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Rule 11: Returning the Teeth to the Tiger

A jury awards millions to a plaintiff who was burned by hot coffee. Plaintiffs sue companies for misusing products or failing to properly read directions. Stories such as these have raised the public consciousness of "litigation abuse." As a result of the outcry of small businesses and many industries, the House of Representatives has taken the lead in proposing the "Lawsuit Abuse Reduction Act." The essence of this Act substantially revises Rule 11 of the Federal Rules of Civil Procedure ("F.R.C.P.") and proponents claim that the Act would put teeth back into Rule 11.

Stephen M. Levine

Historical Perspective of Rule 11

Sanctions against lawyers were initially codified in Rule 11 of the F.R.C.P. in 1938. However, many observers felt that there were two key problems with Rule 11 as originally enacted in 1938. First, Rule 11's certification provisions were "not read enough, not demanding enough, and not honored enough." (Arthur R. Miller & Diana G. Culp, *Federal Practice: Litigation Costs, Delay Prompted the New Rule of Civil Procedure*, Nat'l. L. J., Nov. 28, 1983, at 24.)

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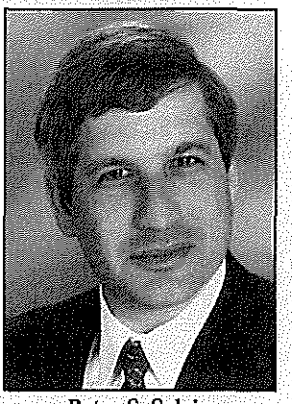
INSIDE

The Sarbanes-Oxley Act: Civil Litigation Implications for Non-U.S. Issuers

The Sarbanes-Oxley Act (SOXA) was enacted by the U.S. Congress in 2002 in response to the corporate scandals surrounding Enron and other well-known U.S. companies. While the primary impetus for the enactment of SOXA was concern about public disclosure and corporate governance in respect to domestic companies, SOXA's requirements also extend to certain non-U.S. companies, including those that have their securities listed on a U.S. securities exchange or traded in Nasdaq.



Peter S. Selvin

Much attention has been paid to the new reporting and auditor independence requirements mandated by SOXA. However, an important emerging issue is whether SOXA will generate additional civil litigation, including shareholder derivative suits, securities litigation based on SOXA, and potential claims that "borrow" from a SOXA violation.

Because of its recent enactment, there have been very few reported judicial decisions interpreting SOXA. There is thus little guidance from the U.S. courts as to the litigation implications of SOXA, much less the extent to which non-U.S. companies may be exposed to litigation risks arising under this statute.

This article explores the application of SOXA to foreign issuers and addresses the civil litigation risks which may be inherent in the statute in respect to companies, foreign or domestic, which are subject to it. As more fully discussed below, SOXA offers a number of opportunities for private litigants to invoke the U.S. courts for the purpose of shareholder litigation. Such a prospect raises the stakes for foreign companies attempting to access the U.S. capital markets.

Application of SOXA to Foreign Issuers

Non-U.S. companies which are subject to SOXA. By its terms, SOXA applies to an "issuer" whose securities are registered under Section 12 of the Securities Exchange Act of 1934 (Exchange Act), or that is required to file reports under Section 15 of the Exchange Act, or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933. SOXA at § 2(a)(7). This definition is sufficiently broad to encompass all non-U.S. companies having securities list-

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gress by Representative Lamar Smith as H.R. 420. The Bill was co-sponsored by over 55 Representatives and was referred to the House Judiciary Committee which referred it to its Subcommittee on Courts, the Internet and Intellectual Propery. When Representative Smith introduced the "Lawsuit Abuse Reduction Act of 2005" he stated that "the filing of frivolous suits by attorneys across the nation has made a mockery of our legal system. Instead of concentrating on real cases that need timely rulings, our courts are forced to wade knee-deep in a pool of false claims and unscrupulous plaintiffs. These suits have increased insurance premiums and raised health care costs.... This measure holds accountable those who abuse our judicial system. It reinstates trust in our legal system."

Key Provisions of H.R. 420

This Bill would (1) reinstate mandatory sanctions for lawyers who file frivolous lawsuits under Rule 11 of the Federal Rules of Civil Procedure; (2) eliminate the current "safe harbor" that gives lawyers 21 days to withdraw suit after a motion for sanctions has been filed; (3) make the new Rule 11 applicable to cases filed in state courts if such cases affect interstate commerce; and (4) make changes relating to jurisdictional and venue for personal injury cases filed in state and federal cases. There is one significant difference between the 2004 legislation and the reintroduced 2005 legislation. The 2004 legislation would have created a "three strikes" for lawyers. Lawyers who have had sanctions three times in the same federal district during the attorney's career would be suspended from practicing for one year after the third time in that court, and the court has discretion to extend the suspension. This provision was extremely controversial and was deleted from the 2005 legislation. This proposed legislation revives the 1983 Rule 11 version. The Bill would also require the courts to award parties prevailing on Rule 11 motions reasonable expenses and attorneys' fees, if warranted. The principal provisions of this Bill are as follows:

- Restore mandatory sanctions for filing frivolous lawsuits in violation of Rule 11 of the Federal Rules of Civil Procedure;
- Restore the opportunity for monetary sanctions, including attorneys' fees and compensatory costs, against any party making a frivolous claim;
- Abolish Rule 11's current safe harbor provision which allows lawyers to avoid sanctions for making frivolous claims by simply withdrawing frivolous claims within 21 days after a motion for sanctions has been filed;
- Restore the opportunity for sanctions for abuses of the discovery process;
- For state cases in all civil proceedings, to conduct an inquiry to determine whether the case may affect interstate commerce; and
- Prevents forum shopping by requiring that personal injury cases be brought only where the plaintiff resides, where the plaintiff was allegedly injured, or where the defendant's principal place of business is located.

The current Rule 11 provision excluding sanctions for discovery violations would be eliminated by this Act. If this Act is passed, practitioners should be aware that sanctions for discovery violations could be sought under both Rule 37 and Rule 11 of the F.R.C.P.

Moreover, for the first time, this new Rule 11 would apply to state cases that the court determines affects interstate com-

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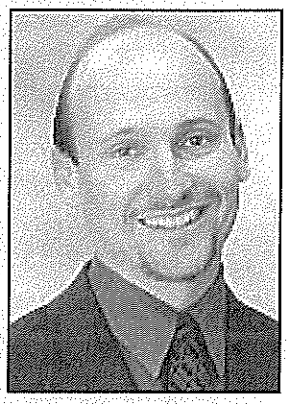
Not So Fast — A Stipulated Reversal of Judgment Belies Its Name

Your client has lost a contentious trial and been hit with a $1.5 million judgment. The case is now on appeal, and before you spend the money on filing an opening brief, you take advantage of the Court of Appeal's mediation program and settle the case. Because one of your client's key requirements was that the judgment be vacated, the settlement is contingent on a stipulated reversal of the judgment. No problem, right? A simple, joint request to the Court of Appeal will secure the stipulated reversal and finally end this unfortunate litigation. Not so fast.



Jens B. Koepke

A recent appellate decision shows how daunting it can be to obtain a stipulated reversal of a judgment, even when all sides want it and when it will remove a case from the appellate court's docket. Parties and their counsel should wisely choose only those types of case well-suited for a stipulated reversal and should take great care to satisfy the statutory prerequisites in seeking the reversal.

Until recently the appellate courts had a laissez-faire attitude toward stipulated reversals. The Supreme Court held that there was a "presumption" that "the parties should be entitled to a stipulated reversal to effectuate settlement absent a showing of extraordinary circumstances that warrant an exception to this general rule." *Neary v. Regents of University of California*, 3 Cal. 4th 273, 277 (1992). But the Legislature disagreed. A 1999 amendment to Section 128 of the Code of Civil Procedure now enshrines essentially a presumption *against* stipulated reversals:

> "An appellate court shall not reverse or vacate a duly entered judgment upon an agreement or stipulation of the parties unless the court finds both of the following:
>
> (A) There is no reasonable possibility that the interests of nonparties or the public will be adversely affected by the reversal.
>
> (B) The reasons of the parties for requesting reversal outweigh the erosion of public trust that may result from the nullification of a judgment and the risk that the availability of stipulated reversal will reduce the incentive for pretrial settlement." (Code Civ. Proc., § 128, subd. (a)(8).)

Recently, in an attorneys' fees dispute between previous and successor attorneys, a court denied the parties' joint motion to reverse a judgment because it did not "affirmatively demonstrate a basis for each of the three findings required to be made by the statute." *Hardisty v. Hinton & Alfert*, 124 Cal. App. 4th 999, 1007 (2004). The court ruled that a nullification of the judgment could adversely affect the public interest and erode the public trust, particularly given the potentially illegal or unethical conduct of the attorney parties: The trial court had found that the successor attorney had falsely represented that he had a written fee agreement, and that one previous attorney was not entitled to attorneys' fees because he had an unwaived conflict of interest.

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(*Id.* at 1003-04.) In addition, the parties failed to describe the extent of pre-trial settlement efforts and whether any unexpected post-trial event only made settlement possible then, and thus parties could not establish that a stipulated reversal would not reduce the incentive for pretrial settlement. (*Id.* at 1012.) The court summed up its concerns this way: The parties "are in effect asking us to ignore the possibility that their purpose is to protect some of them from professional discipline or legal claims." (*Id.*)

The parties' attempt to avoid collateral estoppel and the potential damage to the public interest also underlay the court's rejection of a stipulated reversal in *Muccianti v. Willow Creek Care Center*, 108 Cal. App. 4th 13 (2003). After a jury returned a verdict over $5 million against a nursing home in a wrongful death case, the parties reached a settlement during the appeal and sought a stipulated reversal. (*Id.* at 15.) The court held that the judgment's verification of the nursing home's negligent treatment was "relevant to the public in deciding future placement for its citizens," could be important "in future licensing and/or disciplinary proceedings against the facility," and would impact "the availability and cost of insurance" for the facility — all of which showed that nullifying the judgment would adversely affect the public interest. (*Id.* at 21-22.) In fact, parties should be cautioned that even if they can obtain a stipulated reversal, it may not avoid the possible collateral estoppel effects of the judgment. (*See* Meadow & Olson, *Is It Too Late To Settle? Problems With Settlement After Adjudication*, *ABTL Report* (Feb. 1996).)

By contrast, in *In re Rashad H.*, 78 Cal. App. 4th 376 (2000), the lack of notice to a father of a hearing terminating his parental rights was acknowledged by both sides to be reversible error, which contributed heavily to the court's decision to approve a stipulated reversal. (*Id.* at 381.) Given this "actual judicial error," the public trust would actually be buoyed because the matter could be returned expeditiously (without unnecessary appellate briefing) to the juvenile court for a properly-noticed decision on the merits, and would benefit affected non-parties, namely potential adoptive parents, because it "advance[d] the pace of the decisionmaking process." (*Id.* at 380-381.)

Similarly, a public benefit supported the approval of a stipulated reversal in *Union Bank of California v. Braille Inst. of America, Inc.*, 92 Cal. App. 4th 1324 (2001). The comprehensive settlement of two probate orders on appeal and one pending in the superior court in a dispute between a trustee and the charitable organizations that were the beneficiaries under the trust would benefit the public because it would direct use of charitable moneys away from litigation and into the charities' missions. (*Id.* at 1329.) Also, the fact the agreement also resolved a pending probate petition showed it did not reduce the incentive for pretrial settlement. (*Id.* at 1330.) The court noted that there was no showing of reversible error, but held its absence "is not a bar to the acceptance of a stipulated reversal so long as the appellate court makes the three findings listed in section 128." (*Id.*)

Hence, the type of case where a stipulated reversal will be approved is limited. On one end of the spectrum is a case that only affects the parties, involves clear reversible error and whose early resolution provides a public benefit. This is a prime candidate for stipulated reversal. On the other end of the spectrum is a case whose stipulated reversal would adversely impact the public interest or a specific third party. Indeed, any stipulated reversal that will "cover up" illegal or unethical acts by a party, particularly in a regulated industry, will make a stipulated reversal almost impossible. Since most industries and professions are regulated, this eliminates many cases from qualifying for a stipulated reversal. Your case will likely not fall on the extremes of this spectrum, so careful analysis must be undertaken to decide whether a stipulated reversal is realistically attainable.

In addition, even in an appropriate case, the parties must make a comprehensive showing aimed at establishing that a stipulated reversal satisfies all three conditions in section 128. As *Hardisty* admonishes, "[t]he parties must now submit memoranda of points and authorities and declarations and other documentary evidence persuasively demonstrating that reversal of the judgment in question will not adversely affect nonparties or the public, erode public trust, or reduce the incentive for pretrial settlement." *Hardisty v. Hinton & Alfert, supra*, at 1007. This showing will be much easier if it can be established that the trial court committed clear reversible error.

In fact, the First Appellate District has issued a Local Rule requiring that parties seeking a stipulated reversal submit a joint declaration of counsel that describes the parties and factual and legal issues involved, that indicates what public interests could be affected and what collateral estoppel effects a reversal could have, and if third parties might be prejudiced, that even mandates that they receive notice of the motion. (1st App. Dist., Local Rule 8.) The failure to comply with Rule 8 was another ground for the rejection of a stipulated reversal in *Hardisty v. Hinton & Alfert, supra*, and in another recent First District case, *In re Estate of Regli*, 121 Cal. App. 4th 878 (2004). Even in cases not pending before the First District, Local Rule 8 provides a helpful starting block for counsel to leap over the high hurdles placed before approval of a stipulated reversal.

A stipulated reversal may seem like a convenient and simple way to end unfortunate litigation. But parties and counsel should not be lulled into thinking it will be easy to get the Court of Appeal to sign off on it.

— Jens B. Koepke

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merce. State judges would be required to make the interstate commerce determination within 30 days after a motion for sanctions has been filed. The Act also contains new venue provisions which would allow a plaintiff to sue only where he or she lives or was injured, or where the defendant's principal place of business is located. This is an attempt to eliminate what the Bill's supporters call "judicial hell holes" favoring plaintiffs. Practitioners should note that this provision now eliminates the personal injury plaintiff's ability to choose any United States forum in some cases involving foreign defendants.

Section 5 of this Bill, which provides the Rules of Construction, expressly states that "nothing in" the changes made to Rule 11 "shall be construed to bar and impede the assertion or development of new claims or remedies under Federal, State, or local civil rights law." Civil rights claims are arguably exempted from the Bill's Rule 11 provisions.

Interestingly, this Bill circumvents the Rules Enabling Act (28 U.S.C. §§ 2072-74); by which Congress prescribes the procedure for the formulation and adoption of rules of evidence, practice and procedure for federal courts. This specified procedure contemplates a four step process. First, that initially evidentiary and procedural rules will be considered and drafted by committees of the United States Judicial Conference. Second, that the proposed rules will be subject to thorough public comment and reconsideration. Third, that the proposed changes will then be submitted to the U.S. Supreme Court for consideration and promulgation and fourth, that the proposed changes will finally be submitted to

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