

abtl REPORT

NORTHERN CALIFORNIA

Volume 4 No. 1

NOVEMBER '94

Letter from the President

THE ABTL's new "Guide To Professional Practice" appears on pages 8 and 9 of this issue. It has been approved by the Board of Governors, whose members have also enlisted the support of their respective firms. Thus, the following firms have subscribed to the Guide: Lieff, Cabraser & Heimann; Cotchett, Illston & Pitre; Hoge, Fenton, Jones & Appel, Inc.; Wilson, Sonsini, Goodrich & Rosati; Farella, Braun & Martel; Shartsis, Friese & Ginsburg; Crosby, Heafey, Roach & May; Keker & Van Nest; Heller, Ehrman, White & McAuliffe; McCutchen, Doyle, Brown & Eversen; Pillsbury, Madison & Sutro; Orrick, Herrington & Sutcliffe; PG&E Legal Department; Brobeck, Phleger & Harrison; Morrison & Foerster; and Howard, Rice, Nemerovski, Canady, Robertson, Falk & Rabkin.

The response to the initial publicity about this project has been highly favorable. A number of judges have expressed particular enthusiasm—and optimism that the ABTL's Guide can make a difference.

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Expanding the Use of Magistrate Judges

WHILE serving as a Magistrate Judge for ten years in the Northern District, I seldom missed an opportunity to advocate for the most meaningful possible role for that office. Now, I have been fortunate enough to have been appointed to the District Court. Some have asked me if my expansive views on the ways in which Magistrate Judges can be used has changed after nine months with a District Court caseload. They have not.

In the Northern District of California, unlike some others, Magistrate Judges' major contribution to the work of the Court is to conduct settlement conferences in civil cases. They also decide many nondispositive, mainly discovery, motions, and perform regular criminal duties. Except for the San Jose Magistrate Judges, because of an experiment there which I'll describe below, Northern District of California Magistrate Judges do not have a large civil caseload to manage and try with the parties' consent. And, Magistrate Judges here do not consider habeas corpus petitions or *pro se* prisoner civil rights actions.

Should this mix of services be changed? Several possibilities come to mind. One that has been the subject of considerable study by the Civil Justice Reform Act Advisory Group is assigning *pro se* prisoner cases to Magistrate Judges. Many civil practitioners may not be aware that these cases comprise a substantial part of each active District Judge's caseload: about 25 per cent. In many jurisdictions, this work is a staple of the Magistrate Judges' caseload. But, the role a Magistrate Judge can play in these cases is limited: without the consent of both sides, which is difficult to obtain from *pro se* prisoners, the Magistrate Judge can only write a Report

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Jerome B. Falk, Jr.



Judge Claudia Wilken

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Franchising – A Breeding Ground for Litigation

FRANCHISE disputes are fertile ground for litigation because of tensions inherent in the relationship. The franchisee usually purchases a franchise because it is part of a "proven" system of doing business that still permits some degree of independence. When the franchisee does not do as well as expected, it is not surprising that the franchisor will be blamed, because either it allegedly misled the franchisee or the system failed. A fraud or breach of contract suit by the franchisee is likely to result. This article highlights some key issues encountered in such franchise litigation, including the effect of contractual clauses (integration, arbitration, jury waiver, and forum selection) on such litigation. It also contains some hopefully helpful insights into jury selection in franchise cases.

The Regulatory Scheme

The sale of franchises in California is regulated by the Commissioner of Corporations under the California Franchise Investment Law ("CFIL"), found at sections 31000 *et seq.* of the California Corporations Code. The CFIL and regulations promulgated thereunder are geared to full disclosure

of the risks and benefits of owning a franchise through a registered written franchise offering circular. There is an exemption from registration for large franchisors who meet a certain net worth and minimum franchisee requirement, but certain minimum disclosures still must be made. Cal. Corp. Code §31101.

Violations of the CFIL, *i.e.*, sale of an unregistered franchise or misrepresentations in the sale, can result in damages or rescission, but there is no provision for an award of attorneys fees. Cal. Corp. Code §§31201 & 31300. The principal advantage of the CFIL to the franchisee's attorney is that it permits rescission for "willful" failures to register without having to show fraud. While some franchisee attorneys might also claim that it dispenses with the requirement of reliance, this view does not appear to be supported by the language of §31301 as far as oral or written misrepresentations not contained in the offering circular are concerned.

While the CFIL governs pre-sale disclosure, the California Franchise Relations Act (the "Act"), Business and Professions Code sections 20000 *et seq.*, governs termination and nonrenewal of franchises, essentially requiring "good cause" (*i.e.*, breach with notice and opportunity to cure) for termination. There are few reported cases under the CFIL or the Act. *See, e.g., Spahn v. Guild Industries Corp.*, 94 Cal.App.3d 143 (1979); *Boat & Motor Mart v. Sea Ray Boats, Inc.*, 825 F.2d 1285 (9th Cir. 1987) (holding that repurchase of inventory

by the franchisor under section 20035 of the Act is the exclusive remedy for violations of the Act).

On the federal level, the Federal Trade Commission adopted similar rules governing disclosure (16 C.F.R. §§436-436.6) and is empowered to bring enforcement actions, which can include restitution to injured franchisees. 15 U.S.C. §53(b). Most FTC enforcement actions are settled by consent decree. At present, there is no private right of action under the FTC Rule, *see e.g., Mon-Shore Management, Inc. and Richie v. Family Media, et al.*, 1985 WL 4845 (S.D.N.Y. 1985), but there is a movement by franchisee groups on Capitol Hill to amend the law to include a private right of action, which would presumably result in increasing federal jurisdiction.

Common Litigation Issues

A threshold issue, which becomes important when the franchisee seeks to invoke the private remedies under the CFIL, is whether or not a particular arrangement constitutes a franchise. Obviously, if the franchisor did not believe that it was selling a franchise, the odds are that no franchise offering circular was prepared or registered. For example, the unwitting franchisor in *Kim v. Servosnax, Inc.*, 10 Cal.App.4th 1346 (1992), had a wake-up call from the Court of Appeal when it held that a corporate cafeteria management agreement was indeed a franchise. There, the court affirmed an award of damages for violation of the CFIL simply because the franchisor had not registered its franchise with the State of California and thus had sold an unregistered franchise in violation of section 31110 of the CFIL.

Both the CFIL and the Act contain a three pronged definition of a "franchise": 1) the franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan "prescribed" in substantial part by the franchisor; 2) there is "substantial association" between the operation of the business and the franchisor's trademark, service mark, etc.; and 3) the franchisee is required to pay, directly or indirectly, a franchise fee. To promote clarity, the Commissioner of Corporations has promulgated "Guidelines." "When Does an Agreement Constitute a Franchise?", Cal. Dept. of Corp. Release No. 3-F (Revised), Bus. Franchise Guide (CCH) ¶15050.45 (June 22, 1994). Anyone familiar with securities litigation knows that the definition of a security can produce much litigation, and franchise lawyers and regulators often disagree about what constitutes a "franchise". *See, Kim A. Lambert & Charles G. Miller "The Definition of a Franchise: A Survey of Existing State Legislative and Judicial Guidance," 9 Franchise L.J. 2, at 3, Fall 1989.*

Many franchisee suits include a claim that the franchisee was told that he or she would earn a certain amount of money after a certain period of time. The typical "earnings claim" brought by franchisees is that a franchise salesperson told the prospective franchisee that he or she would break even within a certain period of time, that sales would reach a certain level, that the franchisee could expect to net a certain amount, that expenses will not exceed a certain figure, or that only a certain amount of working capital would be needed.

Earnings claims are a hot topic in the franchise com-

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Charles G. Miller

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Franchising – A Breeding Ground for Litigation

munity. In the past, earnings claims could only be made in offering circulars if very rigorous disclosures were made. Thus, most franchisors opted not to have earnings claims in their offering circulars and many offering circulars would essentially state that no earnings claims were made. Of course, the franchisees always claimed that they received earnings claims despite these disclaimers, and a jury might have trouble believing that persons bought a franchise without someone telling them how much they could make. Many franchisors have responded to the dilemma by encouraging prospective franchisees to speak with existing franchisees and, in that manner, avoid giving earnings claims themselves. The earnings claims rules have been liberalized somewhat, and this will have an impact on future litigation. See, *Representations Regarding Earnings Capability* (Item XIX), Bus. Franchise Guide (CCH) ¶15819 promulgated in November 1986. Also, NASAA is considering the wisdom of mandatory earnings claims.

The parol evidence rule often comes into play because franchises are sold by written offering circulars followed by the signing of a written agreement, which usually contains both an integration clause and a disclaimer or acknowledgment clause that largely deals with preclusion of earnings claims. Recent franchise cases have applied the parol evidence rule to exclude earnings claims, both with respect to fraud and breach of contract claims. See, e.g., *Scott v. Minuteman Press International, Inc.*, Bus. Franchise Guide (CCH) ¶10,344 (N.D.Cal. 1993); *Carlock v. Pillsbury Co.*, 719 F.Supp. 791 (D.Minn. 1989); *Rosenberg v. Pillsbury Co.*, 718 F.Supp. 1146 (S.D.N.Y. 1989); *Traummann v. Southland Corp.*, 842 F.Supp. 386 (N.D.Cal. 1993). See also *Brinderson-Newberg v. Pacific Erectors*, 971 F.2d 272 (9th Cir. 1992), cert. denied, — U.S. —, 113 S.Ct. 1267 (1993).

The "fraud" exception to the parol evidence rule has been held not to apply to fraudulent promises that directly contradict the agreement. *Scott, supra*; *Brinderson-Newberg, supra*. The fraud exception may still apply if the franchisee alleges a claim of fraudulent representation as to past or existing facts as opposed to promises about the future. Thus, claims could be based on representations concerning the success, earnings or failure rates of other franchisees.

While the parol evidence rule may not bar admissibility of fact statements, proving reliance may be difficult. Franchisor lawyers should point to the franchisee's ability to check the information by, for example, talking with other franchisees (including those who have been terminated) or with other litigants disclosed in the offering circular. Many franchisees actually will conduct "due diligence" in some form, and juries are likely to be hard on franchisees who appear to have buried their heads in the sand. The franchisee also may have difficulty, as a matter of law, in proving reliance where the agreement clearly states that there should be no reli-

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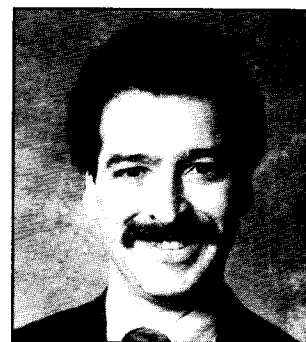
Re-Examining Liability for Projections

IN the midst of the debate about whether legislation is needed to overhaul class action securities litigation, it is possible to overlook important issues that can and should be re-examined by the courts. Perhaps the single most important such issue is company liability under Section 10(b) of the Securities Exchange Act of 1934 and S.E.C. Rule 10b-5 for erroneous projections concerning future operations. The Ninth Circuit law on this issue is ripe for re-examination, and a fresh look at the court's traditional analysis could restore the proper balance of power between companies and their shareholders — without the need to resort to Congress.

This is not merely an academic question. Projections can be a critical way for companies to communicate important information to the market, and complaints alleging misleading projections have been proliferating. District courts in the Ninth Circuit probably see more such cases than those of any other circuit, and Ninth Circuit opinions are closely watched. The extent to which companies are liable for projections has a direct impact on how much information companies are willing to share with the market, and how much of a litigation burden they will face should they turn out to be wrong.

Consider, for example, the case of a hypothetical high-tech company that announces in January that it is projecting earnings of \$1.00 per share for the coming year. During the year, it suffers a series of setbacks, each of which is duly announced, and each of which leads to a downward revision of the earnings forecast. In May, it is unable to secure sufficient quantities of a critical component due to problems with a key supplier; in July, its major competitor is first to unveil a next-generation product; in October, when its own product comes out, it has missed the market. At year's end, the company announces that its yearly earnings will be in the range of 30 cents per share. The stock, which has been sliding all year, drops further and investors sue.

Even if the only sin of the company's officers and directors is their failure to anticipate in January the problems that will confront them later in the year, it is a simple matter for plaintiffs to claim that the forecast was made without a reasonable basis. In the district courts of the Ninth Circuit, the defendants may find it difficult, if not impossible, to obtain summary judgment on such a claim. The prevailing standard was announced in *In re Apple Computer Securities Litigation*, 886 F.2d 1109, 1113 (9th Cir. 1989):



William S. Freeman

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Re-Examining Liability for Projections

A projection or statement of belief contains at least three implicit factual assertions: (1) that the statement is genuinely believed, (2) that there is a reasonable basis for that belief, and (3) that the speaker is not aware of any undisclosed facts tending to seriously undermine the accuracy of the statement. A projection or statement of belief may be actionable to the extent that one of these implied factual assertions is inaccurate.

The *Apple* standard is derived from cases decided twenty years ago, when the Ninth Circuit still permitted 10b-5 liability for negligence. That standard should be critically re-examined, because it has been clear since *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), that at least recklessness is required.

The proper analysis of this issue is a matter of utmost importance to companies and their officers and directors. Due to the well-documented tendency of securities class actions to settle if summary judgment cannot be obtained, defendants in projection cases end up paying significant sums of money to settle cases that arguably should be dismissed as meritless. In addition, companies pay costs of defense and are distracted by litigation; their insurance premiums increase; and they become wary of issuing predictions in the future.

How We Got Here — The Flexible Duty Standard

To understand how we got to this point, it is necessary to go back two decades to a time when the Ninth Circuit was struggling to come up with a workable definition of scienter — the mental state required for liability under Rule 10b-5. Attempting to resolve ambiguity in its prior opinions, the court formulated the “flexible duty standard” in *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974). Rather than settle on a fixed standard applicable to all cases, the court determined that the state of mind required to establish liability should depend on the duty owed by the defendant to the plaintiff. This duty, in turn, was to be decided by the jury based on a variety of factors, including

the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions, and the defendant's activity in initiating the securities transaction in question.

Id. at 735.

Where these factors indicated a casual or remote relationship between the parties, the defendant's sole duty was to avoid intentional misrepresentation. Where the relationship was one of trust and confidence, the duty was “to use extreme care in assuring that all material information is accurate and disclosed.” *Id.* at 736. Increasing the duty of the defendant thus lowered the degree of intent required to impose 10b-5 liability. The court rejected the “compartmentalization” of liability analysis that resulted from applying the elements of common law fraud in favor of a continuum that was held to be more consistent with the remedial goals of the securities laws.

Five months later, the Ninth Circuit applied the flex-

ible duty standard for the first time to a projection case in *Marx v. Computer Sciences Corp.*, 507 F.2d 485 (9th Cir. 1974). The court analyzed the importance of projections under the factors enunciated in *White* and concluded that it was appropriate to impose a heightened duty of care “in light of the great importance attached to an earnings forecast, [the company's] knowledge that investors would rely heavily thereon, and the disparity between the parties in access to the information necessary to judge the accuracy of the forecast.” *Id.* at 490. In other words, because projections were thought to be highly important information, a company making a projection was held to have a heightened duty of care; because of the heightened duty, the state of mind element of Rule 10b-5 was satisfied by a showing of negligence.

In applying the new flexible duty standard, the *Marx* court folded what had historically been two separate elements of liability — the *falsity* of a representation and the *state of mind* of the person making it — into one, and concluded that a projection that was negligently prepared was therefore actionable. The court reached this result by concluding that every projection necessarily implied the company's “informed and reasonable belief” that the projection would be achieved as well as “a reasonable method of preparation and a valid basis.” *Id.* at 490. Suddenly, the “truth” of a projection depended upon management's exercise of due care, and a negligent projection could be actionable without any intentional or reckless wrongdoing.

Two years after the Ninth Circuit decisions in *White* and *Marx*, the Supreme Court in *Hochfelder* held that actions under 10b-5 required a showing of “intent to deceive, manipulate or defraud.” 425 U.S. at 193 n.12. The Court rejected the negligence standard and expressly disapproved *White v. Abrams*, although it left open the question of whether the scienter element could be satisfied by a showing of recklessness. *Id.*

Following *Hochfelder*, the Ninth Circuit continued to have two distinct problems with the issue of scienter. First, although it quickly concluded that recklessness was sufficient to satisfy the scienter element, it struggled to find a definition for recklessness. At times, it adopted one that seemed suspiciously like a description of negligence. In *Kiernan v. Homeland, Inc.*, 611 F.2d 785, 788 (9th Cir. 1980), for example, the court held that “the defendants acted recklessly if they had reasonable grounds to believe material facts existed that were misstated or omitted, but nonetheless failed to obtain and disclose such facts although they could have done so without extraordinary effort.”

In addition, the court continued to analyze 10b-5 cases under the flexible duty standard. While it announced in these cases that it was carefully excluding liability for mere negligence, the court continued to hold that the duty owed by a defendant to a plaintiff, as derived from the particular circumstances of each case, was the touchstone from which liability should be measured.

The Flexible Duty Standard Discarded

It was not until *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1570 (9th Cir. 1990), that the Ninth Circuit,

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STEPHEN OROZA

On CREDITORS' RIGHTS

WHEN a corporation is solvent, its board of directors owes its exclusive loyalty to shareholders. Accordingly, the board of a solvent corporation generally owes no obligation to protect the interests of corporate creditors. What happens, however, when the corporation is arguably insolvent? Does the board of directors then owe duties to creditors? If so, by what standards are those duties measured? Does the board retain its obligations to shareholders at the same time as it owes potentially conflicting obligations to creditors?

Unfortunately, these questions have no clear answers in current case law. And at a time when the economy is still deleveraging after the debt boom of the 1980's, these questions are altogether too real for many of today's boards. While it is unlikely that courts will provide definitive guidance to directors of marginally solvent companies anytime soon, it is possible to provide some workable practical guidelines to directors faced with conflicting duties to shareholders and creditors.

Self-Interest and the Duty of Loyalty

One of the two duties which the board owes to shareholders, and which the board of an insolvent company might owe to creditors, is the duty of loyalty. Courts do not seem to struggle much with cases involving breaches of the duty of loyalty, even if the parties injured are creditors and not shareholders.

Thus, a board member of a marginal company should assume that a court will impose upon him or her the obligation to avoid action which puts his or her personal interests in conflict with those of creditors. Similarly, a board should assume that it will be answerable to shareholders who prove that a "sweetheart" deal with creditors was motivated by a manager/director's interest in self-perpetuation rather than vindication of the interests of shareholders.

The Duty of Care and the Problem of Conflicting Loyalties

If a company files a petition under Chapter 11, the debtor-in-possession owes a fiduciary duty to its creditors and its shareholders. In this context, the board has little risk in balancing these interests since most of the significant actions taken by the debtor in a Chapter 11 case require notice to creditors and shareholders, who have the opportunity to object to the actions.

Outside of Chapter 11, there is ample authority that the insolvency of a corporation creates *some* duty running from the board to creditors of the corporation. What is not clear from the cases is: (1) whether the duty imposed is only one of loyalty or also a duty to act in

accordance with some specified standard of care; and (2) whether the duty owed to creditors supplants or coexists with the duty to shareholders. How then should a board assess its obligations to creditors and shareholders when its solvency is reasonably in doubt?

First, there is some authority for the proposition that the board of an insolvent corporation owes creditors a "fiduciary" duty. Although it is far from clear what this "fiduciary" duty entails, board members should assume that its discharge requires not only that the board be "loyal" (*i.e.*, interested only in the betterment of the corporation) but also that the board will be required to act in accordance with some standard of care. The board should also anticipate that the standard of care might exceed the lenient "good faith business judgment" standard.

Second, the board should assume that the obligation to creditors does not supplant, but rather coexists, with its duty to shareholders. This is the rule in Chapter 11 cases and is consistent with the economic interests of both shareholders and creditors.

If these principles are correct, the question for directors is how to discharge the conflicting duties to shareholders and creditors, a question not addressed by the Chapter 11 cases. One workable answer is to use a "sliding scale" approach which accounts both for the state of the company and the legitimate interests of shareholders and creditors. Under this approach, the board of a clearly insolvent corporation would owe its primary loyalty to creditors but would be expected to consider the interests of shareholders in reaching its decisions. The board of a barely solvent company would have a similar bias in favor of equity holders but could not ignore the interests of creditors.

In more concrete terms, the board of a clearly insolvent corporation would violate its obligations to creditors if it dissipated the company's remaining assets in high-risk ventures having little prospect of success but which were the only means of securing value for shareholders. Likewise, the board of a cash-crunched company would violate its obligations to equity if it negotiated a loan requiring the grant of warrants which unreasonably diluted the interests of existing equity.

If a board can demonstrate that it considered the interests of creditors and shareholders as they appeared in a particular matter and obtained appropriate economic and legal analyses addressing the reasonably-available alternatives, any reasonable decision it reaches should be protected from attack by creditors or shareholders. It is hard to understand how a court could ask more from a board; in the existing legal climate, however, a board would be unwise to ask less of itself.



Stephen Oroza

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Re-Examining Liability for Projections

reviewing its prior cases, candidly conceded that its approach since *Hochfelder* had been wrong. The Court concluded that the flexible duty standard should be laid to rest because, in its focus on the duty owed by the defendant, it was essentially a negligence standard. *Hollinger* also embraced a strict definition of recklessness as:

a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

Id. at 1569.

Based on this definition, it would seem that companies and their officers and directors could no longer be liable for an erroneous projection merely because the projection had an "unreasonable basis" or was not prepared with sufficient care. At the very least, it would seem, a plaintiff would have to prove that the preparation and dissemination of the projection represented "an extreme departure from the standards of ordinary care."

The Ninth Circuit, however, has yet to apply the *Hollinger* approach to projection cases. *Apple*, which was decided a year before *Hollinger*, followed a totally different analytical framework and has never been re-examined. Such a re-examination would show that *Apple* owes its three-pronged analysis of projection liability to the flexible duty standard — a standard that the Ninth Circuit has conceded is not consistent with the scienter requirement as defined in *Hochfelder*. This can be demonstrated by looking at each of the three "implicit factual assertions" that, according to *Apple*, are contained in a projection and may be actionable if false.

1. *That the statement is genuinely believed.* This prong, by itself, is unobjectionable, although it is not necessarily the end of inquiry. Issuance of a projection implies the speaker's belief in it; if the speaker does not believe in it, the projection is false. One must then determine whether the projection was made recklessly or with intent to deceive, although in most instances this will follow from proof that it was not believed.

2. *That there is a reasonable basis for that belief.* Here is where the trouble starts. This language was borrowed from *Marx*, where the court had held that liability could be premised on negligence because the importance of projections gives rise to a duty of care. After *Hochfelder* and *Hollinger*, however, such a concept is no longer viable; a projection that is believed cannot be actionable merely because it has an unreasonable basis or was negligently prepared.

3. *That the speaker is not aware of any undisclosed facts tending to seriously undermine the accuracy of the statement.* This is the most troublesome prong of all, because it suggests that the maker of a projection might have a duty to disclose contrary facts. In fact, this language in *Apple* was derived from an entirely different proposition set forth in *Marx*: the notion that,

given the duty of care attached to the making of a projection, the maker might be liable for "ignoring facts seriously undermining the accuracy of the forecast." *Marx, supra*, 507 F.2d at 490 (emphasis added). Neither *Apple* nor any other Ninth Circuit opinion has ever explained how the original concept of a *duty of care* in preparing a projection could survive the overthrow of negligence liability under 10b-5, much less how it mutated into an implied *duty to disclose* other facts. This prong comes perilously close to suggesting strict liability for projections if any material negative information known by a company is not publicly disclosed. At the very least, if literally followed, this prong would make summary judgment virtually impossible to obtain in projection cases because of the understandable reluctance of courts to weigh the significance of undisclosed negative facts that are bound to be found in a company's files.

Re-Examining *Apple's* Core

Because 10b-5 liability requires either reckless or intentional conduct, a court should address separately the elements of truth and scienter in projection cases, just as it does in other cases. The concept of a duty to investors is irrelevant to these elements. The issue of how heavily investors rely on projections or the availability of other information is adequately addressed by other elements of 10b-5 liability, namely materiality and reliance.

Cases dealing with representations of historical facts address truth and scienter as two separate elements. First, was the statement or omission false or misleading when made? If so, did the speaker act with scienter, that is, recklessly or with intent to deceive? Projection cases can and should be similarly decided. Accordingly, the court should ask the same two questions: (1) Was the projection false when made, *i.e.*, was it inaccurate because the maker did not actually believe it? (2) If so, did the maker act with scienter, *i.e.*, was the projection highly unreasonable and was its issuance an extreme departure from the standards of ordinary care that presented an obvious danger of misleading investors?

It will be said that because a projection implies a state of mind (the actual belief of the speaker), the truth of a projection and the mental state of its maker can never be completely separated. This is quite true. The answer, however, is not to relax the scienter requirement, but rather to recognize that in some circumstances the same evidence may tend to prove both elements. The trier of fact can then evaluate both truth and scienter according to traditional methods of proof. The jury must not be allowed, however, to shortcut the process merely by finding the method of preparation or dissemination to be careless.

The approach suggested here was expressly approved in the recent Supreme Court opinion in *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 111 S.Ct. 2749 (1991). There, the Court examined liability for false statements in a proxy statement under Rule 14a-9. The statements under attack included both the representation that a proposed merger price was "high" and the directors' statement of belief that the

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On ADR

RECENTLY, the American Arbitration Association (AAA) has taken a number of steps to update and improve the Alternate Dispute Resolution (ADR) services it offers. Perhaps the most sweeping change is the introduction of the AAA's Large and Complex Case Program (LCCP). The LCCP offers a small panel of neutrals who are very experienced in commercial and construction disputes and are available to serve as arbitrators and mediators. Panelists must have both a solid background in complex legal or business matters and extensive experience in dispute resolution. In addition, all must complete an advanced AAA panelist training course.

As part of the LCCP effort, the AAA has instituted some new Supplementary Procedures, including the following:

New Supplementary Procedures

1. *Applicability* – The Procedures are meant to apply to cases in which the amount in dispute exceeds \$1 million. However, complex cases involving smaller claims may be appropriate for the LCCP if the parties agree.

2. *Administrative Conference* – Before arbitrator selection, the AAA conducts an Administrative Conference with the parties and/or their counsel in order to discuss the nature and magnitude of the dispute and the anticipated length and scheduling of the hearings. At the Administrative Conference, the parties can discuss the technical and other qualifications of the arbitrator(s), decide whether to use one or three arbitrators, and perhaps even reach agreement on which LCCP arbitrators would be appropriate to hear the case. In addition, they can consider the use of other ADR procedures, such as mediation, in an effort to resolve the dispute short of arbitration.

3. *Preliminary Hearing* – Shortly after the selection of arbitrators, the parties and/or their counsel meet with the arbitrators for a Preliminary Hearing. At the Preliminary Hearing, the parties discuss case management, including service of a detailed statement of claims, damages, and defenses; stipulations to uncontested facts; exchange and pre-marking of documents to be used as

exhibits; identification and scheduling of percipient and expert witnesses; and other matters such as the use of declarations and/or depositions at the hearing.

4. *Management of Proceedings* – Perhaps the most significant procedural change is the mandate given to the arbitrators to take such steps as are "necessary or desirable to avoid delay and to achieve a just, speedy, and cost-effective resolution of Large, Complex Cases." These steps may include exchanges of documents and information or other limited discovery, including the depositions of witnesses who will be unavailable to testify at the hearing, if deemed appropriate by the arbitrators.

5. *Form of Award* – Finally, if requested by the parties, the award of the arbitrator must be accompanied by a statement of the "reasons upon which such award is based."

As part of the LCCP effort, the AAA encourages the parties to a complex dispute to consider mediation before arbitration. Mediation is administered by the AAA in accordance with its own procedures. The AAA's mediation program has a good success rate; however, if mediation fails, the parties can move directly on to arbitration.



Zela G. Claiborne

Dispute Resolution Provision

Parties involved in substantial transactions might want to consider including a provision in their contract providing for dispute resolution under the LCCP Procedures such as the following:

Any controversy or claim arising out of or relating to this contract, or the breach thereof, shall be settled by arbitration administered by the American Arbitration Association under its Construction Arbitration Rules and the Supplementary Procedures for Large, Complex Disputes, and judgment on the award rendered by the arbitrator(s) may be entered in any court having jurisdiction thereof.

CCP cases are administered by senior AAA staff who will conduct the Administrative Conference and guide the parties through the available administrative options. Experienced staff will provide direct, personal service and work with the parties to customize the dispute resolution process.

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Guide to Professional Practice

Association of Business Trial Lawyers of Northern California

Introduction

The Association of Business Trial Lawyers of Northern California has adopted this Guide to Professional Practice. The Guide identifies principles of conduct for lawyers engaged in litigation. The goal of this Guide is to eliminate unnecessary conflict and to reduce the level of contentiousness and stress in the resolution of legal disputes.

The ABTL, as a voluntary association, does not intend these guidelines to provide a basis for further litigation, or for sanctions or penalties. While some of the following guidelines are based upon statutes or existing rules of professional conduct, others go beyond any requirement of current law. Lawyers are encouraged to apply the spirit of the Guide, as appropriate, in circumstances that are not specifically addressed in any of its guidelines.

Nothing in this Guide is intended to inhibit a lawyer's zealous representation of his or her client's interests. The Guide is, however, based on the belief that zealous representation is compatible with professional and civil conduct.

The ABTL encourages firms and individuals to adopt this Guide as their own. As part of that commitment, firms are also encouraged to subscribe to the voluntary inter-firm resolution process discussed below.

Guidelines

1. A lawyer must work to advance the lawful and legitimate interests of his or her client. This duty does not include an obligation to act abusively or discourteously. Zealous representation of the client's interests should be carried out in a professional manner.

2. A lawyer should not engage in derogatory or prohibited conduct on the basis of race, religion, gender, sexual orientation or other immutable characteristics of any person.

3. A lawyer should not behave in an offensive, derogatory or discourteous manner even when his or her client so desires. If necessary, a lawyer should advise the client that civility and courtesy are not signs of weakness.

4. The client's best interests are often served by alternatives to litigation. A lawyer should consider the possibility of settlement or alternative dispute resolution in every case and, when appropriate, bring such alternatives to the client's attention.

5. A lawyer should be punctual and prepared for all court appearances so that all matters may com-

mence on time and proceed efficiently. Lawyers should treat judges, counsel, parties, witnesses, and court personnel in a civil and courteous manner, not only in court but in depositions, conferences and all other written and oral communications.

6. Where an alternative manner of service would not prejudice the client's legitimate interests, a lawyer should not use the timing and manner of service to embarrass or disadvantage the party or person on whom the papers are served.

7. A lawyer should consider opposing counsel's legitimate calendar conflicts when scheduling or postponing hearings, depositions, meetings or conferences, unless to do so would be contrary to the legitimate interests of his or her client. A lawyer should not arbitrarily or unreasonably refuse a reasonable request for extension of time. In considering a request for an extension of time, a lawyer may appropriately take into account the interests of his or her client, whether there have been prior requests for extensions, the time required for the task, the nature of the adversary's scheduling difficulty, and whether the adversary will grant reciprocal reasonable requests.

8. Discovery is an important and appropriate litigation tool, and lawyers are expected to pursue such discovery as is appropriate in order to evaluate and establish the client's position in litigation. A lawyer should not, however, use discovery to harass opposing counsel or the opposing party or for the purpose of delaying the efficient resolution of a dispute. A lawyer should explore with opposing counsel alternatives to formal discovery that will achieve the same objective at lower cost. Lawyers should be willing to agree to mutual stipulations of genuinely undisputed facts.

9. Depositions are generally conducted by lawyers without direct judicial supervision and are frequently the most uncivil phase of litigation. A lawyer should take depositions only when actually needed to learn facts or preserve testimony, and should not engage in any conduct during a deposition that would not be appropriate in the presence of a judge.

10. Written discovery should be limited to seeking such information and documents that a lawyer reasonably believes are necessary for the prosecution or defense of an action. A lawyer responding to written discovery or complying with court rules requiring disclosure should not employ artificially restrictive interpretations to avoid disclosure of relevant and non-privileged information or documents.

11. A lawyer's submissions to the court should be

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Guide to Professional Practice

Continued

professional in tone. A lawyer should at all times strive to be concise and to state accurately the law, the facts and the parties' positions. Briefs and pleadings should not be written in an unnecessarily inflammatory style.

12. A lawyer should avoid personal attacks on other counsel, and should not comment adversely on the intelligence, integrity, motive or conduct of other counsel, except in the unusual circumstance when such matter is legitimately in issue. Even when the zealous representation of a client may necessitate allegations of wrongdoing on the part of an adversary or opposing counsel, a lawyer should review such allegations to ensure that they are justified. A lawyer should bear in mind that such statements frequently are unpersuasive and serve only to increase the level of combativeness.

13. A lawyer should not seek judicial sanctions against a party or opposing counsel without first conducting a reasonable investigation and unless the lawyer is convinced that sanctions would be fully justified.

14. Every law firm's reputation is affected by the professional conduct of its lawyers acting in the name of the firm. Law firms should include the subject of professional and civil conduct in their programs for the training of new lawyers and continuing legal education. Law firms should also identify a lawyer within the litigation practice group to whom questions regarding compliance with this Guide (either by an attorney in the firm or by opposing counsel) may be addressed.

Dispute Resolution

The ABTL encourages law firms subscribing to the principles of this Guide to confirm their willingness to participate in a voluntary inter-firm dispute resolution process where an opposing counsel whose firm has also subscribed to the principles of this Guide believes that there has been a violation of the standards set forth in the Guide or other applicable rules of professional conduct.

Participating firms would each designate an experienced member of the firm for this purpose. The designated lawyer would be available to receive, investigate and assist in the resolution of complaints of unprofessional or uncivil conduct. The ABTL believes that the process would be facilitated if complaints were presented by a disinterested member of the complaining law firm. The goal of the process would be to resolve differences by inter-firm discussion and the intervention of disinterested and responsible members of each firm, rather than through escalating abrasive behavior on each side and motions and counter-motions for sanctions.

If requested by both sides, the ABTL will provide at no cost a disinterested mediator to assist in the consensual resolution of the dispute.

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Letter from the President

I believe that the unique aspect of this program is the mechanism for compliance. Lofty goals and standards are always desirable, but there needs to be some reasonable means for ensuring that they will be honored. Firms subscribing to the principles of the Guide are agreeing that their lawyers will adhere to those principles. They are also agreeing to participate in the informal dispute-resolution mechanism called for in the Guide. That is a real commitment, and one which I am confident the firms who subscribe do and will take seriously.

What has particularly struck me in the comments I have received is that many lawyers now say that practicing law is just less "fun" than it used to be, and that a major reason for that is the personal clashes and incivility that diminish the pleasure they find in their work. That is reason enough to subscribe to the principles of the ABTL Guide.

The next step in this program is to enlist the support of all of the Bay Area firms that support the ABTL. To that end, I have written to the Managing Partner of every such firm asking that their firm subscribe to the principles of the Guide and agree to participate in the dispute resolution process. Many of you will be asked to vote on that question in your respective firms, and I urge to do what you can to see to it that every Bay Area firm signs up.

* * * * *

My year as President of the ABTL of Northern California is now at an end. It has been a great pleasure, and just plain fun, to work with a terrific group of officers and members of the Board of Governors. I'm proud to have played a small role in starting the ABTL in the Bay Area, and helping to develop it. Judging from the response to our dinner programs, the annual seminar and this newsletter, I think we are meeting a real need. Thanks to all of you for supporting the ABTL.

Mr. Falk is a partner in the firm of Howard, Rice, Nemerovski, Canady, Robertson, Falk & Rabkin



COMING EVENTS

December 7, 1994 MCLE Dinner:
 *Discovery Tactics:
 Advocacy or Abuse?*
 Sheraton Palace Hotel
 Cocktails at 6:00 p.m.
 Dinner at 7:00 p.m.

October 13-15, 1995 *Annual Seminar*
 Loews Ventana
 Canyon Resort
 Tucson, Arizona

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

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Franchising – A Breeding Ground for Litigation

ance on the salespersons who have no authority to make such representations. See, e.g., *Carlock, supra*. There are thus a number of tools in the franchisor's arsenal to defeat fraud claims, and the franchisor's lawyer should take advantage of them by, for example, showing the jury all that would have been discovered if the franchisee had conducted due diligence.

Arbitration, Jury Waiver, and Forum Selection Clauses

Many franchise agreements contain forum selection, jury waiver, or arbitration clauses, which often breed their own litigation. Successful enforcement of such clauses will often bring what may otherwise be expensive and lengthy litigation to an abrupt end. A successful motion to change venue could well end the case if the franchisee is unwilling to go to the expense of hiring another lawyer in another state. Similarly, a successful motion striking a jury demand or compelling arbitration could well bring an appealing jury case to an end.

In deciding the enforceability of such clauses, the courts have focused on their prominence, the respective bargaining power of the parties, and the reasonable expectation of the parties. AAMCO Transmissions has been successful in enforcing jury waiver clauses, due largely, in part, to its practice of "debriefing" the franchisee at the time of signing. *AAMCO Transmissions, Inc. v. Harris*, 1990 WL 83336 (E.D.Pa. 1990).

Franchisors have also been successful in enforcing forum selection clauses in light of *Carnival Cruise Lines v. Shute*, 499 U.S. 585 (1991), which involved a forum selection clause contained on the reverse side of a cruise line ticket. While that case involved some federal maritime law, courts in California have adopted its reasoning and have held that forum selection clauses in franchise agreements are enforceable unless they are shown to be unreasonable (i.e., having no relationship to the selected forum, not just creating a financial burden on one of the parties). See, e.g., *Lu v. Dryclean-U.S.A. of California, Inc.*, 11 Cal.App.4th 1490 (1992).

Arbitration clauses have been routinely upheld, even in an adhesion contract, so long as they are not buried in the contract and are within the reasonable expectation of the parties. *Keating v. Superior Court*, 31 Cal.3d 584 (1982), reversed in part, *Southland Corp. v. Keating*, 465 U.S. 1 (1984). The issues of whether the particular dispute was encompassed by the arbitration clause and whether particular parties can be compelled to arbitrate are also often litigated. For example, many franchisees plead fraud in the inducement with the hopes of escaping from a mandatory arbitration clause, and these attempts are usually unsuccessful, especially where the clause pertains to "all disputes". See, e.g., *Keating, supra*; see also, *Rice v. Dean Witter Reynolds, Inc.*, 235 Cal.App.3d 1016, 1024 (1991), *King v. Prudential Bache Sec., Inc.*, 226 Cal.App.3d 749, 756 (1990). And

the addition of nonsigning corporate employees or officers as parties to the litigation will not normally defeat arbitration. See, e.g., *Harris v. Superior Court*, 188 Cal.App.3d 475 (1986).

In the *Keating* case, the franchisees relied upon the nonwaiver provisions contained in the CFIL (Cal. Corp. Code §31512) to escape arbitration. The franchisor in that case successfully argued to the United States Supreme Court that such a nonwaiver clause would thwart the policy in favor of arbitration of all disputes enunciated in the Federal Arbitration Act (9 U.S.C. 1, *et seq.*).

A similar argument can be expected from franchisees about the enforceability of forum selection clauses, i.e., that they fly in the face of the CFIL nonwaiver provisions and should be struck down in the same way as arbitration clauses in securities brokers' agreements were struck down in *Wilko v. Swan*, 346 U.S. 427 (1953). In *Hall v. Superior Court*, 150 Cal.App.3d 411 (1983), the court refused to enforce, in reliance on *Wilko*, a forum selection clause in a securities agreement based upon the nonwaiver provision in the California Corporate Securities Law. Due in large part to the wide acceptance of arbitration, however, *Wilko* was overruled in *Rodriguez de Quijas v. Shearson/Am.Exp.*, 490 U.S. 477 (1989). Because the CFIL does not guarantee any particular forum (only a remedy) and because forum selection clauses have gained wide acceptance, franchisees' arguments against enforcement of forum selection clauses in franchise agreements based on the CFIL's nonwaiver provisions should not be successful.

Trying Franchise Cases to a Jury

From the franchisor's perspective, an important theme to bring home to a jury is that buying a franchise is, after all, the same as buying a business with all of the attendant risks. Since most franchise cases brought by franchisees involve a business failure, juries should be told that, while the franchisor gives the franchisee a sometimes "proven" system, the franchisee must still make it work. There are no guarantees of success. Jurors need to be told that franchisees are responsible for the bottom line—and responsible for investigating before investing. The franchisee's entire case is premised on the franchisor acting irresponsibly. The franchisor's lawyer must, from opening statement through cross-examination and closing argument, reverse that perception and emphasize the franchisee's responsibility to operate the business and to have thoroughly investigated before investing.

In selecting juries, franchisors should thus attempt to select persons that know what it is like to operate a business. These jurors are often difficult to find because of the hardship involved for a sole proprietor to sit on jury duty. Surprisingly, many people have their own concept of a franchise, and it is very important in jury selection to find that out, usually with a jury questionnaire. In that way, parties can find out whether potential jurors in fact believe that, by buying a franchise, a franchisee is guaranteed success.

Mr. Miller is a director and shareholder of the firm of Bartko, Tarrant & Miller.



MICHAEL A. JACOBS

On PATENTS

IS the pro-patentholder pendulum swinging in the other direction? Several important Federal Circuit cases suggest that the court is balancing previous decisions strengthening patent enforceability with new rulings that will narrow a patent's exclusionary reach.

Means-plus-function Claims

The narrowing trend is already visible in the Federal Circuit's cases on the interpretation of "means-plus-function" patent claims. Ordinarily, patent claims — which define the invention that others are excluded from practicing — include specific hardware (e.g., a "screw") or other "structural" limitations. The Patent Act, however, permits claims without such structural limitations that instead claim a "means" for performing a function (e.g., "means for fastening").

Recently, the Federal Circuit has addressed the question of the scope of "means-plus-function" claims. Do they include *all* means (in the example, screws, nails, staples, etc.) for performing the specified function? The common belief was that they did, even though the Patent Act says these claims are limited to the particular structure described in the patent's specification and equivalents. Adhering to the plain language of the statute, the Federal Circuit has stated emphatically that interpreting these claims requires referring to the patent's specification and identifying the structure to which the claims are limited. *See, e.g., In re Donaldson Co.*, 16 F.3d 1189, 1193 (Fed. Cir. 1994) (*en banc*). Moreover, the court has stated that equivalent structures include only *insubstantial* changes over the structure described in the specification. *See, e.g., Valmont Indus. v. Reinke Mfg. Co.*, 983 F.2d 1039, 1043 (Fed. Cir. 1993).

These decisions have sharply limited the scope of means-plus-function claims, to the likely surprise of some patent practitioners and their clients who thought the claims had been broadly drafted.

The Doctrine of Equivalents

The Federal Circuit's narrowing of equivalence in the means-plus-function context is paralleled in its recent cases on the equitable Doctrine of Equivalence. This court-created doctrine permits patentholders to stop others from infringing even where the literal language of the patent's claims does not completely apply to the defendant's products. Because its reach is necessarily uncertain, it gives a patentholder important benefits in a

dispute with an alleged infringer: the patentholders can credibly assert infringement by equivalence even where a competitor believes it has legitimately designed around the claims. In this context too, however, the Federal Circuit has stated in the past few years that only *insubstantial* changes over the patent's claims can be embraced under the doctrine. *See, e.g., Slimfold Mfg. Co. v. Kinkead Ind., Inc.*, 932 F.2d 1453, 1457 (Fed. Cir. 1991).

In a case that is now pending *en banc*, moreover, the Federal Circuit will decide whether some sort of wrongdoing by the defendant, such as copying of the patentholder's product, must be found in order for the doctrine to be applied. *Hilton Davis Chemical Co. v. Warner-Jenkinson Company, Inc.*, No. 93-1088. The court will also decide whether, because the doctrine is equitable, equivalence claims should be decided only by the trial judge, not a jury.

In decisions leading up to the case in question, several judges on the court have made it clear that, in their view, the doctrine is to be applied only in exceptional cases. Thus, the court may well decide both questions in the affirmative. If it does, much of the uncertainty created by the doctrine, and the consequent advantage it offers patentholders, will be vitiated.

Claim Construction

In another case currently pending *en banc*, the Federal Circuit will decide what it means that claim construction is a matter of law. *Pall Corp. v. Micron Separations Inc.*, Nos. 91-1393, 91-1394 and 91-1409, and *Markman v. Westview Instruments Inc.*, No. 92-1049. Does the jury ever get to decide a claim construction question? What if experts disagree about the meaning of a claim term? Does the trial judge decide the disagreement as a matter of law? If so, when? At the end of a trial in which evidence has been received on the implications of multiple possible claim constructions? In a separate trial on claim construction?

In deciding to take the case *en banc*, the court seemed determined to limit jury discretion by treating claim construction as a matter for the bench to the maximum possible extent.

The Federal Circuit's direction seems clear. The court intends to limit patent claims to what they say and constrain efforts to broaden them. It likely will do so by reinforcing doctrines calling for narrow claim construction and limiting the role of the jury. The court's goal is to make the patent system more predictable, and hence better adapted to a high-innovation economy.



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Expanding the Use of Magistrate Judges

and Recommendation on dispositive issues in these cases; this must then be reviewed and adopted or redone by the District Judge assigned. The District Judges in this District have always viewed this procedure as a waste of judicial resources. Even though I now have my share of over one hundred of these difficult prisoner cases, I am still persuaded that it is.

If Magistrate Judges' availability was unlimited, assigning prisoner cases to them certainly would assist the District Judges. As always though, use of that resource in this way would make it unavailable elsewhere. The judge-time savings gained would not outweigh the loss. As I mentioned above, the major role of the Magistrate Judges here is in the area of alternative dispute resolution. I know from conducting settlement conferences that most cases cannot be settled with the investment of a small amount of time from the mediator. Conferences set every half hour are not likely to produce settlements. The Magistrate Judges are able to set aside two hours, or even more, for settlement conferences, and re-set the further conferences that are often required to settle a case. The investment of these few hours of a judicial officer's time frequently pays off in the savings of weeks or months of trial time. True, some of these cases would have settled anyway, but some would not, and others would have settled on the courthouse steps, after investment of many hours in summary judgment motions and trial preparation. True, many cases are settled by private mediators. But, many parties do not have the resources or the inclination to spend them in this way, and in some cases the persuasive power of a judge can settle a case where a private mediator cannot.

Nonetheless, the private alternative dispute resolution market is available, as well as attorney-hosted, court-sponsored mediation, arbitration, and early neutral evaluation. Perhaps the Magistrate Judges could take an increased role beyond their criminal duties and settlement conferences. If so, should that role include writing reports and recommendations in prisoner cases? I think not. A better use of their time, both in terms of job satisfaction to them and time-savings for the District Court Judges would be increased civil caseloads on consent of the parties. These cases should not just be those referred at last minute for trial, although that is a very valuable service. Rather, consents should be obtained at the beginning of the case, so that all the motion work and case management, as well as the trial if there is one, is handled by the Magistrate Judge. Since any appeal goes directly to the Ninth Circuit, these consents very effectively reduce the caseload of the District Court Judge, providing more time for other cases. Civil consent cases don't come back to the District Judges for review of reports and recommendations.

Consents to civil trials before Magistrate Judges, though, are not numerous and do not seem to be increasing greatly or steadily, in spite of the high quality of the Magistrate Judge appointments and the efforts at persuasion by many Judges. A structural change is needed to increase consents. One model for such a change is in progress as close as one of our own divi-

sions, San Jose. There, the judges have borrowed ideas from several other jurisdictions and have provided by local rule that one-third of all civil cases filed in the division are assigned "off-the-wheel" to one of the division's two Magistrate Judges, not to a District Court Judge. Counsel are notified that, if they object to this assignment and wish to exercise their right to a life-tenured judge to try their case, they must affirmatively notify the Court within 30 days of their appearance. Since March of this year, when the system began, cases have been presumptively assigned in this way to Magistrate Judges Patricia Trumbull and Edward Infante. Only 25 per cent of the cases have been reassigned to District Judges on refusal of consent.

This San Jose system is not unique. The District of Oregon has made single assignments "off-the-wheel" to Magistrate Judges for many years with great success. Its system requires affirmative consent, not a presumption of consent with an opt-out period. One District Judge/Magistrate Judge team in Montana uses an "off-the-wheel" single assignment with presumed consent, as does the District of Idaho. The Middle District of North Carolina, Eastern District of Missouri and Eastern District of Wisconsin have begun the system as well.

It seems that this single assignment system is effective and necessary to encourage consents. I attribute this to the fear of the unknown. If a case is assigned on filing to a District Judge, and on consent would be assigned to an unknown Magistrate Judge, the fear of the unknown inhibits consent. Generally, one side, at least, is happy with the District Judge assigned and will not consent to a Magistrate Judge instead. Single assignment to a Magistrate Judge turns the fear of the unknown to the service of consent. If a Magistrate Judge is assigned to a case on filing and both sides are reasonably comfortable with that assignment, the fear of the unknown District Judge who may be assigned if consent is declined may encourage consent.

Some observers are concerned about the presumed consent with an opt-out requirement. Of course, it is important in designing any such system to ensure that both sides are given adequate notice and explanation of the requirement. Assuming that, however, I see no problem with the opt-out system. After all, a civil plaintiff can impliedly waive her Seventh Amendment right to trial by jury by failing to assert it timely after removal to federal court. No one even gives her a form advising her of this possibility. Waiving her right to a judge appointed for life in favor of one appointed for an eight year term seems to be far less significant.

Other methods of encouraging consents have been tried in this District with limited success. We tried a technique of mailing letters to attorneys for both sides of each case after the initial request for consent on the filing of the case. The letter reminded them of their option to consent and asked that the form be returned within ten days, whether consent was given or declined. We have by Local Rule for some time placed the issue of consent explicitly on the agenda for initial and final pretrial conference and required that it be addressed both in the pre-conference statements and at the hearings. Many District Judges and Magistrate Judges have

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Expanding the Use of Magistrate Judges

tried hard to encourage consents, during court appearances and in speeches and educational programs. Our Merit Selection panels have recruited highly qualified judges and lawyers to apply for open Magistrate Judge positions. While all of these efforts are worthwhile and should be continued, none has really increased the percentage of consents to a meaningful degree.

Yet other methods have been tried in other Districts. One is the "trial month" being used by a three Judge team in the District of Massachusetts. Two District Judges set all of their backlogged civil cases that are ready for trial on the four Mondays of a given month. The team includes a Magistrate Judge, and the three Judges commit to continue trying these cases in succession until all are tried. Whichever Judge becomes available first tries whichever case is up next, regardless of its original assignment. If anyone declines consent to the Magistrate Judge, that case goes to the next available of the other two, but this rarely happens. These judges have tried or otherwise disposed of a great deal of their civil backlog in this way. This system requires pairing or teaming of a Magistrate Judge with two District Judges, which has not been done in our District.

A somewhat similar concept is used in the Southern District of New York. Any case that is set but can't be tried by the District Judge assigned, due to a criminal case or double set civil case, is assigned to a Magistrate Judge to try as scheduled. The parties are told that, if they do not consent, the case will be assigned to a Senior District Judge to try as scheduled instead.

These systems work because both sides know that their case will be tried by someone on or about the date set; there is no incentive to refuse consent to avoid the trial. The fear of the unknown plays a role as well. If the case is assigned to a Magistrate Judge, she is a known quantity; if consent is refused, the case will be tried by an unknown Senior District Judge in New York or one of two District Judges in Boston. The Boston and New York experiments are worth our consideration, I think, but I favor the single assignment experiment instead.

The Northern District of California has a history of selecting highly qualified Magistrate Judges and using them in innovative and effective ways, especially in the area of alternative dispute resolution. To the extent that the privatization of the alternative dispute resolution market and the increasing caseload of the District Judges requires assigning additional duties to Magistrate Judges, we should take care not to move backward into less enlightened roles for the Magistrate Judges. Assigning prisoner cases without consent for busy-work, law-clerk-style Reports and Recommendations would be just such a mistake. Rather, we should continue our tradition of progress and innovation, and begin experimenting with a single assignment, opt-out system for civil cases.

Civil business practitioners will find it in their interests to continue to have experienced Magistrate Judges consistently available to conduct settlement conferences. This is especially true in those cases where one side is

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Litigating a Small Complex Case Cost-Effectively

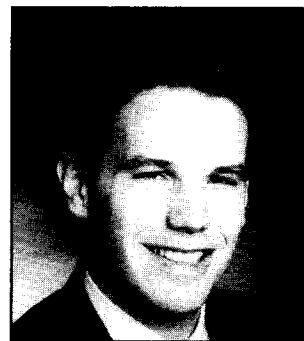
THE conventional wisdom is that the difficulty of litigating a case will bear a direct relationship to the dollar amounts involved. For example, many clients and even some attorneys believe that litigating a \$5 million case is five times as complicated as litigating a \$1 million case, and a \$1 million case is ten times as complicated as a \$100,000 case. While this may be true in some areas of the law, achieving a result which is in the client's best interests in a small case (say, one with less than \$100,000 at issue) in one of the so-called "complex" areas of the law (securities, environmental, real estate, etc.) can often be *more* difficult than achieving a desirable result in a much larger complex case.

The reason that litigating a small "complex" case can be more challenging than one involving multi-million dollar claims is that the time spent in a given case on legal research, discovery, pre-trial work-up and trial seldom bears a direct relationship to the value of a particular case. Not every element of attorneys' fees and costs in the \$100,000 business case will be 100 times less than those same costs in a \$10,000,000 case. For example, drafting a complaint in a small 10b-5 case may often take as much time as drafting a complaint in a case grounded on the same alleged fraudulent conduct but involving exponentially higher damage claims; either case requires generally the same elements and allegations of conduct. Similarly, the legal research involved in determining what claims can be alleged will not differ dramatically in the smaller case. While the underlying facts of the larger case may sometimes (but not always) be more sophisticated and thus require more analysis, the same legal precedent applies in both cases. It takes no less time to read the seminal cases in preparing (or responding to) a complaint alleging a smaller sum than it does to read those same cases in a matter of greater economic value.

Similarly, while discovery usually needs to be more expansive in the larger case, the discovery costs seldom bear a perfect relationship to the amount at issue. While more depositions may be necessary in a \$10,000,000 real estate dispute than one with \$100,000 at issue, it is unlikely that the larger case will need 100 times as many depositions. Though pre-trial conferences and pre-trial exchanges usually require greater effort in the larger case, the ratio again is far from a perfect reflection of the cases' respective values. It takes no less time to travel to court and wait for the court to call one's case in a \$100,000 case than in a \$10,000,000 case. While the motions in limine, jury instructions and trial briefs in the smaller case may take less time, without careful planning they may not end up taking that much less time.

For these reasons, it is often more difficult to pros-

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John S. Worden

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Litigating a Small Complex Case

ecute or defend efficiently the \$100,000 complex case. This difficulty is compounded by the fact that, while most clients may expect a several hundred thousand dollar bill for attorneys' fees in a larger complex case, many assume that small cases can be litigated for a negligible amount of money. As this is seldom the case, sometimes *winning* a \$100,000 complex case is one of the worst things that could happen to the client if achieving that result costs the client that much in fees. (Although, of course, losing would be worse.) Explaining to the client who has just received a large bill in a small case that securities/environmental/real estate/commercial cases are more complicated than most and require greater attorney analysis and involvement is little consolation.

The goal, then, in a complex case involving lower damage claims is to achieve not only a favorable result (either on the merits or via settlement), but to do so at a reasonable cost compared to the smaller amount at issue. This can be done, but it requires thought and commitment from the case's inception, and requires that the client become actively involved early on in the decision making process.

Draft a Detailed Budget Before Doing Anything Else.

Lawyers often draft budgets for their clients in larger, more expensive cases. Clients who anticipate having to pay several hundred thousand dollars in fees nowadays usually demand an initial detailed estimate of how much it will cost and what tasks will be accomplished. However, more than a cursory ballpark estimate is seldom requested or given in a smaller business case. ("Oh, this case shouldn't cost more than \$20,000 or \$30,000.") It is imperative that a very detailed budget be drafted at the outset of a smaller case. Lawyers almost always underestimate the time they will take on a case and the fees and costs they will incur. Being a few thousand dollars off in a larger case may not be a big concern, but a fee estimate that ends up being \$20,000 too low in a \$50,000 case is a major concern.

A careful budget in a small business case is crucial if the client is to answer what should be (but often is not) the first question asked: Is it really in the client's best interest to file (or vigorously defend) the case in the first place? If the client knows up front that it will cost \$40,000 to litigate to the merits a hotly contested \$50,000 dispute, then the client will be better able to determine whether the case is worth the risk at all.

The budget should be very detailed. It is not sufficient simply to estimate a lump sum for "discovery" or "depositions." The budget should set forth a specific cost for each particular step through trial — who will be deposed, how many hours will each deposition take, how much preparation time is necessary, what written discovery is essential and how much time will each written request take, how many status or pre-trial conferences will there be and how much will each cost, etc. Going into such detail may take a little extra time, but it will save the client immensely down the line.

Decide What Tasks Are Really Worth Doing. The question is not simply "is it economically feasible and advantageous to the client to prosecute (or vigorously defend) this smaller business case?" Rather, the question should be "how can one prosecute or defend a smaller business case in an economically feasible manner?" It does not have to be an all or nothing decision.

Let us assume the initial budget calculation is that the case will cost \$50,000 to take through trial. If the maximum recovery will be only \$75,000, the client may decide (understandably) that it is not worth the \$50,000 investment. It does not follow, however, that the client's only option then is to walk away. Instead, the client and the attorney should answer two further questions before deciding that the case is not worth filing: (1) Are there certain elements of the budget (such as redundant depositions) which can be eliminated so that the case can be prosecuted through trial for significantly less than \$50,000? (2) Are there ways to resolve this case before trial (or even before filing a complaint) which will reduce the anticipated attorneys' fees estimate? The lawyer and client can answer these questions effectively only at the outset of the case.

In a larger case, it may be optimal to take the deposition of everyone involved simply out of an abundance of caution. This is not the best idea in a smaller case. Unless one can predict beforehand that a particular potential deponent's testimony is essential in proving a necessary point, the lawyer is doing his or her client a disservice by taking a deposition for which the client will have to pay but from which the case will not benefit in an appreciable manner. In a larger case, it is sometimes the norm to plow into discovery and wait to see where the facts fall before attempting to decide where to go with the case. Again, unless one can predict beforehand that such an approach will achieve a better result — after subtracting the attorneys' fees which will be incurred — then the "business as usual" approach to discovery may not be in the client's best interest in the smaller complex case. Therefore, the lawyer and the client must on day one decide as precisely as is feasible what discovery and other tasks are necessary to achieve the desired result.

Discuss Fee Issues with the Client at the Earliest Opportunity. In a smaller case the client must be very knowledgeable about the legal process and the costs and risks of a particular lawsuit before taking any action. The client must understand from the outset that, as discussed above, fees and costs in a smaller complex case will eat up a much larger percentage of the amount at issue than would be true in a larger case. If the client contact is not a lawyer or not particularly experienced with the legal profession, the lawyer must explain the significance of the various items upon which the attorney will expend time and money. If the lawyer cannot explain why, for example, a particular deposition will help the case and why it is worth the cost involved, perhaps the deposition is not worth taking after all. While in larger cases it may be appropriate for the lawyer to run the show completely (some clients believe that that is why they hire lawyers), this is not appropriate in a smaller case where the client will be asked to make tough choices at various points in the litigation.

One reason to get the client on-board from the earliest point is to avoid fee disputes or "writing off" attorney time later. In a smaller case, scrupulous lawyers tend to become more reluctant as the case progresses to send clients relatively large bills for even the most legitimate attorney time. Lawyers fear that their clients will think that they should have been more efficient on a smaller case. This especially becomes a problem in the later stages of the case, as the amount already billed creeps closer and closer to the amount at issue. In certain

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Litigating a Small Complex Case

extreme circumstances, the lawyer may even conclude simply that he or she cannot continue billing the firm's better clients in this manner, and suspend or drastically reduce *all* further billing while continuing to work on the matter. The lawyer may begin to think that "we got them in this deep, we had better figure out a way to get them out and keep them as a client." (Of course, many lawyers would never consider writing down a bill, regardless of the circumstances.)

By informing the client as to how much it will cost to litigate the case to each respective level (through the pleading stage, to a settlement conference, through trial, etc.), the client is better able to make the ultimate decision regarding how its money will be spent. If the client decides up front that spending \$60,000 litigating a case through verdict in a \$100,000 case is an appropriate use of its money, the client will not be shocked by, or dispute, bills for that much, and the lawyer need not mark down any bill for services the client knowingly authorized. A client informed up front is in the best position to decide whether to assume the risk of prosecuting the case and to what length.

Stand by the Cost Decisions. An important corollary of deciding up front what costs are necessary is that the lawyer and client must be willing to stand by those decisions once the case gets going. It does little good to decide initially that the case can be prosecuted efficiently and effectively by taking only the deposition of the CEO, if the lawyer (or the client) decides mid-way through the case to take the deposition of each director as well. Though litigation is not always predictable, the lawyer and client both must try to live by those presumably thoughtful decisions made at the outset. If you came to an informed conclusion on day one that each director need not be deposed, deciding otherwise four months (and \$15,000 in fees) later may nullify the initial decision that the case could be efficiently litigated at all.

Explore Settlement at the Earliest Possible Juncture. It is amazing how often small complex cases ultimately settle for amounts based on "cost of defense" that bear little resemblance to the parties' substantive damage contentions. After having spent such a high percentage of the amount in controversy on fees, clients often simply throw in the towel and take what they can get — or pay what they have to pay — to extricate themselves from the combine of attorney's fees. If clients realize up front the costs associated with a small complex case, they may be more realistic about settling a case before expending any attorneys' fees. If the client wants to make a point or set precedent by prosecuting or defending a case as far as it takes to win on the merits, it should be prepared to pay for that luxury. From a purely economic sense, however, if a plaintiff can receive and a defendant can pay \$70,000 to settle a \$100,000 case without having expended appreciable amounts of attorney's fees, they may both profit greatly. Again, from a purely economic standpoint, considering the fees involved, sometimes the *worst* thing that can happen to a client (and its lawyers, who may not get paid in full) is to *win* a case of this size on the merits. (Although, again, losing would still be worse.)

Failure to consider settlement initially sometimes ensures that the case cannot settle. After spending \$50,000 in fees defending a \$100,000 case up to the pretrial

stage, the defendant may feel that the only way to justify the costs is to get a defense verdict, and will not pay \$70,000 to settle a case because the settlement payment plus the attorneys' fees would exceed what the defendant would have had to pay if it had simply ignored the case and been subjected to a \$100,000 default judgment. Similarly, the plaintiff, who might have settled for \$70,000 on day one but has since spent \$50,000 in fees, now figures that it will simply roll the dice. Moreover, lawyers will be somewhat sheepish about recommending settlement after generating such proportionately high fee bills. In other words, sometimes small complex cases reach a point where they have to be tried, because no one can afford to settle them.

This problem is sometimes exacerbated by the billing arrangement on the other side. For example, an attorney getting paid by the hour may be more reluctant to recommend a reasonable settlement figure to his or her client where the attorney stands to gain substantially from further hourly billing should the case continue to go forward. Similarly, a client whose case is being handled on a contingency fee may be less likely to want to settle the case for a reasonable sum once the case has reached the latter stages of litigation. ("I might as well roll the dice; it won't cost me anything — my attorneys are handling this case on a contingency fee basis.")

Keep A Lid On Costs. If the other side notices a deposition which turns out to be inconsequential, do not order a transcript. (You can always order one later, if necessary.) And as for experts, bear in mind that the economist who charges you \$100 an hour for the \$1,000,000 case will still charge you \$100 an hour for your \$100,000 matter. As with attorneys' fees, costs in a small complex case will usually represent a larger percentage of the amount at issue than in a larger case. These overhead costs will make it more difficult to stay on your budget and efficiently litigate the smaller matter.

Avoid Discovery Disputes. An "in your face" approach to discovery, assuming that such an approach is ever appropriate in a larger case, is almost never in the client's best interest in a smaller complex case. Agree up front with your opposing counsel as to the informal exchange of documents. If documents are privileged, then by all means fight to keep them that way; but do not spend \$5-10,000 fighting a costly discovery battle over the production of documents of lesser importance. Similarly, decide what documents and interrogatory responses you really need and by all means insist on a thorough response. But avoid the "shot gun" approach of requesting discovery you really do not need. Moving to compel and moving for protective orders usually cost as much in smaller cases as in larger ones.

Finally, Consider at the Outset the Cost of and Prospects for Enforcing the Judgment. Sometimes businesses breach contracts or appear to misuse investors' funds because they simply are out of money (or never had any in the first place). A judgment against such an entity with no assets is worthless. Finding assets of a company trying to hide them can also be futile. Invest initially in the investigatory research, computer searches, etc., necessary to determine whether the defendant has the assets to pay a judgment and, if so, how easy it will be to seize those assets after obtaining the judgment (or through pre-judgment attachment, if available).

The problem of enforcing a judgment against a poten-

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Re-Examining Liability for Projections

transaction was in the best interest of minority shareholders. With respect to the statement of belief, the Court concluded that it would be "open to objection...solely as a misstatement of the psychological fact of the speaker's belief in what he says." *Id.*, 111 S.Ct. at 2759. The Court concluded, however, that both the representation that the price was "high" and the statement of belief could be proven either true or false using traditional methods of proof, including both direct and circumstantial evidence. *Id.*

Where plaintiffs can demonstrate that a projection was not merely unreasonable (negligent) but extremely unreasonable, they may be able to establish, by inference, both falsity and scienter. On the other hand, if a projection is merely unreasonable, plaintiffs would have to show both that the maker did not believe the projection and that he or she acted recklessly or intentionally. Such proof would have to be independent of the projection itself.

Recent district court opinions in the Ninth Circuit, while reciting the *Apple* standard, appear to demonstrate a willingness to move beyond literal adherence to its three-pronged analysis. In *In re Adobe Systems, Inc. Securities Litigation*, 787 F.Supp. 912 (N.D.Cal. 1992), the court granted summary judgment despite plaintiffs' claim that the company's projection was unreasonable, because the company's justification for the projection was sufficient to defeat any notion that it was false when made. The court explicitly rejected plaintiffs' argument that a jury should decide which methodology was more appropriate, noting that "if the mere existence of differing implications (for future corporate performance) reasonably drawable from information available at the time a projection is made can create a triable issue of fact in a lawsuit alleging that the projection was *fraudulent*, then virtually every lawsuit alleging such a projection would, it seems, go to trial...." *Id.*, 787 F.Supp. at 919 (emphasis in original). This analysis was cited with approval and followed by the court in *Steiner v. Tektronix*, 817 F.Supp. 867, 877 (D.Or. 1992).

A forthright reassessment of the *Apple* standard, however, is still necessary. Companies should not have to prove that their interpretation of available information was reasonable at the time a forecast was issued. Nor should they be subject to the uncertainty of knowing whether a district judge in a given case will apply *Apple* flexibly. It is time for the Ninth Circuit to reassure companies and their officers that, in making projections, they will be judged by the same standards of liability applied to other 10b-5 cases. There is no need to wait for Congressional action; the answer to this question is the proper re-assessment of existing precedent.

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Expanding the Use of Magistrate Judges

unwilling or unable to pay for private alternative dispute resolution and those cases that need the persuasive power of a judicial officer and a courtroom setting to gain the attention of a reluctant party. This resource will not be consistently available if five Magistrate Judges, with one law clerk apiece, are assigned to the crushing prisoner caseload currently handled by 12 District Judges with two law clerks apiece. To prevent this, a successful program to increase consents to Magistrate Judges conducting civil trials is needed.

Judge Wilken is a United States District Court Judge for the Northern District of California.

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tially insolvent defendant is an even larger concern in a business case. A judgment against an individual in a personal injury case survives for 10 years, during which time the defendant may get back on his or her feet and ultimately amass attachable assets. An undercapitalized corporate shell with a judgment against it will never again have any assets, and piercing the corporate veil against the principals — assuming they have assets — is difficult and costly. Efficiently litigating the small complex case has no value if the end result is an unenforceable judgment.

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