiff, in no more than 5 class actions filed during any 3-year period.

THE COUNCIL SHOULD REQUIRE CLARIFICATION BEFORE SUPPORTING A PROVISION WHICH DENIES A PERSON ACCESS TO THE COURTS.

Whether this provision can pass Constitutional muster is open to question. The provision as drafted only applies to plaintiffs in class actions and does not limit access to the courts by other plaintiffs such as institutions. If numerical limitations are placed on class plaintiffs, then the legislation should provide that repetitive discovery of such representatives should be prohibited.

5

LOSER PAYS ATTORNEYS FEES

LOSER'S LIABILITY FOR ATTORNEYS' FEES AND COSTS OF SUIT.--
"(1) PAYMENT BY LOSING PARTY.--If the court in any private action under this title enters a final judgment against a party litigant on any basis other than settlement, the court shall, upon motion by the prevailing party, order the losing party to pay the prevailing party reasonable attorneys' fees and other expenses incurred by the prevailing party.
"(2) TIME FOR APPLICATION.--A party seeking an award of fees and other expenses shall, within 30 days of a final, nonappealable judgment in the action, submit to the court an application for fees and other expenses.
"(3) COURT DISCRETION.--The court, in its discretion, may reduce the amount to be awarded pursuant to this section, or deny an award, to the extent that the prevailing party during the course of the proceedings engaged in conduct that unduly and unreasonably protracted the final resolution of the matter in controversy.

THE COUNCIL SHOULD STRENUOUSLY OPPOSE THIS PROVISION.

Under H.R. 10, a court must impose fees and costs against the losing party in a private securities case. The bill's provision is not only mandatory, but automatic. If you lose -- even on a technicality -- you pay the other side's attorneys' fees; and there is no limitation on the amount you may owe. A court can deny an award of fees and costs or reduce such an award only to the extent that the winning party "unduly and unreasonably protracted" the case.

This provision would end class actions and virtually all other security actions by victims of fraud. By definition, a securities class action is a suit by one or a few investors who have lost relatively small amounts of money and who sue on behalf of all those similarly injured. No victim will stand up and sue as the champion of the class if the risk -- under the English Rule -- is paying millions in attorneys' fees incurred by insurance companies, public corporations, investment banking houses, accounting firms and law firms. The English rule is simply inconsistent with the class action device.

Moreover, the provision cannot be fixed by changing the standard to shift fees on the basis of a lower standard. The in terrorem chilling effect exists because of the possibility that fees will be shifted; therefore any threat of a fee shift would be sufficient to deter a plaintiff from pursuing a class claim. As Professor Arthur Miller of Harvard Law School so cogently testified last summer:

> "As a practical matter, fee shifting is almost invariably an intimidation device designed to inhibit people from seeking access to the courts. Fee shifting would eviscerate all -- or

virtually all -- plaintiffs' securities claims, the meritorious along with the meritless. The practical mathematics of deciding whether to bring a lawsuit are clear. No one except the extremely wealthy -- no matter how strong his or her claims appears to be -- would assume the risks of pursuing a class claim against well-resourced defendants with counsel who are compensated on an hourly basis if there was any risk of having to pay the defendants' attorneys' fees. That would create a risk that would be hundreds, if not thousands, of times as great as the loss of any individual class representative.

"Litigation success from the plaintiff's perspective is never certain at the point of institution. Therefore, it does not matter much whether fee shifting is mandatory or discretionary with the court, or even what the standard for imposing it is. As a practical matter, in the context of class actions under the antifraud provisions of the federal securities laws, even a remote possibility that the class representative would have to pay the legal fees of defendants would be a major deterrent to anyone seeking to remedy a justiciable wrong. Who would risk the staggering legal fees if there was a chance the defendants would prevail in a civil suit -- leaving the loser responsible for the fees?

"Nor, do I believe that there is much difference between the "substantially justified" standard in the proposed legislation [H.R. 417 in the last Congress] and the "without merit" standard of Section 11(e) [of the Securities Act of 1933] which has the appearance of being less draconian. In the end, a suit is justified if the plaintiff wins; similarly, strictly speaking, a case that the plaintiff ultimately loses can be characterized as "without merit." My own judgment is that a conscientious judge who is obliged to give effect to such legislative language might well shift fees in virtually all cases."

6

CONFLICTS OF INTEREST

"PREVENTION OF ABUSIVE CONFLICTS OF INTEREST.--In any private action under this title that is certified as a class action pursuant to the Federal Rules of Civil Procedure, if a party is represented by an attorney who directly owns or otherwise has a beneficial interest in the securities that are the subject of the litigation, the court shall make a determination of whether such interest constitutes a conflict of interest sufficient to disqualify the attorney from representing the party."

THE COUNCIL SHOULD OPPOSE THIS AS DRAFTED.

Although the court and the parties should be able to inquire whether an attorney representing a party owns securities that are the subject of the litigation, we believe that mandatory court scrutiny of attorney stock ownership is unwarranted. The bill is also unclear as to how it would operate in practice.

Moreover, the mere ownership of securities should not automatically suggest a disabling conflict. Because the protections built into Rule 23 of the Federal Rules of Civil Procedure and attorneys' professional and ethical duties operate to identify and address conflicts, a court inquiry is not necessary or appropriate unless the attorney's securities ownership reaches some very substantial level. Moreover, a rule mandating court review upon an attorney's ownership of as little as a few shares of the subject securities would be susceptible to abuse by adverse parties for strategic purposes.

The bill also provides the court with no guidance in conducting its inquiry into whether a disabling conflict exists. It is unclear whether the bill contemplates extensive hearings concerning attorney securities ownership, or whether a more streamlined process is envisioned. This lack of an ascertainable standard could lead to widely divergent results. Without reference to any established standard, one court might employ a fact-specific approach and disqualify the attorney only if a conflict actually arises, while another might adopt a *per se* rule of automatic disqualification based on avoiding even the appearance of impropriety.

The bill is also too broad in that it arguably could require attorneys representing parties in securities litigation to inquire periodically of every member and employee of their firm to determine whether they own the subject securities. It also would arguably require attorneys to know and disclose the securities held by any investment vehicle in which they invest, such as a mutual fund. Such a requirement would be onerous and unworkable.

Therefore, although we believe that parties should be able to learn upon request whether an attorney owns a specified threshold amount of securities that are the subject of the litigation to disclose their ownership interest, we do not believe that this is an appropriate subject for legislation.

The above discussion is in accord with the position taken by The Association of the Bar of the City of New York.

7

SECTION 203

SETTLEMENT DISCHARGES

"(o) ENCOURAGEMENT OF FINALITY IN SETTLEMENT DISCHARGES.--

"(1) DISCHARGE.--A defendant who settles any private action brought under this title at any time before verdict or judgment shall be discharged from all claims for contribution brought by other persons. Upon entry of the settlement by the court, the court shall enter a bar order constituting the final discharge of all obligations to the plaintiff of the settling defendant arising out of the action. The order shall bar all future claims for contribution or indemnity arising out of the action--

(A) by nonsettling persons against the settling defendant; and

(B) by the settling defendant against any nonsettling defendants.

"(2) REDUCTION.--If a person enters into a settlement with the plaintiff prior to verdict or judgment, the verdict or judgment shall be reduced by the amount paid to the plaintiff by that person.

THE COUNCIL SHOULD SUPPORT THESE PROVISIONS.

CONTRIBUTION

"(p) CONTRIBUTION FROM NON-PARTIES IN INTERESTS OF FAIRNESS.--

"(1) RIGHT OF CONTRIBUTION.--A person who becomes liable for damages in any private action under this title may recover contribution from any other person who, if joined in the original suit, would have been liable for the same damages.

THE COUNCIL SHOULD SUPPORT THIS PROVISION.

SPECIAL VERDICTS REGARDING SCIENTER

"(q) DEFENDANT'S RIGHT TO SPECIAL VERDICTS ESTABLISHING SCIENTER--In any private action under this title in which the plaintiff may recover money damages, the court shall, when requested by a defendant, submit to the jury a written interrogatory on the issue of each such defendant's state of mind at the time the alleged violation occurred."

THE COUNCIL SHOULD NOT SUPPORT THIS PROVISION.

This proposal is an improper attempt to revise the Federal Rules of Civil Procedure with respect to written interrogatories. Federal Rule of Civil Procedure 49(b) authorizes the court to "submit to the jury, together with appropriate forms for a general verdict, written interrogatories upon one or more issues of fact the decision of which is necessary to a verdict." The purpose of this provision is to allow the court in its discretion to require the jury to focus on particular questions of fact as a means of ensuring that the jury's general verdict will reflect its consideration of the key factual elements of the case. See Industries, Investments & Agencies LTD. v. Panelfab Int'l Corp., 529 F.2d 1203 (5th Cir. 1976).

The proposal would remove from the court's discretion the decision to submit written interrogatories on the scienter issue in securities fraud litigation. This proposal is undesirable, as it would compromise the judge's ability to control the trial. If the proposal were accepted, it would permit the anomalous situation where the court could deny requests to submit written interrogatories on every issue except scienter. We do not believe that revisions to the federal securities laws are the proper vehicle for effecting a significant revision to the Federal Rules of Civil Procedure.

Moreover, because direct proof of state of mind is almost never available and is not, and should not be, required to establish liability, we believe that special provision for written interrogatories on scienter is inappropriate.

8

REFERRAL FEES

(b) PROHIBITION OF REFERRAL FEES THAT FOMENT LITIGATION.--Section 15(c) of the Securities Exchange Act of 1934 (15 U.S.C. 780(c)) is amended by adding at the end the following new paragraph:

"(7) RECEIPT OF REFERRAL. FEES.--No broker or dealer, or person associated with a broker or dealer, may solicit or accept remuneration for assisting an attorney in obtaining the representation of any customer in any private action under this title.".

THE COUNCIL SHOULD SUPPORT THIS PROVISION WITH A CLARIFICATION CONCERNING THE MEANING OF THE PHRASE "PERSONS ASSOCIATED WITH A BROKER OR DEALER" TO ENSURE THAT LAWYERS CAN SPLIT FEES AND ACT IN A CO-COUNSEL RELATIONSHIP WITH OTHER LAWYERS WHO HAPPEN TO REPRESENT ONE OR MORE BROKER(S) OR DEALER(S).

9a

INTENT/SCIENTER

"(a) SCIENTER.--In any action under section 10(b), a defendant may be held liable for money damages only on proof--

"(1) that the defendant made an untrue statement of a material fact, or omitted to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading, and

"(2) that the defendant knew the statement was misleading at the time it was made, or intentionally omitted to state a fact knowing that such omission would render misleading the statements made at the time they were made.

THE COUNCIL SHOULD STRENUOUSLY OPPOSE THIS PROVISION.

This provision would re-write the law on private damage suits in at least two fundamental ways. First, under H.R. 10, a defrauded investor will have to prove that a wrongdoer "knew [a] statement was misleading at the time it was made" or "intentionally omitted to state a fact knowing that such omission would render misleading the statements made at the time they were made." Under current law as interpreted by virtually every circuit court, recklessness -- as opposed to actual knowledge -- is sufficient to establish securities fraud. Moreover, recklessness satisfies the scienter requirement for common-law fraud and should satisfy scienter in 10(b) cases.

It is important to note that recklessness is defined as an extreme departure from the standards of ordinary care which presents a danger of misleading investors that is either known to the defendant or is so obvious that the defendant must have been aware of it. A person acts recklessly if the risk is known to him or her, or it is obvious that an ordinary person under the circumstances would have realized the danger and taken care to avert the harm likely to follow.

Requiring actual knowledge ignores the practical reality that direct evidence that a defendant actually knew a statement was false is extraordinarily rare. Obviously, the defendant will never admit it, and savvy corporate insiders know better than to prepare internal documents referring to the fact that they know they have been deceiving the market with false information about their company.

Because under H.R. 10, no defendant may be liable for damages unless he or she has committed knowing fraud, officers, directors, professionals -- lawyers and accountants -- will no longer be responsible for their reckless involvement in wrongdoing.

Immunizing reckless conduct is poor public policy. Requiring actual knowledge of a fraud by a defendant in such circumstances will encourage officers, directors, accountants and lawyers "to look the other way" in order to avoid liability. This will have a very harmful effect on the integrity of the securities markets in this country. Eliminating a recklessness standard will encourage the very conduct sought to be stopped.

Exempting reckless conduct is manifestly unfair to fraud victims. There can be no justification for favoring a reckless conduct over an innocent victim in deciding who should bear the risk of loss. If a defendant acts recklessly and thereby furthers a fraud, he or she should be answerable to the victims who suffered as a result.

Second, the proposed language states that a defendant can be held for "money damages" under section 10(b) "only" on proof of certain misstatements or omissions. Read literally, the provision would statutorily repeal two of the three provisions of Rule 10-b-5: Rule 10-b-5(a), which prohibits the employment of any device, scheme or artifice to defraud, and 10-b-5(c), which prohibits acts, practices and courses of businesses that would operate as a fraud. These provisions are important and should not be repealed.

Moreover, the effect of this provision will be to require a higher standard of proof in civil fraud cases that is required in criminal cases.

9b

PLEADING MISLEADING STATEMENTS & OMISSIONS

"(b) REQUIREMENT FOR EXPLICIT PLEADING AND PROOF OF SCIENTER.--In any action under section 10(b) in which it is alleged that the defendant--

"(1) made an untrue statement of a material fact; or

"(2) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading,

the complaint shall allege specific facts demonstrating the , state of mind of each defendant at the time the alleged violation occurred. The complaint shall also specify each statement or omission alleged to have been misleading, and the reasons the statement or omission is misleading. If an allegation regarding the statement or omission is made on information and belief, the complaint shall set forth with specificity all information on which that belief is formed. Failure to comply fully with this requirement shall result in dismissal of the complaint for failure to state a cause of action.

THE COUNCIL SHOULD OPPOSE THIS PROVISION.

H.R. 10 creates harsh new pleading requirements for fraud that are impossible for plaintiffs to meet and that will lead to dismissal of meritorious cases. For example, in the complaint a victim would have to "allege specific facts demonstrating the state of mind of each defendant at the time the alleged violation occurred." Information about the "state of mind" of a defendant is not within the plaintiff's possession until after discovery -- yet, H.R. 10 will require the plaintiff to have that information at the beginning of the suit.

This requirement directly contradicts Rule 9(b) of the Federal Rules of Civil Procedure. (Rule 9(b), while requiring that fraud must be pleaded with particularity, states that "malice, intent and other condition of mind of a person" may be pleaded generally.) This provision also overrules the recent en banc decision of the U.S. Court of Appeals for the Ninth Circuit in In re: GlenFed, Inc., No. 92-55419 1994 U.S. App. LEXIS 34334 at 11 (9th Cir., Dec. 9, 1994).

Moreover, as the Report of the Association of the Bar of the City of New York correctly noted, the proposed "standards for pleading scienter in securities fraud cases are contrary to the longstanding philosophy of maintaining relatively uniform procedural rules for civil litigation in the Federal Courts. "(The Association opposed this provision).

In testimony before Congress last summer, Professor Arthur R. Miller, author of the definitive treatise on federal practice and procedure, stated "that the new proposed requirement seems to

suggest that at the outset of the case, the plaintiff must have the clearest proof of each individual defendant's state of mind. But this is totally unrealistic. It is only in the rarest cases that this type of evidence exists. Under the best of circumstances, requiring plaintiffs to plead the defendants' states of mind generally calls for the drawing of subtle inferences from facts available prior to institution, a task that is highly treacherous. It would be impossible in the vast majority of cases in which those facts simply are unavailable prior to the lawsuit."

Courts have recognized that it would be "unworkable and unfair to require great specificity in pleading scienter, since 'a plaintiff realistically cannot, be expected to plead a defendant's actual state of mind." See Stern v. Leucadia Nat'l. Corp., 844 F.2d 997, 1004 (2d Cir.), cert. denied, 488 U.S. 852 (1988) (quoting Connecticut Nat'l. Bank v. Fluor Corp., 808 F.2d 957, 962 (2d Cir. 1987)). See also 3 Leonard B. Sand et al., Modern Federal Jury Instructions ¶ 82.02, at 82-73 (1993) ("Direct proof of state of mind is almost never available, and is not required.").

9c

BURDEN OF PROOF -- FRAUD ON THE MARKET

"(c) RELIANCE.--In any action arising under section 10(b) based upon a material misstatement or omission concerning a security, the plaintiff must prove that he or she had actual knowledge of and actually relied on such statement in connection with the purchase or sale of a security and that the misstatement or omission proximately caused (through both transaction causation and loss causation) any loss incurred by the plaintiff.

THE COUNCIL SHOULD OPPOSE THIS PROVISION.

This provision abolishes the "fraud-on-the-market" theory and requires each victim to prove that he or she actually knew of and actually relied on a defendant's misstatements or omissions. Moreover, it requires that the misstatements or omissions must have "proximately caused" a victim's loss.

This provision directly overrules the 1988 decision of the Supreme Court in Basic, Inc. v. Levinson, 485 U.S. 224 (1988), which endorsed the "fraud on the market" principle and held that an investor need not prove direct reliance on misleading statements so long as the stock's market price (something virtually all investors rely on) was inflated by the false and misleading information. The Supreme Court described fraud on the market as follows:

> The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business .... Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.... The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations. Peil v. Speiser, 806 F.2d 1154, 1160-1161 (CA3 1986).

This provision of H.R. 10 ignores that reality and defies common sense. Most people purchase a stock on a broker's recommendation, because they read a magazine article or analyst's report about the issuing company or on some basis other than

actually reviewing the issuing company's representations. In doing so, the stock purchaser is, however, indirectly relying on the company's representation because the broker making the recommendation or the author of the analysis or article did rely on the company's representation. H.R. 10 ignores this marketplace reality and unfairly limits liability only to those investors who actually read the misrepresentation.

Finally, the provision overrules the Supreme Court's decision in Affiliated Ute Citizens v. United States, which provides a rebuttable presumption for classwide reliance on material omissions. 406 U.S. at 153-54.

Because of the bill's requirement of proof of individual reliance, it would be impossible for groups of small investors to join together to bring a securities fraud class action lawsuit. A successful class action depends on commonality of issues. If reliance must be proved investor-by-investor, the practical problems of disposing of claims on a classwide basis would be insurmountable.

SECTION 10A

"WINDFALL" DAMAGES

(d) **LIMITS ON WINDFALL DAMAGES**.--In any action arising under section 10(b) based on a material misstatement or omission concerning a security, an award of damages that exceeds the price paid for a security purchased in reliance upon a material misstatement or omission shall not exceed the lesser of--

(1) the difference between the price paid for the security which was purchased in reliance upon a material misstatement or omission, and the market value of the security immediately after dissemination to the market of information which corrects the misstatement or omission; and

(2) the difference between the price paid for the security which was purchased in reliance upon a material misstatement or omission, and the price at which the relying party sold the security after dissemination of information correcting the misstatement or omission.

THE COUNCIL SHOULD OPPOSE THIS PROVISION.

The title of this section is a complete misnomer. Both of these measures differ significantly from the so-called out-of-pocket rule now applied in actions arising under Section 10(b) and Rule 10b-5 and would not make investors whole. Under the currently used out-of-pocket measure of damages, a defrauded purchaser is entitled to recover the difference between the price paid for a security and its true value on the date of purchase if there had been no fraud.*

The first proposal seeks to measure damages by the amount of the drop in the price of a security when a disclosure is made. This proposal will not accurately measure damages. The most accurate measure of damages, as recognized by the courts, is the difference between the price paid and the true value of the security on the date of purchase absent any fraud. Moreover, this provision does not take into account the situation where there has been no disclosure. Take for example a situation where the books have been "cooked" but that is never disclosed. Instead, the company cites some "benign" reason for disappointing earnings and the price of the stock drops. Clearly, the price of the security

---

* See, e.g., Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 155 (1972); Randall v. Loftsgaarden, 478 U.S. 647, 661-62 (1986); Harris Trust & Savings Bank v. Ellis, 810 F.2d 700, 806-07 (7th Cir. 1987); Sirota v. Solitron Devices, Inc., 673 F.2d 566, 578 (2d Cir.); cert. denied, 459 U.S. 838 (1982); In re LTV Sec. Litig., 88 F.R.D. 134, 148 (N.D. Tex. 1980); Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1344 (9th Cir. 1976) (Sneed, C.J., concurring).

on the date of purchase was inflated as a result of the false financials which was not disclosed. Thus, the purchaser will have suffered recoverable damages under the "out-of-pocket" rule even in the absence of corrective disclosures. See, In re Worlds of Wonder Securities Litigation, 35 F.3d 1407 (9th Cir. 1994); Wool v. Tandem Computers, Inc., 818 F.2d 1433 (9th Cir. 1987).

The alternative measure of damages contained in H.R. 10 would give the wrongdoers the benefit of an investor's second investment decision if the price of the security rose at some time in the future for reasons unrelated to the fraud.** This provision in effect gives securities law violators a windfall. Under current caselaw, defrauded purchasers can maintain an action under Section 10(b) and Rule 10b-5 even if they sold their shares for a price greater than they paid for the stock.***

Also troubling is the language which incorporates a requirement of "actual reliance upon a material misstatement or omission" to establish damages, which is contrary to the "fraud on the market" rule adopted by the Supreme Court in Basic Inc., et al. v. Levinson, 485 U.S. 224 (1988), and the holding of the Supreme Court in Affiliated Ute Citizens v. United States, 406 U.S. at 153-54, dispensing with the need for proof of reliance where there was a material omission.

** Under the out-of-pocket rule damages are fixed on the date the buyer purchases the securities in question. Any increase or decrease in the price of the stock after the full truth is disclosed does not affect the calculation of damages. See, e.g., Sirota, 673 F.2d at 578 ("[T]he issue is the amount by which each class member was defrauded on the date of his purchase. Any subsequent decline in the market had no effect on that fraudulent sale."); Bernstein v. Crazy Eddie, Inc., 702 F. Supp. 962, 980 (E.D.N.Y. 1988), vacated in part on other grounds sub nom., 714 F. Supp. 1285 (E.D.N.Y. 1989) ("Plaintiffs' eventual realization of a profit or loss upon sale of the shares may result from supervening market forces (e.g., a general stock market rise or crash) that have nothing to do with the misrepresentations that induced the purchase and caused the inflated price."); Katz v. Comdisco, Inc., 117 F.R.D. 403, 408-09 (N.D. Ill. 1987).

*** See, e.g., Rand v. Monsanto Co., 926 F.2d 596, 597 (7th Cir. 1991), aff'd, 946 F.2d 897 (7th Cir. 1991).

SAFE HARBOR FOR PROJECTIONS

SEC. 205. ESTABLISHMENT OF "SAFE HARBOR" FOR PREDICTIVE STATEMENTS.

(a) CONSIDERATION OF REGULATORY OR LEGISLATIVE CHANGES.--In consultation with investors and issuers of securities, the Securities and Exchange Commission shall adopt or amend its rules and regulations to create--

(1) clear and objective criteria that the Commission finds sufficient for the protection of investors, compliance with which shall be readily ascertainable by issuers prior to issuance of securities, by which forward-looking statements concerning the future economic performance of an issuer of securities registered under section 12 of the Securities Exchange Act of 1934 will be deemed not to be in violation of section 10(b) of that Act; and

(2) procedures by which courts shall timely dismiss claims against such issuers of securities based on such forward-looking statements if such statements are in accordance with any criteria under paragraph (1).

(b) COMMISSION CONSIDERATIONS.--In developing rules in accordance with subsection (a), the Commission shall also--

(1) prescribe appropriate limits to liability for conscientiously prepared forward-looking statements that do not fall within any regulatory safe harbor;

(2) set forth procedures for making a summary determination of the applicability of any Commission rule for forward-looking statements early in a judicial proceeding to limit protracted litigation and expansive discovery;

(3) ensure that its rules incorporate and reflect the scienter requirements applicable to actions under section 10(b) of the Securities Exchange ACT of 1934 and

(4) ensure that its rules provide clear guidance to investors, issuers of securities, and the judiciary.

(c) SECURITIES ACT AMENDMENT.--The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), is amended by adding at the end the following new section:

"SEC. 38. APPLICATION OF SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS.

"(a) IN GENERAL.--In any private action under this title that alleges that a forward-looking statement concerning the future economic performance of an issuer registered under section 12 was materially false or misleading, if a party making a motion in accordance with subsection (b) requests a stay of discovery concerning the claims or defenses of that party, the court shall grant such a stay until it has ruled on any such motion.

"(b) SUMMARY JUDGMENT MOTIONS.--Subsection (a) shall apply to any motion for summary judgment made by a party asserting that the forward-looking statement was within the coverage of any safe harbor rule which the Commission may have adopted concerning such predictive statements, if such motion is made not less than 60 days after the commencement of discovery in the action.

"(c) DILATORY CONDUCT; DUPLICATIVE DISCOVERY.--Notwithstanding subsection (a) or (b), the time permitted for discovery under subsection (b) may be extended, or a stay of the proceedings may be denied, if the court finds that--

"(1) the party making a motion described in subsection (b) engaged in dilatory or obstructive conduct in taking or opposing any discovery or

"(2) a stay of discovery pending a ruling on a motion under subsection (b) would be substantially unfair to such party or to other parties to the action.".

THE COUNCIL SHOULD TAKE THE POSITION OF SIMPLY REQUIRING THE

SEC TO STUDY THE ISSUES AND REPORT TO CONGRESS. THE COUNCIL SHOULD OPPOSE SECTION 38.

In October 1994, the SEC issued a concept release concerning forward-looking statements. The SEC hearings will commence in February 1995. The SEC is therefore already responding to the perceived need to review existing "safe-harbor" protections for forward-looking statements.

The proposed draft would require an SEC rulemaking. By imposing terms and conditions beyond those of the Administrative Procedure Act (e.g., the SEC shall "adopt or amend its rules" "[i]n consultation with investors and issuers"), the provision may inadvertently invite court challenges that delay or prevent implementation of any new "safe harbor" rules.

Congress should not be mandating as it does in Section 38 when a court must grant a stay. At a minimum, Section 38 should be clarified to make explicit that the automatic stay and new summary judgment procedures do not apply to "any action alleging that a forward-looking statement is false or misleading," but to any action exclusively predicated on forward-looking statements. Many fraud cases involve one or more forward-looking statements in combination with numerous misstatements or omissions about past or current events. These cases should not be affected, lest the "safe harbor" swallow up the entire range of private civil fraud cases.

12

ADR

SEC. 206. ALTERNATIVE DISPUTE RESOLUTION PROCEDURE.

The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by adding at the end the following new section:

"SEC. 39. ALTERNATIVE DISPUTE RESOLUTION PROCEDURE.

"(a) IN GENERAL.--

"(1) OFFER TO PROCEED.--Except as provided in paragraph (2), in any private action arising under this title, any party may, before the expiration of the period permitted for answering the complaint, de-liver to all other parties an offer to proceed pursuant to any voluntary, nonbinding alternative dispute resolution procedure established or recognized under the rules of the court in which the action is maintained.

"(2) PLAINTIFF CLASS ACTIONS.--In any private action under this title which is brought as a plaintiff class action, an offer under paragraph (1) shall be made not later than 30 days after a guardian ad litem or plaintiff steering committee is ap-pointed by the court in accordance with section 38.

"(3) RESPONSE.--The recipient of an offer under paragraph (1) or (2) shall file a written notice of acceptance or rejection of the offer with the court not later than 10 days after receipt of the offer. The court may, upon motion by any party made prior to the expiration of such period, extend the period for not more than 90 additional days, during which time discovery may be permitted by the court.

"(4) SELECTION OF TYPE OF ALTERNATIVE DISPUTE RESOLUTION.--For purposes of paragraphs (1) and (2), if the rules of the court establish or recognize more than 1 type of alternative dispute resolution, the parties may stipulate as to the type of alternative dispute resolution to be applied. If the parties are unable to so stipulate, the court shall issue an order not later than 20 days after the date on which the parties agree to the use of alternative dispute resolution, specifying the type of alternative dispute resolution to be applied.

"(5) SANCTIONS FOR DILATORY OR OBSTRUCTIVE CONDUCT.--If the court finds that a party has engaged in dilatory or obstructive conduct in taking or opposing any discovery allowed during the response period described in paragraph (3), the court may--

"(A) extend the period to permit further discovery from that party for a suitable period; and

"(B) deny that party the opportunity to conduct further discovery prior to the expiration of the period.".

THE COUNCIL SHOULD SUPPORT THIS PROVISION.

13

RICO

SEC. 107. AMENDMENT TO RACKETEER INFLUENCED AND CORRUPT ORGANIZATIONS ACT

Section 1964(c) of title 18, United States Code, is amended by inserting ", except that no person may bring an action under this provision if the racketeering activity, as defined in section 1961(D), involves conduct actionable as fraud in the purchase or sale of securities" before the period.

THE COUNCIL SHOULD NOT SUPPORT THIS PROVISION.

This provision would immunize any conduct "actionable as fraud in the purchase or sale of securities" from private civil RICO. It is much broader than merely removing securities fraud on a predicate offense. This provision would immunize Charles Keating, Michael Milken and Drexel Burnham Lambert from civil RICO liability because their conduct was actionable as securities fraud.

The Association of the Bar of the City of New York has stated that a similar RICO provision in S. 1976 (103rd Congress) proposal "protects special interests." The Association stated: "Those who defraud others in the sale of securities are not less nor more guilty, and those who are defrauded no less nor more worthy of enhanced damages than those who commit or are victims of similar frauds involving other forms of commercial activity. If it is deemed wise to subject bankers, insurance companies, and vendors of merchandise to enhanced damages when they commit criminal acts -- a point on which we express no opinion -- it is difficult to see why those who sell securities to the general public should stand in a different position.

The Council should not support this special-interest provision.

14

DISPARITY BETWEEN PRIVATE ACTION AND SEC ENFORCEMENT FOR SUBSTANTIVE ELEMENTS, RECKLESSNESS, PLEADING

THE COUNCIL SHOULD OPPOSE DISPARITY.

There should be no disparity between private actions and SEC enforcement for the substantive elements of securities fraud. As the SEC has repeatedly stated over many years, private actions are "a necessary supplement" to SEC enforcement actions. In addition to the extremely important purpose of compensating victims, private actions are extremely important for deterrence. Moreover, certain provisions of H.R. 10 -- such as the knowing intent standard -- are not only tougher than the elements the SEC would have to prove in a civil case, but are tougher than the government's burden in a similar criminal case.

It is the private actions which compensate victims. Thus, it makes no sense to require a higher standard for victims of frauds to seek redress than that required of the SEC.

15

BONUS PAYMENTS

"(j) ELIMINATION OF BONUS PAYMENTS TO NAMED PLAINTIFFS IN CLASS ACTIONS.--In any private action under this title that is certified as a class action pursuant to the Federal Rules of Civil Procedure, the portion of any final judgment or of any settlement that is awarded to class plaintiffs serving as the representative parties shall be equal, on a per share basis, to the portion of the final judgment or settlement awarded to all other members of the class. Nothing in this subsection shall be construed to limit the award to any representative parties of actual expenses (including lost wages) relating to the representation of the class.

THE COUNCIL SHOULD SUPPORT THIS PROVISION.

16

SEC. 207. RULE OF CONSTRUCTION

Nothing in the amendments made by this Act shall be deemed to create or ratify any implied private right of action, or to prevent the Commission by rule from restricting or otherwise regulating private actions under the Securities Exchange Act of 1934.

THE COUNCIL SHOULD NOT OPPOSE THIS PROVISION AS DRAFTED.

In particular, the Council should press to delete the words "or ratify". Implied private actions under section 10(b) and Rule 10-b-5 are a time-honored centerpiece of American law. If anything, their existence should be explicitly ratified.

17

SEC. 208. EFFECTIVE DATE

This Act and the amendments made by this Act are effective on the date of enactment of this Act and shall apply to cases commenced after such date of enactment.

THE PROVISION IS AMBIGUOUS. THE COUNCIL SHOULD SUPPORT THIS PROVISION ONLY IF IT IS CLARIFIED TO MEAN THAT THE LEGISLATION IS PROSPECTIVE.

L. RALPH MECHAM
DIRECTOR

CLARENCE A. LEE, JR.
ASSOCIATE DIRECTOR

ADMINISTRATIVE OFFICE OF THE
UNITED STATES COURTS
WASHINGTON, D.C. 20544

JOHN K. RABIEJ
CHIEF, RULES COMMITTEE
SUPPORT OFFICE

VIA FEDERAL EXPRESS

February 13, 1995

MEMORANDUM TO PARTICIPANTS AT FEBRUARY 16-17 MEETING OF THE ADVISORY COMMITTEE ON CIVIL RULES

SUBJECT: *Materials on Private Securities Litigation Reform and List of Participants Attending the Meeting*

For your information, I am attaching the following materials regarding the *Private Securities Litigation Reform Act*, which will be discussed at the February 16-17 meeting of the Advisory Committee on Civil Rules:

1) Report of Judge Scirica's Subcommittee on *Private Securities Litigation Reform Act*, including a copy of the *Securities Reform Act* contained in Title II of H.R. 10, the *Common Sense Legal Reform Act*; and

2) Statement of Arthur Levitt, chairman of the Securities and Exchange Commission, testifying before the House Commerce Subcommittee;

I am also attaching a list of members of the Advisory Committee on Civil Rules and invited participants who are planning to attend the meeting.

John K. Rabiej

Attachments

LIST OF ATTENDEES AT THE FEBRUARY 16-17, 1995 OF THE ADVISORY COMMITTEE ON CIVIL RULES

MEMBERS OF THE ADVISORY COMMITTEE ON CIVIL RULES, STANDING RULES COMMITTEE, AND STAFF

Honorable Patrick E. Higginbotham, Chair
Honorable Anthony J. Scirica
Honorable Paul V. Niemeyer
Honorable David S. Doty
Honorable C. Roger Vinson
Honorable David F. Levi
Honorable Christine M. Durham
Professor Thomas D. Rowe, Jr.
Carol J. Hansen Fines, Esquire
Mark O. Kasanin, Esquire
Francis H. Fox, Esquire
Phillip A. Wittmann, Esquire
Honorable Frank Hunger
Professor Edward H. Cooper, Reporter
Honorable William O. Bertelsman, Liaison, Standing Committee
Peter G. McCabe, Secretary, Standing Committee
Honorable Alicemarie H. Stotler, Chair, Standing Committee
Professor Daniel R. Coquillette, Reporter, Standing Committee
John K. Rabiej, Chief, and Mark Shapiro, Attorney, Rules Committee Office
Thomas E. Willging, Robert Niemic, and Laurel L. Hooper, Federal Judicial Center

INVITED PARTICIPANTS

Professor Stephen A. Burbanks, Host
Honorable Lowell A. Reed, Jr.
Honorable Edward R. Becker
Honorable William W Schwarzer, Director, Federal Judicial Center
Daniel Berger, Esquire
Sol Schreiber, Esquire
Elizabeth Joan Cabraser, Esquire
Robert C. Heim, Esquire
Henry Thumann, Esquire
Melvyn Weiss, Esquire
Dennis Block, Esquire
Professor John C. Coffee, Jr.
Professor Samuel Estreicher
Professor Stephen C. Yeazell
Professor Geoffrey Hazard

February 10, 1995

To: Advisory Committee on Civil Rules

From: Subcommittee on proposed Private Securities Litigation Reform Act of 1995--

Judge Anthony J. Scirica, Chair
Judge David S. Doty
Judge C. Roger Vinson
Phillip A. Wittman, Esq.
Prof. Thomas D. Rowe, Jr., unofficial reporter

Re: Procedural aspects of proposed securities litigation revisions

This memorandum discusses procedural aspects of the proposed Securities Litigation Reform Act of 1995, which is Title II of H.R. 10--the bill to implement the civil litigation reform plank in the Contract with America. At our meeting in Philadelphia on February 16-17, this will be an agenda item; we will also try to get to you in advance a memo on a competing bill introduced by Rep. Markey (D., Mass.), H.R. 555. The memo goes through the bill in the order of its provisions, thus mixing points of considerable concern with lesser issues. The sections with greatest impact for procedural purposes seem to be the guardian ad litem and plaintiffs' steering committee provisions in the bill's § 202(a); the pleading-specificity requirements in § 204; and the Article III problem with apparent SEC rulemaking authority for federal courts in § 205. For reference, a copy of the securities title of H.R. 10 follows the memo.

The Rules Advisory Committees and the Judicial Conference, to which Congress has delegated the task of recommending to the Supreme Court changes in the federal courts' rules of practice and procedure, bring considerable expertise and experience to matters affecting proceedings in the federal trial and appellate courts. Sensitive to the Rules Enabling Act's ban on rules that would "abridge, enlarge or modify any substantive right," 28 U.S.C. § 2072(b), we do not regard it as within our province to comment on substantive aspects of proposed legislation. We hope, however, that our counsel may be appropriate and valuable in other respects, including whether to make procedural changes for the federal courts by legislation or via the rules process; the desirability of particular procedural changes and their potential impact on federal court caseloads and on other aspects of federal practice and procedure; and the

drafting of procedural legislation to avoid unnecessary problems if Congress sees fit to legislate on federal procedural matters.

The parts of the proposed Securities Litigation Reform Act that would have significant impact on federal court practice and procedure are the following:

Section 202(a), guardian ad litem and class action steering committees:

These provisions would require the appointment of a guardian ad litem or plaintiff steering committee in private class actions under the Securities Exchange Act of 1934. They would make major changes for such cases in the working of present Civil Rule 23 on class actions, sometimes in ways it may be hard to foresee. First, the Congress should be aware that in early 1994 the Advisory Committee on Civil Rules undertook a major study of Rule 23 with an eye to possible broad revisions; that work is proceeding in earnest with research reports and meetings this winter and spring. Class actions under the federal securities laws may present unique problems that call for procedures specific to the securities context. Yet the problems perceived in such class litigation could turn out either to be less serious than they initially seem, or to represent problems that also occur in other class action contexts than securities law--and may thus lend themselves to correction through the rules process. The prospect of procedures tailored to specific substantive areas raises especially sensitive problems for reaching the best combination of legislation with rules promulgated under an Enabling Act process that proscribes rules abridging, enlarging, or modifying substantive rights.

The rules committees would welcome the opportunity to work with Congress to study these problems and to help craft coordinated solutions that combine legislative answers, where needed, with court rules. In particular, the rules committees could consider whether the proposed securities class action changes reflect a need for Rule 23 amendments designed to assure better "client" involvement across the board. One conceivable mechanism that might be explored, already hinted at in a preliminary proposal circulated by the Advisory Committee on Civil Rules within the last few years, would be to give federal district courts discretion to use opt-*in* approaches as well as present Rule 23's opt-out device. As applied in securities litigation, such approaches might let courts require larger shareholders--such as mutual and pension funds--to elect whether to be included in actions brought by owners of tiny fractions of total holdings.

If the funds stayed out, the litigation would remain smaller and probably far less costly (if it continued at all); if they opted in, they might be involved more actively without the need for the formal mechanisms of guardians ad litem or steering committees.

Second, focusing on procedural particulars within the guardian ad litem/steering committee sections: a) As we understand the reality of at least some securities class action practice, the provisions may often be ineffective because they require the court to appoint the guardian or steering committee "not later than 10 days after certifying a plaintiff class"--yet in some securities class actions, the certification decision itself hangs fire for some time, frequently being wrapped up in connection with settlement. With major events possibly taking place before the guardian or steering committee might be in the case, such players' role could amount to very little, rather than acting the "real client" part envisioned for them. b) Existing Rule 23(a)(4) already requires that the representative parties be found to "fairly and adequately protect the interests of the class." Empirical study may be needed of how frequently, despite the rule, present practice not only in securities but also in other class actions appears to produce figurehead representative plaintiffs who play no substantial role.

c) The relationship between named class representatives and guardians or steering committees seems to need clarification in important respects. i) Would named representatives, except as made minority members of a steering committee under proposed SEA § 36(c)(2), retain any aspect of the role they are supposed to play under Rule 23--which this bill would not amend --once a guardian ad litem or steering committee was selected? ii) In the case of a plaintiff class, who would be the losing "party" for purposes of the loser-pays provision in § 203(a)'s proposed SEA § 21(m)--the original named representatives, the entire class, or the guardian or steering committee members? It would be unfair to impose the liability on the named representatives once they lost authority to "direct counsel for the class" to the guardian or steering committee; it would probably be both unfair and practically impossible to collect from the entire class; and making the guardian or steering committee members liable might wipe out the supply of volunteers for the role, leaving the mechanism unusable.

d) Proposed SEA § 36(a) could prove a fount of procedural jockeying with its provision for court appointment of a guardian ad litem "for the plaintiff class from a list or lists provided by the parties or their counsel." The court appears confined to the lists unless it appoints a

steering committee instead, yet both sides' lists would be suspect; nothing assures that guardians --who are not subject to the ownership-share qualifications of proposed SEA § 36(c) for steering committee membership--would be better than original named representatives. Plaintiffs would probably try to water down the effect of the guardian's superseding named representatives by nominating persons they might otherwise have named as representatives. As for defendants, it is imaginable that a defendant's list of nominees could include an appropriate guardian ad litem for a plaintiff class, although that would probably be rare--yet efforts to install a guardian who was at least amenable to defense interests might be frequent and expensively contested. (It is also puzzling to see in proposed § 36(a) the authorization for court apportionment of a guardian's fees and expenses among the parties. Defendants sometimes have to pay for prevailing plaintiffs' lawyers, but rarely for the plaintiffs themselves.)

e) Proposed SEA § 36(d)(2)'s authorization for guardians or steering committees to seek class majority approval for settlement offers leaves important questions unanswered. How, for instance, would success or failure to get a majority affect existing court authority to approve or reject proposed settlements? What would be the status of approval by a majority of those voting when many shareholders do not vote at all? f) In proposed SEA § 36(f) concerning effect on other law, the language about not affecting "any other provision of law concerning class actions" should probably have words such as "except as necessary to implement this section" added to it, because the preceding subsections would affect several aspects of Federal Rule of Civil Procedure 23.

Section 202(b), settlement disclosure:

Proposed SEA § 21(i) would require detailed disclosure to class members of terms of proposed settlements. Existing Federal Rule 23(e) requires court approval for class action settlements and provides that "notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs." Class action settlement notices are already often highly detailed, and the need for more specific regulation may be inadequately known. The Rules revision committees could consider whether practice under the present rule fails to provide adequate notice of the terms of proposed settlements in securities and other federal class litigation.

Section 203(a), additional class action provisions:

Although this subsection is headed "Additional Provisions Applicable to Class Actions," several of its proposed amendments to SEA § 21 speak of "any private action under this title" or "any private action brought under this title." This phrasing could make them applicable to all private civil cases and not just class actions. The proposed subsections that use such language are (m)(1), loser-pays attorney fee shifting; (o)(1), settlement discharge; (p) on contribution; and (q) on special verdicts.

Procedural issues in particular subsections include the following: a) The named plaintiff thresholds of proposed SEA § 21(k) would add to existing Rule 23(a) requirements of typicality and adequacy for representatives in SEA class actions, apparently diluting the premise that the class device is meant to foster aggregation of claims too small to be brought individually. This effect seems especially strong in light of the provisions for guardians ad litem and plaintiff steering committees: small shareholders would largely be unable to bring *or* control private federal securities class actions. The Civil Rules Advisory Committee's study could include whether the perceived token-plaintiff problems that seem to underlie this proposal may exist in other fields such as consumer class actions, and whether existing requirements appear to need general amendment to deal with such problems. b) Proposed § 21(*l*), restricting the number of class actions within three years in which a person may be a named plaintiff, may be subject to easy evasion by getting other potential representatives. Courts already deal with repeat-plaintiff abuse on a case-by-case basis, as one federal court recently did in *Welling v. Alexy*, 155 F.R.D. 654, 658-59 (N.D. Cal. 1994) (refusing to certify as class representative plaintiff who had appeared in many other class actions, was unfamiliar with allegations and status of proceedings, and showed little interest in supervising counsel).

c) Subsection (2) of proposed § 21(m) on loser-pays attorney fee liability requires that fee applications be submitted "within 30 days of a final, nonappealable judgment"--presumably delaying fee applications until after the completion of appeals. The 30-day period conflicts with Federal Rule of Civil Procedure 54(d)(2)(B)'s allowance of 14 days after entry of judgment for filing a motion claiming attorney fees in most cases. It would probably be better to let the Rule's general provision govern. d) Proposed § 21(n) requires a conflict of interest inquiry when a class action attorney owns or has a beneficial interest in the securities at issue. This

requirement may be unnecessary given existing practice under Rule 23(a)(4) on adequacy of representation, which will ordinarily not be found if counsel has a conflict of interest. The provision as drafted also would apply to all counsel--and not just attorneys for the class--in a SEA class action, thus making defense counsel who own stock in a defendant corporation subject to the same conflict inquiry; this effect may or may not be intended. It is not clear whether the problem with which the inquiry in cases of attorney stock ownership is meant to deal is really one of conflict of interest or rather perceived fomenting of litigation, to which the required conflict inquiry might not respond.

e) Proposed SEA § 21(o)'s settlement discharge provision seems to apply not only to class actions, in which courts must approve proposed settlements, but also to nonclass litigation in which settlements need not get court approval. This apparent extension of the discharge protections may be intentional, as it relates to proposed SEA § 21(p) on contribution (which also applies to "any private action under this title"), yet it compounds problems of whether a settling defendant is paying a fair share. f) Proposed SEA § 21(q) on special verdicts may be unnecessary given existing judicial practice on use of jury interrogatories. If adopted, the provision should be clarified by eliminating the reference to "special verdicts" in the title, as the apparent intent is to regulate practice under Federal Rule of Civil Procedure 49(b) on general verdicts with jury interrogatories and not Rule 49(a) on special verdicts--which could be highly troublesome to use in this context.

Section 204, scienter and pleading requirements for SEA § 10(b) securities fraud actions:

Proposed SEA § 10A(a) is substantive in adopting scienter requirements for securities fraud damage actions, but proposed § 10A(b) creates pleading standards for scienter allegations that may be impossible to meet. It also may curtail parties' ordinary opportunities to amend a defective pleading, and courts' ability to use carefully managed and targeted discovery. Federal Rule 9(b) already requires particularity in pleadings of fraud or mistake; at the same time the present rule recognizes, by allowing general averments of "[m]alice, intent, knowledge, and other condition of mind," how hard it can be to make specific allegations about others' mental states at the start of litigation. Federal courts regularly use Rule 9(b) to screen securities fraud complaints; some require, for example, that a plaintiff "set forth facts explaining why the dif-

ference between the earlier and the later statements is not merely the difference between two permissible judgments, but rather the result of a falsehood." *In re Glenfed, Inc., Securities Litigation*, 1994 WL 688969, at *7 (9th Cir. 1994) (en banc) (footnote omitted). Some courts go further and require pleading of "facts giving rise to a 'strong inference of fraudulent *intent.*'" *See id.* at *3 (emphasis added) (rejecting Second Circuit's requirement to that effect); *cf. In re Philip Morris Securities Litigation*, 1995 WL 13528 (S.D. N.Y. 1995) (dismissing, without leave to replead, amended securities fraud class action complaint for lack of "specific allegations supporting fraud").

In any event, the additional requirements of proposed § 10A(b) for allegations of "specific facts" demonstrating "state of mind" in an initial pleading seem demanding to the point of virtual or total impossibility. To the extent that plaintiffs try to comply with them, the proposed requirements raise the possibility of extremely prolix pleadings--which characterized much pre-Rules code pleading and led the framers of the original Federal Rules of Civil Procedure to abandon most requirements for detailed initial allegations. Such detailed, fact-specific pleadings can be highly burdensome not only for plaintiffs to prepare but for defendants and judges to deal with; courts under the less exacting current pleading rules can and do use powers over discovery to control costs when securities fraud pleadings clear existing hurdles. *See, e.g., Glenfed*, 1994 WL 688969, at *16-17 (Norris, J., concurring). Heavy front-loading of the pleading stage may preclude the more desirable alternative of less detailed pleadings followed by judicially controlled discovery, focused sharply on issues that may afford grounds for early dismissal. Highly detailed pleading requirements could also intersect in troublesome ways with such existing provisions as new Rule 26(a)(1) on initial disclosures concerning matters "relevant to disputed facts alleged with particularity in the pleadings." Pleaders already have Rule 26(a)(1)'s recently-created incentive to include factual detail on matters as to which they want to trigger disclosure obligations. That incentive may lead to some helpful specificity and targeted disclosures--rather than broader triggering of disclosure obligations because of detailed fact-pleading requirements. The substantive provisions of proposed § 10A(a) may suffice for the drafters' purposes, without needing reinforcement by pleading specificity requirements that go well beyond those already in force.

Section 205, "safe harbor" provisions:

Subsections (a)(2), (b)(2), and perhaps (b)(4) are drafted in terms that appear to mandate or contemplate SEC action that would create rules of procedure applicable in Article III courts, which might be held unconstitutional on separation of powers grounds. Redrafting could avoid this implication and the possibility that the entire section, which lacks a severability provision, would be held invalid. Subsection (c) would add a new § 38 to the SEA to implement the safe harbor provisions, privileging stay requests premised on safe harbor summary judgment motions and limiting the grounds on which stay denials or discovery extensions could be granted. It would thus affect trial judges' usual discretion to structure discovery. The need for such strictures is not clear.

Section 206, alternative dispute resolution:

Proposed new SEA § 39 contains in its subsection (a)(3) provisions concerning discovery timing that are difficult to understand. The authority there to extend discovery "not more than 90 additional days" during consideration of an ADR offer might be read to ban discovery *after* the 90 days, which is probably an unintended implication. The sanction authority under subsection (a)(5) may be superfluous given existing judicial power to control discovery generally, and could lend itself to negative inferences about other sanction powers in a proceeding governed by § 39. More broadly, although courts have increased their use of ADR mechanisms in many contexts, it is not clear that securities class actions are among those well suited for ADR. These are generally not cases that fail to settle for lack of an impartial estimate of the likely result of trial, or in which someone aggrieved mainly needs to have his or her story heard by a neutral and may be satisfied with an arbitrator's recommendation rather than a jury verdict. The ADR provision could also have limited impact because some federal judicial districts lack a "voluntary, nonbinding alternative dispute resolution procedure established or recognized under the rules of the court."

of the first month beginning more than 180 days after the date of the enactment of this Act.

(b) APPLICATION OF AMENDMENTS.—(1) The amendments made by sections 101 and 105 shall apply only with respect to civil actions commenced after the effective date of this title.

(2) The amendments made by section 102 shall apply only with respect to cases in which a trial has commenced after the effective date of this title.

(3) The amendments made by section 103 shall apply only with respect to claims arising after the effective date of this title.

(4) The amendment made by section 106 shall apply to bills and joint resolutions reported by any committee at least 30 calendar days after the date of enactment of this Act.

TITLE II—REFORM OF PRIVATE SECURITIES LITIGATION

SEC.201. SHORT TITLE; TABLE OF CONTENTS.

(a) SHORT TITLE.—This title may be cited as the "Private Securities Litigation Reform Act of 1995".

(b) TABLE OF CONTENTS.—The table of contents for this title is as follows:

SEC. 202. PREVENTION OF LAWYER-DRIVEN LITIGATION.

(a) PLAINTIFF STEERING COMMITTEES.—The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by adding at the end the following new section:

"SEC. 36. GUARDIAN AD LITEM AND CLASS ACTION STEERING COMMITTEES.

"(a) GUARDIAN AD LITEM.—Except as provided in subsection (b), not later than 10 days after certifying a plaintiff class in any private action brought under this title, the court shall appoint a guardian ad litem for the plaintiff class from a list or lists provided by the parties or their counsel. The guardian ad litem shall direct counsel for the class as set forth in this section and perform such other functions as the court may specify. The court shall apportion the reasonable fees and expenses of the guardian ad litem among the parties. Court appointment of a guardian ad litem shall not be subject to interlocutory review.

"(b) CLASS ACTION STEERING COMMITTEE.—Subsection (a) shall not apply if, not later than 10 days after certifying a plaintiff class, on its own

motion or on motion of a member of the class, the court appoints a committee of class members to direct counsel for the class (hereafter in this section referred to as the 'plaintiff steering committee') and to perform such other functions as the court may specify. Court appointment of a plaintiff steering committee shall not be subject to interlocutory review.

"(c) MEMBERSHIP OF PLAINTIFF STEERING COMMITTEE.—

"(1) QUALIFICATIONS.—

"(A) NUMBER.—A plaintiff steering committee shall consist of not fewer than 5 class members, willing to serve, who the court believes will fairly represent the class.

"(B) OWNERSHIP INTERESTS.—Members of the plaintiff steering committee shall have cumulatively held during the class period not less than—

"(i) the lesser of 5 percent of the securities which are the subject matter of the litigation or securities which are the subject matter of the litigation with a market value of $10,000,000; or

"(ii) such smaller percentage or dollar amount as the court finds appropriate under the circumstances.

"(2) NAMED PLAINTIFFS.—Class members who are named plaintiffs in the litigation may serve on the plaintiff steering committee, but shall not comprise a majority of the committee.

"(3) NONCOMPENSATION OF MEMBERS.—Members of the plaintiff steering committee shall serve without compensation, except that any member may apply to the court for reimbursement of reasonable out-of-pocket expenses from any common fund established for the class.

"(4) MEETINGS.—The plaintiff steering committee shall conduct its business at one or more previously scheduled meetings of the committee at which a majority of its members are present in person or by electronic communication. The plaintiff steering committee shall decide all matters within its authority by a majority vote of all members, except that the committee may determine that decisions other than to accept or reject a settlement offer or to employ or dismiss counsel for the class may be delegated to one or more members of the committee, or may be voted upon by committee members seriatim, without a meeting.

"(5) RIGHT OF NONMEMBERS TO BE HEARD.—A class member who is not a member of the plaintiff steering committee may appear and be heard by the court on any issue in the action, to the same extent as any other party.

"(d) FUNCTIONS OF GUARDIAN AD LITEM AND PLAINTIFF STEERING COMMITTEE.—

"(1) DIRECT COUNSEL.—The authority of the guardian ad litem or the plaintiff steering committee to direct counsel for the class shall include all powers normally permitted to an attorney's client in litigation, including the authority to retain or dismiss counsel and to reject offers of settlement, and the preliminary authority to accept an offer of settlement, subject to the restrictions specified in paragraph (2). Dismissal of counsel other than for cause shall not limit the ability of counsel to enforce any contractual fee agreement or to apply to the court for a fee award from any common fund established for the class.

"(2) SETTLEMENT OFFERS.—If a guardian ad litem or a plaintiff steering committee gives preliminary approval to an offer of settlement, the guardian ad litem or the plaintiff steering committee may seek approval of the offer by a majority of class members if the committee determines that the benefit of seeking such approval outweighs the cost of soliciting the approval of class members.

"(e) IMMUNITY FROM LIABILITY; REMOVAL.—Any person serving as a guardian ad litem or as a member of a plaintiff steering committee shall be immune from any liability arising from such service. The court may remove a guardian ad litem or a member of a plaintiff steering committee for good cause shown.

"(f) EFFECT ON OTHER LAW.—This section does not affect any other provision of law concerning class actions or the authority of the court to give final approval to any offer of settlement.".

(b) ADDITIONAL PROVISIONS APPLICABLE TO CLASS ACTIONS.—Section 21 of the Securities Exchange Act of 1934 (15 U.S.C. 78u) is amended by adding at the end the following new subsection:

"(i) DISCLOSURE OF SETTLEMENT TERMS TO CLASS MEMBERS.—In any private action under this title that is certified as a class action pursuant to the Federal Rules of Civil Procedure, a proposed settlement agreement that is published or otherwise disseminated to the class shall include the following statements:

"(1) STATEMENT OF POTENTIAL OUTCOME OF CASE.—

"(A) AGREEMENT ON AMOUNT OF DAMAGES AND LIKELIHOOD OF PREVAILING.—If the settling parties agree on the amount of damages per share that would be recoverable if the plaintiff prevailed on each claim alleged under this title and the likelihood that the plaintiff would prevail—

"(i) a statement concerning the amount of such potential damages; and

"(ii) a statement concerning the probability that the plaintiff would prevail on the claims alleged under this title and a brief explanation of the reasons for that conclusion.

"(B) DISAGREEMENT ON AMOUNT OF DAMAGES OR LIKELIHOOD OF PREVAILING.—If the parties do not agree on the amount of damages per share that would be recoverable if the plaintiff prevailed on each claim alleged under this title or on the likelihood that the plaintiff would prevail on those claims, or both, a statement from each settling party concerning the issue or issues on which the parties disagree.

"(C) INADMISSIBILITY FOR CERTAIN PURPOSES.—Statements made in accordance with subparagraphs (A) and (B) shall not be admissible for purposes of any Federal or State judicial or administrative proceeding.

"(2) STATEMENT OF ATTORNEYS' FEES OR COSTS SOUGHT.—If any of the settling parties or their counsel intend to apply to the court for an award of attorneys' fees or costs from any fund established as part of the settlement, a statement indicating which parties or counsel intend to make such an application, the amount of fees and costs that will be sought (including the amount of such fees and costs determined on a per-share basis, together with the amount of the settlement proposed to be distributed to the parties to suit, determined on a per-share basis), and a brief explanation of the basis for the application. Such information shall be clearly summarized on the cover page of any notice to a party of a proposed or final settlement.

"(3) IDENTIFICATION OF REPRESENTATIVES.—The name and address of one or more representatives of counsel for the plaintiff class who will be reasonably available to answer written questions from class members concerning any matter contained in any notice of settlement published or otherwise disseminated to class members.

"(4) OTHER INFORMATION.—Such other information as may be required by the court, or by any guardian ad litem or plaintiff steering committee appointed by the court pursuant to this section.".

(c) PROHIBITION ON ATTORNEYS' FEES PAID FROM COMMISSION DISGORGEMENT FUNDS.—Section 21(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78u(d)) is amended by adding at the end the following new paragraph:

"(4) PROHIBITION ON ATTORNEYS' FEES PAID FROM COMMISSION DISGORGEMENT FUNDS.—Except as otherwise ordered by the court, funds disgorged as the result of an action brought by the Commission in Federal court, or of any Commission administrative action, shall not

be distributed as payment for attorneys' fees or expenses incurred by private parties seeking distribution of the disgorged funds.".

SEC. 203. PREVENTION OF ABUSIVE PRACTICES THAT FOMENT LITIGATION.

(a) ADDITIONAL PROVISIONS APPLICABLE TO CLASS ACTIONS.—Section 21 of the Securities Exchange Act of 1934 (15 U.S.C. 78u) is further amended by adding at the end the following new subsections:

"(j) RECOVERY BY NAMED PLAINTIFFS IN CLASS ACTIONS.—In any private action under this title that is certified as a class action pursuant to the Federal Rules of Civil Procedure, the share of any final judgment or of any settlement that is awarded to class plaintiffs serving as the representative parties shall be calculated in the same manner as the shares of the final judgment or settlement awarded to all other members of the class. Nothing in this subsection shall be construed to limit the award to any representative parties of actual expenses (including lost wages) relating to the representation of the class.

"(k) NAMED PLAINTIFF THRESHOLD.—In any private action under this title, in order for a plaintiff or plaintiffs to obtain certification as representatives of a class of investors pursuant to the Federal Rules of Civil Procedure, the plaintiff or plaintiffs must show that they owned, in the aggregate, during the time period in which violations of this title are alleged to have occurred, not less than the lesser of—

"(1) 1 percent of the securities which are the subject of the litigation; or

"(2) $10,000 (in market value) of such securities.

A person may be a named plaintiff in no more than 5 class actions filed during any 3-year period.

"(l) AWARDS OF ATTORNEYS' FEES.—

"(1) PAYMENT BY LOSING PARTY.—If the court in any private action under this title enters a final judgment against a party litigant on the basis of a motion to dismiss, motion for summary judgment, or a trial on the merits, the court shall, upon motion by the prevailing party, order the losing party to pay the prevailing party reasonable attorneys' fees and other expenses incurred by the prevailing party.

"(2) TIME FOR APPLICATION.—A party seeking an award of fees and other expenses shall, within 30 days of a final, nonappealable judgment in the action, submit to the court an application for fees and other expenses.

"(3) COURT DISCRETION.—The court, in its discretion, may reduce the amount to be awarded pursuant to this section, or deny an award, to the extent that the prevailing party during the course of the

proceedings engaged in conduct that unduly and unreasonably protracted the final resolution of the matter in controversy.

"(m) CONFLICTS OF INTEREST.—In any private action under this title that is certified as a class action pursuant to the Federal Rules of Civil Procedure, if a party is represented by an attorney who directly owns or otherwise has a beneficial interest in the securities that are the subject of the litigation, the court shall make a determination of whether such interest constitutes a conflict of interest sufficient to disqualify the attorney from representing the party.

"(n) SETTLEMENT DISCHARGE.—

"(1) IN GENERAL.—A defendant who settles any private action brought under this title at any time before verdict or judgment shall be discharged from all claims for contribution brought by other persons. Upon entry of the settlement by the court, the court shall enter a bar order constituting the final discharge of all obligations to the plaintiff of the settling defendant arising out of the action. The order shall bar all future claims for contribution or indemnity arising out of the action—

"(A) by nonsettling persons against the settling defendant; and

"(B) by the settling defendant against any nonsettling defendants.

"(2) REDUCTION.—If a person enters into a settlement with the plaintiff prior to verdict or judgment, the verdict or judgment shall be reduced by the amount paid to the plaintiff by that person.

"(o) CONTRIBUTION.—A person who becomes liable for damages in any private action under this title may recover contribution from any other person who, if joined in the original suit, would have been liable for the same damages.

"(p) STATUTE OF LIMITATIONS FOR CONTRIBUTION.—Once judgment has been entered in any private action under this title determining liability, an action for contribution must be brought not later than 6 months after the entry of a final, nonappealable judgment in the action.

"(q) SPECIAL VERDICTS.—In any private action under this title in which the plaintiff may recover money damages, the court shall, when requested by a defendant, submit to the jury a written interrogatory on the issue of each such defendant's state of mind at the time the alleged violation occurred.".

(b) RECEIPT FOR REFERRAL FEES.—Section 15(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(c)) is amended by adding at the end the following new paragraph:

"(7) RECEIPT OF REFERRAL FEES.—No broker or dealer, or person associated with a broker or dealer, may solicit or accept remuneration for assisting an attorney in obtaining the representation of any customer in any private action under this title.".

SEC. 204. PREVENTION OF "FISHING EXPEDITION" LAWSUITS.

The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by inserting after section 10 the following new section:

"SEC. 10A. REQUIREMENTS FOR SECURITIES FRAUD ACTIONS.

"(a) INTENT.—In any private action under section 10(b)—

"(1) the plaintiff may recover money damages from a defendant only on proof that the defendant made a material misstatement or omission concerning a security;

"(2) the plaintiff must prove that the defendant had actual knowledge that the statement was false at the time it was made or knowingly and intentionally omitted to state a fact with actual knowledge that such statement would at the time it was made be rendered false by such omission and with the purpose of rendering the statement false; and

"(3) the plaintiff's complaint shall allege specific facts demonstrating the state of mind of each defendant at the time the alleged violation occurred.

"(b) MISLEADING STATEMENTS AND OMISSIONS.—In any private action under section 10(b) in which the plaintiff alleges that the defendant—

"(1) made an untrue statement of a material fact; or

"(2) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading;

the plaintiff shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the plaintiff shall set forth all information on which that belief is formed.

"(c) BURDEN OF PROOF.—In any private action arising under section 10(b) based upon a material misstatement or omission concerning a security, the plaintiff must prove that he or she had actual knowledge of and actually relied on such statement in connection with the purchase or sale of a security and that the misstatement or omission proximately caused (through both transaction causation and loss causation) any loss incurred by the plaintiff.

"(d) DAMAGES.—In any private action arising under section 10(b) based on a material misstatement or omission concerning a security, the plaintiff's damages shall not exceed the lesser of—

"(1) the difference between the price paid by the plaintiff for the security and the market value of the security immediately after dissemination to the market of information which corrects the misstatement or omission; and

"(2) the difference between the price paid by the plaintiff for the security and the price at which the plaintiff sold the security after dissemination of information correcting the misstatement or omission.".

SEC. 205. ESTABLISHMENT OF "SAFE HARBOR" FOR PREDICTIVE STATEMENTS.

(a) CONSIDERATION OF REGULATORY OR LEGISLATIVE CHANGES.—In consultation with investors and issuers of securities, the Securities and Exchange Commission shall adopt or amend its rules and regulations to create—

(1) clear and objective criteria that the Commission finds sufficient for the protection of investors, compliance with which shall be readily ascertainable by issuers prior to issuance of securities, by which forward-looking statements concerning the future economic performance of an issuer of securities registered under section 12 of the Securities Exchange Act of 1934 will be deemed not to be in violation of section 10(b) of that Act; and

(2) procedures by which courts shall timely dismiss claims against such issuers of securities based on such forward-looking statements if such statements are in accordance with any criteria under paragraph (1).

(b) COMMISSION CONSIDERATIONS.—In developing rules in accordance with subsection (a), the Commission shall adopt—

(1) appropriate limits to liability for forward-looking statements;

(2) procedures for making a summary determination of the applicability of any Commission rule for forward-looking statements early in a judicial proceeding to limit protracted litigation and expansive discovery;

(3) rules incorporating and reflecting the scienter requirements applicable to any private actions under section 10(b) of the Securities Exchange Act of 1934; and

(4) rules providing clear guidance to issuers of securities and the judiciary.

(c) SECURITIES ACT AMENDMENT.—The Securities and Exchange Act of 1934 (15 U.S.C. 78a et seq.), is amended by adding at the end the following new section:

"SEC. 38. APPLICATION OF SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS.

"(a) IN GENERAL.—In any private action under this title that alleges that a forward-looking statement concerning the future economic performance of an issuer registered under section 12 was materially false or misleading, if a party making a motion in accordance with subsection (b) requests a stay of discovery concerning the claims or defenses of that party, the court shall grant such a stay until it has ruled on any such motion.

"(b) SUMMARY JUDGMENT MOTIONS.—Subsection (a) shall apply to any motion for summary judgment made by a defendant asserting that the forward-looking statement was within the coverage of any rule which the Commission may have adopted concerning such predictive statements, if such motion is made not less than 60 days after the plaintiff commences discovery in the action.

"(c) DILATORY CONDUCT; DUPLICATIVE DISCOVERY.—Notwithstanding subsection (a) or (b), the time permitted for a plaintiff to conduct discovery under subsection (b) may be extended, or a stay of the proceedings may be denied, if the court finds that—

"(1) the defendant making a motion described in subsection (b) engaged in dilatory or obstructive conduct in taking or opposing any discovery; or

"(2) a stay of discovery pending a ruling on a motion under subsection (b) would be substantially unfair to the plaintiff or other parties to the action.".

SEC. 206. ALTERNATIVE DISPUTE RESOLUTION PROCEDURE.

The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by adding at the end the following new section:

"SEC. 39. ALTERNATIVE DISPUTE RESOLUTION PROCEDURE.

"(a) IN GENERAL.—

"(1) OFFER TO PROCEED.—Except as provided in paragraph (2), in any private action arising under this title, any party may, before the expiration of the period permitted for answering the complaint, deliver to all other parties an offer to proceed pursuant to any voluntary, nonbinding alternative dispute resolution procedure established or recognized under the rules of the court in which the action is maintained.

"(2) PLAINTIFF CLASS ACTIONS.—In any private action under this title which is brought as a plaintiff class action, an offer under paragraph (1) shall be made not later than 30 days after a guardian ad litem or plaintiff steering committee is appointed by the court in accordance with section 38.

"(3) RESPONSE.—The recipient of an offer under paragraph (1) or (2) shall file a written notice of acceptance or rejection of the offer with the court not later than 10 days after receipt of the offer. The court may, upon motion by any party made prior to the expiration of such period, extend the period for not more than 90 additional days, during which time discovery may be permitted by the court.

"(4) SELECTION OF TYPE OF ALTERNATIVE DISPUTE RESOLUTION.—For purposes of paragraphs (1) and (2), if the rules of the court establish or recognize more than 1 type of alternative dispute resolution, the parties may stipulate as to the type of alternative dispute resolution to be applied. If the parties are unable to so stipulate, the court shall issue an order not later than 20 days after the date on which the parties agree to the use of alternative dispute resolution, specifying the type of alternative dispute resolution to be applied.

"(5) SANCTIONS FOR DILATORY OR OBSTRUCTIVE CONDUCT.—If the court finds that a party has engaged in dilatory or obstructive conduct in taking or opposing any discovery allowed during the response period described in paragraph (3), the court may—

"(A) extend the period to permit further discovery from that party for a suitable period; and

"(B) deny that party the opportunity to conduct further discovery prior to the expiration of the period.".

SEC. 207. AMENDMENT TO RACKETEER INFLUENCED AND CORRUPT ORGANIZATIONS ACT.

Section 1964(c) of title 18, United States Code, is amended by inserting ", except that no person may bring an action under this provision if the racketeering activity, as defined in section 1961(1)(D), involves conduct actionable as fraud in the sale of securities" before the period.

SEC. 208. RULE OF CONSTRUCTION.

Nothing in this title or in the amendments made by this title shall be deemed to create or ratify any implied right of action, or to prevent the Commission from restricting or otherwise regulating private actions brought under the Securities Exchange Act of 1934.

SEC. 209. EFFECTIVE DATE.

This title and the amendments made by this title are effective on the date of enactment of this Act and shall apply to cases pending on or commenced after such date of enactment.

TESTIMONY OF

ARTHUR LEVITT, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING LITIGATION REFORM PROPOSALS

BEFORE THE

SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE
COMMITTEE ON COMMERCE

U.S. HOUSE OF REPRESENTATIVES

FEBRUARY 10, 1995

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

TESTIMONY OF
ARTHUR LEVITT, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING LITIGATION REFORM PROPOSALS

BEFORE THE SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE
COMMITTEE ON COMMERCE
UNITED STATES HOUSE OF REPRESENTATIVES

FEBRUARY 10, 1995

Chairman Fields and Members of the Subcommittee:

I appreciate this opportunity to testify on behalf of the Securities and Exchange Commission regarding legislative proposals to reform the system of private litigation under the federal securities laws.[1]

As you know, the Commission has consistently stressed the importance of private remedies against securities fraud. Besides serving as the primary vehicle for compensating defrauded investors, private actions also provide a "necessary supplement" to the Commission's own enforcement activities by serving to deter securities law violations.[2] Private actions are crucial to the integrity of our disclosure system because they provide a direct incentive for issuers and other market participants to meet their obligations under the securities laws.

These hearings are being held in order to consider proposals to make the private litigation system work more effectively. The Commission supports this effort,

---

1. I recently discussed securities litigation reform issues in a speech before the Securities Regulation Institute in San Diego, California. A copy of that speech is attached to this testimony as an appendix.

2. Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310 (1985); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975); J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).

because private litigation imposes substantial unnecessary costs when it is abused by private plaintiffs or their attorneys. The threat of misdirected litigation also tends to impede beneficial corporate disclosure practices, such as the dissemination of forward-looking information, that the Commission encourages. Finally, meritless lawsuits may adversely affect the development of substantive securities law, as courts develop broad doctrines in an attempt to curb what they perceive to be vexatious litigation.

The important task at hand, therefore, is to identify ways to make the system more efficient while preserving the essential role that private actions play in supporting the integrity of our markets. This involves striking a fair balance between competing interests. Although we might strive for a system in which corporate issuers never spend a dime defending meritless claims, we should recognize that it is impossible to eliminate all meritless cases without also affecting the cases that do have merit and thereby eroding the deterrence provided by private actions. In the same vein, we cannot allow investors to seek compensation for their losses in a way that unnecessarily exposes defendants to unproductive litigation and excessive costs.

As I stated in testimony before this Subcommittee last July, the Commission believes that meaningful improvements to the existing system can be accomplished through a combination of legislation, increased judicial activism in the case management process, and the Commission's exercise of its existing rulemaking and interpretative authority. The Commission is already in the process of examining its existing safe harbor for the disclosure of forward-looking information, and we are expanding a program under which Commission attorneys monitor private litigation and select appropriate cases in which to make our views known to the court.

With respect to legislation, the Commission supports measures that would eliminate the most prevalent abuses associated with class action lawsuits, provide for greater sanctions or a modified form of fee shifting in appropriate cases, eliminate civil RICO liability predicated on securities law violations, and enact a proportionate scheme of contribution among defendants. Although there are other proposals that the Commission could accept with modifications or that it is still in the process of considering, the enactment of the above proposals alone would significantly improve the system without eradicating any of its benefits.

The Commission recognizes that many proponents of litigation reform, including some members of this Subcommittee, regard these measures as an inadequate response to the problems they perceive to be associated with private litigation. The Commission opposes a move to the more drastic measures that have been proposed, however, such as imposing automatic fee shifting under a strict "English Rule," eliminating antifraud liability based on reckless conduct, and eliminating the fraud-on-the-market theory of liability. Proposals such as these, by severely limiting the private remedy against fraud and undermining the incentives for market participants to comply with the disclosure laws, could fundamentally damage the integrity and discipline of our capital markets, which are now the strongest and safest in the world.

Just as it is clear that problems exist within our private litigation system, and that constructive action is necessary, it should be equally clear that an overreaction could cause substantial harm to our markets. The Commission therefore urges the Subcommittee to examine the issues carefully and to craft appropriate legislation that improves the system without eliminating its benefits. Before embracing a proposal

designed to guarantee that no meritless case will go unpunished, examine how that proposal would affect investor rights in cases of serious fraud. Before concluding that liability should attach only upon proof of actual, subjective knowledge of fraud, examine how such a rule would affect the discipline that corporate executives and professional advisers bring to the disclosure process. Before deciding that investors should have a remedy only if they can establish that they specifically relied on a particular misstatement or omission, examine the ramifications that such a rule would have for the Commission's administration of the disclosure laws.

The remainder of this testimony, which discusses various proposals set forth in H.R. 10, the Common Sense Legal Reform Act, as well as other bills currently pending in both the House and the Senate,[3] is intended to assist in that effort.

I. PROPOSALS TO REDUCE MERITLESS LITIGATION

One of the most critical aspects of a fair and efficient litigation system is its ability to identify meritless cases early in the process, before the costs associated with protracted litigation are incurred. Critics of the current system contend that it does not effectively screen out the cases that lack merit. These cases are often referred to as "frivolous" in the rhetoric of the litigation reform debate, but the concern extends to cases that may more accurately be characterized as speculative.[4] The extent to

---

3. These bills are H.R. 555, introduced by Congressman Markey; H.R. 681, introduced by Congressman Tauzin; H.R. 675, introduced by Congressman Mineta and Congresswoman Eshoo; and S. 240, introduced by Senators Dodd and Domenici.

4. In hearings held before this Subcommittee last summer, for example, Professor Langevoort testified that:

> The primary problem we face is not so much *frivolous* litigation. Ample mechanisms exist currently to deal with suits that have no merit whatsoever. Rather, the problem is an excess of *speculative* litigation, where there are small bits and pieces of evidence that, in hindsight,

which frivolous or speculative cases are filed is difficult to quantify, but it appears that the federal courts have recently been dismissing securities cases more frequently than in the past.

Meritless litigation may be addressed in a variety of ways. One method is to deter the filing of meritless cases by providing for fee shifting or the imposition of sanctions against plaintiffs or their attorneys. Another method is to establish stringent pleading standards that only the strongest cases can satisfy. Each of these methods has drawbacks. Automatic fee shifting will deter the filing of good cases as well as meritless ones. Overly stringent pleading standards also will preclude meritorious cases from being filed, as plaintiffs often will be unable to plead specific facts regarding a defendant's state of mind without first obtaining access to corporate documents through discovery.

It is especially important, before enacting legislation, to consider the effect that fee shifting and stringent pleading requirements would have when used in combination. To the extent that any form of fee shifting is imposed, stringent pleading standards may not be necessary to deter marginal cases. If stringent pleading standards are established, fee shifting will produce inequitable results in a greater proportion of cases.

---

might suggest some possibility that defendants were not completely candid in each one of the many items of information that became available to the investing public. Yet they rarely add up to a serious claim of fraud.

Summary of Testimony of Donald C. Langevoort, Vanderbilt University School of Law, Before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives (August 10, 1994).

A. FEE SHIFTING

Section 203 of H.R. 10 would provide that courts must order the losing party to pay the prevailing party's reasonable attorneys' fees and expenses in any private action brought under the Securities Exchange Act of 1934. This award would be mandatory, and a court would have discretion to reduce the award only to the extent that the prevailing party engaged in conduct that unduly and unreasonably protracted the litigation.

In the Commission's view, a strict "English Rule" provision of the type contemplated by H.R. 10 would effectively eliminate the private right of action for small investors. Although major corporations might continue to file suits under Exchange Act Section 10(b) and Rule 10b-5, individual investors would inevitably be deterred from filing meritorious cases because they could not take the risk of being exposed to a fee award if they failed to prevail. In class action lawsuits, in particular, individual plaintiffs frequently stand to recover only a small amount if they prevail. Their potential liability under an automatic fee shifting provision would be totally disproportionate to their potential recovery.

An automatic fee shifting provision of this type also fails to distinguish between cases that deserve to be litigated and cases that are frivolous or speculative. There is a vast difference between cases that are decided as a result of close factual determinations made by a jury after an extended trial and cases that are dismissed on the pleadings because they fail to state a claim. H.R. 10, however, would leave courts without any discretion to make distinctions between such cases.

The legislation introduced by Congressman Tauzin would provide that a court must award fees to the prevailing party unless a determination is made that the losing

party's position was "substantially justified." The terminology is borrowed from the Equal Access to Justice Act ("EAJA"),[5] which provides that certain persons who prevail in a suit brought by the federal government may recover attorneys' fees and costs if a court finds that the litigating position of the government was not "substantially justified." Fee shifting of this type would allow for some element of judicial discretion, and for that reason it would be preferable to the automatic fee shifting contemplated by H.R. 10. At the same time, it is important to note that the "substantially justified" standard under the EAJA applies only against the government, and that the statute was designed to enable individuals and small businesses to defend their rights in litigation with government agencies that have a superior ability to sustain the costs of litigation and usually conduct an investigation prior to filing suit.[6] It does not follow that the same standard should govern investor lawsuits brought against corporate defendants.

The Commission recommends that the Subcommittee adopt a somewhat different approach and provide courts with express authority to award fees and costs when cases are filed (or defenses raised) without any reasonable prospect of prevailing. Section 11(e) of the Securities Act, for example, already provides that a party may be required to pay the opposing party's costs and reasonable attorneys' fees "if the court believes the suit or the defenses to have been filed without merit." There is no comparable provision for cases brought under Sections 10(b) or 14 of the Exchange Act, and some have suggested that the absence of such a rule has

---

5. 5 U.S.C. § 504.

6. Since the EAJA was adopted in 1985, the Commission has been ordered to pay attorneys' fees and costs in three cases, and it entered into a settlement when fees were sought in one other case. The amount paid by the Commission in these cases ranged from $14,000 to $88,000.

encouraged plaintiffs to proceed under that Act rather than the Securities Act.[7] Congress should make it clear, in such a provision, that a court may impose a fee award not only against a party, but also against its counsel.[8]

The Commission recognizes that the effectiveness of discretionary fee shifting depends on the willingness of courts to exercise their discretion to award fees. Courts already have the authority under Rule 11 of the Federal Rules of Civil Procedure to order limited fee shifting in abusive and meritless cases, but this authority is used relatively infrequently.[9] Most federal judges believe that meritless litigation is controlled most effectively by prompt rulings on motions to dismiss or motions for summary judgment,[10] and there may be an understandable tendency to avoid fee awards that may themselves lead to ancillary litigation. Congress could ensure that judges do not ignore a fee shifting provision, however, by providing that, where cases are resolved by means of a dispositive motion, the court must make findings as to why fees should or should not be awarded to the prevailing party.

---

7. "The desire to escape the double danger of paying counsel fees and posting security was yet another reason for buyers with complaints to rush to Rule 10b-5 in the face of the express remedies under §§ 11 and 12(2) of the Securities Act." 10 Louis Loss & Joel Seligman, Securities Regulation at 4648 (1993) (footnote omitted).

8. See Healey v. Chelsea Resources, Ltd., 947 F.2d 611, 624-25 (2d Cir. 1991) (declining to award fees against an attorney under Section 11(e)).

9. Prior to 1993, a court was required to impose sanctions under Rule 11 in the case of filings made for an improper purpose, such as to cause unnecessary delay or needless increase in the cost of litigation. In 1993, the Supreme Court adopted significant substantive amendments to Rule 11. Under the revised Rule 11, sanctions are discretionary rather than mandatory, and in cases in which one party has moved for sanctions against another, there is a safe harbor of 21 days following notice of an alleged violation during which a party may withdraw the offending filing before a request for sanctions can be filed.

10. Elizabeth C. Wiggins, Thomas E. Willging & Donna Stienstra, Rule 11: Final Report to the Advisory Committee on Civil Rules of the Judicial Conference of the United States, Federal Judicial Center (1991).

Different forms of fee shifting are proposed in the bills introduced by Congressman Markey in the House, and by Senators Dodd and Domenici in the Senate. The Markey Bill provides for a voluntary evaluation procedure using an independent mediator, and a party that chooses to litigate a position which the mediator has determined to be either clearly frivolous or clearly meritorious would be subject to automatic fee shifting. The Dodd/Domenici bill suggests awarding fees to the prevailing party if the losing party has refused to accept an offer to use alternative dispute resolution mechanisms to resolve the case.[11] As noted above, however, we believe that a more straightforward approach is to give the courts express authority to shift fees where cases (or defenses) are without merit, provided that a court must make findings on the appropriateness of fee shifting in all cases that are resolved on a dispositive motion.

B. PLEADING REQUIREMENTS

The device most frequently used to screen out deficient securities fraud claims is Rule 9(b) of the Federal Rules of Civil Procedure, which requires that plaintiffs allege fraud with particularity.[12] As a general matter, federal courts today are granting dispositive motions dismissing securities law cases with greater frequency than in the past. Although it is difficult to quantify the extent to which there has

---

11. We note that the use of neutral evaluators or alternative dispute resolution mechanisms could be useful in certain types of cases. Consequently, we believe that proposals to encourage their use deserve further consideration.

12. See 10 Louis Loss & Joel Seligman, Securities Regulation, at 4526-27 (1993) (citing 5 Charles Wright & Arthur Miller, Federal Practice & Procedure, § 1297 at 613-14 (1990)("courts have shown a tendency to be more demanding in their application of Rule 9(b) . . . [to] securities fraud actions.").

been an increase in the percentage of cases dismissed on the pleadings, there is widespread agreement that a trend in this direction exists.[13]

Although Rule 9(b) requires that fraud be pleaded with particularity, it further provides that "[m]alice, intent, knowledge, and other condition of mind" may be pleaded "generally." Some courts nevertheless require that plaintiffs plead with some particularity facts suggesting that defendant had the requisite scienter. The Second Circuit Court of Appeals, for example, has long required that plaintiffs pleading securities fraud allege facts giving rise to a "strong inference" of fraudulent intent on the part of the defendants.[14] In recent years, the First, Fifth, and Seventh Circuits have all started to require a similar "inference" of scienter,[15] and this trend has resulted in the dismissal of numerous cases. Other courts of appeal, however, have rejected this approach on the ground that it goes beyond the language of Rule 9(b).[16]

---

13. See Jonathan Eisenberg, Beyond the Basics: 50 Defense Doctrines that Every Securities Litigator Needs to Know, in New Dimensions in Securities Litigation at 611 (ALI-ABA Course Materials 1994) ("many [securities] defendants are having significantly greater success than in the past in having cases dismissed at the motions stage"); Julie Triedman, Class Warfare, Corporate Counsel, July/Aug. 1994, at 51, 55 ("The trend is toward more dismissals and more summary judgments. We don't like it, but it's a fact") (quoting Leonard Simon of Milberg Weiss Bershad Hynes & Lerach).

14. Ross v. A.H. Robins Co., 607 F.2d 545, 558 (2d Cir. 1979), cert. denied, 446 U.S. 946 (1980).

15. See Greenstone v. Cambex Corp., 975 F.2d 22, 25 (1st Cir. 1992) ("The courts have uniformly held inadequate a complaint's general averment of the defendant's 'knowledge' of material falsity, unless the complaint also sets forth specific facts that make it reasonable to believe that defendant knew that a statement was materially false or misleading."); Tuchman v. DSC Communications Corp., 14 F.3d 1061, 1068 (5th Cir. 1994) ("To plead scienter adequately, a plaintiff must set forth specific facts that support an inference of fraud."); DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir.) ("Although Rule 9(b) does not require 'particularity' with respect to the defendants' mental state, the complaint still must afford a basis for believing that plaintiffs could prove scienter."), cert. denied, 498 U.S. 941 (1990).

16. See In re Glenfed, Inc., 1994 U.S. App. LEXIS 34334 at *16 (9th Cir. Dec. 9, 1994) (en banc) ("We conclude that plaintiffs may aver scienter generally, just as the rule states - that is, simply by saying that scienter existed."); Phelps v. Wichita Eagle-Beacon, 886 F.2d 1262, 1270 n.5 (10th Cir. 1989) (strict approach cannot be reconciled with plain language of rule); Auslender v. Energy Management Corp., 832 F.2d 354, 356 (6th Cir. 1987) ("[T]he allegation of 'recklessness'

H.R. 10 and three of the other pending bills contain provisions regarding particularity of pleading in private securities fraud actions. H.R. 10 would require plaintiffs to plead specific facts "demonstrating" the state of mind of each defendant -- a test which arguably is more severe than that employed in any of the circuits today. It is likely that there would be many cases in which plaintiffs with meritorious claims would be unable to make such a demonstration without an opportunity to conduct discovery.

The Commission believes that it would be beneficial to resolve the split between the circuits regarding the proper application of Rule 9(b).[17] Before doing so through legislation, however, the Commission recommends that Congress seek the views of the Advisory Committee on Civil Rules of the Judicial Conference of the United States.

C. TREATMENT OF FORWARD-LOOKING STATEMENTS

Some of the most difficult cases to screen are those involving the disclosure of forward-looking or "soft" information. Issuers frequently complain that they are sued under the antifraud provisions simply because the corporation made a projection that failed to materialize. Besides enforcing pleading requirements strictly, courts have applied substantive securities law principles for the purpose of promptly dismissing cases involving forward-looking statements that they suspect are meritless.[18]

---

on the part of [the defendant] is adequate to satisfy the scienter requirement of Rule 10b-5.").

17. Although the pleading requirements specified in H.R. 10 would only apply to actions under Section 10(b), any resolution of the proper pleading standard under Rule 9(b) should be equally applicable to other antifraud provisions of the federal securities laws.

18. See Luce v. Edelstein, 802 F.2d 49, 56 (2d Cir. 1986); Polin v. Conductron Corp., 552 F.2d 797, 806 n.28 (8th Cir.), cert. denied, 434 U.S. 857 (1977) ("We are not inclined to impose liability on the basis of statements that clearly 'bespeak caution.'"); In re Donald J. Trump Casino Sec. Litig., 793 F. Supp. 543, 549 (D.N.J. 1992), aff'd, 7 F.3d 357 (3d Cir. 1993). See, also,

The Commission recognizes the important role played by projections and other forward-looking statements, as well as the potential for abusive litigation based on a "fraud by hindsight" theory when such projections do not come true. To address this issue, the Commission recently published a "concept" release soliciting comments on current practices relating to disclosure of forward-looking information, with a view to developing a new safe harbor for projections that provides issuers with meaningful protection but continues to protect investors.[19] Our challenge will be to craft a rule which accomplishes this goal.

Changes to the Commission's safe harbor for forward-looking statements may have a significant impact on litigation practices. We are continuing this process with the review by the Commission's staff of the many comments received in response to the concept release and with the public hearings on the issue to be held next week in Washington and San Francisco.

D. COMMISSION SCRUTINY OF CASES

For many years, the Commission has participated in selected appellate court proceedings by filing briefs amicus curiae on significant issues arising under the federal securities laws. Because most of the perceived problems associated with private securities litigation arise at the trial court level, however, the Commission has determined that it would be beneficial to monitor district court litigation and select appropriate cases in which we might have the ability to assist in assessing particular claims or defenses, or in protecting the interests of investors. Three months ago, the

---

Raab v. General Physics Corp., 4 F.3d 286, 290 (4th Cir. 1993); Krim v. BancTexas Group, Inc., 989 F.2d 1435, 1446-47 (5th Cir. 1993)("projections of future performance not worded as guarantees are generally not actionable under the federal securities laws").

19. Securities Act Release No. 7101 (Oct. 13, 1994), 59 FR 52723.

Commission's General Counsel provided a letter to defense counsel in a class action setting forth the Commission's view that the case should be dismissed.[20] In an earlier case, the Prudential Securities litigation,[21] the General Counsel presented a letter to the court addressing a fee application submitted by class counsel.

Two weeks ago, I announced that the Commission's Office of the General Counsel would establish a Litigation Analysis Unit. Lawyers in the unit will evaluate the claims and the legal support for selected private cases, and provide the Commission's views where appropriate to investors, corporations, lawyers, and judges. Private litigants who believe they are encountering abuses on either side are encouraged to bring them to the General Counsel's attention.

The Commission is also considering whether to ask Congress to enact a provision that would allow the Commission to appear and be heard on any issue in a private action brought under the securities laws. This would be modelled on the provision that already exists in the Bankruptcy Code,[22] and would ensure that the Commission could express its views in the public interest.

---

20. Letter from Simon M. Lorne, General Counsel, Securities and Exchange Commission, to Cooper Industries, Inc., dated November 8, 1994, re Frank v. Cooper Industries, Inc., Civil Action No. H-94-0280 (S.D. Tex.). The Commission has learned that the district court judge denied the defendant's motion to dismiss on February 6, 1995.

21. Letter from Simon M. Lorne, General Counsel, Securities and Exchange Commission, to The Honorable Marcel Livaudais, Jr., Untied States District Judge, Eastern District of Louisiana, dated February 24, 1994, re Prudential-Bache Energy Income Partnership Securities Litigation, MDL Docket No. 888.

22. 11 U.S.C. 1109(a).

II. PROPOSALS TO CHANGE LIABILITY STANDARDS

The Commission has previously urged Congress to weigh the consequences that each litigation reform proposal might have on the existing financial reporting and disclosure system. It has also recommended that, before resorting to any changes in the standards for liability, Congress first determine the effectiveness of measures directly targeted at meritless litigation.[23]

H.R. 10 would create fundamental changes in the existing standards of liability. First, it would eliminate private liability based on recklessness, a standard that has received the unanimous support of the federal circuit courts. Second, it would effectively eliminate the fraud on the market theory of liability, which has been upheld by the Supreme Court and is consistent with the philosophy underlying the Commission's disclosure program. Finally, it can be read to eliminate liability for certain types of violations, such as market manipulations, which do not necessarily involve a misstatement or omission. The Commission opposes each of these proposals.

With respect to other liability issues, the Commission supports removing securities fraud as a predicate offense for purposes of the RICO statute. In addition, as the Commission has testified before this Subcommittee, Congress should restore private aiding and abetting liability.

---

23. See Testimony of William R. McLucas, Director, Division of Enforcement, Securities and Exchange Commission, Concerning Private Litigation Under the Federal Securities Laws, Before the Securities Subcommittee, Committee on Banking, Housing, and Urban Affairs, U.S. Senate (June 17, 1993).

A. SCIENTER

Prior to the Supreme Court's decision in Ernst & Ernst v. Hochfelder,[24] courts were divided on whether liability under Rule 10b-5 could be predicated on mere negligence or whether some degree of scienter was required. In Hochfelder, the Court concluded that "Section 10(b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone."[25] Because the plaintiffs had proceeded on a theory of liability premised on negligence, the question of whether recklessness could satisfy the scienter requirement of Section 10(b) and Rule 10b-5 was not before the Court in Hochfelder. The Court explicitly recognized, however, that "in certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act."[26]

The common law has long recognized recklessness as a form of scienter for purposes of proving fraud.[27] Under the common law, one who acts with reckless disregard for the potentially harmful consequences of his actions has long been regarded as equally culpable with one who acts with actual knowledge of the potential

---

24. 425 U.S. 185 (1976).

25. Id. at 201.

26. Id. at 193-94 n.12.

27. See Restatement (Second) of Torts, § 526(b), comment e (1977); Prosser and Keeton, Law of Torts, § 107 at 741-42.

consequences.[28] In part, this rule serves to discourage deliberate ignorance of facts indicating fraud.

In the 20 years since Hochfelder, all of the courts of appeal that have considered the question have held that recklessness is sufficient to establish primary liability under Rule 10b-5.[29] H.R. 10, however, would reverse this body of law by eliminating liability for reckless conduct and requiring proof that the defendant acted

---

28. This concept is not new. In the seminal common law case in this area, Derry v. Peek, 14 App. Cas. 337 (H.L. 1889), the House of Lords stated that:

> fraud is proved when it is shewn that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false. Although I have treated the second and third as distinct cases, I think the third is but an instance of the second, for one who makes a statement under such circumstances can have no real belief in the truth of what he states. * * * [I]f I thought that a person making a false statement had shut his eyes to the facts, or purposely abstained from inquiring into them, I should hold that honest belief was absent, and that he was just as fraudulent as if he had knowingly stated that which was false.

In another leading case, State Street Trust Co. v. Ernst, 278 N.Y. 104, 112, 15 N.E.2d 416, 418-19 (1938), the court stated:

> Accountants, however, may be liable to third parties, even where there is lacking deliberate or active fraud. A representation certified as true to the knowledge of the accountants when knowledge there is none, a reckless misstatement, or an opinion based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth, are all sufficient upon which to base liability. A refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely on the balance sheet. In other words, heedlessness and reckless disregard of consequence may take the place of deliberate intention.

29. See, e.g., Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 46-47 (2d Cir.), cert. denied, 439 U.S. 1039 (1978); McLean v. Alexander, 599 F.2d 1190, 1197 (3d Cir. 1979); Broad v. Rockwell Int'l Corp., 642 F.2d 929, 961-962 (5th Cir.) (en banc), cert. denied, 454 U.S. 965 (1981); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1024 (6th Cir. 1979); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1044 (7th Cir.), cert. denied, 434 U.S. 875 (1977); Van Dyke v. Coburn Enterprises, Inc., 873 F.2d 1094, 1100 (8th Cir. 1989); Nelson v. Serwold, 576 F.2d 1332, 1337 (9th Cir.), cert. denied, 439 U.S. 970 (1978); Hackbart v. Holmes, 675 F.2d 1114, 1117 (10th Cir. 1982); SEC v. Carriba Air, Inc., 681 F.2d 1318, 1324 (11th Cir. 1982).

knowingly and intentionally.[30] Such a retreat from the recklessness standard would greatly erode the deterrent effect of private actions.

The Commission has consistently supported a recklessness standard because such a standard is needed to protect the integrity of the disclosure process. The law should sanction corporations and individuals who act recklessly when making disclosures, because that is the only way to assure the markets of a continuous stream of accurate information. Any higher scienter standard would lessen the incentives for corporations and other issuers to conduct a full inquiry into areas of potential exposure, and thus threaten the process that has made our markets a model for nations around the world.

Moreover, because an actual knowledge standard would virtually foreclose recovery against attorneys, accountants, and financial advisers, it would reduce the degree to which such professional advisers encourage full and complete disclosure. There are relatively few cases in which it is established that professional advisers acted with actual, subjective knowledge that the representations made by an issuer were false. Rather, the liability of such advisers typically is predicated on a finding that they participated in the dissemination of false statements while recklessly ignoring indications of fraud. While the Commission understands that there are serious concerns that professional advisers are too often unfairly subjected to litigation, those concerns can be addressed without eliminating altogether the incentive to exercise diligence in the preparation of disclosure documents.

---

30. Although it would not eliminate the recklessness standard, the Tauzin bill would require the plaintiff to establish scienter by clear and convincing evidence rather than by a preponderance of the evidence. This strict standard would greatly curtail private actions by making proof of knowing or intentional conduct, as well as reckless conduct, difficult.

It is important to recognize that the threshold for a finding of recklessness is quite high. Although the definition of recklessness varies somewhat in different courts, most of the federal courts of appeal follow the standard enunciated by the Seventh Circuit in Sundstrand Corporation v. Sun Chemical Corporation,[31] or some variant thereof.[32] In Sundstrand, the court defined a reckless omission as:

> a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.[33]

In short, the recklessness standard requires a high level of culpability -- a form of intent and a standard clearly distinguishable from negligence.[34]

Finally, practical necessities also require a recklessness standard. Proving a defendant's actual knowledge of fraud in a securities case can be a daunting task, particularly when (as is frequently the case) the evidence is entirely circumstantial. As the Second Circuit stated, in deciding that recklessness was the appropriate standard: "To require in all types of 10b-5 cases that a factfinder must find a specific intent to deceive or defraud would for all intents and purposes disembowel the private cause of

---

31. 553 F.2d 1033 (7th Cir.), cert. denied sub nom., Meers v. Sunstrand Corp., 434 U.S. 875 (1977).

32. See Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 & n.8 (9th Cir. 1990)(en banc)(citing cases).

33. 553 F.2d at 1045 (citation omitted).

34. In Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977), cert. denied, 450 U.S. 1005 (1981), the court noted that the definition of recklessness "should not be a liberal one lest any discernable distinction between 'scienter' and 'negligence' be obliterated" and, therefore, should be regarded as a "lesser form of intent" rather than "merely a greater degree of ordinary negligence." At common law, recklessness, like conscious intent, involves a culpable mental state, in contrast to negligence, which entails no culpable mental state. See Prosser and Keeton, Law of Torts, § 107; Restatement (Second) of Torts, § 552 comment a, § 526(b) comment e.

action under § 10(b)."[35] The SEC itself often relies on the recklessness standard in its own enforcement program.

Critics of the recklessness standard assert that juries fail to make a meaningful distinction between recklessness and negligence. In response to this criticism, some reform proposals would require the jury to make a specific finding that the defendant had indeed acted with the required state of mind. This would serve to deter the jury from simply ignoring the stringent legal standard required in order to hold a reckless defendant liable.[36] H.R. 10, as well as the Mineta/Eshoo bill and the Dodd/Domenici bill, has a provision requiring such special verdicts. The Commission supports such a requirement and believes that it may be a useful means for ensuring the proper application of the recklessness standard.

B. FRAUD-ON-THE-MARKET

Under the fraud-on-the-market theory of liability, a plaintiff who trades in a corporation's stock after the issuance of a material false statement by the corporation is entitled to a rebuttable presumption that he relied on the integrity of the market price in making his investment decision. As the Supreme Court stated in upholding

---

35. Rolf, 570 F.2d at 47. See also Mansbach, 598 F.2d at 1025 ("Requiring a plaintiff to show that the defendant acted with actual subjective intent to defraud could impose a great burden upon recovery, greatly limiting the § 10(b)/Rule 10b-5 claim"); Hackbart, 675 F.2d at 1118 ("requiring the plaintiff to show [conscious] intent would be unduly burdensome"); G. A. Thompson & Co. v. Partridge, 636 F.2d 945, 961 n.32 (5th Cir. 1981); cf. Herman & MacLean v. Huddleston, 459 U.S. 375, 390-91 n.30 (1983)("If anything, the difficulty of proving the defendant's state of mind supports a lower standard of proof").

36. The use of special verdicts, has generated a great deal of controversy. The most vocal proponent was Judge Jerome N. Frank, who was an outspoken critic of the jury system. Judge Frank urged that a special verdict is "usually preferable to the opaque general verdict." Skidmore v. Baltimore & O.R. Co., 167 F.2d 54, 67 (2d Cir. 1948), cert. denied, 335 U.S. 816 (1948) (footnote omitted). On the other side of the argument were Justices Douglas and Black who believed that the rule allowing special verdicts should be repealed. "One of the ancient, fundamental reasons for having general jury verdicts was to preserve the right of trial by jury as an indispensable part of a free government." 374 U.S. 861, 867-68 (1963) (dissenting from the adoption of amendments to the Federal Rules of Civil Procedure).

the fraud-on-the-market theory in Basic Inc. v. Levinson,[37] reliance is an element of a Rule 10b-5 action,[38] but "[b]ecause most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations . . . may be presumed for purposes of a Rule 10b-5 action."[39] This presumption may be rebutted by the defendant.[40]

The fraud-on-the-market theory rests on two propositions: that in an active secondary market, the price of a company's stock is determined by all available information regarding the company, its business and general economic conditions; and that investors rely on the integrity of market prices when making investment decisions. Misleading corporate statements or the failure to disclose material information are regarded as a fraud on all stock purchasers, even those who did not personally read the fraudulent information, because the price paid for the stock reflects the misrepresentations. The Commission believes that the ability of investors to rely on the integrity of the market is important for our system of securities regulation.

H.R. 10 would effectively eliminate the fraud-on-the-market theory by requiring that each plaintiff prove that he or she had actual knowledge of and actually relied on a misstatement or omission in connection with the purchase or sale of stock. Much of the Commission's disclosure regulation, however, is premised on the assumption that the market will absorb all available information and incorporate it

---

37. 485 U.S. 224 (1988).

38. Id. at 243 ("Reliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury.").

39. Id. at 247.

40. Id. at 249.

into a company's stock price. We do not, for example, require that companies mail their periodic SEC reports to every shareholder. Rather, we assume that analysts, brokers, and others will obtain and evaluate that information and rely on it in making recommendations to investors. When someone buys stock at a price affected by misrepresentations, the buyer has in effect bought the misrepresentations, whether or not he or she actually read the statements in question.

An actual reliance requirement of the type proposed would also make it virtually impossible for investors to assert their claims as part of a class action. As the Supreme Court pointed out in Basic, "[r]equiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented respondents from proceeding with a class action, since individual issues then would have overwhelmed the common ones."[41]

In addition to eliminating the fraud-on-the-market theory, H.R. 10 would adopt a much more stringent reliance standard for claims based on omissions (as opposed to misrepresentations) than courts have required. In Affiliated Ute Citizens v. United States,[42] a class action under Rule 10b-5 involving alleged material omissions, the Supreme Court held that:

> Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. [citations omitted.] This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.[43]

---

41. Id. at 242.

42. 406 U.S. 128 (1972).

43. Id. at 153-54.

By overturning the holdings of the Supreme Court in both Basic and Affiliated Ute, H.R. 10 would fundamentally alter existing law. The Commission believes that such an alteration would have a detrimental effect on our disclosure system, a system that has led to fair and efficient markets in our country.

C. AIDING AND ABETTING LIABILITY

Last April, the Supreme Court held in Central Bank of Denver[44] that investors do not have a private right of action against persons who aid and abet violations of Section 10(b) and Rule 10b-5. The decision means that private investors may no longer be able to recover damages against persons who substantially assist the perpetration of a securities fraud, even if such persons act knowingly and intentionally.[45] In addition, the decision has created unnecessary uncertainty as to the Commission's ability to use the aiding and abetting theory of liability where it is not expressly provided by statute. For these reasons, the Commission has recommended that Congress enact legislation addressing the Central Bank of Denver decision.[46]

H.R. 10 would limit liability under Rule 10b-5 to an even greater degree than the Supreme Court's holding in the Central Bank of Denver case. Section 204 of the

---

44. Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 114 S.Ct. 1439 (1994).

45. The ultimate impact of the Central Bank of Denver decision is uncertain today because it will depend on the manner in which the federal courts develop the law of primary liability. The distinction between primary and secondary liability was not very important prior to Central Bank of Denver, since a person who was found to have aided and abetted a fraud had joint and several liability with the primary violator. The distinction is crucial today, however, since a participant in a fraud may be totally insulated from liability in private actions if primary liability cannot be established.

46. Of the pending bills, only legislation introduced by Congressman Markey would restore aiding and abetting liability as it existed prior to Central Bank of Denver. The legislation introduced by Congressman Tauzin also would restore aiding and abetting liability, but only to the extent that a defendant acted with deliberate intent to defraud for the defendant's own direct pecuniary benefit. The term "direct pecuniary benefit" would be defined to exclude ordinary compensation for services provided by the defendant.

bill (adding a new Section 10A(a)) provides that damages may be recovered only against defendants who "make" a material misstatement or omission. Section 10 and Rule 10b-5, by contrast, contain the words "directly or indirectly," which can enable courts to find that persons who participate in the preparation of false statements indirectly "make" those statements. This flexibility is critical, and it should be preserved. An attorney who knowingly prepares a false statement made by a corporate issuer, for example, should not be insulated from liability simply because his or her name is not identified with the statement.[47]

Finally, as a result of what may have been an unintended drafting error, the language of Section 204 of H.R. 10 could preclude recovery in certain types of cases, such as market manipulations, which are not based on fraudulent misrepresentations. The Supreme Court has described certain types of manipulative activity, such as wash sales, matched orders, and rigged prices, as being inherently deceptive because they are intended to mislead investors by artificially affecting market activity.[48] There is no requirement in such cases to allege that the defendant made misstatements or omissions. Because H.R. 10 requires a misstatement or omission, it could prevent a corporate issuer from instituting an action under Rule 10b-5 against persons who manipulate the price of its shares.

D. RICO LIABILITY

For many years, the Commission has supported legislation to eliminate the overlap between the private remedies under the Racketeer Influenced and Corrupt

---

47. It is unclear whether H.R. 10 is also intended to limit the liability of controlling persons. Section 20(a) of the Exchange Act makes a controlling person liable for the acts of any person under its control, unless the controlling person acted in good faith and did not induce the unlawful conduct.

48. See Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 476 (1977).

Organizations Act ("RICO") and under the federal securities laws.[49] Because the securities laws generally provide adequate remedies for those injured by securities fraud, it is both unnecessary and unfair to expose defendants in securities cases to the threat of treble damages and other extraordinary remedies provided by RICO.

Although a recent Supreme Court decision substantially narrowed the liability of professional advisers under RICO,[50] issuers and other market participants continue to be exposed to RICO claims in securities cases.[51] These claims tend to coerce settlements and force defendants to litigate issues that would not otherwise arise in securities cases. Congressional action continues to be needed, and measures addressing this issue are included in H.R. 10, the Mineta/Eshoo bill, and the Dodd/Domenici bill.

III. PROPOSALS TO ALTER THE CONSEQUENCES OF LIABILITY

A. LIMITATION ON DAMAGES

H.R. 10, the Mineta/Eshoo bill, and the Dodd/Domenici bill each have provisions which would limit damages in actions under Section 10(b) to the lesser of: (1) the difference between the price paid by the plaintiff and the market value of the security immediately after dissemination to the market of information correcting the

---

49. See Testimony of Mary L. Schapiro, Commissioner, Securities and Exchange Commission, Concerning H.R. 1717, the RICO Amendments Act of 1991, Before the Subcommittee on Intellectual Property & Judiciary Administration, Judiciary Committee, U.S. House of Representatives (Apr. 25, 1991).

50. The Court held that one must participate in the operation or management of an enterprise in order to be liable under Section 1962(c) of RICO. Reves v. Ernst & Young, 113 S. Ct. 1163 (1993).

51. E.g., Powers v. British Vita, plc, 842 F. Supp. 1573 (S.D.N.Y. 1994); Aizuss v. Commonwealth Equity Trust, 847 F. Supp. 1482 (E.D. Cal. 1993); Greenwald v. Manko, 840 F. Supp. 198 (E.D.N.Y. 1993).

misstatement or omission, or (2) the difference between the price paid by the plaintiff and the price at which the plaintiff sold the security after dissemination to the market of information correcting the misstatement or omission.

These provisions are intended to bring greater certainty to the difficult issue of calculating damages in many securities cases. The Commission has concerns, however, that the proposed measures of damages will not reach the appropriate result in certain types of cases. Between the time that a misrepresentation is made and the time that information correcting the information is disseminated to the market, the price of a security may rise or decline for reasons totally unrelated to the violations. As a result, plaintiffs may be undercompensated under the first proposed measure of damages. In addition, the second proposed measure would reduce damages on the basis of unrelated stock price movements that occur after the dissemination of the corrective information.[52]

The scope of the provision in H.R. 10 is also problematic because, unlike the provisions in the Mineta/Eshoo bill and the Dodd/Domenici bill, it is not limited to fraud-on-the-market cases. The proposed limitation of damages may be wholly inappropriate in many other sorts of transactions, such as transactions not involving publicly traded securities.

B. CONTRIBUTION

Securities fraud cases often involve multiple defendants with differing degrees of involvement in, and responsibility for, the fraudulent conduct. If multiple defendants are found liable to the plaintiff in a securities case, however, their liability

---

52. We also note that the proposed measures are directed only at cases in which the plaintiffs' injuries result from the purchase, as opposed to the sale, of securities.

is joint and several, and the plaintiff may collect the entire amount of the judgment from any one of the defendants. To mitigate the potential unfairness of this approach to defendants, courts have implied a right to contribution in actions under Exchange Act Section 10(b).[53] Under this equitable doctrine, a defendant against whom judgment has been rendered may seek reimbursement from other persons who are jointly liable with him for payments made in excess of his share of the liability.

The Commission has recommended that Congress enact legislation to specify that, as among the contributing defendants, liability should be apportioned on the basis of relative fault.[54] This departs from the practice which prevailed at the time the securities laws were first enacted, when liability for contribution (where it existed) was apportioned among defendants in equal shares or pro rata. Four of the pending bills address this issue.

The Commission also supports legislation that would resolve a split in the circuits by providing that, where one defendant settles a case, the liability of the co-defendants is reduced by an amount equal to the greater of the amount paid or the settling defendant's proportionate responsibility.[55] The alternative approach would

---

53. See Musick, Peeler & Garrett v. Employers Ins. of Wausau, 113 S. Ct. 2085 (1993).

54. Testimony of Arthur Levitt, Chairman, Securities and Exchange Commission, Concerning Litigation Under the Federal Securities Laws, Before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives (July 22, 1994), at 18.

55. The Ninth Circuit has adopted such a proportionate contribution rule. See Franklin v. Kaypro Corp. 884 F.2d 1222 (9th Cir. 1989), cert. denied sub nom., Franklin v. Peat Marwick Main & Co., 498 U.S. 890 (1990).

release the liability of the co-defendants on a pro tanto basis, that is, dollar for dollar based on the amount actually paid by the settling defendant.[56]

While the pro tanto method provides greater protection to plaintiffs, the proportionate reduction approach is arguably more fair to non-settling defendants. Under the proportionate reduction approach, defendants cannot be saddled with more than a proportionate share of liability simply because the plaintiff settled part of the case too cheaply. As a result, defendants who believe they have meritorious defenses can litigate a case without having to worry that their exposure will be increased due to settlements made by other defendants. The proportionate reduction approach would inevitably result in some cases where defrauded investors are precluded from recovering all of their damages, but the Commission believes it represents a reasonable compromise.[57] The legislation introduced by Congressman Markey, as well as the Mineta/Eshoo bill and the Dodd/Domenici bill, adopt the proportionate reduction approach. H.R. 10 adopts the pro tanto approach.

C. PROPORTIONATE LIABILITY

If Congress enacts a system of proportionate contribution which includes a proportionate reduction approach to partial settlements, a defendant will never be required to pay more than its fair share of damages in a securities fraud case in which all responsible parties are solvent. Securities fraud cases sometimes involve bankrupt issuers or individuals, however, who are unable to pay their fair share of

---

56. The Second Circuit has adopted a pro tanto contribution rule. See Singer v. Olympia Brewing Co., 878 F.2d 596 (2d Cir. 1989), cert. denied, 493 U.S. 1024 (1990).

57. In McDermott, Inc. v. AmClyde, 114 S. Ct. 1461 (1994), the Supreme Court recently considered the choice between the proportionate reduction rule and the pro tanto rule in the context of an admiralty case. While noting that the arguments between them were closely matched, the Court chose to apply the proportionate rule, largely because it was deemed to be more consistent with the general policies of contribution.

the damages they have jointly caused. Under the existing system of joint and several liability, the solvent defendants in such cases must bear the share of the bankrupt defendants. Under a system of strict proportionate liability, the defrauded investors would be required to absorb the loss.

Advocates of proportionate liability argue that joint and several liability produces an inequitable result in such circumstances because it forces parties who are only partially responsible for harm to bear more than their proportionate share of the damages. The accounting profession, in particular, argues that the current system provides plaintiffs with an incentive to join as many "deep pockets" as possible, and compels defendants to settle weak claims in order to avoid disproportionate liability. The response to this argument is that, although the traditional doctrine of joint and several liability may cause accountants and others to bear more than their proportional share of liability in particular cases, this is because the current system is based on equitable principles that operate to protect innocent investors. In essence, the policy underlying the current system is that, as between defrauded investors and the professional advisers who assist a fraud by knowingly or recklessly failing to meet professional standards, the risk of loss should fall on the latter. Defrauded investors should not be denied an opportunity to recover all of their losses simply because some defendants are less capable of paying than others.

The legislation introduced by Congressman Tauzin would restrict the application of joint and several liability to defendants who engage in "knowing securities fraud." The Mineta/Eshoo bill and the Dodd/Domenici bill would limit its application to persons defined as "primary wrongdoers" and their controlling persons, as well as secondary participants who engage in "knowing securities fraud." The

latter two bills would also provide that, where all or part of a primary wrongdoer's obligation is uncollectible due to insolvency, individual plaintiffs who meet certain criteria may collect additional amounts from the other defendants. Among other things, the plaintiffs must have a net worth of less than $200,000 and must have unrecoverable damages equal to or exceeding 10% of their net worth.

Because proportionate liability would affect investors in the most serious cases (e.g., where an issuer becomes bankrupt after a fraud is exposed), the Commission recommends that Congress focus on measures more directly targeted at meritless litigation before considering any changes to the liability rules. Should Congress nevertheless determine to adopt some form of proportionate liability for reckless conduct, the Commission believes that it would be preferable simply to establish a cap on damages (e.g., liability is joint and several except that no defendant shall be forced to pay more than the greater of 50% of the total damages or two times the defendant's proportionate share). This would be far easier to administer than the procedures proposed in the Mineta/Eshoo bill and the Dodd/Domenici bill, and it would avoid affording disparate treatment to plaintiffs based on an economic needs test. The Commission recommends that any form of proportionate liability should be limited to cases based on reckless conduct, as proposed in the pending bills. The Commission also believes that it should be confined to fraud-on-the-market cases brought under Rule 10b-5. It is in those cases that the scope of liability is least predictable since it depends on the volume of trading and other market factors beyond the control of the potential defendants.

IV. CLASS ACTION REFORM PROPOSALS

Class action lawsuits generally further judicial efficiency and make it feasible for a broad group of investors who have relatively small individual claims to maintain an action for damages. This aggregation of claims makes class actions a powerful deterrent against fraud. Many critics of the private litigation system express concern, however, that the existing system contains inadequate safeguards against abuse.

Reforms designed to eliminate abuses in class action lawsuits are an important area in which it appears that a consensus can be reached. Virtually all parties to the litigation reform debate agree that restrictions should be placed on the manner in which class counsel locate and enlist the "named plaintiffs" for class actions. The "race to the courthouse" phenomenon serves no useful purpose.

The Commission has previously endorsed a number of legislative measures included in each of the pending bills.[58] These measures would prohibit the payment of additional compensation to a class representative, the payment of referral fees by an attorney seeking to act as class counsel, and service as class counsel by an attorney who has a beneficial interest in the securities that are the subject of the litigation unless specifically authorized by the court.[59] The Commission believes that

---

58. Although the bills are limited to certain types of actions, most of these proposals should by applicable to class action lawsuits under all of the private causes of action provided in the federal securities laws.

59. The Tauzin bill would prohibit attorneys from representing any party in cases under the Securities Act or the Exchange Act if they knowingly violate the bill's provision barring attorneys from having a beneficial interest in the subject securities. There may be situations in which a lawyer's beneficial ownership of shares is not objectionable, such as where a defendant corporation is represented by its general counsel, who owns shares or options of the company as part of his or her compensation. Therefore, it would be more appropriate to give courts some flexibility to enforce provisions such as this, rather than to mandate a penalty. H.R. 10, the Mineta/Eshoo and Markey bills, as well as the Dodd/Domenici bill, take a more flexible approach on this point, by requiring the court to make a determination of whether the lawyer's beneficial interest constitutes a conflict of interest.

measures such as these would impose some discipline in the system and provide a check against the precipitous filing of class action lawsuits that have not been adequately investigated.[60] The Commission also supports the prohibition on the payment of attorneys' fees from funds disgorged in a Commission action.

Several of the pending bills would also require more specific disclosure of settlement terms to class members. The Commission strongly supports efforts to enhance disclosure to class members.

Several other class action procedural reforms are proposed in the Markey bill and the Mineta/Eshoo bill, as well as in the Dodd/Domenici bill. Among other things, these bills would restrict settlements under seal in implied private class actions unless good cause is shown for such filing;[61] and require that attorneys' fees be calculated as a percentage of the amount actually paid to the class, rather than under the "lodestar" method in which courts review attorneys' time records and multiply the hours worked times a reasonable hourly rate.[62]

The Markey bill would require named plaintiffs in class actions to personally certify, among other things, that they have reviewed and approved the complaint, and that they did not purchase the securities in question in order to commence litigation or at the direction of their lawyers. They would also be required to set forth all of their transactions in the security and information about previous securities suits that they have brought.

60. See Testimony of William R. McLucas, Director, Division of Enforcement, Securities and Exchange Commission, Concerning Private Litigation Under the Federal Securities Laws, Before the Securities Subcommittee, Committee on Banking, Housing, and Urban Affairs, U.S. Senate (June 17, 1993).

61. In addition, the Markey bill would restrict the sealing of discovery materials unless the court found that disclosure of the materials would cause direct and substantial harm to the competitive or privacy interests of a person.

62. Proponents of the percentage-of-recovery method argue that it better aligns the interests of class members and their lawyers than does the lodestar method. At least two circuits mandate the use of the percentage-of-recovery approach in securities class action and other "common fund" cases. See Swedish Hospital Corporation v. Shalala, 1 F.3d 1261 (D.C. Cir. 1993); Camden I Condominium Association v. Dunkle, 946 F.2d 768, 774 (11th Cir. 1991). An expert task force appointed by the Third Circuit also recommended abandoning the lodestar method for a percentage fee method. See Report of the Third Circuit Task Force, Court Awarded Attorneys' Fees, 108

The Commission believes that the overall approach suggested by these proposals deserves further study and careful consideration. The Commission does not oppose any of these proposals and sees some merit in each of them. However, measures such as these may have implications outside the Commission's area of expertise. The Commission recommends that the Committee seek the views of the Judicial Conference of the United States on these points.

A number of the proposals for legislation, including H.R. 10 and the Mineta/Eshoo bill, as well as the Dodd/Domenici bill, contain provisions which would mandate some oversight of class counsel by class representatives in securities class actions. Class counsel have incentives that may differ from those of the underlying class members and frequently have a significantly greater interest in the litigation than any individual member of the class. Fees in class action cases are typically determined as part of a settlement negotiation in which the actual plaintiffs, the individual investors, play no role. In addition, class counsel usually advances the costs of litigation, which means that counsel may have a greater incentive than the members of the class to accept a settlement that provides a significant fee and eliminates any risk of failure to recoup funds already invested in the case.[63]

Under these proposals, the court would be required to appoint either a guardian ad litem or a steering committee of class members to direct class counsel and perform whatever other functions the court may specify. The guardian ad litem or the

---

F.R.D. 237 (1985).

63. For more extensive discussions of the agency problems in class actions, see Jonathan R. Macey & Geoffrey P. Miller, The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform, 58 U. Chic. L. Rev. 1 (1991); John C. Coffee, Jr., Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions, 86 Colum. L. Rev. 669 (1986).

steering committee would have the authority to retain or dismiss class counsel and to reject offers of settlement or preliminarily accept offers of settlement. These proposals are designed to address the difficulty that investors in the plaintiff class have in exercising any meaningful direction over the case brought on their behalf. The Commission supports greater voluntary involvement by investors, and particularly institutional investors, in class action suits brought on their behalf. Because these specific proposals have not received significant support from parties on either side of the issue, however, it may be more productive to focus on measures as to which a consensus can be reached.[64]

Finally, both H.R. 10 and the Dodd/Domenici bill contain provisions that would restrict the right of investors to serve as class representatives unless they held a certain minimum amount of the securities at issue. These proposals also have been strongly opposed by parties who believe that it is inconsistent with the goal of protecting the rights of individual investors to require that investors meet a minimum threshold of share ownership before being allowed to initiate an action on behalf of a class. Because there are other ways to ensure the suitability of class representatives, the Commission does not believe that a share ownership threshold is essential.

V. STATUTE OF LIMITATIONS

In 1991, the Supreme Court held that private actions under Section 10(b) of the Exchange Act must be filed within one year after discovery of the alleged violation,

---

64. See Association of the Bar of the City of New York, Report on Private Securities Litigation Reform Legislation (S. 1976, the Dodd-Domenici Bill) by the Committee on Securities Litigation and the Committee on Federal Courts (December 19, 1994), at 13-17.

and no more than three years after the violation occurred.[65] The Commission has previously urged Congress to address the Lampf decision by enacting an express statute of limitations that would allow cases to be filed up to five years after a violation occurs, provided they are brought within two years after discovery of the violation. Extending the statute of limitations is warranted because many securities frauds are inherently complex, and the law should not reward the perpetrator of a fraud who successfully conceals its existence for more than three years.

VI. CONCLUSION

Our first goal must be to preserve and strengthen our capital markets, which are the deepest and richest in the world. Our markets are the envy of the world precisely because they operate fairly and efficiently under a system in which full disclosure, not inside advantage, is the rule. Private litigation serves as a vital element in the enforcement of the federal securities laws, but a proper balance between encouraging meritorious suits and restricting frivolous or speculative suits must be maintained. There are usually investors on both sides in private securities litigation, and we must ensure that our system works for all of them.

There are many proposals for improving private litigation under the securities laws that the Commission supports. We believe that these proposals, if enacted, would significantly improve the system, balancing the need to eliminate abusive litigation practices with the need to preserve the benefits provided by private enforcement of the securities laws. The Commission opposes other proposals under consideration, however, because they would put the system out of balance, and

---

65. Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991).

potentially undermine the integrity and discipline of our capital markets. We look forward to working with the Subcommittee in its effort to craft legislation addressing these important issues.

"BETWEEN *CAVEAT EMPTOR* AND *CAVEAT VENDITOR*: THE MIDDLE GROUND OF LITIGATION REFORM"

REMARKS BY

ARTHUR LEVITT, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

22ND ANNUAL SECURITIES REGULATION INSTITUTE
SAN DIEGO, CALIFORNIA

JANUARY 25, 1995

U.S. SECURITIES AND EXCHANGE COMMISSION
450 Fifth Street, N.W.
Washington, D.C. 20549

Check against delivery

REMARKS BY CHAIRMAN ARTHUR LEVITT
UNITED STATES SECURITIES AND EXCHANGE COMMISSION
22ND ANNUAL SECURITIES REGULATION INSTITUTE
SAN DIEGO, CALIFORNIA
JANUARY 25, 1995

I want to use this opportunity to continue the dialogue we began a year ago about securities litigation. Although I'm not a lawyer, I do work in Washington, where -- as Justice Sandra Day O'Connor once said -- there may actually be more lawyers than people. And I've sure learned a few things in the past year.

Last January, I shared with you my views about litigation reform. Almost immediately, a blizzard of letters descended on my office, some favoring my canonization, the vast majority calling for my immediate resignation. There's no denying that the words "litigation reform" evoke the kind of passion usually reserved for politics, religion, football, and stock option accounting. I wish we could coin another expression -- perhaps "legal abuse abatement" -- that might get us past the flash point.

Clearly, last year, I was staking out positions the SEC had not embraced in its history. What did I say that was so controversial? I said I was troubled by signs that our private litigation system is flawed; I asserted that litigation imposes tremendous unnecessary costs on issuers and other market participants when it is abused; and I cited the common criticism that the process often fails to distinguish between strong and weak cases. For this I was considered by some to be the single greatest threat to the continued viability of private remedies against fraud.

But not for long. Just a few months after I addressed the Institute, the Supreme Court overturned several decades of precedent and held that no private right of action exists against persons who aid and abet violations of Section 10(b) of the Exchange Act and Rule 10b-5. At about the same time, Senators Dodd and Domenici introduced comprehensive legislation to stem abuses in private securities litigation. A Congressional hearing in July put a spotlight on reform legislation proposed by Congressman Billy Tauzin. In November, the Republican party captured control of the House for the first time since the Eisenhower administration, and earlier this month Representative Chris Cox introduced litigation reform legislation that can fairly be termed fundamental. Congressman Markey then weighed in with his own alternative.

What a difference a year makes! The tone of my mail has certainly changed. Last year, I was a bomb-thrower. This year,

I'm the voice of reason. Which shows just how polarized the debate has become.

The truth is, my position hasn't changed -- nor did it ever depart from the longtime SEC belief that private rights of action are not only fundamental to the success of our securities markets, they are an essential complement to the SEC's own enforcement program. In my judgment, draconian denials of the right of private action represent as tangible a danger to our markets as the status quo. It would be difficult, not to say unwise, to centralize all responsibility for the integrity of our markets in Washington. The Commission was not intended to be the KGB of Capitalism -- we're not equipped to operate as an all-pervasive agency. Instead, over the decades, a structure has been created in which, for the most part, market forces can solve market problems, and investors reserve the right to protect themselves. The securities laws are not a call for market participants to relinquish responsibility, but rather to take it.

We've also remained squarely within the SEC tradition of advancing the interests of investors. The individual investor is our touchstone -- the measure by which we appraise our every action. There should be no doubt that the Commission will actively oppose measures that would eviscerate investors' legitimate remedies against fraud. But at the same time, there is no denying that there are real problems in the current system -- problems that need to be addressed not just because of abstract rights and responsibilities, but because investors and markets are being hurt by litigation excesses. Let us not forget that there are investors on both sides of this issue. I want to make it clear that there are provisions in the Cox bill, in the Markey bill, and in the legislation reintroduced by Senators Dodd and Domenici, that the Commission can and will endorse.

The question is not, "Is there a crisis?" That calls for a value judgment, which isn't productive. The real question is, "Can the system be improved? Can it serve our nation better?" The answer to that is a resounding "Yes." The world has grown much too competitive to hamper American companies with unnecessary inefficiencies.

I've been in the corporate world for most of my life. I know the punishing costs of meritless lawsuits -- the time, the money, the anxiety -- as well as some less obvious costs, such as the stifling of much needed innovation and job formation when accounting firms are unwilling to take on smaller entrepreneurial clients, due to litigation fears.

I also know the value of well-founded litigation, not just as recourse for victims of securities fraud, but also as a deterrent against those who might otherwise be willing to cross the line. I believe that it's possible -- indeed, necessary --

to enact meaningful legislation that would eliminate the worst abuses in private litigation, without eradicating its benefits. The ideas are there. But for a consensus to be reached, all parties to the debate need to stop shouting and start talking. All parties need to recognize the legitimate interests of their adversaries. And, perhaps more than anything else, all parties need to be realistic in their expectations -- to measure new proposals against today's realities, not against the world as they would like it to be. We must not allow the perfect to become the enemy of the good.

I've made it clear that the SEC will work with any group, examine any idea, entertain any proposal, and consider any perspective, if it will help resolve this contentious issue without compromising investor protection. In the last year, I've conducted a form of shuttle diplomacy with all parties to the debate -- the National Association of Manufacturers, representatives of the plaintiffs' bar, the state securities administrators, the AICPA, the AARP, investor rights groups, federal judges, the SEC's Consumer Affairs Advisory Committee, corporate executives, and countless others -- trying to move the dialogue along.

The Commission supports a number of measures designed to eliminate abuses in class action lawsuits, and I'm more convinced than ever that in these areas, a consensus <u>can</u> be reached. Virtually all parties seem to agree with us that lawyers should not pay referral fees to brokers who refer clients; that named plaintiffs should not receive bounty payments; that we need to set a class organization period or some other method of eliminating the "race to the courthouse"; that disclosure to class members must be improved; and that private plaintiffs' legal fees should not be paid out of SEC disgorgement pools. Most parties also concur that civil RICO charges in securities fraud cases, and their treble damages, should be prohibited. It may be harder to reach agreement on other proposals, such as the further involvement of institutional investors in class action lawsuits.

The best solution of all would be to find ways to screen out cases that lack merit early in the process, before the tremendous costs associated with discovery have been incurred.

One idea that we will be considering is whether the Commission should have <u>explicit</u> authority to exempt certain types of disclosures or transactions from <u>private</u> liability under the securities laws. If a disclosure or transaction were subject to this type of exemption, violations could be prosecuted by the Commission, but could not be used as the basis for a private lawsuit seeking damages. Though we have yet to satisfy certain concerns about this approach, it <u>would</u> allow the Commission to act more quickly and flexibly to prevent meritless litigation,

while preserving its ability to respond to any who would take improper advantage of the exemption.

Perhaps there's room also to consider ideas, such as that contained in the Dodd/Domenici bill, for voluntary submission of fraud claims to specialized tribunals or fact finders who know the law and understand these cases. This might eliminate some of the uncertainties that cause meritorious cases to settle for too little, and frivolous cases to settle for too much.

The Commission's current focus on the safe harbor for forward looking statements may have significant impact on litigation practices. The question is how to provide meaningful protection to issuers acting in good faith, without also insulating companies that intentionally hype their stock by making unreasonable projections. Finding an answer will not be easy, but I assure you that we are committed to the task. We issued a concept release on this in October; we're now studying the comments we've received; and in February we'll conduct public hearings on the issue in Washington and in San Francisco.

In my remarks last year, I said the SEC was willing to file amicus briefs in support of motions to dismiss, or requests for sanctions under Rule 11. Three months ago, the Commission's General Counsel provided a letter in a class action, Frank v. Cooper, setting forth the Commission's view that the case should be dismissed. In an earlier case, the Prudential Securities litigation, we presented a letter to the court addressing a fee application submitted by class counsel.

To my mind, the Commission must continue to do whatever it can to assist the courts in assessing particular actions or defenses, and in protecting the interests of class members. I've asked our General Counsel, Sy Lorne, to devote more resources to this effort, and I'm pleased to announce today the creation of a Litigation Analysis Unit within the office of the General Counsel. These lawyers will evaluate the claims and the legal support for private cases, and where appropriate, they will provide our views to investors, corporations, lawyers, and judges. I encourage any of you who believe you're encountering abuses on either side to bring them to the General Counsel's immediate attention.

The Commission will also consider asking Congress to enact a provision that would allow us to appear and be heard on any issue in a private action brought under the securities laws. This would be modelled on the provision that already exists in the Bankruptcy Code, and would allow us to express our views in the public interest.

I've told you about some ideas we feel are worth examining. Let me now turn to the ideas we oppose, and explain why.

It's been suggested that plaintiffs be required to prove that they read and relied upon a misleading statement by the defendant in order to bring action. This is antithetical to our entire system of disclosure, which is premised on the notion that when information is disclosed generally, it is incorporated into market prices. If that were not true, we'd have a system in which all prospectuses and periodic disclosures had to be distributed to all shareholders and prospective investors on a continuous basis -- a tremendous, if not an impossible, burden on business. We allow a fair amount of information to be filed with us, knowing that analysts will see just about everything. When someone buys stock at a price affected by misrepresentations, the buyer has in effect bought the misrepresentations, whether or not he or she actually read the statements in question -- and that buyer simply must have recourse. The proposal in question would eliminate the notion of fraud on the market, and the need to demonstrate actual reliance by each member of the class would make it impossible to be certified as a class. That's a cure far worse than the disease -- not just for investors, nor only for our disclosure system, but for the markets that depend on it.

Like so many other catch-phrases, the concept of an "English Rule," or "loser-pays-all," is neither as good nor as bad as its proponents and detractors would have us believe. Proponents argue that the English Rule would screen out frivolous lawsuits, and there's no question in my mind that it would have that effect. The problem is that, if it is applied in class actions, it would also eliminate meritorious cases. Imagine you're a small investor whose nest egg of $10,000 loses its value overnight, due to the sudden disclosure that a company has withheld its true earnings. Two hours after the meter has started ticking at the law firm hired by the defendant, one senior partner alone has already racked up $1,000 in fees. Within a month, you're weighing the possibility of paying lawyers' fees that are dozens, if not hundreds of times larger than your whole investment; that strikes me as a powerful deterrent, no matter how legitimate your claim.

This, too, is not just a question of investor interests -- it is a question of the market's interests. Private securities litigation plays a prominent role in checking market excesses. To change that, we'd need to recalibrate our entire system of checks and balances.

This is a crucial point. Our markets are the best in the world, partly because our securities laws are the best in the world. We tamper with the securities regulation system at our peril, because you shouldn't fix what "ain't broke." What is "broke" is the litigation resolution system -- we must not confuse the two. Precipitous steps in one could lead to structural damage in the other. The race to the steps of the

courthouse should not be matched by a race to the steps of the Capitol.

There are more reasonable and measured reform proposals. One would be to give judges stronger authority to award fees when cases clearly lack merit, as provided in Section 11(e) of the Securities Act, and to make the attorney who files a frivolous case responsible for the fees. Last July, I testified before Congress in support of this concept, and today I reaffirm that support. Congress might also consider a requirement that, where cases are dismissed on the pleadings alone or in response to a motion for summary judgment, the presumption is in favor of awarding fees to the defendant. Some proposals for alternate dispute resolution (ADR), including one in the Dodd/Domenici bill, suggest awarding fees to the winner if the parties fail to accept an offer to resolve the case in an ADR forum. This, too, deserves close attention.

That brings us to the question of scienter. Let me be clear on this: We are against any proposal to require a plaintiff to prove that the defendant had actual knowledge that the relevant statements were false. The circuit courts have been unanimous in holding that liability can be predicated on reckless conduct. The Commission has strongly supported these decisions because such a standard is needed to protect the integrity of the disclosure process -- which is to say the integrity of our markets. We want corporations to worry about the accuracy of their disclosures, because that is the best way to assure the markets of a continuous stream of accurate information. Any higher scienter standard threatens the process that has made our markets what they are. Indeed, an actual knowledge standard could create a legal incentive to ignore indications of fraud. The phrase "ignorance is bliss" could take on new meaning.

The final question I want to examine is whether there should be a change in the scope of private liability in fraud cases brought under Rule 10b-5. The accounting profession has argued that joint and several liability is fundamentally unfair because it sometimes forces parties that are only partially responsible to pay more than their proportionate share of the damages. We acknowledge these fears, and we recognize the vital role accountants play in the capital formation process. We do not want to see the profession weakened or hampered in its ability to retain talent. Many ideas have been offered, including liability caps, one of the proposals of the Dodd/Domenici bill. Even while these ideas are being discussed, the Commission believes that Congress should at least minimize the flaws in the existing scheme by enacting a system of proportionate contribution, which is also one of the features of the Dodd/Domenici bill. We would be prepared to support a rule providing that, where one defendant settles a case, the liability of the co-defendants is reduced by an amount equal to the greater of the amount paid or the settling

defendant's proportionate responsibility. This could result in some cases where defrauded investors are precluded from recovering all of their damages, but it strikes me as a reasonable compromise.

Let me summarize, if I may, our position at the SEC: We want strong safe harbor protection for forward-looking statements made in good faith. We want to eliminate abuses in the litigation of class actions. We want to preserve antifraud liability based on recklessness, and to have liability for aiding and abetting reaffirmed, certainly for the Commission. Finally, we want to make it easier for courts to make awards against plaintiffs' attorneys in meritless cases, and to implement a system of proportionate contribution.

The bottom line is that we're in this together -- the Congress, the SEC, the courts, the defendants' bar, the plaintiffs' bar, the public accounting firms, and, most importantly, the investors and the public companies that make ours the deepest, richest capital markets in the world. No system can survive that is skewed to one side or another.

Imagine, if you will, a world in which the remedy against fraud is too weak: companies will be able to say anything they want about themselves or their expectations, but investors will not want to risk their capital. Imagine, on the other hand, a world in which the remedy against fraud is too strong: any mistake in any company statement will risk huge lawsuits alleging fraud, so no company will be able to raise capital. Either way, our capitalist system is the loser. What we need is a balance between caveat emptor and caveat venditor -- between "buyer beware" and "seller beware."

It's in that spirit that I make this speech. Most reasonable people familiar with the issue feel the system must change -- the debate is now about what form it will take. The fact that strongly opposing positions have been staked out may actually be helpful, because they leave a lot of ground in between. That's where the Commission has made its camp -- and that's where I ask you to join us -- in the middle. The changes we make must be profound, not drastic; they must be visionary, not just revisionary; they must create something that's new and right, not just destroy something that's old and wrong.

For my part, in the year ahead as in the year just past, I will work with the Congress, and with any reasonable person concerned about this issue, to find a fair and workable solution. I have no illusion that change will come overnight -- but by the same token, I have no doubt that, if people of goodwill on all sides work together, then by the time you meet again next year, we can and will have an answer that improves the capital

formation process, reinforces investor confidence, and maintains America's international leadership.

# # #

Duke University
School of Law
Science Drive at Towerview
Box 90360
Durham, North Carolina 27708-0360

Thomas D. Rowe, Jr.
Professor of Law
Internet trowe@faculty.law.duke.edu

Telephone (919) 613-7099
Facsimile (919) 613-7231
Home phone (919) 383-6775

February 13, 1995

To: Advisory Committee on Civil Rules

From: Tom Rowe

Re: H.R. 555

H.R. 555 addresses many of the same areas as H.R. 10, but with major differences in coverage and often in content when coverage is similar. Of matters in H.R. 10 with particular significance for the Federal Rules of Civil Procedure, H.R. 555 omits entirely the following: 1) the provision in H.R. 10's § 202(a) for guardians at litem or plaintiff steering committees in securities fraud class actions, including the authorization to seek class majority approval for settlement offers; 2) § 203(a)'s threshold requirements, in proposed Securities Exchange Act § 21(k), that named class action plaintiffs hold a certain percentage or dollar value of the stock in question; 3) the repeat-plaintiff restriction in proposed SEA § 21(*l*), although H.R. 555 would require disclosure including recent securities class action filings by the same plaintiffs; 4) proposed § 21(m)'s loser-pays rule on attorney fees; 5) H.R. 10's special verdict requirements in proposed SEA § 21(q) concerning scienter findings; and 6) § 204's detailed fact pleading requirements concerning defendants' state of mind.

Procedural provisions in H.R. 555 that closely or roughly parallel sections in H.R. 10 include the following: 1) a conflict of interest inquiry like that in H.R. 10's proposed SEA § 21(n), although H.R. 555's counterpart--proposed SEA § 21(j)--would apply only in *implied* private actions certified as class actions, to the extent that makes a difference with H.R. 10's coverage of all private actions; 2) settlement disclosure requirements in H.R. 555's proposed SEA § 21(n), paralleling H.R. 10's proposed SEA § 21(i); 3) a settlement discharge provision in H.R. 555's proposed SEA § 21(o)(2)-(3), paralleling H.R. 10's proposed SEA § 21(o)(1) but

with statutory requirements concerning good faith settlements and pro rata, rather than pro tanto, reduction of the plaintiff's recovery; 4) an early evaluation procedure in proposed SEA § 27B(c), which corresponds roughly to the ADR provision in H.R. 10's § 206; and 5) safe-harbor provisions in H.R. 555's § 104 that somewhat parallel those in H.R. 10's § 205, including a mandate that the SEC adopt such rules and apparent contemplation of SEC rules that might regulate court procedures in ruling on applicability of safe-harbor protections, although H.R. 555 is less directive to the SEC in this respect than H.R. 10.

Finally, provisions of procedural significance in H.R. 555 that have no approximate counterpart in H.R. 10 are: 1) in proposed SEA § 21(k), restrictions on secrecy in settlements and protective orders; 2) in proposed SEA § 21(*l*), requirements for preservation of evidence from receipt of notice of filing of a complaint in implied private actions; 3) in proposed SEA § 21(o)(3)(A), apparently nonproblematic jury interrogatory requirements in connection with liability apportionment (as opposed to H.R. 10's "special verdict" requirement for scienter findings); 4) in proposed SEA § 27B(a), detailed information requirements about plaintiffs' backgrounds to be included in implied private actions filed as class actions; and 5) in proposed SEA § 27B(b), provision for consolidation and lead counsel selection in multiple securities class actions.

Brief comments on the procedural aspects of H.R. 555, in order as the provisions appear in the bill:

Section 101(c), like § 203(a) in H.R. 10, is headed "Additional Provisions Applicable to Class Actions," but--as in H.R. 10--some of the provisions that follow are phrased so that they could apply more broadly, speaking of "an implied private action arising under this title" without referring to its being "certified as a class action." This omission is in subsections (k), on secrecy restrictions, and (*l*), on preservation of evidence. Subsection (o) on contribution, settlement discharges, and liability apportionment also refers to actions "under section 10(b)" without limiting the provisions to having effect in class actions only.

The conflict of interest determination provision in § 101(c)'s proposed SEA § 21(j) is identical, except for its applicability to "implied" private actions certified as class actions rather than to "any" private class action, to H.R. 10's proposed SEA § 21(n). The comments at lines 137-46 of the H.R. 10 memo apply to this H.R. 555 provision as well.

H.R. 555's proposed SEA § 21(k) would establish significant new restrictions on settlements under seal and on protective orders and the sealing of cases, with a burden of proof on the party seeking such an order and a ban on agreements limiting disclosures to Congress or federal or state regulatory agencies with relevant enforcement authority. The limit in subsection (1) on sealing settlements without a showing of "good cause," to be found only if "publication of a term or provision of a settlement agreement would cause direct and substantial harm to any person," needs further consideration for its possible effect on settlements and court procedure. It might give plaintiffs leverage to seek private agreements before filing. Subsection (2) restricts protective orders or sealing of court records after final judgment, allowing them only after "particularized findings of fact that such disclosure or access would cause direct, immediate, and substantial harm to the competitive or privacy interests of a person." These requirements would greatly complicate discovery in much federal securities litigation, destroying the benefits of stipulated protective orders and drastically changing Rule 26(c) as it now stands and as it would be amended by current proposals of the Standing Committee on Rules of Practice and Procedure. The definition of good cause for a protective order does not recognize that the harm that justifies protection must be weighed in relation to the importance of disclosing the harmful information. Subsection (4) on disclosure to Congress or agencies would limit parties' agreements but without affecting court authority.

Proposed SEA § 21(*l*) on preservation of evidence would bar destruction of relevant evidence after a defendant received actual notice of the filing of a complaint with allegations about the defendant's conduct. This problem, if it is a significant one, must go beyond the securities area and could call for general rulemaking rather than substance-specific legislation.

The settlement disclosure provision in proposed SEA § 21(n) is similar in most respects to H.R. 10's proposed SEA § 21(i), and the comments at lines 101-08 of the H.R. 10 memo apply. The settlement *discharge* provision in H.R. 555's proposed SEA § 21(o)(2), by contrast, adds language not present in H.R. 10's proposed SEA § 21(o)(1) requiring a judicial determination "that the settlement was entered into in good faith" for the defendant to benefit from the discharge protections. This difference eliminates for H.R. 555 the "fair share" problem mentioned at lines 151-52 of the H.R. 10 memo. H.R. 555 also provides for pro rata, rather than pro tanto, reduction of the plaintiff's recovery.

H.R. 555's § 102 has major provisions for securities class action complaints, consolidation of multiple securities class actions, selection of lead counsel, and early evaluation. Proposed SEA § 27B(a) requires a certification to be filed with the complaint by each plaintiff seeking to serve as a class representative, with seven statements including: that the plaintiff has reviewed the complaint and authorized its filing; information in connection with the plaintiff's purchase of the securities; a statement of willingness to serve as the class representative; a listing of the plaintiff's transactions in the securities during the class period, and of class action suits filed by the plaintiff in the preceding year; and a renunciation of payment beyond a pro rata share of any recovery except as ordered by the court. Some of these requirements might be worth considering beyond the securities class action context, if they seem meritorious. Those about not buying the securities with the intent of commencing litigation or at the direction of plaintiff's counsel seem substantive. These elements may be appropriate as substantive requirements but are awkward as pure certification requirements in connection with pleadings, when the legislation would apparently not affect the underlying substantive law (unless the certification requirements reflect already settled substantive law).

Proposed SEA § 27B(b) creates an entirely new procedure requiring JPMDL consolidation of multiple securities class actions. These provisions largely affect 28 U.S.C. § 1407 and are outside our sphere, although they raise questions about whether such revisions should be limited to securities litigation. Subsection (3) would govern selection of lead counsel; it is not

clear whether existing court practice on choosing lead counsel is in need of fixing. The requirement that if plaintiffs' counsel "do not organize themselves" in short order the court "shall promptly designate lead counsel" does not appear intended to inhibit innovative approaches such as the competitive bidding used by Judge Vaughn Walker of the Northern District of California, but the requirement that lead counsel be designated within 45 days after the first multiple action is filed would have that effect. Subsection (4), providing that later-filed cases "shall be subject to the decisions taken during the case organization period," leaves unclear the important question whether such decisions would have full preclusive effect or would amount instead to law of the case.

Proposed SEA § 27B(c) creates an early evaluation procedure whose details bear on many of the Civil Rules. Initially, subsection (1) is obscure on the events required to support an order invoking the early evaluation procedure. The order is to enter "if the class representatives and each of the other parties to the action agree, and any party so requests," which seems to require unanimous agreement and a request by one of the agreeing parties. If that really requires all parties to agree, the provision is hard to object to. Subsection (2) provides that during the early evaluation procedure the defendants need not answer the complaint; the plaintiffs may file a consolidated or amended complaint or may dismiss at any time without sanction; no discovery may occur, aside from discovery requests to third parties "to preserve evidence," which requests would create an obligation not to destroy evidence; and the parties are to provide access to or exchange all nonprivileged documents relating to the allegations of the complaint, damage studies, and "such other expert reports as may be helpful" to the evaluation--disclosure well beyond the requirements of Civil Rule 26(a)(1). Failure to disclose would subject a party to sanctions "pursuant to the Federal Rules of Civil Procedure," which should perhaps be read as referring only to the disclosure sanctions of Rule 37 but is troublingly unclear.

The mediator is to evaluate whether an unsettled action is clearly frivolous, clearly meritorious, or neither, and to give a written evaluation "with respect to the claims against and defenses of each defendant." If a claim is evaluated as frivolous and the plaintiff loses, or as

meritorious and the defendant loses, sanctions are awarded against the party or counsel if the court agrees, "based on the entire record," that the loser proceeded "in bad faith." These provisions could need clarification on whether and how they intersect with sanction powers under Rule 11. At the end of the 150-day early evaluation period, which the parties may extend by stipulation, "the action shall proceed in accordance with [the] Federal Rules of Civil Procedure," with the sides to share equally the reasonable fees and expenses of a non-judicial mediator.

Last, the safe-harbor provisions in H.R. 555's § 104 do require the SEC to adopt rules limiting liability for forward-looking statements, but without the detailed criteria in H.R. 10's § 205. Most importantly for our purposes, the apparent H.R. 10 mandate that the SEC make rules of procedure for the federal courts is watered down--but still present. Under subsection (b)(1), the SEC after adopting the safe-harbor rules required by subsection (a) (which makes no reference to court procedure) is to submit to Congressional committees a report including a description of "the procedures which shall be followed for making a summary determination of the applicability of any Commission rule for forward-looking statements early in a judicial proceeding to limit litigation and discovery and for promoting timely dismissal of claims" against issuers who are in compliance with the SEC's safe-harbor rules. In H.R. 555 the Article III problem described in lines 198-200 of the H.R. 10 memo may not be as plainly on the surface as it is in H.R. 10, but H.R. 555 appears to presume SEC action that could create the same difficulties. Similarly, H.R. 555's proposed SEA § 40 closely tracks H.R. 10's proposed SEA § 38, with stay and discovery provisions affecting trial judges' usual discovery powers as described in the H.R. 10 memo at lines 202-06.

ference between the earlier and the later statements is not merely the difference between two permissible judgments, but rather the result of a falsehood." *In re Glenfed, Inc., Securities Litigation*, 1994 WL 688969, at *7 (9th Cir. 1994) (en banc) (footnote omitted). Some courts go further and require pleading of "facts giving rise to a 'strong inference of fraudulent *intent.*'" *See id.* at *3 (emphasis added) (rejecting Second Circuit's requirement to that effect); *cf. In re Philip Morris Securities Litigation*, 1995 WL 13528 (S.D. N.Y. 1995) (dismissing, without leave to replead, amended securities fraud class action complaint for lack of "specific allegations supporting fraud").

In any event, the additional requirements of proposed § 10A(b) for allegations of "specific facts" demonstrating "state of mind" in an initial pleading seem demanding to the point of virtual or total impossibility. To the extent that plaintiffs try to comply with them, the proposed requirements raise the possibility of extremely prolix pleadings--which characterized much pre-Rules code pleading and led the framers of the original Federal Rules of Civil Procedure to abandon most requirements for detailed initial allegations. Such detailed, fact-specific pleadings can be highly burdensome not only for plaintiffs to prepare but for defendants and judges to deal with; courts under the less exacting current pleading rules can and do use powers over discovery to control costs when securities fraud pleadings clear existing hurdles. *See, e.g., Glenfed*, 1994 WL 688969, at *16-17 (Norris, J., concurring). Heavy front-loading of the pleading stage may preclude the more desirable alternative of less detailed pleadings followed by judicially controlled discovery, focused sharply on issues that may afford grounds for early dismissal. Highly detailed pleading requirements could also intersect in troublesome ways with such existing provisions as new Rule 26(a)(1) on initial disclosures concerning matters "relevant to disputed facts alleged with particularity in the pleadings." Pleaders already have Rule 26(a)(1)'s recently-created incentive to include factual detail on matters as to which they want to trigger disclosure obligations. That incentive may lead to some helpful specificity and targeted disclosures--rather than broader triggering of disclosure obligations because of detailed fact-pleading requirements. The substantive provisions of proposed § 10A(a) may suffice for the drafters' purposes, without needing reinforcement by pleading specificity requirements that go well beyond those already in force.

Section 205, "safe harbor" provisions:

Subsections (a)(2), (b)(2), and perhaps (b)(4) are drafted in terms that appear to mandate or contemplate SEC action that would create rules of procedure applicable in Article III courts, which might be held unconstitutional on separation of powers grounds. Redrafting could avoid this implication and the possibility that the entire section, which lacks a severability provision, would be held invalid. Subsection (c) would add a new § 38 to the SEA to implement the safe harbor provisions, privileging stay requests premised on safe harbor summary judgment motions and limiting the grounds on which stay denials or discovery extensions could be granted. It would thus affect trial judges' usual discretion to structure discovery. The need for such strictures is not clear.

Section 206, alternative dispute resolution:

Proposed new SEA § 39 contains in its subsection (a)(3) provisions concerning discovery timing that are difficult to understand. The authority there to extend discovery "not more than 90 additional days" during consideration of an ADR offer might be read to ban discovery *after* the 90 days, which is probably an unintended implication. The sanction authority under subsection (a)(5) may be superfluous given existing judicial power to control discovery generally, and could lend itself to negative inferences about other sanction powers in a proceeding governed by § 39. More broadly, although courts have increased their use of ADR mechanisms in many contexts, it is not clear that securities class actions are among those well suited for ADR. These are generally not cases that fail to settle for lack of an impartial estimate of the likely result of trial, or in which someone aggrieved mainly needs to have his or her story heard by a neutral and may be satisfied with an arbitrator's recommendation rather than a jury verdict. The ADR provision could also have limited impact because some federal judicial districts lack a "voluntary, nonbinding alternative dispute resolution procedure established or recognized under the rules of the court."

U.S. House of Representatives
Committee on Commerce
Room 2125, Rayburn House Office Building
Washington, DC 20515–6115

Opening Statement of
The Honorable Thomas J. Bliley, Jr.
Subcommittee on Telecommunications and Finance
Markup of H.R. 10 - Common Sense Legal Reforms Act
February 14, 1995

It has been observed that in civil jurisprudence it too often happens that there is so much law, that there is no room for justice. Claimants can expire of wrong in the midst of right, as mariners die of thirst in the midst of water. It is with this in mind that we address the national need for litigation reform.

Our effort is one to restore balance to the litigation of shareholder class actions. Ordinarily, the equities of this process would involve a fine tuning of the system to insure the rights of plaintiffs to proceed forward, and the rights of defendants to present a strong defense before the trier of facts. Unfortunately, class action litigation is not ordinary. The evidence concerning shareholder class actions tells us that much more than fine tuning is necessary.

These cases are not tried, they strike out at corporate defendants. By using and abusing the discovery process, settlements are extorted. A trial on the merits is an exception not the rule. Even in a suit where the potential exposure rises to the low seven figures, the cost of settling may not be that much greater than the cost of a successful defense. When would a sane corporate management risk the possibility of an unsuccessful defense in that situation? In summary, it appears that the system has provided plaintiffs with incentives to sue regardless of merit, and defendants with an incentive to settle regardless of merit. A litigation system that does not have any connection to the merits cannot effectively punish fraudulent conduct or provide compensation to truly injured investors.

Far more valuable are reforms which will discourage plaintiffs and their attorneys from filing meritless cases in the first place. Our goal is to eliminate the expense and uncertainly of litigation that pressures defendants to settle, rather than defend, even completely meritless cases.
Far better are reforms that change the rules so that entrepreneurial lawyers will not receive multimillion dollar fees and investors will receive more than pennies on the dollar for their losses. Far more valuable are our efforts to correct the harmful environment that has been created in which frightened companies have to be circumspect, and curtail the disclosure of information to their own shareholders.

These are the reforms of H.R. 10, as it was introduced, and as it will be marked up and reported out today. This legislation is a giant step towards restoring common sense to our legal system. I am proud of the way this subcommittee has met its responsibilities in this matter and yield back the balance of my time.

Summary of Amendment in the Nature of a Substitute to H.R. 10
Common Sense Legal Reform

Contents-Title II-Reform of Private Securities Litigation

Plaintiff Steering Committees- The bill creates "Plaintiff Steering Committees," a "class action steering committee appointed by the court from the recommendations of the parties or their counsel. Service on the class action steering committee is limited to members of the class who own at least five percent of the securities that are the subject of the case with a market value of ten million dollars or a smaller percentage of the dollar amount as the court finds appropriate. Named plaintiffs may serve but not constitute a majority of the committee. Members of the committee are immune from liability for all but intentional wrongdoing as a result of that service. Class members will still be liable for "loser pays" fee awards. A class member who is not on the steering committee may still appear and be heard by the court on any issue concerning the organization or actions of the plaintiff steering committee.

The purpose of the steering committee is to retain, direct and dismiss counsel, to reject offers of settlement, and to have the preliminary authority to accept an offer of settlement so that it can be considered by the court and the class members. The final approval must be made by at least a majority of the class members.

Publication of Terms of Any Settlement.-- The bill provides that the terms of any settlement must be disclosed to the class members in a statement that contains specific statutorily required statements. These cover the subjects of (1) the amount of damages per share that would be recoverable if the plaintiff had won; (2) a statement concerning the probability that the plaintiff would prevail; if there is a disagreement on the amount of damages or the likelihood of prevailing, (3) a statement from each settling party on the issue must be included.

Statement of Attorney's Fees sought.--If any of the settling parties or their counsel intend to apply for an award of attorney's fees from any fund established as part of a settlement, a statement to that effect listing the amount to be sought must be sent to parties to the suit. The statement must include the amount of the fees on a per share basis and a comparison to the amount proposed to be distributed to the parties to the suit, also on a per share basis. The name and address of a counsel for the plaintiffs must be supplied to answer questions. The bill contains a prohibition on the payment of attorney's fees from funds disgorged as the result of an SEC enforcement action.

Prevention of Abusive Practices that Foment Litigation.-- The bill prohibits payment of bonuses to named plaintiffs. It also does not permit a person to be a named plaintiff in more than 5 class actions filed during any 3 year period unless permitted by the court.

Payment of Attorney's Fees by the Losing Party. - If a court enters a final judgment on the basis of a motion to dismiss, summary judgment, or a trial on the merits, upon motion of the prevailing party, the court will require the losing party, the party's attorney, or both to pay reasonable fees except if the losing party establishes that its position was substantially justified and that imposing such fees and expenses on the losing party or the losing parties attorney would

be unjust, and that the cost of such fees to the prevailing party is not burdensome.Costs can be awarded for all the expenses of the litigation or for individual instances of discovery.

Security for Payment of Costs.--In any class action, the court will require the attorney, the class or both to post security for costs. A bond or other form of security required by the court may initially posted by the attorney but the court has the authority to allocate its costs to the class at such time and in such amounts as shall be equitable.

Protection Against Abuse of Process --Since settlement or withdrawal removes the exposure of the plaintiff to having to pay fees, if the court believes the plaintiff continued the case for the purpose of raising the costs of the defendant, the court can refuse to allow a plaintiff to withdraw voluntarily.

Conflicts of Interest. The court is authorized to determine if the plaintiff's attorney is in conflict of interest and may be disqualified because he owns an interest in the securities that are the subject of the case

Settlement Discharge. A defendant who settles any private action before verdict or judgment is discharged from all claims for contribution from the other parties, and the verdict or judgment will be reduced by an amount equal to his proportional share or the amount he paid. For example, if one defendant settles for an amount equal to forty percent of the ultimate liability, the other defendants cannot be held for more than sixty percent total.

No securities firm or person associated with that firm may be paid for sending class action clients to an attorney.

SECTION 10A. Requirements for Securities Fraud Action.

Scienter (intent)

In any private action arising out of a misstatement or omission of a material fact, liability may not be established unless the defendant possessed the intent to deceive, manipulate, or defraud. A defendant may be found to have acted with such intent only on proof that (a) the defendant directly or indirectly made a fraudulent statement; (b) the defendant possess the intention to deceive, manipulate or defraud; and (c) the defendant made such fraudulent statement knowingly or recklessly.

"Fraudulent statements" are defined as containing an untrue statement of a material fact, or omitting a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading.

"Knowingly" is defined as a defendant knowing that the statement of a material fact was misleading at the time it was made, or knowing that an omitted fact was necessary in order to make other statements made, in the light of the circumstances in which they were made, not misleading.

"Recklessness" is defined as: a defendant makes a fraudulent statement recklessly if the defendant, in making such statement, acted with willful blindness such that the defendant was consciously aware of a high probability that the statement was false, and took deliberate actions in order to avoid ascertaining its truth or falsity. A defendant who actually believed the statement was true is not reckless.

Requirement For Explicit Pleading-- In any private action based on a misstatement or omission the complaint shall specify each statement or omission alleged to have been misleading and the reasons therefore. The complaint shall also make specific allegations which, if true, would be sufficient for this purpose to plead the mere presence of facts inconsistent with a statement or omission alleged to have been misleading. If an allegation is made on information and belief, the complaint shall set forth with specificity all information on which the belief is formed.

Dismissal for Failure to Meet Pleading Requirements-- In any private action based on misstatements or omissions, the court shall dismiss the complaint if the specific pleading requirements are not met. The court may allow one re-pleading. During the pendency of the dismissal motion discovery is stayed. If the complaint satisfies the specific pleading requirement, the plaintiff is entitled to conduct discovery limited to the facts concerning the allegedly misleading statement or omission.

Reliance and Causation- In any private action based on misstatements or omissions, the plaintiff must prove he had knowledge of and relied on the statement that contained the misstatement or omission. The statement containing the misstatement or omission must also be shown to have proximately caused any loss.

Fraud on the Market-- Reliance may be proven by establishing the market as a whole considered the fraudulent statement, that the price at which the security was purchased or sold reflected the market's estimation of that fraudulent information, and that the plaintiff relied on that market price. Proof of these facts may consist of evidence that the statement received wide distribution in research reports, news reports, and other methods. Such proof will establish a rebuttable presumption.

Issuers with Illiquid Markets. --A plaintiff may not rely on the fraud on the market/reliance test if it is unreasonable to rely on the market price to reflect all current information. The legislation outlines objective criteria concerning the securities of the company to establish the depth and liquidity of its market. These criteria remain the subject of discussion and redrafting.

Allocation of Liability--A defendant may be liable for joint and several damages only if found to have acted knowingly. Defendants found liable for recklessness will be held proportionately liable.

Safe Harbor Defined-- In any action based on a misstatement or omission, a person shall not be held liable for the publication of any forward looking information if that portion of the information expressly identified as the basis for the projections is not inaccurate as of the date of publication, determined without benefit of subsequently available information or information not

known to the person at that time and the basis for any projections is briefly described with general citations only to representative sources of authority. A disclaimer must be made to alert persons that the projections should not be given more weight than the described basis therefor would reasonably justify.

Automatic Protective Order Staying Discovery-- In any action based on misstatements or omissions of a material fact in a forward looking statement, a defendant may obtain an automatic protective order staying discovery, except that which is directed to the specific issue of the applicability of the safe harbor. At the conclusion of a hearing, the court shall either dismiss the case or determine that a safe harbor was unavailable.

The bill directs the SEC to adopt rules to create clear and objective criteria by which "forward looking statements" concerning the future economic performance of a company can be made and, if wrong, not be found to have violated the antifraud laws.

Damages. In securities fraud actions damages would be limited to the lesser of the difference between the price paid by the plaintiff for the security and the market value of the security immediately after the dissemination to the market of the information which corrects the misstatement or omission and; the difference between the price paid by the plaintiff for the security and the price at which the plaintiff sold the security after dissemination of information correcting the misstatement or omission.

AMENDMENT IN THE NATURE OF A SUBSTITUTE

TO TITLE II OF H.R. 10

OFFERED BY MR. COX OF CALIFORNIA

[Cox-Fields Substitute]

Page 18, beginning on line 5, strike all of title II and insert the following:

TITLE II—REFORM OF PRIVATE SECURITIES LITIGATION

SEC. 201. SHORT TITLE; TABLE OF CONTENTS.

(a) SHORT TITLE.—This Act may be cited as the "Securities Litigation Reform Act".

(b) TABLE OF CONTENTS.—The table of contents for this Act is as follows:

SEC. 202. PREVENTION OF LAWYER-DRIVEN LITIGATION.

(a) PLAINTIFF STEERING COMMITTEES TO ENSURE CLIENT CONTROL OF LAWSUITS.—The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by adding at the end the following new section:

"SEC. 36. CLASS ACTION STEERING COMMITTEES.

"(a) CLASS ACTION STEERING COMMITTEE.—In any private class action brought under this title, the court shall, at the earliest practicable time, appoint a committee of class members to direct counsel for the class (hereafter in this section referred to as the 'plaintiff steering committee') and to perform such other functions as the court may specify. Court appointment of a plaintiff steering committee shall not be subject to interlocutory review.

"(b) MEMBERSHIP OF PLAINTIFF STEERING COMMITTEE.—

"(1) QUALIFICATIONS.—

"(A) NUMBER.—A plaintiff steering committee shall consist of not fewer than 5 class members, willing to serve, who the court believes will fairly represent the class.

"(B) OWNERSHIP INTERESTS.—Members of the plaintiff steering committee shall have cumulatively held during the class period not less than—

"(i) the lesser of 5 percent of the securities which are the subject matter of the litigation or securities which are the subject matter of the litigation with a market value of $10,000,000; or

"(ii) such smaller percentage or dollar amount as the court finds appropriate under the circumstances.

"(2) NAMED PLAINTIFFS.—Class members who are named plaintiffs in the litigation may serve on the plaintiff steering committee, but shall not comprise a majority of the committee.

"(3) NONCOMPENSATION OF MEMBERS.—Members of the plaintiff steering committee shall serve without compensation, except that any member may apply to the court for reimbursement of reasonable out-of-pocket expenses from any common fund established for the class.

"(4) MEETINGS.—The plaintiff steering committee shall conduct its business at one or more previously scheduled meetings of the committee, of which prior notice shall have been given and at which a majority of its members are present in person or by electronic communication. The plaintiff steering committee shall decide all matters within its authority by a majority vote of all members, except that the committee may determine that decisions other than to accept or reject a settlement offer or to employ or dismiss counsel for the class may be delegated to one or more members of the committee,

or may be voted upon by committee members seriatim, without a meeting.

"(5) RIGHT OF NONMEMBERS TO BE HEARD.—A class member who is not a member of the plaintiff steering committee may appear and be heard by the court on any issue relating to the organization or actions of the plaintiff steering committee.

"(c) FUNCTIONS OF PLAINTIFF STEERING COMMITTEE.—The authority of the plaintiff steering committee to direct counsel for the class shall include all powers normally permitted to an attorney's client in litigation, including the authority to retain or dismiss counsel and to reject offers of settlement, and the preliminary authority to accept an offer of settlement. Dismissal of counsel other than for cause shall not limit the ability of counsel to enforce any contractual fee agreement or to apply to the court for a fee award from any common fund established for the class.

"(d) IMMUNITY FROM CIVIL LIABILITY; REMOVAL.—Any person serving as a member of a plaintiff steering committee shall be immune from any civil liability for any negligence in performing such service, but shall be not be immune from liability for intentional misconduct or from the assessment of costs pursuant to section 20B(c). The

court may remove a member of a plaintiff steering committee for good cause shown.

"(e) EFFECT ON OTHER LAW.—This section does not affect any other provision of law concerning class actions or the authority of the court to give final approval to any offer of settlement.".

(b) FULL DISCLOSURE OF PROPOSED CLASS ACTION SETTLEMENTS.—Section 21 of the Securities Exchange Act of 1934 (15 U.S.C. 78u) is amended by adding at the end the following new subsection:

"(i) DISCLOSURE OF SETTLEMENT TERMS TO CLASS MEMBERS.—In any private action under this title that is certified as a class action pursuant to the Federal Rules of Civil Procedure, a proposed settlement agreement that is published or otherwise disseminated to the class shall include the following statements:

"(1) STATEMENT OF POTENTIAL OUTCOME OF CASE.—

"(A) AGREEMENT ON AMOUNT OF DAMAGES AND LIKELIHOOD OF PREVAILING.—If the settling parties agree on the amount of damages per share that would be recoverable if the plaintiff prevailed on each claim alleged under this title and the likelihood that the plaintiff would prevail—

"(i) a statement concerning the amount of such potential damages; and

"(ii) a statement concerning the probability that the plaintiff would prevail on the claims alleged under this title and a brief explanation of the reasons for that conclusion.

"(B) DISAGREEMENT ON AMOUNT OF DAMAGES OR LIKELIHOOD OF PREVAILING.—If the parties do not agree on the amount of damages per share that would be recoverable if the plaintiff prevailed on each claim alleged under this title or on the likelihood that the plaintiff would prevail on those claims, or both, a statement from each settling party concerning the issue or issues on which the parties disagree.

"(C) INADMISSIBILITY FOR CERTAIN PURPOSES.—Statements made in accordance with subparagraphs (A) and (B) concerning the amount of damages and the likelihood of prevailing shall not be admissible for purposes of any Federal or State judicial or administrative proceeding.

"(2) STATEMENT OF ATTORNEYS' FEES OR COSTS SOUGHT.—If any of the settling parties or

their counsel intend to apply to the court for an award of attorneys' fees or costs from any fund established as part of the settlement, a statement indicating which parties or counsel intend to make such an application, the amount of fees and costs that will be sought (including the amount of such fees and costs determined on a per-share basis, together with the amount of the settlement proposed to be distributed to the parties to suit, determined on a per-share basis), and a brief explanation of the basis for the application. Such information shall be clearly summarized on the cover page of any notice to a party of a proposed or final settlement.

"(3) IDENTIFICATION OF LAWYERS' REPRESENTATIVES.—The name and address of one or more representatives of counsel for the plaintiff class who will be reasonably available to answer written questions from class members concerning any matter contained in any notice of settlement published or otherwise disseminated to class members.

"(4) OTHER INFORMATION.—Such other information as may be required by the court, or by any plaintiff steering committee appointed by the court pursuant to this section.".

(c) PROHIBITION ON ATTORNEYS' FEES PAID FROM COMMISSION DISGORGEMENT FUNDS.—Section 21(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78u(d)) is amended by adding at the end the following new paragraph:

"(4) PROHIBITION ON ATTORNEYS' FEES PAID FROM COMMISSION DISGORGEMENT FUNDS.—Except as otherwise ordered by the court, funds disgorged as the result of an action brought by the Commission in Federal court, or of any Commission administrative action, shall not be distributed as payment for attorneys' fees or expenses incurred by private parties seeking distribution of the disgorged funds.".

SEC. 203. PREVENTION OF ABUSIVE PRACTICES THAT FOMENT LITIGATION.

(a) ADDITIONAL PROVISIONS APPLICABLE TO PRIVATE ACTIONS.—The Securities Exchange Act of 1934 is amended by inserting after section 20A (15 U.S.C. 78t-1) the following new section:

"PROCEDURES APPLICABLE TO PRIVATE ACTIONS

"SEC. 20B.(a) ELIMINATION OF BONUS PAYMENTS TO NAMED PLAINTIFFS IN CLASS ACTIONS.—In any private action under this title that is certified as a class action pursuant to the Federal Rules of Civil Procedure, the portion of any final judgment or of any settlement that is awarded to class plaintiffs serving as the representative

parties shall be equal, on a per share basis, to the portion of the final judgment or settlement awarded to all other members of the class. Nothing in this subsection shall be construed to limit the award to any representative parties of actual expenses (including lost wages) relating to the representation of the class.

"(b) RESTRICTIONS ON PROFESSIONAL PLAINTIFFS.—Except as the court may otherwise permit for good cause, a person may be a named plaintiff, or officer, director, fiduciary, or beneficiary of a named plaintiff, in no more than 5 class actions filed during any 3-year period.

"(c) AWARDS OF FEES AND EXPENSES.—

"(1) AUTHORITY TO AWARD FEES AND EXPENSES.—If the court in any private action arising under this title enters a final judgment against a party litigant on the basis of a motion to dismiss, motion for summary judgment, or a trial on the merits, the court shall, upon motion by the prevailing party, award the prevailing party reasonable fees and other expenses incurred by that party, except that if the losing party establishes that (A) the position of the losing party was substantially justified, (B) imposing such fees and expenses on the losing party or the losing party's attorney would be unjust,

and (C) the cost of such fees and expenses to the prevailing party is not substantially burdensome or unjust, then the court shall not award fees and expenses to the prevailing party. The determination of whether the position of the losing party was substantially justified shall be made on the basis of the record in the civil action for which fees and other expenses are sought, but the burden of persuasion shall be on the losing party.

"(2) SECURITY FOR PAYMENT OF COSTS IN CLASS ACTIONS.—In any private action arising under this title that is certified as a class action pursuant to the Federal Rules of Civil Procedure, the court shall require an undertaking from the plaintiff for the payment of the fees and expenses that may be awarded under paragraph (1). Such undertaking may be required from the plaintiff class, the attorney or attorneys for the plaintiff class, or both, in such proportions and at such times as the court determines are just and equitable.

"(3) APPLICATION FOR FEES.—A party seeking an award of fees and other expenses shall, within 30 days of a final, nonappealable judgment in the action, submit to the court an application for fees and other expenses that verifies that the party is entitled

to such an award under paragraph (1) and the amount sought, including an itemized statement from any attorney or expert witness representing or appearing on behalf of the party stating the actual time expended and the rate at which fees and other expenses are computed.

"(4) ALLOCATION AND SIZE OF AWARD.—The court, in its discretion, may—

"(A) determine whether the amount to be awarded pursuant to this section shall be awarded against the unsuccessful party, its attorney, or both; and

"(B) reduce the amount to be awarded pursuant to this section, or deny an award, to the extent that the prevailing party during the course of the proceedings engaged in conduct that unduly and unreasonably protracted the final resolution of the matter in controversy.

"(5) AWARDS IN DISCOVERY PROCEEDINGS.—In adjudicating any motion for an order compelling discovery or any motion for a protective order made in any private action arising under this title, the court shall award the prevailing party reasonable fees and other expenses incurred by the party in bringing or defending against the motion, including

reasonable attorney fees, unless the court finds that special circumstances make an award unjust.

"(6) RULE OF CONSTRUCTION.—Nothing in this subsection shall be construed to limit or impair the discretion of the court to award costs pursuant to other provisions of law.

"(7) PROTECTION AGAINST ABUSE OF PROCESS.—In any action to which this subsection applies, a court shall not permit a plaintiff to withdraw from or voluntarily dismiss such action if the court determines that such withdrawal or dismissal is taken for purposes of evasion of the requirements of this subsection.

"(8) DEFINITIONS.—For purposes of this subsection—

"(A) The term 'fees and other expenses' includes the reasonable expenses of expert witnesses, the reasonable cost of any study, analysis, report, test, or project which is found by the court to be necessary for the preparation of the party's case, and reasonable attorney fees and expenses. The amount of fees awarded under this section shall be based upon prevailing market rates for the kind and quality of services furnished.

"(B) The term 'substantially justified' shall have the same meaning as in section 2412(d)(1) of title 28, United States Code.

"(d) PREVENTION OF ABUSIVE CONFLICTS OF INTEREST.—In any private action under this title pursuant to a complaint seeking damages on behalf of a class, if a plaintiff is represented by an attorney who directly owns or otherwise has a beneficial interest in the securities that are the subject of the litigation, the court shall, on motion by any party, make a determination of whether such interest constitutes a conflict of interest sufficient to disqualify the attorney from representing the plaintiff.

"(e) ENCOURAGEMENT OF FINALITY IN SETTLEMENT DISCHARGES.—

"(1) DISCHARGE.—A defendant who settles any private action brought under this title at any time before verdict or judgment shall be discharged from all claims for contribution brought by other persons with respect to the matters that are the subject of such action. Upon entry of the settlement by the court, the court shall enter a bar order constituting the final discharge of all obligations to the plaintiff of the settling defendant arising out of the action. The order shall bar all future claims for contribution or indemnity arising out of the action—

"(A) by nonsettling persons against the settling defendant; and

"(B) by the settling defendant against any nonsettling defendants.

"(2) REDUCTION.—If a person enters into a settlement with the plaintiff prior to verdict or judgment, the verdict or judgment shall be reduced by the greater of—

"(A) an amount that corresponds to the degree of responsibility of that person; or

"(B) the amount paid to the plaintiff by that person.

"(f) CONTRIBUTION FROM NON-PARTIES IN INTERESTS OF FAIRNESS.—

"(1) RIGHT OF CONTRIBUTION.—A person who becomes liable for damages in any private action under this title (other than an action under section 9(e) or 18(a)) may recover contribution from any other person who, if joined in the original suit, would have been liable for the same damages.

"(2) STATUTE OF LIMITATIONS FOR CONTRIBUTION.—Once judgment has been entered in any private action under this title determining liability, an action for contribution must be brought not later

than 6 months after the entry of a final, nonappealable judgment in the action.

"(g) DEFENDANT'S RIGHT TO SPECIAL VERDICTS ESTABLISHING SCIENTER.—In any private action under this title in which the plaintiff may recover money damages, the court shall, when requested by a defendant, submit to the jury a written interrogatory on the issue of each such defendant's state of mind at the time the alleged violation occurred.".

(b) PROHIBITION OF REFERRAL FEES THAT FOMENT LITIGATION.—Section 15(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78*o*(c)) is amended by adding at the end the following new paragraph:

"(8) RECEIPT OF REFERRAL FEES.—No broker or dealer, or person associated with a broker or dealer, may solicit or accept remuneration for assisting an attorney in obtaining the representation of any customer in any private action under this title.".

SEC. 204. PREVENTION OF "FISHING EXPEDITION" LAWSUITS.

The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by inserting after section 10 the following new section:

"SEC. 10A. REQUIREMENTS FOR SECURITIES FRAUD ACTIONS.

"(a) SCIENTER.—

"(1) IN GENERAL.—In any private action arising under this title based on a misstatement or omission of a material fact, liability may not be established unless the defendant possessed the intent to deceive, manipulate, or defraud. The defendant may be found to have acted with such intent only on proof that—

"(A) the defendant directly or indirectly made a fraudulent statement;

"(B) the defendant possessed the intention to deceive, manipulate, or defraud; and

"(C) the defendant made such fraudulent statement knowingly or recklessly.

"(2) FRAUDULENT STATEMENT.—For purposes of paragraph (1), a fraudulent statement is a statement that contains an untrue statement of a material fact, or omits a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading.

"(3) KNOWINGLY.—For purposes of paragraph (1), a defendant makes a fraudulent statement knowingly if the defendant knew that the statement

of a material fact was misleading at the time it was made, or knew that an omitted fact was necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading.

"(4) RECKLESSNESS.—For purposes of paragraph (1), a defendant makes a fraudulent statement recklessly if the defendant, in making such statement, acted with willful blindness such that the defendant was consciously aware of a high probability that the statement was false, and took deliberate actions in order to avoid ascertaining its truth or falsity. A defendant who actually believed the statement was true is not reckless.

"(b) REQUIREMENT FOR EXPLICIT PLEADING AND PROOF OF SCIENTER.—In any private action to which subsection (a) applies, the complaint shall specify each statement or omission alleged to have been misleading, and the reasons the statement or omission is misleading. The complaint shall also make specific allegations which, if true, would be sufficient to establish scienter as to each defendant at the time the alleged violation occurred. It shall not be sufficient for this purpose to plead the mere presence of facts inconsistent with a statement or omission alleged to have been misleading. If an allegation is made

on information and belief, the complaint shall set forth with specificity all information on which that belief is formed.

"(c) DISMISSAL FOR FAILURE TO MEET PLEADING REQUIREMENTS; STAY OF DISCOVERY; SUMMARY JUDGMENT.—In any private action to which subsection (a) applies, the court shall, on the motion of any defendant, dismiss the complaint if the requirements of subsection (b) are not met; *provided,* that the court may, in its discretion, permit a single amended complaint to be filed. During the pendency of any such motion to dismiss, all discovery and other proceedings shall be stayed unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party. If a complaint satisfies the requirements of subsection (b), the plaintiff shall be entitled to conduct discovery limited to the facts concerning the allegedly misleading statement or omission. Upon completion of such discovery, the parties may move for summary judgment.

"(d) RELIANCE AND CAUSATION.—

"(1) IN GENERAL.—In any private action to which subsection (a) applies, the plaintiff shall prove that—

"(A) he or she had knowledge of, and relied (in connection with the purchase or sale of a security) on, the statement that contained the misstatement or omission described in subsection (a)(1); and

"(B) that the statement containing such misstatement or omission proximately caused (through both transaction causation and loss causation) any loss incurred by the plaintiff.

"(2) FRAUD ON THE MARKET.—For purposes of paragraph (1), reliance may be proven by establishing that the market as a whole considered the fraudulent statement, that the price at which the security was purchased or sold reflected the market's estimation of that fraudulent information, and that the plaintiff relied on that market price. Proof that the market as a whole considered the fraudulent statement may consist of evidence that the statement—

"(A) was published in publicly available research reports by analysts of such security;

"(B) was the subject of news articles;

"(C) was delivered orally at public meetings by officers of the issuer, or its agents;

"(D) was specifically considered by rating agencies in their published reports; or

"(E) was otherwise made publicly available to the market in a manner that was likely to bring it to the attention of, and to be considered as credible by, other active participants in the market for such security.

Proof that the market as a whole considered the fraudulent statement may not consist of nonpublic information.

"(3) PRESUMPTION OF RELIANCE.—Upon proof that the market as a whole considered the fraudulent statement pursuant to paragraph (2), the plaintiff is entitled to a rebuttable presumption that the price at which the security was purchased or sold reflected the market's estimation of that fraudulent statement and that the plaintiff relied on such market price. This presumption may be rebutted by evidence that—

"(A) the market as a whole considered other information that corrected the allegedly fraudulent statement; or

"(B) the plaintiff possessed such corrective information prior to the purchase or sale of the security.

"(4) ISSUERS WITH ILLIQUID MARKETS.—

"(A) RELIANCE ON MARKET NOT PERMITTED.—A plaintiff who bought or sold a security for which it is unreasonable to rely on market price to reflect all current information may not establish reliance pursuant to paragraph (2). Such reliance shall be considered to be unreasonable if—

"(i) during a period of at least 24 months immediately preceding the date of the plaintiff's purchase or sale of the security, the issuer (I) has not had an issue of securities registered pursuant to section 12 of this title, and (II) has not been subject to the requirements of section 15(d) of this title;

"(ii) the monthly trading volume of the security purchased or sold by the plaintiff for any of the 24 months preceding such purchase or sale was less than 500,000 shares; or

"(iii) the average aggregate market value of the voting securities held by nonaffiliated persons of the issuer was less

than $400,000,000 for any one of the 24 months preceding such purchase or sale.

"(B) DEFINITIONS; ADJUSTMENTS.—For purposes of this paragraph—

"(i) the term 'issuer' means the issuer of the securities that are the subject of the plaintiff's complaint;

"(ii) aggregate market value as of any date shall be computed on the basis of the price at which the security last sold on such date, or the average of the bid and asked price at closing on such date; and

"(iii) the Commission may by rule adjust the dollar amount specified in subparagraph (A)(iii) as necessary to reflect inflation.

"(e) ALLOCATION OF LIABILITY.—

"(1) JOINT AND SEVERAL LIABILITY FOR KNOWING FRAUD.—A defendant who is found liable for damages in a private action to which subsection (a) applies may be liable jointly and severally only if the trier of fact specifically determines that the defendant acted knowingly (as defined in subsection (a)(3)).

"(2) PROPORTIONATE LIABILITY FOR RECKLESSNESS.—If the trier of fact does not make the findings required by paragraph (1) for joint and several liability, a defendant's liability in a private action to which subsection (a) applies shall be determined under paragraph (3) of this subsection only if the trier of fact specifically determines that the defendant acted recklessly (as defined in subsection (a)(4)).

"(3) DETERMINATION OF PROPORTIONATE LIABILITY.—If the trier of fact makes the findings required by paragraph (2), the defendant's liability shall be determined as follows:

"(A) The trier of fact shall determine the percentage of responsibility of the plaintiff, of each of the defendants, and of each of the other persons or entities alleged by the parties to have caused or contributed to the harm alleged by the plaintiff. In determining the percentages of responsibility, the trier of fact shall consider both the nature of the conduct of each person and the nature and extent of the causal relationship between that conduct and the damage claimed by the plaintiff.

"(B) For each defendant, the trier of fact shall then multiply the defendant's percentage of responsibility by the total amount of damage suffered by the plaintiff that was caused in whole or in part by that defendant and the court shall enter a verdict or judgment against the defendant in that amount. No defendant whose liability is determined under this subsection shall be jointly liable on any judgment entered against any other party to the action.

"(C) Except where contractual relationship permits, no defendant whose liability is determined under this paragraph shall have a right to recover any portion of the judgment entered against such defendant from another defendant.

"(4) EFFECT OF PROVISION.—This subsection relates only to the allocation of damages among defendants. Nothing in this subsection shall affect the standards for liability under any implied private action arising under a provision of this title.

"(f) DAMAGES.—In a private action arising under this title based upon a misstatement or omission of a material fact concerning a security, and in which the plaintiff claims to have bought or sold the security based on a reasonable belief that the market value of the security re-

flected all publicly available information, the plaintiff's damages shall not exceed the lesser of—

"(1) the difference between the price paid by the plaintiff for the security and the market value of the security immediately after dissemination to the market of information which corrects the misstatement or omission; and

"(2) the difference between the price paid by the plaintiff for the security and the price at which the plaintiff sold the security after dissemination of information correcting the misstatement or omission.".

SEC. 205. ESTABLISHMENT OF "SAFE HARBOR" FOR PREDICTIVE STATEMENTS.

The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by adding at the end the following new section:

"SEC. 37. APPLICATION OF SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS.

"(a) SAFE HARBOR DEFINED.—In any action arising under this title based on a misstatement or omission of a material fact, a person shall not be liable for the publication of any forward-looking information if—

"(1) that portion of such information expressly identified as the basis for any projections is not in-

accurate as of the date of publication, determined without benefit of subsequently available information or information not known to such person at such date; and

"(2) the basis for any projections is briefly described therein, with general citations only to representative sources or authority, and a disclaimer is made to alert persons for whom such information is intended that the projections should not be given any more weight than the described basis therefor would reasonably justify.

"(b) AUTOMATIC PROTECTIVE ORDER STAYING DISCOVERY; EXPEDITED PROCEDURE.—In any action arising under this title, based in whole or in part upon an allegation of a misstatement or omission of a material fact in a party's publication of forward-looking information, such party may, at any time beginning after the filing of the complaint and ending 10 days after the filing of such party's answer to the complaint, move to obtain an automatic protective order under the safe harbor procedures of this section. Upon such motion, the protective order shall issue forthwith to stay all discovery as to the moving party, except that which is directed to the specific issue of the applicability of the safe harbor. A hearing on the applicability of the safe harbor shall be conducted within 45 days

of the issuance of such protective order. At the conclusion of the hearing, the court shall either (1) dismiss the portion of the action based upon the use of forward-looking information, or (2) determine that the safe harbor is unavailable in the circumstances.

"(c) REGULATORY AUTHORITY.—In consultation with investors and issuers of securities, the Commission shall adopt rules and regulations to facilitate the safe harbor provisions of this section. Such rules and regulations shall—

"(1) include clear and objective guidance that the Commission finds sufficient for the protection of investors,

"(2) prescribe such guidance with sufficient particularity that compliance shall be readily ascertainable by issuers prior to issuance of securities, and

"(3) provide that forward-looking statements that are in compliance with such guidance and that concern the future economic performance of an issuer of securities registered under section 12 of this title will be deemed not to be in violation of section 10(b) of this title.".

SEC. 206. RULE OF CONSTRUCTION.

Nothing in the amendments made by this title shall be deemed to create or ratify any implied private right of action, or to prevent the Commission by rule from restricting or otherwise regulating private actions under the Securities Exchange Act of 1934.

SEC. 207. EFFECTIVE DATE.

This title and the amendments made by this title are effective on the date of enactment of this Act and shall apply to cases commenced after such date of enactment.

Federal Judicial Center
Research Division

memorandum

TO: Advisory Committee on Civil Rules and Invitees to February 16-17 Meeting

FROM: Tom Willging

SUBJECT: Preliminary Report on Time Study Class Actions

DATE: February 9, 1995

I have enclosed a copy of our Preliminary Report on Time Study Class Actions. This is the material referenced in Agenda item I(E) in the materials for the February 16-17 meeting at the University of Pennsylvania. This preliminary report represents an opportunity to preview the type of data that will be available from the Center's field study. We welcome any suggestions you may have for modifying this report or for approaches to take in future reports.

Laural, Bob and I look forward to seeing you in Philadelphia.

Attachment

Federal Judicial Center
Research Division

memorandum

DATE: February 9, 1995
TO: Advisory Committee On Civil Rules
FROM: Thomas E. Willging, Laural L. Hooper, and Robert J. Niemic[1]
SUBJECT: Preliminary Report On Time Study Class Action Cases

I. Summary and Highlights

A random national sample of 8,320 civil cases filed between November 1987 and January 1990 in 86 federal district courts included 51 cases involving class action allegations in the complaint or judicial action in response to class action activity. The incidence of class actions was 61 class actions per 10,000 cases. The following data highlight the results of examining the documents and docket sheets in those 51 cases.

- Data reported to the Administrative Office of the U. S. Courts ("AO Data") included only 71% of those cases, indicating an undercount of class action activity. These data and data from other sources,[2] to be reported in detail to the Committee in April 1995, indicate that there are no reliable national data on class action activity in the federal courts.
- Securities cases represented the single largest type of case (24%; 12 cases) followed by three types of civil rights cases—(Prisoner (16%; eight cases), Other Civil Rights (14%; seven cases), and Employment (6%; three

---

[1] The authors received substantial assistance from George Cort, William Eldridge, David Ferro, Scott Gilbert, Jane Ganz Heinrich, Julie Hong, Patricia Lombard, John Shapard, Charles Sutelan, Elizabeth Wiggins, Carol Witcher, and other members of the Research Division staff.

[2] Data from the Center's field study trips to the Eastern District of Pennsylvania show that only 38 (28%) of the 137 class actions that had been terminated in that district between July 1, 1992 and June 30, 1994 were included in the AO data. The field study research team identified the other 99 cases (72%) with the aid of various searches of the electronic docketing system by court personnel.

cases)—that accounted for more than one out of three class action filings (Figure 1, p.7).

- Almost all class action cases were based on federal question jurisdiction and were filed as original proceedings in federal court. Only two cases asserted diversity of citizenship as the basis for jurisdiction and three cases were removed from state courts (p. 7).
- The largest numbers of filings were in district courts in the 5th and 11th circuits, accounting for 35% of the total; there were no class action filings for the D.C., 1st, and 10th circuits in the sample (Figure 2, p. 8).
- Of the 51 cases, 25 had motions filed (23) or sua sponte orders issued (2) to certify a class (p. 8). Sixty-four percent of the motions/orders were filed within 100 days of the filing of the complaint (Figure 3, p. 9). Of the 25 motions/orders, 11 classes were certified, 8 were denied certification, 2 rulings explicitly deferred the certification decision, and 4 had no certification action indicated before case closing (Figure 5, p. 13).
- All motions sought certification of plaintiffs' classes. Plaintiffs most frequently sought and obtained certification of (b)(3) (opt-out) classes (7 obtained out of 13 sought: 54%) and (b)(2)(injunctive relief) classes (3 obtained out of 8 sought: 38%) (Table 1, p. 10). No (b)(1) class was certified. One class was certified after the parties had proposed a settlement (pp. 9-10).
- The majority (65%) of motions for class certification were opposed but the opposition rarely focused on the type of class to be certified (Table 2, p. 11). In two cases the judge's ruling involved extensive discussion of the type of class to be certified. Most of the arguments centered on typicality, commonality, and representativeness. Numerosity was infrequently contested (Figure 4, p. 12).
- The average amount of judicial time spent on certification rulings was about 5 hours (Table 3, p. 14). Most rulings consisted of a single page but some were as long as 25 to 35 pages. The average ruling was approximately 8 pages (p. 13).
- Motions to dismiss were frequently filed and ruled on before there was a ruling on class certification (Table 4, p. 15). In ten cases the rulings

dismissed the entire complaint (Table 5, p. 16). Motions for summary judgment were also filed and granted in six cases where there was no ruling on class certification (Tables 6, 7, pp. 16-17). The average amount of judge time spent ruling on these motions was approximately six to seven hours (Table 8, p. 17).

- Cases with a certified class had an average case life of approximately three years, compared to approximately two and a quarter years for a case denied certification, approximately one and a quarter years for a case in which there was no ruling on certification, and less than one year for a non-class action time study case (Table 9, p. 19). As measured by the number of docket entries, the amount of activity in certified class actions was almost three times that of cases that were not certified and about seven times that of cases with no certification ruling (Table 10, p. 20).
- In all certified cases—including two exclusively (b)(2) actions—notice was communicated to the class. In almost all of the (b)(3) actions, notice was given through individual mailings. In about half of those cases, notice was also communicated by publication in one or more newspapers (p. 20).
- Cases with certified classes settled more often (82%) than cases that were not certified (50%) (Table 11, p. 22). For all certified class actions that were settled, notice was sent of the proposed settlement, including the time and place of the hearing on settlement approval. Notices stated the estimated size of the class in two of five cases for which we had information. Otherwise, notices generally included information about the total amount of the settlement, the procedures for opting into or out of the class, the plan of distribution, and any equitable relief (Table 12, p. 23).
- Hearings on class settlements were held in seven cases; settlement rulings with a average length of approximately fourteen pages were issued (p. 23). Judges spent an average of about four hours in ruling on settlements in certified class actions. All but one of the proposed settlements that had been acted on were approved without changes; the one exception was approved with changes (pp. 23).
- Information about settlements funds established and distributed to class members was available in seven cases (Figure 6, p. 24). In five of those

seven cases, proceeds were distributed to members who filed claims and in the other two cases proceeds went to all class members who did not opt- out (p. 25). Generally the shares of the settlement were determined by consensual methods, typically involving counsel's application of a legal formula to the claims (Table 13, p. 25).

- In five cases for which information was available, attorneys' fees ranged from 14% to 45% of the settlement amounts, with higher percentages for the smaller settlements and smaller percentages for the two largest settlements (Table 14, p. 25).
- In seven cases, information was available about a court's action on a fee request. In all seven, the court awarded the full amount of the request (Table 15, p. 26).
- Bench trials were held in two cases, neither of which had been certified as a class action. Each resulted in a judgment for the defendant (p. 27).
- Appeals were filed in seven cases, mostly by class plaintiffs. Of the four for which information was available, none was successful (p. 28).
- Overall, records of judge time spent on class actions indicate that, on average, class actions demand more time than any type of civil case except death penalty habeas corpus cases. Certified class actions require, on average, about 34 hours of judicial time while cases that are not certified require, on average, about 6 hours (Table 16, p. 29).

II. Overview and Statistical Profile

A National Sample. In the Federal Judicial Center's District Court Time Study, district and magistrate judges maintained records of the time they spent on a random sample of 8,320 civil cases filed in 86 United States District Courts between November 1987 and January 1990. Fifty-one of those cases (0.61%, an incidence of 61 class actions for every 10,000 cases filed) contained class action allegations (hereafter "class actions"). A case was defined as a class action either by reference to the case statistics maintained by the Administrative Office (AO) (36; 71%) or, where there was no class action indicator in the AO statistics, to

class action activity in a judge's time records (15; 29%).[3] Those data lead us to conclude that information on class actions reported to the AO substantially undercounted class action activity during the time study period. Data from the field study accentuate this finding[4] and lead us to conclude that there are no reliable national data on class action activity in the federal courts.

For all 51 cases, we reviewed docket sheets and pleadings, documents, briefs, and orders relating to the class issues. We generally examined rulings on motions to dismiss and summary judgment, all briefs and orders relating to class certification, filings relating to notice and approval of settlement, and applications for attorneys' fees. In this report we will describe the major characteristics of those cases and examine them in relation to issues raised by the Advisory Committee at the outset of the FJC's Class Action Project.

Before presenting the data, it is important to call attention to their limits. Though informative and national in scope, the time study class action data need to be used with caution. In many instances, information on important class action activity was available only for two or three cases, which should be viewed simply as examples not to be generalized to the universe of class action activity. The time study data should be read as descriptive of a small national random sample of class actions. The data are certainly more than anecdotal evidence. However, the data are certainly not generalizable to a universe of class action activity.[5]

Relationship to the Field Study. The presentation in this preliminary report parallels the analysis we plan to present for class actions in the current FJC field study. There are, however, several major differences in the data. First, the time study records represent the only national data that we will be able to present to the Committee.[6] The preliminary field study report we will present to the

---

[3] One case identified in the AO data as a class action had no indication on the docket sheet or in the documents in the file that any class action allegations were involved. That case was eliminated from the sample discussed in this report.

[4] See note 2, *supra.*

[5] The time study data as a whole, of course, are fully suitable to their intended purpose of assigning case weights to various types of cases that were observed with much greater frequency than class actions. There is no separate case weight for class actions.

[6] Problems in gathering national data are described in the January 19, 1995 memorandum to the Advisory Committee from Thomas E. Willging.

Committee in April will focus on recent class action activity in N. D. Cal. and E. D. Pa. Later we expect to report on activity in N. D. Ill. and S. D. Fla.

Second, the number of cases in the time study is relatively small and will preclude discussion of some events in the class action process that occur infrequently. In the field study, we will examine a larger sample of cases within the four districts selected for the study and will be able to discuss some of these less frequent events.

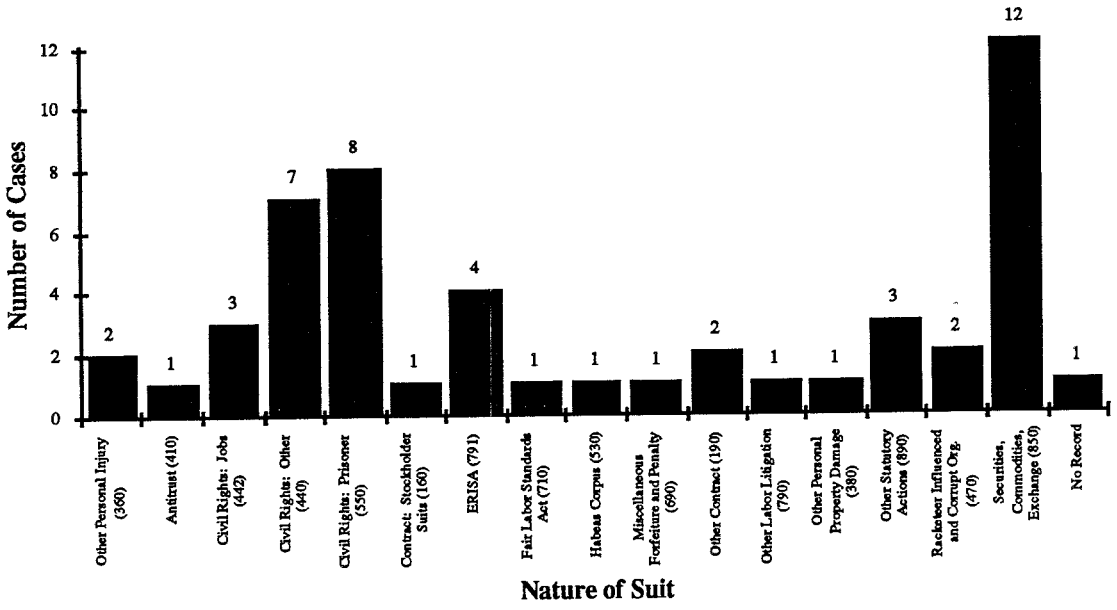
Third, the field study will include more complete records on the mechanics of the class action process (e.g., notices to the class and attorneys' fee requests) because, by visiting the district courts, we have full access to court records. In the time study, our review has been limited to documents that could be identified from the docket sheets and photocopied without imposing an excessive burden on the courts.

Finally, in the field study there are no judicial time records for the cases. Thus, the time study cases represent a unique opportunity to look at the judicial time required for various aspects of class actions.

Incidence of class action activity. The time study data suggest that the filing of a class action in federal court is a relatively rare event, occurring approximately 61 times per 10,000 cases. Certified class actions are even more rare, occurring 11 times in the sample, an incidence of 13 times per 10,000.

Types of cases. In the time study, as Figure 1 shows, securities cases represented the single largest type of case (24%; twelve cases). Civil rights cases of various types—Prisoner (16%; eight cases), Other Civil Rights (14%; seven cases), and Employment (6%; three cases)—accounted for more than one out of three class action filings. ERISA (8%; four cases) and Other Federal Statutory Actions (6%; three cases) were the only other types with more than two cases in the sample.

Figure 1
Nature of Suit for Time Study Class Actions, 1987 - 1990 (N=51)



Source: FJC Time Study

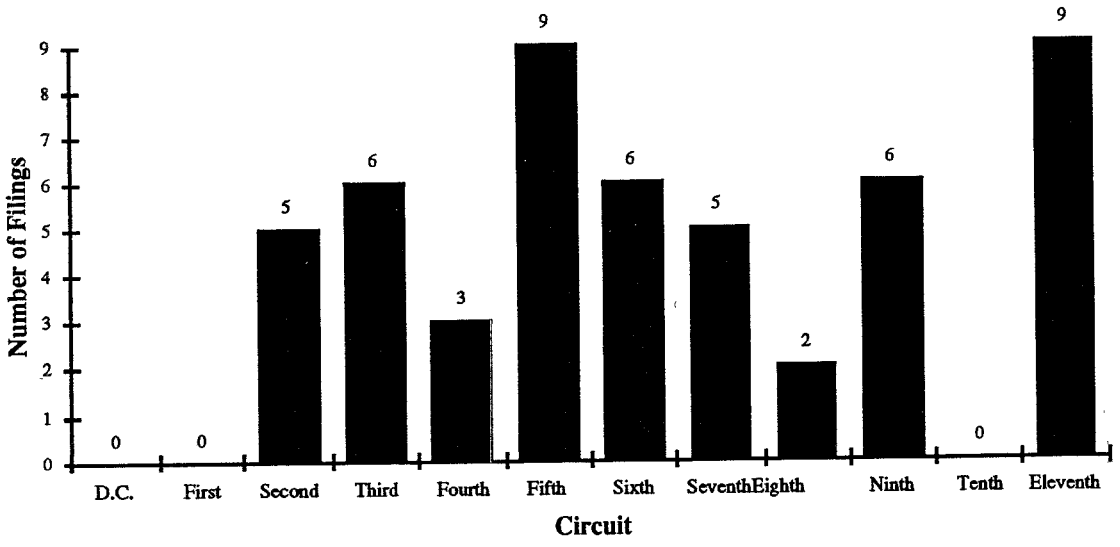
Bases of jurisdiction and origin of cases. Almost all of the cases (90%; 46 cases) invoked federal question jurisdiction. Only two cases invoked diversity of citizenship, reflecting, perhaps, the strict jurisdictional requirements for such cases. In addition, almost all of the cases (92%; 47 cases) were filed in the federal courts at the outset; only three cases were removed from state courts.

Distribution among circuits.[7] District courts in the 5th and 11th circuits accounted for 35% of the class action filings (Figure 2). Three circuits had no class action filings during the sample period in the district courts within their jurisdiction and two other circuits had only 10% of the filings. This limited sample suggests that the distribution of class action activity across the circuits

[7] The distribution of filing among the district courts cannot be addressed because the number of time study cases is too small to present a reliable picture of activity among the districts. Because there were more districts (86) than class action cases (51) in the time study, most districts did not have a single case filed during the two week sampling period for each court. Two weeks' filings represent approximately 4% of the total annual caseload for a district. For example, a district with 1,000 cases per year would be expected, on average, to have about 40 cases in the time study. At a national incidence rate of 61 class actions per 10,000 cases, the average district would have less than one class action in a given year.

may warrant further research to determine if there is any pattern and, if so, to identify factors that might account for any differences. Such factors might include the class action jurisprudence of the circuit, the local legal culture, or the specialization of the bar.

Figure 2
Filings of Class Actions by Circuits in Which the Districts Are Located, Time Study Class Actions, 1987 - 1990 (N=51)



Source: FJC Time Study

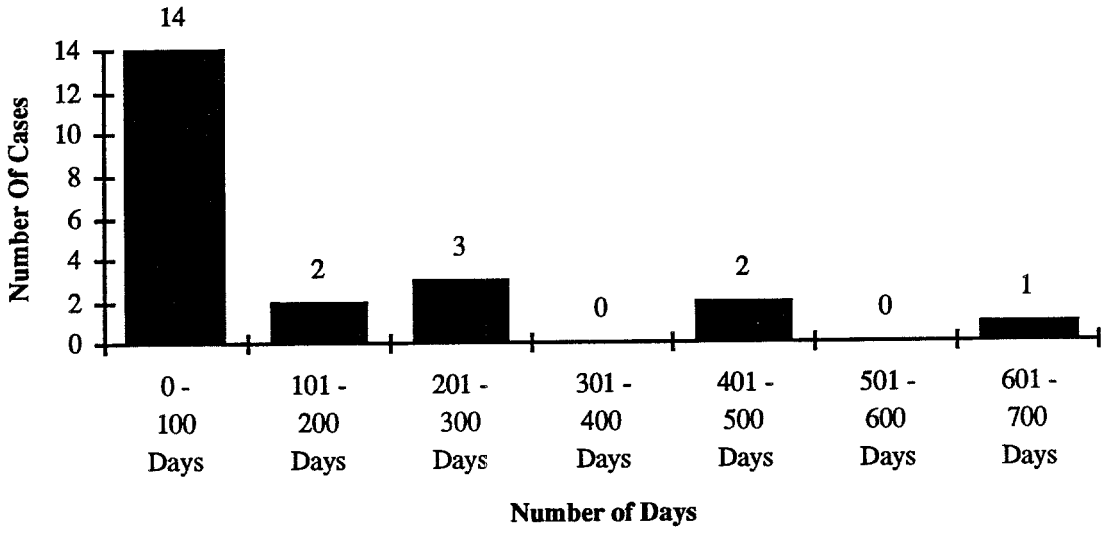
III. The Certification Process

Certification motions and sua sponte orders. In 23 (45%) of the 51 cases a motion to certify a class action was filed and in another two cases (4%) the judge issued a sua sponte order regarding class certification. The motions were filed an average of 139 days after the complaint was filed; the sua sponte orders were issued an average of 180 days after the complaint. All 23 motions were motions by plaintiffs to certify a plaintiffs' class. The data did not include any case with a motion filed—or a sua sponte order issued—to certify a defendants' class.

Timing of motions. F. R. Civ. P. 23 (c) (1) directs a district court to determine whether an action is to be maintained as a class action "as soon as practicable after the commencement" of the case. Some jurisdictions, for example, the Eastern District of Pennsylvania, have adopted a local rule requiring the filing of

such motions within 90 days after filing of the complaint. As Figure 3 shows, 14 of the 22 cases (64%) had certification motions filed within 100 days of the commencement of the action. The median number of days is 77.

Figure 3
Days from Filing of Complaint to Filing of Motion to Certify a Class, Time Study Class Actions, 1987 - 1990 (N=22)*



Source: Unless otherwise indicated all subsequent figures and tables are based on data collected for the FJC Class Action Project. * Missing data = 1

Type of class. As Table 1 shows, plaintiffs most frequently sought and obtained certification of (b)(3) (opt-out) classes (7 obtained out of 13 sought: 54%)[8] and (b)(2)(injunctive relief) classes (3 obtained out of 8 sought: 38%). One case was certified under both (b)(2) and (b)(3). In three cases plaintiffs sought certification of a mandatory class under subsection (b)(1)(A) (one case) or (b)(1)(B) (two cases) but the courts certified none.

Settlement classes. In only one of the 25 cases involving certification motions or orders did the documents or docket entries indicate that a proposed

[8] Presumably the seven cases in which the type of class was not specified were also (b)(3) actions because the proponent of a mandatory class generally is held to a stricter burden of proof than the proponent of an opt-out class and would have addressed the special criteria of (b)(1) and (b)(2) classes in a way that should have been clear to the person reviewing the file.

settlement was submitted to the court before or simultaneously with the first motion to certify a class.

Table 1
Type of Class Sought and Approved,
Time Study Class Actions, 1987 - 1990 (N=25)*

Type of Class	Discussed in Motion or Order	Certified by the Court
Rule 23(b)(1)(A)	1	0
Rule 23(b)(1)(B)	2	0
Rule 23(b)(2)	8	3
Rule 23(b)(3)	13	7
Type Not Specified	7	2

*** Some cases included discussion of more than one type of class in the motion, order, or ruling.**

Opposition to certification. There was opposition to 15 of 25 (65%)[9] motions or orders regarding class certification. In the 12 cases for which data were available, the length of the opposition briefs averaged 45 pages, with a median length of 41 pages. For the 19 cases for which information was available, the briefs supporting certification averaged 25 pages, with a median length of 13 pages. Some of the briefs were in support of motions that were not opposed.

Arguments about class type. A central feature of the draft revision of Rule 23 circulated in January, 1993 is the amalgamation of the current subdivisions (b)(1), (2), and (3). A major consequence of the proposed change is that the judge would no longer have to decide which type of class fits the litigation. To learn more about this phenomenon, we examined the extent to which the parties and the courts address the issue of the type of class. As Table 2 indicates, in about half of the instances for which information was available did the parties' arguments address whether one type of class or another should be certified. In six of the seven cases where the parties argued about the type of class, the portion of the briefs devoted to such arguments was less than 25% of the size of the briefs.

[9] Information on opposition to certification is not available for 2 of the 25 cases in which certification motions or orders were filed.

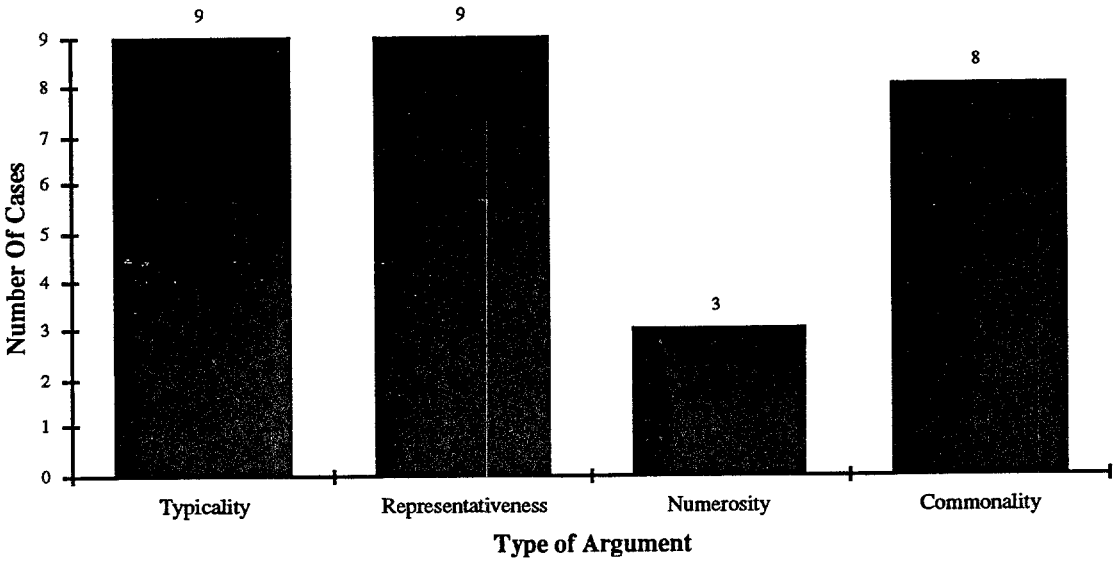
How did the courts respond to arguments about class type? Table 2 shows that of the 21 rulings for which information was available, 8 (38%) addressed the type of class to be certified. Of those 8 rulings, 2 devoted 50-74% of the opinion to the class-type issue; 6 devoted less than 25%.

Table 2
Extent of Arguments About Type of Class
Time Study Class Actions, 1987 - 1990

Extent of Argument or Discussion Directed at Class Type	In Briefs (N=15)	In Rulings (N=21)
100%	0	0
75 - 99%	0	0
50 - 74%	1	2
25 - 49%	0	0
1 - 24%	6	6
None	8	13

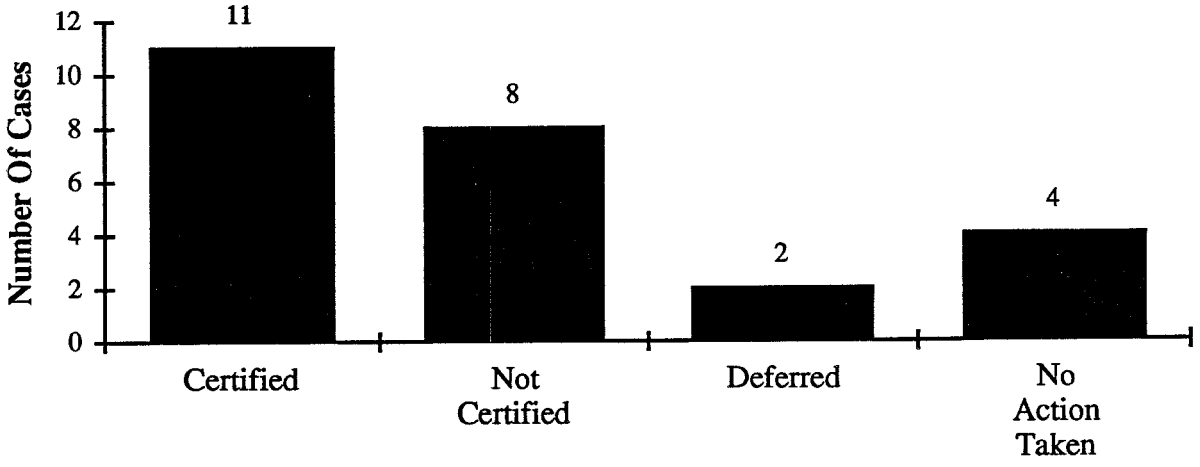
Other arguments. Most of the contested cases included arguments about three of the four traditional F. R. Civ. P. 23(a) issues: typicality, representativeness, and commonality, as shown by Figure 4. Arguments about the other traditional issue, the size of the class (numerosity), occurred in three (20%) of the fifteen contested motions. In many cases, there appeared to be little basis for arguing that the class was not large enough. The plaintiffs' most frequent estimate of the class size was that there were "thousands" of members. In the five cases in which the court referred to class size in its ruling, the most frequent references were in the thousands and the smallest size was 100.

Figure 4
Arguments Raised in Opposition to Class Certification Time Study Class Actions, 1987 - 1990 (N=15)



Outcome. As Figure 5 shows, of the 25 cases in which certification motions or sua sponte orders were filed, eleven were ultimately certified as class actions, eight were denied certification, and two were expressly deferred. In five cases no action was taken with regard to certification. In three cases motions to reconsider were filed, and, in one instance, the court reversed its decision to certify a class.

Figure 5
Outcome of Motions/Orders
Re Class Certification
Time Study Class Actions, 1987 -1990 (N=25)



Judge time and length of rulings. In the 20 cases for which information on the length of the certification ruling was available, the length ranged from 1 page (ten cases) to 35 pages (one case). The length includes the order and any related memorandum opinion. The average length was 8 pages, but most rulings consisted of 1 page. In the 18 cases for which time records were available, judges spent about 5 hours, on average, per certification ruling (Table 3). The median was 2 hours in a range from 2 minutes to 28 hours. Recall from Table 2 that only two cases involved extensive ruling addressing the type of class to be certified. One of those cases consumed 4 hours and 45 minutes of the judge's time; the other consumed 20 minutes.

Table 3
Judicial Hours Spent on Certification Rulings
Time Study Class Actions, 1987 - 1990 (N=18)

	Class Certified (N=9)	Class Not Certified (N=9)	All Rulings (N=18)
Mean	9	2	5
Median	4	1	2
Minimum	less than 1	less than 1	less than 1
Maximum	28	5	28

Source: FJC Integrated Data Base and Class Action Project

IV. Relationships among Motions for Certification and Motions to Dismiss or for Summary Judgment

The proposed amendment to Rule 23 that the Advisory Committee on Civil Rules circulated in January, 1993 contained a new provision in § 23(d)(1)(B) authorizing a court to "decide a motion under Rule 12 or 56 before the certification determination if the court concludes that the decision will promote the fair and efficient adjudication of the controversy and will not cause undue delay." At the outset of the class action research project, the Advisory Committee's Research Subcommittee indicated an interest in learning how courts treat Rule 12 and 56 motions under the current rule. The time study data shed light on this issue.

Motions to dismiss. Among the 51 class action cases in the time study, 10 included a ruling on a motion to dismiss as well as a ruling on a motion to certify a class. Five of the rulings on dismissal motions were issued before the ruling on class certification and five were issued after the certification ruling. In addition, judges ruled on nine motions to dismiss in cases where they had not ruled on class certification. Table 4 presents the outcomes of rulings on motions to dismiss, grouped according to their relationship to certification rulings.

Table 4
Timing and Outcome of Motions to Dismiss
In Relation to Timing of Class Certification Motions
Time Study Class Actions, 1987 - 1990 (N=19)

Outcome	Motion to Dismiss Ruling Before Certification Ruling (N=5)	Motion to Dismiss Ruling After Certification Ruling (N=5)	No Ruling on Certification (N=9)
Dismissed the entire complaint	0	3	7
Dismissed one or more claims for relief but not entire complaint	2	1	1
Denied the motion	3	1	1
Deferred action	0	0	0
Total	5	5	9

While the numbers are too small to permit any general inferences, it is clear that a few courts have not felt constrained to rule on class certification before addressing a motion to dismiss. In two cases the court dismissed part of the case, and in three cases the court denied a motion to dismiss, all before ruling on a motion to certify a class. At least those courts have not seen themselves as lacking authority to so rule. On the other hand, in three cases a court certified a class but later dismissed the entire complaint, bypassing what would appear in hindsight to have been a more economical way to address proposed class actions that are deficient on the merits.

Next, we look at the relationship between the outcome of motions for class certification and the outcomes of motions to dismiss. Table 5 shows that in none of the six cases where a court certified a class did that court dismiss the complaint in its entirety.

Table 5
Outcomes of Motions to Dismiss
In Relation to Class Certification Outcomes
Time Study Class Actions, 1987 - 1990 (N=19)

Outcome	Class action certified	Class action denied	No Ruling on Class status	Total
Dismissed the entire complaint	0	3	7	10
Dismissed one or more claims for relief but not entire complaint	3	0	1	4
Denied the motion	3	1	1	5
Deferred action	0	0	0	0

F. R. Civ. P. 12(b)(6) was the procedural rule most frequently cited in the motions to dismiss, occurring six times. For those cases, the outcomes were dismissal of the entire complaint in three cases, dismissal in part in two cases, and denial of the entire motion in one case.

Motions for summary judgment. Not surprisingly, a court rarely rules on a motion for summary judgment before ruling on a motion for class certification. In the time study, eight cases had rulings both on motions for summary judgment and on class certification. Seven of the summary judgment rulings came after a class certification ruling. In six additional cases, however, summary judgment was granted without any ruling on class certification. Table 6 shows the outcomes for all summary judgment motions.

Table 6
Outcomes of Motions for Summary Judgment
In Relation to Timing of Class Certification Motions
Time Study Class Actions, 1987 - 1990 (N=19)*

Outcome	Filed Before Certification Ruling	Filed After Certification Ruling	No Ruling on Class status
Granted	0	4	6
Denied	0	3	1
Granted in part, denied in part	1	0	0
No action	0	0	2

***Missing data = 2**

Table 7 shows the outcomes of summary judgment motions in relation to the outcome of the class certification motion. Summary judgment was granted in six cases in which there was no ruling on class certification, in two cases in which classes had been certified, and in two in which certification had been denied.

Table 7
Outcomes of Motions for Summary Judgment
In Relation to Class Certification Outcomes
Time Study Class Actions, 1987 - 1990 (N=19)*

Outcome	Class certified	Certification denied	No Ruling on Class Status
Granted	2	2	6
Denied	3	0	1
Granted in part, denied in part	0	1	0
No action	0	0	2

*Missing data = 2

Judge time. Table 8 presents data on the amount of time the assigned judges spent in ruling on motions to dismiss and on motions for summary judgment. In ruling on motions to dismiss, in the cases for which data are available, judges spent an average of approximately seven hours. The median time was about four hours.

Again for cases for which data were available, judges spent an average of about six hours in ruling on motions for summary judgment. The median time was approximately four hours.

Table 8
Judicial Hours Spent Ruling on Motions to Dismiss
And Motions for Summary Judgment
Time Study Class Actions, 1987 - 1990 (N=22)

Time Spent on Ruling	Motions to Dismiss (N=10)	Motions for Summary Judgment (N=12)
Mean Hours	7	6
Median Hours	4	4
Minimum	less than 1	less than 1
Maximum	32	27

V. Relationship between Class Certification and the Life and Volume of the Litigation

Life of case. Certification of case as a class action would be expected to have a strong correlation with the duration of the litigation and the volume of activity in the case, and it does. Certified class actions have a longer life, by far, than cases that are filed as class actions but not certified. The data cannot tell us, however, whether certification causes the longevity or whether certification itself is a byproduct of or related to some other factors that extend the life of the litigation.

Table 9 shows the mean, median, minimum, and maximum times from filing to termination for all time study cases categorized according to the outcome of a motion to certify a class or the absence of such a motion or order. As expected, there is a noteworthy difference (259 days) between the lifetimes of certified cases and cases in which certification was denied in a written ruling. The largest difference in longevity (616 days), however, is between certified cases and cases in which there was no ruling on certification. Two cases in which the certification decision was deferred had the shortest life span, probably evidencing a decision by a judge to defer ruling on certification because an impending ruling on dismissal might moot the certification issue.

To put the data on class action longevity into perspective, we computed the average time from filling to termination for non-class action time study cases (Table 9, last row). The average for those cases was about a year, more than 100 days less than the average for cases filed as class actions that had no ruling on certification and more than two years less than a certified class action.

Table 9
Days from Filing to Termination By Action on Certification
Time Study Cases(N=7637) and Class Actions (N=50)*, 1987 - 1990

Certification Outcome	Mean (Days)	Median (Days)	Minimum Days from Filing to Termination	Maximum (Days)	Difference (Maximum-Minimum)
Class Certified (N=11)	1088	1247	341	2386	2045
Certification denied (N=8)	829	759	269	1728	1459
No Ruling on Class Status (N=31)	453	306	10	1420	1410
All Class Actions Cases (N=50)*	610	457	10	2386	2376
All Time Study Cases (N=7637)**	350	***	0	2156	2156

Source: FJC Integrated Data Base and Class Action Project * One case is pending ** Except class action cases and cases for which either a filing or a termination date is missing. * Not available**

Volume of activity. Another way to look at the relationship between class certification and the length and complexity of a case is to look at the volume of activity in the litigation. We did so by measuring the number of docket entries in the case. Table 10 shows that the amount of activity in certified class actions is almost three times the amount of activity in cases that were not certified and approximately seven times the amount of activity in cases that had no ruling. This is not to say that class certification causes the added activity. Indeed, it may be that the additional activity represented a prelude to the class certification.

Table 10
Number of Docket Entries By Action on Certification
Time Study Class Actions, 1987 - 1990 (N=51)

Certification Outcome	Mean	Median	Minimum	Maximum
Class Certified (N=11)	196	86	41	988
Certification denied (N=8)	68	52	17	161
No Ruling on Class Status (N=32)	28	20	2	84
All Cases (N=51)	71	35	2	988

Source: FJC Integrated Data Base, Time Study, and Class Action Projects.

VI. Notice to the Class

General. In all 11 certified class actions, notice was communicated to the class at some stage of the proceedings, with notice sent after class certification and prior to settlement in 6 of the 11 cases.

In the two cases that were exclusively (b)(2) classes, notice was given to the class despite the fact that F. R. Civ. P. 23 (c) does not require such notice. In both cases the post-settlement notice was designed to call the class's attention to the terms of the injunction against a governmental agency. Noticing methods included distributing notices to legal services offices and other advocacy groups, posting notices at the affected governmental offices, and mailing notices to individuals, workers, and organizations likely to have contact with class members.

Method. In 8 of the 11 cases, notice was accomplished by individual mailings or personal delivery to class members. In 1 of the (b)(2) cases and 4 of the (b)(3) cases, notice was by publication in a newspaper. In 4 of the 11 cases notice was both by individual mailings and publication. Aside from the (b)(2) actions discussed in the previous paragraph, the data did not reveal use of any other form of notice (such as radio or TV or the Internet).

In the three cases for which information was available, notices were sent to 4,000; 5,653; and 5,900 class members. In those cases, 98% of the estimated class was notified in one case and 100% in the other two. In only three cases was an

aspect of notice contested; the nature of these disputes appeared to be relatively minor.[10]

Cost. In the documents examined in time study cases, no information was available as to the cost of administering the notice. Information about who paid for the notice was available in only a few cases. Records indicated that plaintiffs or their counsel paid the costs of notice in three cases and defendants paid in one case. Because all but two of the certified cases eventually settled (Table 11) and generally produced a common fund for the benefit of the class, it is likely that plaintiffs or their counsel were reimbursed for notice costs out of the proceeds of the settlement.

VII. Settlement and Approval

Certified v. Not Certified Cases. F. R. Civ. P. 23(e) calls for the court to review the dismissal or compromise of a class action and to direct notice to the class. We will examine in detail the settlement approval process for the 11 cases that were certified as class actions. Before doing so, however, it may be useful to compare the rate of settlement in cases that were certified and cases that were not certified. Table 11 shows the number of settlements for cases in those two categories, revealing that settlement occurred more often when a class has been certified than when a class had not been certified.

[10] In one instance a non-party tried to expand the scope of the notice, but plaintiff noted that the proposed "expansion" was already in the notice plan. In another case the parties initially argued about a form for identifying subclass members and then resolved their differences.

Table 11
Proposed Settlements by Class Certification Status
Time Study Class Actions, 1987-1990 (N=51)

Outcome	Certified (N=11)	Not Certified (N=40)
Settlement (Proposed or actual)	9	20
No Settlement	2	20

Of the two certified cases that did not settle, one was transferred to another district and the other was resolved by summary judgment for the defendant. Seven of the nine proposed settlements were approved by the court, one proposed settlement was rejected, and one was still pending when we collected the court documents in the summer of 1994. In three of the nine cases the record showed that the court preliminarily approved the settlement as within an acceptable range of reasonableness and fairness before issuing notice of a hearing on settlement approval.

Notice. For the certified class actions that settled, notice of the proposed settlement was sent in all of the eight cases for which information was available. Table 12 presents the available information about the content of those notices.[11] The responses show that the notice often does not include an estimate of the size of the proposed class. Such an estimate would seem essential if a class member is to be able to estimate the value of that member's share of the settlement. In only one case did the notice fail to include the total amount of the settlement.[12] Note that in Table 12 there are no negative responses for stating a plan of distribution, establishing a claims procedure, and specifying a time and place for a hearing on the proposed settlement.

---

[11] For these items the time study data were not as complete as we expect the field study data to be. We present the available time study data here, but note that the not applicable ("N. A.") and unknown ("U") categories cover a large percentage of the cases.

[12] Data from the field study will include information about the net amount of the settlement and whether the notice included information about attorneys' fees, expenses, and the costs of administering the settlement.

Table 12
Content of Notice in Proposed Settlements of Certified Time Study Class Actions, 1987 - 1990 (N=9)*

Content of Notice	Yes	No	N.A.	U
State the Approximate Class Size	2	3	0	3
Indicate the Total Settlement Amount	3	1	2	2
State a Plan of Distribution	4	0	2	2
Describe any Equitable Relief	2	1	2	3
Indicate a Right to Opt-Out	3	0	2	3
Establish a Claims or Opt-In Procedure	4	0	2	2
Specify a Time and Place for a Hearing	6	0	0	2

Missing Data = 1

Hearings. Hearings on a proposed settlement were held in seven cases. Participation at the hearing could be determined only in a small number of cases. In three cases the record indicated that class representatives attended the hearing; in one case a nonrepresentative class member attended; and in one case a person who opted-out attended. In four cases objections to the settlement were indicated, one of which claimed that the settlement was based on collusion between plaintiffs and defendants.[13] In the only two cases for which information was available, the hearing lasted an hour in one case and less than an hour and a quarter in the other.

The rulings on proposed settlements ranged from 2 pages to 34 pages, with an average of 14 pages and a median of 10.[14] All but one of the proposed settlements were approved without changes; the one exception was approved with changes.

Judge Time Spent Ruling on Settlements. District and magistrate judges expended an average of approximately three hours per certified class action in ruling on proposed settlements. In contrast, in non-certified cases the comparable mean was less than a quarter of an hour per case. This time included reviewing proposed settlements, presiding at settlement approval hearings, and ruling on settlements, but did not include judicial efforts to facilitate settlement.

---

[13] Another objection related to confusion about when the cash settlement would be paid to class members and yet another objection related to the scope of relief in a (b)(2) settlement.

[14] The length of the ruling may not be a good measure of the effort required of a judge in ruling on a settlement. In the field study we observed that it was a standard practice in securities class actions for plaintiffs' counsel to draft a proposed order which was generally signed by the judge if no objections were presented at the hearing.

Opt-outs and opt-ins. In two cases, counts were available of the number of opt-outs, 4 in one case and 139 in the other. In those 2 cases the estimated size of the class was 2,700 and 1,750 respectively. In 5 of the settlements an opt-in procedure was used. Information about the number of opt-in claimants was available in 2 cases; the numbers were 49 and 960 in classes the size of which had been estimated at 100 and 2700.

Settlement Funds. Of the 16 time study class action cases where the court approved a settlement, 7 cases produced a settlement fund to be distributed to members of a plaintiffs' class, as illustrated by Figure 6. The 7 cases represent 44% of settled cases and 14% of time study class actions. Eight cases were settled without the establishment of a settlement fund.

Figure 6
Percent of Settled Cases with Settlement Funds in Time Study Class Actions, 1987 - 1990 (N=16)

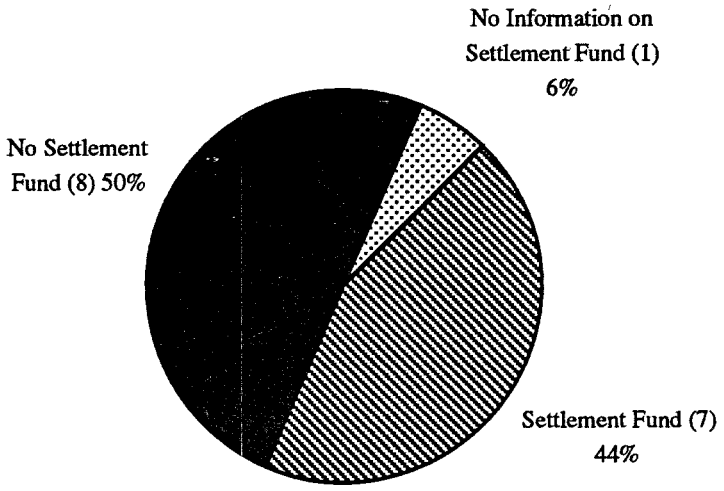


Table 13 lists the methods used to determine individual class member shares in settlement funds. In general, shares were determined by consensual methods, either by consent of the parties (2 cases) or by application of a formula by counsel pursuant to a settlement (4 cases).

Table 13
Methods for Determining Class Member Shares in Settlement Fund
Time Study Class Actions, 1987 - 1990 (N=7)

Method	Number of Cases	Percent of Total
Settlement Formula	4	57 %
Consent of the Parties	2	29 %
Individual Trials	1	14 %

Monies from two (29%) of the settlement funds were distributed to all class members who did not opt out. Monies from the other five (71%) funds were distributed only to class members who filed claims. The entire fund was distributed to class members in most cases (71%; five cases). In one case, however, the remaining funds were returned to the defendant. In another case, $250,000 was reserved for settlement of appeals with any remainder reverting to the defendant. Data are not available on the amounts, if any, actually returned.[15]

Settlement amounts and attorneys' fees. Table 14 presents the percentage of settlement allocated to attorneys' fees for those cases where both settlement and fee award amounts are available.

Table 14
Settlement Amounts and Attorneys' Fee Awards in
Time Study Class Actions, 1987 - 1990 (N=5)

	Settlement Amount	Attorneys' Fees Awarded	Attorneys' Fees as Percentage of Settlement Amount
Case 1	$175,000	$78,000	45%
Case 2	240,000	90,716	38%
Case 3	1,750,000	667,872	38%
Case 4	6,955,828	975,554	14%
Case 5	17,500,000	4,000,000	23%

[15] These data are generally not recorded in court records because fund distribution often occurs after a case is closed.

VIII. Attorneys' Fees

Applications for Attorneys' Fees.[16] In 10 cases (20% of class actions) plaintiffs' attorneys requested court approval of their fees either by fee application or as part of a proposed settlement. In all 10 cases, a proposed settlement was brought to the court's attention. As shown in Table 15, the amount of fees requested in these 10 cases ranged from $17,498 to $4.0 million, with $828,555 as the mean and $466,783 as the median amount requested. Where class certification information is available, all cases with fee requests were certified as class actions (with only one of these certified for settlement purposes only). Defendants' counsel did not request court approval of their fees in any of the time study class action cases.

Table 15
Plaintiffs' Counsel Fees Requested/Awarded in Time Study Class Actions, 1987 - 1990 (N=10)

	Fees Requested	Fees Awarded
Case 1	$17,498	Missing
Case 2	45,000	45,000
Case 3	78,000	78,000
Case 4	90,716	90,716
Case 5	265,694	Missing
Case 6	667,872	667,872
Case 7	750,000	Missing
Case 8	975,554	975,554
Case 9	1,395,217	1,395,217
Case 10	4,000,000	4,000,000

Source: FJC Class Action Project

Awards of Attorneys' Fees. Fee award information is available for seven of the ten[17] plaintiffs' counsel requests, as shown in Table 15. In all seven cases, the court awarded the full amount requested. Fee awards ranged from $45,000 to $4.0 million.

The time study collected information on the methods used for calculating counsel fee awards for only six cases. Four awards were stated in terms of a percentage of the gross settlement; two were determined by the lodestar method.

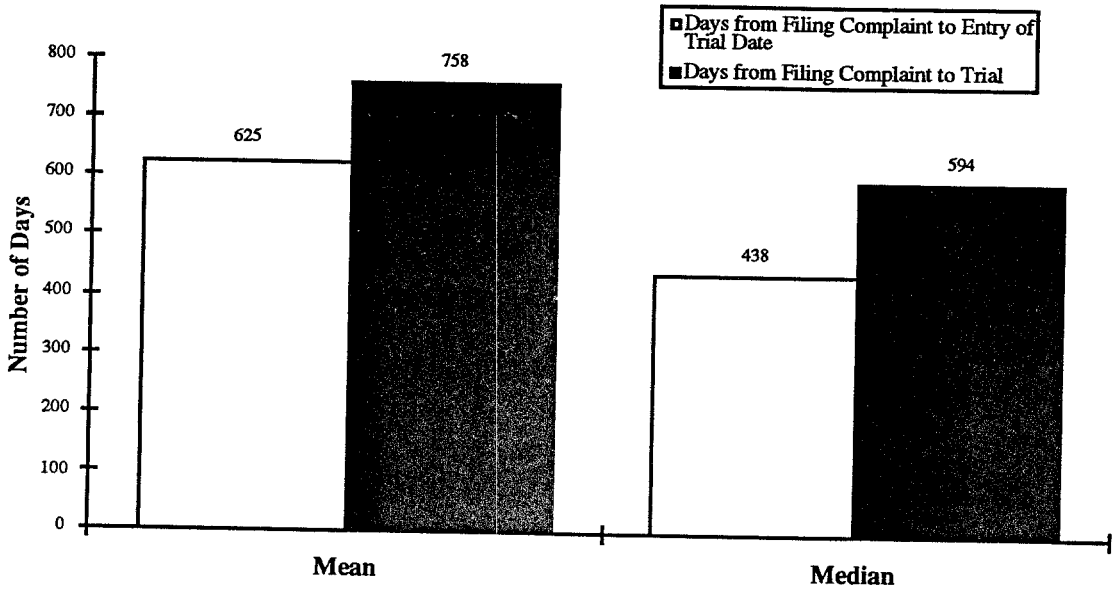
[16] Attorneys' fees in this report do not include sanctions nor attorneys' out-of-pocket expenses.
[17] In the remaining 3 cases with fee requests, no information is available on fee awards. There are indications in case files that the parties settled these fee issues out of court.

Hearings on Fees. Our on-going field study indicates thus far that hearings on proposed settlements sometimes include hearings on fees. In the time study, however, we recorded data only on fee hearings that were separate from other hearings. Those data show that the court held separate fee hearings on only 2 of the 10 fee requests. District and magistrate judges spent a total of 25 hours ruling on attorneys' fee applications in the 10 cases--an average of 2.5 hours per case.

IX. Trials

A trial date was set in 10 (20%) of the 51 cases with class action allegations. As illustrated in Figure 7, a trial date was entered on the record an average of 625 days after the filing of the first complaint; the date set for trial was an average of 758 days after the complaint filing.

Figure 7
Time from Filing Complaint to Trial Date
Time Study Class Actions, 1987 - 1990 (N=10)



Trial was held in only two cases. Both were not certified as class actions. Each of these trials was a bench trial resulting in a judgment for the defendant.

The total amount of judge time spent on trial for one case was 9 hours and 45 minutes. Data are not available for the other trial.

X. Appeals

An appeal was filed in seven (14%) of the class action cases, with over half (4 cases) involving an appeal from a final order or judgment. Most (71%; five cases) were filed by a named class plaintiff, one was filed by an intervening class member, and the other by a party opposing the class.

The time study recorded information on the issues and outcomes on appeal for only four cases. In these cases, orders appealed from included denial of a motion to intervene, grant of a defendant's summary judgment motion, and denial of an emergency motion for injunctive relief. Outcomes on appeal included affirmance of summary judgment, dismissal for want of jurisdiction of the appeal of denial of intervention, and dismissal of another appeal for want of prosecution.

XI. Judge Time in Certified and Uncertified Cases

Judge time in certified and uncertified cases compared. Table 16 shows the distribution of judge time among various activities in the cases, comparing cases in which class certification was granted and those in which it was not granted (including in the latter category those cases in which no action was taken on certification). The table should be read with an awareness that time study data probably understate the amount of judge time spent on the various activities. The director of the time study estimated that roughly ten to twenty percent of the time expended on time study cases was not reported to the Center.[18]

[18] Letter from John Shapard to Subcommittee on Judicial Statistics of the Committee on Judicial Resources, page 1, July 20, 1993.

Table 16
District Judge and Magistrate Judge Time Expended in Time Study Class Actions Filed, 1987 - 1990 (N=51)

Type of Activity	Certified (N=11) Judge Time (Hours)	Not Certified (N=40) Judge Time (Hours)	Certified Average Hours Per Case	Not Certified Average Hours Per Case
Class Certification	79	16	7	less than 1
Motions to Dismiss	61	13	6	less than 1
Discovery	64	7	6	less than 1
Summary Judgment	30	48	3	1
Notice to Class	4	0	less than 1	0
Pretrial Conference	1	1	less than 1	0
All Other Pretrial Conferences	1	0	less than 1	0
Trial	0	10	0	less than 1
Facilitating Settlement	38	20	4	1
Review and Rule on Proposed Settlement	31	6	3	less than 1
Presiding at Settlement Approval Hearing	16	1	1	0
Ruling on Attorneys' Fees	25	0	2	0
Monitoring or Enforcing Final Order	11	0	1	0
Other	18	119	2	3
Total of All Activities	379	240	34	6

Source: FJC Time Study

Comparing the time demands of class action cases with the time demands of other case types gives a perspective of the relative burden that class actions impose on the courts. Case weights are scaled in relation to the weight of an average case, which is rated as a "1." If class actions were treated as a separate category for case weighting purposes (which they are not), the hours demanded for the class action cases in the district court time study would justify a case weight of 4.71, higher than any civil case type except death penalty habeas corpus (6.15). The next closest civil case is a RICO claim (3.02). To compare further, an average class action case would require about as much judge time as a criminal prosecution for extortion, racketeering, and threats (4.62) and would require less time than the average criminal prosecution for bankruptcy or

securities fraud (5.30).[19] Based data from the entire time study (including non-class action cases), the case weights for the four types of cases that were most prevalent in the current study (See Figure 1) are:

Securities, Commodities and Exchange (850)	1.96
Prisoner Civil Rights (550) (not U.S. defendant)	0.43
Other Civil Rights (440) (filed originally in federal court)	1.61
Civil Rights: Jobs (442) (filed originally in federal court)	1.61

The calculation of the above hypothetical 4.71 case weight for class actions included both certified and uncertified cases. The average number of judge hours per case was approximately 11 for all class actions, but, as Table 16 shows, the amount of judge time for certified class actions was approximately three times that. The large number of cases that were not certified brings down the average for certified cases.

Most relevant to the Advisory Committee's concern with the certification process is the fact that certified class actions represented an investment, on average, of about seven hours of judge time on certification matters. Note, however, that the cases that were not certified required less than a half hour of judicial time, on average, for certification issues. Matters related to class notice required less than a half hour of a judge's time, on average.

For certified class actions, ruling on motions to dismiss demanded slightly less time, on the average, than did ruling on motions to certify a class. Ruling on discovery disputes also demanded less time than the certification process, as did the combined time devoted to facilitating and ruling on proposed settlements. At all stages except trial, certified class actions demanded more judge time, on the average, than cases that are not certified. For the average case not certified, the most demanding activity involved ruling on motions for summary judgment. Facilitating settlement was the next highest category of judicial activity.

---

[19] *Id.* at 6-7. The 4.71 case weight for class actions was stated in a memorandum from John Shapard to Mark Shapiro, February 8, 1994 and included in the materials for the Advisory Committee's May, 1994 meeting.

XII. Conclusion (and Preview)

This preliminary report provides descriptive information on class action activity in 51 cases drawn from a national random sample of civil cases filed between November 1987 and January 1990. This information, though informative and national in scope, represents a limited introduction to the type of data that we will be collecting from the courts in the field study. For example, we have examined approximately 136 class actions in the Eastern District of Pennsylvania and expect to examine a similar number in the Northern District of California in time to report to the Committee at its April meeting in New York. We recognize that there is still a great deal that is not known about class action activity. As we continue to collect more data on these activities in our field study, we will be able to provide a more extensive and detailed view of the approaches various federal courts have taken to manage class action cases.

Please let us know if you see additional questions or analyses that we might explore using the time study data.