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RECOVERY OF ATTORNEYS' FEES UNDER RULE 10b-5

I. Introduction

Rule 10b-5¹ is the most litigated provision of the federal securities laws.² Since its informal beginnings in 1942,³ the rule has become an important means of enforcement for the broad anti-fraud provisions of the Securities Exchange Act of 1934.⁴ Basically, the goal of the rule is to prevent persons with access to information not generally known from exploiting less informed persons in securities transactions. The rule attempts to achieve this objective by requiring that all parties to a securities transaction fully and completely disclose to one another all material facts relevant to the transaction.⁵

A person who seeks redress under rule 10b-5 must bear in mind, however, that the American legal system traditionally has denied a successful litigant an award of attorneys' fees. This so-called "American Rule of attorneys' fees"⁶ basically holds that in the absence of contrary statutory authority, a litigant must, with few exceptions,⁷ bear the single greatest cost of asserting his legal rights—the attorneys' fees—regardless of the outcome of the action.⁸

Although the American Rule applies to all varieties of litigation, it presents a special problem for the successful 10b-5 litigant: in actions under rule 10b-5, the attorneys' fees may well exceed the damages recovered.⁹ Thus, the net effect of applying the American Rule to 10b-5 litigation is that the successful litigant may win a legal victory but suffer a financial defeat.

1 17 C.F.R. § 240.10b-5 (1975). The rule states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

2 Jacobs, *Birnbaum in Flux: Significant 10b-5 Developments*, 7 SECURITIES L. REV. 403 (1975).

3 Then-SEC Staff Attorney Milton Freeman drafted the rule in response to a report that he had received concerning a corporation president who was buying out his fellow shareholders' stock by falsely telling them that the company was doing poorly. When the draft was presented to the Commission, all of the commissioners read the rule and tossed it on the table, indicating approval. No one said anything except Sumner Pike, who said, "Well, we are against fraud aren't we?" Conference on Codification of the Federal Securities Laws, 22 BUS. LAW 893, 922 (1967).

4 Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1970) [hereinafter cited as the 1934 Act.]

5 This is a broad statement of the purposes of rule 10b-5. The purposes of the rule will be discussed more fully later in this note, but for an extensive treatment of the development and purposes of rule 10b-5, see BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10b-5 (1971).

6 The American Rule of Attorneys' Fees hereinafter cited as the American Rule.

7 The traditional exceptions to the American Rule are the bad faith of a party, the creation of a common benefit by the plaintiff, and the private attorney general theory. The first two of these exceptions will be discussed at length later in this note.

8 MCCORMICK, HANDBOOK ON THE LAW OF DAMAGES § 60 (1935).

9 See, e.g., *Straub v. Vaisman & Co.*, 540 F.2d 591 (3d Cir. 1976), in which the damages awarded the plaintiffs totalled \$38,875.00 and the amount of attorneys' fees was \$47,808.42. *Id.* at 594-95. The *Straub* case is discussed in the text accompanying notes 143-82 *infra*.

This note suggests that this inequity should be remedied by expanding the traditionally accepted and judicially fashioned "bad faith" and "common benefit" exceptions to the American Rule to allow successful litigants in 10b-5 actions to recover reasonable attorneys' fees unless special circumstances of the case would render such an award unjust.¹⁰ To perceive fully the status of the present law with regard to both the American Rule and rule 10b-5, however, it is first necessary to examine the development of each with regard to its historical context and underlying rationale.

II. Background and Development

A. *Development of Rule 10b-5*

The dominant congressional purposes behind passage of the Securities Exchange Act of 1934 were the promotion of free and open public securities markets and the protection of the investing public from inequities in securities trading.¹¹ Section 10(b) of the 1934 Act was designed by Congress as a "catch-all." It authorized the Securities and Exchange Commission (SEC) to issue rules and regulations necessary to prevent fraudulent and deceptive devices and contrivances in securities transactions.¹² Section 10(b) was not intended to have a narrow scope, but rather a broad, remedial interpretation.¹³ Rule 10b-5, promulgated pursuant to this congressional authorization, makes unlawful any deceptive or manipulative practice detrimental to the interests of investors.¹⁴ The rule does not specify particular practices that constitute fraud. Rather, it was designed to encompass the "infinite variety of devices by which undue advantage may be taken of investors and others."¹⁵

1. Expansion of Rule 10b-5

Neither rule 10b-5 nor § 10(b) of the 1934 Act expressly provides for civil liability, and therefore neither expressly defines nor delimits the scope of relief available to private litigants who seek redress for damages allegedly caused by violations thereof. Thus, actions under rule 10b-5 were originally brought only by the SEC. The federal courts soon began to hold, however, that the rule gave rise to private civil liability as well,¹⁶ although it was not until 1971 that

10 This language is discussed in *Newman v. Piggie Park Enterprises, Inc.*, 390 U.S. 400, 402 (1968). See note 198 *infra*.

11 SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 858 (2d Cir. 1968).

12 3 LOSS, SECURITIES REGULATION 1424 n.7 (2d ed. 1961).

13 Pitt, *The Long Arm of Securities Exchange Act Rule 10b-5, FRAUD, INSIDE INFORMATION, AND FIDUCIARY DUTY UNDER RULE 10b-5*, 64 (1976).

14 The rule was designed to prevent frauds not covered by § 17 of the Securities Act of 1933, 15 U.S.C. § 77q (1970). § 17 requires a seller of securities to disclose material information to any buyer of his securities; it does not, however, require the buyer to make any disclosure to his seller. Thus, prior to the promulgation of rule 10b-5 there was no statutory liability imposed on a buyer for failure to disclose the same type of information that the seller was required to disclose to the buyer. See Sargent, *The Development of Rule 10b-5, EMERGING FEDERAL SECURITIES LAW: POTENTIAL LIABILITY* 1-6 (1961).

15 *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961).

16 *Kardon v. National Gypsum Co.*, 69 F. Supp 512 (E.D. Pa. 1946), which involved a seller of securities, was the first case to recognize a private action under rule 10b-5. In *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951), a buyer of securities was held to have a cause of action under rule 10b-5.

the Supreme Court gave its official approval to private actions under rule 10b-5.¹⁷

In addition, the Supreme Court, in *J. I. Case Co. v. Borak*,¹⁸ made it clear that the federal courts should fashion liability to further the purposes of the 1934 Act. The Court stated:

[I]t is the duty of the courts to provide such remedies as are necessary to make effective the Congressional purpose. . . . [W]here legal rights have been invaded, and a federal statute provides for a general right to sue for such invasion, federal courts may use any available remedy to make good the wrong done.¹⁹

The Court's policy statement has since been extended by the lower courts to rule 10b-5 violations.²⁰

Thus, as a result of the liberal predisposition of the federal courts to grant relief under rule 10b-5, the rule quickly came to the forefront of federal securities regulation. The early trend was clearly in the direction of expansion of liability under rule 10b-5 as the use of the rule for private civil action increased.²¹

In an attempt to limit liability under the broad language of rule 10b-5 and thereby slow the rate of expansion of private actions under the rule, courts have applied the common law fraud doctrines of scienter, reliance, justifiable reliance, and materiality as requirements for recovery,²² even though none of these qualifications are specifically required by it. In addition, the courts have required that the plaintiff fall within the category of either "purchaser" or "seller" of securities to claim protection under the rule.²³ Application of these doctrines was intended to provide a balance between extending greater protection to the investing public and discouraging champerty²⁴ and strike suits.²⁵ Without gui-

17 *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971).

18 377 U.S. 426 (1964). The case involved a violation of federal proxy regulations and was brought under § 14 of the 1934 Act.

19 *Id.* at 433.

20 See *A. T. Bond & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967); *Polakoff v. Delaware Steeplechase & Race Ass'n.*, 254 F. Supp. 574 (D. Del. 1966).

21 For a discussion of the expansion of 10b-5 liability, see Soloman & Wilke, *Securities Professionals and Rule 10b-5: Legal Standards, Industry Practices, Preventative Guidelines and Proposals for Reform*, 43 *FORD. L. REV.* 505 (1975).

22 Campbell, *Elements of Recovery Under Rule 10b-5: Scienter, Reliance, and Plaintiff's Reasonable Conduct Requirement*, 26 *S. CAR. L. REV.* 653 (1975). The language of rule 10b-5 resembles the tort action of deceit. At common law, the elements of the action for deceit are: 1) a false representation made by the defendant. In the ordinary case, this must be a misrepresentation of fact;

2) knowledge or belief on the part of the defendant that the representation is false, or that he does not have a sufficient basis of information to make it. This element is given the technical name of "scienter;"

3) an intention to induce the plaintiff to act or to refrain from action in reliance upon the misrepresentation;

4) justifiable reliance upon the representation by the plaintiff; and

5) damage to the plaintiff as the result of his reliance. W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* 685 (4th ed. 1971).

23 *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied* 343 U.S. 956 (1952). The now famous "Birnbaum Doctrine" specifically limits the private litigants who may bring a 10b-5 action to individuals who have actually bought or sold the securities on which the claim of fraud is based.

24 Champerty involves an agreement whereby a person without an interest in another's law suit undertakes to carry it on at his own expense in consideration of receiving, if successful, part of the proceeds of the litigation.

25 A strike suit is an action brought solely in the hope of winning a large attorneys' fee or private settlement and without an intention of benefitting the corporation or class on behalf of which the action was theoretically brought.

dance from the Supreme Court, however, none of these requirements were uniformly applied in the lower courts, and the result was a continuing expansion in the number of private civil actions brought under the rule.

Until recently,²⁶ the Supreme Court allowed the lower courts to adopt what can basically be termed a case-by-case approach to 10b-5 litigation. Notwithstanding conflicts among the lower courts on the extent of liability under rule 10b-5, the Supreme Court generally declined to intervene. Moreover, to the extent certiorari was granted, there was no consistent pattern. Thus, the only generalization possible with regard to this early period of 10b-5 development is that the securities laws, as remedial legislation, were to be construed flexibly and liberally. The result of the Supreme Court's noninvolvement was a generally liberal tendency to grant relief in the federal courts in 10b-5 cases.²⁷

2. Contraction of Liability Under Rule 10b-5

Nearly everything that has been written during the expansionary period of 10b-5 liability, however, will now have to be reconsidered in light of a new and more restrictive trend of judicial interpretation evidenced by recent decisions of the Supreme Court.²⁸ The Court has made it apparent that it intends to assume a more active role in fashioning and limiting the development of the federal securities laws in general and rule 10b-5 in particular.²⁹ As a result of this new trend, a 10b-5 litigant can expect to encounter greater difficulties in establishing his case in court.³⁰ The result may well be an incurrence by the litigant of greater attorneys' fees due to the heavier burden on the plaintiff and his attorney to present evidence sufficient to sustain a cause of action within the newly contracted sphere of 10b-5 liability. This would serve only to compound the problem that faces the potential 10b-5 litigant, who currently stands a good chance of encountering a net financial loss even if successful in his 10b-5 suit.³¹

B. *Development of the American Rule*

The underlying reason for the existence of this inequitable situation is the adherence by the federal courts to the American Rule on the award of attorneys' fees. Legal commentators have in recent years expressed both amazement and disappointment at the American system's continuing adherence to the Rule, despite both its nearly unique status in the jurisprudential world³² and the

26 Prior to the period of June 9, 1975 through March 30, 1976. See BLOOMENTHAL, *Introductory Survey*, 8 SECURITIES L. REV. xi, xii-xiv (1976).

27 *Id.* at xiii.

28 See text accompanying note 26 *supra*. During this period the Court decided *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), which involved the seller-purchaser requirement under rule 10b-5, and *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), which involved the requirement of scienter under the rule. These cases will be discussed more fully later in this note.

29 See BLOOMENTHAL, *supra* note 26, at xii.

30 See notes 78-99 *infra*.

31 See note 9 *supra*.

32 See Ehrenzweig, *Reimbursement of Counsel Fees and the Great Society*, 54 CALIF. L. REV. 792 (1966).

voluminous collected evidence of its inequities and shortcomings.³³

1. Historical Justification

The American Rule of attorneys' fees directly contrasts with the English Rule, which taxes all costs, including attorneys' fees, to the losing litigant.³⁴ In early colonial America, most courts adopted the English Rule and awarded attorneys' fees to the prevailing litigant in actions at law. Subsequent statutes, however, limited these awards to specific maximum amounts. In addition, these early courts and statutes did not adopt the theoretical goal of the English system—to compensate fully the wronged party. As a result, the fees allowed by the early courts and statutes were never increased to keep pace with the continual increases in the cost of living. Furthermore, the new states that joined the Union rarely provided for attorneys' fees to be taxed as costs and in no case made the award adequate. Thus, the English practice of allowing fee awards to a prevailing litigant, a clearly available option in colonial America, was rejected by the legal establishment of the new United States.³⁵

There is disagreement concerning why the American states adopted a different rule. One suggestion is that the difference is due largely to an historical accident.³⁶ This view suggests that because the awards fixed by statute were unrealistically low, lawyers and courts gradually disregarded them. Another explanation for the English Rule's rejection is that frontier settlers soon developed attitudes of hostility and distrust towards legal practitioners.³⁷ This distrust of the American bar was fostered by a belief that the law was composed of simple rules easily comprehensible by everyone and that a lawyer therefore was not necessary to vindicate one's rights. Underlying both of these reasons, however, was the frontier experience that engendered an individualistic spirit in the pioneers of early America.³⁸ The popular view of the solitary pioneer dependent on his own ability to achieve justice and preserve his rights played a substantial role in the emergence of the unique American Rule.³⁹

In 1796 the Supreme Court made its first ruling on attorneys' fees.⁴⁰ The Court held that the judiciary itself would not create a general rule, independent of statute, that would allow awards of attorneys' fees in federal courts. Although the Court admitted that its decision was not completely satisfactory, it rejected

33 See, e.g., Goodhart, *Costs* 38 YALE L.J. 849 (1929); Kuenzel, *The Attorney's Fee: Why Not a Cost of Litigation?*, 49 IOWA L. REV. 75 (1963); Stoebuck, *Counsel Fees Included in Costs: A Logical Development*, 38 U. COLO. L. REV. 202 (1966); Ehrenzweig, *Reimbursement of Counsel Fees and the Great Society*, 54 CALIF. L. REV. 792 (1966); Note, *Attorney's Fees: Where Shall the Ultimate Burden Lie?*, 20 VAND. L. REV. 1216 (1967); Comment, *Court Awarded Attorney's Fees and Equal Access to the Courts*, 122 U. PA. L. REV. 636 (1974).

34 See Note, *Attorney's Fees: Where Shall the Ultimate Burden Lie?*, 20 VAND. L. REV. 1216 (1967).

35 See *Alyeska Pipeline Co. v. Wilderness Society*, 421 U.S. 240, 247-68 (1975); Comment, *Court Awarded Attorney's Fees and Equal Access to the Courts*, 122 U. PA. L. REV. 636 (1974); Note, *Attorney's Fees: Where Shall the Ultimate Burden Lie?*, 20 VAND. L. REV. 1216 (1967).

36 See note 32 *supra*.

37 See note 35 *supra*.

38 See R. POUND, *THE SPIRIT OF THE COMMON LAW* (1921).

39 *Id.*

40 *Aracambel v. Wiseman*, 3 U.S. (3 Dall.) 306 (1796).

the inclusion of attorneys' fees as recoverable damages. The Court stated that "[t]he general practice of the United States is in opposition [*sic*] to it; and even if that practice were not strictly correct in principle, it is entitled to the respect of the court."⁴¹ The Supreme Court has continued to adhere to that early holding.⁴²

2. Exceptions to the American Rule

Although the American Rule is now an established doctrine, it is not without exceptions,⁴³ and the Supreme Court has in recent years addressed these exceptions in an attempt to clarify this confused and inconsistent area of the law. Basically, the exceptions are grounded upon either statutory provisions that permit the court to award attorneys' fees⁴⁴ or the court's inherent equity power.⁴⁵

a. *Bad Faith*

One major area in which the federal courts have exercised their equity power to award attorneys' fees is in cases that involve bad faith by one of the parties litigant.⁴⁶ Two aspects of the bad faith exception control its application—the type of conduct involved and the timing of the bad faith in relation to the litigation.

With regard to the type of wrongful conduct deemed sufficient to justify application of the bad faith exception, the federal courts, as a result of the prevailing American Rule, have been restrictive in their allowance of attorneys' fee awards. Thus, there is no award except "in exceptional cases and for dominating reasons of justice."⁴⁷ The Supreme Court, in *F. D. Rich Co. v. Industrial Lumber Co.*,⁴⁸ allowed the use of the exception because the defendant had acted "in bad faith, vexatiously, wantonly, or for oppressive reasons."⁴⁹ In such cases, the award of attorneys' fees is both punishment to the wrongdoer and just compensation to the successful party who has been forced to expend funds unnecessarily.

The timing of the bad faith conduct has also been interpreted restrictively.⁵⁰

41 *Id.* at 306.

42 *See, e.g.,* *Fleischman Distilling Corp. v. Maier Brewing Co.*, 386 U.S. 714 (1967); *Stewart v. Sonneborn*, 98 U.S. 187 (1879); *Oelrichs v. Spain*, 82 U.S. (15 Wall.) 211 (1872); *Day v. Woodworth*, 54 U.S. (13 How.) 363 (1852).

43 *See* note 7 *supra*.

44 *See* *Alyeska Pipeline Co. v. Wilderness Society*, 421 U.S. at 260 n.33, at which the statutes are compiled.

45 Note, *Attorney's Fees: Where Shall the Ultimate Burden Lie?*, 20 VAND. L. REV. 1216 (1967); *see also* *Guardian Trust Co. v. Kansas City So. Ry. Co.*, 28 F.2d 233, 240-41 (8th Cir. 1928), where authorities are compiled.

46 For a discussion of the bad faith exception to the American Rule, *see generally* Comment, 52 NOTRE DAME LAW. 572 (1977).

47 *Sprague v. Ticonic Nat'l Bank*, 307 U.S. 161, 167 (1939). *See also* *Fleischman Distilling Corp. v. Maier Brewing Co.*, 386 U.S. 714, 718 (1967) (overriding considerations of justice).

48 417 U.S. 116 (1973).

49 *Id.* at 129. *See generally* 6 MOORE, FEDERAL PRACTICE, ¶ 54.77[2] (2d ed. 1972). Courts have authorized the shifting of attorneys' fees when a party has acted wrongfully even though his duties under the law were explicit, *Vaughan v. Atkinson*, 369 U.S. 527, 530-31 (1961); when he has put his opponent to unnecessary expense, *Fed. R. Civ. P. 37(c)*; and when he has caused unnecessary delay, harassment, or engaged in unfounded litigation, *Annot.*, 8 L. Ed. 894, 912-13 (1962).

50 *See* *Universal Oil Co. v. Root Ref. Co.*, 388 U.S. 575, 580 (1946).

The general rule is that the wrongful acts must occur during the course of the litigation itself.⁵¹ The Supreme Court indicated in *Hall v. Cole*,⁵² however, that it may be appropriate to consider pre-litigation bad faith as a basis for an award of fees. In this context, the *Hall* Court stated, "It is clear, however, that 'bad faith' may be found, not only in the actions that led to the lawsuit, but also in the conduct of the litigation."⁵³ The lower federal courts have also allowed an award of attorneys' fees based on pre-litigation bad faith.⁵⁴

b. *Common Benefit*

A second major area in which courts exercise their equity power to award attorneys' fees is in cases that involve a common fund or benefit. The award in these cases is theoretically made to avoid unjust enrichment of a class of potential plaintiffs at the expense of an individual litigant who has protected or created a fund or benefit in which all are entitled to share.⁵⁵ The fee itself is thus paid out of the common fund.

The Supreme Court expanded this judicially created exception to the American Rule in *Mills v. Electric Auto-Lite Co.*⁵⁶ In *Mills*, shareholders of Auto-Lite sued their company to set aside a merger on the grounds that the management of the company had violated § 14(a) of the 1934 Act⁵⁷ and SEC rule 14a-9⁵⁸ by the use of a false proxy statement. The Court ruled that the proxy statement was indeed materially misleading and remanded to the district court for consideration of the proper relief. The Court then turned its attention to the plaintiffs' request for an interim award of attorneys' fees. Although all that had been decided was the causation issue and no damages had as yet been awarded or any monetary fund created, the Court ordered the defendant corporation to pay the attorneys' fees incurred by the plaintiffs. The Supreme Court held that "fair and informed corporate suffrage" was a benefit produced by the suit sufficient to justify the award of fees out of corporate assets where the

51 6 MOORE, FEDERAL PRACTICE, ¶54.77[2] (2d ed. 1972).

52 412 U.S. 1 (1973). The case involved a consideration of the propriety of an award of attorneys' fees to a successful plaintiff union member who had been expelled from his union for introducing a set of resolutions which cited various instances of alleged short-sighted policies on the part of union officers. His suit under section 102 of the Labor-Management Reporting and Disclosure Act, 29 U.S.C. § 412 (1970), vindicated his rights of free speech as well as the interests of the union and its members. The Supreme Court discussed the "bad faith" rationale with regard to the district court's denial of punitive damages and award of attorneys' fees. *Id.* at 15. In addition, courts have awarded attorneys' fees simply on the ground that the party has acted in bad faith, *Bell v. School Bd. of Powhatan County*, 321 F.2d 494, 500 (4th Cir. 1963).

53 *Id.* at 15. See also *Bond v. Stanton*, 528 F.2d 688 (7th Cir. 1976), citing *Hall v. Cole* in support of pre-litigation bad faith as sufficient to justify fee-shifting. In addition, the Court in *Vaughan v. Atkinson*, 369 U.S. 527 (1962), upheld assessment of attorneys' fees against the losing party based on pre-litigation bad faith. *Vaughan*, however, was a case in admiralty, which generally allows fee-shifting on a finding of bad faith. *The Appollon*, 22 U.S. (9 Wheat.) 362 (1824).

54 See notes 154-55 *infra*.

55 The classic case espousing the traditional common fund rationale is *Trustees v. Greenough*, 105 U.S. 527 (1882).

56 396 U.S. 375 (1970).

57 15 U.S.C. § 78 n(a) (1970).

58 17 C.F.R. § 240.14a-9 (1970).

benefit extended to all the shareholders.⁵⁹ The benefit, in the Court's view, was the furtherance of the goals of the securities statute under which the suit was brought.

The *Mills* exception to the American Rule is therefore more aptly described as a "substantial benefit" rather than a "common fund." The Supreme Court defended its endorsement of an expansion of the common benefit exception to include an award of attorneys' fees even when no technical fund was created as follows:

Nevertheless, the stress placed by Congress on the importance of fair and informed corporate sufferage leads to the conclusion that, in vindicating the statutory policy, petitioners have rendered a substantial service to the corporation and its shareholders. . . . [P]rivate stockholders' actions of this sort 'involve corporate therapeutics,' and furnish a benefit to all shareholders by providing an important means of enforcement of the proxy statute.⁶⁰

Thus, the "benefit" was essentially defined as the vindication of congressional policy. The Supreme Court in *Mills* legitimized a stockholders' suit attorneys' fee exception based solely on law enforcement policy considerations.⁶¹ The broad language used by the *Mills* Court to justify its new standard was immediately endorsed by the lower federal courts.⁶²

3. *Alyeska Pipeline Co. v. Wilderness Society*

Five years after *Mills* was decided, the Supreme Court, in *Alyeska Pipeline Co. v. Wilderness Society*,⁶³ met the American Rule head-on in an effort to clarify the availability of attorneys' fee awards to prevailing litigants in the federal courts. Although the Court's decision was a significant step toward clarification, it also restricted the use of such awards and thus abruptly curtailed the lower courts' discretionary power to award attorneys' fees. The *Alyeska* Court dealt with the American Rule in general terms, however, and did not specifically address the Rule in relation to securities law litigation.

Alyeska involved an attempt by the Wilderness Society to prevent the

⁵⁹ For a detailed discussion of the substantial benefit exception as elaborated by the Supreme Court in *Mills*, see Note, *The Allocation of Attorneys' Fees After Mills v. Electric Auto-Lite Co.*, 38 U. CHI. L. REV. 316 (1971).

⁶⁰ 396 U.S. at 396. The term "corporate therapeutics" derives from Hornstein, *Legal Therapeutics: The "Salvage" Factor in Counsel Fee Awards*, 69 HARV. L. REV. 658 (1956).

⁶¹ The actual holding of the Court on the issue of attorneys' fees is: "[P]etitioners, who have established a violation of the securities laws by their corporation and its officials, should be reimbursed by the corporation or its survivor for the costs of establishing the violation." 396 U.S. at 389-90. This holding was in response to the *amicus curiae* brief of the United States, which had asserted that in cases that involve "corporate therapeutics" the absence of express statutory authority should be no bar to an award of attorneys' fees. See note 59 *supra*. In *Hall v. Cole*, 412 U.S. 1 (1973), the Supreme Court reaffirmed the benefit approach used in *Mills*. The Court found fee-shifting justified both as a way to enhance the protection of statutory rights, *id.* at 13, and because the benefitted class would have had to pay for the attorneys' fees had it brought the suit. *Id.* at 9. See generally Comment, 17 WAYNE L. REV. 205 (1971).

⁶² See, e.g., *Kahan v. Rosenstiel*, 424 F.2d 161 (3d Cir.), *cert. denied*, 398 U.S. 950 (1970), which extended to private actions under rule 10b-5 the Supreme Court's broad endorsement of attorneys' fees awards as a supplement to enforcement of the federal securities laws.

⁶³ 421 U.S. 240 (1975).

federal government from issuing the permits necessary for the construction of the trans-Alaska oil pipeline. The attempt failed, but the Court of Appeals for the District of Columbia Circuit held that an award of attorneys' fees was appropriate under the private attorney general exception to the American Rule. The private attorney general exception states that attorneys' fees may be recovered by a prevailing plaintiff who has acted as a "private attorney general" in vindicating important statutory rights of all citizens by bringing litigation which effectuates strong congressional policy. The Supreme Court reversed the award of attorneys' fees and thus halted reliance upon the private attorney general theory as grounds for assessing attorneys' fees against the losing party of a lawsuit.

In *Alyeska*, the Court reviewed at length the history and development of the American Rule.⁶⁴ Based on its evaluation of congressional intent, statutory provisions, and policy considerations, the Court determined that the plaintiff environmental organizations were not entitled to an award of attorneys' fees under the private attorney general doctrine.⁶⁵ Although the Court dispensed with the private attorney general theory, however, it left intact the traditional judicially created exceptions of common benefit⁶⁶ and bad faith.⁶⁷ In discussing the continuing viability of these exceptions to the general rule, the Court stated, "These exceptions are unquestionably assertions of inherent power in the courts to allow attorneys' fees in particular situations, unless *forbidden* by Congress."⁶⁸ The Court found that Congress had not repudiated these exceptions⁶⁹ and that the Court was therefore free to uphold them.

With regard to the bad faith exception, the Supreme Court in *Alyeska* again indicated that pre-litigation bad faith⁷⁰ may justify an award of attorneys' fees. The Court referred to *F. D. Rich Co. v. Industrial Lumber Co.*⁷¹ in discussing the requirements of the bad faith exception. An explanatory footnote cites, in addition to the admiralty case of *Vaughan v. Atkinson*,⁷² three circuit court nonadmiralty cases in which attorneys' fees also were awarded for pre-litigation bad faith.⁷³ It seems, therefore, that the *Vaughan* standard concerning pre-litigation bad faith is not restricted to admiralty cases and remains intact after *Alyeska*. By citing the *Rich* decision to demonstrate the existence and

64 See text accompanying note 35 *supra*.

65 In discussing the private attorney general theory, the Court was forced to consider the effect of this exception on 28 U.S.C. § 2412, which expressly excludes an award of "the fees and expenses of attorneys" in any civil action brought for or against the United States. Faced with this express manifestation of congressional intent, the Court reasoned that federal courts could not award attorneys' fees beyond the limits of 28 U.S.C. § 2412, nor should the courts "purport to adopt on their own initiative a rule awarding attorneys' fees based on the private-attorney-general approach when such judicial rule will operate only against private parties and not against the government." 421 U.S. at 269.

66 421 U.S. at 257-58. The Court cited, *inter alia*, *Mills v. Electric Auto-Lite Co.*, in support of the common benefit exception.

67 The Court stated that an award was justified when a losing party acted "in bad faith, vexatiously, wantonly, or for oppressive reasons." 421 U.S. at 258-59.

68 *Id.* at 259 (emphasis supplied).

69 *Id.* at 269.

70 See text accompanying notes 50-53 *supra*.

71 417 U.S. 116 (1973).

72 369 U.S. 527 (1962).

73 *McEntegart v. Cataldo*, 451 F.2d 1109 (1st Cir. 1971); *Bell v. School Bd. of Powhatan County*, 321 F.2d 494 (4th Cir. 1963); *Rolax v. Atlantic Coast Line R. Co.*, 186 F.2d 473 (4th Cir. 1951).

limitations of the bad faith exception, the Supreme Court in *Alyeska* implicitly incorporated within that exception the *Rich* decision's endorsement of *Vaughan* and the other pre-litigation bad faith cases. Thus, pre-litigation bad faith may be held sufficient to allow an award of attorneys' fees.⁷⁴

Ultimately, then, the Supreme Court did in fact uphold the American Rule in the *Alyeska* case, but its endorsement was moderate at best. In the concluding paragraph of the majority opinion, the Court commented that it was not assessing the merits of the American Rule; rather, the Court stated that notwithstanding that private action to implement public policy is desirable in various circumstances, the Rule had survived.⁷⁵

C. *The Supreme Court and Rule 10b-5*

1. *Blue Chip Stamps v. Manor Drug Stores*

The predisposition of the Supreme Court toward restrictive interpretation of liability under rule 10b-5 was not limited to consideration of attorneys' fees awards. Less than a month⁷⁶ after *Alyeska*, the Supreme Court reached another trend-setting decision. In this instance it was the trend of generally expanding liability under rule 10b-5 that was evaluated by the Court.⁷⁷ That trend seemed to come to an abrupt halt in *Blue Chip Stamps v. Manor Drug Stores*,⁷⁸ in which the Supreme Court reaffirmed the relatively restrictive standing requirement⁷⁹ espoused in *Birnbaum v. Newport Steel Corp.*⁸⁰ This standing requirement, which had fallen victim in some circuits to the general trend toward liberalization,⁸¹ was given an official blessing by the *Blue Chip Stamps* Court.

The case involved a reorganization and a merger of the Blue Chip Stamps Co. ("Old Blue Chip") into a new corporation ("New Blue Chip") as the

⁷⁴ See also *Skehan v. Bd. of Trustees*, 538 F.2d 53, 57-8 (3d Cir. 1976), for a discussion of pre-litigation bad faith in light of *Alyeska*. The case involved an untenured teacher who brought a civil rights suit against a state college. The Third Circuit held that the teacher was not entitled to an award of attorneys' fees under the private attorney general theory. The court remanded the case to the district court, however, for a determination of whether attorneys' fees should be taxed against the college on the basis of obduracy in maintaining a defense to the teacher's suit. The obduracy issue had not been previously considered by the district court.

⁷⁵ 421 U.S. at 270-71. The Court stated:

We do not purport to assess the merits or demerits of the "American Rule". . . . It has been criticized in recent years, and courts have been urged to find exceptions to it. It is also apparent from our national experience that the encouragement of private action to implement public policy has been viewed as desirable in a variety of circumstances. But the rule followed in our courts with respect to attorneys' fees has survived.

The Court went on to intimate that it was the sweeping potential of the private attorney general theory to engulf the general Rule completely that was objectionable in this case. It concluded its opinion by stating, "It is not for us to invade the legislature's province by redistributing litigation costs in the manner suggested by the respondents and followed by the Court of Appeals." *Id.* at 271.

⁷⁶ *Alyeska Pipeline Co. v. Wilderness Society* was decided on May 12, 1975; *Blue Chip Stamps v. Manor Drug Stores* was decided on June 9, 1975.

⁷⁷ See text accompanying notes 12-27 *supra*.

⁷⁸ 421 U.S. 723 (1975).

⁷⁹ See note 23 *supra*.

⁸⁰ 193 F.2d 461 (2d Cir.) cert. denied, 343 U.S. 956 (1952).

⁸¹ See Note, *Standing to Sue in 10b-5 Actions: Eason v. GMAC and Its Impact on the Birnbaum Doctrine*, 49 NOTRE DAME LAW. 1131 (1974).

result of a civil antitrust action brought by the United States against Old Blue Chip, a corporation engaged in the business of providing trading stamps to retailers. Under the merger plan, New Blue Chip was required to offer a substantial number of its shares of common stock to retailers who had used the stamp service in the past but who had not been shareholders in Old Blue Chip. Two years after the reorganization and merger, the plaintiff retailer, an original offeree, brought an action in which he alleged that the defendant New Blue Chip had violated rule 10b-5 by offering a prospectus that constituted an intentionally overly pessimistic appraisal of New Blue Chip's status and future prospects. The plaintiff further alleged that this had been done to discourage him from accepting what turned out to be a bargain offer in order that New Blue Chip could later sell the shares to the public at an inflated price. The plaintiff alleged that as a result of these statements, he had declined to purchase any of the shares. The Court held that because he was not an actual buyer or seller of securities, but merely an offeree, the plaintiff did not have standing to assert a 10b-5 violation. This decision was a first step by the Court toward curbing the growth of rule 10b-5, which the Court described as the "judicial oak which has grown from little more than a legislative acorn."⁸²

In *Blue Chip Stamps*, the Court discussed the factors it considered important in its decision to depart from its previously held position that rule 10b-5 should be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes."⁸³ The Court determined that litigation under rule 10b-5 "presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."⁸⁴ The *Birnbaum* purchaser-seller doctrine, it concluded, helps to lessen the danger of strike suits by those who have never been involved at all in the corporation.⁸⁵ According to the Court, "[T]he inexorable broadening of the class of plaintiff who may sue in this area of the law will ultimately result in more harm than good."⁸⁶ Thus, in the Court's view, a restrictive standing requirement was justified.

To emphasize its new approach to rule 10b-5, the Court stated further: "[W]e are not dealing here with any private right created by the express language of § 10(b) or of Rule 10b-5. . . . We are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited."⁸⁷ The Court thus greatly restricted the class of persons who would be allowed to assert a violation of Securities rule 10b-5.

82 421 U.S. at 737.

83 *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972).

84 421 U.S. at 739.

85 *Id.*

86 *Id.* at 747-48. In support of its position, the Court cited *Ultramares Corp. v. Touche*, 174 N.E. 441 (1931), in which Chief Judge Cardozo espoused the dangers with respect to "a liability in an indeterminate amount for an indeterminate time to an indeterminate class." 174 N.E. at 444. The case involved an action for damages by a third party investor who had relied on an inaccurate balance sheet prepared and certified as correct by the defendant accountants. The court held that the public accountants were not liable for negligence to creditors and investors to whom their employer showed the certificate, but that they would be liable to such third parties for intentional or reckless misrepresentations.

87 421 U.S. at 748-49.

2. *Ernst & Ernst v. Hochfelder*

Less than a year later,⁸⁸ in *Ernst & Ernst v. Hochfelder*,⁸⁹ the Supreme Court again had occasion to consider liability under rule 10b-5, this time in relation to the requirement of scienter⁹⁰ necessary to sustain a cause of action. The case involved customers of a brokerage firm who invested in a fraudulent securities scheme. The customers brought an action against the defendant accounting firm which had undertaken an audit of the brokerage firm's books. The claim, based on a theory of negligent nonfeasance, was that the defendant had failed to utilize appropriate auditing procedures and had thereby failed to discover the fraudulent scheme. The holding of *Hochfelder* was as succinct as it was significant: "We granted certiorari to resolve the question whether a private cause of action for damages will lie under section 10(b) and Rule 10b-5 in the absence of any allegation of "scienter"—intent to deceive, manipulate, or defraud. . . . We conclude that it will not."⁹¹

Scienter refers to an "intent to deceive, to mislead, to convey a false impression . . . [Such] intent must be a matter of belief, or absence of belief, that the representation is true."⁹² Although the word *scienter* is not included in the language of rule 10b-5, the courts have held that a requirement of scienter follows from the similarity of 10b-5 to common law fraud.⁹³ A controversy arose in the lower courts, however, with regard to whether negligence was sufficiently wrongful conduct to constitute a violation of the rule.⁹⁴ The *Hochfelder* decision settled this conflict with its definitive holding that a 10b-5 action must be based on some element of *scienter* and cannot be based on negligent conduct alone.⁹⁵ As in *Blue Chip Stamps*,⁹⁶ the Court relied on the wording and legislative intent of the statute to support its holding. According to the Court, "The words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that section 10(b) was intended to proscribe knowing or intentional misconduct."⁹⁷ In addition, the Court found that when rule 10b-5 was adopted, "it was intended to apply only to activities that involved scienter."⁹⁸

Thus, once again the effect of the Supreme Court's ruling was to restrict the class of potential plaintiffs who would be allowed protection under rule 10b-5. It is apparent that the Court felt the same concerns about the problem of scienter that it did about the question of standing in *Blue Chip Stamps*. Citing the majority opinion in *Blue Chip Stamps*, the *Hochfelder* Court reiterated that broadening the class of plaintiffs who may sue in this area of the law would result in more harm than good.⁹⁹ Based on the holdings and rationale of these two cases, it

88 The case was decided on March 30, 1976.

89 425 U.S. 185 (1976).

90 See note 22 *supra*.

91 425 U.S. at 193.

92 PROSSER, *HANDBOOK OF THE LAW OF TORTS*, 700 (4th ed. 1971).

93 See note 22 *supra*.

94 For a discussion of the scienter element in a 10b-5 violation, see Note, *Scienter's Scope and Application in Rule 10b-5 Actions: An Analysis in Light of Hochfelder*, 52 *NOTRE DAME LAW.* 925 (1977).

95 425 U.S. at 201.

96 See text accompanying notes 76-87 *supra*.

97 425 U.S. at 197.

98 *Id.* at 212.

99 *Id.* at 214 n.33, citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. at 747.

seems clear that the intent of the Supreme Court is to bring under control the expansion of 10b-5 liability that had taken place on a case-by-case basis in the lower courts since the rule was promulgated in 1942. This restriction on liability has the desired effect of foreclosing non-meritorious 10b-5 litigation, and this result supports the view that the American Rule justifiably can be relaxed with regard to suits under rule 10b-5.¹⁰⁰

III. Practical Justifications for the American Rule: Its Effect on Litigation

In light of the present state of the law with regard to both the American Rule and rule 10b-5 litigation requirements, changes should be made to alleviate the current situation in which a plaintiff with a meritorious cause of action may have to lose money in order to uphold his legal rights in court. In this regard, an expansion of the traditional bad faith and common benefit exceptions to the American Rule would be consistent with judicial precedent and would allow for a more just result to the litigation.¹⁰¹

The arguments in favor of adherence to the American Rule are familiar ones.¹⁰² It has been argued that legal fees are too remote from the defendant's wrongful conduct¹⁰³ and that a proper fee could not be accurately determined by the court.¹⁰⁴ It has also been contended that without the American Rule attorneys would charge exorbitant fees and that litigants would be discouraged from bringing suit for fear of having to pay two sets of costs upon losing. With regard to securities fraud specifically, it has been suggested that absence of the American Rule could encourage strike suits or champerty.¹⁰⁵ None of these arguments, however, justifies the basic inequities of the Rule. As one commentator has suggested, the Supreme Court

“adopted a rule first announced in 1796 by a Court which admitted the possible unsoundness of its own position. While justifications have concededly been offered in its continued support over the years, the courts have tended to rely heavily on early cases as compelling and authoritative support for the rule, without ever examining frontally its essential underpinnings.”¹⁰⁶

Although these justifications have sustained the presence of the Rule in the American judicial system, each of them can be rebutted.

A. Non-Meritorious Litigation

The Supreme Court has, in essence, already eliminated the problem of

¹⁰⁰ See text accompanying notes 107-09 *infra*.

¹⁰¹ *Id.*

¹⁰² For a discussion of the policy justifications for the American Rule, see generally Ehrenzweig, *Reimbursement of Counsel Fees and the Great Society*, 54 CALIF. L. REV. 792 (1966); Note, *Attorney's Fees: Where Shall the Ultimate Burden Lie?*, 20 VAND. L. REV. 1216 (1967); McLaughlin, *The Recovery of Attorney's Fees: A New Method of Financing Legal Services*, 40 FORD. L. REV. 761 (1972).

¹⁰³ *Stewart v. Sonneborn*, 98 U.S. 187 (1878).

¹⁰⁴ *Oelrichs v. Spain*, 82 U.S. (15 Wall.) 211 (1872).

¹⁰⁵ See text accompanying note 84 *supra*.

¹⁰⁶ Comment, *Court Awarded Attorney's Fees and Equal Access to the Courts*, 122 U. PA. L. REV. 636, 644 (1974).

champerty and other non-meritorious litigation with regard to 10b-5 causes of action. Through its rationale and holdings in *Blue Chip Stamps* and *Hochfelder*, the Court has effectively limited the class of persons who can prevail in a 10b-5 suit to those who are both directly involved in the transaction¹⁰⁷ and who are able to prove scienter on the part of the defendant.¹⁰⁸ The restrictive standing requirement of *Blue Chip Stamps* makes certain that the only 10b-5 plaintiffs will be those who have made an actual purchase or sale of securities, and the scienter requirement of *Hochfelder* provides that the defendant will not be held liable unless the plaintiff can prove willful or intentional misconduct. These two requirements reinforce each other to produce the net effect of allowing only plaintiffs with meritorious claims to prevail.¹⁰⁹ In light of the difficult standards the plaintiff must now meet, a defendant will not easily be pressured into accepting a settlement for fear of losing a long battle in court. Thus, because of the Supreme Court's new 10b-5 requirements, champertous claims, as well as so-called "nuisance" suits based on mere technical violations of the law, can no longer pass Supreme Court muster.

B. Foreseeability of the Award

Similarly, the argument based on the postulated remoteness of damages is easily rebutted. Authorities have uniformly suggested that in today's complex legal system, which necessitates the intervention of an attorney, legal fees may be foreseen as a direct result of the wrong committed.¹¹⁰ Arguably this suggestion is even more applicable in the technical area of securities fraud litigation. Because of the technicalities and complexity involved in the highly regulated field of securities transactions, a plaintiff of necessity must be represented by an attorney who possesses the requisite specialized knowledge of securities law. The indispensability of legal representation makes attorneys' fees in 10b-5 litigation more foreseeable than fees in other types of litigation in which a plaintiff may well be able to prevail with *pro se* representation.

C. Calculation of the Award

The "problem" of fee calculation has also been considered a major reason to retain the American Rule.¹¹¹ The Supreme Court has suggested that if courts had discretion to determine the amount of the award, a special master might have to be appointed to make the determination, which would render the original litigation more complex and expensive.¹¹² These fears carry little weight today.¹¹³ There currently exist a significant number of federal statutes which grant courts the power to award attorneys' fees.¹¹⁴ There is no indication that the courts have

107 See text accompanying notes 76-87 *supra*.

108 See text accompanying notes 88-99 *supra*.

109 See generally Allen, *Rule 10b-5 and the Burger Court—Time to Reexamine the Elements for a 10b-5 Action*, 82 COMMERCIAL L.J. 118 (1977).

110 MCCORMICK, HANDBOOK ON THE LAW OF DAMAGES, § 71 at 257 (1935).

111 For a discussion of methods of attorneys' fees calculation, see Comment, *Court Awarded Attorney's Fees and Equal Access to the Courts*, 122 U. PA. L. REV. 636 (1974).

112 *Oelrichs v. Spain*, 82 U.S. (15 Wall.) 211, 231 (1872).

113 See Comment, *Distribution of Legal Expense Among Litigants*, 49 YALE L.J. 699 (1940).

114 See note 44 *supra*.

been unable to determine adequate and fair awards or that the process has involved excessive delay or complexity. Particularly in equity cases, in which judicial discretion is the norm, judges are familiar with this type of evaluative determination.

The fees, if awarded, should be "reasonable,"¹¹⁵ and there are accepted guidelines that courts may use to determine the size of the award.¹¹⁶ Not only should the "skill and experience"¹¹⁷ of the lawyer be taken into consideration, but also the amount of time "reasonably expended on a matter."¹¹⁸ Also relevant are all other circumstances that surround the case, including its importance and the result reached.¹¹⁹ Specifically with regard to "benefit" cases in which there is no monetary recovery, the value of the judgment to the class benefitted must also be considered.¹²⁰ In sum, any factor that is pertinent to the result and equitable to both the attorney and the parties may be considered.¹²¹ "Such an allowance rests within the sound discretion of the trial judge, and will be interfered with by an appellate court only when it is convinced that it is clearly excessive or insufficient."¹²²

Although a detailed discussion of the mechanics and the frequency of fee-shifting is beyond the scope of this note,¹²³ enough illustrations have been given to make the point salient to this discussion: the allowance of substantial attorneys' fees is hardly a rarity in the law. The cases in which fee-shifting is allowed

115 *Id.* These statutes do not fix a specific fee schedule; rather, Congress has given statutory authorization for awarding "reasonable" attorneys' fees.

116 There is an extensive discussion of the factors to be taken into account in awarding attorneys' fees in *Johnson v. Georgia Highway Express, Inc.*, 488 F.2d 714 (5th Cir. 1974). The court cited the following factors: (1) the time and labor required, (2) the novelty and difficulty of the questions, (3) the skill required, (4) the preclusion of other employment, (5) the customary fee, (6) whether the fee is fixed or contingent, (7) time limitations, (8) the amount involved and the results obtained, (9) the experience, reputation, and skill of the attorney, (10) the "undesirability" of the case, (11) the nature and length of the professional relationship with the client, and (12) awards in similar cases. *See also Kerr v. Screen Extras Guild, Inc.*, 526 F.2d 67 (9th Cir. 1975), *cert. denied*, 425 U.S. 951 (1976). *See generally* 6 MOORE, FEDERAL PRACTICE, ¶54.77[2] (1976).

117 *Adair Lumber Co. v. Atchison, Topeka & Santa Fe Ry. Co.*, 19 F. Supp. 415, 417 (W.D. Mo. 1937).

118 *See* note 202 *infra*.

119 *See Mercantile-Commerce Bank & Trust Co. v. Southeast Arkansas Levee Dist.*, 106 F.2d 966, 972 (8th Cir. 1939), in which an award of attorneys' fees for services rendered in receivership and bankruptcy proceedings was increased from \$1,000 to \$5,000 in connection with litigation in which "numerous conferences were necessary to reconcile conflicting interests. Hearings were held and the appearances and preparation of briefs entailed the expenditure of time and labor. These hearings were bitterly contested . . . and the efforts of counsel for the trustees were met with energetic opposition." *Id.* at 972.

120 *See Merola v. Atlantic Richfield Co.*, 515 F.2d 165 (3d Cir. 1975).

121 *See Pitchford v. Pepi, Inc.*, 531 F.2d 92, *cert. denied*, 426 U.S. 935 (1976), in which a distinction is drawn between cases that involve protection of a benefit, in which attorneys' fees come from the group benefitted, and cases in which fees are awarded against the defendant. The court found that in either case, attention should be on the reasonable hourly rate of compensation and the number of hours expended by counsel. The court may then deviate from this figure according to the level of counsel's performance or the likelihood of failure at the start. In the action in which fees are awarded against the defendant, however, the court held that any contingent fee arrangements between the plaintiff and his counsel cannot be considered because this might lead to unrealistic agreements and result in excessive counsel fees. The court also stated that if a reasonable fee as determined by the court does not fully satisfy a contingent fee agreement, the excess should be taken out of the damage award. *See also Evans v. Sheraton Park Hotel*, 503 F.2d 177 (D.C. Cir. 1974).

122 6 MOORE, FEDERAL PRACTICE ¶54.77[2] at 1716.

123 *See generally* Goodhart, *Costs*, 38 YALE L.J. 849 (1929); Comment, *Court Awarded Attorney's Fees and Equal Access to the Courts*, 122 U. PA. L. REV. 1216 (1974).

comprise a substantial proportion of American litigation; in the vast majority of these, the sole statutory or decisional measure of the award is that it shall be "reasonable."¹²⁴ Thus, a more liberal allowance of fee-shifting would create no new or drastic problems; rather, American judges would merely perform more frequently a function that they already perform. The difference would be one of degree and not of kind.

These rebuttals to the alleged justifications for the American Rule illustrate that the Rule itself no longer rests on a solid foundation in American law.¹²⁵ In light of this fact, its resultant inequity in 10b-5 litigation is even less acceptable.

IV. Bases for Reform

Because of the complexity of modern securities regulations and public securities markets, a plaintiff with a small or moderate claim in technical and lengthy securities fraud litigation may well be forced to spend considerably more money on the costs involved in litigating (principally because of attorneys' fees) than he is able to recover by way of provable losses due to the fraud. Understandably, this leads to reluctance of the "little man" to seek judicial vindication of his legal rights.

A. Present Responses to the Problem

The present legal system's dual response to this dilemma consists of the contingent fee device and the legal aid office. Unfortunately, both are inadequate to the task. The former will simply not operate where the anticipated award is not large, whereas the latter suffers from a dearth of offices and qualified attorneys able and willing to handle this type of work.¹²⁶ This situation is considerably aggravated in 10b-5 litigation, the preparation of which may necessitate an atypical amount of time and effort on the part of an attorney. In these circumstances, the court's award of attorney's fees may offer the "sole stimulus" for bringing a 10b-5 action and therefore the "sole stimulus" for the private enforcement of the securities laws.¹²⁷

A fundamental ideal of the common law is to make the wronged person whole, at least to the extent that this result can be accomplished by an award of money. This ideal, however, is not only frustrated, but undermined in the inequitable situation in which a prevailing party in a 10b-5 action wins a legal victory but suffers a financial defeat because he cannot recover the attorneys' fees incurred in vindicating his legal rights. Moreover, the inequity does not operate against the plaintiff alone; the defendant may suffer as well. The cost of defending against an unjust small or moderate claim may well be greater than the cost of simply paying what has been demanded.

¹²⁴ See notes 114-15 *supra*.

¹²⁵ See note 106 *supra*.

¹²⁶ Carlin & Howard, *Legal Representation and Class Justice*, 12 U.C.L.A. L. REV. 381 (1965); Ehrenzweig, *Reimbursement of Counsel Fees and the Great Society*, 54 CALIF. L. REV. 792 (1966).

¹²⁷ *Smolowe v. Delendo Corp.*, 136 F.2d 231, 241 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943). In this case, which involved a violation of § 16(b) of the 1934 Act, the court awarded attorneys' fees on the "sole stimulus of enforcement" theory.

For the reasons stated above, it is contended that a relaxation of the American Rule in 10b-5 litigation is necessary, justifiable, and workable within the American system of justice.¹²⁸ The mechanism for achieving a relaxation of the Rule is likewise available without creating a major disruption in judicial administration. The bases have traditionally been recognized by the courts;¹²⁹ they merely require expansion to achieve the desired result.

B. *Expansion of the Bad Faith Exception*

Expansion of the bad faith exception to the American Rule has the advantage of focusing directly on the elimination of wrongful conduct,¹³⁰ because under this exception the litigant must have demonstrated bad faith actions before attorneys' fees will be assessed against him. It therefore seems particularly well-suited to post-*Hochfelder* litigation under rule 10b-5.¹³¹ By expanding the bad faith exception to allow for pre-litigation bad faith as a general rule, the successful plaintiff would almost automatically be awarded attorneys' fees since, under the *Hochfelder* ruling, he must first prove *intentional* or *knowing* wrongful conduct on the part of the defendant before he is able to recover any damages at all. This wilful intent to defraud certainly meets the "wanton, vexatious" standard endorsed by the Supreme Court.¹³² Because there is already case support for allowing pre-litigation bad faith to qualify as grounds for an award of attorneys' fees¹³³ this expansion would not be the "drastic" departure from the American Rule that concerned the *Alyeska* Court.¹³⁴

Even if it is not possible to use pre-litigation bad faith as a basis for the award, the plaintiff should still be able to recover fees in 10b-5 litigation. The defendant's conduct comes within the bad faith exception to the American Rule if one defines the defendant's proven *scienter* as tantamount to litigious bad faith. The argument would be as follows: the defendant must be guilty of knowing wrongful conduct for the plaintiff to recover under *Hochfelder*; thus if the plaintiff does recover, the contumacious defendant's defense of this intentionally wrongful conduct is, absent exceptional circumstances, "in bad faith or for

128 For a discussion of the need for relaxation of the American Rule and a proposed statute to implement the change, see Stoebuck, *Counsel Fees Included in Costs: A Logical Development*, 38 U. COLO. L. REV. 202 (1966). Professor Stoebuck favors a system that routinely shifts fees except when an action turns upon a question of law not previously decided.

129 See text accompanying notes 46-55 *supra*.

130 See generally Comment, *Court Awarded Attorneys' Fees and Equal Access to the Courts*, 122 U. PA. L. REV. 636 (1974).

131 See notes 88-99 *supra*.

132 See note 49 *supra*. This result is consistent with a similar standard set by Congress in the area of civil rights legislation. In § 718 of the Emergency School Aid Act, Pub. L. No. 92-318, 86 Stat. 369 (1972), Congress enacted a liberal standard that allows successful plaintiffs to recover attorneys' fees simply because they were forced to go to court to vindicate their rights. Specifically, the Act provides that a court may award the prevailing party a reasonable attorneys' fee as part of the costs "upon a finding that the civil rights proceedings were necessary to bring about compliance." *Id.* Under prior law in school desegregation cases, plaintiffs were required to demonstrate that the defendant school board acted in an unreasonable and obdurately obstinate manner. See *Herry v. Clarksdale Municipal Separate School Dist.*, 480 F.2d 583 (5th Cir. 1973).

133 See note 73 *supra*.

134 421 U.S. at 269. The Court held that courts were "not free to fashion drastic new rules with respect to the allowance of attorneys' fees." *Id.*

oppressive reasons."¹³⁵ Therefore, because he has conducted litigation in bad faith, the defendant comes within the present generally accepted definition of the bad faith exception, which states that the bad faith must occur during the course of the litigation itself.¹³⁶

Thus, in the context of 10b-5 litigation, where the plaintiff's clearly established legal right not to be defrauded has been intentionally abused by the defendant so that judicial proceedings are needed to vindicate that right, the plaintiff should be awarded attorneys' fees. It is unfair to cause the burden of the litigation costs to fall on the party who would have freely enjoyed his legal rights but for the knowing wrongful conduct of his opponent.

There would, of course, be situations in which an award of attorneys' fees would be unfair, but in these special circumstances the courts would have discretion not to allow the award.¹³⁷ If the defendant had a "reasonable ground to believe he might prevail on the matter"¹³⁸ or if there was "other good reason"¹³⁹ for him to defend his conduct and thus cause full judicial proceedings to be brought, he would not be assessed the plaintiff's attorneys' fees.

Under the judicial constraints imposed upon rule 10b-5 causes of action, however, the defendant generally would not be able to escape such an assessment of fees. The defendant's proven knowing wrongful conduct would create a strong presumption that he did not have a "reasonable ground to believe that he might prevail" in the defense of his conduct. Thus, unless there are "special circumstances that would render such an award unjust,"¹⁴⁰ the plaintiff should recover attorneys' fees because he has been deprived of his legal rights by the bad faith of the defendant and, in addition, because he must resort to the courts to vindicate those rights. The defendant who in bad faith chooses to defend conduct which he does not have reasonable grounds to believe can be successfully defended, merely in the hope that the plaintiff will tire of the fight and either withdraw completely or settle his claim for a lesser amount, should be assessed the plaintiff's fees.

Similarly, when a plaintiff is shown to have brought a suit in bad faith, the defendant would be allowed to recover reasonable attorneys' fees. Thus, the pressure on the defendant to settle a claim he knows to be unfounded would be eliminated.¹⁴¹ The fact that a defendant may also be allowed to collect attorneys' fees should not deter plaintiffs from bringing meritorious suits under rule 10b-5 when those suits have only a "borderline" chance of being successful. In such cases, fees would not be assessed against the plaintiff. It is only in the event that the plaintiff's suit was clearly unfounded and therefore brought in bad faith that

135 See note 49 *supra*.

136 See note 51 *supra*.

137 See *Northcross v. Memphis Board of Education*, 412 U.S. 427 (1973).

138 FED. R. CIV. P. 37(c)(3). The rule applies specifically to a party's failure to make discovery, but the standards enunciated by the rule arguably should apply to a party's conduct in 10b-5 litigation.

139 FED. R. CIV. P. 37(c)(4).

140 See note 198 *infra*.

141 See note 128 *supra*. Professor Stoebuck's system provides that when the prevailing party is adjudged to have brought or defended an action in bad faith, obstinately refused to settle, or otherwise abused the legal apparatus, the judge has the discretion to dismiss or eliminate the award of attorneys' fees to that party. 38 U. COLO. L. REV. 202, 214 (1966).

he would be penalized. Thus, the mere fact that the plaintiff is unsuccessful in the litigation would not render him liable for his opponent's attorneys' fees. If his claim is brought in good faith, the losing claimant would pay only his own counsel fees.¹⁴²

This reasoning is not so much an expansion of the concept of the bad faith exception as it is a recognition of the higher degree of wrongful conduct and proof of that conduct that the Supreme Court now requires under rule 10b-5.

1. *Straub v. Vaisman & Co.*

In *Straub v. Vaisman & Co.*,¹⁴³ the Court of Appeals for the Third Circuit had an opportunity to expand the bad faith exception in the manner described above but declined to do so. The case involved foreign nationals who purchased stock in an American corporation on the strength of fraudulent recommendations by an American securities broker who stood in a position of trust with regard to the defrauded plaintiffs. The District Court for the District of New Jersey entered judgement for the plaintiffs and awarded attorneys' fees because it found the defendant's conduct "reprehensible."¹⁴⁴

In an opinion announced less than three months after *Hochfelder*,¹⁴⁵ the Third Circuit decided that only bad faith that occurs during the course of the litigation justifies an award of attorneys' fees under the bad faith exception. The court did not dwell on this issue, however, because its holding was of a more limited nature.

The *Straub* court concluded that § 28(a)¹⁴⁶ of the 1934 Act prohibited an award of attorneys' fees because that section limits recovery under the Act in general, and therefore under § 10(b) and rule 10b-5, to "actual damages." Since the term "actual damages" is not defined anywhere in the Act, however, there is no explicit congressional prohibition against an award of attorneys' fees under this provision, as other circuits have noted.¹⁴⁷ Therefore, in light of the underlying purpose of the 1934 Act—the prevention of fraud—an equally valid interpretation of "actual damages" includes attorneys' fees. When the cost of counsel is paid out of the damage award, the plaintiff himself does not recover all of his proven actual damages. He recovers only so much of the damages as may remain after he has paid this necessary litigation expense.

In 10b-5 litigation, the plaintiff who must pay his own attorney's fees may actually recover little or nothing, or he may be left with a net loss. He will never

142 See notes 200-01 *infra*.

143 540 F.2d 591 (1976).

144 *Id.* at 595.

145 *Straub* was decided on June 15, 1976; *Hochfelder* was decided on March 30, 1976.

146 15 U.S.C. § 78bb(a) (1970). The section provides:

(a) The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgement in one or more actions, a total amount in excess of his actual damages on account of the act complained of.

147 See *Coffee v. Permian Corp.*, 474 F.2d 1040 (5th Cir.) *cert. denied*, 412 U.S. 920, *reh. denied*, 414 U.S. 882 (1973), and *Young v. Taylor*, 466 F.2d 1329 (10th Cir. 1972), which hold that a plaintiff may recover compensatory as well as punitive damages where common law fraud is proved in addition to violations of the federal securities laws.

recover the full amount of the "actual damages on account of the act complained of"¹⁴⁸ that he is authorized to recover under the 1934 Act. An interpretation of § 28(a) that supports the award of attorneys' fees thus seems consistent with the language of the statute as well as its spirit and purpose.

The Third Circuit in *Straub* also interpreted the *Hochfelder* mandate to require that the courts apply each section of the 1934 Act with precision.¹⁴⁹ It thus determined that the power of the courts to award attorneys' fees in § 10(b) litigation is "sharply circumscribed."¹⁵⁰ Therefore, the court concluded that it could not award attorneys' fees unless the applicable section specifically authorized an award.¹⁵¹ The court also determined that the bad faith exception itself could apply only to conduct that occurred during the course of the litigation.¹⁵² Thus, the court held, "Since we have concluded that the [1934 Act] precludes an allowance because of bad faith inherent in the cause of action itself, we need concern ourselves here only with conduct which occurred [after the litigation commenced]."¹⁵³ The court acknowledged, but declined to review or discuss, a line of cases in which attorneys' fees were awarded on the basis of bad faith that occurred before litigation actually commenced¹⁵⁴ or in which bad faith formed the basis of the suit itself.¹⁵⁵

A strong dissenting opinion, however, argued that the award of attorneys' fees made by the district court could be upheld.¹⁵⁶ The dissent first discussed the wilfully fraudulent intent of the defendant and concurred with the finding of the district court that his conduct was "willful, wanton, and reprehensible."¹⁵⁷ The dissent then cited *Hall v. Cole*¹⁵⁸ as an endorsement by the Supreme Court that bad faith sufficient to justify an award of attorneys' fees can be found in actions that occur before, as well as during, the course of the litigation.¹⁵⁹

148 See note 146 *supra*.

149 540 F.2d at 599.

150 *Id.* See note 163 *infra*.

151 540 F.2d at 599.

152 *Id.* at 600.

153 *Id.*

154 *Vaughan v. Atkinson*, 369 U.S. 527 (1962); *Fairley v. Patterson*, 493 F.2d 598 (5th Cir. 1974); *Sims v. Amos*, 340 F. Supp. 691 (M.D. Ala.), *aff'd summarily*, 409 U.S. 942 (1972).

155 *Rolax v. Atlantic Coast Line R. Co.*, 186 F.2d 473 (4th Cir. 1951); *Schein v. Smith*, 160 F.2d 22 (1947).

156 540 F.2d at 600-01.

157 *Id.* at 595, 601.

158 See text accompanying note 53 *supra*.

159 540 F.2d at 601. The dissent also maintained that this principle was reaffirmed by the language of the Supreme Court in *F. D. Rich Co. v. Industrial Lumber Co.*, 417 U.S. 116, 129 (1974); and in *Alyeska Pipeline Co. v. Wilderness Society*, 421 U.S. 240, 258-59 (1975). *Id.* See *Lamb v. Sallee*, 417 F. Supp. 282, 288 (E.D. Ky. 1976), which cites *Hall* as an endorsement of the award of attorneys' fees based on bad faith that occurs either in the actions that led to the law suit or in the conduct of the litigation itself. The *Lamb* court found no indication that there had been bad faith in the course of the litigation, but awarded the plaintiff attorneys' fees based on the pre-litigation "obdurate obstinacy" of the defendant. See also *Havecker v. Milburn*, 538 F.2d 1241, 1245 n.9 (1976), which cites *Hall v. Cole* as support for an award of attorneys' fees based on the bad faith of the defendant and states in footnote to its citation of *Hall* that "[t]he 'bad faith' which justifies the award of attorneys' fees may be demonstrated in the conduct which necessitated the action or in conduct occurring during the course of the action. *Hall v. Cole*, . . . 412 U.S. at 15. . . . Bad faith may be demonstrated by showing that a defendant's obstinacy in granting a plaintiff his clear legal rights necessitated resort to legal action with all the expense and delay entailed in litigation. . . . In this regard, the purpose of an award of attorneys' fees

In addition, since the plaintiff's attorneys' fees exceeded the amount of the recoverable damages,¹⁶⁰ the decision of the majority in finding for the plaintiff but not allowing the fees to be shifted was a hollow "victory" indeed. Thus, because of the defendant's bad faith in this action, an interest in rendering a fair and equitable result justified the exercise of the court's discretion to award attorneys' fees.

It appears that the majority opinion in *Straub* may have been the result of an overly narrow reading of both the 1934 Act and the *Alyeska* and *Hochfelder* decisions, for the court's holding is not the only one justified by legal precedent. Had it chosen to do so, the Third Circuit might well have upheld an award of attorneys' fees in *Straub*. The justification for such an award can be found in the very precedents cited by the court.

Although the Supreme Court in *Alyeska* approved the American Rule, it specifically upheld the bad faith exception to that Rule.¹⁶¹ It also specifically declined to comment on the wisdom of the Rule and concluded only that it was still a part of the American legal system.¹⁶² In *Hochfelder*, fee-shifting was not even an issue; the Supreme Court in a footnote merely noted without elaboration the existence of the bad faith exception in 10b-5 cases.¹⁶³ The majority in *Straub* interpreted the Supreme Court's *Hochfelder* footnote to mean that the bad faith exception is still viable in 10b-5 litigation.¹⁶⁴ The dissenting opinion cited the same footnote for the proposition that a district court has the power to award attorneys' fees in 10b-5 cases in which bad faith is present.¹⁶⁵ The *Straub* court, however, without further discussion, summarily concluded that "[g]enerally, an allowance because of bad faith is based on conduct which occurs during the course of the litigation,"¹⁶⁶ and in conjunction with its restrictive reading of the 1934 Act, the court reversed the plaintiff's fees award.

With regard to the 1934 Act, the *Straub* court, after limited discussion, concluded that attorneys' fees could not be awarded absent a specific authorization in the applicable section of the Act.¹⁶⁷ As stated above, the court cited *Hochfelder* to justify its position.¹⁶⁸ The Supreme Court in *Hochfelder*, however, was not primarily concerned with remedies under the 1934 Act; rather, its primary concern was the issue of standards of liability. Thus, the *Hochfelder* Court

based on a defendant's bad faith is both punitive and to compensate a plaintiff for the added expense of having to vindicate clearly established rights in court."

160 *Id.* at 594-95. The amount of counsel fees was \$47,808.42; damages awarded the plaintiffs totalled \$38,875.00.

161 See note 67 *supra*.

162 See note 75 *supra*.

163 425 U.S. at 210. This footnote in its entirety reads:

Congress regarded these restrictions on private damage actions as significant. In introducing Title II of the 1934 Act, Senator Fletcher indicated that the [amendment] of § 11(e) of the 1933 Act, providing for potential payment of costs, including attorneys' fees, "is the most important amendment of all." . . . One of its purposes was to deter actions brought solely for their potential settlement value. . . . This deterrent is lacking in the § 10(b) context, in which a district court's power to award attorneys' fees is sharply circumscribed. See *Alyeska Pipeline Co. v. Wilderness Society*, 421 U.S. 240 (1975) . . . ("bad faith" requirement) [other citations omitted].

164 540 F.2d at 599.

165 *Id.* at 601.

166 *Id.* at 600.

167 *Id.* at 599.

168 See note 149 *supra*.

required a literal reading of § 10(b) of the 1934 Act because, in the absence of clear legislative history,¹⁶⁹ a close reading was deemed necessary to proper interpretation of the statute. In its limited discussion of remedies available under § 10(b),¹⁷⁰ the Court emphasized that the procedural restrictions under other sections of the 1934 Act precluded an expansion of liability under § 10(b) itself, lest § 10(b) be used to circumvent these other sections and thus to “nullify the effectiveness of the carefully drawn procedural restrictions on these express actions.”¹⁷¹

In light of this language, the *Straub* court ruled that it had to apply the 1934 Act with precision, even though “the allowance of counsel fees under a § 10(b) proceeding is consistent with the purpose of the Act.”¹⁷² In addition, the court noted that the provisions of the 1934 Act that authorized the allowance of counsel fees¹⁷³ did so with “counterbalancing restrictions”¹⁷⁴ and that no such restrictive conditions had been incorporated into § 10(b) litigation.

The *Straub* court, however, also failed to consider the rationale of the Supreme Court in *Mills v. Electric Auto-Lite Co.*¹⁷⁵ The complaint in *Mills* had been brought under § 14(a) of the 1934 Act—a section that is completely silent on the question of attorneys’ fees. Inasmuch as §§ 9(e)¹⁷⁶ and 18(a)¹⁷⁷ of the Act specifically allow fee-shifting, the Supreme Court could have found that Congress intended not to allow attorneys’ fees under § 14(a). Nevertheless, the Supreme Court chose not to interpret the congressional silence as a prohibition, but rather as an authorization to the Court to decide the attorneys’ fees issue itself.¹⁷⁸ The Supreme Court found the obstacle of congressional silence no bar to the utilization of its equity power.

Additionally, the Third Circuit in *Straub* failed to consider the judicially created restrictions placed on rule 10b-5 litigation by the Supreme Court in *Blue Chip Stamps* and *Hochfelder*.¹⁷⁹ By restricting recovery under rule 10b-5 to plaintiffs who have been directly harmed by proven “bad faith and vexatious conduct” of a defendant, the Supreme Court has indeed imposed its own set of safeguards on the rule. It is arguable that because it is limited at the outset by these restrictions, a district court already works within the “sharply circumscribed”¹⁸⁰ limitations alluded to by the Supreme Court in *Hochfelder* and relied upon by the Third Circuit in *Straub*. This interpretation is further buttressed by the *Alyeska* opinion, which, in discussing the exceptions to the American Rule, stated not that the exceptions could be utilized only upon express authorization

169 The Court found that the legislative history of the 1934 Act was “bereft of any explicit explanation of Congress’ intent.” 425 U.S. at 201.

170 *Id.* at 206-10. This discussion of remedies must be read in the context of the Court’s basic discussion of the standard of liability.

171 *Id.* at 210.

172 540 F.2d at 599.

173 See notes 176-77 *infra*.

174 540 F.2d at 599.

175 See text accompanying notes 56-61 *supra*.

176 15 U.S.C. § 78i(e) (1970).

177 15 U.S.C. § 78r(a) (1970).

178 The Court concluded that it must determine “whether the special circumstances exist that would justify an award of attorneys’ fees.” 396 U.S. at 391.

179 See text accompanying notes 76-99 *supra*.

180 See note 163 *supra*.

of Congress, but rather that the courts could allow counsel fees "unless forbidden by Congress."¹⁸¹

Thus, if the *Straub* court had utilized a more liberal, but not inconsistent interpretation of the same precedents, it could have upheld the district court's award of attorneys' fees and thus could have reached a more equitable decision—one that would have been, by its own admission, "consistent with the purpose of the [1934] Act."¹⁸²

C. *Expansion of the Common Benefit Exception*

The 1934 Act was intended to overcome the problem of fraud that can arise from inadequate regulation of securities transactions. Because of the broad language of rule 10b-5 and the congressional intent¹⁸³ that underlies the 1934 Act from which the rule was derived, it is arguable that litigation under 10b-5 is analogous to public interest litigation. In this regard, the "common benefit" standard enunciated by the Supreme Court in *Mills*¹⁸⁴ is similar to the implicit public benefit standard that underlies civil rights legislation. In each case a class of potential plaintiffs is benefitted through the litigious action taken by one member of the class. At a minimum, a successful action for fraud brought by a plaintiff under rule 10b-5 conveys a benefit to the involved corporation and its stockholders—the prevention or correction of the fraud.

For this reason the common benefit exception to the American Rule should be expanded to allow a second rationale for a general award of attorneys' fees in 10b-5 litigation. *Mills v. Electric Auto-Lite Co.*, which was cited with approval by the Supreme Court in *Alyeska*,¹⁸⁵ serves as the basis of the modern interpretation of the common benefit exception.¹⁸⁶ The broad impact of the *Mills* decision lies in its use of the term "common benefit" coupled with its adoption of the "corporate therapeutics" principle.¹⁸⁷ The decision thus confronts the problem of prohibitively high litigation costs and posits that successful litigation to enforce the law creates a benefit to the investing public. Within this structure, the elimination of fraudulent practices, as evidenced by "the importance of fair and informed corporate suffrage"¹⁸⁸ is the benefit rendered to "members of an ascertainable class,"¹⁸⁹ and the award of fees thus operates to "spread the costs proportionately among them."¹⁹⁰ The letter and the spirit of this language clearly lend themselves to equitable expansion. The authorization is already present in the case law; the "expansion" would merely be an expansion in the frequency with which the award is sanctioned, rather than the opening up of an entirely new area in which awards would be permitted.

181 421 U.S. at 259.

182 See note 172 *supra*.

183 See text accompanying notes 11-15 *supra*.

184 See note 60 *supra*.

185 421 U.S. at 258.

186 See text accompanying notes 56-61 *supra*.

187 396 U.S. at 396. See note 60 *supra*.

188 *Id.*

189 *Id.* at 394.

190 *Id.*

1. The Attorneys' Fees Awards Act of 1976

As contended above, securities fraud litigation is analogous to public interest litigation—with the emphasis switched from public to private action. In this regard, it is helpful briefly to examine the intent inherent in Congress's most recent action concerning the award of attorneys' fees. Public Law 94-559,¹⁹¹ enacted specifically in response to the Supreme Court's ruling in *Alyeska Pipeline Co. v. Wilderness Society*,¹⁹² expressly provides that "the court, in its discretion, may allow the prevailing party, other than the United States, a reasonable attorney's fee as part of the costs [of litigation under federal civil rights statutes]."¹⁹³

The intent embodied in the Act is no less explicit.¹⁹⁴ Essentially, Congress chose to resurrect the "private attorney general" exception to the American Rule with regard to civil rights litigation.¹⁹⁵ The rationale behind the new law was a matter of simple legal fact: "If the cost of private enforcement actions becomes too great, there will be no private enforcement."¹⁹⁶ Furthermore, the standard adopted by Congress to guide the courts in implementing the Act is itself a judicial pronouncement. Congress cited *Newman v. Piggie Park Enterprises, Inc.*¹⁹⁷ in determining that "[a] party seeking to enforce the rights protected by the statutes covered by S. 2278, if successful, 'should ordinarily recover an attorney's fee unless special circumstances would render such an award unjust.'"¹⁹⁸

Congress also confronted the "penalty" rationale which had been cited in justification of maintaining the American Rule.¹⁹⁹ Congress concluded that such "private attorneys general" should not be deterred from bringing good faith actions to vindicate their rights by the prospect of having to pay their opponent's counsel fees should they lose, because the losing plaintiff would be assessed his opponent's fee only if it were shown that his suit was "clearly frivolous, vexatious, or brought for harassment purposes."²⁰⁰ Thus, the Act deters frivolous or nui-

191 The Civil Rights Attorney's Fees Awards Act of 1976, Pub. L. No. 94-559, 90 Stat. 2641 (1976).

192 The purpose of the Act is to "remedy anomalous gaps in our civil rights laws created by the United States Supreme Court's recent decision in *Alyeska Pipeline Co. v. Wilderness Society*, 421 U.S. 240 (1975), and to achieve consistency in our civil rights laws." [1976] 5 U.S. CODE CONG. & ADM. NEWS 5909.

193 Sec. 2. That the Revised Statutes section 722 (42 U.S.C. § 1988) is amended by adding the following: "In any action or proceeding to enforce a provision of sections 1977, 1978, 1979, 1980 and 1981 of the Revised Statutes, title IX of Public Law 92-318, or in any civil action or proceeding, by or on behalf of the United States of America, to enforce, or charging violation of, a provision of the United States Internal Revenue Code, or title VI of the Civil Rights Act of 1964, the court in its discretion may allow the prevailing party, other than the United States, a reasonable attorney's fee as part of the costs."

The Civil Rights Attorney's Fees Awards Act of 1976, Pub. L. No. 94-559, § 2, 90 Stat. 2641 (1976).

194 [1976] 5 U.S. CODE CONG. & ADM. NEWS 5908-13.

195 *Id.* at 5910. The history reads, "Congress has commonly authorized attorneys' fees in laws under which 'private attorneys general' play a significant role in enforcing our policies." The history includes a list of statutes in which fee-shifting has been authorized; the list begins with the Securities Exchange Act of 1934.

196 *Id.* at 5913.

197 390 U.S. 400, 402 (1968).

198 [1976] 5 U.S. CODE CONG. & ADM. NEWS 5912.

199 See text accompanying notes 102-05 *supra*.

200 [1976] 5 U.S. CODE CONG. & ADM. NEWS 5912.

sance suits by authorizing an award of attorneys' fees against a party shown to have litigated in "bad faith."²⁰¹ Even the amount of the award was addressed; Congress determined that counsel for prevailing parties should be paid "for all time reasonably expended on a matter."²⁰²

Admittedly, the Attorneys' Fees Awards Act applies only to cases that arise under civil rights laws, but the rationale and arguments cited in support of the statute are equally applicable to cases under rule 10b-5. In citing the 1934 Act as an example of laws that authorize fee-shifting, the legislative history reads, "In cases under these laws, fees are an integral part of the remedy necessary to achieve compliance with our statutory policies."²⁰³ In both civil rights and 10b-5 litigation, the motivating factor, although perhaps different in degree, is essentially the same in kind: without an award of attorneys' fees, the cost of bringing (or defending) an action may well be prohibitive. When the cost is prohibitive, important legal rights will not be vindicated.

Of additional importance is that Congress in the Attorneys' Fees Awards Act not only specifically directs the courts to continue to use their traditional equity powers in awarding attorneys' fees, but also offers guidance to the courts as to the types of cases in which such fees should not be awarded and how the fee should be determined. Similarly, courts in rule 10b-5 cases should, pursuant to the exercise of this same equity power and in accordance with expanded bad faith and common benefit exceptions to the American Rule, also award attorneys' fees as a general rule and in accordance with the guidelines Congress has enunciated. Without an award of fees there can be no truly effective remedy in the courts.

V. Conclusion

An examination of the history and developments of the American Rule on attorneys' fees awards reveals an inequitable situation based on unconvincing justifications. Whatever reasons existed for the Rule's prominence early in American history, these reasons have now largely disappeared with the growing complexity of litigation and the rising cost of effective legal representation.

Total repudiation of the American Rule is neither advocated nor advisable without a thorough investigation into the ramifications of such a drastic revamping of the existing legal structure. In the interim, however, the courts, through the exercise of their inherent equity power, possess the ability to accomplish immediate and necessary reform in the area of rule 10b-5 litigation. Moreover, this can be done without disrupting the present legal system.

Either by expanding the traditional bad faith exception to the American Rule so that pre-litigation bad faith will generally suffice to invoke fee-shifting, or by defining a party's bad faith in defending his intentionally wrongful conduct as "litigious bad faith" capable of sustaining an award of fees, a more just result to 10b-5 litigation will ensue. In addition, by expanding the common benefit exception to include the benefits of fraud prevention and elimination, a similar just result will be effectuated.

201 *Id.*

202 *Id.* at 5913.

203 *Id.* at 5910.

Expansion of both of these exceptions can take place in the area of 10b-5 litigation without a "drastic" departure from legal precedent. In addition, expansion can take place without substantial disruption or unfairness in litigation results because of the tight constraints placed by the Supreme Court on all litigation under rule 10b-5. Although the net effect will be for the exceptions to swallow the American Rule with regard to 10b-5 cases, in this area of the law the Rule is not worth saving.

Until Congress takes the necessary step of enacting appropriate legislation to eliminate this problem, the courts as a matter of course should, in the absence of "special circumstances [that] would render such an award unjust,"²⁰⁴ allow an award of attorneys' fees to successful parties in litigation under rule 10b-5.

Donald R. Schmidt

204 See note 198 *supra*.