Predatory Attorneys and Professional Plaintiffs: Reforms are Needed to Limit Vexatious Securities Litigation

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NOTE

PREDATORY ATTORNEYS AND PROFESSIONAL PLAINTIFFS: REFORMS ARE NEEDED TO LIMIT VEXATIOUS SECURITIES LITIGATION

I. INTRODUCTION

Congress enacted the Securities Exchange Act of 1934 ("1934 Act") to give shareholders rights against corporations which sought to defraud them. The Act also contained a provision that created the Securities and Exchange Commission ("SEC").2 The SEC has broad authority to promulgate rules pursuant to the 1934 Act, and to enforce these rules against violators.3 Specifically, under Rule 10b-5, corporations could be held liable for deceitful or misleading practices.4 Although not specifically enunciated in the 1934 Act or in the rules, the courts have long recognized that private citizens have a right to sue corporations under Rule 10b-5.5 This right was necessary because it, in effect, created "private attorney generals" who would provide additional vigilance beyond that provided by the SEC against fraudulent securities practices.6 Underfunded and overburdened, the SEC could not possibly police all such fraudulent activity.

However, this system of providing a private cause of action to injured shareholders has not been without its pitfalls. Although most

2. Id. § 78d.
3. Id. § 78d-1.
6. 5 ARNOLD S. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5, § 8.01, at 221-24 (2d ed. 1989). The term "private attorney general" originated in 1943 to refer to private individuals authorized to bring actions to "vindicate the public trust." Associated Indus. v. Ickes, 134 F.2d 694, 704 (2d Cir. 1943), vacated, 320 U.S. 707 (1943); see also Outlook '93, Daily Rep. for Execs. (BNA), at 14 (Jan. 25, 1993).
would agree that shareholders who have been fleeced by deceitful corporations should be recompensed, there is equal agreement that meritless claims of fraud should not be allowed to prevail. Shareholder suits against corporations have given rise to "strike suits," defined as "shareholder derivative action[s] begun with [the] hope of winning large attorney fees or private settlements, and with no intention of benefiting [the] corporation on behalf of which [the] suit is theoretically brought."8 Although not defined as such, a strike suit need not be a derivative action, it may also be a direct action against the corporation either by an individual plaintiff or by a class of plaintiffs.

With public opinion mounting against lawyers and the spiraling costs of litigation, a movement is underway toward litigation reform in general, and in particular toward reform in the securities laws.9 During 1992, Rep. W.J. Tauzin introduced House Bill 5828, the Securities Private Enforcement Reform Act, and Sen. Pete V. Domenici introduced Senate Bill 3181, the Securities Private Enforcement Act of 1992, to address the problems of excessive securities litigation.10 After both bills failed to pass their respective Houses of Congress, Rep. Tauzin reintroduced a modified version of the Securities Private Enforcement Reform Act.11 This bill however also failed to garner enough votes to pass the House of Representatives.

The 1994 Congressional elections placed the Republican Party in control of both Houses of Congress. This change of control was


9. See, e.g., Senate Panel, supra note 7, at 847; Serwer, supra note 7, at 140; Rick Stouffer, Litigation Explosion 'Booming,' PITTSBURGH BUS. TIMES & J., Aug. 25, 1986, at 1S. Cf. Boennighausen, supra note 7, at 30, 33; Witnesses Dispute Whether Reform Needed to Stem Spurious Litigation, Banking Rep. (BNA), at 121 (July 26, 1993) [hereinafter Witnesses Dispute].


accompanied by renewed vigor to reform the legal system. As part of their Contract With America, one of the first bills introduced during the 104th Congress was the Common Sense Legal Reform Act of 1995.12 Title I—Civil Justice Reform—deals generally with numerous issues of civil litigation and specifically addresses reforms to product liability actions.13 Title II—Reform of Private Securities Litigation—as its name implies, deals specifically with reforms to private securities actions.14

Along with the Common Sense Legal Reform Act of 1995, several other House bills concerning reforms to private securities litigation have recently been introduced. Rep. Tauzin reintroduced the Securities Private Enforcement Reform Act in much the same form as its predecessors.15 Rep. Edward J. Markey put forth his own private securities reform bill entitled the Private Securities Litigation Reform Act of 1995.16 A fourth bill, named the Securities Litigation Equity Act of 1995, was submitted by Rep. Norman Y. Mineta.17

13. Under Title I, in all diversity actions decided in federal court, the judge is required to award attorneys fees to the prevailing party unless the judge finds “special circumstances” that make such an award “unjust.” Id. § 101. With regard to expert testimony, the court can disqualify an expert who testifies on a contingency basis, and may also hold such testimony inadmissible if the expert’s opinion is not “based on sufficiently valid reasoning” which is not sufficiently probative. Id. § 102. The bill also suggests that states should require attorneys who enter into contingency fee arrangements to disclose in writing to their clients the actual services performed and the number of hours expended by the attorney. Id. § 104(a). Federal Rule of Civil Procedure 11(c), dealing with court sanctions of attorneys, also would be altered by removing the court’s discretion to award sanctions, and instead mandating that the court order appropriate sanctions against a violating party. Id. § 104(b).

Another provision of the bill mandates that a plaintiff contemplating action in federal court must deliver notice of the claims alleged and the amount of damages sought to the defendant at least thirty days prior to commencing an action. Id. § 105. Exceptions would be allowed under various circumstances, such as where the defendant is likely to flee or where the action is to enforce a lien. Id. This section also deals with situations where the statute of limitations may become a factor. Id.

The bill also deals extensively with product liability actions. Such changes would apply to all product liability actions, whether brought in state court or federal court. Id. § 103(a). It would provide stringent burdens to be met if the plaintiff attempts to sue the product seller. Id. § 103(b). To obtain punitive damages, the plaintiff must prove “actual malice” by “clear and convincing evidence.” Id. § 103(c). Moreover, punitive damages would be limited to the greater of $250,000 or three times the economic injury damages. Id. Finally, there would be proportionate liability rather than joint and several liability for all non-economic damages. Id. § 103(d).

14. Id. § 201.
Uncertainty exists as to which bill, or combination of bills, will pass the House, or whether any form of securities reform bill will pass. In many instances, the bills overlap or there are only minor variations between the bills. Most would agree that enacting into law any or all of the proposals in these various bills would reduce the number of suits brought pursuant to the securities laws. Of course, certain proposals would have a more dramatic impact than others. However, the more difficult questions remain. Will there be a vast reduction in meritless claims? Will there be a chilling effect on meritorious claims? Assuming that there will be a reduction in both meritorious and meritless claims, in what proportion? And, can such a reduction in meritorious claims be justified?

The purpose of this Note is not to speculate on the political maneuvering behind the bills. Rather, the aforementioned questions will be addressed. Part II of this Note will examine the current securities litigation climate to focus on its problems. Part III will explore the current procedural remedies available to alleviate these problems, and explain why they have failed. Part IV will look at several of the most important provisions put forth in these bills, discuss how they will affect the area of securities litigation, and suggest how improvements could be made. Also, references to these bills will be made in footnotes where a proposed provision directly addresses one of the problems raised in this Note.

II. CURRENT SECURITIES LAW ENVIRONMENT

A. Debate Concerning Extent and Effect of Securities Litigation

There is a current trend in this country toward reducing the costs of litigation. Recent efforts, such as the bills discussed in the previous section, seek to reduce litigation costs in one particular area, namely those associated with suits brought pursuant to the 1934 Act. General disagreement exists concerning whether the number and costs of such lawsuits have actually increased over the past several years.

18. See supra note 9 and accompanying text; Boennighausen, supra note 7, at 33.
19. See supra note 9 and accompanying text.
The assumption that the costs of litigation are detrimental to the economy is also in dispute. Proponents of reform claim that the costs of litigation impose a tax on corporations that tends to decrease resources otherwise available to promote growth. By draining away corporate resources, investment in new products and new businesses is diminished, and the cost of capital is increased. As a result, new ideas and expertise are not generated as quickly or are developed in other countries that are not burdened by the litigation tax.

This problem is particularly acute in the high technology fields—electronics, computers, instrumentation, and medical devices—which tend to get sued disproportionately more often than other industries. High technology companies tend to have more volatile stock prices due to high price-to-earnings ratios, and the fact that stock prices may be directly tied to future innovations that may or may not be realized. Because Rule 10b-5 suits are often instituted automatically if a stock price falls a fixed percentage, even if the price rebounds quickly, industries that traditionally have volatile stock prices—such as high technology—tend to be sued more often. The net effect is that the fear of lawsuits will prevent corporations from taking on new and potentially risky ventures, even where it would otherwise be a sound business decision. When the corporation is actually sued, resources that would have gone towards researching and developing new technology go instead to cover litigation expenses such as damage awards, settlements, and lawyers' fees.

Another serious problem associated with securities litigation is the effect on directors and officers, who are often the target of litigation where there is a claim that the corporation withheld important

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21. See Marc Galanter, Pick a Number, Any Number, AM. LAW., Apr. 1992, at 82; Presumed Guilty, THE ECONOMIST, Sept. 12-18, 1992, at 27; Serwer, supra note 7, at 138; Stouffer, supra note 9, at 28; Unwarranted Litigation, supra note 7, at 2.
22. See H.R. 681, supra note 15, § 2; Boennighausen, supra note 7, at 31; Section 10(b) Suits Would be Revamped Under Bill Introduced by Rep. Tauzin, Banking Daily (BNA), at 1 (Jan. 28, 1993) [hereinafter Suits Revamped]; Senate Panel, supra note 7, at 117; Unwarranted Litigation, supra note 7, at 2; Witnesses Dispute, supra note 9, at 33.
23. See H.R. 681, supra note 15, § 2; Unwarranted Litigation, supra note 7, at 2; Witnesses Dispute, supra note 9, at 3.
25. Senate Panel, supra note 7, at 118; see also Boennighausen, supra note 7, at 30; Serwer, supra note 7, at 136.
26. Senate Panel, supra note 7, at 117.
27. See Boennighausen, supra note 7, at 30, 31.
information or misled the public in some way.\textsuperscript{28} As a first line of defense, most corporate charters allow for indemnity insurance, which provides legal services to officers and directors who are sued as a result of corporate activities.\textsuperscript{29} If there is a judgement against them, the corporation will cover any damages awarded.\textsuperscript{30} However, these provisions are only as reliable as the corporate treasury, and if the corporation cannot, or will not pay, the officers or directors being sued are personally liable.\textsuperscript{31} As a secondary protection, corporations often procure directors and officers ("D&O") insurance to cover these costs.\textsuperscript{32} However, many D&O insurers refuse to cover certain corporations and industries because the potential for liability is simply too high.\textsuperscript{33} Even where D&O insurance is available, it often is offered at astronomical rates. From 1985 to 1986, D&O insurance premiums rose over 500\%, and in some cases exceeded 1,100\%.\textsuperscript{34} Today, D&O insurance premiums are as high as \$500,000 per year for larger corporations.\textsuperscript{35}

This corporate climate has led to increasing difficulties in hiring and retaining competent officers and directors.\textsuperscript{36} In one recent survey, two-thirds of all people approached for a board nomination refused.\textsuperscript{37} This effect on corporate health cannot be easily quantified. One must assume that the reluctance of qualified people to accept positions of responsibility in corporations, due to the fear of being held personally liable in a securities suit, has led to a less than optimal position for American corporations and the American economy.

Conversely, those who favor the current system insist that these litigation costs are justified. If the corporation has engaged in fraudulent practices that have defrauded investors, then it should be made to pay for these losses. Even reformers of the system agree that where fraud or deceit can be shown, investors who have suffered losses as a

\begin{footnotes}
\item[29] See Stouffer, supra note 9, at 55.
\item[30] Id.
\item[31] Id.
\item[32] D&O insurance typically pays for 50\% of the settlement. Serwer, supra note 7, at 137.
\item[33] See Falkowski, supra note 28, at 57; Stouffer, supra note 9, at 55.
\item[34] Behar & Clifford, supra note 28, at 71.
\item[35] Serwer, supra note 7, at 137.
\item[36] See H.R. 681, supra note 15, § 2(2).
\item[37] Behar & Clifford, supra note 28, at 70.
\end{footnotes}
result should be recompensed. This not only serves the goals of justice, but also makes good economic and business sense. The integrity of the market must be preserved so that people will feel confident investing capital in it. The investing public can feel more confident that fraud is being minimized if, in addition to the governmental agency charged with detecting and prosecuting fraudulent activities, there is also a battery of private citizens and lawyers who have a large financial incentive to ferret out fraud and sue accordingly. Therefore, the debate should not focus on whether the securities laws serve a useful purpose—they do; rather, the focus should be on how a compromise can be reached to more appropriately balance the competing needs of corporations and their investors.

There seems to be general agreement by both sides that where there exists a meritorious claim, private securities litigation is beneficial not only to the injured plaintiff, but also to the investing public and the market as a whole. Similarly, there is agreement that in cases where there is no basis in fact or in law to support the suit, such frivolous nuisance suits should either be dismissed or not allowed in the first place. The real disagreement is on whether these frivolous suits represent any substantial detriment to the corporations being sued or to the general economy. Also, there is disagreement about whether the benefit to corporations in reduced litigation costs brought about by reform legislation, will outweigh the detriment to shareholders who will find it more difficult to initiate and prevail in securities litigation.

Both sides point to specific facts that they claim "prove" that reform is or is not needed. Opponents of reform point out that there is evidence that the number of lawsuits initiated is not drastically increasing and that there is evidence that the increase in the number of lawsuits brought over time is in direct proportion to the increase in the general population. For example, the number of securities suits

38. Boennighausen, supra note 7, at 32; Senate Panel, supra note 7, at 116; Unwarranted Litigation, supra note 7, at 2.
39. See supra note 7 and accompanying text.
40. See supra note 7 and accompanying text.
41. See supra note 7 and accompanying text.
42. See supra note 9 and accompanying text.
43. See Boennighausen, supra note 7, at 30; Outlook '93, supra note 6, at 14, 15; Securities Litigation Reform Could Harm Investors, Pensions & Benefits Daily (BNA), at 2 (July 13, 1993) [hereinafter Harm Investors]; Senate Panel, supra note 7, at 847; Serwer, supra note 7, at 140.
44. Stouffer, supra note 9, at 25.
filed only increased from 631 in 1973 to 642 in 1992,\textsuperscript{45} and between 1989 and 1992, the number of companies sued for securities violations increased only 4.6\%.\textsuperscript{46} Proponents of reform often point to the problem that accounting firms are increasingly made the target of strike suit litigation, but over the past ten years, litigation alleging audit failure by accounting firms has remained constant at approximately fifty suits per year.\textsuperscript{47}

On the other hand, proponents of reform cite contrary statistics that tend to show securities law litigation is indeed increasing. For example, the number of lawsuits filed in federal court between 1989 and 1992 increased 57\%.\textsuperscript{48} With regard to the issue of suits involving accounting firms, although the number of such suits may not have increased, the liability stemming from these suits is enormous. The six largest U.S. accounting firms, which are usually sued along with the corporation and its directors and officers, are currently facing $30 billion in liability claims.\textsuperscript{49} Over the past two years the median settlement for such claims was $4.5 million.\textsuperscript{50}

\textbf{B. Analysis of a Securities Law Strike Suit}

1. Initiation and Control of the Action

Regardless of whether there has been a dramatic increase in the number or cost of securities litigation, the procedures followed by many plaintiffs' attorneys supports the argument that reform of the laws is needed. There are certainly many lawyers whose practice is beyond reproach. However, with regard to securities litigation, a large segment of the plaintiffs' bar operates a highly questionable practice that despite being legal, is marginally ethical at best. Mention will be made here of the typical strike suit that has led many to support the reform movement.

Many lawsuits are indeed initiated by aggrieved investors who genuinely believe that they have been defrauded by a corporation's

\begin{itemize}
  \item \textsuperscript{45} Boennighausen, \textit{supra} note 7, at 32.
  \item \textsuperscript{46} Serwer, \textit{supra} note 7, at 137.
  \item \textsuperscript{47} Witnesses Dispute, \textit{supra} note 9, at 121.
  \item \textsuperscript{48} Serwer, \textit{supra} note 7, at 137.
  \item \textsuperscript{49} Witnesses Dispute, \textit{supra} note 9, at 121.
  \item \textsuperscript{50} Serwer, \textit{supra} note 7, at 136; Legal costs for accounting firms can be quite high. These costs are the second largest costs of doing business, and at Deloitte & Touche, for example, litigation costs consume up to 12\% of revenues. AICPA Proposes 11-Point Reform Plan for Improving Financial Reporting System, 60 Banking Rep. (BNA) No. 24, at 880 (June 14, 1993).
\end{itemize}
officers or directors. However, a substantial number of these suits are brought not because of any wrongdoing, but merely to extract a settlement from the corporation. Numerous law firms begin such suits as a part of their practice, but several firms specialize exclusively in shareholder derivative and class action suits. In such firms, effort is not placed on defending the rights of clients, but rather on creating litigation that will ultimately result in a settlement of the case, with the attorney typically receiving 30% of the settlement.

The first step in generating such suits is to uncover some wrongdoing or potential wrongdoing. This may be the basis of a legitimate claim—such as where there have been allegations or indictments based on securities laws violations of insider trading or withholding material non-public information. However, much more frequently a suit will be initiated based on a drop in stock price, regardless of the reasons or whether the price subsequently rebounds. Alternatively, a suit may be started based on allegations in a newspaper article. The attorney bringing suit may not even have investigated to determine if there is any evidence of actual misconduct. In certain cases, if a stock price where to fall a certain percentage—for example 10%—it would be an automatic trigger to file suit. The claim may state that the directors failed to disclose adverse information to the

51. See H.R. 681, supra note 15, § 2(3); Accounting Firms Predict Dim Future if Joint and Several Liability Remains, 25 Sec. Reg. & L. Rep. (BNA), at 872 (June 18, 1993) [hereinafter Dim Future]; Boennighausen, supra note 7, at 30, 31; Christi Phelps, Cubic Execs Seek Sanctions Against San Diego Lawyer, SAN DIEGO BUS. J., Sept. 12, 1988, at 2; Serwer, supra note 7, at 136; Suits Revamped, supra note 22, at 95; Unwarranted Litigation, supra note 7, at 2.

52. Behar & Clifford, supra note 28, at 70; Joan B. Schaeffer & Martin H. Scherzer, Despite Soft Cycle, Alternative Market Stays Strong, NAT'L UNDERWRITER, Mar. 9, 1992, at 17; Serwer, supra note 7, at 137; Stouffer, supra note 9, at 4S; Suits Revamped, supra note 22, at 95; Unwarranted Litigation, supra note 7, at 2.

53. See Boennighausen, supra note 7, at 31; Serwer, supra note 7, at 136. In many cases there is in reality no plaintiff. The plaintiffs receive a fraction of their losses and the attorneys receive a large part of the settlement. See Senate Panel, supra note 7, at 847, 848. It has been estimated that in these actions, attorneys receive 33% of the settlement while investors receive only 5% to 10%. See Suits Revamped, supra note 22, at 95. Two of the pending securities bills provide for restrictions on how much of the recovery can be used to pay attorneys fees. See H.R. 555, supra note 16, § 101(c); H.R. 675, supra note 17, § 2(c).

54. See Stouffer, supra note 9, at 1S.

55. Senate Panel, supra note 7, at 847. See Boennighausen, supra note 7, at 30, 31; Serwer, supra note 7, at 136, 138-39; Stouffer, supra note 9, at 1S.

56. Phelps, supra note 51, at 1; Serwer, supra note 7, at 139.

57. See Boennighausen, supra note 7, at 30, 31; Phelps, supra note 51, at 1; Serwer, supra note 7, at 138, 139.

58. Senate Panel, supra note 7, at 847.
public, causing losses that otherwise would not have occurred.\(^9\)

Suits are also often started in the context of takeovers. If the board of directors rejects a takeover bid, investors will file suits claiming they would be better off after the takeover, and that the directors were acting with regard to their own interests.\(^6\) If the board had accepted that same takeover bid, investors would bring a similar suit claiming that the corporation was worth more than the bid accepted, and either should not have been sold, or a higher bidder should have been solicited.\(^6\) Again, the claim will state that directors acted in their own interests rather than the interests of the shareholders.\(^6\) In some instances, a boilerplate complaint is on file with the attorney.\(^6\) Once the potential wrongful conduct has occurred, the attorney merely fills in the name of the stock, the relevant stock prices, the names of the plaintiffs and defendants, dates, and any other relevant information.\(^6\)

Although the law allows private causes of action for securities violations,\(^6\) there are restrictions on who is allowed to bring suit. One requirement is that the plaintiff bringing the action must have been a shareholder of the corporation at the time of the transaction in question.\(^6\) This ensures that the person suing actually has suffered an injury as a result of the alleged wrongdoing. However, the courts have not placed any restrictions on the number of shares that must be owned by the plaintiff.\(^6\) In many cases, the courts have allowed

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60. Monteleone & McCarrick, supra note 59, at 41; see Falkowski, supra note 28, at 56.

61. See Behar & Clifford, supra note 28, at 71; Falkowski, supra note 28, at 55.

62. See Behar & Clifford, supra note 28, at 71; Falkowski, supra note 28, at 55.

63. Senate Panel, supra note 7, at 847; see Serwer, supra note 7, at 138.

64. Senate Panel, supra note 7, at 847; see Serwer, supra note 7, at 138.

65. See supra note 5 and accompanying text.

66. Fed. R. Civ. P. 23.1 ("In a derivative action . . . the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains . . . ."); see also Fed. R. Civ. P. 23 (requiring that representative parties be members of a class, i.e. a shareholder in a securities fraud case).

67. See, e.g., Koster v. American Lumberman's Mut. Casualty Co., 330 U.S. 518 (1947) (permitting courts to hear derivative action if all other requirements were met, even though shareholder's interest was minimal); Subin v. Goldsmith, 224 F.2d 753 (2d Cir.), cert. denied, 350 U.S. 883 (1955) (holding that ownership of only a few shares of stock did not affect right to bring derivative action); Pellegrino v. Nesbit, 203 F.2d 463 (9th Cir. 1953) (holding that right to bring suit pursuant to 16(b) of the Securities Exchange Act of 1934 for short swing profits is not defeated by small number of shares owned by stockholder). But see H.R.
suits to continue even where the plaintiff held only one or a few shares of stock.\footnote{68}

One argument against such decisions is that the courts should not concern themselves with cases where the amount in controversy is so trivial, and should dismiss such cases. However, what may appear to be a de minimis sum to most observers may be substantial to the parties bringing suit. Also, the plaintiff may be more interested in vindicating his rights than in being reimbursed for capital losses. In any case, Congress realized that in many situations, the loss to any one person might be small, but the aggregate loss of all similarly situated people might be quite large. To address this problem, the Federal Rules of Civil Procedure ("Federal Rules") created the class action suit and later, the derivative action.\footnote{69} Thus, the fact that the named plaintiff in a securities action holds only a minimal amount of stock should not be an automatic bar to commencing legal action.

The above analysis can be somewhat misleading. In reality, the reason why so many securities actions are initiated by plaintiffs with minor stock holdings is a function of the practice of plaintiffs' attorneys. When an attorney discovers some potential misconduct, as described above, an action can be maintained only if a shareholder can be found who both owned the stock at the time of the alleged misconduct and is willing to become the named plaintiff in the suit.\footnote{70}

It is illegal and unethical for an attorney to solicit clients, and thus it may be difficult to procure a client after the alleged misconduct has occurred.\footnote{71} Therefore, the preferred method of obtaining suitable clients is to have them at the ready before any infraction has occurred.\footnote{72} For example, the attorney may ask his existing clients to

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\footnote{68. See Koster, 330 U.S. 518; Subin, 224 F.2d 753; Pellegrino, 203 F.2d 463.}
\footnote{69. Fed. R. Civ. P. 23.}
\footnote{70. Fed. R. Civ. P. 23.1.}
\footnote{71. See Serwer, supra note 7, at 139; Stouver, supra note 9, at 43S.}
\footnote{72. See Ohralik v. Ohio State Bar Ass'n, 436 U.S. 447 (1978) (disbarring attorney who solicited client in face to face contact). But see Shapero v. Kentucky Bar Ass'n, 486 U.S. 466 (1988) (allowing solicitation by mass mailing to a class of people known to share a common problem); In re Primus, 436 U.S. 412 (1978) (allowing attorney to solicit clients by mail if the suit is in the public interest and is not brought for purely commercial reasons). Several of the proposed bills prohibit an attorney from paying or a broker from receiving a fee to procure a client to be the named plaintiff in a securities action. See H.R. 10, supra note 12, § 203(b); H.R. 555, supra note 16, § 101(a); H.R. 675, supra note 17, § 2(a); H.R. 681, supra note 15, § 3.}
\footnote{73. See Senate Panel, supra note 7, at 848; Serwer, supra note 7, at 139; Stouffer,
provide lists of their stock holdings and to update them regularly. More commonly, the attorney may ask friends, relatives or colleagues to purchase stock in numerous corporations. As a last resort, the attorney himself may purchase stock. Ultimately, the attorney will have at his disposal a battery of clients who have agreed beforehand to become the named plaintiff in a securities action should one of their stocks become the target of litigation. As no one can know ahead of time which corporations will behave improperly, or which stocks will take a substantial plummet, ownership in a large number of corporations is a necessity. However, this cost of doing business can become quite expensive, and as a result, the holdings in any one corporation are minimized and limited to one or a few shares of stock. This practice explains why some shareholders tend to be frequent plaintiffs against a number of corporations, and why these plaintiffs tend to have minor holdings in the stock.

This practice entails attorney-initiated and attorney-driven litigation—the client apparently has little or no role in the action.

supra note 9, at 4S.

74. See Serwer, supra note 7, at 139; Stouffer, supra note 9, at 4S.
75. See Stouffer, supra note 9, at 4S.
76. See Stouffer, supra note 9, at 4S. All four House bills require either that the attorney cannot represent the class if he owns or has a beneficial interest in the securities that are the subject of the litigation, or require a finding by the court that such ownership or interest does not create a conflict of interest before the attorney is allowed to represent the class. See H.R. 10, supra note 12, § 3(a); H.R. 555, supra note 16, § 101(c); H.R. 675, supra note 17, § 2(c); H.R. 681, supra note 15, § 3.
77. See Senate Panel, supra note 7, at 848. In one case of this nature, after sanctioning the attorney for not properly screening the surrogate shareholder, the court stated "the firm apparently initiates lawsuits by creating plaintiffs. There is strong evidence to suggest that the firm maintains a list of potential clients to be pressed into service at the drop of certain stock prices." Serwer, supra note 7, at 139. Often the attorney will employ "professional plaintiffs" who receive "bounties" for being named as the plaintiff in a securities lawsuit. All four securities reform bills prohibit the named plaintiff from receiving a disproportionate share of the damages awarded. See H.R. 10, supra note 12, § 203(a); H.R. 555, supra note 16, § 101(c); H.R. 675, supra note 17, § 2(c); H.R. 681, supra note 15, § 3.
78. Senate Panel, supra note 7, at 848 (reporting that one investor appeared as a plaintiff in over 300 such suits); see Stouffer, supra note 9, at 4S. A Dallas judge recently commented that Steven G. Cooperman must be "one of the unluckiest and most victimized investors in the history of the securities business . . . he has been a plaintiff in 38 class-action securities fraud cases." Serwer, supra note 7, at 140.
79. See Boennighausen, supra note 7, at 31; Serwer, supra note 7, at 139; see also supra note 53 and accompanying text. To rectify this problem, two of the reform bills propose that the class members appoint a plaintiff steering committee to control the litigation. If the class members cannot agree on such a committee, the court would be directed to appoint a guardian ad litem with similar powers to direct the litigation. See H.R. 10, supra note 12, § 202(a); H.R. 675, supra note 17, § 4.
violates the intent, if not the letter, of the laws on securities regulation. Congress intended these regulations to provide aggrieved shareholders with a vehicle by which to redress their grievances. The above described practice bypasses the client and tends to benefit only the attorney driving the action.

Even if this practice of obtaining clients does not violate the securities laws, it may still contravene the Federal Rules if the suit is brought as a derivative or class action. In both derivative and class actions, the Federal Rules require the named plaintiff to fairly and adequately represent the interests of those similarly situated. In the strike suits being described, the attorney, rather than the named plaintiff, actually initiates and controls the litigation. Because the named plaintiff in these actions has not initiated the action, and in fact plays no part in the proceedings or ultimate resolution of the action, he cannot possibly be fairly or adequately representing shareholders. Fair and adequate representation seems to imply more than a mere showing of stock ownership; some active role in the course of litigation is expected. By allowing the attorney to make all decisions—without any involvement whatsoever by the disinterested plaintiff—all other shareholders are not being fairly or adequately represented by that plaintiff.

It is true that in many cases a client may give full discretion to his attorney to make any and all decisions concerning the action. However in those cases, the reason for such discretionary authority is the superior knowledge of the attorney. The client may feel reluctant to make any decisions, and may feel more comfortable deferring to the lawyer’s judgment in those decisions. The client should feel confident that the attorney is proceeding with the action according to the client’s best interests. Likewise, all similarly situated persons in a class action or derivative action should feel confident that their rights are being addressed by this lawyer. In fact, the lawyer is ethically

80. Unwarranted Litigation, supra note 7, at 2; see Boennighausen, supra note 7, at 30; Serwer, supra note 7, at 136; Suits Revamped, supra note 22, at 95.

81. See Boennighausen, supra note 7, at 30. In reality, the securities laws often benefit attorneys at the cost of investors. In one instance, an investor received only 17% of the award while legal fees awarded were $3.3 million. Senate Panel, supra note 7, at 848.

82. "One or more members of a class may sue or be sued as representative parties on behalf of all only if . . . (4) the representative parties will fairly and adequately protect the interests of the class." FED. R. CIV. P. 23. "The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association." FED. R. CIV. P. 23.1.
bound to pursue the lawful interests of his clients.

However, this situation is markedly different from the one being discussed. The distinction lies in the outlook of the named plaintiff. Where the client has legitimate interests in the action, he and all others similarly situated would be justified in believing that the attorney is pursuing these interests within the bounds of the law, even if the attorney is given free discretion to make any and all decisions. However, where the named plaintiff is disinterested, as in the situations being contemplated here, by definition the attorney cannot be pursuing the interests of his client, because the client has none. This does not preclude the possibility that the attorney is fairly and adequately pursuing the genuine interests of all similarly situated stockholders which he is purporting to represent. An assumption can be made that the attorney always acts legally and ethically and thus is assumed to be fairly and adequately representing the interests of all similarly situated shareholders affected by the action.

The facts tend to negate this assumption. A large majority of cases brought under these circumstances tend to settle before trial, regardless of the merits of the case. Moreover, the intention of the attorney from the outset is not to produce a fair result but rather to create a quick settlement with a hefty contingency fee. In addition to any violations of the Federal Rules, the attorney surely has violated his ethical responsibilities concerning conflicts of interest and his duty of zealous representation. These considerations will be dis-

83. In a case involving conflict of interest, one party was attempting to disqualify a law firm because one of its partners had a conflict, even though the other partners did not (imputed disqualification). The court held that it should assume that lawyers always act legally and ethically, and thus it was assumed that the partner with the conflict did not disclose confidences or secrets of his former client. Glueck v. Jonathan Logan, Inc., 653 F.2d 746, 749 (2d Cir. 1981).

84. If the assumption is that the lawyer acts legally and ethically, and the Federal Rules require fair and adequate representation, then it must be assumed that the lawyer will fairly and adequately represent the interests of the shareholders, and if he cannot, then he should withdraw from the case.

85. *Unwarranted Litigation*, supra note 7, at 2. Because of the risk of potentially devastating jury awards, there is a great incentive for corporate defendants to settle out of court, even if they are not at fault. *AICPA Calls for Stronger Financial Reporting Standards*, Banking Daily (BNA), at 960 (Dec. 20, 1993) [hereinafter *Stronger Financial Reporting*]; see Boennighausen, *supra* note 7, at 31; Serwer, *supra* note 7, at 136; Stouffer, *supra* note 9, at 5S. Approximately 95% of Rule 10b-5 cases settle. This rate is much higher than for other types of civil suits. *Suits Revamped*, supra note 22, at 95. It is often less expensive to settle than to prove there was no wrongdoing. Boennighausen, *supra* note 7, at 31.

86. See Boennighausen, *supra* note 7, at 31; *Dim Future*, *supra* note 51, at 872; *Suits Revamped*, *supra* note 22, at 95, 96; Stouffer, *supra* note 9, at 5S.

87. See generally *MODEL CODE OF PROFESSIONAL RESPONSIBILITY* DR 5-101(A), DR 5-
There is a second, more important reason for having so many potential clients ready before the misconduct occurs. The combination of boilerplate complaints coupled with ready clients, allows plaintiff attorneys to file complaints almost immediately after some transaction has occurred. Complaints can thus be filed days, in some cases even hours, after some triggering event. This event may be a fall in the stock price, newly released negative news about the corporation, or the acceptance or rejection of a takeover or merger proposal.

The significance of this is found in the "race to the courthouse" phenomenon. The first lawyer to file a complaint in a derivative or class action is often made lead attorney, although no rule of law requires such a result. It is often convenient for the judge to simply accept the first attorney bringing a particular complaint, rather than wait for all claims to be brought, and then arbitrarily choose one attorney from a group of equally qualified lawyers. The judge accepting the complaint would find it difficult to justify why the attorney filing a valid complaint is not sufficiently qualified to proceed through the litigation as lead attorney. This method relieves the judge of defending charges of favoritism. Thus, for all practical purposes, the attorney who acts fastest will end up as lead attorney. As lead attorney, he enjoys the lion's share of any contingency fees created by the action.

The lead attorney is not the only lawyer who stands to gain from the action. Once a suit is filed, there may be numerous other lawsuits filed by shareholders and their attorneys making similar

88. See Boennighausen, supra note 7, at 31; Serwer, supra note 7, at 137.
89. Falkowski, supra note 28, at 56. Five suits were filed in federal court within two hours after Minitel refused a takeover offer from Megacorp. Monteleone & McCarrick, supra note 59, at 41.
90. See Falkowski, supra note 28, at 56; Serwer, supra note 7, at 138; see also supra text accompanying notes 60-68.
91. See Stouffer, supra note 9, at 48.
92. Id. However, H.R. 555 contains a provision whereby the attorneys filing the various complaints are allowed to appoint lead counsel, subject to approval of the court. If the attorneys cannot agree, the court is directed to appoint lead counsel. In deciding who should be lead counsel the attorneys and the court should not give "undue weight to the order of filing" of the complaints. See H.R. 555, supra note 16, § 102.
93. See Stouffer, supra note 9, at 48.
94. Id.; Serwer, supra note 7, at 139.
These "me too" claims may be little more than a paraphrase of the original complaint with a different plaintiff and attorney. In one case, the second complaint was so similar to the first that even misspelled words and names were the same. These attorneys stand to gain a percentage of the contingency fees, albeit a smaller percentage than the lead attorney, simply by filing a similar claim. Even though these attorneys lost the race to the courthouse, they ultimately win in the walk to the bank.

2. Settlement of the Action

Although the practice of bringing securities actions by certain members of the plaintiffs' bar leaves one with an uneasy feeling that the justice system is being abused, it could be justified if the claims were clearly meritorious, and then either litigated or settled for fair value based on the amount in question and the prospects for success at trial. However, it is not the initial creation of the suit that has led many to call for a reform of the system, rather many find fault with the ultimate resolution of most of these suits.

One study indicates that of all shareholder securities lawsuits filed, 70% are settled out of court. However, of the remainder, the corporation almost always wins. These facts tend to support the belief that many of these claims have no basis in law or in fact, and have little or no prospects for success at trial. As stated previously, such suits are called nuisance suits or strike suits. These suits often settle for larger than their fair settlement value.

Some argue, that if such suits had little or no merit then the corporation would either use more traditional litigation tactics to prove this fact, or would settle the case for a small fraction of that being asked for, based on the small chance the claim will succeed. Although these arguments seem compelling on first glance, they ignore transactional costs and thus are untenable.

95. See Serwer, supra note 7, at 138.
96. Id.
97. Id. at 139.
98. Id.
99. Stouffer, supra note 9, at 58.
100. Id.
101. See Serwer, supra note 7, at 136; Unwarranted Litigation, supra note 7, at 3.
102. Witnesses Dispute, supra note 9, at 121.
103. Id. However, in some cases it is more advantageous to litigate rather than settle because the precedent set by an early settlement could be extremely harmful to that particular corporation, or to the industry as a whole. Schaeffer & Scherzer, supra note 52, at 16;
A simple example will serve to illustrate. Assume A and B are two parties to a suit. 104 A sues B for $100,000. This case will have a certain probability of success at trial: assume a 40% chance of victory for A and a 60% chance of victory for B. If both A and B agree on these probabilities, there is a good chance, barring any extreme ill will between A and B, that the case will settle before trial, saving both parties the expense, inconvenience and consternation of litigating the merits of the claim. Under these circumstances, the case will settle for $40,000 ($100,000 claim multiplied by the 40% chance that A will succeed equals $40,000). If the parties cannot agree on their respective probabilities of success (i.e. A believes there is a 60% chance he will prevail but B believes this probability to be only 40%), then the parties may either litigate or agree on some settlement value between these two probabilities. As the discrepancies between these two probabilities increase, there will be a lesser chance that the case will settle and will instead go to trial.

The consideration of litigation costs would certainly alter the analysis. Assume both A and B have $10,000 in litigation costs if the case proceeds to trial. Assume also that the parties agree the fair settlement value of the case to be $40,000. If the case goes to trial, A will stand to gain $30,000 ($40,000 gain in damages - $10,000 costs) and B will stand to lose $50,000 ($40,000 loss in damages + $10,000 costs). Both parties will be better off settling than going to trial. The actual settlement value will be somewhere between $30,000 and $50,000. If neither party has an advantage over the other in terms of bargaining power or savvy, then the amount actually settled on should be roughly halfway between these figures or approximately $40,000. This is the same figure as was reached when litigation costs were ignored. Thus, the fair settlement value of the case will be achieved, even when litigation costs are considered, if these costs are the same for both parties.

A different outcome is reached where litigation costs are higher for one party than for the other. For example, assume that A still has costs of $10,000, but B now has costs of $30,000. In this scenario,

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104. The example assumes that this may be any type of litigation, not merely one involving securities. It also assumes A and B to be any two parties, corporate or individual. Initially, transaction costs will also be ignored. (Transaction costs involve any cost to either party aside from the award of damages. These costs are both quantifiable, such as court costs, attorneys fees, discovery costs, etc. and non-quantifiable, such as bad publicity, inconvenience to the parties, etc.)
A's potential gain if litigated remains at $30,000, but B's potential loss has increased to $70,000. Again, if the settlement reached is halfway between these figures, the result will be a $50,000 payment to A. This is a $10,000 premium over what the settlement value would be if there were no litigation costs, or if these costs were the same for both parties. Thus, a premium in favor of the party with lower litigation costs can be expected whenever there is a discrepancy between the costs to each party.

Interestingly, this premium can be expected, regardless of the fair settlement value of the suit, or the merits of the underlying case. One recent survey found that many such cases settle regardless of the merits of the action. Assume a case to be completely meritless, and thus there is theoretically no chance of success at trial. Under the above conditions, in such a case the settlement value is $0 because there is no chance A will succeed at trial. A will stand to lose $10,000 by going forward with the case, but B will stand to lose $30,000 by vindicating his rights. A will need $10,000 just to cover the cost of going to trial and therefore the settlement value will be halfway between that figure and the $30,000 B will stand to lose by going forward. Thus B will give A $20,000, even though A has no case. The rationale is that B would prefer to spend $20,000 in a settlement rather than $30,000 to prove there was no case at all. Thus, it can be seen that the premium paid over the fair settlement value will occur, regardless of the merits of the case, and is a function solely of the discrepancy in litigation costs of the parties. The greater the merits of the case, the greater will be the settlement value, but the party with lower litigation costs will benefit from the premium, regardless of the merits. This is the basic theory behind nuisance suits or strike suits, and explains why even frivolous lawsuits have some intrinsic settlement value.

This scenario is recurrent in securities litigation. In a case brought against a corporation, or its officers and directors, there often will be a very large discrepancy in the litigation costs of the plaintiff.

105. Unwarranted Litigation, supra note 7, at 2.
106. This analysis concerning A and B is based on positive economic theory where it is assumed that both A and B act rationally to maximize their respective wealth. This simplistic example avoids the problem of initial distribution of wealth, which would bring in such other factors as the marginal utilities of A and B, and whether A or B could afford the costs of the action. Although these considerations offer an explanation as to why not all cases settle, they also unnecessarily complicate the analysis and are beyond the scope of this Note. See generally, PAUL WONNACOTT & RONALD WONNACOTT, ECONOMICS 454-67 (4th ed. 1990).
and of the defendants. Costs to the plaintiff are generally low. There is the minimal cost of filing the complaint, little or no discovery costs because there is usually little investigation into the merits of the case, and the lawyer's time in drafting the complaint and negotiating a settlement. Conversely, costs to the defendants can be extremely high. These costs include high priced attorneys, extensive discovery costs to prove there was no wrongdoing, and the hiring of expert witnesses. It also includes such intangible costs as unfavorable publicity, the prospect that a loss at trial will lead to subsequent litigation, and the inconvenience to officers and directors who must devote valuable time defending their actions, rather than running the corporation. This tends to explain why many securities cases are settled prior to trial, and why those that do go to trial are usually won by the defendants.

Lawyers bringing these suits are well aware of these facts. Most cases brought against corporate defendants have a settlement premium above the fair settlement value of the case. For this reason, lawyers initiating securities actions are interested from the outset in settling the case rather than litigating on the merits. This is true even for meritorious cases. The plaintiff's attorney can get the fair settlement value of the case, plus extract extra money from the corporation based on the litigation cost discrepancy. Furthermore, by settling the case, the plaintiff's attorney saves the time and expense of going to trial. The time saved can then be used to initiate the next securities case, in effect creating litigation machines.

The lawyer's intention to settle the case from the outset may run counter to the interests of his clients. The named plaintiff is merely a conduit by which the attorney is allowed to bring suit. This plaintiff is disinterested in the outcome, and thus the attorney is not acting against that plaintiff's interests. However, in derivative actions and class actions the attorney is also representing a large class of absentee shareholders who have absolutely no say in the course of the ac-

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107. See generally Senate Panel, supra note 7, at 847.
108. See Boennighausen, supra note 7, at 31; Serwer, supra note 7, at 137; Suits Revamped, supra note 22, at 95.
109. See Boennighausen, supra note 7, at 32; Serwer, supra note 7, at 137, 138.
110. See Serwer, supra note 7, at 136.
111. See Dim Future, supra note 51, at 872; Stouffer, supra note 9, at 24; Suits Revamped, supra note 22, at 95.
112. See Stouffer, supra note 9, at 24.
113. See Serwer, supra note 7, at 136; Unwarranted Litigation, supra note 7, at 3.
114. See Serwer, supra note 7, at 140.
They may prefer to litigate rather than to settle, or they may prefer that the action not be brought in the first place, as it may ultimately be detrimental to the corporation as a whole, and thus adversely affect its shareholders. Without a named plaintiff who is sufficiently interested in the action, the absentee shareholders are at the mercy of the lawyer to act in their best interests. Since the lawyer is intent on settling the case to extract the most fees with the least time and effort spent, he may well not be acting in the best interests of the shareholders he is attempting to represent. This raises serious ethical questions regarding the duty of zealous representation and conflicts of interest.

C. Ethical Considerations

The ABA’s Model Rules of Professional Conduct and the Model Code of Professional Responsibility, adopted in some form by all fifty states, require an attorney to zealously represent his client, and to end that representation where there exists a conflict between the interests of the attorney and the interests of his clients. Zealous representation means that the attorney will pursue the goals of the client using any and all lawful means. In a situation where the lawyer is intent on settling the case from the outset, he is foreclosing all other lawful means to obtain the clients’ objectives. In the securities actions being considered the attorney represents a large group of shareholders.

115. In a class action, the named plaintiff obviously represents the class of shareholders of the corporation. Theoretically, in a derivative action the named plaintiff represents only the corporate entity. However, Congress recognized that, in reality, the named plaintiff was also representing all other similarly situated shareholders. See supra note 82. In derivative actions, those shareholders not party to the suit have no input as to the course or ultimate resolution of the action, and have no means to remove themselves from the action. FED. R. CIV. P. 23.1. The rules on class action suits are somewhat more lenient. Once a class is certified by the court, all members of the class are joined, but any individual member can “opt out” of the class by notifying the court of an intention not to be part of the class. FED. R. CIV. P. 23(c)(2)(A).

116. One method of alleviating this problem is to create plaintiff steering committees or by appointing a guardian ad litem to control the action, including any settlement of the action. See supra note 79. In addition, certain proposals have been made that would require full disclosure of all settlement terms to the members of the class. Such disclosure would include an opinion on the outcome of the case, the damages likely to be recovered, the attorneys fees involved, and the amount each class member can expect to receive. See H.R. 10, supra note 12, § 202(b); H.R. 555, supra note 16, § 101(c); H.R. 675, supra note 17, § 2(c).

117. See supra note 87 and accompanying text.

118. See supra note 87 and accompanying text.

In at least some cases it will better serve the interests of these shareholders to litigate rather than to settle. In such cases, when the lawyer settles the case he has failed to zealously represent his clients. The lawyer has failed to pursue a lawful method of advancing the rights of his clients, namely litigation.

A similar analysis can be made concerning the ethical considerations of conflict of interest. A conflict of interest occurs where there is the possibility that the interests of the attorney conflict with the interests of his clients.\textsuperscript{120} The attorney need not act against his clients’ interest for there to be a conflict, the potential for such wrongdoing is sufficient.\textsuperscript{121} Therefore, in a situation where the attorney intends to settle a case, and the clients would prefer to litigate, a conflict of interest exists. This occurs in many contingency fee arrangements.\textsuperscript{122} However, this situation is ameliorated by the fact that the client is ultimately directing the course of the action. The attorney may wish to settle, and may advise his client to do so, but the attorney cannot act unilaterally. If the client prefers to litigate, the attorney is bound to comply with these wishes. In such a situation, a conflict of interest exists, even if not actual misconduct has occurred. Conversely, in the securities actions being discussed, the attorney, not his clients, actually controls the course of the action.\textsuperscript{123} In these cases, the attorney is free to make all decisions without input from the class of shareholders.\textsuperscript{124} Here, the potential for abuse is much greater, and the degree of seriousness associated with the conflict of interest is sufficient to indicate an ethical violation.

Thus far the analysis has focused on the practice of initiating and settling strike suits. It was shown that at best, such practices have found flaws in the system that allow private securities suits in situations not contemplated by Congress. At worst, these suits may run contrary to the Federal Rules which require fair and adequate representation of shareholders in derivative and class action suits. Furthermore, the practice of settling these cases may involve breaches of the lawyer’s ethical responsibilities. The following two sections will ex-

\begin{itemize}
\item \textsuperscript{120} Id. at 173.
\item \textsuperscript{121} Id. at 177-78.
\item \textsuperscript{122} The attorney would prefer to settle, so that he does not risk losing at trial, and eliminates the time and expense of litigation. The client, on the other hand, may stand to receive a much greater award of damages after trial, and may be willing to risk losing at trial. In this situation, a conflict of interest exists. Id. at 173.
\item \textsuperscript{123} See supra note 79 and accompanying text.
\item \textsuperscript{124} See supra note 79 and accompanying text.
\end{itemize}
plore existing procedural safeguards aimed at preventing strike suits, and pending legislation attempting to further limit strike suits.

III. EXISTING PROCEDURAL SAFEGUARDS FOR PREVENTING STRIKE SUITS

Congress has not been oblivious to the reality of strike suits. From the outset there have been procedural safeguards to minimize the number of such suits, while allowing meritorious claims to be brought. Several of these safeguards have already been discussed, namely the requirement of ownership, the fair and adequate representation requirement, and the possible ethical considerations. Two other important safeguards are court ordered sanctions for frivolous suits and the requirement that any dismissal or settlement of a derivative or class action suit be approved by the court. Also, the court has the power to determine who will be lead counsel, and to dismiss meritless suits. For a variety of reasons, these measures have failed to adequately eliminate strike suits.

When a suit is initiated, the first requirement is that the named plaintiff has actually owned stock in the corporation at the time of the alleged wrongdoing. This requirement is necessary to allow suits only where someone actually suffers damages, and to prevent suits where no plaintiff exists. As discussed, this requirement is easily circumvented by lawyers who manufacture plaintiffs. Since the courts have held that the actual number of shares owned is not relevant, these plaintiffs are allowed to sue.

Once the court determines that the plaintiff and his attorney have standing to sue, the next question is whether to make that attorney

125. See supra notes 65-68 and accompanying text.
126. See supra notes 82-87 and accompanying text.
127. See supra part II.C.
128. See Fed. R. Civ. P. 11. "If a pleading, motion or other paper is signed in violation of this rule, the court, upon motion or upon its own initiative, shall impose upon the person who signed it, a represented party, or both, an appropriate sanction . . . ." Id.
129. See Fed. R. Civ. P. 23(e), 23.1.
130. See supra notes 91-92 and accompanying text.
132. See supra note 66 and accompanying text.
133. See, e.g., Bateson v. Magna Oil Corp., 414 F.2d 128, 131 (5th Cir. 1969), cert. denied, 397 U.S. 911 (1970) (determining that the purpose of the rule is to "prevent the federal court from being used to litigate purchased grievances or from becoming party to speculative suits against corporations").
134. See supra note 67 and accompanying text.
lead counsel. Although the attorney can generate legal fees anyway, it is much more lucrative to do so as lead counsel.\textsuperscript{135} The judge has discretion in this area, and may believe that an attorney who specializes in generating this type of litigation should not be rewarded with lead counsel status merely because he has won the race to the courthouse.\textsuperscript{136} The judge would be forced to justify his decision and may be accused of favoritism. There is no justifiable reason why a competent attorney, pursuing a legal right for his client, should be denied the role of lead counsel merely because the judge dislikes his methods. Furthermore, someone must be named lead counsel, and if there are contingency fees to be made, someone else will step forward to make them. Therefore, any discretion in naming lead counsel will not lessen the number of strike suits, it will merely alter which lawyer receives the bulk of the fees.

Another requirement is that the suit be filed within the time period allowed by the statute of limitations.\textsuperscript{137} Some reform advocates have suggested decreasing this time period to force actions to be brought before any alleged misconduct is reflected in the stock price.\textsuperscript{138} This seems irrelevant, because cases are brought almost immediately after a stock price drop, and the infraction complained of occurs at approximately the same time.\textsuperscript{139} Therefore, all strike suits of this nature will always be within the statute of limitations. Any time limit requirement will thus have no bearing on the number of strike suits filed.

Some of the suits brought have absolutely no merit and no chance of success at trial.\textsuperscript{140} In these cases, the judge is free to dismiss the action pursuant to a motion to dismiss\textsuperscript{141} or a summary judgment motion\textsuperscript{142} filed by the defendants. However, even these suits may retain some settlement value.\textsuperscript{143} The defendants are required to pay attorneys fees and any discovery costs incurred in dismissing the case. Furthermore, even if the case is dismissed, defen-

\textsuperscript{135} See Serwer, supra note 7, at 139.

\textsuperscript{136} Id.

\textsuperscript{137} See Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 364 (1991) (establishing a one year limit from the date of discovery but not longer than three years from the date of the alleged misconduct).

\textsuperscript{138} See Unwarranted Litigation, supra note 7, at 2.

\textsuperscript{139} See supra text accompanying notes 88-98.

\textsuperscript{140} See Serwer, supra note 7, at 136; Stouffer, supra note 9, at 1S.

\textsuperscript{141} FED. R. CIV. P. 41(b).

\textsuperscript{142} FED. R. CIV. P. 56(a).

\textsuperscript{143} See supra text accompanying notes 99-117.
dants may suffer bad publicity. Thus, the defendants may be compelled to settle with the plaintiff to avoid these costs, even though the case would ultimately be dismissed. Mere dismissal of a suit based on lack of merit will not lessen the occurrence of strike suits because even in these situations the lawyer may reap a profit.

To respond to this problem of vexatious litigation, Congress enacted Rule 11 of the Federal Rules to deal with frivolous lawsuits. The main focus of this rule is that the lawyer and the party bringing a lawsuit must verify that, after reasonable inquiry, the suit has a basis in law and is not brought to harass, delay or increase the costs of litigation. Judges are required to sanction attorneys and parties who have violated this Rule. Such sanctions may include non-monetary directives, court penalties, or payment to the opposing party of some or all expenses incurred in the litigation, including reasonable attorneys' fees. The "appropriate sanction" is left to the court's discretion.

In the past, Rule 11 has not met its goals of deterring frivolous litigation. Attorneys are eager to recoup their costs of litigation, and thus readily make Rule 11 motions requesting sanctions against the opposing party and their attorneys, whenever a case appears to have little merit. However, judges are not so quick to grant these motions, due to the potentially chilling effect on future cases. What may appear to be frivolous on its surface may ultimately be viewed as meritorious with the benefit of hindsight. Many landmark cases that changed the course of the law were, when filed, contrary to the vast amount of case law on the subject at issue—e.g. Erie v. Tompkins, MacPherson v. Buick, and Brown v. Board of Education, to name only a few. If decided differently, the judge could

144. See Fed. R. Civ. P. 11, advisory committee's notes to 1993 Amendment.
145. Id.
146. Id.
147. Id.
149. See supra note 149 and accompanying text.
151. 304 U.S. 64 (1938).
152. 111 N.E. 1050 (N.Y. 1916).
potentially have sanctioned the parties and their lawyers for bringing "frivolous" suits that were obviously contrary to existing law. Although Rule 11 has a provision for such situations, it does not entirely address the problem. Because of the provision, cases such as those named above, would probably not incur sanctions. However, the real problem is that if Rule 11 sanctions were doled out liberally, these cases may not have been brought in the first place. Judges are well aware of this fact, and thus are reluctant to impose sanctions against any lawyer merely for bringing a case to court. Attempts to correct this problem have resulted in amendments to Rule 11, but it is far from certain whether these amendments will, in fact, correct the problem.

The above analysis concerned cases that are completely meritless. If a case has some chance of success, the analysis changes. If reasonable people could differ as to the outcome of the case at trial then the case should not be dismissed. Furthermore, if a case cannot be dismissed, it cannot be frivolous, and thus is completely outside the realm of Rule 11. Such cases must be allowed to proceed either to litigation or to settlement. This brings with it all the problems associated with settlements already discussed.

The area of settlement offers the greatest chance for deterrence of these suits. The opposing parties are, of course, free to reach any out of court settlement agreeable to both parties. The problem lies in the fact that, to a degree, the plaintiff's attorney is extracting money from the corporation out of proportion with what should be the fair settlement value of the suit. When the suit is brought as a derivative or class action the lawyer and his client are representing a large number of absentee shareholders. The Federal Rules require fair and adequate representation of these shareholders by the plaintiff and the attorney. This is because the rights of these absentee shareholders will be adjudicated or settled without any input from them. Res judicata will then bar these shareholders from initiating

154. Rule 11 is not violated if the suit makes "a good faith argument for the extension, modification or reversal of existing law . . . ." FED. R. CIV. P. 11.
155. Id.; see also supra note 145.
156. See, e.g., Scheur v. Rhodes, 416 U.S. 232, 236 (1974); American Nurses' Ass'n v. Illinois, 783 F.2d 716, 724 (7th Cir. 1986).
157. See supra notes 99-117.
158. See supra notes 110-13 and accompanying text.
159. See supra note 115 and accompanying text.
160. See supra note 82.
further action in regard to the issue in question.\textsuperscript{162}

Because of the possibility that the lawyer may seek to act in his own interests by settling the case, the Federal Rules require that any dismissal or settlement must first be approved by the court.\textsuperscript{163} In effect, if the dispute is to be ended without a trial, the judge is to be another representative of the absentee plaintiffs to act in their interests.\textsuperscript{164} If the settlement is not in the interests of this group, the judge is free to veto the settlement, and either force the parties to litigate, or come up with a settlement that reflects the interests of the absentee plaintiffs.\textsuperscript{165}

This requirement was intended to further protect the interests of the shareholders.\textsuperscript{166} Congress believed that to avoid the possibility of quick settlements by the lawyer, to the detriment of those he was representing, active judicial involvement was necessary.\textsuperscript{167} In reality, judicial involvement is rare, and this is understandable.\textsuperscript{168} If the parties have reached an agreement, it must be assumed that both parties are satisfied with the resolution of the dispute, and do not wish to litigate. Judges who face crowded court dockets should have no interest in forcing parties to litigate when they would prefer to settle. All parties involved—the judge, the named plaintiff, the corporate defendant, and their respective attorneys—would prefer that the case not be litigated. Therefore, the judge is, and should be, reluctant to veto a settlement of the matter in question.

Of course, if the settlement is grossly unfair to the absentee plaintiffs, the judge should step in and act on their behalf. However, this is not often the case. Because the plaintiff's lawyer is seeking a settlement above the fair settlement value of the case based on the litigation cost premium, the class of plaintiffs will stand to gain at

\begin{footnotes}
\item[163] Fed. R. Civ. P. 23(e), 23.1.
\item[165] See Seigat v. Merrick, 590 F.2d 35, 37 (2d Cir. 1978).
\item[166] See, e.g., Shlensky, 574 F.2d at 147; Schlusselberg v. Colonial Management Ass'ns., Inc., 389 F. Supp. 733, 741 (D. Mass. 1974) (purpose of judicial involvement was to protect against collusive settlement).
\item[167] Shlensky, 574 F.2d at 131; Schlusselberg, 589 F. Supp. at 733.
\item[168] See Serwer, supra note 7, at 140.
\end{footnotes}
least as much as they are entitled to, and possibly more. The interests of the class of plaintiffs may be addressed by the settlement, but the interests of the corporate defendants may not be. Although the corporate defendant has voluntarily agreed to the settlement, its acquiescence was coerced by the plaintiff's attorney as a result of the litigation cost premium. Since the rule focuses on judicial involvement on the part of absentee shareholders, judges will not veto a settlement if it appears unfair to the corporate defendant. After all, the rights of the absentee plaintiffs must be protected by the judge since they cannot protect their own rights, but the corporation is fully represented and is an active party in the settlement negotiations, thus no judicial involvement on their behalf is necessary. Therefore, judicial involvement in the settlement will not protect corporate defendants and will not reduce strike suits.

Opponents of securities law reform point to all of the above procedural safeguards built into the system that prevent or discourage strike suits.\textsuperscript{169} They claim that any strike suits that result, even in the face of these measures, are a necessary expense in allowing private citizens to vindicate their rights with regard to corporate defendants.\textsuperscript{170} Even if there is a proliferation of strike suits, it is due to lack of judicial oversight, and if judges would do their jobs properly the situation could be corrected.\textsuperscript{171}

However, the analysis has shown that even with an active judiciary, strike suits will be commonplace. The procedural safeguards in the system are simply inadequate to deal with the problem. Moreover, judicial inactivity is not due to apathy or incompetence. It should be presumed that federal judges act to meet the competing goals of justice and efficiency, and if they act a certain way with regard to the system, it should be to address these two goals. Any attempt to alter their behavior without altering the rules would be difficult, if not impossible, and would be imprudent.

A serious problem exists with regard to strike suits brought against corporations. Although there are several procedural safeguards designed to address this problem, clearly they have fallen short of achieving the goal of reducing or eliminating strike suits. For this

\textsuperscript{169} See Boennighausen, supra note 7, at 32; Harm Investors, supra note 43, at 2, 3; Senate Panel, supra note 7, at 847.

\textsuperscript{170} See Boennighausen, supra note 7, at 30, 32; Serwer, supra note 7, at 137; Stouffer, supra note 9, at 18.

\textsuperscript{171} See Boennighausen, supra note 7, at 33; Harm Investors, supra note 43, at 2, 3; Senate Panel, supra note 7, at 118; Serwer, supra note 7, at 140.
reason, reformers have urged changing the existing rules. The following section will examine proposed changes to the securities laws.

IV. PROPOSED REFORMS

Reform measures are necessary due to the obvious problems associated with frivolous lawsuits, and the inadequacy of the current system to effectively deal with them. No less than four bills dealing with reform of the laws on private securities litigation were introduced in the House of Representatives during the first month of the 104th Congress. The major provisions of these bills include:

1) mandating that the prevailing party be awarded attorneys fees;\(^{172}\)
2) altering joint and several liability to some form of proportionate liability;\(^{172}\)
3) creating an early evaluation procedure;\(^{174}\)
4) limiting the Racketeer Influenced and Corrupt Organizations Act so that securities actions are no longer included within that Act;\(^ {175}\)
5) creating plaintiff steering committees, or in the alternative appointing a guardian ad litem, in class actions to control the litigation and prevent attorney-driven litigation;\(^{176}\)
6) creating rules on the full disclosure to class members of any proposed settlement, including an opinion on the outcome of the case, the damages likely to be received, the attorneys fees involved, and the amount to be received by each class member;\(^{177}\)
7) prohibiting attorneys fees from being paid from disgorged funds received pursuant to SEC actions;\(^{178}\)
8) prohibiting attorneys from paying, and named plaintiffs from receiving a disproportionate share of any damages received in a class action;\(^{179}\)
9) requiring a certain minimum ownership level by the named plain-

\(^{172}\) H.R. 10, supra note 12, § 203(a); H.R. 681, supra note 15, § 3.
\(^{173}\) H.R. 10, supra note 12, § 203(a); H.R. 555, supra note 16, § 101(c); H.R. 675, supra note 17, § 6; H.R. 681, supra note 15, § 3.
\(^{174}\) H.R. 555, supra note 16, § 102.
\(^{175}\) H.R. 10, supra note 12, § 107; H.R. 675, supra note 17, § 9.
\(^{176}\) H.R. 10, supra note 12, § 202(a); H.R. 675, supra note 17, § 4.
\(^{177}\) H.R. 10, supra note 12, § 202(b); H.R. 555, supra note 16, § 101(c); H.R. 675, supra note 17, § 2(c).
\(^{178}\) H.R. 10, supra note 12, § 202(c); H.R. 555, supra note 16, § 101(b); H.R. 675, supra note 17, § 2(b); H.R. 681, supra note 15, § 3.
\(^{179}\) H.R. 10, supra note 12, § 203(a); H.R. 555, supra note 16, § 101(c); H.R. 675, supra note 17, § 2(c); H.R. 681, supra note 15, § 3.
tiffs;\textsuperscript{150}

10) prohibiting attorneys with a financial interest in the securities that are the subject of the litigation from representing the class;\textsuperscript{181}

11) prohibiting attorneys from paying and brokers or dealers from receiving fees for the referral of clients who may serve as named plaintiff;\textsuperscript{182}

12) requiring a higher level of scienter in order to prove a violation under Section 10 of the 1934 Act;\textsuperscript{183}

13) mandating that the SEC establish “safe harbor” rules for forward-looking statements, such that investors will be adequately protected and issuers of securities will be immune from liability under Section 10 of the 1934 Act;\textsuperscript{184}

14) establishing alternative dispute resolution procedures for securities class actions;\textsuperscript{185}

15) prohibiting settlements from being filed under seal;\textsuperscript{186}

16) limiting the amount of attorneys fees that can be paid out of class action awards;\textsuperscript{187}

17) altering the statute of limitations for private securities actions;\textsuperscript{188}

18) consolidating multiple class actions and setting selection criteria for choosing lead counsel;\textsuperscript{189} and

19) providing for aiding and abetting liability with respect to securities laws violations.\textsuperscript{190}

The provisions in these bills are necessary to stem the tide of vexatious litigation and to relieve the economy of an unnecessary burden to innovation and productivity.

\textsuperscript{180} H.R. 10, supra note 12, § 203(a).
\textsuperscript{181} H.R. 10, supra note 12, § 203(a); H.R. 555, supra note 16, § 101(c); H.R. 675, supra note 17, § 2(e); H.R. 681, supra note 15, § 3.
\textsuperscript{182} H.R. 10, supra note 12, § 203(b); H.R. 555, supra note 16, § 101(a); H.R. 675, supra note 17, § 2(a); H.R. 681, supra note 15, § 3.
\textsuperscript{183} H.R. 10, supra note 12, § 204; H.R. 675, supra note 17, § 5; H.R. 681, supra note 15, § 3.
\textsuperscript{184} H.R. 10, supra note 12, § 205; H.R. 555, supra note 16, § 104; H.R. 675, supra note 17, § 7.
\textsuperscript{185} H.R. 10, supra note 12, § 206.
\textsuperscript{186} H.R. 555, supra note 16, § 101(c); H.R. 675, supra note 17, § 2(c).
\textsuperscript{187} H.R. 555, supra note 16, § 101(c); H.R. 675, supra note 17, § 2(c).
\textsuperscript{188} H.R. 675, supra note 17, § 3.
\textsuperscript{189} H.R. 555, supra note 16, § 102.
\textsuperscript{190} H.R. 555, supra note 16, § 103; H.R. 681, supra note 15, § 3.
A. Fee Shifting

1. Current Proposals

The most important, and most controversial, provision involves fee shifting. Two of the four pending bills include mandatory fee shifting provisions, but give the court discretion to reduce or deny such an award if the prevailing party "unduly and unreasonably protracted the final resolution of the matter in controversy." House Bill 681 goes further by giving the court discretion as to whether the amount awarded is to be assessed against the unsuccessful party, its attorney, or both. Moreover, the court can reduce or deny any award for attorneys fees or expenses if it finds that the position of the losing party was "substantially justified."

This rule of fee shifting has traditionally been known as the English Rule. In contrast, the American Rule states that each party is responsible for paying its own attorneys fee regardless of the outcome of the suit. This distinction may be a misnomer, because in many situations in the United States the losing party is made to bear the cost of the winning party's attorneys' fees. One such situation has already been mentioned. Under Rule 11 sanctions, the judge has discretion to award attorneys' fees to the prevailing party if there is a determination that the suit filed is frivolous.

The debate concerning the merits and drawbacks of the English Rule and the American Rule has continued in this country for the past 200 years. The case for each side can be summarized quite easily. The English Rule prevents plaintiffs from using the legal system to extort money from defendants through nuisance suits. The American Rule encourages meritorious claims to be resolved through the judicial process. Early on, the Supreme Court favored the American

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191. H.R. 10, supra note 12, § 203(a); H.R. 681, supra note 15, § 3.
192. H.R. 681, supra note 15, § 3.
193. Id. For the purposes of this bill, the term "substantially justified" is to have the same meaning as in 28 U.S.C. § 2412(D)(1) (1988). See H.R. 681, supra note 15, § 3.
197. See supra text accompanying notes 141-44.
Rule, hence its name.198 However, over the years, specific situations have called for use of the English Rule,199 and there is a movement favoring increased use of the English Rule.200

Opponents of the English Rule fear that its adoption will have a chilling effect on meritorious as well as frivolous suits, and that under this rule the system of private enforcement of the securities laws will be seriously hindered.201 This fear is justified, but may be a necessary consequence of curtailing frivolous suits. Because adoption of the English Rule concerning attorneys’ fees will necessarily curtail both meritless and meritorious claims, its use should be limited so as to have the least detrimental effect on private enforcement of valid claims.

Although a large number of nuisance suits involve allegations of securities fraud, many others are brought as derivative actions that do not claim securities fraud.202 By focusing exclusively on private securities actions, the bills fail to address the problem of strike suits brought as derivative actions where securities violations are not at issue. As already stated, strike suits are generally brought either as a class action or a derivative action. It is uncommon for nuisance suits to be initiated and followed through by an individual shareholder. But, House Bill 681 includes a fee shifting provision covering all securities suits, class actions as well as individual suits, without making a distinction.203 Since individual suits are not likely to be strike suits, and an individual may lack the means to pay opposing attorneys’ fees, such a rule would indeed have a dramatic chilling effect on private enforcement of the securities laws.

Such a drastic change in the securities laws should be handled cautiously. A more appropriate alternative would be to require fee

199. See supra note 196 and accompanying text.
202. See supra note 8 and accompanying text, which defines strike suits as being derivative actions.
203. See H.R. 681, supra note 15, § 3.
shifting in all *class action* securities cases, while maintaining the American Rule for non-class action cases. This amendment to the securities laws could then be supplemented by a similar change in Federal Rule 23.1 concerning derivative suits. Such a change would require mandatory fee shifting for all derivative actions brought in federal courts.

Fears that mandatory fee shifting will curtail private enforcement can be alleviated by the provision allowing judges to deny an award of opposing attorneys' fees if the position taken can be substantially justified.204 One effect of this proposed change would be to force the hand of the judiciary to sanction frivolous suits in a way that could not be accomplished by gentle coercion with regard to Rule 11. Not only would actions that fall under the ambit of Rule 11 be covered by this fee shifting rule, but positions that cannot be substantially justified will also be included. This rule is little more than an extension of Rule 11 in one particular problem area. Although fee shifting would be mandatory, judges still retain some control in determining whether a position is substantially justified so that fee shifting is not required.

The same problems and fears associated with Rule 11 sanctions can be extended by analogy to mandatory fee shifting arrangements. However, by limiting its application to derivative suits and securities fraud class actions, the negative implications can be minimized. Suits of this type are polluted with overtones of questionable practices as discussed previously. Fee shifting in this area is a necessary response to the increasing use of strike suits. To the extent that meritorious suits are discouraged, this result is justified and can be minimized by the safety valve built into the provision, namely the substantially justified clause.

2. Early Evaluation Procedure

House Bill 555 includes an interesting provision that would create a procedure for early evaluation and disposal of the action.205 In private securities class actions, if the parties agree, the court must order this early evaluation procedure which may not extend beyond 150 days of the filing of the original complaint unless the parties

204. H.R. 681 exempts from its fee shifting provision any suit that can be “substantially justified.” See id.
agree to an extension.\textsuperscript{206}

Under this procedure, a mediator agreed upon by the parties or appointed by the court, would have the authority to make limited findings that would aid in the disposal of the action.\textsuperscript{207} During this procedure, the defendant shall not be required to answer or respond to the plaintiff's complaint.\textsuperscript{208} The plaintiffs would be allowed to consolidate or amend the complaint, or dismiss the action without incurring sanctions.\textsuperscript{209} No formal discovery would take place, but the parties would be required to provide access to all relevant non-privileged documents concerning allegations in the complaint.\textsuperscript{210} If the parties refuse to do so, the mediator can order production of these documents and can sanction the parties for failure to comply with such an order.\textsuperscript{211}

At the conclusion of the early evaluation procedure, the mediator must submit written findings to the parties that the action is

1) clearly frivolous, such that it can only be further maintained in bad faith; or
2) clearly meritorious, such that it can only be further defended in bad faith; or
3) neither clearly frivolous nor clearly meritorious.\textsuperscript{212}

This written evaluation is not admissible as evidence in the action, but may be used by the court to sanction the losing party or its counsel.\textsuperscript{213}

Any procedure that would aid in the fair settlement prior to discovery and trial of private securities actions should be welcomed. However, this proposal suffers from two main drawbacks. First, the procedure can only be instituted if both parties agree to submit to such a procedure. Common sense would dictate that if there is even a small possibility that the mediator will find the action to be clearly frivolous or clearly meritorious, the party against whom such a finding would be made, would refuse to submit to this procedure. There is no incentive for a party with a weak case to agree to such a pro-

\textsuperscript{206} Id.
\textsuperscript{207} Id.
\textsuperscript{208} Id. \textsuperscript{102}(c)(2).
\textsuperscript{209} Id.
\textsuperscript{210} Id.
\textsuperscript{211} Id. \textsuperscript{102}(c)(3).
\textsuperscript{212} Id. \textsuperscript{102}(c)(4).
\textsuperscript{213} Id. \textsuperscript{102}(c).
procedure. Moreover, that party stands to lose a great deal if the mediator finds against it. Not only would that party lose in the underlying action, but it may also be subject to court sanctions. One way to alleviate these problems is to allow the court in its discretion to order an early evaluation procedure when warranted by the facts, regardless of the wishes of the opposing parties.

A second flaw to the early evaluation procedure is that it limits the power of the mediator to make relevant findings. As stated above, it is unlikely that a party with a weak case will agree to the early evaluation procedure. Thus, it may be assumed that most of these procedures will end in a finding that the action is neither clearly frivolous nor clearly meritorious, both of which are difficult standards to prove. In the vast majority of cases then, the early evaluation procedure will not aid in an early disposition of the action. In fact, such a procedure will unnecessarily delay the action.

In the alternative, an early evaluation procedure would be beneficial if the mediator were allowed to make other findings. For example, as described in part IV.A.1, House Bill 681 would require the losing party to pay the reasonable attorneys fees and expenses of the prevailing party, unless the court found the action to be substantially justified.\(^\text{214}\) Opponents of fee shifting object that the substantially justified exception will not alleviate the problems of fee shifting. Because the parties will not know in advance who will prevail, or whether the court believes the action to be substantially justified, the parties will be reluctant to proceed with the action for fear of incurring court sanctions.

As a way to reduce the uncertainties involved, the early evaluation procedure could be modified so that upon motion of either party to the action, the court would be required to order the early evaluation procedure. At the conclusion of the procedure, the mediator would be required to submit written reports to the parties and to the court, finding that

1) the action is substantially justified;
2) the defense to the action is substantially justified;
3) both the action and the defense to the action are substantially justified; or
4) at this point in the process neither the action nor the defense to the action can be said to be substantially justified.

\(^{214}\) See supra note 193 and accompanying text.
The mediator's findings would be conclusive proof upon the court, such that the court could not order sanctions at the conclusion of the action against a party whose position had been found by the mediator to be substantially justified. Of course, in extreme circumstances, where new evidence is adduced at trial which would negate the mediator's findings, the court would be able to order sanctions. However, this exception should be limited to situations where the new evidence conclusively proves that the mediator's findings were clearly incorrect.

On the other hand, either party would be free to pursue the action or the defense in the absence of a finding by the mediator that its position was substantially justified. Such a party however, would not be protected, and could be sanctioned by the court at the conclusion of the action if the court finds that the position was not substantially justified.

In effect, the early evaluation procedure is similar to an advisory opinion or SEC no-action letter. A party armed with an SEC no-action letter is free to pursue the course of conduct described to the SEC without fear of reprisals from that agency. If the conduct deviates from that represented, the SEC would have the option of taking action against that party. Also, if the SEC refused to issue a no-action letter, the party would still be allowed to pursue its course of conduct, but would be in danger of SEC actions against it.

Similarly, a mediator's finding that a party's position is substantially justified would create certain protections. If no new evidence negating the mediator's findings is produced, that party is assured that the court will not order sanctions against it. If new evidence is produced, the party would lose its protection, but would still be allowed to continue with the action. Also, even if the mediator refused to find that the party's position was substantially justified, the party would still be free to pursue that position, however it would not automatically be protected from court sanctions.

One drawback of such a procedure is that very little evidence will be available at such an early stage in the action. Although this is often true, the burden to be met at the early evaluation procedure is low. A party initiating or defending a private securities action should be able to show early on that its position is substantially justified. If the party cannot meet this minimal burden, perhaps that party should be allowed to proceed with the action only at its own risk. Moreover, a party should not be heard to complain that it cannot justify its position because the information to do so is under the control of the
opposing party. A party should not be allowed to justify its position by engaging in so-called “fishing expeditions” which are at the heart of securities strike suits.

B. Joint and Several Liability v. Proportionate Liability

Another proposal in the congressional bills seeks to change the degree of liability from joint and several liability to proportionate liability.215 Under the current tort system, any tortfeasor who is found liable to the plaintiff for injuries sustained, is liable for the entire amount of damages, regardless of the degree of fault.216 This is known as joint and several liability. Because of this result, plaintiffs are prone to sue defendants who are financially capable of satisfying the entire judgement, even if those defendants were not substantially at fault. This is often known as the “deep pocket theory” of liability because the plaintiff searches for a defendant with large financial resources, i.e. one with “deep pockets.”217 A tortfeasor will be sued not because of a high degree of culpability, but merely because of sufficient wealth. Joint and several liability allows for a situation where a less culpable defendant pays vastly more than a more culpable defendant.

Principles of equity would suggest that one should be liable only to the degree of fault.218 Proportionate liability is being suggested as an alternative to joint and several liability not only in the area of securities fraud, but also in the area of products liability.219

The current system has produced a crisis situation for many accounting firms.220 Because of the joint and several liability they face from potential lawsuits, many firms are now refusing to audit certain corporations and industries.221 This could have a serious impact on the ability of these corporations to raise capital.222

215. See H.R. 10, supra note 12, § 203(a); H.R. 555, supra note 16, § 101(c); H.R. 675, supra note 17, § 6; H.R. 681, supra note 15, § 3.

216. See JACOBS, supra note 6, § 260.03[j], at 11-226 -27.

217. See Dim Future, supra note 51, at 872; David Rees, First Executive Tax Bill Makes Talking Auditors Hard to Find, LOS ANGELES BUS. J., May 6, 1991, at 1; Stouffer, supra note 9, at 25.


220. See Dim Future, supra note 51, at 17; Stronger Financial Reporting, supra note 85, at 956-60; Witnesses Dispute, supra note 9, at 121.

221. ARTHUR ANDERSON, ET. AL., supra note 218, at 5.

One response to this problem is to allow proportionate liability for ancillary parties to the action, such as accounting firms. The proposed bills allow for proportionate liability in these cases. However, if the plaintiff can prove knowing fraud, then the joint and several liability standard applies. This is a realistic compromise that addresses the interests of plaintiffs and of accounting firms. Plaintiffs can still recover against accounting firms to the degree of their culpability, and if the plaintiff can prove knowing fraud, then the full amount of damages can be assessed against the firm. Accounting firms can thus limit their liability if they have refrained from engaging in knowing fraud. As a result, strike suits brought with the intention of extorting money from deep pocket defendants will be deterred if there is no indication of knowing fraud.

V. CONCLUSION

The proliferation of strike suits in this country has reached epidemic proportions. The enormous amount of liability faced by American corporations has reduced innovation, drained corporate assets, forced businesses to move overseas and discouraged qualified people from seeking positions of authority in large corporations. Although there are numerous existing procedural safeguards to deal with such

Domenici). 223. H.R. 555, H.R. 675, and H.R. 681 each provide for some form of proportionate liability in private securities actions. H.R. 681 states that joint and several liability will be assessed against a defendant only if the plaintiff can prove that the defendant engaged in knowing securities fraud. H.R. 681, supra note 15, § 3. "Knowing securities fraud" is defined in the bill as either a "material representation with actual knowledge that the representation is false" or as an omission "with actual knowledge that, as a result of the omission, one of [defendant's] material representations is false." Id. Also, the defendant must "know[] that other persons are likely to rely on that misrepresentation or omission." Id. If there has been no showing of knowing securities fraud, then each defendant will be liable only for the percent of damages assessed against it by the finder of fact. Contribution from other defendants would not be allowed. Id.

H.R. 675 provides for joint and several liability not only in cases of knowing securities fraud, but also where the defendant was the primary wrongdoer or was in a position of control. H.R. 675, supra note 17, § 6. If these conditions are not met, then the defendant is liable only for the proportion of damages assessed against it, and under limited circumstances for a percentage of any amounts uncollectible from other defendants. Id.

H.R. 555 retains the joint and several liability standard for defendants, but limits the amount of contribution a defendant will be required to pay to the defendant's proportionate share of the damages, plus that defendant's proportionate share of any uncollectible amounts. H.R. 555, supra note 16, § 101(e).
suits, they have thus far failed to stem the tide of increasing nuisance litigation. Accordingly, reforms to the current system are necessary.

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