NOTES

PROPORTIONATE LIABILITY IN 10b-5 RECKLESS FRAUD CASES

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The battle to redefine the role of securities regulation pits investors, supported by the Securities and Exchange Commission (SEC),[1] against companies and firms accessing or assisting in the accessing of capital markets. A microcosm of this conflict was described recently in the pages of the *Wall Street Journal.* On September 15, 1993, John G. Adler, CEO of Adaptec, Inc., wrote an article in the "Rule of Law" column entitled "A Frivolous Securities Suit Claims Another Victim: Me."[2] Adler related the troubles brought upon his company by a securities fraud suit triggered when Adaptec's earnings did not live up to the corporation's forecast. He described the costs of litigation and the chilling effect the threat of litigation and liability had on attracting talent to the boardroom and on fostering an entrepreneurial, risk-taking environment.[3] Adler and Adaptec eventually settled the claim "to end

1. *See* Christopher P. Saari, Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031, 1032 (1977) (noting that the SEC "has come to perceive the primary purpose of securities laws to be the protection of investors"). SEC Chairman Arthur Levitt has, in testimony to Congress, strongly stated the Commission's mission: "[T]he Commission's primary responsibility is the protection of investors." *Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 103d Cong., 2d Sess. (1994), Federal News Service, July 24, 1994, *available in* LEXIS, Legis library, Fednew file [hereinafter *Hearings*] (testimony of SEC Chairman Arthur C. Levitt). However, there is evidence that the SEC is becoming more willing to intervene to prevent meritless litigation. In a speech to the Securities Regulation Institute, Levitt announced that the Commission is considering taking action on behalf of defendants in shareholder litigation. Levitt also said that the SEC would support federal legislation aimed at curbing the incentives to class action attorneys and class representative plaintiffs. Christi Harlan, *SEC's Levitt Talks of Active Attempts to Curb Litigation*, WALL ST. J., Jan. 27, 1994, at B7; *see also* Stephen Power, *Legislation to Curb Frivolous Lawsuits Is Urged by Levitt*, WALL ST. J., July 25, 1994, at A9.

2. John G. Adler, *A Frivolous Securities Suit Claims Another Victim: Me*, WALL ST. J., Sept. 15, 1993, at A23.

3. *Id.*

the expense of litigation and the distraction of the company's management . . . ."[4]

Three plaintiffs in the Adaptec litigation answered Adler's column on November 3, 1993, in a letter to the editor.[5] Their response contained allegations that Adaptec management coupled misstatements to the financial press with timely sales of stock to turn millions of dollars in personal profit. The investors hailed litigation as "the most potent deterrent to financial fraud in this country" and cautioned against reforming a system that is essential to ensuring investor confidence in capital markets.[6]

The Adaptec controversy is revealing because of the merits of both sides' allegations.[7] Both securities fraud and frivolous litigation are serious legal issues with pronounced economic ramifications. The Adaptec case neatly encapsulates some of the major shortcomings of securities fraud litigation. The two sides were both potential wrongdoers and potential victims. The suit was settled, not tried, resulting in formal legal resolution but lacking the certainty and decisiveness of a jury verdict. The potential dual nature of parties as both victim and wrongdoer and the high incentive to settle are important considerations for evaluating prospective reforms of the federal securities laws.

This Note analyzes the climate precipitating the alleged crisis in securities fraud litigation and examines the merits of congressional proposals to change the standard of liability from joint and several to proportionate for those found culpable of reckless securities fraud under section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 (the '34 Act).[8] The rationale underlying the change in liability encompasses two distinct motivations: (1) to lessen the incentives of potential securities fraud plaintiffs and (2)

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4. *Id.*

5. Elliot Tolan et al., *Seriously, It's Anything But Frivolous*, WALL ST. J., Nov. 3, 1993, at A23.

6. *Id.*

7. SEC Chairman Arthur Levitt, in testimony to Congress, noted the forceful arguments on both sides of the debate. Levitt stated, "Preserving private actions as a source of deterrence and as the primary vehicle for compensating defrauded investors will be increasingly important as our securities markets continue to grow in size and complexity." *Hearings, supra* note 1. However, the chairman also recognized that "meritless lawsuits may adversely affect the development of substantive securities law, as courts develop broad doctrines in an attempt to curb what they perceive to be vexatious litigation." *Id.*

8. *See, e.g.*, S. 1976, 103d Cong., 2d Sess. § 203 (1994); H.R. 417, 103d Cong., 1st Sess. § 2 (1993).

to redefine the role that accountants, lawyers, and underwriters play in securities regulation.

Part I of this Note provides the necessary background of section 10(b) and Rule 10b-5 of the '34 Act as they relate to scienter and remedies. This Part contains a detailed analysis of the use of contribution and partial settlement set-offs in securities fraud litigation. Part II examines the likely impact of a proposed proportionate liability system on the parties in securities fraud suits and on the judicial system as a whole. The proportionate liability system is then compared with a joint and several liability system using contribution. This Note concludes that the need to lessen the incentives of plaintiffs to file securities fraud claims and the need to redefine the role of the professional support staff in the securities markets are legitimate and necessary motivations for reforming the federal securities laws. A prudent and equitable element of reform would be to change the apportionment of Rule 10b-5 liability for those found guilty of reckless fraud from joint and several to proportionate.

I. THE EXCHANGE ACT, SECTION 10(B), AND RULE 10B-5 LIABILITY

A. *Background*

As originally enacted, the Securities Act of 1933[9] (the '33 Act) and the '34 Act[10] were intended to "substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry."[11] While protecting investors, federal securities regulation also helps promote an efficient capital market. Congress passed the '33 and '34 Acts with the intuitive belief that full disclosure would lead to better resource allocation in society.[12] Insofar as federal securities regulation promotes the creation and dissemination of information not otherwise attainable, it also promotes the nation's general economic interest.

The objectives of the federal securities laws have not changed since their enactment. However, the impact of the liability provi-

9. 15 U.S.C. §§ 77a-77bbbb (1988).
10. 15 U.S.C. §§ 78a-78ee (1988).
11. SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963).
12. Saari, *supra* note 1, at 1032.

sions and their implementation through joint and several liability are now undergoing an important reassessment. This evaluation puts into sharper focus the trade-off between the interests of investors and the interests of business. In the 1930s, Congress responded to outraged investors who sought relief from sharp practices in capital markets.[13] Private remedies created by these laws were an important element in originating and implementing investor protection. In the 1990s, however, efforts are being made to respond to the corporations, accountants, lawyers, and underwriters who seek remedy from an increasingly burdensome consequence of securities regulation: the ability of investors to impose unwarranted and extreme costs on economic agents through private actions.[14]

Congress intended the '34 Act to "prevent inequitable and unfair practices and to insure fairness in securities transactions generally, whether conducted face-to-face, over the counter, or on exchanges."[15] Section 10 of the '34 Act[16] furthers this purpose by making illegal the use of deceptive devices or schemes in connection with the purchase or sale of securities.[17] Rule 10b-5[18] implements congressional policy by "clos[ing] a loophole in the protections against fraud administered by the Commission by pro-

13. *See* Central Bank v. First Interstate Bank, 114 S. Ct. 1439, 1445 (1994) (commenting on the events that led to promulgation of the '33 and '34 Acts).

14. A recent congressional finding notes that "excessive securities litigation is a serious burden on the national economy" and that "meritless lawsuits filed under Federal securities laws are making it harder for American companies to raise capital and attract experienced members to serve on their boards . . . ." H.R. 417, 103d Cong., 1st Sess., § 2 (1993); *see also* H.R. 5828, 102d Cong., 2d Sess. § 2(1)-(2) (1992); S. 3181, 102d Cong., 2d Sess. § 2(1)-(2) (1992).

15. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir.), *cert. denied*, 394 U.S. 976 (1968); *see also* Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 391 (1990) (stating that "[t]he theme that ties the Act together is a concern with security prices"). Also revealing is the statement of Senator Duncan Fletcher introducing Senate Bill 2693, the bill that became the '34 Act:

> Under this bill the securities exchanges will not only have the appearance of an open market place for investors but will be truly open to them, free from the hectic operations and dangerous practices which in the past have enabled a handful of men to operate with stacked cards against the general body of the outside investors.

78 CONG. REC. 2271 (1934).

16. 15 U.S.C. § 78j (1988).

17. *See* Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971).

18. 17 C.F.R. § 240.10b-5 (1994).

hibiting individuals or companies from buying [or selling] securities if they engage in fraud in their purchase [or sale]."[19] Fraud includes the use of (1) any deceptive "device, scheme, or artifice," (2) untrue statements or omissions of material facts, or (3) any deceptive "act, practice, or course of business."[20] Thus, Rule 10b-5 ensures that investors have, at a minimum, access to material information equal to that of corporate insiders.[21]

Rule 10b-5 is enforceable through both government and private actions. Government actions taken by the SEC can result in injunctions, civil penalties, or cease and desist orders.[22] Private actions under 10b-5, however, far outnumber public actions.[23] The primary private cause of action is the implied right granted under section 10(b) of the '34 Act[24] and Rule 10b-5[25] promulgated

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19. SEC Exchange Act Release No. 3230 (May 21, 1942). Rule 10b-5 was created in an ad hoc fashion with a limited intent regarding its regulatory scope. One of the Rule's creators relates the story of its origin:

> I received a call from Jim Treanor who was then the Director of the Trading and Exchange Division. He said, "I have just been on the telephone with Paul Rowen, . . . and he has told me about the president of some company in Boston who is going around buying up the stock of his company from his own shareholders at $4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be $2.00 a share for this coming year. Is there anything we can do about it?" So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at Section 17, and I put them together, and the only discussion we had there was where "in connection with the purchase or sale" should be, and we decided it should be at the end.

Milton V. Freeman, Remarks at the Conference on Codification of the Federal Securities Laws (Nov. 18-19, 1966), 22 BUS. LAW. 793, 922 (1966-1967). The development of Rule 10b-5 into the weapon it has become was unforeseen by its authors. *Id.*

20. 17 C.F.R. § 240.10b-5 (1994).

21. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir.), *cert. denied*, 394 U.S. 976 (1968).

22. 15 U.S.C §§ 78u, 78u-3 (1988 & Supp. IV 1992).

23. For the 12-month period ending December 31, 1991, public plaintiffs' actions accounted for only 10.8% of all suits filed under "Securities, Commodities, and Exchanges" legislation. ADMINISTRATIVE OFFICE OF THE U.S. COURTS, FEDERAL JUDICIAL WORKLOAD STATISTICS 32-33 (1991) (Table C2).

24. The statute states in relevant part,

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
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> . . . .
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> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j (1988).

25. Rule 10b-5 states,

thereunder. Congress has found that in the three years from 1990 to 1992, one out of every twelve issuers of securities traded on the New York Stock Exchange were sued for securities fraud.[26] The costs of such litigation to defendants range from the direct costs of legal defense and liability or settlement to indirect costs including increased insurance premiums, indirect business costs caused by using corporate time in defense, the costs of defensive reporting and excessive auditing, reputational harm, the financial effect on existing securities from the disclosure of contingent liability, and restrictions on business options (especially regarding mergers and acquisitions).[27] Of course, these costs reflect only part of the picture, hiding from view the costs to the accountants, lawyers, and underwriters who may also be caught in the net of an alleged securities fraud violation.

Neither section 10(b) nor Rule 10b-5 contains an express provision for a private cause of action. However, the private cause of action under Rule 10b-5 has been implied almost since the rule's inception.[28] Under the weight of mass acceptance in the lower courts, the Supreme Court has acknowledged the existence of the 10b-5 implied right of action.[29] Not only has it had a role in creating the implied cause of action, but the judiciary has also taken on the task of defining the guidelines for its application.[30]

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
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> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1994).

26. H.R. 417, 103d Cong., 1st Sess., § 2 (1993).

27. *See* Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 571 (1991).

28. The first judicial recognition of the implied private right was in Kardon v. National Gypsum Co., 69 F. Supp. 512, 513-14 (E.D. Pa. 1946), four years after the promulgation of Rule 10b-5.

29. Musick, Peeler & Garrett v. Employers Ins. of Wausau, 113 S. Ct. 2085, 2088 (1993); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 729-30 (1975); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971).

30. *See Musick, Peeler & Garrett*, 113 S. Ct. at 2089 ("The federal courts have accepted and exercised the principal responsibility for the continuing elaboration of the

For the purposes of this Note, the important elements of the judicially created private right are (1) scienter and (2) remedies and contribution.

B. *Scienter*

The Supreme Court held in *Ernst & Ernst v. Hochfelder* that liability under Rule 10b-5 is predicated on a showing of scienter, meaning "a mental state embracing intent to deceive, manipulate, or defraud."[31] While the holding in *Ernst & Ernst* clearly eliminates negligence as a basis for liability,[32] it does not address the question of whether recklessness creates liability under Rule 10b-5.[33] The majority of lower courts have held, however, that recklessness satisfies the scienter requirement created in *Ernst & Ernst*.[34]

The degree of culpability required to support a finding of Rule 10b-5 recklessness is very high. The Rule 10b-5 standard of recklessness has been characterized as "a lesser form of intent [rather] than merely a greater degree of ordinary negligence."[35] The distinction between recklessness and knowing behavior comes not from the subjective disclosure of a defendant's thoughts, but from an objective consideration of what the defendant must have

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scope of the 10b-5 right and the definition of the duties it imposes."); *Blue Chip Stamps*, 421 U.S. at 737 ("When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn.").

31. *Ernst & Ernst*, 425 U.S. at 194 n.12.

32. *See id.*

33. *Id.*

34. *E.g.*, Van Dyke v. Coburn Enter., Inc., 873 F.2d 1094, 1100 (8th Cir. 1989); Woods v. Bennett Bank, 765 F.2d 1004, 1010 (11th Cir. 1985); Dirks v. SEC, 681 F.2d 824, 844-45 (D.C. Cir. 1982), *rev'd on other grounds*, 463 U.S. 646 (1983); Sharp v. Coopers & Lybrand, 649 F.2d 175, 193 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982); Broad v. Rockwell Int'l Corp., 642 F.2d 929, 961 (5th Cir.), *cert. denied*, 454 U.S. 965 (1981); Nelson v. Serwold, 576 F.2d 1332, 1337 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44-47 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); Sunstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); Xaphes v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 600 F. Supp. 692, 693-94 (D. Me. 1985); *see* JAMES D. COX ET AL., SECURITIES REGULATION: CASES & MATERIALS 740 (1991) (stating that "the overwhelming weight of authority among the courts of appeals has been that [recklessness] does [create liability]"); *see also* Hoffman v. Estabrook & Co., 587 F.2d 509, 516 (1st Cir. 1978) (stating that the court "assume[s] without deciding that recklessness, as well as fraud, will ground an action under Rule 10b-5").

35. COX ET AL., *supra* note 34, at 740 (quoting Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977), *cert. denied*, 450 U.S. 1005 (1981)).

known.[36] A widely accepted definition of securities fraud recklessness is "conduct that is an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of [it]."[37] This definition places heavy emphasis on an objective evaluation of a defendant's responsibilities to the plaintiff. In the hands of the trier of fact, the standard of recklessness is important in defining and enforcing the public perception of a party's duty to society.

C. *Remedies and Contribution*

The primary remedy for 10b-5 violations is the measure of damages mandated by section 28 of the '34 Act.[38] In most cases, damages are "the difference between the fair value of all that the . . . seller received and the fair value of what he would have received had there been no fraudulent conduct."[39] This measure of damages is commonly referred to as the "out of pocket" measure and is similarly formulated as the difference between the value and the price of a security when it was bought or sold subject to a fraud.[40]

Damages are apportioned through joint and several liability. The liability component of the joint and several system is relatively straightforward, following well-established principles of tort law.

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36. *See Sunstrand Corp.*, 553 F.2d at 1045 ("[T]he danger of misleading buyers must be actually known or so obvious that any reasonable man would be legally bound as knowing . . . .").

37. SEC v. Pros Int'l, 994 F.2d 767, 772 (10th Cir. 1993) (Owen, J., dissenting) (quoting Hackbart v. Holmes, 675 F.2d 1114, 1118 (10th Cir. 1982)). This formulation of recklessness is similar to versions used by other circuits. *See, e.g.*, Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990) (quoting *Sunstrand Corp.*, 553 F.2d at 1045, and stating the same standard used by the Tenth Circuit), *cert. denied*, 499 U.S. 976 (1991); *Hoffman*, 587 F.2d at 517 (same).

38. 15 U.S.C. § 78bb(a) (1988) reads, "[N]o person permitted to maintain a suit for damages under the provisions of this Chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of." On rare occasions, other measures of damages are used. *See In re* Letterman Bros. Energy v. Banc Texas Dallas, 799 F.2d 967, 972 (5th Cir. 1986) (discussing the use of the rescission remedy); Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1173 (2d Cir. 1970) (holding that rescission is appropriate when the parties are in privity).

39. Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972).

40. *See* Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1344 (9th Cir. 1976) (Sneed, J., concurring).

The plaintiff may bring an action against any of several potential joint tortfeasors without risking the availability of actions against remaining tortfeasors.[41] A defendant may be liable for all the plaintiff's damages, regardless of that particular defendant's role in causing the harm.[42] Under this system, defendants bear a substantial risk of shouldering excessive liability relative to their fault.

The burden on defendants is tempered by their ability to seek contribution.[43] Contribution stems from the equitable notion that it is unfair for one party among a group of tortfeasors to bear liability alone.[44] Liability is spread by requiring each culpable party to pay a proportionate share of the damages.[45] Although the doctrine was originally applicable only to unintentional tortfeasors,[46] lawmakers, including the authors of the '33 and '34 Acts, have been willing to allow contribution in cases of intentional torts.[47]

The Supreme Court recognized in *Musick, Peeler & Garrett v. Employers Insurance* the right to contribution in 10b–5 cases.[48] The decision in *Musick* was not based on the merits of contribution per se;[49] rather, the Court construed section 10(b) as the Congress of '34 would have if it had created a private cause of action in the section.[50] The Court examined sections 9 and 18 of the '34 Act,[51] sections that are "close in structure, purpose, and intent to the 10b–5 action," and found that those sections contain contribution provisions.[52] Thus, to maintain the intent and struc-

41. W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 47, at 327–28 (5th ed. 1984).

42. *Id.* at 328.

43. Musick, Peeler & Garrett v. Employers Ins., 113 S. Ct. 2085, 2091 (1993); *see infra* text accompanying notes 48–54.

44. *See* KEETON ET AL., *supra* note 41, at 337–38; M. Patricia Adamski, *Contribution and Settlement in Multiparty Actions Under Rule 10b–5*, 66 IOWA L. REV. 533, 536 (1981).

45. *See* Adamski, *supra* note 44, at 536.

46. KEETON ET AL., *supra* note 41, at 336–37.

47. *Id.* at 339; *see also Musick, Peeler & Garrett*, 113 S. Ct. at 2090–91 (noting that § 9 and § 18 of the '34 Act, 15 U.S.C. §§ 78i, 78r (1988), require scienter for culpability while allowing contribution).

48. *Musick, Peeler & Garrett*, 113 S. Ct. at 2086.

49. *Id.* at 2089.

50. *Id.* at 2089–90.

51. 15 U.S.C. §§ 78i, 78r.

52. *Musick, Peeler & Garrett*, 113 S. Ct. at 2090. Section 9 of the '34 Act, 15 U.S.C. § 78i, concerns "[m]anipulation of security prices." Section 18, 15 U.S.C § 78r, establishes "[l]iability for misleading statements."

tural integrity of the '34 Act, the right to contribution is implied under section 10(b).[53] Contribution provisions in the '34 Act, with their equitable underpinnings, are "an important, not an inconsequential, feature of the federal securities laws."[54]

The extent to which contribution promotes the equitable spreading of liability depends on the method of application employed. There are at least four methods of apportioning contribution shares: pro rata, "benefits received," proportionate fault, and entity allocation. The pro rata method is the most common and involves the numerically equal apportionment of liability among the tortfeasors.[55] The primary benefit of the pro rata method is its administrative simplicity. However, with that simplicity comes an inherent insensitivity for relative culpability. Increasingly, courts are finding that the administrative benefits of pro rata allocation do not compensate for the inequities it creates and are shifting to the use of other methods.[56]

The "benefits received" method allocates liability according to the benefit the tortfeasor received from the wrongdoing.[57] Typical "benefits" include fees for underwriters, attorneys, or accountants and the increased value of the stock for the issuer. However, the benefits received method is best applied in contract cases in which there is a homogeneity among tortfeasors and responsibilities are established by the contract.[58] Use of the benefits received method may result in outcomes that are clearly counter to the intent of the securities laws. For example, directors found liable for a 10b-5 violation would, under this system, be entirely compensated by the other joint tortfeasors because they would have received no benefit. The benefits received method in such a situation would be tantamount to indemnification[59] and would undermine the deterrent interests of the federal securities laws.[60]

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53. *Musick, Peeler & Garrett*, 113 S. Ct. at 2091.

54. *Id.*

55. *See* John H. Langmore & Robert A. Prentice, *Contribution Under Section 12 of the Securities Act of 1933: The Existence and Merits of Such a Right*, 40 EMORY L.J. 1015, 1101 (1991).

56. *See, e.g.*, Smith v. Mulvaney, 827 F.2d 558, 561 (9th Cir. 1987); McLean v. Alexander, 449 F. Supp. 1251, 1273 (D. Del. 1978), *rev'd on other grounds*, 599 F.2d 1190 (3d Cir. 1979); Adamski, *supra* note 44, at 557; Langmore & Prentice, *supra* note 55, at 1102.

57. *See* Langmore & Prentice, *supra* note 55, at 1103.

58. *See id.*; Note, *Contribution Under the Federal Securities Laws*, 1975 WASH. U. L.Q. 1256, 1304.

59. *E.g.*, Gould v. American-Hawaiian S.S. Co., 387 F. Supp. 163, 171 (D. Del. 1974).

60. *See* Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1288–89 (2d Cir. 1969)

The proportionate fault method of allocation requires the trier of fact to determine the relative culpability of all participants in the wrong and to assess liability accordingly. Proportionate fault contribution promotes deterrence of the more culpable parties by correlating culpability and liability.[61] Its adaptability to situations involving varying degrees of culpability makes it well suited for securities fraud cases.[62] The primary criticism of the proportionate fault method is that it is difficult to administer.[63] However, this criticism does not carry much weight, because the judicial system has shown its amenability to apportioning culpability in other areas through the advent of comparative fault negligence,[64] thus suggesting that any administrative problems that may arise are not insurmountable.[65]

The entity method is a hybrid of the pro rata and proportionate fault methods. Parties who share a "common purpose and unified position" are treated as one entity.[66] The liability of the entity is determined by proportionate fault, and the liability of the individuals comprising the entity is determined on a pro rata basis.[67] The entity method thus combines the flexibility of the proportionate fault method with the administrative simplicity of the pro rata method. The factfinder is left to determine the culpability

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(discussing the rationale behind the antipathy of the federal securities law toward indemnification), *cert. denied*, 397 U.S. 913 (1970).

61. *See* McLean v. Alexander, 449 F. Supp. 1251, 1273 (D. Del. 1978), *rev'd on other grounds*, 599 F.2d 1190 (3d Cir. 1979); Adamski, *supra* note 44, at 558; Langmore & Prentice, *supra* note 55, at 1105. Proportionate fault contribution was adopted in the American Law Institute's Federal Securities Code. FED. SEC. CODE § 1724(f)(2) (1980).

62. *See McLean*, 449 F. Supp. at 1272.

63. *See* Adamski, *supra* note 44, at 559.

64. *See McLean*, 449 F. Supp. at 1276 n.84 (noting that the administrability of apportioning damages is greatly simplified by considering factors such as (1) "the defendant's extent of involvement," (2) "duration of involvement," (3) "knowledge of entire scheme to defraud," (4) "intent," (5) "extent of [defendant's] contribution toward causation of the losses," and (6) "benefit received"); Langmore & Prentice, *supra* note 55, at 1105.

65. As of 1988, 44 states had adopted some form of comparative fault negligence. KEETON ET AL., *supra* note 41, § 67, at 471 n.30.

66. *McLean*, 449 F. Supp. at 1276; *see* Adamski, *supra* note 44, at 564 ("When there is a natural group whose members shared similar responsibilities and a similar degree of participation in the alleged fraud, it makes sense for such defendants to be treated as one entity . . . .").

67. For example, in *McLean*, four selling shareholders created a "web of deceit" involving the two areas of misrepresentation. Another defendant, an accountant, was found culpable for reckless behavior in one area of wrongdoing. The four selling shareholders were grouped as one entity and were assessed 90% of the liability. The accountant was assessed the residual 10% share. *McLean*, 449 F. Supp. at 1276–77.

of a similarly situated group without having to determine the relative burdens within the group.

The relative contribution among wrongdoers is determined in a setting in which most disputes are settled.[68] These settlements may be complete or partial, that is, involving all or only some of the parties. In analyzing partial settlements, important consideration needs to be given to the rights of non-settling defendants against settling defendants, and to the impact of a prior settlement on the plaintiff's claim against the non-settling defendants.[69] The traditional approach of courts was to maintain the non-settling defendant's right to contribution from a settling party.[70] However, the right to contribution is at odds with the promotion of settlement.[71] A party who settles does so to prevent or limit the costs of litigation and to fix his liability. The existence of a right to contribution leaves open the possibility that, after trial, a settling defendant will find himself liable for contribution.[72] His stake in the total liability will have been determined at a proceeding in which he was not an active participant. The savings gained by not participating in the litigation are thus mitigated by the heightened risk of additional exposure.

To preserve the incentives for settlement, courts have adopted contribution bar rules prohibiting non-settling defendants from seeking contribution from settling defendants.[73] The fashioning of an appropriate contribution bar rule deters securities fraud

68. Alexander, *supra* note 27, at 498 ("Most cases are resolved through settlement.").

69. Settlement and other extrajudicial means of resolving disputes are zealously promoted by the courts. *See* Van Bronkhurst v. Safeco Corp., 529 F.2d 943, 950 (9th Cir. 1976) ("It hardly seems necessary to point out that there is an overriding public interest in settling and quieting litigation."); Nelson v. Bennett, 662 F. Supp. 1324, 1334 (E.D. Cal. 1987) ("[T]he promotion of settlement is, as a practical matter, an absolute necessity. Otherwise, the already congested federal dockets would be bound in a hopeless gridlock.").

70. *See* Harrison v. Sheats, 608 F. Snpp. 502, 507 (E.D. Cal. 1985) (rejecting a contribution bar in a settlement agreement); Altman v. Liberty Equities Corp., 54 F.R.D. 620, 625 (S.D.N.Y. 1972) (same).

71. *See In re* Atlantic Fin. Management, Inc. Sec. Litig., 718 F. Supp. 1012, 1016 (D. Mass. 1988) (noting that claims for contribution against settling defendants deter settlement); *McLean*, 449 F. Supp. at 1266 (same); Adamski, *supra* note 44, at 542.

72. *See* South Carolina Nat'l Bank v. Stone, 139 F.R.D. 335, 341 (D.S.C. 1991).

73. *E.g.*, *In re Atlantic Fin. Management*, 718 F. Supp. at 1016; *Nelson*, 662 F. Supp. at 1335.

through the application of reasonable penalties, promotes fairness to the non-settling parties, and encourages settlement.[74]

The carrot that makes the stick of the contribution bar rule palatable to non-settling defendants is the set-off provided against their ultimate liability. There are two methods of set-off deserving attention: pro tanto and proportionate reduction.[75] The pro tanto method, also called the settlement bar rule, reduces the potential liability of the non-settling defendants by the amount of the settlement.[76] This approach places the burden of an unfair settlement squarely on the non-settling defendants and, for this reason, requires a fairness hearing to approve the settlement. The factors addressed in a fairness hearing include the financial solvency of the settlor, the strength of the plaintiff's case against the settlor, the settlor's relative culpability, and whether a judge or magistrate participated in the settlement process.[77] The primary benefit of the pro tanto method is that it provides certainty to the plaintiff, encouraging settlement.[78] The plaintiff is assured an opportunity to receive full satisfaction from the settlement payment and from damages from the non-settling defendants if the non-settling defendants are found liable.[79] The contribution bar, established by the

74. *See Nelson*, 662 F. Supp. at 1335.

75. A third method of set-off, pro rata, is the logical extension of the pro rata contribution apportionment method. It is most easily demonstrated by example. The settlement by one party among four defendants in a suit will leave the non-settling defendants responsible for 75% of the total damages. The pro rata method assumes *ab initio* that all parties are responsible for an equal share of the damages. The removal of one party through settlement reduces the remaining liability accordingly. Just as pro rata contribution is disfavored for being insensitive to relative culpability, so too is pro rata set-off disfavored. *See* Smith v. Mulvaney, 827 F.2d 558, 560–61 (9th Cir. 1987) ("[T]he potential inequity outweighs the slight administrative benefits to be gained from using the pro rata measure.").

76. Singer v. Olympia Brewing Co., 878 F.2d 596, 600 (2d Cir. 1989), *cert. denied*, 493 U.S. 1024 (1990); U.S. Indus., Inc. v. Touche Ross & Co., 854 F.2d 1223, 1261–62 (10th Cir. 1988); TBG Inc. v. Bendis, 811 F. Supp. 596, 603–04 (D. Kan. 1992); South Carolina Nat'l Bank v. Stone, 139 F.R.D. 335, 343–44 (D.S.C. 1991); MFS Mun. Income Trust v. American Medical Int'l, Inc., 751 F. Supp. 279, 287 (D. Mass. 1990); *In re Atlantic Fin. Management*, 718 F. Supp. at 1018; *In re* Nucorp Energy Sec. Litig., 661 F. Supp. 1403, 1408–09 (S.D. Cal. 1987).

77. *In re Atlantic Fin. Management*, 718 F. Supp. at 1017. The pro tanto method fairness hearing is similar to the hearing for the approval of a class action settlement under FED. R. CIV. P. 23(e). Both hearings are intended to assure the suitability of the settlement for the affected parties. *See MFS Mun. Income Trust*, 751 F. Supp. at 285.

78. *See* Adamski, *supra* note 44, at 549. *Cf. In re Atlantic Fin. Management*, 718 F. Supp. at 1018 (noting that under the pro tanto method, "the impact of any settlement will be clear to all when approved").

79. *See MFS Mun. Income Trust*, 751 F. Supp. at 282; *In re Atlantic Fin. Manage-*

proof of a fair settlement, fixes the liability of the settling defendants at the negotiated amount.

Concerns regarding the effectiveness of fairness hearings are the primary objection to the pro tanto method.[80] Such hearings have the potential to slow the trial process or to become "mini-trials" in their own right.[81] A fairness hearing may also be proved unnecessary by later settlements.[82] Fairness hearings, especially if held early in the litigation process, may be mired in uncertainty because of undeveloped facts and premature estimates of total liability.[83] The pro tanto method might also overcompensate the plaintiff by not accounting for the discounts offered by plaintiffs in settlements.[84] The benefits of having immediate access to money and a lesser burden in litigation allow a plaintiff to accept a settlement whose value deviates from the plaintiff's estimate of the settling defendant's liability.[85] Under pro tanto set-off, this discount is recaptured by the plaintiff from the non-settling party.

The second method of set-off, proportionate reduction (also called comparative fault), requires the factfinder to determine the liability of the settling party in determining the liability of the non-settling defendants.[86] The liability of the non-settling defendants is reduced by this amount, irrespective of the amount of settlement. Proportionate reduction thus shifts the burden of a bad settlement to the plaintiff.[87]

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ment, 718 F. Supp. at 1018.

80. *See* Donovan v. Robbins, 752 F.2d 1170, 1181 (7th Cir. 1985) (discussing partial settlement set-offs in an ERISA case).

81. *Id.*

82. Adamski, *supra* note 44, at 550.

83. *Id.*

84. *See* Franklin v. Kaypro Corp., 884 F.2d 1222, 1230 (9th Cir. 1989).

85. *See id.*

86. For examples of courts adopting the proportionate reduction method in securities cases, see *Franklin*, 884 F.2d at 1231; Smith v. Mulvaney, 827 F.2d 558, 559 (9th Cir. 1987); *In re* Sunrise Sec. Litig., 698 F. Supp. 1256, 1261 (E.D. Pa. 1988).

87. *See In re* Jiffy Lube Sec. Litig., 927 F.2d 155, 161 (4th Cir. 1991) ("[P]laintiffs bear the risk of a 'bad' settlement under the 'proportionate' rule . . . ."); Alvarado Partners v. Mehta, 723 F. Supp. 540, 552 (D. Colo. 1989) ("[Under the proportionate reduction method,] the risk of a 'bad' settlement is borne by plaintiff."). To see why the plaintiff bears the risk of a bad settlement, consider the following example. Suppose a plaintiff who suffered total damages D settles with one of several defendants for S. After trial, the jury determines that the settling party's liability is $S+X$. The plaintiff will recover from the non-settling defendants $D-(S+X)$ and will be undercompensated in total by amount X.

At trial, the plaintiff is required to take up the cause of the settling defendants to minimize the risk of being undercompensated.[88] It has been argued that the risk of undercompensation will deter plaintiffs from settling.[89] However, as noted above, a settlement amount contains within it a discount for the savings from reduced litigation costs and the benefits of early liquidity.[90] It is therefore less likely that the plaintiff's risk of undercompensation will reduce his willingness to settle.

There is also a risk that the plaintiff may be overcompensated in violation of the single satisfaction rule.[91] However, this concern is unwarranted.[92] There is little reason to view a factfinder's determination of liability as more accurate than the determination of liability through settlement. The valuation of a settlement is achieved through the process of negotiation involving subjective assessments by the parties.[93] If all parties in an action settle, the plaintiff might well receive more than what a jury would have awarded. Nevertheless, settlements do not violate the single satisfaction rule.[94] The rule is meant to prevent plaintiffs from collecting multiple compensations for the same loss; it is not meant to endorse a jury's valuation of that loss over a valuation found through settlement.

The proportionate reduction method of set-off better balances the interests of fairness, deterrence, and promotion of settlement than does the pro tanto method. Making defendants liable for their relative culpability, when that culpability is determined either through settlement negotiations or by a factfinder, promotes deterrence by placing the heaviest burden on the most culpable party.[95] The burdens on the plaintiff, primarily that of representing

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88. *See In re* Atlantic Financial Management, Inc. Sec. Litig., 718 F. Supp. 1012, 1018 (D. Mass. 1988) ("The plaintiffs inherit the settlor's interest in minimizing its degree of fault, and can so argue at trial.").

89. *See* Adamski, *supra* note 44, at 552 (noting and rejecting this argument).

90. *See supra* text accompanying notes 84–85.

91. Single satisfaction is an equitable doctrine holding that a plaintiff is entitled to only one compensation for a loss irrespective of the number of parties that caused that loss. *See* KEETON ET AL., *supra* note 41, § 48, at 330–32.

92. *Cf.* Franklin v. Kaypro Corp., 884 F.2d 1222, 1232 (9th Cir. 1989) (stating that it is not clear whether the single satisfaction rule applies in contribution cases), *cert. denied*, 498 U.S. 890 (1990).

93. *See* MFS Mun. Income Trust v. American Medical Int'l, Inc., 751 F. Supp. 279, 284–85 (D. Mass. 1990).

94. *See Franklin*, 884 F.2d at 1232.

95. Adamski, *supra* note 44, at 558.

the settling defendants at trial, do not impair the plaintiff's motive to settle. The plaintiff gains the benefits of reduced trial costs and immediate liquidity while preserving his ability to minimize the risk of reduced settlement through a vigorous prosecution of the remaining defendants.[96] The remaining defendants are protected by having their liability determined entirely by a factfinder and limited to their collective proportionate liability as determined by that factfinder.[97] The role of the factfinder eliminates the need for a fairness hearing, promoting judicial economy.[98]

The integration of joint and several liability with contribution and a settlement bar rule flavors 10b–5 litigation with equitable considerations. The ascent of proportionate fault contribution at the expense of pro rata contribution[99] clearly reflects the advance of equity interests. As the Ninth Circuit noted, "Contribution is an equitable doctrine. To apportion damages without regard to fault reduces, to an extent, the equity which the doctrine was intended to provide."[100] In the case of settlement bar provisions, equity analysis has been muddled by the unwarranted application of the single satisfaction doctrine.[101] In the absence of the single satisfaction rule, proportionate reduction set-off is the most equitable method.[102] The increased use of proportionately determined liability in both contribution and settlement bar provisions attests to the trend in securities litigation of defining with ever greater precision the link between equity, responsibility, and liability. The significance of this linkage is established by the statutory language of the federal securities laws[103] and the efforts of the courts to best implement congressional intent.

96. *Franklin*, 884 F.2d at 1231.

97. *Id.*

98. *See id.* at 1230 (noting that a fairness hearing "means bogging down the settlement process in a miniature trial before trial" (quoting Donovan v. Robbins, 752 F.2d 1170, 1181 (7th Cir. 1985))).

99. *See* Smith v. Mulvaney, 827 F.2d 558, 561 (9th Cir. 1987).

100. *Id.*

101. *See supra* text accompanying notes 91–94.

102. *See Franklin*, 884 F.2d at 1231 (endorsing proportionate reduction set-off and stating that "[a]lthough we do not lose sight of the fact that we are speaking of equities between wrongdoers, we decline to back away from our goal of equity").

103. *Cf. supra* text accompanying note 54 (discussing the progressive nature of the statutory contribution provisions of § 9 and § 18 of the '34 Act).

D. *The Potential for Abuse*

Through its judicial development, Rule 10b–5 has become the most potent tool for imposing liability for federal securities fraud.[104] However, with this potency comes the potential for abuse. The Supreme Court, in *Blue Chip Stamps v. Manor Drug Stores*, commented on this potential, noting that 10b–5 actions present a "danger of vexatiousness" greater than that found in other types of litigation.[105] Much of this danger stems from the interaction of provisions of the Federal Rules of Civil Procedure with the nature of securities transactions. Rule 23 allows class action suits in which representative plaintiffs may bring claims on behalf of similarly situated individuals who do not "opt out" of the litigation.[106] The use of class actions is beneficial to plaintiffs in securities fraud claims because it allows the bundling of individual claims that by themselves would not be cost-effective to pursue.[107] Class action suits are enormous group claims that spread the costs of litigation and invite private enforcement of the 10b–5 provisions. The potential for abuse arises from the ease with which the Federal Rules of Civil Procedure allow a disappointed purchaser or seller of securities to perceive himself as a fraud victim. Typically, a large drop in the price of a stock is enough to trigger

104. *See* John E. Kennedy, *Securities Class and Derivative Actions in the United States District Court for the Northern District of Texas: An Empirical Study*, 14 HOUS. L. REV. 769, 824 (1977) (finding that 10b–5 actions accounted for 30% of the securities class and derivative actions when pleaded alone and 70% of the same actions when combined with other sections). *Cf.* Michael P. Dooley, *The Effects of Civil Liability on Investment Banking and the New Issues Market*, 58 VA. L. REV. 776, 834 (1972) ("By expanding the limits of liability under 10b–5, the courts have elevated civil liability from the limited role assigned in the '33 Act to a position of paramount importance."). Keep in mind, however, that many suits are brought under state law claims. The six largest accounting firms face 10b–5 liability in only 30% of the cases filed against them; the bulk of potential liability is through state court claims. ARTHUR ANDERSEN & CO. ET AL., THE LIABILITY CRISIS IN THE UNITED STATES: IMPACT ON THE ACCOUNTING PROFESSION 6–7 (1992) (detailing the views of the "Big Six" accounting firms: Arthur Andersen & Co., Coopers & Lybrand, Deloitte & Touche, Ernst & Young, KMPG Peat Marwick, and Price Waterhouse). However, the accountants at these firms believe that reforming the federal securities law would be an important first step in improving the regulatory environment. *Id.* at 7.

105. 421 U.S. 723, 739 (1975).

106. FED. R. CIV. P. 23.

107. *See* Dooley, *supra* note 104, at 828–29.

a 10b-5 lawsuit.[108] The onus falls largely on plaintiff's attorneys to identify these drops and to assemble the class for the suit.[109]

E. *Motives for Settlement*

Once a case is filed, financial and prudential considerations drive the parties toward settlement.[110] It has been estimated that upwards of 90% of all securities-related civil suits are settled.[111]

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108. *See* Alexander, *supra* note 27, at 513 ("[S]uits alleging securities violations were filed whenever the stock price declined sufficiently following the IPO [initial public offering] to support an award of attorney's fees that would make it worthwhile to bring a case."); Dooley, *supra* note 104, at 829 ("[R]ule 23 sharply increases the chances that a disappointing offering will result in litigation . . . ."); Kennedy, *supra* note 104, at 807 ("The data here tends to support the theory that a dramatic event gives rise to a large number of filed cases."); Tower C. Snow, Jr., *Stock Crash Needn't Lead to Legal Hash*, WALL ST. J., Nov. 8, 1993, at A23 ("Gradual declines in the price of a stock usually do not provoke lawsuits. Precipitous declines do."). William Lerach identifies five events that are likely to get the attention of investors and plaintiff's attorneys and begin the investigative process that may lead to a securities fraud claim. The five "triggers" are (1) a sharp decline in stock price; (2) an announcement by the issuer of adverse information; (3) adverse press about the issuer; (4) resignations or dismissals of top executives; and (5) investigations by the SEC, the Department of Justice, or other government agencies. William S. Lerach, *Securities Class Actions and Derivative Litigations Involving Public Companies: A Plaintiff's Perspective*, *in* 1 SECURITIES LITIGATION: PROSECUTION AND DEFENSE STRATEGIES 7, 92 n.82 (PLI Corp. Law & Practice Course Handbook Series No. 491, 1985); *see also Hearing on Private Litigation Under Federal Securities Laws Before the Securities Subcomm. of the Senate Comm. on Banking, Housing, & Urban Affairs*, 103d Cong., 1st Sess. (1993), Federal News Service, July 21, 1993, *available in* LEXIS, Legis library, Fednew file (statement of Ralph V. Whitworth, president, United Shareholders Association) (relating an account by a partner in a plaintiff's securities litigation firm of how cases are selected).

109. *See* Alexander, *supra* note 27, at 513. The task of assembling a class was made easier by the Supreme Court's decision in Zauderer v. Office of Disciplinary Counsel, 471 U.S. 626, 646-47 (1985), barring disciplinary actions against attorneys whose advertising focuses on a group with a specific legal problem. Lerach notes that *Zauderer* may increase the number of securities litigation cases by promoting public awareness of potential claims through attorney solicitation. Lerach, *supra* note 108, at 93 n.82; *see also* John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 679 (1986) ("[B]ecause the attorney as private enforcer looks to the court, not the client, to award him a fee if successful, the attorney can find the legal violation first and the client second.").

110. For an extensive discussion of the factors driving parties to settlement, see Alexander, *supra* note 27, at 524-68. Professor Alexander's findings are summarized herein.

111. Professor Alexander found that in 1987, of 5,147 private securities actions (individual and class) brought in federal courts, only 224 (4.4%) went to trial. *Id.* at 525 (citing ANNUAL REPORT OF THE DIRECTOR OF THE ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS 116, 227 (1987) (Tables S-12 and C8)). Also, Professor Alexander reported that

The settlement pressures on the defendants arise from the economic consequences of litigation. The amount of the potential recovery in a suit must be large enough to support the attorney's fees awarded on a contingent fee basis. This necessity requires in class action suits a minimum of $20 million in potential recovery.[112] These significant claims give cases with even a small probability of success a settlement value to the defendant.[113]

An additional incentive for defendants to settle is the high cost of legal representation, which burdens defendants more heavily than plaintiffs. As noted above, plaintiff's attorneys are motivated to seek out lawsuits and take their compensation on a contingent fee basis.[114] Defense attorneys, however, are often associated with large institutional firms charging expensive hourly rates.[115] Exacerbating this costly tendency is the fact that individual defendants often retain individual counsel to protect against potential conflicts of interest.[116] The costs of discovery also weigh heavily against defendants. Plaintiff's attorneys face the relatively low-cost obligation of making discovery requests. Defense attorneys and their corporate clients bear the costly, time-consuming obligation of compliance.[117]

Another impetus for settlement comes from the risk-averse nature of the parties. The defendant group often includes directors and officers to whom personal joint and several liability is an ominous specter far outweighing the benefits of being a director

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> a study of 1,479 private securities litigations in the Southern District of New York from 1966 to 1973 found that 48 percent of nonrepresentative . . . actions went to trial, while only 2 percent of "pure class" suits and 9 percent of suits with both class and derivative claims did so. Of all 1,479 cases, only 18, or 1.2 percent, were terminated by adjudication before trial.

Id. at 525–26 (citing Barbara Ann Banoff & Benjamin S. DuVal, Jr., *The Class Action as a Mechanism for Enforcing the Federal Securities Laws: An Empirical Study of the Burdens Imposed*, 31 WAYNE L. REV. 1, 57–59, 75 n.176 (1984)). *Cf.* Coffee, *supra* note 109, at 698 ("The one persistent empirical observation about shareholder litigation is that it results in very few litigated victories for plaintiffs."). John E. Kennedy, in his study of class and derivative actions in the U.S. district court in Dallas from 1966 to 1973, found that of 35 cases completed, 29 (83%) were settled. Kennedy, *supra* note 104, at 811.

112. Alexander, *supra* note 27, at 513 n.46 (noting that $20 million in potential recovery assures fees "in the range of $1.25 million or more").

113. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740 (1975).

114. *See supra* notes 109 and 112.

115. John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, LAW & CONTEMP. PROBS., Summer 1985, at 5, 17.

116. *Id.*

117. Alexander, *supra* note 27, at 548–50; Coffee, *supra* note 115, at 17.

or officer.[118] Further, directors and officers have reputational interests that affect their standing, and thus their earning potential, in the corporate community.[119]

Directors and officers are generally covered by directors' and officers' (D&O) liability insurance that provides substantial funding for settlements.[120] The workings of such insurance policies induce settlement in two ways. First, insurance companies cannot refuse a reasonable settlement offer out of hand because of the increasingly prevalent tort doctrine that imposes liability for bad-faith refusals to settle.[121] Rejection of a reasonable settlement offer may subject the insurance company to liability for trial expenses and for the amount of the judgment—even in excess of policy limits.[122] Second, a judgment against the directors and officers at trial in a 10b-5 action necessarily implies scienter, a trigger for the dishonesty exceptions found in most D&O policies.[123] The presence of a D&O policy, while expressly limited to directors and officers, is also a factor in the decisionmaking of all defendants because it is an outside source of contribution toward the claim, reducing the liability of all defendants.[124] The defendants' rejection of settlement increases the value of the potential liability for the entire defendant pool by risking the loss of D&O insurance coverage.

Plaintiff's attorneys are the driving force in the litigation and in the move to settlement.[125] Plaintiff's attorneys view securities

118. Alexander, *supra* note 27, at 531; Coffee, *supra* note 115, at 19.

119. Alexander, *supra* note 27, at 532; Coffee, *supra* note 115, at 19.

120. Alexander reports that 94% of public companies with more than 500 shareholders have D&O insurance. Alexander, *supra* note 27, at 550. D&O insurance is thus a factor in approximately 80% of shareholder litigation cases and provides between 50% and 80% of the settlement money in such cases. *Id.*; *see also* Lerach, *supra* note 108, at 99 n.86 (predicting continued reliance on D&O insurance despite increased premiums and reduced coverage).

121. *See* Continental Casualty Co. v. United States Fidelity & Guar. Co., 516 F. Supp. 384, 387 (N.D. Cal. 1981); Alexander, *supra* note 27, at 861–62 ("Recent years have seen the development . . . of an insurer's obligation to settle an insured claim in good faith."); Note, *Bad Faith Refusal to Pay First-Party Insurance Claims: A Growing Recognition of Extra-Contract Damages*, 64 N.C. L. REV. 1421, 1430 (1986) ("There is consensus among a growing number of jurisdictions that a tort action for bad faith serves as an effective deterrent against unfair claims practices.").

122. *See* Alexander, *supra* note 27, at 561.

123. *See id.* at 552; Coffee, *supra* note 115, at 19–20.

124. *See* Alexander, *supra* note 27, at 550–51.

125. As noted above, plaintiff's attorneys carry the organizational impetus in most securities claims. *See supra* note 109. The plaintiff's lawyer as an entrepreneur must bal-

class actions as high-risk-high-reward investments.[126] Accordingly, it is in their interest to hedge against these risks to the greatest extent possible. The most practical and effective means of risk minimization is through the maintenance of a "portfolio" of cases in which no single action is afforded disproportionate time or effort.[127] To maintain this portfolio, the plaintiff's attorney must avoid major trials that draw time and energy toward one pursuit. This incentive is bolstered by the fact that trial involves the most significant and onerous efforts for the plaintiff's attorney, and that once in trial, the realization of a fee is in the hands of the factfinder.[128] To avoid this, plaintiff's attorneys generally maintain a volume of cases, each requiring minimal effort and providing a return to the attorney through settlement.[129]

F. *Claims Against the Professional Support Staff*

In a multidefendant case, the professional support staff in securities transactions, including lawyers, underwriters, and accountants, is placed in a precarious position.[130] The benefits of fees,

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ance the representational obligation to his client with his own financial incentive. This balance is skewed by the autonomy afforded to securities plaintiffs' attorneys. *See* Alexander, *supra* note 27, at 534–35 ("[C]lass representatives in securities class actions . . . have no meaningful role in key litigation decisions."); Coffee, *supra* note 109, at 677–78 (distinguishing the nominal stake of the client in class actions from the high incentives of the plaintiff's attorney); *see also* Piambino v. Bailey, 757 F.2d 1112, 1144 (11th Cir. 1985) (noting that class action attorneys adopt a fiduciary obligation toward the class that extends through the settlement negotiations), *cert. denied*, 476 U.S. 1169 (1986).

126. *See* Lerach, *supra* note 108, at 129.

127. *See* Coffee, *supra* note 115, at 20–23. Professor Coffee explains that risk minimization is also possible by seeking legal work not based on contingent fees and joining a relatively large firm with a diverse practice. These counterbalances to risk are appealing theoretically but are not practically feasible. *Id.* at 22. Lerach points out that risk can be removed through a thorough preliminary investigation into a potential claim. Lerach, *supra* note 108, at 132–33. He notes that "[t]he most important decisions that the 'big case' contingent fee lawyer makes involve the cases he turns down." *Id.* at 129.

128. *See* Alexander, *supra* note 27, at 543–44.

129. *See* Coffee, *supra* note 115, at 48–49.

130. The Supreme Court has provided some relief for the professional support staff against securities fraud claims. In Central Bank v. First Interstate Bank, 114 S. Ct. 1439 (1994), the Court found that aider and abettor liability does not exist under the § 10(b) and Rule 10b-5 private cause of action. The Court, in reaching its decision, noted that the language of § 10(b) does not mention aiding and abetting. *Id.* at 1447. Further, the Court stated that "aiding and abetting liability reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do." *Id.* However, "the statute [§ 10(b)] prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act." *Id.* at 1448. Without the commission of a

commissions, or other compensation are far outweighed by the massive potential liability accompanying a securities fraud allegation. The support staff professionals are often pursued as "deep pockets," those defendants having the greatest ability to pay.[131] A look at the burden faced by accountants provides insight into the financial consequences of 10b–5 liability.[132] For the fiscal year 1991, the average 10b–5 joint and several liability claim against a "Big Six" accounting firm was $85 million.[133] The average legal cost per claim was $3.5 million.[134] In the same year, the Big Six firms spent 9%, a total of $477 million, of their auditing and accounting revenues in the United States on defending and settling lawsuits.[135]

These costs weigh against countervailing pressures on the support staff to resist settlement. The support staff professionals are, at least potentially, "repeat players," meaning that they can expect to be defendants in securities fraud cases as part of their cost of doing business.[136] They have incentive to resist settlement both to preserve their reputation from the insinuations settlement implies and to deter meritless claimants seeking to cash in through settlement.[137] The calculus that weighs the risk of potential liability against the future risks incurred through settlement is an uncertain

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fraudulent act, the critical element of reliance under § 10(b) would not be met. *Id.* at 1448–49. Therefore, the Court held, aider and abettor liability does not exist under § 10(b). *Id.* at 1455.

Nevertheless, even the Court recognized that the professional support staff in securities transactions is not immunized from § 10(b) liability by the *Central Bank* decision. The Court remarked,

> The absence of 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b–5, assuming *all* of the requirements for primary liability under Rule 10b–5 are met.

Id. (citation omitted). Therefore, by the Court's own acknowledgment, *Central Bank* is not likely to significantly protect the professional support staff from securities fraud suits.

131. *See* COX ET AL., *supra* note 34, at 1129.

132. For reasons discussed later, accountants are particularly susceptible to securities fraud claims. *See infra* text accompanying notes 157–68. Therefore, the burden on accountants can be expected to be more onerous than that borne by other professionals.

133. ARTHUR ANDERSEN & CO. ET AL., *supra* note 104, at 2.

134. *Id.*

135. *Id.*

136. *See* Alexander, *supra* note 27, at 558.

137. *See id.*

one. However, a persistent attack of meritless claims leading to settlements by other defendants will erode the foundations of the "no settlement" strategy. The prevalence of settlements lessens the reputational stigma of settlement, as the business community comes to recognize the cost-benefit incentives to settle. The lack of a united front by defendants, moreover, means that a support staff will not, by itself, be able to deter meritless claims by employing a fight-at-all-costs strategy. The consequence is that over time, the professionals will be more inclined to settle to limit litigation and collateral costs.

The abuse of 10b–5 private actions is costly to the general economy. The drain on resources from defending securities fraud suits increases costs and reduces opportunity for the productive utilization of assets.[138] On a different scale, to the extent that the costs of a suit and the threat of liability lead to settlement, private securities fraud actions are used as an insurance policy against stock market losses.[139] Such behavior reduces the efficiency of the market by removing the incentive (the potential for loss) for investors to differentiate between prudent and imprudent investments.[140]

For professional support staffs, potential 10b–5 liability has contributed to widespread restructuring, especially in the accounting profession. Smaller accounting firms, finding the risks of auditing and the costs and conditions of insurance too costly, have abandoned that field.[141] The larger firms are avoiding auditing high-risk companies such as high-tech firms and smaller banks.[142] In general, the burdens placed on professional support staffs in-

138. *See supra* note 14.

139. Professor Alexander offers a rather apt description of the rights an investor purchases with his stock. The use of private actions as insurance results in the purchase of two securities: the share of stock and a "litigation put" allowing the investor to sue and recover part of his losses in the event of a stock price decline. Alexander, *supra* note 27, at 570.

140. *See* Dooley, *supra* note 104, at 835.

141. *See* Marie L. Fiala, *CPAs Retreat from Auditing, in* ACCOUNTANTS' LIABILITY 1993, at 25, 31 (PLI Litig. & Admin. Practice Course Handbook Series No. 467, 1993). For firms other than the Big Six, insurance premiums rose by 300% from 1985 to 1991. The median deductible in 1991 was $240,000, up from a 1985 median of $42,000. ARTHUR ANDERSEN & CO. ET AL., *supra* note 104, at 3. In 1991, Big Six firms faced deductibles in excess of $25 million for the first loss. *Id.*

142. Fiala, *supra* note 141, at 30–31; *see* ARTHUR ANDERSEN & CO. ET AL., *supra* note 104, at 5.

crease their cost of doing business, a cost that is eventually passed to their corporate clients and then to consumers.[143]

II. Reform Through Proportionate Liability

A. *The Proportionate Liability System*

A potential reform of Rule 10b–5 liability, modeled after congressional proposals, would replace the current system of joint and several liability with proportionate liability in situations when a defendant is culpable under 10b–5 with a scienter of less than "knowing."[144] "Knowing securities fraud" has two elements: making a "material representation with actual knowledge that the representation is false or omit[ting] to make a statement with actual knowledge" that the omission makes a material representation false, and knowing "that other persons are likely to rely on that misrepresentation or omission."[145] Reckless conduct would not constitute "knowing securites fraud."[146]

The change from joint and several to proportionate liability for reckless wrongdoers, while clearly favoring defendants, would be a moderate step in addressing the problem of excessive litigation and liability. As an initial matter, the implementation of a proportionate liability system would provide implicit support for

143. In Central Bank v. First Interstate Bank, the Supreme Court gave a detailed account of the "ripple effects" that meritless litigation has on the economy in general:

> [N]ewer and smaller companies may find it difficult to obtain advice from professionals. A professional may fear that a newer or smaller company may not survive and that business failure would generate securities litigation against the professional, among others. In addition, the increased costs incurred by professionals because of the litigation and settlement costs under 10b–5 may be passed on to their client companies, and in turn incurred by the company's investors, the intended beneficiaries of the statute.

114 S. Ct. 1439, 1454 (1994).

144. H.R. 417, 103d Cong., 1st Sess. § 3 (1993). The text of § 3 is reprinted in the Appendix to this Note. A similar, though more detailed, proportionate liability system is proposed in S. 1976, 103d Cong., 2d Sess. § 203 (1994). The text of § 203 that relates to proportionate liability is also reprinted in the Appendix.

House Bill 417 and Senate Bill 1976 contain many other reforms of securities fraud litigation practices and procedures beyond the proportionate liability system discussed in this Note. On balance, House Bill 417 and Senate Bill 1976 provide a series of disincentives to plaintiffs and regulations for attorneys. The conclusion reached in this Note regarding proportionate liability applies only to the change in liability provisions discussed herein and does not in any way reflect on the merits of the other provisions of House Bill 417, Senate Bill 1976, or on any package of reforms as a whole.

145. H.R. 417 § 3(a)(3).

146. *Id.*

the judicial notion that recklessness satisfies the scienter requirement of Rule 10b–5.[147] Joint and several liability would be maintained for knowing or willful conduct, both acknowledging and preserving the deterrence element of Rule 10b–5.

For those found guilty of reckless securities fraud, proportionate liability would substantially reduce the financial costs of their conduct. Proportionate liability employs a holistic view of responsibility that is beneficial to defendants relative to a joint and several system. A proposed proportionate liability system mandates that, upon a finding of reckless conduct, the trier of fact determine liability by ascertaining the "percentage of responsibility of the plaintiff, of each of the defendants and of each of the other persons or entities alleged by the parties to have caused or contributed to the harm alleged by the plaintiff."[148] The trier of fact "shall consider both the nature of the conduct of each person and the nature and extent of the causal relationship between that conduct and the damage claimed by the plaintiff" in determining the percentage of responsibility.[149] The percentage of responsibility is then multiplied by the total damages to find the reckless defendant's liability.[150] The jury considers all the "but for" and contributory causes of the fraud. The distinguishing characteristic among those involved in the fraud is their level of culpability. Those found reckless are necessarily less culpable (in the sense of blameworthiness) than willful wrongdoers and therefore are less responsible. Under proportionate liability, less responsibility would mean less liability. By evaluating the culpability of wrongdoers through a stratified construction of scienter, the proportionate liability system would link culpability with liability, substantially reducing the expected value of liability for reckless wrongdoers.

B. *Effects on the Parties*

Given the restraint used in crafting the proposed provision, it is interesting to look at who would win and who would lose with the change in liability. Proportionate liability would have two major impacts: (1) it would lessen the incentive of plaintiffs to bring suit; and (2) it would alter the culpability of the support staff

147. *See supra* text accompanying notes 31–37.
148. H.R. 417 § 3(a)(2)(A).
149. *Id.*
150. *Id.* § 3(a)(2)(B).

professionals for failure to fulfill their duty as perceived by society.

Because plaintiffs would bear much of the burden in the change, the provision should be viewed on one level as shifting the procedural burden of litigation from defendants to plaintiffs. A plaintiff would have to join all possible defendants in an alleged fraud or run the risk that, in the absence of potential parties, the lack of knowing or willful defendants would result in incomplete compensation. Further, the insolvency or bankruptcy of a culpable defendant would force the plaintiff to bear the risk of being undercompensated.[151] This risk would be heightened by a combination of two factors: perceived culpability rises as an alleged wrongdoer is "closer to the facts,"[152] and insolvency and bankruptcy are most likely to afflict issuers. The "deep pocket" accountants, lawyers, and underwriters are necessarily more removed from a fraud than the issuer. The marginal separation from the events constituting the fraud means that the "deep pocket" defendants are more likely than the bankrupt issuer at the origin of the fraud to be found recklessly, as opposed to knowingly or willfully, culpable. From the plaintiff's perspective, this means that the change in the measure of liability would lessen the expected value of compensation for a finding of fraud, diminishing one of the fundamental incentives for bringing suit.

The same "closer to the facts" argument suggests that among defendants, issuers would not be helped by changing the standard of liability to proportionate fault for reckless behavior. The issuer would be more likely than any of its professional support staff to be found guilty of knowing securities fraud because of its proximity to the events and its stake in the wrongdoing.[153] Under the

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151. *See* Adamski, *supra* note 44, at 570–72. Senate Bill 1976 addresses the issue of insolvent or bankrupt culpable defendants by creating a provision for uncollectible shares. *See* S. 1976 § 41(d)(2). Only relatively poor individual plaintiffs can take advantage of this provision: the individual plaintiff must be seeking recoverable damages equal to more than 10% of his net worth, and plaintiff's net worth must be less than $200,000. *Id.* § 41(d)(2)(A). The qualified plaintiffs may collect from each remaining defendant a portion of the uncollected share that does not exceed the greater of (1) the remaining defendant's percentage of fault or (2) five times (i) what the remaining defendant gained from the conduct that caused liability or (ii) if the defendant did not realize a financial gain, the defendant's gross revenues received for the provision of services to the other entity in the violation during the calendar year in which the services giving rise to liability were provided. *Id.* § 41(d)(2)(B).

152. *See* Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1288 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

153. *Cf. id.* (describing the increased risk of culpability when a defendant is "closer to

congressional proposal, knowing securities fraud occurs when a party "(A) makes a material representation with actual knowledge that the representation is false or omits to make a statement with actual knowledge that, as a result of the omission, one of his material representations is false; and (B) knows that other persons are likely to rely on that misrepresentation or omission."[154] This demanding standard of knowledge places greater scrutiny on those who control the primary record-keeping apparatus. Information developed through a company's internal workings is more easily attributed to that company and to its officers. If recklessness and knowledge lie on the same continuum, the issuer's position of control and the financial benefits accruing to it often tip the scale toward measuring the issuer's conduct as knowing. Liability for the issuer in that situation would be joint and several.

Having recognized the burdens faced by corporations because of securities fraud litigation, it is reasonable to consider extending proportionate liability to all levels of scienter. Such a result may in effect be achieved in jurisdictions that employ proportionate reduction set-off and proportionate fault contribution.[155] Of course, in those jurisdictions the risk of disproportionate liability is borne by those defendants initially found jointly and severally liable. Removing the fortuity of settlement and the need for culpable and solvent non-suited parties are the only steps needed to conceive of a working comprehensive proportionate liability system.

While comprehensive proportionate fault liability would protect issuers, it would do so only at the cost of narrowly and unfairly defining equity. Analyzing a proposal to make all 10b-5 liability proportionate brings into sharper focus the incentives behind creating a liability system. Knowing and willful fraud is meant to be deterred before its onset and punished upon its discovery by the 10b-5 system of liability. When fraud is perpetrated intentionally, the utility of apportioning liability according to relative fault is highly questionable.[156] The equitable appeal of spreading liability through contribution stems not from lessening

the facts").

154. H.R. 417, 103d Cong., 1st Sess., § 3(a)(3) (1993).

155. *See supra* text accompanying notes 61 and 86.

156. *Cf.* Helen S. Scott, *Restructuring Indemnification and Contribution Clauses in Underwriting Agreements*, 61 N.Y.U. L. REV. 223, 256 (1980) ("Where proof of scienter . . . is required, the appeal of a relative fault standard is diminished.").

the punishment of the wrongdoer (or, for that matter, from lessening the award to the plaintiff) but from correlating liability and culpability. A shift to proportionate liability would shift the allocation of risk from defendant to plaintiff. In the event that a defendant is insolvent, the loss would be borne by the plaintiff under proportionate liability. In allocating the risk of loss, the importance of enhancing deterrence and notions of fairness suggest that it is better that such a risk be shouldered by the willful wrongdoer. Thus, a broader view of equity calls for joint and several liability for knowing or willful wrongdoers. That proportionate liability would be imposed on reckless conduct suggests that there is a difference between reckless and knowing conduct. In keeping with the principal of equity, proportionate liability should be used not to remove responsibility or shield wrongdoers from risk, but to better correlate responsibility, culpability, and liability and to better allocate risk between plaintiffs and defendants.

The second way of viewing the proposed liability reform is as a means of redefining the role of the professional support staff in capital markets. These professionals would reap a significant benefit from the change in the standard of liability. Potential liability for securities fraud stems from the role of these professionals in the preparation of the issuer's documents and from their perceived duty to the public. Document preparation creates liability upon a showing of an intent to deceive, thereby fulfilling the "knowing" and "willful" segments of the scienter spectrum.[157] The perceived public duty of the support staff[158] helps create a standard of recklessness. As discussed above,[159] recklessness is defined as disregarding known risks. The determination of what risks are cognizable and what risks create a duty of disclosure is established in large part by the public duty created by regulatory and societal norms.[160]

Attorneys have benefited from the limited duty they owe the general public. The attorney's role as advocate limits his obligation to the service of his client. Courts have increasingly recognized that attorneys owe no duty of disclosure to third-party beneficia-

157. *See* Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 495–96 (7th Cir. 1986).

158. *See infra* notes 161–69 (discussing the origins of the public perception).

159. *See supra* text accompanying notes 35–37.

160. *See Barker*, 797 F.2d at 497 ("Neither lawyers nor accountants are required to tattle on their clients in the absence of some duty to disclose.").

ries in securities fraud cases.[161] Attorney fraud liability is limited to knowing misrepresentations in the solicitation of securities.[162]

Underwriters and, to a greater extent, accountants are held to higher standards of public obligation than are lawyers. Underwriters and accountants are not advocates; they are conduits of information between investors and companies accessing capital markets.[163] Underwriters are held to a duty to investigate the issuer.[164] This investigation may be relied on by the general public, which makes the underwriter liable not only for intentional deception but also for recklessness.[165] As a commentator notes, "In light of an underwriter's responsibility to the public, its leverage over the issuer, and its specialized knowledge, once liability is found, the 'fault' of the underwriter is as much a question of status violation as mental state."[166]

While the obligations of the underwriter are coterminous with the public offering, the obligations of accountants are continuous, reflecting the continuous disclosure requirements of issuers. Public expectations, augmented by the promises of the accounting profession, have conferred a high duty on accountants. As Chief Justice Burger remarked in *United States v. Arthur Young & Co.*,

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a

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161. *See* Fortson v. Winstead, McGuire, Sechrest & Mirick, 961 F.2d 469, 475 (4th Cir. 1992) (declining the opportunity to make lawyers "function in the business world as designated watchdogs"); Schatz v. Rosenberg, 943 F.2d 485, 491 (4th Cir. 1991) ("[T]he law . . . only rarely allows third parties to maintain a cause of action against lawyers for the insufficiency of their legal opinions." (quoting Abell v. Potomac Ins. Co., 858 F.2d 1104, 1124 (5th Cir. 1988), *vacated on other grounds*, 492 U.S. 914 (1989))), *cert. denied*, 112 S. Ct. 1475 (1992); *Barker*, 797 F.2d at 497 (noting that "attorneys have privileges not to disclose").

162. *See Schatz*, 493 F.2d at 492.

163. *See In re* Michigan Gen. Corp., 77 B.R. 97, 108 (Bankr. N.D. Tex. 1987).

164. The obligations of the underwriter when a registration statement is filed stem from the requirements of § 11 of the '34 Act, 15 U.S.C. § 78 (1988), and from the antideception provision in Rule 10b-5, 17 C.F.R. § 240.10b-5 (1994). *See* Sanders v. John Nuveen & Co., 524 F.2d 1064, 1070 (7th Cir. 1975); *see also* Milton P. Kroll, *Some Reflections on Indemnification Provisions and SEC Liability Insurance in the Light of* BarChris *and* Globus, 24 BUS. LAW. 681, 687 (1969) (stating that § 11 creates for underwriters a "high standard of trusteeship and a 'duty of competence as well as innocence'" (quoting H.R. REP. NO. 85, 73d Cong., 1st Sess. 9 (1933))).

165. *See Sanders*, 524 F.2d at 1071 ("The underwriter is under a duty to make at least some investigation directed at the question whether the ever present possibility of fraud is in fact a reality.").

166. Scott, *supra* note 156, at 260.

> *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.[167]

As with underwriters, failure to meet this duty constitutes recklessness for the purposes of Rule 10b-5.

Definitions of the accountant's duty to the public are inexact and depend heavily on perspective. There is a marked difference between the expectations that the public holds for accountants and those that the accounting profession has for itself. This "expectations gap" has its greatest impact when factfinders attempt to define accountants' negligence.[168] However, the gap also plays a role in defining Rule 10b-5 recklessness through the determination of the risks of which an accountant was or should have been aware. For a trier of fact, a business downturn or failure is often equated with an audit failure.[169] Having given its "approval" to the financial statements it has audited, it is difficult, after a company has failed, for an accounting firm to escape a finding that it disregarded a substantial risk that the company records were inaccurate.

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167. United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984).

168. *See* NEWTON N. MINOW, SPECIAL REPORT: ACCOUNTANTS' LIABILITY 3 (1987). In recent years the accounting profession has taken steps to diminish the size of the "expectations gap" by promulgating rules that better define the duties of the accountant/auditor. *See* Erica B. Baird, *Legal Liability Under the Expectation Gap Statements on Auditing Standards, in* ACCOUNTANTS' LIABILITY 1991, at 63, 65-66 (PLI Litig. & Admin. Practice Course Handbook Series No. 415, 1991); Dan L. Goldwasser, *Accountants' Liability: The Accounting Profession at the Crossroads, in* ACCOUNTANTS' LIABILITY 1993, *supra* note 141, at 9, 17-19.

169. *See* MINOW, *supra* uote 168, at 3. Minow quotes from a 1972 article by Victor Earle, general counsel for Peat, Marwick, Mitchell & Co., that found five misperceptions regarding the work of accountants. Those misperceptions are (1) that accountants check the accuracy of all a clients' records; (2) that accountants evaluate the business wisdom and legality of client decisions; (3) that accountants provide absolutely accurate numbers on audited financial statements; (4) that the audited results of a client's performance can be presented in a single number; and (5) that accountants certify the financial health and investment viability of the company. *Id.* (quoting Victor Earle, *Accountants on Trial in a Theater of the Absurd*, FORTUNE, May 1972, at 227). This misinformed public view of accountants blurs the line between corporate and accountant responsibility and leads to the imposition of liability on accountants for the willful and other wrongdoings of their clients.

The change from joint and several to proportionate liability would lessen the burdens faced by accountants due to the expectations gap. Making recklessness subject to proportionate liability would recognize that factfinders are prone to find accountants, and to a lesser extent other professionals, liable for the failure of their clients, and that such a finding of recklessness is not the "fraud" that Rule 10b–5, through joint and several liability, was meant to deter. Stated another way, Rule 10b–5 recklessness, because it is predicated on public expectations, tends to largely overpunish and thus overdeter professionals, resulting in higher costs to the professionals, the issuer, and ultimately the investors.

The deterrence function of Rule 10b–5 is well served by holding accountants and other professionals to standards of conduct that they are unable to attain, but this deterrence comes at a high cost. When professionals fail in their role as "public watchdog," the joint and several liability system and the systemic pressure to settle claims force the professionals into another role—that of stock market insurer.[170] Changing the measure of liability would provide a more realistic depiction of the professionals' responsibilities as "watchdog." While still being responsible for the quality of their work, professionals would not be placed in the shoes of frauds for failing to catch the frauds. The greatest burden of liability would be placed on those acting with intent, leaving the watchdogs responsible only for the role that their failure played in allowing the fraud.

C. *Effect on Judicial Economy*

The change from joint and several to proportionate liability would also have a substantial impact on judicial caseloads and judicial economy. By effectively decreasing the potential liability of "deep pocket" defendants, the reform would deter meritless suits. As discussed above, potential damages in a fraud suit must be very high to make litigation cost-effective.[171] Proportionate liability would increase the discount factor that must be applied by plaintiffs and their attorneys in evaluating the cost-effectiveness of weak cases. Instead of only calculating the risk that a defendant would be found not culpable, the plaintiff would also have to

170. *See* Alexander, *supra* note 27, at 570.
171. *See supra* text accompanying note 112.

consider the probability that the defendant would be found only reckless. This would lower the plaintiff's potential recovery and at the margin deter frivolous litigation.[172]

Proportionate liability would also alter the role of the jury. The factfinder would bear the burden of (1) more carefully distinguishing between reckless and knowing fraud and (2) determining the relative culpability of the reckless parties. These burdens would not be significantly time-consuming and would be consistent with the current role of the factfinder.[173] Determining the precise level of scienter is a common task for civil and criminal juries.[174] The apportionment of responsibility would mirror the factfinder's role in proportionate fault contribution and set-off jurisdictions as well as in comparative fault negligence jurisdictions.[175]

Careful consideration must be given to the effect of the proposed standard on settlements because of the importance of settlement in the judicial process. The change in the standard of liability would deter settlement by professionals by substantially decreasing the risk, in the form of liability, faced by the "deep pocket" defendants. However, the decrease in potential liability, in keeping with the intent of the policy, would decrease the impor-

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172. This proposition is best demonstrated by example. Consider a case with potential damages (D) of 100. Under joint and several liability, the expected value of defendant X's liability to the plaintiff is his probability of guilt times his potential liability. If X's probability of guilt ($P(g)$) is 20%, then the expected value of X's liability to the plaintiff is 20 (20% times the 100 potential liability). Under a proportionate liability system, $P(g)$ is composed of two elements: the probability of reckless liability ($P(r)$) and the probability of knowing liability ($P(k)$). If $P(r) = P(k) = 10\%$, then the expected value of X's liability for the knowing component is $P(k) \times D = 0.1 \times 100 = 10$. This amount is added to the expected value of the reckless liability determined by multiplying $P(r)$ times the potential reckless liability. The potential reckless liability is determined by multiplying the probable relative fault of X times D. For any probable relative fault less than 100%, the potential reckless liability will be less than D, and the expected value of the reckless liability will be less than 10. Therefore the total expected value of the potential liability under the proportionate liability system will be less than that of the joint and several system. The presence of numerous potential and actual defendants as well as of differing levels of culpability will decrease the probable relative fault, driving the expected value of the potential reckless liability toward zero.

173. *See* Smith v. Mulvaney, 827 F.2d 558, 561 (9th Cir. 1987) (finding compelling the argument of critics of the pro rata method that "[l]ittle, if any, additional evidence . . . would actually be necessary for the trier of fact to decide each defendant's relative culpability").

174. *See supra* notes 61, 86 and accompanying text (discussing the trier of fact's role in the implementation of proportionate fault contribution and set-off, respectively).

175. *See supra* note 65 and accompanying text (discussing the prevalence of comparative fault negligence).

tance of professionals in the litigation. The relative rise in meritorious suits and the increased risk faced by those "closer to the facts"[176] (i.e., issuers) would leave plaintiffs with the opportunity to settle with the most culpable parties and to realize substantial compensation through such settlement.

D. *Comparing Contribution and Proportionate Liability*

Both contribution and proportionate fault liability alleviate the financial burdens placed on defendants. The policies behind these measures further equitable interests in differing ways. A contribution system maintains the long-standing doctrines of the federal securities laws by preserving the incentives for private plaintiffs to enforce federal policy. Contribution lessens the burden on defendants through an equitable apportionment of liability. Proportionate fault liability, on the other hand, would be a new track for federal securities law. The change in the standard of liability would target the role of the professional support staff and would take the rare step of diminishing the liability, though not the responsibility, of that group.

The difference between contribution and proportionate fault liability is difficult to distinguish, at first glance, when a proportionate fault contribution system is employed. Proportionate fault contribution allocates liability according to relative culpability, exactly mirroring the result of a proportionate liability system. The legislative enactment of a proportionate fault contribution system would realize the goal of reducing the risks faced by professionals by correlating liability and culpability. Nevertheless, proportionate fault contribution fosters equity only after fixing culpability. A proportionate liability system would go further, taking account of equity in determining culpability, thus eliminating the fortuity of settlement and the need for solvent non-suited joint tortfeasors. This earlier application of equitable considerations would change the accountability of the professional support staff and deter the filing of meritless claims.

The merits of proportionate liability hinge on the merits of changing the role of accountants, lawyers, and underwriters. Joint and several liability, even with contribution, pushes the professionals to the highest standard of conduct, as is evidenced by the new

176. *See supra* text accompanying notes 152–53.

rules establishing guidelines for auditors' responsibilities.[177] A change to proportionate liability for reckless conduct would not absolve professionals of responsibility. The typically large stakes in securities fraud cases mean that proportionate liability still would involve significant sums. It is unlikely that a change from tens of millions of dollars in potential liability to millions or hundreds of thousands of dollars in potential liability would seriously diminish the deterrent effect of such liability on professionals.

Another issue to consider is whether the change to proportionate liability would remove the incentive for plaintiffs to bring meritorious suits. In a case in which all the potential defendants are fiscally sound, the incentives would remain intact. The plaintiff who proves securities fraud would be compensated in full. However, when the potential defendants, and especially the issuer, are insolvent or bankrupt, the plaintiff would be left without recourse. This result is harsh but is beneficial to the efficient operation of the capital markets. Eliminating or shrinking the safety net of deep pocket insurance would foster cautious, thoughtful investment, leading to a better allocation of investment resources. The securities laws and Rule 10b–5 are primarily concerned with protecting investors in general and not with compensating aggrieved investors.[178] Investors necessarily face risk, and one substantial risk is that a company will fail because of corporate wrongdoing. In such a situation, the onus of deterrence shifts from private civil remedies to government-initiated criminal sanctions against the knowing and willful parties.

CONCLUSION

The system of joint and several liability in Rule 10b–5 private actions misallocates the risks faced by parties involved in securities transactions. By casting the professional support staff in the role of deep pocket defendant and by creating nearly insuperable incentives for settlement, the system causes the professionals to bear much of the risk initially taken by investors and issuers. A finding of recklessness, in the context of joint and several liability, places the professionals in the shoes of the fraudulent party. The costs of litigation, procedures regulating the use of class action lawsuits,

177. *See supra* note 168 and accompanying text (discussing the promulgation of new accounting standards).

178. *See supra* note 1.

and the potential for massive liability drive the parties to settlement, allowing nonfraudulent investment losses to be recovered by plaintiffs.

In a fair and economically efficient system of securities regulation, parties are held accountable for their actions. Professionals are responsible for their work and for the consequences of their failures. Issuers and their management are responsible for the consequences of deceiving the market. Investors bear the risk of imprudent investment and economic downturn, and they are responsible for investment losses in the absence of financially solid parties who knowingly cause such losses. The use of a contribution system diminishes inequity by spreading liability to all culpable parties. However, this relief does not affect the determination of culpability and thus does not alter the allocation of risk to reckless defendants. Proportionate liability for reckless conduct is a necessary component of a fair and economically efficient system of securities regulation. The proposed reform would restore the proper distribution of responsibility in the securities market. The incentives created by proportionate liability would alleviate the financial burdens placed on professionals while maintaining the deterrence necessary to protect investors from unscrupulous or systemically careless practices.

APPENDIX

I. H.R. 417, 103D CONG., 1ST SESS. § 3 (1993)

Sec. 20B. *(a) Requirement of Proportionate Liability.—*

(1) LIMITATION ON JOINT AND SEVERAL LIABILITY.—A defendant who is found liable for damages in an implied private action arising under a provision of this Act may be liable jointly and severally only if the trier of fact specifically determines that the defendant engaged in knowing securities fraud, as defined in paragraph (3).

(2) DETERMINATION OF LIABILITY.—If the trier of fact does not find, pursuant to paragraph (1), that the defendant engaged in knowing securities fraud, the defendant's liability shall be determined as follows:

(A) The trier of fact shall determine the percentage of responsibility of the plaintiff, of each of the defendants and of each of the other persons or entities alleged by the parties to have caused or contributed to the harm alleged by the plaintiff. In determining the percentages of responsibility, the trier of fact shall consider both the nature of the conduct of each person and the nature and extent of the causal relationship between that conduct and the damage claimed by the plaintiff.

(B) For each defendant, the trier of fact shall then multiply the defendant's percentage of responsibility by the total amount of damage suffered by the plaintiff that was caused in whole or in part by that defendant and shall enter a verdict or judgment against the defendant in that amount. No defendant whose liability is determined under this subsection shall be jointly liable on any judgment entered against any other party to the action.

(C) Except where contractual relationship permits, no defendant whose liability is determined under this subsection shall have a right to recover from another defendant any portion of the judgment entered against him.

(3) DEFINITION.—A defendant engages in "knowing securities fraud" only if he (A) makes a material representation with actual knowledge that the representation is false or omits to make a statement with actual knowledge that, as a result of the omission,

one of his material representations is false; and (B) knows that other persons are likely to rely on that misrepresentation or omission. Reckless conduct by the defendant shall not constitute "knowing securities fraud." The liability in damages, in [sic] any, of a defendant who acts in a reckless manner shall be determined in accordance with paragraph (3).

(4) COVERAGE OF PROVISION.—This subsection relates only to the allocation of damages among defendants. Nothing herein shall affect the standards for liability under any implied private action arising under a provision of this Act.

II. S. 1976, 103D CONG., 2D SESS. § 203 (1994)

Sec. 41. *Proportionate Liability and Joint and Several Liability in Implied Actions*

(a) APPLICABILITY.—This section shall apply only to the allocation of damages among persons who are, or who may become, liable for damages in an implied private action arising under this title. Nothing in this section shall affect the standards for liability associated with an implied private action arising under this title.

(b) APPLICATION OF JOINT AND SEVERAL LIABILITY.—

(1) IN GENERAL.—A person against whom a judgment is entered in an implied private action arising under this title shall be liable jointly and severally for any recoverable damages on such judgment if the person is found to have—

(A) been a primary wrongdoer;

(B) committed knowing securities fraud; or

(C) controlled any primary wrongdoer or

person who committed knowing securities fraud.

(2) PRIMARY WRONGDOER.—As used in this subsection-

(A) the term 'primary wrongdoer' means—

(i) any—

(I) issuer, registrant, purchaser, seller, or underwriter of securities;

(II) marketmaker or specialist in securities; or

(III) clearing agency, securities information processor, or government securities dealer; if such person breached a direct statutory or regulatory obligation or if such person otherwise had a principal role in the conduct that is the basis for the implied right of action; or

(ii) any person who intentionally rendered substantial assistance to the fraudulent conduct of any person described in clause (i), with actual knowledge of such person's fraudulent conduct or fraudulent purpose, and with knowledge that such conduct was wrongful; and

(B) a defendant engages in "knowing securities fraud" if such defendant—

(i) makes a material representation with actual knowledge that the representation is false, or omits to make a statement with actual knowledge that, as a result of the omission, one of the defendant's material representations is false and knows that other persons are likely to rely on that misrepresentation or omission, except that reckless conduct by the defendant shall not be construed to constitute "knowing securitites fraud"; or

(ii) intentionally rendered substantial assistance to the fraudulent conduct of any person described in clause (i), with actual knowledge of such person's fraudulent conduct or fraudulent purpose, and with knowledge that such conduct was wrongful.

(c) DETERMINATION OF RESPONSIBILITY.—In an implied private action in which more than 1 person contributed to a violation of this title, the court shall instruct the jury to answer special interrogatories, or if there is no jury, shall make findings, concerning the degree of responsibility of each person alleged to have caused or contributed to the violation of this title, including persons who have entered into settlements with the plaintff. The interrogatories or findings shall specify the amount of damages the plaintiff is entitled to recover and the degree of responsibility, measured as a percentage of the total fault of all persons involved in the violation, of each person found to have caused or contributed to the damages incurred by the plaintiff or plaintiffs. In determining the degree of responsibility, the trier of fact shall consider—

(1) the nature of the conduct of each person; and

(2) the nature and extent of the causal relationship between that conduct and the damage claimed by the plaintiff.

(d) APPLICATION OF PROPORTIONATE LIABILITY.—Except as provided in subsection (b), the amount of liability of a person who is, or may through right of contribution become, liable for damages based on an implied private action arising under this title shall be determined as follows:

(1) DEGREE OF RESPONSIBILITY.—Except as provided in paragraph (2), each liable party shall only be liable for the portion of the judgment that corresponds to that party's degree of responsibility, as determined under subsection (c).

(2) UNCOLLECTIBLE SHARES.—If, upon motion made not later than 6 months after a final judgment is entered, the court determines that all or part of a defendant's share of the obligation is uncollectible—

(A) the remaining defendants shall be jointly and severally liable for the uncollectible share if the plaintiff establishes that—

(i) the plaintiff is an individual whose recoverable damages under a final judgment are equal to more than 10 percent of the plaintiff's net financial worth; and

(ii) the plaintiff's net financial worth is less than $200,000; and

(B) the amount paid by each of the remaining defendants to all other plaintiffs shall be, in total, not more than the greater of—

(i) that remaining defendant's percentage of fault for the uncollectible share; or

(ii) 5 times—

(I) the amount which the defendant gained from the conduct that gave rise to its liability; or

(II) if a defendant did not obtain a direct financial gain from the conduct that gave rise to the liability and the conduct consisted of the provision of deficient services to an entity involved in the violation, the defendant's gross revenues received for the provision of all services to the other entity involved in the violation during the calendar years in which deficient services were provided.

(3) OVERALL LIMIT.—In no event shall the total payments required pursuant to paragraph (2) exceed the amount of the uncollectible share.

(4) DEFENDANTS SUBJECT TO CONTRIBUTION.—A defendant whose liability is reallocated pursuant to paragraph (2) shall be subject to contribution and to any continuing liability to the plaintiff on the judgment.

(5) RIGHT OF CONTRIBUTION.—To the extent that a defendant is required to make an additional payment pursuant to paragraph (2), that defendant may recover contribution—

(A) from the defendant originally liable to make the payment;

(B) from any defendant liable jointly and severally pursuant to subsection (b)(1);

(C) from any defendant held proportionately liable pursuant to this subsection who is liable to make the same payment and has paid less than his or her proportionate share of that payment; or

(D) from any other person responsible for the conduct giving rise to the payment who would have been liable to make the same payment.

(e) NONDISCLOSURE TO JURY.—The standard for allocation of damages under subsections (b)(1) and (c) and the procedure for reallocation of uncollectible shares under subsection (d)(2) shall not be disclosed to members of the jury.

(f) SETTLEMENT DISCHARGE.—

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

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

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

(2) REDUCTION.—If a person enters into a settlement with the plaintiff prior to verdict or judgment, the verdict or judgment shall be reduced by the greater of-

(A) an amount that corresponds to the degree of responsibility of that person; or

(B) the amount paid to the plaintiff by that person.

(g) CONTRIBUTION.—A person who becomes liable for damages in an implied private action arising under this title may recover contribution from any other person who, if joined in the original suit, would have been liable for the same damages. A claim for contribution shall be determined based on the degree of responsibility of the claimant and of each person against whom a claim for contribution is made. . . .