Rule 23 - Don Quixote Has a Field Day: Some Ethical Ramifications of Securities Fraud Class Actions

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The 1966 amendments to Federal Rules of Civil Procedure 23 have yielded a veritable rash of stockholder litigation. The new procedural simplicity has opened the floodgates to unrestrained, widespread and lucrative exploitation of the class action device by members of the trial bar.¹

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¹ Fed. R. Civ. Pr. 23:
(a) Prerequisites to a Class Action. One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

(b) Class Actions Maintainable. An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:
(1) the prosecution of separate actions by or against individual members of the class would create a risk of
(A) inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class, or
(B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests; or
(2) the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or
(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the
Lawyers used to wait with baited breath for the fine day they would receive that big case, meaning a banana peel at Woolworth's. But now the struggling attorney's new dream is that some disgruntled little old lady, owning perhaps two shares of General Motors, will present her fifty dollar dividend claim to him for collection. With amended Rule 23, an attorney so lucky no longer need struggle. He has arrived. Thanks to the liberalized class action device, the little old malcontent's fifty dollar claim will be magnified into a multi-million dollar looting operation.  

But ethically so? Perhaps the time has come for the courts to question the propriety of certain widespread and growing practices not heretofore challenged. The time may be ripe for the courts to delineate certain outer limits beyond which the class device may not properly be used. The purpose of this manuscript, then, is to examine possible ethical objections to the class suit.

This manuscript raises two questions: (1) May a class action ethically be maintained when there is a conflict of interests among the members of the class such that the rights of counsel's principal clients, his named plaintiffs, will be prejudiced by the inclusion of the absent class members? and, (2) Does the maintenance of a class action on a contingent fees basis constitute the stirring up of litigation or the solicitation of clients?

1. May a Class Action Ethically Be Maintained When There Is a Conflict of Interests Among the Members of the Class Such That the Rights of Counsel's Principal Clients, His Named Plaintiffs, Will Be Prejudiced by the Inclusion of the Absent Class Members?

Lord Brougham is credited with having remarked:

There are many whom it may be needful to remind that an advocate—by the sacred duty of his connection with his client—knows, in the discharge of that office, but one person in the world

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—that client and none other. To serve that client by all expedient means, to protect that client at all hazards and costs to all others (even the party already injured), and, amongst others, to himself is the highest and most unquestioned of his duties. And he must not regard the alarm, the suffering, the torment, the destruction, which he may bring upon any others. Nay, separating even the duties of a patriot from those of an advocate, he must go on, reckless of the consequences, if his fate should unhappily be to involve his country in confusion for his client.\(^3\)

When that one stockholder walks into her attorney's office with her fifty dollar cause of action, and her attorney accepts that case, that attorney's first duty of loyalty is to that client and none other. Even if the defendant corporation is undergoing a Chapter X Bankruptcy reorganization,\(^4\) which usually is the case with a 10b-5 security fraud\(^5\) class suit, there is an excellent possibility that this one client's claim may be settled out of court. Perhaps one of the twenty or more members of the board of directors will be willing to pay the full fifty dollar claim just to avoid litigation. But by transforming the case into a multi-million dollar suit, plaintiff's counsel virtually ensures protracted litigation. By choosing the class device for reasons that have little to do with the welfare of the original client, counsel throws his client into the courtroom. In the typical class suit, it is doubtful if there are enough assets that a judgment for the full *ad damnum* will ever be satisfied, not even out of the combined assets of all the directors. If a class judgment is rendered against one or more of the defendants, it is likely that all the members of the class will have to take a fractional share in the proceeds. Counsel can spare his client this reduction merely by filing an individual suit.

On that fateful day when the original plaintiff walked into her attorney's office there existed an excellent opportunity for that attorney to assist his client in obtaining a full recovery. Why, then, would any attorney ever choose another alternative? Perhaps the enthralling prospect of homing in on a large contingent fee is sufficient temptation for some lawyers to abandon forever the

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\(^3\) G. Keeton, *Harris's Hints on Advocacy* 208-09 (18th ed. 1943) (emphasis added).

*But see* ABA Canons of Professional Ethics No. 15.


opportunities their clients once had to recover substantial fractions of their claims.

According to the Canons of Professional Ethics:

The obligation to represent the client with undivided fidelity . . . forbids also the subsequent acceptance of retainers or employment from others in matters adversely affecting any interest of the client with respect to which confidence has been reposed.  

Observe, however, that this objection to class actions is applicable only where there is a true conflict of interests among members of the class, such as insufficient assets to satisfy all claimants. In citizen suits, taxpayer actions, and even in securities cases involving only voting or dividend rights in a solvent corporation, there would seem to be no conflict of interests such that the original client would be prejudiced by the inclusion of others in his suit. One court has observed:

[T]he taxpayer suit device would lose its utility if we held that a single taxpayer could not provide representation for his fellow taxpayers. Without the searching and determined scrutiny of gadfly taxpayers, often solitary in their pursuit of justice, many excesses of governmental administration might escape unnoticed.

But where there is a conflict of interests, "[i]t is unprofessional to represent conflicting interests ... ."  

2. DOES THE MAINTENANCE OF A CLASS ACTION ON A CONTINGENT FEE BASIS CONSTITUTE THE STIRRING UP OF LITIGATION OR THE SOLICITATION OF CLIENTS?

According to the Canons of Professional Ethics:

It is unprofessional for a lawyer to volunteer advice to bring a lawsuit, except in rare cases where ties of blood, relationship or trust make it his duty to do so. Stirring up strife and litigation is not only unprofessional, but it is indictable at common law. It is disreputable to hunt up defects in titles or other causes of action and inform thereof in order to be employed to bring suit or collect judgment, or to breed litigation by seeking out those with claims for personal injuries or those having any other grounds of action in order to secure them as clients . . . .

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6 ABA Canons of Professional Ethics No. 6.
7 Concerning conflicts of interest, see generally Hansberry v. Lee, 711 U.S. 32 (1940).
9 ABA Canons of Professional Ethics No. 6.
10 Id. No. 28; cf. Id. No. 27.
In a taxpayer or citizen suit, counsel may of course become the self-appointed gladiator for absentees. But there he usually does so without obtaining additional remuneration. In the typical citizen suit, counsel is paid a fee certain by his principal client regardless of whether the pleadings are framed to extend the benefits of any judgment to the class as well as to the client. The class beneficiaries pay nothing.

But in the typical securities fraud case, one attorney fortuitous enough to have been contacted by one stockholder with one fifty dollar claim is in a position to appoint himself contingent counsel to thousands of persons, many of whom are unaware that they even have a possible claim.

There can be no doubt that in the United States today the securities fraud variety of class suit, spurred by the amendment to Rule 23, is in danger of becoming just such a device whereby attorneys may stir up or enlarge litigation, may solicit clients, may become their own clients, and may represent persons for a fee without their advance knowledge or express consent.

In one recent case, the Pennsylvania federal court, fearful of such ethical ramifications, was unwilling even to delegate to plaintiffs' counsel the "ministerial" task of transmitting notices of the class action to the members of the class. And the reasoning of that opinion is singularly eloquent.

In another recent case, the District Court for the Northern District of California granted an order "[t]hat pending notification of the class as hereinafter specified, neither plaintiffs or their counsel, nor defendants or their counsel, shall solicit or otherwise contact the class independently and in the absence of court approval."

As early as 1955, Judge Dimock of the Southern District of New York said:

It may be argued that the rights of hundreds of servicemen may be lost if plaintiffs cannot afford to adequately resist the

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appeal and cannot ascertain the names of others who might contribute to the cost. It may also be argued that the rights of hundreds of servicemen may become bound by the Statute of Limitations unless plaintiffs can obtain their names so as to warn them. The natural answer to those arguments would be that these plaintiffs are not their brothers’ keepers. Can they constitute themselves their brothers’ keepers by bringing an action on their behalf? Only on such a theory could one support the right here asserted. . . . The possibility of abuse of the right is so extensive as to argue against the very existence of the right.\textsuperscript{14}

On the other hand, not all federal courts have taken such a dim view of representative actions.\textsuperscript{15} In one class action arising under the Sherman Act, Judge Evans said:

Nor is the financial aspect to be overlooked—that is, the plaintiffs’ and defendants’ relative financial ability. The relative financial interest in the outcome of the litigation is such, that greater parity of ability is obtained by a joinder of plaintiffs.

To permit the defendants to contest liability with each claimant in a single suit, would, in many cases, give defendants an advantage which would be almost equivalent to closing the door of justice to all small claimants. This is what we think the class suit practice was to prevent. Like many another practice, necessity was its mother. Its correct limitations must be ascertained by the experiences which brought it into existence.\textsuperscript{16}

The Seventh Circuit did not tell us exactly where these “correct limitations” lie. But the Second Circuit, also taking a favorable view of class actions, writes of Rule 23:

In our complex modern economic system where a single harmful act may result in damages to a great many people there is a particular need for the representative action as a device for vindicating claims which, taken individually, are too small to justify legal action but which are of sufficient size if taken as a group. In a situation where we depend on individual initiative, particularly the initiative of lawyers, for the assertion of rights, there must be a practical method for combining these small claims, and the representative action provides that method.\textsuperscript{17}

But while the representative device itself generally is held to be desirable, the trial courts have been given a broad measure of

\textsuperscript{14} Hormel v. United States, 17 F.R.D. 303, 305 (S.D.N.Y. 1955).
\textsuperscript{16} Weeks v. Bareco Oil Co., 125 F.2d 84, 90 (7th Cir. 1941).
\textsuperscript{17} Escott v. Barchris Constr. Corp., 340 F.2d 731, 733 (2d Cir. 1965) (emphasis added); see Kainz v. Anheuser-Busch, Inc., 194 F.2d 737, 743 (7th Cir.), cert. denied, 344 U.S. 820 (1952).
discretion in determining whether that device should be applied in any particular case.\(^*\) For example, in the classic case of *Bairn & Blank, Inc. v. Warren-Connelly Co.*, Judge Dawson of the Southern District of New York disallowed a Sherman Act class action, saying that "[t]he permissive use of class action permitted by Rule 23 of the Rules of Civil Procedure was never intended as a device to enable client solicitation, nor should it be permitted to be used for that purpose."\(^*\) The notes of the Advisory Committee that drafted new Rule 23 accord with this view.\(^*\)

In the leading case of *Cherner v. Transitron Electronic Corporation*,\(^*\) the principal plaintiff, an Alabama lawyer who evidently had styled himself a "private, albeit reluctant, Attorney General,"\(^*\) together with two members of his family, filed a securities fraud class suit, *pro se* as to the principal plaintiff, on behalf of themselves and all other stockholders similarly situated. Ruling on this situation, Judge Wyzanski of the Massachusetts federal court said:

No precedent supports the suggestion that the plaintiffs or their counsel have a moral duty to act as unsolicited champions of others. Without going so far as to agree with defendants' arguments that the proposed conduct of the plaintiffs or their counsel would be champertous, or would violate either Canon 27 or Canon 28 of the American Bar Association Canons of Professional Ethics, this Court concludes that at the present stage of the controversy (when there is no more reason to accept as true plaintiffs' declaration than defendants' answers,) Rule 23 should not be used "as a device to enable client solicitation."\(^*\)

Later, the Court approved a compromise in the case,\(^*\) and awarded the stockholder-cum-law-license and his associates a contingent fee of $200,000 for having so ably represented themselves and their class.\(^*\)

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\(^*\) Advisory Committee's Notes, 39 F.R.D. 69, 107 (1966).


\(^*\) 201 F. Supp. 934, 936.

\(^*\) Ibid.

\(^*\) 221 F. Supp. 48.

\(^*\) Id. at 55, 61.
In non-representative suits it has long been held that contingent fee contracts contemplate arm's length bargaining. Where an attorney volunteers his services in an easy case, the contingency contract is deemed to have been procured by fraud. Counsel may not solicit a contingent fee contract. But even the common ambulance chaser has at least the written consent of all his clients, which is more than can be said of the securities fraud attorney.

Is there any logical basis for the tacit distinction between the vilified ambulance chaser, on the one hand, and the much more respectable corporate looter, on the other? If so, the time has come for the bench and the bar to codify the reasoning behind this distinction. If they are unable to do so, it is a distinction without a difference and ought to be discarded.

**CONCLUSION**

In conclusion, the time is ripe to strike some balance between the highly useful class device and the highly questionable consequences that often follow when that device is used in cases involving shortages of money. It should be apparent that class actions should not be allowed in such cases, where there invariably exists a conflict of interests between the named plaintiff and the class.

Absent any such conflict of interests (as, for example, where only rights are involved, or where the defendants have ample resources to satisfy any prospective judgment), the courts should permit the action to proceed if it also complies with the terms of the Rule itself. Still, the courts should carefully examine the fee basis. There can be little objection if the contract is for a fee certain. If plaintiffs' counsel are motivated to represent the absentees solely by a spirit of altruism, there can be no complaint on any ground other than conflict of interests.

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26 See, e.g., Hamilton v. Webster's Ex'r, 284 Ky. 564, 145 S.W.2d 82 (1940).
27 See, e.g., Henry v. Vance, 111 Ky. 72, 63 S.W. 273, 23 Ky. L. Rptr. 491 (1901).
29 "In New York City there is a style of lawyers known to the profession as 'ambulance chasers' because they are on hand wherever there is a railway wreck or a street car collision or a gasoline explosion . . . with their offers of professional service." 1897 Cong. Rec July 24, 1961. This is the first use of the phrase, according to Matthews, Dictionary of Americanisms (1951). Should we add "corporate bankruptcy" to the above list?
30 Concerning conflicts of interest, see generally Hansberry v. Lee, 311 U.S. 32 (1940).