Legal Backgrounder

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APPLYING ENGLAND'S "WOOLF RULES" IN AMERICA COULD HELP REIN IN SECURITIES CLASS ACTION SUITS

by

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The Problems with Securities Class Action Lawsuits. "Today, our litigation system allows, indeed encourages, abusive 'strike suits' — class actions typically bought under the anti-fraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder . . . Whether a shareholder lawsuit is meritorious or not, the corporation sued must spend a great deal of money to defend itself. It is common for a corporation simply to agree to a substantial settlement out of court. Despite the absence of wrongdoing by managers, corporations are essentially forced to pay large sums of money to avoid even larger expenses associated with legal defense. This has been described by some as legal extortion." H.R. Rep. No. 104-50, 104th Cong., 1st Sess., pt. J, at 15 (1995).

These words from the House Committee on Commerce, urging passage of the Private Securities Litigation Reform Act (the "PSLRA") in 1995, capture in a nutshell the debilitating effects of class action litigation on the modern corporation. Given the costs involved in defending such lawsuits, almost all 10b-5 class action lawsuits are ultimately settled regardless of their merit.

The settlement usually bears no relationship to any actual damages suffered by stockholders, but instead is related principally to the amount claimed or the defendants' insurance coverage. Individual shareholder claims tend to be relatively small, so class members have little incentive to monitor the litigation of the case and the settlement decision. *See*, *e.g.*, Jonathan Macey & Geoffrey Miller, *The Plaintiffs' Attorney's Role in Class Actions and Derivative Suits: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991).

Plaintiffs' lawyers, on the other hand, have an incentive to maximize their fee relative to the amount of work they invested in the case, a motivation that bears no necessary correlation to the size of the recovery to class members. The large size of the lawyers' economic interests relative to those of their clients create

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a structure in which plaintiffs' lawyers have both primary decision making authority and the incentive to make litigation decisions in their own economic interests.

These perceived abuses of the class action vehicle have spurred efforts, primarily in the form of the adoption of the PSLRA, to transfer control of litigation away from lawyers and back to clients. *See*, *e.g.*, *H.R. Conf. Rep. No. 104-369 (1995), Joint Explanatory Statement of the Committee of Conference — The 'Private Securities Litigation Reform Act of 1995*,' (describing "abusive practices committed in private securities litigation" as including "the manipulation by class action lawyers of the clients whom they purportedly represent"). Even the specific reforms established by the PSLRA, however, have failed to properly address the central problem of lawyer-driven class actions in the securities context. *See*, *e.g.*, Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 ARIZ. L. REV. 533 (1997). This is because of the continuing absence of meaningful judicial pressure upon class action lawyers to ensure that the cases they file are warranted and properly conducted with the best interests of the class in mind. The answer to this problem may lie in the reforms recently instituted in England under the aegis of Lord Woolf.

Overview of the Woolf Reforms. Lord Woolf was appointed in 1994 to recommend changes to the existing rules of civil procedure in the courts of England and Wales. His studies resulted in an interim and a final report containing wide-ranging recommendations for overhauling the English civil justice system. Most of these recommendations were subsequently codified in a new set of Civil Procedure Rules which took effect on April 26, 1999.

Lord Woolf identified three problem areas of English civil litigation: delay, cost, and complexity. *See generally Lord Woolf, Access to Justice (Interim Report)* (1995) and *Access to Justice (Final Report)* (1996) (both available online at http://www.law.warwick.ac.uk/woolf/). As a remedy, he proposed a redefinition of civil justice built around three corresponding key concepts: speed, economy and proportionality. The aim of his reforms is to 1) reduce dramatically the advantage of the "deep pocket;" 2) charge judges with "active case-management;" and 3) require litigants to help the court achieve the "Over-Riding Objective" of dealing with cases justly. Civil Procedure Rules 1.1, SI 1998/3132 (Eng.). The court must apply the rules so as to further the overriding objective.

Dealing with a case justly includes ensuring, so far as is practicable, that the parties are on an equal footing; saving expense; dealing with the case in ways which are "proportionate;" ensuring that it is dealt with expeditiously; and allotting to it an appropriate share of the court's resources, while taking into account the need to allot resources to other cases.

The reforms aim to discourage unnecessary litigation — the "sue now, decide on your case later" school of thought — by requiring more work at the start. Claims have to be detailed at a much earlier stage. Litigants must sign "statements of truth" verifying the facts in the claim or defense document. Criminal penalties are possible for statements which are subsequently found to be untrue.

The Issue of Costs and Proportionality. One of the most significant aspects of the Woolf reforms, at least in relation to U.S. securities litigation, is the measures adopted to reduce the cost of litigation. The concept of "proportionality" is central to the Woolf Reforms: the costs[1] payable by the parties in any legal action must not become disproportionate to the issues in dispute and the amount that the claim is actually worth.

Consequently, courts are tasked to deal with each case, so far as is practicable, in ways which are proportionate to: the amount of money involved; the importance of the case; the complexity of the issues; and the financial position of each party.

The new norms for discovery also reflect this goal of responding proportionally to controversies.

[1] "Costs," in the English sense, includes both regular costs *and* attorneys' fees.

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For example, parties are only required to state that a "reasonable search" was conducted for documents. What is reasonable will depend on the size of the case.

In addition, proportionality appears when assessing the amount of costs which a successful litigant is to recover, under the "English rule" of awarding costs to the prevailing party. There are two bases on which costs are recoverable — the "standard basis" and the "indemnity basis."[2]

Where the amount of costs is to be assessed on the standard basis, the court will: (1) only allow costs which are proportionate to the matters in issue; and (2) resolve any doubt which it may have as to whether costs were reasonably incurred or reasonable and proportionate in amount in favor of the paying party. Where the amount of costs is to be assessed on the indemnity basis, the court will resolve any doubt which it may have as to whether costs were reasonably incurred or were reasonable in amount in favor of the receiving party.

The court has a discretion to award either standard or indemnity basis costs. Generally, indemnity basis costs will only be awarded where the court feels that there has been either some improper or unreasonable conduct on the part of the paying party. The court will not, in either case, allow costs which have been unreasonably incurred or are unreasonable in amount to be recovered.

Further, the court has an obligation to look to the conduct of the parties in regard to, and even before, the proceedings, so that overbearing and aggressive claimants or applicants may win on the main issues, but not as regards costs. Thus, the English courts will examine such issues as the extent to which the parties followed any relevant pre-action settlement procedures; whether it was reasonable for a party to raise, pursue or contest a particular allegation; the manner in which a party has pursued or defended his case or a particular allegation or issue; and whether a claimant who has succeeded in his claim, in whole or in part, exaggerated his claim.

In summary, all judicial decisions are governed by the "proportionality test," *i.e.*, whether any particular step is "worth it" and whether any particular sanction is "proportionate." A court may refuse to order any step to be undertaken if it is not proportionate to the value of the claim.

The concept of proportionality is equally applicable to U.S. securities litigation. While there is no award of costs to the prevailing party, U.S. courts could use the Woolf model to deter unmeritorious litigation and questionable discovery tactics by making a plaintiff (or defendant) bear the cost of forcing the other party to incur litigation expenses which are not proportionate to the nature of the claims at issue.

As long as litigation costs are proportionate to the dispute, both sides would bear their own costs in accordance with the standard American rule on damages. Carefully crafted individual costs orders, however, could be imposed to address disproportionate conduct, thus serving to make class action lawyers think more carefully about the necessity of each litigation decision. Lord Woolf's guidelines on costs, which examine all aspects of a party's conduct, would make an efficient tool for this purpose.

Conditional Fee Agreements. Another aspect of the Woolf reforms which could beneficially impact class action lawsuits in this country is the provisions regarding conditional fee agreements ("CFAs"). CFAs are now allowed in England as a result of the Woolf reforms, but are not the same as U.S. contingency fees. The amount the attorney is entitled to charge is related to what the "normal" cost would be and cannot exceed 100% of that figure. *See generally* Conditional Fee Agreements Regulations, (2000) SI 2000/692. Accordingly, the maximum recovery for an attorney under the Woolf system is *twice his normal hourly fees*.

Under the regulations governing CFAs, a CFA must specify: (1) the particular proceedings or parts of proceedings to which it relates; (2) the circumstances in which the lawyer's fees are payable; and (3) what

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[2]The new guidelines on costs are contained in Rule 44 of the English Civil Procedure Rules.

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payment (if any) is due to the lawyer if those circumstances do not occur or if the agreement terminates for some reason. Where the agreement provides for a percentage uplift or success fee, the agreement must specify the reasons for the percentage agreed.

Other regulations also serve to prevent the abuse of CFAs. A CFA must contain: (1) detailed provisions giving information to clients on such matters as the circumstances in which the client may be liable to pay legal costs in accordance with the agreement; (2) the circumstances in which the client may seek assessment of the lawyer's fees; (3) how the client must proceed in seeking such an assessment; and (4) whether other methods of financing the client's legal costs are available. In addition, before a CFA is entered into, the lawyer must explain its effects clearly to the client. Further, a party who has entered into a CFA must inform all other parties to the litigation of the existence of the CFA and disclose the nature (but not the detail) of the agreement. Details of the CFA are revealed when the parties' costs are assessed at the conclusion of the litigation.

These restrictions on contingency fees, the lifeblood of the securities lawsuit, would serve to curb the worst excesses of class action lawyering. Without the prospect of potentially huge fee recoveries for a small investment of labor, the incentive to file suit without first carefully examining the merits of the case would be significantly diminished. Such restrictions would also increase the recoveries of the individual class members, and make the lawyers "work harder" for a favorable outcome.

Costs and Offers of Settlement. The third feature of the English litigation system which would benefit U.S. securities litigation is the ability to make an offer of settlement carrying real risks for a party refusing it. This device was not introduced by Woolf, but his reforms retained and enlarged it. As before, a defendant has to pay money into court when he makes an offer to settle. The consequences for the claimant of failing to beat the offer at trial, however, are that, unless the court considers it unjust, the claimant must pay the defendant's costs from 21 days after the offer and payment into court were made.

After the Woolf reforms, offers to settle by a defendant before the commencement of proceedings can also be taken into account when deciding liability for costs, provided there is payment into court within 21 days of the commencement of proceedings.

The rationale for this device is to encourage both claimants and defendants to consider realistically what the claim is worth at an early stage of the dispute. Such a result would be most welcome in U.S. class action litigation. American offers of judgment, shifting only the burden of regular costs to the losing party, almost always lack any real "bite." Unless significant costs are incurred through, for example, the use of expert witnesses, the specter of failing to beat an offer of settlement is not a real deterrent to a plaintiff. Imposing the successful party's attorneys fees upon the losing side, however, would provoke much more rigorous analysis of the merits and value of the litigation being brought.

Conclusion. It is clear that, even in the wake of the PSLRA, more stringent controls are necessary to halt the runaway train of class action securities litigation.[3] It is time to look outside the United States for assistance in determining what these controls should be. The Woolf reforms, with their emphasis on keeping the cost of litigation proportionate to the nature of the claims at issue and in rewarding the injured party, rather than his lawyer, can serve as a practical model for reform in this country.

[3] According to a recent study, total damages paid out by defendants in private securities class actions rose in 2002 by 50% to $2.4 billion from 2001. In 2002, 98 securities class action cases were settled, the most since the year the PSLRA was passed. The number of cases filed was also up in 2002 by 31%. Kara Scannell, *Damages in Class Settlements in Securities Cases Rise 50%*, WALL ST. J., Apr. 10, 2003.

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