

Daubert REPORT

NORTHERN CALIFORNIA

Volume 3 No. 3

JULY '94

VeriFone and Wells Fargo — The End of Securities Laws?

IN an article published in the March 1994 *ABTL Report for Northern California*, authors Paul T. Friedman and Jordan Eth (partners at the firm of Morrison & Foerster) opine that the Ninth Circuit's decision in *In re VeriFone Securities Litigation*, 11 F.3d 865 (9th Cir. 1993), "reinforces" the "proper role" of the district court and "clarifies several significant and recurring issues" in securities fraud cases. Their article, however, ignores certain important facts of the *VeriFone* case and fails to discuss the impact of the Ninth Circuit's more recent decision in *In re Wells Fargo Securities Litigation*, 12 F.3d 922 (9th Cir. 1993), on their theory. In fact, closer scrutiny of the *VeriFone* decision and a review of the *Wells Fargo* decision shows that the Ninth Circuit has not, to any notable extent, moved away from well established principles regarding the pleading requirements for securities actions.

In *VeriFone*, plaintiffs alleged that the defendants, which included the underwriters, failed to disclose material facts and trends regarding VeriFone's



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Earning the Daubert Seal of Approval for Expert Witnesses

IN 1923, James Alfonso Frye was charged with second degree murder. Frye claimed that he was innocent. He submitted himself for examination by a scientist who believed that lying requires a conscious effort which is reflected in increased blood pressure. At his trial, Frye attempted to introduce testimony by the expert witness that Frye had passed the "systolic blood pressure deception test," a rudimentary version of the modern polygraph. The trial judge refused to admit the expert testimony, and James Frye was convicted. On appeal, in affirming the exclusion of the expert witness, the court of appeals articulated what became known as the *Frye* test: **for expert testimony to be admissible, the basis for it "must be sufficiently established to have gained general acceptance in the particular field in which it belongs."** *Frye v. United States*, 293 F. 1013, 1014 (D.C. Cir. 1923).

Ironically, the deception test was apparently valid in indicating that Frye was telling the truth about his innocence. After Frye was convicted and sentenced to life imprisonment, the real murderer confessed to the crime. See *State v. Valdez*, 371 P.2d 894, 896 n. 4 (Ariz.S.Ct. 1962), citing Wicker, *The Polygraph Truth Test and the Law of Evidence*, 22 Tenn.L.Rev. 711, 715 (1953).

For the past eight years, polygraph evidence and numerous novel scientific theories, sometimes dubbed "junk science," have been rejected by judges on the ground that they lacked "general acceptance" in the scientific community under *Frye*. Proponents of novel theories have steadfastly asserted that trial judges should permit these matters to be determined by the jury, which could assess its credibility like any other evidence.

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Earning the Daubert Seal of Approval

Last year, in *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 113 S.Ct. 2786 (1993), the Supreme Court held that *Frye's* "general acceptance" standard was not the prerequisite to the admissibility of expert testimony in federal litigation. Instead, admissibility must be determined in a pretrial proceeding under the Federal Rules of Evidence. Under Rule 702, expert testimony is admissible if it is based on "scientific knowledge" that "assists the trier of fact." Whether proffered expert testimony meets this standard is a preliminary question to be decided by the district judge at the "outset" of the case.

Both sides of the so-called "junk science" debate have claimed victory from *Daubert*. The proponents of novel theories celebrate termination of the "general acceptance" litmus test. Opponents claim that the Supreme Court's admonition that trial judges act as metaphorical "gatekeepers" means that unsupported opinions should be excluded.

For now, perhaps it is appropriate that both sides claim victory. There are numerous issues which will require further refinement. What is "scientific knowledge"? Is the test the same for so-called soft science? Under what circumstances does scientific knowledge "assist the trier of fact"? Is this one test or two? In other words, if opinion evidence is scientifically reliable, won't it always assist the trier of fact and, if it is not, doesn't that mean that it will not? How does the resolution of the reliability question relate to the admissibility of the evidence?

Business trial lawyers are impacted by these developments. In a recent article in *The National Law Journal*, Senior U.S. District Judge Jack Weinstein, author of the authoritative treatise on the Federal Rules of Evidence, notes *Daubert* has been used to screen the testimony of accountants, clinical physicians, economists, product liability experts and failure analysts.

The bench and bar should consider the effect which *Daubert* will have on the types of technical cases prevalent in the federal courts here in the Northern District of California. Of particular concern in our district is how the *Daubert* pretrial review of expert witness may be tied into pretrial case review in Case Management Conferences under General Order 34. Also, effective December 1, 1993, substantial amendments were made to the Federal Rules of Civil Procedure, many of which permit local districts to vary their implementation. Included among the amendments are provisions requiring expanded pretrial disclosures with respect to expert witnesses. Particularly, Rule 26(a)(2) requires parties (1) to make early pretrial disclosure of the identity of all expert witnesses; and (2) to provide a written report prepared and signed by the expert witness, which contains all opinions to be expressed and the data or other information considered by the witness in forming the opinions.

When the active scrutiny of expert witnesses required by *Daubert* is combined with the active case management contemplated by General Order 34 and the full disclosure required by the amended Federal Rules, this

may result in fundamental changes in the standard and procedures for the admission of scientific evidence.

Question No. 1: Reliability?

Pretrial examination of reliability goes to the heart of the most fundamental questions concerning expert testimony. If one asks what is the predominant use of expert witnesses, the answer tends to focus on two functions: (1) stating opinions of the standard of care in their field; and (2) reviewing the evidence in a case and expressing opinions on what happened, why it happened and what is or will be the probable consequences. We have become so accustomed to expert testimony in some types of cases that often there is no examination of whether the expert derived her or his opinion from scientifically reliable methodology.

The majority opinion in *Daubert* holds that expert testimony is admissible if it is based on scientific knowledge. "Scientific" implies a grounding in the methods and procedures of science, and "knowledge" connotes more than subjective belief or unsupported speculation. The Supreme Court lists nonexclusive factors which the trial judge should consider in making a determination. All of the factors focus on the reliability of the methodology being employed: will the technique proposed or used by the expert generate scientifically reliable results?

Frye remains viable, because general acceptance of the methodology in the scientific community is one of the nonexclusive factors suggested by the Supreme Court for determining reliability. In addition, the Supreme Court urged trial judges to consider: whether the expert evidence can be or has been tested; whether it has been subjected to peer review; and the known or potential rate of error.

Case Management Conferences under General Order 34 provide a convenient procedure for making a preliminary determination of reliability. The question for consideration is whether the technique or procedure used or proposed is capable of producing scientifically reliable information upon which to base an opinion. A reliability review at the CMC would prove particularly useful if the expert analysis has not been completed because it could avoid expensive preparation for an opinion which might ultimately be unacceptable. A specially set CMC could be scheduled with the experts in attendance. Questions which a trial judge might ask the expert to assess the reliability of the proposed methodology would be:

- What is the question under investigation on which you have been asked to conduct research?
- How will you design your proposed research so that it will be appropriate for answering the question?
- What will be the size of the data you will study and will it be adequate to allow you to draw a valid conclusion?
- Will you have controls in your study to ensure that errors can be detected?
- What error rate will you allow?
- Are the results capable of being falsified? If so, what testing will you do to ensure that your results are not false?

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Notice the emphasis on research — the essence of scientific methodology. This kind of examination will have an adverse impact upon “opinion only” experts, *i.e.*, professionals who conduct no research and perform no tests but merely read the evidence and express an opinion about how the judge or jury should decide the case. For pre-*Daubert* cases rejecting such testimony, see *United States v. Various Slot Machines on Guam*, 658 F.2d 697 (9th Cir. 1981); *Merit Motors, Inc. v. Chrysler Corp.*, 569 F.2d 666 (1977).

Of course, the need for reliability review will depend upon the scientific or technical subject involved. Some techniques are so generally accepted that reliability is presumed: blood typing, ballistics, fingerprint identification, actuarial analysis, value based upon comparables. Others once questioned, such as DNA typing and statistical matching, are quickly gaining acceptance. See, *e.g.*, *United States v. Martinez*, 3 F.3d 1191 (8th Cir. 1993). Even these presumptively reliable methodologies may be subjected to *Daubert* review for admissibility.

Question No. 2: Admissibility?

The question of whether the proposed expert witness will “assist the trier of fact” relates to its admissibility. Admissibility is focused on the opinion as opposed to the data used to formulate the opinion. Once reliability of method and application has been established, Rule 703 permits the expert to testify to opinions even if the facts or data used to come to the opinion are inadmissible. *Mendes-Silva v. United States*, 980 F.2d 1482 (D.C. Cir. 1993). As indicated above, it may well be that any truly scientifically reliable analysis will assist the jury. However, for admissibility, the issue is whether the expert’s analysis relates to a disputed factual issue which the jury must decide and pertains solely to matters beyond common understanding. In addition, the focus moves from general reliability of the *methodology* to whether the expert actually employed the approved and “testable” techniques. The question of admissibility could be reviewed in a pretrial conference or a hearing out of the presence of the jury during trial. If so, there is a proper foundation for receiving the opinion in evidence.

Question No. 3: Credibility?

Once the trial judge rules that the evidence is admissible, it may be heard by the jury. The jury hears the opinion and its basis. The jury considers its weight, including possible infirmities in the collection and analysis of the data and the background of the expert.

We should spend a great deal more time discussing whether there is a better model for experts in our adversary system and whether to use experts who should be scientifically neutral. Perhaps more frequent use of a neutral teaching expert appointed by the Court under Rule 706 of the Federal Rules of Evidence would be of greater assistance to the trier of fact and could make litigation less costly.

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Titan v. Aetna — A Detour, Not a Derailment

FACED with the “sudden and accidental” or “absolute” pollution exclusion included in most comprehensive general liability (CGL) policies issued after 1970, policyholders returned to their insurance contracts and read them anew. Those who had purchased the “broad form” CGL endorsement found they also had “personal injury” coverage, which was not subject to a pollution exclusion. Most policies (prior to the late 1980s) define “personal injury” to cover “wrongful entry or eviction or other invasion of the right of private occupancy.” Where the lawsuit alleged that the policyholder had committed trespass or nuisance by releasing toxics onto land, policyholders argued — and a number of courts around the country agreed — that such allegations fell within the personal injury coverage.

In *Titan Corporation v. Aetna Casualty and Surety Company*, 22 Cal.App.4th 457, 27 Cal.Rptr.2d 476 (1994), however, the court held the personal injury coverage inapplicable to pollution claims. Insurers have been quick to hail *Titan* as the end to their indemnity and defense obligations under the personal injury coverage. When closely read, however, it becomes apparent that *Titan* did not present facts triggering the personal injury coverage under any analysis and that the court’s application of rules of contract interpretation overlooked the purpose of the broad form endorsement.

The Titan Decision

Titan had produced ferrite at a New Jersey facility for nearly 80 years. In 1985, Titan decided to close the facility. After Titan purchased a CGL policy from Aetna in 1986, it discovered for the first time an area where TCE had apparently been spilled.

Titan tendered a claim under the Aetna policy for the costs of cleaning up the site in compliance with New Jersey’s statutory requirements. Aetna denied the tender on various grounds, including the “absolute pollution exclusion,” which barred coverage for any property damage or bodily injury arising out of certain defined polluting events. The policy, however, also included a broad form CGL endorsement which provided personal injury coverage for injuries arising out of “wrongful entry or eviction or other invasion of the right of private occupancy,” and which did not include a pollution exclusion.

The *Titan* court sided with Aetna on application of the personal injury coverage. First, the Court reasoned that a finding of coverage under the personal injury

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endorsement would nullify the effect of the absolute pollution exclusion written into the property damage and bodily injury sections of the policy. The court held that it was compelled to find no coverage by the contract interpretation rule in favor of "giv[ing] force and effect to every clause rather than to one which renders clauses nugatory." 27 Cal.Rptr.2d at 485. Second, the court interpreted the personal injury clause as limited to "damages *other* than the injury to realty which an occupier of land may suffer when his quiet enjoyment of occupancy is disturbed." *Id.* at 486.

On careful analysis neither of these grounds is persuasive.

Titan's Misapplication of Contract Interpretation Principles

Of course, the *Titan* court's citation to the rule requiring contracts to be interpreted as a whole is valid in the insurance context. The court went astray, however, by failing to recognize that the personal injury coverage is provided by a special endorsement to the policy and, as a result, additional contract interpretation rules apply.

The standard form CGL policy covers liability for bodily injury and property damage, subject to various limitations and exclusions. Beginning in 1976, the Insurance Services Office ("ISO") promulgated the Broad Form CGL Endorsement as an optional supplement (for an additional premium) to the basic CGL coverages. "This [Broad Form Endorsement] was a so-called package endorsement that included 12 coverage *extensions* which previously could be added only with separate endorsements." Wielinski & Gibson, *Broad Form Property Damage Coverage* (3d. ed. 1992) p. 8 (emphasis added).

The typical Broad Form CGL Endorsement opens with the words:

This endorsement *modifies* such insurance as is afforded by the provisions of the policy relating to the following: Comprehensive General Liability Insurance.

(Emphasis added.) The endorsement goes on to provide the policyholder with forms of coverage specifically not available under the CGL form. For example, the CGL policy typically excludes coverage for "liability assumed by contract" except for "incidental contracts," which are defined very narrowly. The Broad Form Endorsement provides that the definition of "incidental contract" is "expanded" to cover any contract relating to "the named insured's business." (ISO form GL 04 04 (Ed. 5-81)) Thus, the *Titan* court's view that it could not allow the personal injury coverage to modify other policy term misses the very purpose of the Broad Form Endorsement – modification and expansion of coverage.

The court's narrow reliance on the "whole contract" rule of construction also ignores other fundamental tenets of insurance contract interpretation. First, endorsements to policies control over the terms of the original policy. 2 *Couch on Insurance* (2d ed.) § 15.30. Even if the personal injury coverage totally abrogated the pollution exclusion, such a result is consistent with the

reason endorsements are sold: to modify, expand or contract basic policy terms.

Nor did the *Titan* court square its decision with a second, long established principle of insurance law: the requirement that courts read coverage clauses broadly in favor of finding coverage, and read exclusionary clauses narrowly against the insurer. *E.g.*, *Reserve Ins. Co. v. Piscotta*, 30 Cal.3d 800 (1982). Moreover, exclusionary clauses must be "clear and conspicuous" and positioned so as to clearly bear on the specific coverage the exclusion purports to limit. See *National Ins. Underwriters v. Carter*, 17 Cal.3d 380 (1976).

Had the *Titan* court considered these principles, it would have noted that the pollution exclusion in the CGL policy appears in the policy part covering bodily injury and property damage; the personal injury coverage appears in a totally separate policy part. Moreover, the pollution exclusion explicitly states that it applies to "bodily injury or property damage." Nothing in the standard CGL policy "clearly and conspicuously" makes the pollution exclusion applicable to the personal injury coverage provided in the Broad Form Endorsement.

Nothing in the *Titan* decision indicates whether the parties raised these issues with the court. The court's apparent failure to consider these principles renders the *Titan* decision problematic at best.

Analysis of Personal Injury Coverage for Trespass and Nuisance Claims

The second basis for the *Titan* court's holding is equally suspect. Finding that the personal injury coverage could not expand the insurance limited by the pollution exclusion, the court held that personal injury coverage is "... limited to damages *other* than the injury to realty which an occupier of land may suffer when his quiet enjoyment of occupancy is disturbed." 27 Cal.Rptr.2d at 486 (emphasis in original). Here, the court relied on *Nichols v. Great American Ins. Companies*, 169 Cal.App.3d 766 (1985).

Nichols, however, does not stand for the cited proposition. The *Nichols* court held that the personal injury coverage applies to the "wrongful entry, eviction or other invasion of the right to private occupancy" relating to some interest in real property. The [complaint for which *Nichols* sought coverage] *alleges no invasion of any interest attendant to the possession of real property.*" 169 Cal.App.3d at 776 (emphasis added). The *Nichols* decision turned on the absence of any allegation of interference with an interest in real property. Nothing in *Nichols* suggests that the personal injury coverage applies only to damages *other than* injury to realty.

The *Titan* court did not analyze whether an insured accused of nuisance or trespass by means of a toxic release onto real property is covered under the personal injury clause. For example, the court did not consider that California's statutory definition of nuisance, found at section 3479 of the Civil Code, includes any "obstruction to the free use of property, so as to interfere with the comfortable enjoyment of . . . property," nor did it compare this language to the functionally similar words used to define personal injury coverage – "invasion of the right of private occupancy."

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New Federal Rules: A Confusing 'Local' Mosaic

In theory, federal practice was to be profoundly altered as of December 31, 1993, when amendments to the Federal Rules of Civil Procedure became effective due to Congressional inaction. In practice, however, action by local courts has forestalled implementation of the more controversial provisions in many federal courts in California, as illustrated in the chart on pages 6-7, *infra*.

Federal courts have the option of refusing to accept certain amendments to the Federal Rules — that is, Rules 5(c), 16(b), 26(a)(1), 26(a)(2)(c), 26(a)(3), 26(a)(4), 26(b)(2), 26(d), 29, 30(d)(2), 32(c) and 54(d)(2)(D). Local courts have elected to opt out of many of these provisions, at least on an interim basis, in favor of local rules with varying provisions. Thus, what used to be a relatively straightforward set of Federal Rules is now a hodge podge of different practices and procedures. The following chart attempts to sort out some of the confusion by listing the provisions that have been accepted and rejected by the local federal district courts.

The rules of the district courts must be consulted to determine the local provisions that are in effect. In addition, many judges adhere to their own personal "local-local" rules. These rules will become apparent when an individual judge issues an order advising counsel of requirements governing, for example, early meetings of counsel and joint reports.

Provisions not presently in effect in most California District Courts include Rule 26(a)(1) and (a)(4), which would require litigants to make extensive disclosures at the outset of the litigation about documents and witnesses "relevant to disputed facts alleged with particularity in the pleadings". The Northern District has adopted these Amended Federal Rules in theory, but they are superseded by the similar (but not identical) provisions of General Orders 34 and 39 to the extent of any conflict with respect to most civil cases.

Litigators in the Central and Southern Districts are free to conduct discovery from the moment when litigation is filed, without the constraints of new Rule 26(f), which requires parties to meet "as soon as practicable," or Rule 26(d), which prohibits discovery until this meeting has taken place.

The Central District deferred accepting most of the Amended Federal Rules under General Order 339 and General Order 339A. Those orders provide for the Rules Committee of the Central District to study the Amended Federal Rules and make recommendations. The court thus opted out of implementing Rule 5(c), 16(b), 26(a)(1), 26(a)(2)(c), 26(a)(3), 26(a)(4), 26(b)(2), 26(d), 29, 30(d)(2), 32(c) and 54(d)(2)(D). The other Amended Federal Rules are effective and they supersede the Local Rules to the extent that there is any conflict.

Thus, early meeting requirements continue to be governed in the Central District by Local Rule 6, except to

the extent that particular judges may have their own rules governing such meetings and early meeting reports. Under Local Rule 6, counsel will continue to be required to meet within 20 days after service of an answer by each defendant.

Pursuant to Rule 253, the Eastern District specifically declined to adopt the mandatory disclosure provisions described in Rule 26 and the limitations on depositions and interrogatories described in Rules 30 and 31. Thus, it will be governed by its local rules and the non-discovery related Amended Federal Rules.

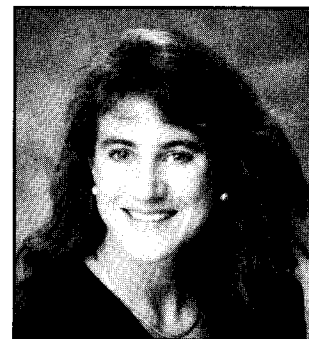
Pursuant to General Order 394-E, as extended by General Order 394-F, the Southern District deferred implementation of most of the discovery related amendments. The Civil Justice Reform Act Committee for the Southern District is studying the potential effects of the new rules. After reviewing the Committee's report, the court will decide the form in which the amendments will be implemented in the Southern District.

The Northern District

The Northern District has generally adopted the spirit of the Amended Federal Rules but has imposed its own variations on those provisions through its General Orders Nos. 34 and 39. General Order 39 states that, except as specifically provided in General Orders 34 and 39, the Amended Federal Rules will govern all civil cases filed on or after December 1, 1993, and, to the extent practicable, cases pending on that date. General Order 34 supersedes the Amended Federal Rules to the extent of any conflict with respect to cases governed by General Order 34. (General Order 39(III)(A).)

Notwithstanding Rule 26(a)(4), disclosures made pursuant to the Federal Rules or General Order 34 shall not be filed with the Court. (General Order 39(III)(B).) Rule 26(a)(3) is supplanted by Local Rules 235-7, 235-8, and 235-9, except to the extent those provisions are modified or extended by standing or case-specific orders entered by a judge. Additionally, Appendix A to General Order 39 lists specific cases that are not affected by Amended Federal Rules 16(b), 26(a)(1) and 26(a)(2), 26(d), or 26(f). These include bankruptcy appeals and Freedom of Information Act proceedings. Bankruptcy cases are not affected by that portion of Rule 16(b) that fixes a deadline for entry of a scheduling order; Rule 26(a)(1)-(4); Rule 26(d)'s presumptive stay of discovery until completion of the meet and confer required by Rule 26(f); Rule 26(f); Rule 30(a)(2)(C); Rule 31(a)(2)(C); or those portions of Rules 32(a), 33(a), 34(b), and 36(a) that incorporate the requirements of Rule 26(d).

General Order 34 provides detailed requirements governing discovery that are largely consistent with those required under Amended Rule 26. It applies to all civil litigation except cases listed in Appendix B, including multidistrict litigation, class actions, transferred cases,



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(See Chart on Pages 6-7)

CHART OF FEDERAL RULES

	<u>Northern District</u>	<u>Eastern District</u>	<u>Central District</u>	<u>Southern District</u>
Governing document (states the status of Amendments to the Federal Rules)	Gen. Orders 34 and 39.	Amended local rules.	Gen. Orders 339 and 339A.	Gen. Orders 394-E and 394-F.
FRCP 4: (Summons)	In effect but Gen. Order 34 supersedes conflicting deadlines.	In effect	In effect.	In effect.
FRCP 5: (Service and Filing of Pleadings)	In effect.	In effect.	Deferred implementation of 5(c) until after consideration by Rules Committee ("Deferred").	In effect.
FRCP 11: (Signing of Pleadings; Sanctions)	In effect.	In effect.	In effect.	In effect.
FRCP 12: (Defenses and Objections)	In effect.	In effect.	In effect.	In effect.
FRCP 16: (Pretrial Conferences)	In effect, but 16(b) does not apply to Gen. Order 39 Appendix A cases: 1) Bankruptcy appeals and withdrawals; 2) Freedom of Info Act; 3) in forma pauperis; 4) habeas corpus; 5) defaulted student loans; 5) recovery of overpayment, enforcement of judgment; 6) recovery of overpayment of veteran's benefits; and 7) Social Security review. 16(b) provision regarding deadline for entry of scheduling order in-applicable to bankruptcy cases.	Declined to adopt.	Deferred 16(b).	In effect (except reference to 26(f) meeting).
FRCP 26(a)(1-4) (Required Disclosures)	Requirements of 26(a)(1) & (a)(2) do not apply to Gen. Order 39 Appendix A cases. Gen. Order 34 supersedes conflicting disclosure requirements. Disclosures not filed with court. Rule 26(a)(3) supplanted by Local Rules 235-7, 235-8, and 235-9 and judicial orders. Rules 26(a)(1)-(4) inapplicable to bankruptcy cases.	Declined to adopt.	Deferred 26(a)(1)-(4) except 26(a)(2)(A) & 26(a)(2)(B) (which require disclosure of expert witnesses and reports). (District already operates under mandatory disclosure provisions.)	Deferred implementation until after court's evaluation of report from local advisory panel ("Deferred").
FRCP 26(b)(2) (Allows court to alter discovery limits by local rule, so check local rules for limits)	In effect.	In effect.	Deferred.	In effect.

CHART OF FEDERAL RULES *Continued*

	<u>Northern District</u>	<u>Eastern District</u>	<u>Central District</u>	<u>Southern District</u>
FRCP 26(d) (Discovery Timing)	In effect, but does not apply to Gen. Order 39 Appendix A cases and the presumptive stay of discovery does not apply to bankruptcy cases.	Opted out.	Deferred.	Deferred.
FRCP 26(f) (Meeting of Parties)	In effect, but does not apply to Gen. Order 39 Appendix A cases or bankruptcy cases.	Opted out.	In effect, except reference to 26(a) mandatory disclosures.	Deferred.
FRCP 29	In effect.	In effect.	Deferred.	In effect.
FRCP 30	In effect. Rule 30(a)(2)(C) does not apply to bankruptcy cases.	In effect, but opted out of 30(a)(2)(A)'s requirement via 26(b)(2).	In effect, but deferred 30(d)(2) (time limit for depositions).	In effect, but deferred 30(a)(2)(A).
FRCP 31	In effect. Rule 31(a)(2)(C) does not apply to bankruptcy cases.	In effect, but opted out of 31(a)(2)(A)'s requirement via 26(b)(2).	In effect.	In effect but deferred 31(a)(2)(A).
FRCP 32	In effect.	In effect.	In effect but deferred 32(c).	In effect.
FRCP 33: (Interrogatories)	In effect.	Opted out of 33(a)'s requirement via 26(b)(2).	In effect, except 33(a)'s reference to 26(d) timing.	In effect, except 33(a)'s reference to 26(d) timing.
FRCP 34: (Requests for Documents & Things)	In effect.	In effect, except 34(b)'s reference to 26(d) timing.	In effect, except 34(b)'s reference to 26(d) timing.	In effect except 34(b)'s reference to 26(d) timing.
FRCP 37: (Discovery Sanctions)	In effect.	In effect.	In effect.	In effect.
FRCP 54: (Judgment; Costs)	In effect.	In effect.	Deferred 54(d)(2)(D).	In effect.
FRCP 58: (Entry of Judgment)	In effect.	In effect.	In effect.	In effect.
Application of Amendments to Removed Cases	Filing of Removal Notice triggers deadlines in Gen. Order 34. Removing defendant must serve copy of Gen. Order 34 with Notice of Removal.	No mention.	No mention.	No mention.
Application to Transferred Cases	Within 30 days after filing of transferred case, plaintiffs will be notified of status conference at which Judge will decide whether Gen. Order 34 applies.	No mention.	No mention.	No mention.

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business. In addition, the plaintiffs alleged that the listing of 52 "prominent" customers in the prospectus was misleading because it did not disclose whether those customers had current orders with VeriFone. Judge Walker of the United States District Court for the Northern District of California dismissed the amended complaint. The Ninth Circuit, in affirming, characterized the complaint as one based on a "failure to disclose a forecast of future sales and revenue and nothing further." The Ninth Circuit rejected plaintiffs' argument that a company is under an obligation to reveal *any* known forecast, even if no public projections are made regarding future performance, revenue, or growth.

As characterized by the Ninth Circuit, the *VeriFone* complaint involved only allegations that the Ninth Circuit had not previously considered actionable. The Ninth Circuit merely rejected an attempt to extend the securities laws by requiring a company to make public projections by disclosing "internal" future forecasts. This notion is not new. See, e.g., *Vaughn v. Teledyne, Inc.*, 628 F.2d 1214, 1221 (9th Cir. 1980) ("The SEC does not require a company to disclose financial projections") (cited in *VeriFone*). The Ninth Circuit did not in any way undermine the well established case law that a projection or future looking statement, *if made*, is actionable if it lacked a reasonable basis. See, e.g., *Marx v. Computer Science, Inc.*, 507 F.2d 485 (9th Cir. 1974).

Thus, *VeriFone*, fairly read, does not indicate some new trend or allow district courts to dismiss federal securities claims because of a disbelief in the validity of the allegations. Scrutiny of complaints alleging federal securities laws has always been the norm, not the exception. The most that can be made from *VeriFone* is that the Ninth Circuit declined to expand the securities laws to hold that a company is obligated to disclose internal projections when no projections are publicly made. Projections, if made, however, must have a reasonable basis.

The above analysis is bolstered by the Ninth Circuit's recent reversal of Judge Walker's dismissal of another securities case. See *In re Wells Fargo Securities Litigation*, 12 F.3d 922 (9th Cir. 1993). Judge Rymer reversed Judge Walker's determination that the plaintiffs had not adequately pled a Section 10(b) claim against Wells Fargo and certain individual defendants.

In *Wells Fargo*, plaintiffs alleged that the company artificially inflated the price of its securities by failing to disclose how poorly Wells Fargo had been managed and how badly its financial and operating condition had deteriorated. Plaintiffs alleged that, for the relevant time period, Wells Fargo had deliberately understated its loan loss reserves and failed to adjust these reserves to reflect known problem loans. The defendants' motion to dismiss strenuously argued that this was a classic case of the plaintiffs' securities bar drumming up business by filing a class action complaint after a sharp drop in a stock's trading price (from \$97.00 to \$74.00 per share). Apparently agreeing with this position, Judge Walker dismissed the complaint with prejudice, noting that the

action was essentially "a collaborative effort by a dozen law firms with significant experience who could not further improve the complaint," which, in the court's view, alleged only non-actionable "fraud-by-hindsight." On appeal, however, the Ninth Circuit rejected out of hand the arguments advanced by the defendants in the court below.

First, the Ninth Circuit rejected the argument that the complaint was deficient, as claimed by defendants, "because it does not state how much the nine named corporations borrowed; when the loans were made; whether these loans were in default, and, if so, when the default occurred; or whether reserves should have been established (but were not), and, if so, when and on what basis." The court held that such a "level of specificity is not required at the pleading stage." 12 F.3d at 927.

Second, the court rejected the assertion (which inevitably winds up in almost every defendant's motion to dismiss in cases of this nature) that the complaint at bar was similar to the complaint dismissed by the Seventh Circuit in *Dileo v. Ernst & Young*, 901 F.2d 624, 626-27 (7th Cir.), *cert. denied*, 498 U.S. 1941 (1990). In the court's view, however, *Dileo* and the other *Dileo*-based decisions cited by defendants turned on the plaintiffs' failure to allege any facts suggesting that the defendants' failure to disclose was attributable to fraud.

Third, despite the defendants' recharacterization (on appeal) of management's affirmative statement regarding the company's loan loss reserve and management practices (i.e., "substantially secured" and "adequate"), the Court determined that, because the defendants made affirmative remarks regarding the current state of affairs of the Company's business, such statements were actionable under Section 10(b).

Thus, *VeriFone* and *Wells Fargo* are consistent with other decisions by the Ninth Circuit over the last decade and simply require a district court to analyze the specific allegations of the complaint before it. They do not support the dismissal, out-of-hand, of a securities fraud complaint.

The Ninth Circuit has not now embarked on a mission — as Messrs. Friedman and Jordan would like us to believe — to guide the district courts to "dismiss more securities fraud complaints at an early stage." In fact, in light of the *Wells Fargo* decision, it is clear that the Ninth Circuit requires the courts to analyze the complaints on a case-by-case basis and to reject a defendant's broad brush claim that each and every complaint lacks adequate specificity at the pleading style. In short, the Ninth Circuit has reaffirmed that the federal securities law are alive and well.

Mr. Audet is a partner in the firm of Loeff, Cabraser & Helmann.

COMING EVENTS

September 28, 1994

MCLE Dinner:
Topic to be announced
Sheraton Palace Hotel
Cocktails at 6:00 p.m.
Dinner at 7:00 p.m.

Call Phyllis Montoya (415) 434-1600
for tickets or information.

MARY E. McCUTCHEON

On INSURANCE

THE practice of attorneys serving on the boards of directors of client corporations has become widespread and has obvious advantages for both parties. An attorney-director may find, however, that the risks associated with the position outweigh the benefits as plaintiffs increasingly target attorney-directors in corporate litigation. Understanding the coverage available under an attorney-director's professional liability insurance policy is critical to alleviating the financial burdens of such claims.

A professional liability policy covers claims "arising out of the performance of professional services for others in the insured's capacity as a lawyer." While some courts look at *the nature of the services* out of which the claim arises, others focus on *the reason for the engagement* to determine if the claim arises out of "professional services." See *Continental Cas. Co. v. Burton*, 795 F.2d 1187, 1190-91 (4th Cir. 1986) (attorney retained for legal services insured for error in investment service provided to client).

An attorney is asked to sit on a board of directors because of his or her legal expertise. Although the attorney may be called on to perform nonlegal services, the reason for the initial "engagement" is the attorney's ability to offer legal advice. Under "the reason for the engagement" test a claim against an attorney-director arises out of "professional services...as a lawyer" even if the attorney steps out of that role to perform nonlegal services for the client.

Recognizing the significant risks associated with insuring attorney-directors, professional liability policies now contain exclusions for these liabilities. One such exclusion excludes liability arising out of any insured's "capacity" as an officer or director of a business or charitable enterprise. Other policies go further, excluding liability arising out of the insured's "activities and/or capacity" as an officer or director. Other exclusions employ less restrictive language, excluding only claims made "solely" because the insured is an officer or director. Long, Rowland, *The Law of Liability Insurance*, Volume 2, § 12C.05[5] (1993). The exclusion typically is worded to eliminate coverage for the firm as well as the individual attorney-director. With this narrower exclusion, however, an attorney-director should have coverage when at least some part of the lawsuit is based on negligent legal representation. Claims against the attorney which do not arise from legal representation might be insured under the corporation's D&O policy.

Some professional liability carriers are considering expanding their D&O exclusion to exclude *any* claim against a member of the firm serving as a director or high-ranking officer of the client corporation, even if the allegedly negligent work is performed by another attorney in the firm and is unrelated to the management or board position. An attorney-director thus might not have malpractice insurance coverage where the complaint involves both legal and nonlegal claims. This presents a

considerable risk, as some corporations' D&O liability coverage only provides coverage if the insured is acting *solely* in the capacity of director. Consequently, the attorney's dual capacity creates the danger that the professional liability carrier could deny coverage because the case arises out of the attorney's position on the board, while the D&O carrier could deny coverage because the attorney was offering legal advice. Mallen & Smith, *Legal Malpractice*, § 20.12, p. 276 (3d. ed. 1989).

Law firms concerned about claims against attorney-directors have several options. The most drastic approach is to prohibit attorneys from accepting board positions. If the firm rejects this option, it should require that the corporation maintain D&O insurance and that the corporation indemnify the attorney-director to the fullest extent permitted by law. Law firms with numerous attorneys on corporate boards should consider purchasing their own D&O insurance or an endorsement to their professional liability coverage eliminating the D&O exclusion. Mallen § 28.22 at 761.

As attorneys' liability exposures have expanded, professional liability insurers have added other exclusions which may limit coverage for claims against attorney-directors. These include exclusions for "business pursuits," criminal acts or "dishonesty," an array of securities claims, personal injury (e.g., libel or slander), fiduciary activities, wrongful termination or discrimination, claims by regulatory agencies, and pollution. See, generally, Mallen § 28.18 *et seq.* Thus, the risk of uninsured exposures for attorney-directors extends far beyond the question of whether the D&O exclusion applies.

Practical considerations arise when a malpractice carrier acknowledges coverage for some but not all of the causes of action against an attorney-director. Professional liability insurance carriers traditionally were liberal in extending coverage to an entire claim if the attorney could be held liable for any portion of that claim in his or her capacity as an attorney. As malpractice claims increase in size and scope, however, professional liability carriers may seek to avoid payment of defense fees or indemnity claims perceived to be outside their policy coverage. They may also be reluctant to participate in the defense and settlement of claims for which they determine the corporation's D&O carrier bears substantial responsibility. Conversely, the D&O carrier presumably will argue that the claim is primarily a malpractice exposure and expect the professional liability carrier to shoulder the burden of defense and indemnity.

Protecting an attorney-director against uninsured claims requires careful analysis of all applicable policies even before the attorney accepts the position. Once a claim is made, the attorney should carefully analyze the facts of the claim, and the legal duties even potentially implicated, to maximize coverage under his or her professional liability policy.

[This column is an abridged version of a paper delivered at the American Bar Association Torts and Insurance Practice Section's Insurance Coverage Litigation Committee's 1994 Annual Mid-Winter Meeting.]

Mrs. McCutcheon is a partner in the firm of Farella, Braun & Martel.



Mary E. McCutcheon



Continued from Page 3

Earning the Daubert Seal of Approval

Daubert and Summary Judgment Motions

Given the frequency of summary judgment motions in federal court and the frequency with which these motions are supported or opposed by expert witness declarations, we should consider the effect of *Daubert* on expert testimony presented in the form of declarations. *Daubert*, itself, was a case where the district judge granted summary judgment based on declarations of defense experts.

For summary judgment purposes, all three questions – reliability, admissibility and credibility – are collapsed into a single analysis by the district judge. It is not unusual to have motions where the dispute between the experts becomes the barrier to summary adjudication. *Daubert* assists in resolving a historical conflict between the Federal Rules of Evidence and the Federal Rules of Civil Procedure with respect to expert testimony.

Rules 702, 703 and 705 liberally allow admissibility of expert testimony by permitting experts to base their opinions on hearsay and other evidence not admissible in court. Rule 705 provides that an expert may state her or his opinion and give reasons for the opinion without prior disclosure of the underlying facts or data. However, according to the requirements of Rule 56(e), "specific facts" must be set forth in order to defeat or advance a motion for summary judgment. Therefore, a tension occurs between these two provisions when expert testimony is presented in the form of declarations for the determination of a motion for summary judgment.

Daubert has formed a bridge between the liberality of the Rules of Evidence and the specificity required by the Rules of Civil Procedure. Experts may still testify *in trial* without prior testimony *in the trial* of the underlying facts, as permitted by Rule 705. However, similar to the specificity required by Civil Procedure Rule 56(e), before experts are permitted to testify at trial, there must be a pretrial showing of specific facts based on scientific knowledge upon which the opinion testimony is based.

Daubert and Silicon Valley Science

In our district, which includes Silicon Valley, novel technology is the ordinary course of business. When these leading-edge technologies become the subject of litigation, of necessity novel techniques must be used to analyze and explain them. For example, there is a proliferation of computer-generated evidence. Experts say that they are able to reduce the evidence pertaining to a plane crash or a fire or a stock price history to "data," which is fed into a computer. The computer analyzes the evidence using incomprehensibly complex mathematical formulas. The result is demonstrated dramatically by a computer-generated animation, which shows how the event took place.

A reliability analysis under *Daubert* might require the proponent of this computer-generated animation to prove that it can be tested. In other words, shouldn't it be possible to feed in the parameters of a fire, accident or economic event for which the sequence is already known to see if the mathematical formula would come to the known results? Shouldn't it be possible for one to change

an assumption or data point in a way which should alter the results in some predictable fashion and have the expert demonstrate that the results will change accordingly?

This all translates to very interesting issues which will make life more difficult for trial judges. Will parties be permitted to comment on the fact that the trial judge has made a preliminary determination that the methodology is reliable and the evidence admissible? Presumably, it will be incumbent upon district judges to give a reasoned statement about why evidence is being excluded or, for that matter, why it is being allowed.

Business trial lawyers, who place heavy reliance on expert analysis, should be eager participants in helping to refine the new procedures required by *Daubert*. This applies to both the plaintiff and defense bar. Let those who disagree – who claim that they never present unsupported expert opinion; that it is those on the other side of the courtroom who hold the monopoly on presenting experts whose opinions are devoid of scientific merit or have untested reliability – be the first to volunteer to take a polygraph test.

The Hon. James Ware is a U.S. District Court Judge, Northern District, San Jose Division. He wishes to acknowledge the research assistance provided by judicial extern Nicole Hamilton.



Maui Hosts Annual Seminar in October

THE ABTL's 21st Annual Seminar – scheduled for October 21-25, 1994 at the Four Seasons Hotel in Maui – will review lawyer liability issues in the 1990's. Two teams of celebrated trial lawyers will try a legal malpractice case before a panel of distinguished judges. In addition, panels of experienced attorneys, judges and clients will discuss the issues that drive attorneys and clients apart and lead to malpractice claims.

This year's program will feature many of the most respected litigators and judges in the state. Chief Justice Malcolm Lucas of the California Supreme Court and U.S. Supreme Court Justice Anthony Kennedy will participate in special presentations. This year's program will also feature a discussion of the "video revolution" in the courtroom of the 1990's and exhibits of legal technology.

Participants will earn 10.5 hours of MCLE credit, including 6 hours for legal ethics, 1 hour for elimination of bias in the profession and 1 hour for control of stress and treatment of substance abuse. ABTL members and their guests can also enjoy swimming, diving, snorkeling, tennis, golf, sailing, shopping, hiking, biking and other island activities.

Robert Fram, this year's Northern California Program Chair, welcomes questions and suggestions at (415) 772-6160.

CHARLES R. RICE

On SECURITIES

COMPLEX, multi-million dollar securities cases almost never go to trial. Our firm recently had the opportunity, however, to participate in one of the longest and most complicated securities class actions ever tried in this area.

The Equitec Rollup Case

In re Equitec Rollup Litigation (N. D. Cal. C-90-2064 CAL) arose from the "rollup" or merger of real estate limited partnerships syndicated by Equitec during the real estate boom of the mid-1980s. Hallwood purchased Equitec's general partner interests, and the limited partners approved the rollup by majority vote. The trading price of the new securities was far less than expected, and a class action for alleged securities fraud and breach of fiduciary duty was filed against Equitec, Hallwood and others.

Our firm represented three former officers and directors of Equitec. After more than three years of discovery and motion practice, the trial began last October. When plaintiffs rested their case four months later, U.S. District Judge Charles Legge granted our clients' motion for judgment as a matter of law under FRCP 50(a). The trial continued until the eve of closing arguments, when the remaining defendants (Hallwood and two investment banks) agreed to a reported \$35.5 million settlement.

The Big Picture

Securities litigators, like most other lawyers, can get caught up in legal technicalities and factual details. Facing a jury, however, forces a litigator to focus on the "big picture" as seen through the eyes of ordinary people. You must be prepared to persuade the jury in a clear, direct and credible way that your clients did the right thing.

Our trial team, led by my partner Ron Malone, always believed in our clients' good faith. We knew, however, that the complexity of the case, the number of defendants, the bad press regarding other rollups and the poor results for thousands of investors presented serious risks. Our clients had made many tough decisions under difficult circumstances, so we were concerned that a jury could be persuaded that, *in hindsight*, they could and should have been more careful. Our strategy was to make the trial a test of our clients' good faith – a test we were confident they would pass.

The standard of care applied would obviously be crucial, so our pretrial motions focused on dismissing claims that did not require *scienter*, i.e., intentional or reckless wrongdoing. For example, we won a crucial ruling on summary judgment that, although Equitec as a general partner owed a direct fiduciary duty to the limited partners, the individual officers and directors of Equitec did not. By the time of trial, the trier of fact would have had to find bad faith in order to hold our clients liable.

For our clients to be judged fairly, we also had to establish the context for their decisions, which were made under great time and financial pressure. We stressed the evidence of the widespread depression of commercial real estate and the particularly distressed state of Equitec and its partnerships. This evidence showed that, like the limited partners themselves, our clients were victims of economic problems that were beyond their control.

Mastering the Documents

In big securities cases, documents can be essential stepping stones to help tell the story, but they can also be coral reefs that surprise witnesses, contradict their testimony and damage their credibility. Important witnesses have to be given plenty of time to review the most troublesome documents so that they can explain what they mean in context. Finding the really important documents in the roomfuls of paper produced in a securities class action, however, can be like searching for a needle in a haystack.

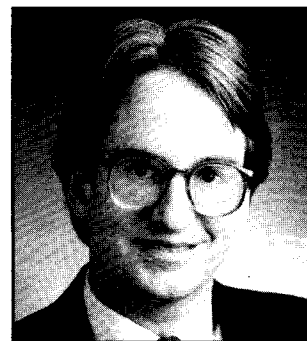
We established a computer database to track documents that, for example, were prepared or received by a particular person or mentioned a particular subject. This database was particularly helpful in the pretrial phase: we could retrieve documents quickly as needed for the dozens of depositions taken in rapid succession. At trial, however, no computer database could substitute for the responsible lawyers being intimately familiar with the most important documents.

Working With Co-Counsel

A plaintiff's best ally against any particular defendant can often be another defendant, so cross-fire among the defendants must be avoided if possible. Our clients, however, had unique interests that sometimes clashed with those of the other defendants. Since there were six groups of defendants represented by different counsel, complete consensus on every strategy was impossible. At best, we hoped to limit disagreements and avoid unnecessary sniping – especially in front of the jury. Good working relationships were fostered early in the case by sharing resources during the discovery phase and encouraging candid but cordial communications. The respect and regard developed among defense counsel helped resolve conflicts that flared later. Although defense counsel often had to agree to disagree, we were able to avoid a breakdown of cooperation from such occasional disagreements.

Perhaps the most important lesson from our experience is that securities defendants do not have to settle claims that they feel are wrong in order to avoid the risk of a catastrophic judgment. If defendants can accept the costs and risks of going to trial, they can win these cases on the merits by mastering the documents, maintaining good working relationships among co-counsel, and focusing on the big picture.

Mr. Rice, Editor of ABTL Report Northern California, is a partner in the firm of Shartsis, Friese & Ginsburg.



Charles R. Rice



Titan v. Aetna

Nor did the *Titan* court consider California's rapidly developing law governing environmental trespass and nuisance as articulated in cases like *Mangini v. Aerojet-General Corp.*, 230 Cal.App.3d 1125 (1991) (ruling that nuisance "appears to be broad enough to encompass almost every conceivable type of *interference with the enjoyment or use of land or property*," (at 1136) and that trespass claims are adequately pleaded by allegations of interference with the "*right to possession of [land] by wrongfully depositing hazardous substances*" on property (at 1141)); and *Newhall v. Superior Court*, 19 Cal.App.4th 334 (1993) (overruling a demurrer to a cause of action for trespass where the complaint alleged "the continuing presence of...contaminants on property"). The torts of trespass and nuisance turn on allegations of "wrongful entry or eviction or other invasion of the right of private occupancy." The types of damages normally available for these torts – cost to abate or remove the injurious condition or depreciation in value – should therefore be within personal injury coverage.

The *Titan* court's failure to parse the policy language against the elements of trespass and nuisance may be explained by the facts of the case. *Titan* sought coverage for costs of a clean up on *Titan's own* property. No one had accused *Titan* of trespass or nuisance or of any other act amounting to an interference with the use of private land. Thus, the analysis employed by other courts that have found the personal injury coverage triggered by environmental claims for trespass and nuisance would not seem to have applied to the *Titan* facts. See *Scottish Guarantee Ins. Co. v. Dwyer*, 19 F.3d 307 (7th Cir. 1994) (under Wisconsin law, chemical trespass amounts to "wrongful entry" and so may be insured by personal injury coverage); *Titan Holdings Syndicate v. City of Keene, N.H.*, 898 F.2d 265 (1st Cir. 1990) (under New Hampshire law, noxious fumes that interfered with the landowner's "right to quiet enjoyment" were within the personal injury coverage); *Pipefitters Welfare Educational Fund v. Westchester Fire Ins. Co.*, 976 F.2d 1037, 1040-42 (7th Cir. 1992) (holding under Illinois and Missouri law that chemical trespass is encompassed within the coverage for "other invasion of the right of private occupancy"); *Hirschberg v. Lumbermens Mutual Casualty*, 798 F.Supp. 600 (N.D.Cal. 1992) (allegations of interference with "comfortable use and enjoyment of property" are potentially covered by the personal injury clause and must be defended under California law).

Titan Does Not End The Debate

Titan should not be viewed as the last word on the subject in California. There are significant legal arguments and factual distinctions to be made that may persuade other courts to reexamine the issue and find in favor of coverage. Policyholders and their counsel should look beyond carriers' reliance on a mere statement of *Titan's* holding and continue pushing for recognition of the personal injury coverage based on the actual language of the insurance contract.

Ms. Formanek is a partner in the firm of Farella, Braun & Martel.

New Federal Rules

cases filed by *pro se* plaintiffs, cases remanded from appellate court, and reinstated and reopened cases.

Under General Order 34, except by stipulation of the parties, no formal discovery can take place until after the parties have completed disclosures and meetings required under Sections VII and VIII of General Order 34. (General Order 34 (VI).) Under Section VII, required initial disclosures include the name, title, and address of each person known to have information about factual matters relevant to the case; unprivileged documents that tend to support the disclosing party's likely position; insurance agreements; and damages computations. These disclosure requirements supersede those of Amended Federal Rule 26(a)(1-4).

General Order 34 also supersedes the pre-trial disclosure requirements of 26(a)(3). Additionally, it changes the timing requirement of the 26(f) meet and confer provision, requiring that an early meeting be conducted no later than 100 days after the complaint is filed. (General Order 34 (VIII).)

Thus, the days of uniform application of the substantive Federal Rules appear to be over. Counsel must carefully and frequently review the local rules in the different districts to keep abreast of the multiple "local" Federal Rules.

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