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Some Practical Questions Concerning the Effect of the Proposed Federal Securities Code on Civil Litigation

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Some Practical Questions Concerning the Effect of the Proposed Federal Securities Code on Civil Litigation

*J. Vernon Patrick, Jr.**

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I. INTRODUCTION

A major impetus for the launching of the Federal Securities Code project in 1969 was the view, widely held by businessmen and their lawyers, that it was far too easy for investors to bring class action suits under the federal securities laws, seeking multi-million dollar judgments against business corporations, directors, accountants, and lawyers.¹ The business community's concern about possible exposure to large judgments in securities litigation was heightened by the news that plaintiffs had obtained a judgment in a class action brought against the issuer and several "outside director" defendants in *Escott v. BarChris Construction Corp.*,² and by several United States Supreme Court decisions that appeared to approve of "implied remedies" for violations of criminal statutes and Securities Exchange Commission (SEC) Rule 10b-5³ and to elimi-

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1. Loss, *Introduction: The Federal Securities Code—Its Purpose, Plan, and Progress*, 30 VAND. L. REV. 315 (1977).

2. 283 F. Supp. 643 (S.D.N.Y. 1968). The *BarChris* action was brought under § 11 of the Securities Act of 1933 [hereinafter referred to as 1933 Act] (codified at 15 U.S.C. §§ 77a-77aa (1976)), which expressly creates a civil remedy for investors. The particular significance of *BarChris* for potential securities litigation defendants was the exacting scrutiny given by the court to the "due diligence defense" contentions of the various defendants, including the outside directors—those directors who did not also hold internal management positions in *BarChris*.

3. *E.g.*, *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971).

nate any need for each class member to prove "reliance" and "in fact causation."⁴ Relying on the doctrine *expressio unius est exclusio alterius*, some critics suggested that the courts' recognition of a private right of action for violation of SEC Rule 10b-5 (and other statutes) was inconsistent with the expressly created civil liability provisions (and express limitations on the damages recoverable and the time for filing suit) contained in sections 11, 12, 13, and 15 of the 1933 Act and sections 16(b), 18, and 20 of the 1934 Act.⁵ Professor Louis Loss, who has acted as Reporter for the Federal Securities Code project, expressed the view that civil liability has become a "jungle," and that SEC Rule 10b-5 has "dwarfed, upstaged, outshone, and made wide end runs around, the express civil liability provisions."⁶

Two of the most important provisions of the proposed Code, therefore, are section 1708,⁷ which imposes a ceiling on recoveries

4. See, e.g., *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) (in a nondisclosure case, if plaintiff shows that the nondisclosed fact was "material," he need not separately prove reliance or causation); *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970) (in a misrepresentation suit arising from a proxy rule violation, reliance ordinarily should be presumed once the misrepresentation is shown to be "material").

5. Securities Exchange Act of 1934 [hereinafter cited as 1934 Act] (codified at 15 U.S.C. §§ 77k, 77l, 77m, 77o, 78p(b), 78r, 78t (1976)). For example, section 11(e) of the 1933 Act, 15 U.S.C. § 77k(e), limits the liability of an underwriter who participates in a public offering to the offering price of the securities underwritten by him and distributed to the public. Section 11(g) of the 1933 Act, 15 U.S.C. § 77k (g), limits the damages recoverable under § 11 to the price at which the security was sold to the public. Section 13 of the 1933 Act, 15 U.S.C. § 77m, provides that any action seeking recovery under § 11 or § 12 must be filed within one year from the date of discovery and within three years after the security was *bona fide* offered to the public. Section 18(c) of the 1934 Act, 15 U.S.C. § 78r(c), contains a similar built-in statute of limitations. There is no federal statute prescribing a specific statute of limitations applicable to implied actions for damages based on SEC Rule 10b-5 or under § 17(a) of the 1933 Act. Instead, the federal courts apply the most analogous state statute of limitations, which frequently is longer than the time limits imposed by § 13 of the 1933 Act and § 18 of the 1934 Act. See, e.g., *Nickels v. Koehler Management Corp.*, 541 F.2d 611 (6th Cir. 1976); *Clegg v. Clark*, 507 F.2d 1351 (10th Cir. 1974); *United Cal. Bank v. Salik*, 481 F.2d 1012 (9th Cir. 1973). The courts uniformly have held that the statute of limitations in an action under Rule 10b-5 does not begin to run until the plaintiff discovers the fraud practiced on him (or until he should have discovered the fraud). See, e.g., *Azalea Meats v. Muscat*, 386 F.2d 5 (5th Cir. 1967). In some actions brought under § 11 or § 12(1) of the 1933 Act, the time for filing suit prescribed by § 13 has been held to be an absolute bar, "irrespective of whether the plaintiff knew of the fraud," *Cook v. Avien, Inc.*, 573 F.2d 685, 691 (1st Cir. 1978), but fraudulent concealment has been held to toll the running of the § 13 limitations period. *Katz v. Amos Treat & Co.*, 411 F.2d 1046 (2d Cir. 1969); *Houlihan v. Anderson-Stokes, Inc.*, 434 F. Supp. 1319 (D.D.C. 1977).

6. Loss, *supra* note 1, at 315.

7. ALI FED. SEC. CODE § 708 (Proposed Official Draft, 1978) [hereinafter cited as 1978 Draft] provides:

[Measure of damages for sections 1703-07.]

(a) [For section 1703(a).] The measure of damages under section 1703(a) is

(1) if the plaintiff is a buyer, the amount that he paid (with interest) less

the value of the security as of the end of the reasonable period specified in section 1703(h)(1), and less any return (with interest) that he received on the security, except that

(A) to the extent that the plaintiff sold a security of the class and series after his purchase and before the end of the reasonable period specified in section 1703(h)(1), the measure of damages is the amount that he paid (with interest) less any return (with interest) that he received on the security, and less the amount that he received on sale (with interest), and

(B) to the extent that the defendant bought a security of the class and series after his sale on which the action is based and before the end of the reasonable period specified in section 1703(h)(1) at a profit (compared with his sale price to the plaintiff) greater than the measure of damages as defined in the foregoing portion of section 1708(a)(1), the measure of damages is that profit; and

(2) if the plaintiff is a seller, the value of the security as of the end of the reasonable period specified in section 1703(h)(1) plus any return (with interest) that the buyer received on the security, less the amount (with interest) that the plaintiff received, except that

(A) to the extent that the plaintiff bought a security of the class and series after his sale and before the end of the reasonable period specified in section 1703(h)(1), the measure of damages is the amount that he paid on purchase (with interest) plus any return (with interest) that the buyer received on the security, less the amount (with interest) that the plaintiff received, and

(B) to the extent that the defendant sold a security of the class and series after his purchase on which the action is based and before the end of the reasonable period specified in section 1703(h)(1) at a profit (compared with his purchase price from the plaintiff) greater than the measure of damages as defined in the foregoing portion of section 1708(a)(2), the measure of damages is that profit.

(b) [*For section 1703(b).*] The measure of damages under section 1703(b) is computed as in section 1708(a), except that

(1) sections 1703(h)(1)(B), 1708(a)(1)(A), and 1708(a)(2)(A) do not apply;

(2) the measure is reduced to the extent (which may be complete) that the defendant proves that the violation did not cause the loss; and

(3) the measure (apart from any assessment of consequential damages or costs under section 1723(a) and (d)) is limited as if all the plaintiffs, together with all the members of the class in the case of a class action, had bought (or sold) only the amount of securities that the defendant had sold (or bought). See also section 1711.

(c) [*For section 1704.*] The measure of damages under section 1704 is computed as in section 1708(a), except as provided in section 1708(b)(1) and (2), and except that

(1) in an action involving an offering statement or amendment

(A) the measure (apart from any assessment of consequential damages or costs under section 1723(a) and (d)) is limited as if all the plaintiffs, together with all the members of the class in the case of a class action, had bought (or sold) only the amount of securities that the defendant has sold (or bought),

(B) the price may not be taken to exceed the public offering price, and

(C) in no event is an underwriter liable for more than the portion of the total public offering price represented by the portion of the distribution underwritten by him; and

(2) the measure (inclusive of any consequential damages or costs assessed under section 1723(a) and (d)) is limited with respect to a particular filing (or

unless knowledge⁸ is proven, and section 1711,⁹ which creates new procedures for consolidation of securities litigation, notice to poten-

with respect to substantially the same misrepresentation or omission reflected in more than one filing or form of publicity within section 1704 or 1707 or both to the greatest, so far as each defendant is concerned, of

(A) \$100,000,

(B) one percent (to a maximum of \$1,000,000) of gross revenues in the defendant's last fiscal year before the filing of the action, or

(C) the profit specified in section 1708(a)(1)(B) or 1708(a)(2)(B);

but section 1708(c)(2) does not apply if the plaintiff proves a misrepresentation made with knowledge by the particular defendant, nor does it apply with respect to the registrant to the extent that an offering statement or amendment covers a distribution by or for its account or benefit, or with respect to an underwriter. See also section 1711.

(d) [*For sections 1705 and 1707.*] The measure of damages under sections 1705 and 1707 is computed as in section 1708(c), read without the references to offering statements or amendments and as if section 1708(c)(2) referred to section 1705 rather than section 1704.

8. The term *scienter* has generally been considered roughly synonymous with "knowledge," but has been given various meanings. The United States Supreme Court has held that some element of *scienter* must be proved in order to recover damages under SEC Rule 10b-5, but has expressly reserved decision on whether reckless disregard would be sufficient. See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). Several post-*Hochfelder* decisions permit recovery of damages under Rule 10b-5 upon proof of reckless conduct. See, e.g., *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

9. 1978 Draft, *supra* note 7, § 1711 provides:

[*Proration of damages.*] (a) [*Scope of section.*] Section 1711 applies to actions under section 1702(b), 1703(b), 1704, 1705, 1706, or 1707, or within section 1710(d). See also section 1819(1).

(b) [*Initial procedure.*] Promptly after the second or any subsequent such action (in the same court or elsewhere) is instituted against the same defendant, he shall, by written notice to every court involved, (1) identify all such actions, and (2) state whether their aggregate prayers for damages against him exceed the limitation on damages with respect to any such action.

(c) [*Reference to multidistrict panel.*] Whether or not the defendant gives such notice, every court in which such an action is pending, promptly after learning that such an action is pending against the same defendant in another court and that the aggregate prayers for damages exceed the limitation with respect to any such action, shall (1) transmit the record or records before it to the judicial panel on multidistrict litigation authorized by section 1407 of the Judicial Code, and (2) stay the action or actions before it pending determination by the panel.

(d) [*Procedure before panel.*] The panel, after notice and hearing pursuant to section 1407(c) of the Judicial Code, and on consideration of (1) the convenience of parties and witnesses, (2) whatever disposition will promote the just and efficient conduct of the litigation, and (3) the extent to which one or more actions have progressed, shall consolidate all the actions and transfer the consolidated action for all purposes to any district court (herein "the trial court"), whether or not an action was previously pending or venue lies under section 1822(f) in that court. Section 1407(b) of the Judicial Code applies to the consolidated action for purpose of trial as well as pretrial proceedings. The panel may separate and remand any claim, crossclaim, counterclaim, or third-party claim. The papers in any action that is subsequently filed in any court other than the trial court and that would have been subject to section 1711 if it had been filed before

tial plaintiffs, and proration and distribution of any recovery to those investors who are damaged by the defendant's wrongful act. The proposed ceiling on recoveries and the proposed procedures for distributing such recoveries raise a number of practical problems. This Article will explore those problems, attempt to determine whether sections 1708 and 1711 are workable, and propose possible alternatives.

the panel's transfer order shall be transmitted to the panel for disposition consistent with the section.

(e) [*Review of panel orders.*] Orders of the panel are reviewable only pursuant to section 1407(e) of the Judicial Code.

(f) [*Actions not referable to panel.*] When a notice identifies one or more pending actions pursuant to section 1711(b)(1) and they are all in the same court, that court shall consolidate the actions and function as the trial court for purposes of section 1711 until it learns of the pendency of such an action against the same defendant in another court.

(g) [*Dismissal or compromise.*] A consolidated action under section 1711 may not be dismissed or compromised without the approval of the trial court.

(h) [*Notice to potential plaintiffs.*] Before entering judgment if the statute of limitations has not expired with respect to all actions within section 1711(b)(1), or before approving a dismissal or compromise, the trial court shall order that all potential plaintiffs be given the best notice practicable under the circumstances, including consideration of the cost (which the court may charge, in whole or in part, to any party). No such action may be brought (1) after expiration of the statute of limitations or (2) more than ninety days after such notice, whichever date occurs first.

(i) [*Class actions.*] When the consolidated action in the trial court is determined to be a class action, the relevant procedure with respect to class actions applies to the extent that it is not inconsistent with section 1711.

(j) [*Recipients of damages.*] If the aggregate damages awarded in an action under any of the sections specified in section 1711(a) exceed the limitation in any of those sections, the trial court shall award the proceeds (after payment of any costs assessed under section 1723(d))

(1) among all the plaintiffs (or all members of the class or any appropriate subclass if it is a class action) to the extent that the trial court determines that the expense of making the proration is warranted in relation to the amounts that would be awarded to individual plaintiffs (or members of the class or subclass),

(2) otherwise to the issuer if (A) the action is not brought under sections 1704 to 1707 inclusive, (B) the issuer is not held liable as a defendant, and (C) the trial court determines that under the circumstances, including the degree of ownership of the issuer by the defendants, an award to the issuer would not be inequitable, and

(3) otherwise to SIPC.

(k) [*Appointment of master.*] When the circumstances warrant, the trial court may appoint a master, who may be the bankruptcy judge for the district, to aid in making any proration under section 1711(j). A bankruptcy judge so appointed shall be compensated and reimbursed for his expenses on the same basis as another master.

(l) [*Rulemaking authority.*] The panel may adopt, amend, suspend, and rescind rules to carry out section 1711.

II. THE PROPOSED LIMITS ON LIABILITY FOR INADVERTENT MISREPRESENTATIONS

Section 1708(c)(2) undertakes to establish a limit on each defendant's liability if a registrant files a deceptive report with the SEC or issues a deceptive news release, or if the registrant files several reports with the SEC or issues several news releases that contain the same misrepresentation. Each defendant's liability is limited to the greatest of: (a) \$100,000; (b) one percent (to a maximum of \$1,000,000) of gross revenues in the defendant's last fiscal year before the filing of the action, if the defendant is a "company;"¹⁰ or (c) the profit realized by a defendant on his sale of securities. The ceiling on liability does not apply, however, "if the plaintiff proves a misrepresentation made with knowledge by the particular defendant"¹¹ Moreover, there is no ceiling on liability with respect to a registrant, to the extent that an offering statement or amendment covers a distribution by or for its account or benefit, or with respect to an underwriter.

Because section 1708(c)(2) does not limit the amount that can be recovered if a plaintiff can prove a misrepresentation "made with knowledge by the particular defendant," section 1708 creates an incentive for the plaintiff to include in his complaint an allegation that each misrepresentation complained of was "made with knowledge" by each of the defendants, in addition or as an alternative to the simpler allegation that such a misrepresentation was made (or was negligently made).

It is one thing to allege scienter.¹² It is another thing to prove it. Moreover, section 1708 does not clearly state what must be proved, nor how it may be proved. One may argue that section 1708 requires the plaintiff who wishes to avoid the ceiling on liability to prove not only (a) that the misrepresentation complained of was known by the particular defendant to be false, but also (b) that such misrepresentation was "made" by *that* defendant. It is questionable, however, whether that meaning really is intended. If it is proved that an individual officer or director named as a defendant sat quietly while the company issued a false press release or filed a false report that the individual defendant knew at the time was false, the individual defendant should not be permitted to claim that his own

10. 1978 Draft, *supra* note 7, § 228 provides: "'Company' means a corporation, partnership, association, joint-stock company, trust (other than a conventional inter vivos or testamentary trust), separate account, or fund, an organized group of persons, or a receiver, trustee in bankruptcy, conservator, or other liquidating agent of any of the foregoing."

11. *See* note 7 *supra*.

12. *See* note 8 *supra*.

liability is limited by section 1708, even though it might be argued that the false filing or release was "made" by the corporate registrant.¹³

How does a party go about proving that a corporate registrant named as a defendant did or did not have knowledge of a misrepresentation at the time of a news release or SEC filing? It may be argued that a corporation only acts by or through its officers, employees, and agents, and should be held to "know" only such facts as are known by its officers, employees, and agents. Under familiar *respondeat superior* principles, a company probably would be held liable without limit if the plaintiff proves that the officer or employee who issued the release knew at the time that the release was false. The corporate registrant might call its president, financial vice president, and auditor to testify that they did not know that a particular statement made in the news release or SEC filing was false. It seems doubtful, however, that a corporate registrant would be permitted to argue that its officers and it did not know that a particular statement made in its own filings with the SEC was false, if the falsity of the statement could have been determined from an examination of the corporation's own books and records. Thus it would seem that a party should be permitted to prove or disprove knowledge on the part of a company, its officers, and its directors, by offering (a) the books and records of the company, and (b) testimony of employees or officers of the company.¹⁴

Section 1708 does not clearly indicate the extent to which familiar principles of *respondeat superior* and attribution of knowledge

13. See *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673 (N.D. Ind. 1966) (upholding against motion to dismiss a complaint which alleged that the defendant was liable because it failed to report known violations by another). In *Brennan*, the court stated: "[T]here are circumstances under which a person or a corporation may give the requisite assistance or encouragement to a wrongdoer so as to constitute an aiding and abetting by merely failing to take action." *Id.* at 682. After trial, defendant was found liable. 286 F. Supp. 702 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir.), *cert. denied*, 397 U.S. 989 (1969).

14. See *Hall v. Henderson*, 126 Ala. 449, 493, 28 So. 531, 543 (1900) (quoting THOMPSON ON CORPORATIONS § 5308). *Hall* holds that directors and officers of a corporation may be held to be

conclusively presumed to know its condition, its business, its receipts and expenditures, and all the general facts which go to make up that condition and business, as shown by the entries on its regular books. The reason of this is that it is *their duty* to know these things in the exercise of their official functions.

The presumption appears to be recognized, but it is considered rebuttable in some states. See, e.g., *Huntington v. Attrill*, 118 N.Y. 365, 23 N.E. 544 (1890). In others, it has been suggested that the degree of knowledge of the company's affairs that might reasonably be expected of directors depends on the size of the corporation and other factors. See, e.g., *Campbell v. Watson*, 62 N.J. Eq. 396, 50 A. 120 (1901).

apply. Could a corporate registrant limit its own liability by proving that the officer or employee who issued a false news release or SEC filing was engaged in a fraud on his corporation, on the theory that a principal is not chargeable with the knowledge of an agent who is engaged in a fraud upon his principal?¹⁵ Could a partnership limit its liability under section 1708, even though the partner (or an employee of the partnership working on a matter assigned to him in the usual course of business) is shown to have known a press release or SEC filing was false, by proving that the managing partner and other partners had no actual knowledge of the falsity of the report or filing?¹⁶ Could the individual partners of an accounting firm or law firm, if named as defendants solely because of the acts of another partner (or employee acting in the line and scope), claim the benefit of the limits established by section 1708?¹⁷ These questions do not appear to be clearly answered by section 1708.

Section 1708 creates an incentive for plaintiff's counsel to allege more than one misrepresentation or omission, each of which may be the basis for a separate count of the complaint. The purpose of

15. See, e.g., *State Bank of Pamplin v. Payne*, 156 Va. 837, 843, 159 S.E. 163, 165 (1931):

It is hardly necessary to cite authority for the broad general doctrine that the principal is bound by the knowledge of an agent; that so far as third persons are concerned, notice to an agent is notice to his principal, even though the agent has not in fact communicated such notice. The basis for that rule is the duty of the agent to disclose all material facts coming to his knowledge with reference to the subject of his agency, and the presumption that he has discharged that duty. There is an important exception, however, to this rule, in cases where the knowledge of the agent is obtained while he is himself engaged in committing an independent fraudulent act on his own part, communication of which to the principal would prevent its consummation. To this exception there is a qualification, equally important and decisive; that is, in cases in which the agent, when committing the fraud, was the sole representative of the principal. When this appears, the general rule of imputed notice to his principal applies.

16. Sections 12 and 13 of the *Uniform Partnership Act* provide as follows:

§ 12. **Partnership Charged with Knowledge of or Notice to partner.**—Notice to any partner of any matter relating to partnership affairs, and the knowledge of the partner acting in the particular matter, acquired while a partner or then present to his mind, and the knowledge of any other partner who reasonably could and should have communicated it to the acting partner, operate as notice to or knowledge of the partnership, except in the case of a fraud on the partnership committed by or with the consent of that partner.

§ 13. **Partnership Bound by Partner's Wrongful Act.**—Where, by any wrongful act or omission of any partner acting in the ordinary course of the business of the partnership or with the authority of his co-partners, loss or injury is caused to any person, not being a partner in the partnership, or any penalty is incurred, the partnership is liable therefor to the same extent as the partner so acting or omitting to act.

17. See note 16 *supra*. In *Westinghouse Elec. Corp. v. Kerr-McGee Corp.*, 580 F.2d 1311, 1318 (7th Cir. 1978), the Court of Appeals disqualified a law firm, reaffirming the traditional rule that knowledge imparted by a client to one partner of a large law firm is to be imputed to all members of the firm.

alleging more than one misrepresentation would be to obtain separate judgments with respect to each misrepresentation, so as to argue that each defendant's maximum liability is some multiple of the limit established by section 1708(c)(2).

In addition to creating an incentive to complain of as many separate and distinct misrepresentations as possible, section 1708 may further complicate securities litigation by creating an incentive to sue as many defendants as possible.¹⁸ Under existing law, plaintiff's attorneys often sue only the company (in those cases in which the company is financially able to respond in damages) in order to simplify the litigation. If the Code is adopted, plaintiff's attorneys will have an incentive to sue all the directors, as well as the company, in order to maximize the total recovery. Since publicly held corporations often purchase directors' and officers' insurance and agree to indemnify their directors,¹⁹ the litigation costs resulting from any increased pressures to name the directors as defendants will ultimately be borne in large part by public corporations. On the other hand, the \$100,000 limit on the liability of individual defendants (in the absence of proof of scienter) should make it easier for public corporations to obtain adequate insurance coverage for directors and officers with respect to inadvertent misrepresentations.²⁰

Thus section 1708 may have some undesirable effects on securities litigation because it creates an incentive to sue more defendants

18. This approach would be not unlike the familiar "shotgun" approach now followed by a few plaintiff's attorneys in personal injury litigation and in securities litigation. They follow the familiar advice to "sue everyone in sight" under every conceivable theory, hoping to find at least one claim against at least one defendant that ultimately can be proved and collected or settled. Whereas the primary purpose of the shotgun approach is to find a substantive claim that will produce liability, the purpose of alleging more than one misrepresentation or suing more than one defendant under the Code would be to avoid the ceiling on the amount of damages recoverable notwithstanding § 1708(c)(2). The shotgun approach obviously complicates litigation. Most plaintiff's attorneys prefer the "rifle" approach. In cases in which a registrant is solvent, advocates of the rifle approach might well decide not to sue the registrant's directors. Suing the directors adds to the complexity of the plaintiff's case, and may actually result in a lower verdict (because of jury sympathy for individual defendants). Under the proposed Code, however, there would be some incentive to sue all the directors, in order to recover \$100,000 per director, in addition to the maximum recovery permissible from the registrant.

19. The validity of such indemnification agreements has been opposed by the SEC. 17 C.F.R. § 230.460 (1978). In *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970), the court refused to enforce an indemnity agreement on policy grounds underlying the 1933 and 1934 Acts. The continuing validity of indemnification and the Code's impact on that controversy still is open to question. See generally Kroll, *Some Reflections on Indemnification Provisions and S.E.C. Liability Insurance in the Light of BarChris and Globus*, 24 Bus. Law. 681, 685-92 (1969).

20. The SEC has not opposed insurance against liabilities under the 1933 and 1934 Acts. Securities Act Release No. 4936 (Dec. 9, 1968), reprinted in [1968] FED. SEC. L. REP. (CCH) ¶¶ 3760-3813.

and to allege several separate and distinct misrepresentations. The impact on securities litigation, however, should not be unduly serious, because there are offsetting pressures on plaintiff's counsel to keep his case as simple as possible. The jury may throw up its hands if the case is too complicated. Moreover, if a large number of defendants are sued and a number of misrepresentations are relied upon, the trial court may refuse to certify the action as a class action on the ground that it is unmanageable as such. Accordingly, although section 1708 may result in some increase in the complexity of securities litigation (thereby increasing litigation costs and the burdens upon the courts and parties), there are offsetting practical restraints that should prove reasonably effective.

III. THE PROPOSED PROCEDURES FOR CONSOLIDATION OF LITIGATION, NOTICE TO ALL POTENTIAL PLAINTIFFS, AND PRORATION OF DAMAGES

When more than one action is instituted against the same defendant, consolidation of all actions appears to be mandatory under the Code. Section 1711(b) provides that the defendant "shall, by written notice to every court involved, (1) identify all such actions, and (2) state whether their aggregate prayers for damages against him exceed the limitation on damages with respect to any such action."²¹ The consequences, if the defendant fails to notify each court in which such an action is filed, are not spelled out by the statute. It could be argued that any defendant who fails to comply with the statute waives whatever right he might have to contend that his liability to all similar plaintiffs is limited by section 1708.

The Code provides, however, that whether or not the defendant gives such notice, every court in which any such action is pending that learns that other actions are pending against the same defendant and that the aggregate damages sought exceed the recovery limits provided for by the Code shall "(1) transmit the record or records before it to the judicial panel on multidistrict litigation authorized by section 1407 of the Judicial Code, and (2) stay the action or actions before it pending determination by the panel."²² Section 1711(d) provides that the Judicial Panel "shall" consolidate

21. See note 9 *supra*.

22. *Id.* Contrast Rule 16 of the Rules of Procedure of the Judicial Panel on Multidistrict Litigation, which presently provides:

The pendency of a motion or order to show cause before the Panel concerning transfer of an action pursuant to 28 U.S.C. § 1407 does not affect or suspend orders and pretrial proceedings in the district court in which the action is pending and does not in any way limit the pretrial jurisdiction of that court. A transfer shall be effective when the transfer order is filed in the office of the clerk of the district court of the transferee district.

and transfer all such actions to any appropriate district court for pretrial proceedings and for trial.²³ Section 1711(g) provides that the actions which have been consolidated for trial under section 1711 “may not be dismissed or compromised without the approval of the trial court.”²⁴

Section 1711(h) provides that the trial court “shall order that all potential plaintiffs be given the best notice practicable under the circumstances, including consideration of the cost (which the court may charge, in whole or in part, to any party)” before entering judgment if the statute of limitations has not expired with respect to all actions within section 1711, or before approving a dismissal or compromise.²⁵ Section 1711(h) also provides that “[n]o such action may be brought (1) after expiration of the statute of limitations or (2) more than ninety days after such notice, whichever date occurs first.”²⁶

Thus, even though none of the consolidated actions was filed as a class action and even though the trial court may have determined that the consolidated action is not manageable or maintainable as a class action, section 1711(h) seems to require (a) that the trial or settlement of a securities case be delayed until the statute of limitations has run, which seems highly undesirable; or (b) that the “best possible notice practicable under the circumstances” be given to “all potential plaintiffs” of the pendency of any securities action if the complaint can be construed as including, as one of the claims asserted, a claim based on a negligent or inadvertent violation of the Federal Securities Code by any one of the defendants. The language of section 1711 suggests that published notice (in, say, the *Federal Register*) would be sufficient if individual notice to each potential plaintiff would be inordinately expensive. Section 1711(e), however, provides that the court-ordered notice is intended to shorten the statute of limitations for the filing of similar actions by all potential plaintiffs to a date ninety days following such notice, so that each potential plaintiff’s claims will be barred unless (a) the court has ordered that the consolidated action be maintained as a class action, or (b) the potential plaintiff files his own individual action for damages within ninety days from date of such notice. Apparently the ninety days would begin to run upon the date of mailing notice or publication of notice, rather than upon the date of receipt. Accordingly, if a potential plaintiff has moved and re-

23. See note 9 *supra*.

24. *Id.*

25. *Id.*

26. *Id.*

ceives no actual notice, or is on vacation, or for some other reason does not promptly receive actual notice, section 1711(h) would nonetheless bar his claim unless he files suit within ninety days, or unless the court has directed that the consolidated action be maintained as a class action.

Section 1711 creates serious practical disincentives for the plaintiff who seeks only individual relief. The requirement that the best practicable notice be given to all potential plaintiffs even if no action was filed as a class action and even if the trial court has not ordered the consolidated action to be maintained as a class action, and providing that all or part of the costs of such notice may be taxed against the plaintiff, will probably have a "chilling effect" on the filing of individual actions seeking recovery only for individual plaintiffs.

On the other hand, section 1711 should be of material assistance to the plaintiff who files a class action. The trial courts will probably be more likely to permit an action subject to section 1711 to be maintained as a class action. The trial court may be reluctant to issue the notice required by section 1711 if there is no class action because the expense of such notice may exceed the amount in controversy and because valid claims of potential plaintiffs will be barred if they fail to file suit within ninety days. Moreover, certification of the consolidated action as a class action should not materially add to management problems already imposed on the trial court by section 1711. Finally, section 1711 vests the trial court with discretion to tax part of the costs of the notice against the defendants.

Section 1711 appears to raise due process questions if no one has sought in the first instance to represent a class and if no action has been certified as a class action pursuant to Rule 23(c)(1) of the Federal Rules of Civil Procedure.²⁷ Let us suppose that a trial court

27. FED. R. CIV. P. 23 provides:

(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 class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action.

(c) Determination by Order Whether Class Action to be Maintained; Notice; Judgment; Actions Conducted Partially as Class Actions.

(1) As soon as practicable after the commencement of an action brought as a class action, the court shall determine by order whether it is to be so maintained. An order under this subdivision may be conditional, and may be altered or amended before the decision on the merits.

(2) In any class action maintained under subdivision (b)(3), the court shall direct to the members of the class the best notice practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort. The notice shall advise each member that (A) the court will exclude him from the class if he so requests by a specified date; (B) the judgment, whether favorable or not, will include all members who do not request exclusion; and (C) any member who does not request exclusion may, if he desires, enter an appearance through his counsel.

(3) The judgment in an action maintained as a class action under subdivision (b)(1) or (b)(2), whether or not favorable to the class, shall include and describe those whom the court finds to be members of the class. The judgment in an action maintained as a class action under subdivision (b)(3), whether or not favorable to the class, shall include and specify or describe those to whom the notice provided in subdivision (c)(2) was directed, and who have not requested exclusion, and whom the court finds to be members of the class.

(4) When appropriate (A) an action may be brought or maintained as a class action with respect to particular issues, or (B) a class may be divided into subclasses and each subclass treated as a class, and the provisions of this rule shall then be construed and applied accordingly.

(d) Orders in Conduct of Actions. In the conduct of actions to which this rule applies, the court may make appropriate orders: (1) determining the course of proceedings or prescribing measures to prevent undue repetition or complication in the presentation of evidence or argument; (2) requiring, for the protection of the members of the class or otherwise for the fair conduct of the action, that notice be given in such manner as the court may direct to some or all of the members of any step in the action, or of the proposed extent of the judgment, or of the opportunity of members to signify whether they consider the representation fair and adequate, to intervene and present claims or defenses, or otherwise to come into the action; (3) imposing conditions on the representative parties or on intervenors; (4) requiring that the pleadings be amended to eliminate therefrom allegations as to representation of absent persons, and that the action proceed accordingly; (5) dealing with similar procedural matters. The orders may be combined with an order under Rule 16, and may be altered or amended as may be desirable from time to time.

(e) Dismissal or Compromise. A class action shall not be dismissed or compro-

directs that notice to all potential plaintiffs, pursuant to section 1711(h), be given by publication shortly after the date of the alleged misrepresentation. Would such published notice in, let us say, the *Federal Register* be sufficient under due process standards to start the ninety days running against all potential plaintiffs? In cases in which the consolidated action was commenced as a class action and has been certified as a class action, so that failure of a potential plaintiff to file suit will not bar his right to share in any recovery effected for the class, it may be argued that the interests of all similarly situated persons have been and will be properly protected and represented by the representative plaintiff, under the doctrine of "virtual representation," so as to make the court's order and notice binding under traditional due process grounds.²⁸ But if the action has not been certified as a class action, so that the failure of a potential plaintiff to act will bar his claim, it might be argued that due process requires, at the very least, that each potential plaintiff whose address is readily ascertainable must be given individual notice (as distinguished from notice by publication), before his claim could be held to be barred.²⁹ Moreover, it may be argued under some circumstances that ninety days notice is inadequate to permit potential plaintiffs to investigate the matter and make an intelligent decision, and that barring the claim on only ninety days notice deprives the potential plaintiff of due process.³⁰

Section 1711(i) provides, when a consolidated action is determined to be a class action, that the trial court shall follow the procedures established by Rule 23 of the Federal Rules of Civil Procedure³¹ for handling class actions, but only to the extent that such procedures are not inconsistent with section 1711. Three such inconsistencies should be noted. First, section 1711 does not expressly require that *individual* notice be given to all potential plaintiffs; in those cases in which the costs of individual notice would be

mised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs.

28. Under the doctrine of virtual representation, a judgment in a properly certified class action binds those members of the class whose interests were adequately represented by existing parties to the litigation. *See, e.g.*, *Sam Fox Publishing Co. v. United States*, 366 U.S. 683 (1961); *Hansberry v. Lee*, 311 U.S. 32 (1940).

29. *See Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306 (1950). In *Mullane* the Court declared that due process requires that the means of notice to interested parties "must be such as one desirous of actually informing the absentee might reasonably adopt to accomplish it." *Id.* at 315. Although the means may vary from case to case, "[e]xceptions in the name of necessity do not sweep away the rule that within the limits of practicability notice must be such as is reasonably calculated to reach interested parties." *Id.* at 318.

30. *See* note 29 *supra*.

31. *See* note 27 *supra*.

prohibitive, notice by publication is apparently thought to be sufficient.³² In other class actions for damages brought under Rule 23(b)(3), Rule 23(c)(2) requires individual notice to all class members "who can be identified through reasonable effort."³³ Second, civil actions filed under the Federal Securities Code for damages in those in which any of the section 1708 limitations on liability may apply, section 1711(h) authorizes the trial court to tax the costs of notice in whole or in part against the defendants.³⁴ Rule 23, on the other hand, has been construed as requiring that the costs of notice to the class must be borne by plaintiffs.³⁵ Third, under section 1711 of the proposed Federal Securities Code, potential plaintiffs or class members cannot effectively request exclusion from the consolidated action.³⁶ In contrast, Rule 23(c)(2) provides that in class actions for damages maintained under Rule 23(b)(3), each member of the class must be notified that he may request exclusion from the class.³⁷ Under present Rule 23 procedures a claimant with a substantial claim may opt out of a class action for the purpose of filing a separate action seeking money damages. The separate action may, of course, be consolidated with the class action or other individual actions for trial pursuant to Rule 42(a) of the Federal Rules of Civil Procedure,³⁸ or consolidated for pretrial proceedings pursuant to 28 U.S.C. § 1407(a).³⁹

32. It might be argued, however, that it is a violation of the due process required by the Constitution to bar or adjudicate the claims of potential plaintiffs without representation of their interests and without notice reasonably designed to call the matter to their attention, including individual notice to those potential plaintiffs whose address is known or ascertainable with reasonable effort. See notes 28-29 *supra*.

33. See *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156 (1974). *Eisen* was an antitrust and securities action brought on behalf of approximately 3,750,000 odd-lot investors against the major odd-lot dealers on the New York Stock Exchange. The Supreme Court construed Rule 23(c)(2) as requiring that individual notice be given to all class members whose names and addresses could be ascertained through reasonable effort, at the expense of the plaintiff.

34. See note 9 *supra*.

35. See note 33 *supra*.

36. See note 9 *supra*.

37. See note 27 *supra*.

38. Fed. R. Civ. P. 42(a) provides:

(a) **Consolidation.** When actions involving a common question of law or fact are pending before the court, it may order a joint hearing or trial of any or all the matters in issue in the actions; it may order all the actions consolidated; and it may make such orders concerning proceedings therein as may tend to avoid unnecessary costs or delay.

39. 28 U.S.C. § 1407(a) (1976) provides:

When civil actions involving one or more common questions of fact are pending in different districts, such actions may be transferred to any district for coordinated or consolidated pretrial proceedings. Such transfers shall be made by the judicial panel on multidistrict litigation authorized by this section upon its determination that transfers for such proceedings will be for the convenience of parties and witnesses and will promote

The inability to opt out of the consolidated action and the mandatory transfer requirements of section 1711(d) will create special problems in cases in which plaintiffs allege in one or more counts or separate complaints that a particular defendant acted "with knowledge" and other plaintiffs (or counts) do not allege scienter on the part of that defendant.⁴⁰ In a Reporter's Comment, Professor Loss states that the third sentence of section 1711(d) "takes care" of those situations in which inconsistent allegations are made, presumably by allowing separation of claims or suits in such cases.⁴¹ The third sentence of section 1711(d) merely states, however, that "[t]he panel may separate and remand any claim, cross-claim, counterclaim, or third-party claim."⁴²

The suggestion that individual claims might be separated out and remanded seems impractical. It would be undesirable to burden the defendants and the federal courts with separate discovery proceedings before several federal courts at the same time with respect to the same set of facts, merely because one plaintiff alleges that a particular defendant acted with knowledge and another plaintiff (or the same plaintiff in another count of his complaint) does not allege such knowledge. Moreover, except in unusual circumstances it would be inefficient and wasteful to try the same plaintiff's case twice with respect to the same conduct, the same defendants, the same transactions, and the same news release or SEC filings, merely because a plaintiff in one count of his complaint charges a particular defendant with knowledge and in another does not. Rules 18,⁴³ 19,⁴⁴

the just and efficient conduct of such actions. Each action so transferred shall be remanded by the panel at or before the conclusion of such pretrial proceedings to the district from which it was transferred unless it shall have been previously terminated: *Provided, however,* That the panel may separate any claim, cross-claim, counterclaim, or third-party claim and remand any of such claims before the remainder of the action is remanded.

40. Since what was known by each defendant is not ordinarily ascertainable by the plaintiff and his lawyer on the date of filing the action, and since the amount which can be recovered from any defendant is unlimited in the event the plaintiff can prove the particular defendant acted with knowledge, it follows that most plaintiffs' complaints will include allegations that each defendant had knowledge of the misrepresentation. This will not always, however, be the case.

41. The comment to § 1711(d) of the 1978 Draft states in full: "The reference to venue at the end of the 1st sentence has been added. And a comment will state that the 3d sentence takes care (*inter alia*) of the complaint that pleads a misrepresentation in the alternative with and without knowledge."

42. See note 9 *supra*.

43. FED. R. CIV. P. 18 provides:

(a) **Joinder of Claims.** A party asserting a claim to relief as an original claim, counterclaim, cross-claim, or third-party claim, may join, either as independent or as alternate claims, as many claims, legal, equitable, or maritime, as he has against an opposing party.

20,⁴⁵ 23,⁴⁶ and 42(a)⁴⁷ of the Federal Rules of Civil Procedure and 28

(b) Joinder of Remedies; Fraudulent Conveyances. Whenever a claim is one heretofore cognizable only after another claim has been prosecuted to a conclusion, the two claims may be joined in a single action; but the court shall grant relief in that action only in accordance with the relative substantive rights of the parties. In particular, a plaintiff may state a claim for money and a claim to have set aside a conveyance fraudulent as to him, without first having obtained a judgment establishing the claim for money.

44. FED. R. CIV. P. 19 provides:

(a) Persons to be Joined if Feasible. A person who is subject to service of process and whose joinder will not deprive the court of jurisdiction over the subject matter of the action shall be joined as a party in the action if (1) in his absence complete relief cannot be accorded among those already parties, or (2) he claims an interest relating to the subject of the action and is so situated that the disposition of the action in his absence may (i) as a practical matter impair or impede his ability to protect that interest or (ii) leave any of the persons already parties subject to a substantial risk of incurring double, multiple, or otherwise inconsistent obligations by reason of his claimed interest. If he has not been so joined, the court shall order that he be made a party. If he should join as a plaintiff but refuses to do so, he may be made a defendant, or, in a proper case, an involuntary plaintiff. If the joined party objects to venue and his joinder would render the venue of the action improper, he shall be dismissed from the action.

(b) Determination by Court Whenever Joinder not Feasible. If a person as described in subdivision (a)(1)-(2) hereof cannot be made a party, the court shall determine whether in equity and good conscience the action should proceed among the parties before it, or should be dismissed, the absent person being thus regarded as indispensable. The factors to be considered by the court include; first, to what extent a judgment rendered in the person's absence might be prejudicial to him or those already parties; second, the extent to which, by protective provisions in the judgment, by the shaping of relief, or other measures, the prejudice can be lessened or avoided; third, whether a judgment rendered in the person's absence will be adequate; fourth, whether the plaintiff will have an adequate remedy if the action is dismissed for nonjoinder.

(c) Pleading Reasons for Nonjoinder. A pleading asserting a claim for relief shall state the names, if known to the pleader, of any persons as described in subdivision (a)(1)-(2) hereof who are not joined, and the reasons why they are not joined.

(d) Exception of Class Actions. This rule is subject to the provisions of Rule 23.

45. FED. R. CIV. P. 20 provides:

(a) Permissive Joinder. All persons may join in one action as plaintiffs if they assert any right to relief jointly, severally, or in the alternative in respect of or arising out of the same transaction, occurrence, or series of transactions or occurrences and if any question of law or fact common to all these persons will arise in the action. All persons (and any vessel, cargo or other property subject to admiralty process in rem) may be joined in one action as defendants if there is asserted against them jointly, severally, or in the alternative, any right to relief in respect of or arising out of the same transaction, occurrence, or series of transactions or occurrences and if any question of law or fact common to all defendants will arise in the action. A plaintiff or defendant need not be interested in obtaining or defending against all the relief demanded. Judgment may be given for one or more of the plaintiffs according to their respective rights to relief, and against one or more defendants according to their respective liabilities.

(b) Separate Trials. The court may make such orders as will prevent a party from being embarrassed, delayed, or put to expense by the inclusion of a party against whom he asserts no claim and who asserts no claim against him, and may order separate trials or make other orders to prevent delay or prejudice.

46. See note 27 *supra*.

47. See note 38 *supra*.

U.S.C. §§ 1404(a)⁴⁸ and 1407(a)⁴⁹ are designed to permit the parties to avoid duplicative discovery, multiple trials, and multiple hearings arising out of the same facts. It seems highly unlikely as a practical matter, therefore, that the Judicial Panel would ever decide to separate out and remand to another court any actions or claims based upon the same facts, SEC filings, news releases, and transactions, merely because one plaintiff or a plaintiff in one count alleges that a particular defendant acted with knowledge and another makes no such allegation. Thus, it is difficult to see how the third sentence of section 1711(d) "takes care" of any problem and it seems doubtful that this provision would ever be used.

If a plaintiff who does not wish to be transferred under section 1711(d) to another district for all purposes, including trial, alleges that each defendant acted *with knowledge*, then the entire procedure established by section 1711 arguably is inapplicable to that particular plaintiff's complaint, so that the Judicial Panel would have no authority *under section 1711* to transfer that plaintiff's action to another district for pretrial purposes and for trial. Under existing case law interpreting the liberal pleading procedures established by the Federal Rules of Civil Procedure, however, that plaintiff might be entitled to recover, notwithstanding the allegations of his complaint, under the "lesser included offense," on proof of a misrepresentation made without knowledge.⁵⁰ Thus, if the plaintiff

48. 28 U.S.C. § 1404(a) (1976) provides: "For the convenience of parties and witnesses, in the interest of justice, a district court may transfer any civil action to any other district or division where it might have been brought."

49. See note 39 *supra*.

50. FED. R. CIV. P. 54(c) provides in part: "every final judgment shall grant the relief to which the party in whose favor it is rendered is entitled, even if the party has not demanded such relief in his pleadings."

FED. R. CIV. P. 8(f) provides: "All pleadings shall be so construed as to do substantial justice."

FED. R. CIV. P. 15(b) provides:

(b) **Amendments to Conform to the Evidence.** When issues not raised by the pleadings are tried by express or implied consent of the parties, they shall be treated in all respects as if they had been raised in the pleadings. Such amendment of the pleadings as may be necessary to cause them to conform to the evidence and to raise these issues may be made upon motion of any party at any time, even after judgment; but failure so to amend does not affect the result of the trial of these issues. If evidence is objected to at the trial on the ground that it is not within the issues made by the pleadings, the court may allow the pleadings to be amended and shall do so freely when the presentation of the merits of the action will be subserved thereby and the objecting party fails to satisfy the court that the admission of such evidence would prejudice him in maintaining his action or defense upon the merits. The court may grant a continuance to enable the objecting party to meet such evidence.

See *Conley v. Gibson*, 355 U.S. 41, 45-46, 48 (1957):

[A] complaint should not be dismissed for failure to state a claim unless it appears

alleges that a misrepresentation was made with knowledge, but fails to prove knowledge to the satisfaction of the jury, the plaintiff might nonetheless be entitled to recover a judgment, and the court might be bound to instruct the jury that the plaintiff is entitled to recovery for the misrepresentation⁵¹ (subject, of course, to the limitations on recovery imposed by section 1708).

A practical solution to these problems would be an order of the district court under 28 U.S.C. § 1404(a)⁵² or an order of the Judicial Panel under 28 U.S.C. § 1407⁵³ transferring the action complaining of misrepresentations made "with knowledge" to the same district court selected by the panel for other cases under section 1711 of the Federal Securities Code. In the event of a transfer under section 1407, the transferee court would then have the power to transfer the case for all purposes to the transferee district for trial pursuant to 28 U.S.C. § 1404(a).

The Code does not change the existing law preserving existing remedies under state law.⁵⁴ Accordingly, pendent state law claims arising out of the same facts can be asserted in the federal court action.⁵⁵ The recovery on pendent claims would not be subject to the limitations imposed by section 1708 on the damages recoverable under the Code.⁵⁶ There is the troublesome possibility that defendants may be subjected to the burden of defending in state and federal courts separate actions regarding the same transaction. This problem might be handled by moving for a stay of proceedings in the state court until the trial or settlement of the federal and state claims in the federal court action. A trial of the federal court action could be dispositive of the factual issues raised in the state court under *res judicata* or collateral estoppel principles.⁵⁷

As a practical matter, the procedures established by section 1711 requiring transfer and consolidation of all actions brought

beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief.

. . . . The Federal Rules reject the approach that pleading is a game of skill in which one misstep by counsel may be decisive to the outcome and accept the principle that the purpose of pleading is to facilitate a proper decision on the merits.

51. *Id.*

52. *See* note 48 *supra*.

53. *See* note 39 *supra*.

54. 1978 Draft, *supra* note 7, § 1904(i)(1) provides: "(i) [Residual state power.] (1) Nothing in this Code affects the application of State law to any security, transaction, or person except as provided in sections 917(a) and (b), 1904(a) to (d) inclusive, and 1906."

55. *See, e.g.,* *Coffee v. Permian Corp.*, 474 F.2d 1040, 1044 (5th Cir.), *cert. denied*, 414 U.S. 882 (1973); *Young v. Taylor*, 466 F.2d 1329, 1337 (10th Cir. 1972).

56. *Id.*

57. *Parklane Hosiery Co. v. Shore*, 99 S. Ct. 960 (1979).

under the Code in one district and requiring that notice be given to all potential plaintiffs, appear to be unnecessarily awkward, expensive, and cumbersome, and may unduly inhibit the filing of individual actions seeking individual relief. In cases in which no action has been filed as a class action or ordered to be maintained as a class action, or in which the defendants are reasonably confident that they will be able to defeat any plaintiffs' actions or settle them for a modest or nominal sum, the defendants might prefer to be given an option not to take advantage of section 1708's limitations on liability, particularly if the price that must be paid for such limitations on liability is the notice required by section 1711 to *all potential claimants* and if all or part of the costs of such notice may be imposed by the court on the defendants. The costs of the notice alone (entirely aside from the unfavorable publicity) may exceed the amount sued for an individual action. If no plaintiff has filed a class action, or if the defendants feel that the trial court will not permit the plaintiff's actions to be maintained as a class action, or if the defendants feel confident that they can defeat the plaintiff's action, it seems questionable why notice *must* nonetheless be given to all potential plaintiffs of a claim which the defendants (and the court) may justifiably feel is totally lacking in merit.

From the viewpoint of the defendant, therefore, section 1711 of the Code may create more problems than section 1708 solves, at least in those cases in which no one has filed a class action. The defendants may be confident of victory or confident that they can settle the case cheaply, and prefer to defend (or settle) the action without giving notice to all potential plaintiffs.

From the viewpoint of the individual plaintiff, the transfer, notice, and proration procedures created by section 1711 seem highly undesirable. Section 1711 appears to permit a trial court to require an individual plaintiff who has filed an individual action to pay part or all of the costs of giving the best practicable notice to all potential plaintiffs. The cost of such notice may exceed the amount claimed. Accordingly, section 1711 may have an unduly chilling effect upon the filing of individual actions. An individual plaintiff who wishes to litigate an individual claim should be permitted to do so without being encumbered with the costs of notice and other burdens presently attendant to bringing, maintaining, and litigating a class action.

IV. CONCLUSION

Section 1708 appears to create reasonable limits on liability for inadvertent misrepresentations. Although it may tend to complicate

securities litigation, there are countervailing pressures on plaintiff's counsel to simplify such litigation, and the adverse effects of section 1708 should not be great.

Section 1711, however, appears to create unduly burdensome and cumbersome procedures. Section 1711 may deter an individual plaintiff from bringing an individual action because of the possibility that the complaint might be construed as asserting a claim (against any *one* defendant) that is subject to the limits on recovery created by section 1708. Section 1711 would, however, probably make it easier to maintain class actions for violations of the proposed Federal Securities Code, since section 1711(h) authorizes the trial court to require the defendants to pay part or all of the costs of notice to members of the class.

The advantages flowing from the adoption of section 1708 may be outweighed by the procedural problems created by section 1711. Accordingly, alternative procedures should be considered for handling the proration and distribution of damages, including the procedures recently proposed for the improved handling of class actions, incorporated in Senate Bill 3475,⁵⁸ introduced by Senator DeConcini (for himself and Senator Kennedy), and drafted by the Office for Improvements in the Administration of Justice of the United States Department of Justice. Such procedures seem preferable to those that would be established by section 1711 of the Federal Securities Code.

58. S. 3475, 95th Cong., 2d Sess. (1978).

