Rethinking the Proportional Reduction Rule in the Settlement of Multiparty Securities Actions: Judicial Overreaching or a Neat Solution?

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RETHINKING THE PROPORTIONAL REDUCTION RULE IN THE SETTLEMENT OF MULTIPARTY SECURITIES ACTIONS: JUDICIAL OVERREACHING OR A NEAT SOLUTION?

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This article focuses on a relatively new, judge-made rule which applies to partial settlements of civil suits under the federal securities laws. This rule is known as the “proportional reduction” type of “settlement bar” rule, and it cuts off a non-settling defendant’s rights to obtain contribution from a defendant who has settled. The rule also provides that any judgment that the plaintiff later obtains from the non-settling defendant will be reduced by the percentage of fault attributable to the defendant who settled. The allocation of tens of millions of dollars of liability will often turn on the judge’s decision to apply this rule, or a different rule, or no rule at all.

Judges and commentators have recently heaped praise on this proportional reduction rule, claiming that it is a “neat solution” to problems and inequities created by earlier alternatives.1 This article is intended to examine this rule more closely and realistically.

Section I of this article explains the rule and its alternatives. Section II examines its historical underpinnings. Section III discusses whether judges have the power to create this rule and concludes that in most cases they do not. Section IV discusses how the rule meets the goals of deterrence, promotion of settlement, judicial economy and fairness to plaintiffs. This section concludes that while the rule is quite equitable to defendants who refuse to settle, it (i) reduces deterrence to a large class of participants in securities transactions; (ii) prevents many types of partial settlements; (iii) results in negligible overall savings in judicial time and energy; and (iv) places severe burdens on plaintiffs.

Section V presents the overall conclusion of this article, which is that the this rule and its alternatives present close and difficult policy questions which should be resolved by Congress rather than by the courts. Section V therefore recommends that until Congress acts on this issue, courts should adopt state settlement bar rules rather than creating such rules of their own. Finally, the section proposes a new settlement bar rule which Congress should consider in order to more fairly balance the interests of all parties.

I. INTRODUCTION

Sections 11, 12(1) and 12(2) of the Securities Act of 1933 (commonly referred to as the Securities Act),\(^2\) Section 18 of the Securities Exchange Act of 1934 (commonly referred to as the Exchange Act)\(^3\) and Securities and Exchange Commission ("SEC") rule 10b-5\(^4\) each provide investors with a private right of action to recover losses suffered in securities transactions. These provisions have been the basis for complex lawsuits, often involving hundreds of plaintiffs whose securities have become valueless when a securities issuer has fallen upon hard times. Defendants in these suits are often numerous, frequently including not only the officers and directors of the troubled issuer, but also its bankers, lawyers, accountants and underwriters.

While federal courts generally want to encourage settlement of these complex cases, a "global" settlement with all defendants is usually impossible. Accordingly, courts often seek to dispose of these cases by means of successive partial settlements: the plaintiffs settle with one defendant at a time. Each settlement finances the litigation against the remaining defendants, assures some recovery to the injured plaintiffs, and places pressure on the defendants who have not settled to do so.

This partial settlement process, however, often runs into a practical obstacle, namely, the contribution rights of the non-settling co-defendants. Federal securities laws contain express and implied rights to contribution among those liable for any given injury.\(^5\) Thus, when one defendant settles with the plaintiffs, she does not escape the lawsuit; rather, she remains exposed to the contribution claims of her co-defendants. Given this fact, there is little advantage for a defendant to enter into a partial settlement with the plaintiffs, since the plaintiffs'

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claims against the settling defendant will usually be resurrected immediately after the settlement in the form of cross-claims for contribution filed by co-defendants.

Partial settlements, however, are an important means of simplifying large securities cases, and federal courts have found a way of making these settlements attractive to the settling defendant. Specifically, when one defendant settles with the plaintiff, federal courts often enter orders which extinguish any contribution claims against that settling defendant. With such an order, a settling defendant completely escapes the litigation. While there is no statutory basis in the securities laws for such "settlement bar" orders, courts are entering them with increasing frequency.  

When such settlement bar orders are entered, there must be some means of preventing a double recovery to the plaintiffs. Otherwise, plaintiffs could pocket the money paid by the settling defendant and continue to sue the remaining non-settling defendants for all the damages. In order to prevent this, the orders usually provide for a "judgment reduction," by which any judgment later entered against the non-settling defendants will be reduced by the amount which the settling defendant paid to the plaintiff.

In practice, the process works as follows:

Assume that plaintiffs sue a corporate officer and the company's outside accounting firm for $100 lost due to a securities fraud. The officer is the mastermind of the fraud and bears 70% of the responsibility for plaintiffs' loss. The accounting firm disseminated fraudulent information and bears 30% of the blame for the loss.

Assume that the officer settles with plaintiffs by paying them $10, and a settlement bar order is then entered, barring any contribution claims against the settling officer. Plaintiffs take the accounting firm to trial and win a verdict of $100. This verdict is reduced by the $10 already paid by the officer, and a $90 judgment is entered against the accounting firm.

The partial settlement and settlement bar order thus have the following effect: while the accounting firm bears only 30% of the blame for plaintiffs' loss, it is left to pay 90% of plaintiffs' damages. Meanwhile the officer, who is 70% responsible for the fraud, pays only 10% of the damages. Plaintiffs recover all of their losses.

In such cases, the effects of the settlement bar order may seem quite unfair to the non-settling defendant. The more culpable defendant, who happened to settle first, pays only a fraction of his fair share of the damages. The less culpable, non-settling co-defendant is stripped of his rights to contribution and is left to pay plaintiff the bulk of the damages, most of which were caused by the more culpable, settling defendant.

In reaction to this perceived unfairness, courts and commentators have touted a "neat solution" which has been accepted by the Ninth Circuit. Under this solution, a settlement bar order will be entered when a plaintiff settles with one defendant, but any judgment the plaintiff obtains against the other defendants will be reduced by the percentage of fault attributable to the settling defendant, rather than by the dollar settlement amount paid by that defendant.

Returning to the above example, this solution, known as the "proportional reduction rule," would work as follows (the assumptions are the same as in the last example): Plaintiffs have sued the officer and the accounting firm for $100; the officer pays $10 to settle; plaintiffs then win a verdict for $100 from the accounting firm; and the jury allocates 70% of the fault to the officer and 30% to the accounting firm.

Under the proportional reduction rule, the verdict against the accounting firm is reduced by the percentage of fault attributable to the settling officer (70%), rather than by the $10 that the officer paid in settlement. The $100 verdict against the accounting firm is therefore reduced by 70%, and the accounting firm pays the plaintiff $30 ($100 - 70% = $30). Under this rule, the accounting firm pays only its fair share of the

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8. Franklin v. Kaypro, 884 F.2d 1222 (9th Cir. 1989).
damages. Plaintiffs, however, recover only $40 of their $100 loss, $10 from the officer and $30 from the accounting firm.

This solution has been praised because it permits partial settlements, while placing the risks that these settlements might be too cheap on the person who negotiates the settlement—the plaintiff. This eliminates the unfairness to the non-settling defendants.

The purpose of this article is to re-examine this "neat solution" and to discuss the weaknesses which have not been dealt with in detail by the courts and legal scholars who have considered this issue. Section II discusses the historical background which led to this solution. Section III examines whether judges have the power to adopt this solution or, for that matter, any "settlement bar" rule which summarily extinguishes contribution rights prior to trial. Section IV discusses the merits of the solution, specifically its effect on deterrence, settlement, judicial economy and plaintiffs' rights. Section V proposes that Congress enact a new settlement bar rule which more effectively balances the interests of all parties.

II. THE HISTORICAL BACKGROUND

In the aftermath of the 1929 Stock Market crash, Congress passed the 1933 Securities Act and the Securities Exchange Act of 1934. The Securities Act was designed to provide investors with full disclosure, to protect them against fraud, and to promote ethical standards of fair dealing in securities transactions. To that end, the Securities Act prohibits offers and sales of securities unless the securities are exempt or registered with the SEC. Additionally, it requires that issuers disclose accurate information about themselves and the securities they are offering. The Securities Act provides three private rights of action which are described in the next section.

The purpose of the 1934 Exchange Act was to regulate exchanges and markets and to protect investors from manipulation. To accomplish this goal, the Exchange Act

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9. See supra note 1.
established the SEC, imposed disclosure requirements, prohibited "manipulative devices or contrivances," and required registration of dealers, brokers, exchanges, transfer agents, and information processors. The 1934 Act contained one express private right of action for investors and a second has been judicially recognized.

A. The Private Rights of Action

The private rights of action under the Securities Act and the Exchange Act provide injured investors with the right to sue various parties under certain circumstances. Section 11 of the Securities Act provides a private right of action to purchasers of registered securities who have suffered losses as a result of misrepresentations and omissions in a registration statement. A section 11 action may be brought only against certain defendants, i.e., persons who signed the registration statement, directors, underwriters and accountants, and engineers and appraisers who prepared or certified part of, and are named in, the registration statement. The plaintiff in a section 11 action does not need to prove that these defendants acted with scienter.

Section 12(2) of the Securities Act allows injured purchasers a private right of action against those who misstate a material fact in an offer to sell a security. The purchaser may sue only persons from whom he bought the security or who played a substantial role in the transaction.

Section 12(1) of the Securities Act gives purchasers the right to obtain a refund of the purchase price from anyone who sells securities which are not registered in accordance with section 5 of the Act.

19. Id.
Section 18 of the Exchange Act gives a purchaser or seller the right to sue any person who makes a false or misleading statement in documents filed with the SEC. Plaintiff, however, must prove that he read and relied on the misleading statement.

These express causes of action have been overshadowed by a judicially implied right of action which has arisen under SEC Rule 10b-5. That rule was promulgated by the SEC in 1942, pursuant to its authority under Section 10(b) of the Exchange Act. Rule 10b-5 contains a “catch all” provision that prohibits fraud and deception in the broadest terms.

In 1946, a federal district court first recognized a private right of action under Rule 10b-5. As interpreted by the Supreme Court, this private cause of action is available to purchasers and sellers of securities, who may sue any person who causes them damage by fraud, deceit or use of any manipulative device. The plaintiff in a 10b-5 action, however, must prove that the defendant acted with scienter. Together, the Securities Act and the Exchange Act contain five private rights of action, four of which are expressly stated and one of which is implied. The next section focuses on the contribution rights set forth in those Acts.

25. The Rule provides:

Employment of Manipulative and Deceptive Devices.

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 the 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.

B. The Right to Contribution

Contribution is a means of apportioning liability among joint tortfeasors. A joint tortfeasor who pays more than his share of the plaintiff's damages may recover the excess from the other joint tortfeasors in a contribution action.29

Unlike other large federal regulatory schemes,30 the 1933 and 1934 Acts specifically provide for a right of contribution among defendants.31 Of course, since the right of action under rule 10b-5 is judicially implied, there is no express right to contribution under this rule. However, the courts which have considered the question have generally concluded that Congress intended contribution rights to exist among defendants in securities actions and, therefore, have recognized that an implied right to contribution exists under Rule 10b-5.32

31. Subsection 11(f) of the 1933 Act provides:
All or any one or more of the persons specified in subsection (a) of this section shall be jointly and severally liable, and every person who becomes liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation.
15 U.S.C. 77k(f) (West 1991)). Section 9(e) of the 1934 Act provides: "Every person who becomes liable to make payment under this section may recover contribution as in cases of contract from any person who, if joined in the original suit, would have been liable to make to same payment." 15 U.S.C.A. § 78i(e) (West 1991). Section 18(b) of the Exchange Act contains a nearly identical provision. 15 U.S.C. § 78r(b) (West 1991).
C. Two Trends in Modern Law

By including private rights of action under the securities laws, Congress set the stage at the federal level for the conflict between two important trends in the law. The first trend is toward a fair - critics say an impossibly mathematically exact - allocation of damages among joint tortfeasors. The second trend is toward encouraging partial settlements in complex, multi-defendant cases. The next two sections will examine these trends.

1. The Trend Toward a Fair Allocation of Damages Among Joint Tortfeasors

For the past two centuries American courts and state legislatures have expanded and refined the contribution rights of defendants. The English case of Merryweather v. Nixan\(^{33}\) stated the common law rule that there could be no contribution among intentional tortfeasors. Unfortunately, Merryweather suffered a sea change as it was imported into this country, and it came to be cited for the proposition that there was no right to contribution among any joint tortfeasors, irrespective of whether their torts were negligent or intentional.\(^{34}\) This revised, harsher Merryweather rule was adopted into the common law of virtually every state, and contribution among tortfeasors became generally unavailable in this country.\(^{35}\) The trend toward fair allocation of liability among joint tortfeasors began as courts and legislatures recognized the rule against contribution as unduly harsh. The large majority of states have eased this rule, either by statute or judicial decision, to allow some sort of contribution among joint tortfeasors.\(^{36}\)

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34. See Theodore W. Reath, Contribution Between Persons Jointly Charged for Negligence—Merryweather v. Nixan, 12 Harv. L. Rev. 176, 177 (1898); Keeton et al., supra note 29, at 337. Apparently in this country the Merryweather rule was first applied only to cases involving intentional torts; however, when courts began allowing joinder of persons who were negligently responsible for the same torts, the Merryweather rule began to be applied to negligence cases as well. Keeton et al., supra note 29, § 50 at 337.
35. Keeton et al., supra note 29, § 50 at 337.
Some states began allocating fault among joint tortfeasors in a rough and simple way; specifically, contribution was allowed on a "pro rata" basis. Thus, for contribution purposes, damages were divided equally among the joint tortfeasors regardless of their relative fault, and a defendant was entitled to contribution only to the extent that he paid more than his fractional share of the plaintiff's damages.37

For example, assume that A and B caused $100 in damages to P. After trial, A pays P the entire $100 judgment. Under the pro rata system, A's share of the damages would be the total damages ($100) divided by the number of tortfeasors (2), or $50. Since A has paid $100 to P, A would have the right to recover the $50 he paid in excess of his share from B. A could file a contribution claim against B for this amount.

The trend toward precise allocation of damages took its next step as courts realized the unfairness inherent in the pro rata system: It divides fault equally among defendants who might not be equally responsible for the plaintiffs' damages. Thus in the last example, even if A were only 10% responsible for P's damages, the pro rata system would require A to pay 50% of the damages.

Courts and legislators, troubled with this result, began allowing contribution on a "comparative fault" basis.38 Under such a system, a defendant can recover from his co-defendants any amount he pays in excess of his fair share of the damages. Returning to the previous example, assume that A is 10% responsible and B is 90% responsible for the $100 in damages to P. A's fair share of the damages is $10 and B's is $90. If A pays P the entire $100, A has paid $90 more than his fair share and may file a contribution claim against B for this $90.

This trend toward a more precise allocation of damages is specifically seen in cases decided under the securities laws. The early cases allowed contribution on a pro rata basis.39 Recent

37. Keeton et al., supra note 29, § 50, Item 8 at 340.
securities law cases have held that contribution should be based on the relative culpability of defendants.40

2. The Trend Toward Partial Settlement of Complex Securities Cases

The trend toward fairer allocation of damages among joint tortfeasors conflicts with another trend, which arises from the desire of district court judges to foster partial settlements of complex, multi-defendant cases, similar to those often filed under the Securities Act and the Exchange Act. The Acts themselves are silent as to the importance of settlement, but practical considerations give judges great incentives to push for, and approve, partial settlements.

The main practical consideration is the size and complexity of many securities cases. The demise of a major company can give rise to claims for millions of dollars under the Acts. The number of possible defendants is also quite large, and includes more than the corporate “insiders” who may have played a central role in the fraud. Modern plaintiffs’ lawyers feel obliged to also sue the troubled corporation’s securities underwriters, investment bankers, bankers, accountants, attorneys and major investors. Trials of such cases, which may involve different theories of liability and standards of proof as to the various defendants, may take months.

Judges and magistrates, therefore, expend enormous energy in attempts to settle these cases.41 If a “global” settlement as to all defendants is not possible, courts strongly encourage partial settlements, in which the plaintiff settles with one, or a few, of the many defendants. Courts see several advantages to

42. The term “insider” is used in this article to refer to directors and officers of an issuer and does not connote any prohibited insider trading.
43. See, e.g., Nelson v. Bennett, 662 F. Supp. 1324, 1326 (E.D. Cal. 1987); In re Nucorp Energy Sec. Litig., 661 F. Supp. 1403, 1405 (S.D. Cal. 1987) (“over one hundred settlement or settlement-related conferences or hearings” were held).
these partial settlements. First, they simplify the remaining litigation by removing one defendant and much of the controversy as to what that defendant did or did not do. Second, they ensure that at least some money is paid to the plaintiffs. These plaintiffs usually have suffered genuine economic loss due to the failure of their investment, and courts are happy to see them compensated. Finally, these settlements put pressure on the other defendants to settle because the remaining defendants realize that plaintiff's case will be adequately financed by the first settlement and do not want to be the last defendant left to go to trial.

D. The Conflict Between the Trends

The goals of contribution and partial settlement are in conflict. The very existence of a right to contribution makes partial settlement virtually impossible. Where such a right exists, if one joint tortfeasor settles with the plaintiff that tortfeasor remains liable in contribution to all of the other joint tortfeasors, many of whom will already have filed cross-claims against him. Accordingly, there is very little incentive for one defendant to enter into a settlement with the plaintiff. Judge Irving has noted that in the absence of any means for cutting off contribution rights against a settling defendant, partial settlement of any federal securities question before trial is, as a practical matter, impossible:

Any single defendant who refuses to settle, for whatever reason, forces all other defendants to trial. Anyone foolish enough to settle without barring contribution is courting disaster. They are allowing the total damages, from which their ultimate share will be derived, to be determined in a trial in which they are not even represented.

E. A Solution: Settlement Bar Statutes

Many states have solved this problem by enacting "settlement bar" statutes. A settlement bar statute extinguishes con-
tribution rights against a settling defendant. If such a statute is applicable, the settling defendant can escape the lawsuit without any further liability to the plaintiff or to joint tortfeasors.

Settlement bar statutes have been enacted in twenty-six states and fall into three general categories. The major difference among the three categories is the means of calculating the "judgment reduction," i.e., the amount of credit the non-settling defendants receive in light of the settlement. This credit or "judgment reduction" is necessary to prevent a double recovery. Without it, a plaintiff could recover all of its damages from one defendant and proceed to sue and recover a large settlement from the remaining defendants.

The first type of settlement bar statute is based on the Uniform Contribution Among Joint Tortfeasors Act of 1939. This Act provides that contribution rights against a settling defendant are extinguished if the settlement is reached before the "right of the other tortfeasor to secure a money judgment has accrued." The non-settling defendants receive a pro rata


The Arkansas statute reads:

A release by the injured of one (1) joint tortfeasor does not relieve him from liability to make contribution to another joint tortfeasor unless the release is given before the right of the other tortfeasor to secure a money judgment for contribution has accrued, and provides for a reduction, to the extent of the pro rata share of the released tortfeasor, of the injured person's damages recoverable against all the other tortfeasors.

judgment reduction. Any judgment entered against these non-settling parties will be reduced by the pro rata share of damages attributable to the settling defendant.49

The following example illustrates the application of this rule. Assume the Settling Defendant (SD) and the Non-Settling Defendant (NSD) cause $100 in damages to P. SD immediately settles by paying $20 to P. P then takes NSD to trial and obtains a verdict against NSD for the $100 in damages. NSD, however, is entitled to a judgment reduction as a result of the settlement between SD and P. With a pro rata judgment reduction rule, the amount of the judgment reduction is SD’s pro rata share. Since there are two defendants, SD’s pro rata share is one half, or $50. NSD is therefore liable to P for only $50 (the $100 judgment less SD’s $50 pro rata share). Under this rule, because P accepted less in settlement from SD than SD’s pro rata share, P recovers a total of only $70 ($20 from SD and $50 from NSD), rather than the $100 in damages that she suffered.

The second type of settlement bar statute, based on the 1955 revised version of the Uniform Act, provides that a settlement made in “good faith” between plaintiff and one defendant extinguishes any rights of contribution which the non-settling defendants may have against the defendant who settled.50 “Good faith” is usually defined to mean the absence

49. In continuance of the trend toward a more precise allocation of fault among joint tortfeasors, the term pro rata has recently been interpreted in at least one state to mean a comparative fault share. Charles v. Giant Eagle Markets, 522 A.2d 1, 5 (Pa. 1987).


The Ohio statute reads in part:

(F) When a release or a covenant not to sue or not to enforce judgment is given in good faith to one of two or more persons liable in tort for the same injury or loss to person or property or the same wrongful death, the following apply:

1) The release or covenant does not discharge any of the other tortfeasors from . . . claim[s] against the other tortfeasors to the extent of any amount stipulated by the release or the covenant, or in
of fraud or collusion between the settling defendant and the plaintiff.\textsuperscript{51} The 1955 Uniform Contribution Among Tortfeasors Act provides a \textit{pro tanto} judgment reduction provision rather than the \textit{pro rata} provision applicable under the 1939 Uniform Act.\textsuperscript{52} Under the \textit{pro tanto} rule, the ultimate judgment against the non-settling defendant is reduced by the \textit{amount actually paid} in settlement by the settling defendant.

The following example illustrates the \textit{pro tanto} rule: as in the last hypothetical, assume SD and NSD caused $100 in damages to P, and SD settles by paying $20. P then obtains a verdict against NSD for the $100. NSD is entitled to a judgment reduction of the \textit{amount paid} by SD ($20). NSD's liability to P is therefore $80 ($100 minus $20), and P recovers all of her damages ($20 in settlement from SD and $80 from NSD).

In some states, before the contribution rights of the non-settling defendants are extinguished, a court must make the determination that the partial settlement has been made in "good faith." In California, a summary pre-trial hearing is held to determine whether the settlement was reached in good faith.\textsuperscript{53} Under the seminal case of \textit{Tech-Bilt v. Woodward-Clyde and Associates,} the amount of the settlement is relevant to the issue of good faith. In order to meet the "good faith" standard, the amount which the settling defendant pays to settle

\begin{itemize}
\item[53.] Section 877.6 of the California Code of Civil Procedure provides in part:
\begin{itemize}
\item[(a)] Any party to an action wherein it is alleged that two or more parties are joint tortfeasors or co-obligors on a contract debt, shall be entitled to a hearing on the issue of the good faith of a settlement entered into by the plaintiff or other claimant and one or more alleged tortfeasors or co-obligors . . . .
\item[(b)] The issue of the good faith of a settlement may be determined by the court on the basis of affidavits served with the notice of hearing, and any counter-affidavits filed in response thereto, or the court may, in its discretion, receive other evidence at the hearing.
\item[(c)] A determination by the court that the settlement was made in good faith shall bar any other joint tortfeasor or co-obligor from any further claims against the settling tortfeasor or co-obligor from equitable comparative contribution, or partial or comparative indemnity, based on comparative negligence or comparative fault.
\end{itemize}
\item[54.] 698 P.2d 159 (Cal. 1985).
\end{itemize}
the case must be in the "ballpark," that is, it must not be grossly disproportionate to the settling defendant's fair share of damages.\(^5\) If the settlement amount is so low as to be "out of the ballpark," the court will not extinguish contribution rights of the non-settling defendant.

The third type of settlement bar statute is exemplified by the 1977 Uniform Comparative Fault Act, which has been adopted in two states.\(^6\) Section 6 of this act provides that "the claim of the releasing person against other persons is reduced by the amount of the released person's equitable share of the obligation . . . ." In other words, any judgment against the non-settling defendant will be reduced by the percentage of fault which is attributable to the defendant who settled. This type of statute is discussed in detail in section II, H of this article.

F. The Securities Acts Contain No Specific Means for Reconciling the Competing Trends

Settlement bar rules are creatures of statute. A serious problem has arisen under the securities law because, while the Securities Act and Exchange Act contain explicit and implied rights to contribution, the Acts contain no mention of any means of extinguishing contribution claims in the context of a partial settlement. Accordingly, if the securities laws are taken at face value, partial settlement of multi-defendant cases is virtually impossible because there is no mechanism for a settling defendant to obtain a settlement bar and escape the case.

G. The Ninth Circuit Experience

This problem has been most fully played out in the Ninth Circuit, which ultimately became the first circuit to judicially

\(^5\) *Id.* at 167. This inquiry into the price of the settlement is at odds with the rule in most states which have adopted the 1955 Revised Version of the Uniform Contribution Among Tortfeasors Act. In these states good faith is defined to mean only the absence of collusion between plaintiff and defendant.

adopt the “proportional reduction” type of settlement bar rule. Until recently, the Ninth Circuit took the absence of a settlement bar rule under the securities laws as it found it, declining two invitations to create a settlement bar rule by judicial action.57

1. The Laventhol Case

In Laventhol,58 for example, plaintiffs, who had invested in ill-fated real estate partnerships, sued the partnership’s “insiders,” as well as its underwriter and its accounting firm, alleging losses of at least $2,000,000. Prior to trial plaintiffs entered into a settlement with two of the “insider” defendants by which plaintiffs received $8,000 towards costs and a promise that these defendants would cooperate in the remaining litigation. These settling defendants then sought a settlement bar order. Specifically, they asked the court for summary judgment on the cross-claims for contribution which had been filed against them by the remaining defendants. They argued that these claims were barred by the settlement. The district court, apparently eager to simplify the litigation by approving this partial settlement, granted the motion and extinguished the contribution claims of the non-settling defendants.

The Ninth Circuit reversed, noting that there was no basis in the securities laws for extinguishing settlement rights prior to trial. “By enacting section 77k(f) of the Securities Act, Congress expressed its preference between the sometimes conflicting values of settlement and contribution. A right of contribution is clearly enunciated, but the statute is silent as to the encouragement of settlements.”59

In dicta, however, the Ninth Circuit suggested a “no harm, no foul” rule. Specifically, the court stated that “[i]f it could be said that [settling defendants’] settlement with the plaintiff class had resulted in their bearing their proper share of damages,” it “might” be proper to extinguish any contribution rights against the settling defendants.60 The reasoning was ap-

57. Smith v. Mulvaney, 827 F.2d 558 (9th Cir. 1987); Laventhol, Krekstein, Horwath & Horwath v. Horwitch, 637 F.2d 672 (9th Cir. 1980), cert. denied, 452 U.S. 963 (1981).
58. Laventhol, 637 F.2d at 672.
59. Id. at 675.
60. Id.
parently that there is no right of contribution against a defendant who pays his "proper share." Contribution exists only in favor of defendants who pay too much and against defendants who pay less than their "proper share."

The settlement in Laventhol was patently unfair. It called for major defendants to escape a two million dollar action by payment of $8,000 in costs. Thus, there was little incentive for the Ninth Circuit to hold that this inadequate payment extinguished contribution rights.

2. Smith v. Mulvaney

Seven years later, however, the Ninth Circuit received a case presenting a much more balanced settlement and a much more developed record. In Smith v. Mulvaney, investors in a defunct bank sued directors and officers of the bank. A group of directors and officers settled with plaintiff by paying $722,000. A non-settling "insider" defendant, Mrs. Smith, went to trial. The jury awarded $4,402,476 against Mrs. Smith and assessed an additional $750,000 in punitive damages.

Mrs. Smith then brought an action for contribution against the settling directors. These directors moved for summary judgment on the ground that their prior settlement had extinguished Mrs. Smith's right to contribution from them. The trial court granted the settling directors' motion, finding that, under Laventhol, these defendants had paid their "proper share" of the damages. The Ninth Circuit, however, reversed, stating, "[t]his court finds that the evidence on which the trial court based its decision fails to support adequately a conclusive finding the settling defendants paid their proper share of damages."

Taken at face value, the standard enunciated by the Ninth Circuit in Smith is surprisingly strict. Before contribution claims against a settling defendant can be extinguished, the defendant must make a "conclusive" showing that he has paid his "proper share" of the damages.

61. Smith v. Mulvaney, 827 F.2d 558 (9th Cir. 1987).
62. Id. at 559-60.
63. Id. at 561.
3. District Court Cases

At the time when the Ninth Circuit was refusing to extinguish contribution rights against settling defendants, the district courts, which were faced with the prospect of trying these complex cases if settlements could not be reached, were viewing partial settlements with a more accepting eye. In fact, these trial courts were approving such settlements and extinguishing contribution rights against the settling defendants.\

*Nucorp,* decided in the Southern District of California just prior to the decision in *Smith,* exemplifies the problems faced by the district courts. *Nucorp* arose from the bankruptcy of Nucorp Energy, Inc. Investors sued corporate "insiders" as well as Nucorp's accountant, securities underwriter, banker and a major investor. Plaintiffs' "baseline" damages were estimated to be $230 million.\(^{64}\) The trial threatened to be very lengthy and the judge and magistrate made concerted efforts to reach a pretrial settlement, including over one hundred settlement conferences.\(^{67}\) Finally a partial settlement was reached by which "insider" defendants offered to pay plaintiffs $41 million, contingent on the court's entering a settlement bar order extinguishing any contribution claims against these settling "insider" defendants.\(^{68}\) The settlement bar order was to require a *pro tanto* reduction of any subsequent judgment. Therefore, any judgment later entered against the non-settling defendants would be reduced by the $41 million the settling defendants had paid in settlement.

The non-settling defendants challenged the proposed settlement bar order, arguing that the securities laws contain no provision for extinguishing contribution rights prior to trial and that the proposed settlement was unfair because it allowed the primarily liable "insider" defendants to escape liability by payment of $41 million. The non-settling defendants argued

\[^{65}\text{In re Nucorp Sec. Litig., 661 F. Supp. 1403 (S.D. Cal. 1987).}\]
\[^{66}\text{Id. at 1410.}\]
\[^{67}\text{Id. at 1405.}\]
\[^{68}\text{Id.}\]
that the proposed order would leave the secondarily liable defendants exposed to pay the balance of damages, which could exceed $180 million.\textsuperscript{69}

The court approved the settlement and entered the settlement bar order as requested by the settling "insiders." The court did not dispute the settling defendants' liability. On the contrary, it noted that a major portion of the settlement payment was made under the settling defendants' insurance policies and that there was evidence that the settling "insiders" had committed "acts of dishonesty" which, if exposed at trial, would not be subject to coverage under the policies.\textsuperscript{70} The court felt the settlement was wise because it captured these policies for the benefit of the plaintiffs.

The court also reasoned that the settlement should be accepted because an independent magistrate had participated in settlement discussions, because the settlement was adequate in light of the uncertainty of collecting a larger judgment, and because of the uncertainties of litigation.\textsuperscript{71} Finally, while the court cited the "proper share" standard enunciated in Laventhol, it could not quite hold that these "insider" defendants (who may have committed "acts of dishonesty" sufficient to vitiate their insurance coverage) were paying their "proper share" by contributing 18\% of plaintiffs' damages. The court, therefore, altered the "proper share" standard and found merely that the settling defendants' payment was "sufficiently related" to their fair share of the liability.\textsuperscript{72}

The court obviously felt great pressure to approve the settlement. First, doing so would simplify what was bound to be a lengthy trial and it would put great pressure on the other defendants to settle. Second, the settlement locked in a substantial cash recovery for plaintiffs who had suffered palpable economic losses.

On the other hand, aspects of the settlement were seemingly unfair. It allowed apparently highly culpable defendants to escape the action by paying only a small percentage of the damages they had caused, leaving secondarily liable parties exposed to pay the balance.\textsuperscript{73} In addition, there is no clear

\textsuperscript{69} Id. at 1406.
\textsuperscript{70} Id. at 1409.
\textsuperscript{71} Id.
\textsuperscript{72} Id. at 1409-10.
\textsuperscript{73} In the Nucorp case, the plaintiffs later went to trial against the
basis in the securities laws for the settlement bar order entered in this and similar cases, and *Nucorp* contains no discussion of the basis for the court's power to enter such an order. The *Nucorp* case thus illustrates the dilemmas presented by a settling defendant's request that contribution rights be extinguished. Other aspects of the *Nucorp* case will be discussed in later sections.

H. *The Kaypro Solution*

The settlement bar question again reached the Ninth Circuit in the case of *Franklin v. Kaypro Corp.*74 There, investors in the troubled Kaypro Corporation brought a class action against various "insiders" and against Kaypro's accounting firm and securities underwriter. The plaintiffs alleged that violations of the securities laws had caused them to suffer between $19 million and $22 million in damages. Plaintiffs agreed to settle with the "insider" defendants for $9.25 million with the condition that a settlement bar order be entered with a provision for a *pro tanto* judgment reduction. Over the objections of the non-settling defendants, the district court entered the order, which was then appealed to the Ninth Circuit.

By the time this case reached the Ninth Circuit, several district court judges had dealt with the settlement bar issue in thoughtful opinions.75 The court was therefore fully aware of the practical importance of the settlement bar rule in promoting partial settlements,76 but it was also aware of the great unfairness which partial settlements can work on non-settling defendants.77

The court, therefore, adopted what had previously been termed a "neat solution."78 It used its "common law" powers to create a settlement bar rule which would extinguish the contribution rights of non-settling defendants against those non-settling defendants. One defendant defaulted during trial and later settled with plaintiff. The jury returned a defense verdict against the other defendants.
who settle.79 The court then rejected the *pro tanto* judgment reduction rule, by which plaintiff’s recovery against the non-settling defendants is reduced by the actual amount the settling defendant has already paid in settlement. Instead, the court adopted a “proportional reduction rule,” by which any judgment against the non-settling defendant will be reduced by the proportion of fault attributable to the settling defendant. In line with the trend toward precise allocation of damages among co-defendants, this proportion is not to be calculated on a *pro rata* basis. Rather, when the plaintiff takes the case to trial against the non-settling defendant, the jury will be asked to decide not only the liability of that defendant, but also what percentage of fault is attributable to the defendant who has settled. The plaintiff’s ultimate judgment against the non-settling defendants will be reduced by that percentage.80

The following example illustrates the “proportional reduction” rule. Assume that SD and NSD cause $100 in damage to P. P settles with SD first, for $20. P then goes to trial against NSD. The jury finds P’s damages to be $100 and finds that 90% of these damages are attributable to SD and 10% to NSD. Under the proportional reduction rule, the amount to be paid by NSD is the amount of P’s damages ($100) less the proportion attributable to SD (90%). NSD is therefore liable to P for only $10 ($100 minus 90% = $10). Moreover, because P made a cheap settlement with SD, P recovers a total of only $30 ($20 from SD and $10 from NSD), rather than the $100 in damages that she suffered.81

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79. Franklin v. Kaypro Corp., 884 F.2d 1222 (9th Cir. 1989).
80. Id. at 1231-32. While Kaypro did not cite the 1977 Uniform Comparative Fault Act, it did adopt a judgment reduction rule which is substantially similar to the rule set forth in § 6 of that Act.
81. Of course the system can also work in the plaintiff’s favor. Again, assume SD and NSD cause $100 in damages to P. P accepts $20 in settlement from SD. P then goes to trial against NSD. The jury finds P’s damages to be $100 and finds that 90% are attributable to NSD and 10% to SD. NSD must therefore pay P $90, which consists of P’s damages ($100) less the proportion attributable to SD (10%, i.e., $10). P thus collects $90 from NSD and $20 from SD, for a total of $110, more than her total damages.

One state statute prevents this excess recovery to plaintiff by providing that the judgment reduction will be the percentage of fault attributable to the non-settling defendant or the amount paid in settlement by that defendant, whichever is greater. See N.Y. GEN. OBLIG. LAW § 15-108.
The Kaypro court concluded that the proportional reduction rule is an optimal solution because it meets the statutory goals of punishing each wrongdoer, limiting each defendant's liability to his or her relative culpability, and encouraging settlement.\(^{82}\)

This article will now subject this "neat solution" to critical analysis. First, the threshold question passed over by cases and commentators will be faced: whether courts have the power to create a rule that will summarily extinguish legal rights which have been created by statute or implied from the intent of Congress. Then other aspects of the proportional reduction rule will be turned to, returning from time to time to the facts of the Nucorp decision to see how this rule would have changed the outcome in that difficult case. Finally, this article will propose that Congress consider a new settlement bar rule which better balances the interests of all parties.

### III. THE THRESHOLD QUESTION: DO COURTS HAVE THE COMMON LAW POWER TO CREATE A SETTLEMENT BAR RULE?

Federal courts have spent a great deal of energy debating the merits of the pro tanto and proportional reduction rules. The cases, however, give little attention to the threshold question of whether courts have the power to extinguish, before trial, the contribution rights of non-settling defendants. Thus, several cases conclude, without discussion, that federal courts do have the common law power to extinguish contribution rights and apply a judgment reduction rule.\(^{83}\) Kaypro comes to this conclusion in a footnote with a cite to Texas Industries, Inc. v. Radcliff Materials, Inc.\(^{84}\) Similarly, an insightful article promoting the proportional reduction rule assumes, with a brief citation to Clearfield Trust Co. v. United States and United States v. Kimbell Foods, Inc., that courts have the common law power to extinguish contribution rights before trial.\(^{85}\)

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82. Kaypro, 884 F.2d at 1291.
84. Kaypro, 884 F.2d at 1228 n.10 ("However, because Congress has not yet created laws governing the right it created, the federal courts are free to fashion a common law.") (citing Texas Indus., Inc. v. Radcliff Materials, Inc., 451 U.S. 630 (1981)).
85. William Bruce Davis, Note, Multiple Defendant Settlement in 10b-5: Good...
The following discussion questions whether courts have this power. First, this section lists the traditional bases for creation of federal common law rules. After this, the article examines the *Texas Industries* case and concludes that it does not support the proposition that judges can create rules that summarily extinguish causes of action for contribution. Specifically, the traditional prerequisites for exercise of federal common law powers are absent because no uniquely federal interests are involved and the proposed rules are not supported by the intent of Congress.

Next, this section examines whether creation of a settlement bar rule is a legitimate exercise of the federal courts' power to fill in the gaps or interstices in federal statutes. After discussing a line of cases that distinguishes between statutorily and judicially created rights, the section concludes that courts lack power to extinguish the statutorily created contribution rights, but they may have power to apply settlement bar rules to judicially created contribution rights.

After this, the section discusses the two types of judgment reduction rules. Specifically, I deal with the argument that courts have the power to apply the proportional reduction rule because it involves a lesser exercise of judicial power than does application of the *pro tanto* rule.

Finally, the section turns to the argument, passed over by most observers, that if judges do have the power to adopt settlement bar rules, they must borrow these rules from state law. The section concludes that courts should borrow settlement bar rules from state law, if any state rules are applicable.

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86. A detailed discussion of the *Texas Indus.* case is set forth below. Neither *Clearfield* nor *Kimbell* is a particularly appropriate basis for creation of federal common law rules regarding contribution between private parties. *Clearfield* involved an action on a federal contract, and actions involving such federal rights have long been held to invoke "uniquely federal interests" sufficient to invoke federal common law powers. Similarly, *Kimbell* involved contractual liens arising from federal loan programs. No such federal rights are involved in a private action for contribution under the securities laws and the basis for federal common law jurisdiction in *Clearfield* and *Kimbell* is therefore of little relevance here.
A. The Traditional Bases for Creation of Federal Common Law

Traditionally, federal courts have created common law rules in the following five types of situations:

1. Admiralty cases;87
2. Cases between states or nations;88
3. Cases involving uniquely federal interests, such as the property or contractual rights of the United States;89
4. Cases where Congress has given courts the power to create common law rules;90 and
5. Cases where federal common law is needed to fill in the gaps or interstices in federal statutory provisions.91

The first two of these traditional bases for creation of federal common law are not relevant here. Creation of a settlement bar rule in the securities law context does not involve any admiralty issues or any disputes between states or nations. Accordingly, it is necessary to determine whether either the third, fourth or fifth factor is present. More specifically, it must be determined whether judicial creation of settlement bar rules is warranted (1) by any uniquely federal interest, (2) by the intent of Congress, or (3) by the need to fill in the interstices in federal securities laws. This inquiry begins with an examination of the Texas Industries case.

B. The Texas Industries Case

Texas Industries is one of two 1980 cases in which the Supreme Court was asked to decide whether a right to contribution could be judicially implied under federal statutes. In Texas Industries and a companion case, Northwest Airlines, Inc. v. Transport Workers,92 the Supreme Court concluded that federal courts lacked the common law power to imply a right of action for contribution.93 Because Texas Industries gives insight into

92. Id.
93. In Northwest, flight attendants sued the airline under the Equal Pay Act of
the Supreme Court's thinking on the extent to which judges may create common law rules, it will be examined more closely here.

The defendant, Texas Industries, was accused of fixing the prices of ready-mix concrete in violation of section 1 of the Sherman Antitrust Act. Plaintiff sought treble damages under section 4 of the Clayton Antitrust Act. During discovery, Texas Industries learned that certain parties were alleged to be its co-conspirators in the purported price fixing scheme. The company thereupon filed claims for contribution against these alleged co-conspirators. The district court dismissed Texas Industries' contribution claims and the Fifth Circuit affirmed. Both courts engaged in a weighing of the policy considerations for and against the creation of a right to contribution, and then concluded that such a right did not exist.

When it granted certiorari, the Supreme Court thus faced a situation similar to the one described in this article, where the advantages of a proposed rule had been discussed to the exclusion of an examination of federal courts' power to create the rule. In fact, in writing for the unanimous court, Chief Justice Burger noted that in the "vigorous debate over the advantages and disadvantages of contribution and various contribution schemes, the parties, amici, and commentators have paid less attention to a very significant and perhaps dispositive threshold question: whether courts have the power to create such a cause of action absent legislation." Accordingly, the Court did not spend much time discussing the relative merits of the proposed contribution remedy. Rather, Chief Justice Burger's opinion was a discourse on the means by which such a right could be recognized.

The Court noted that a right of contribution may be created in two ways, "first, through the affirmative creation of a right of action by Congress, either expressly or by clear impli-

1963 and Title VII of the Civil Rights Act of 1964 alleging discriminatory practices. Northwest filed a claim for contribution against the employees' union, claiming that the union had promoted the discriminatory practices. Neither act contained an explicit right to contribution, and the Supreme Court held that the courts lacked the power to create such a right.

95. Abraham Const. Co. v. Texas Indus., 604 F.2d 897 (5th Cir. 1979).
96. Id.
97. Texas Indus., 451 U.S. at 688.
cation; or second, through the power of federal courts to fashion a federal common law of contribution.” The Court rejected both theories. In reviewing the antitrust statute, the Court found nothing in the text or legislative history which would warrant implication of a right to contribution.

The Court then turned to federal common law. It noted that there is no general federal common law, and no specific federal common law of contribution, but that common law could be created in limited areas which are “few and restricted.” The Court described how these limited areas fall essentially into two categories, those in which a federal rule of decision is “necessary to protect uniquely federal interests” and those in which “Congress has given the courts the power to develop substantive law . . . .”

The Court noted that cases involving “uniquely federal interests” were usually those involving the rights and obligations of the United States, disputes between the states, and admiralty matters. In such cases, where the sovereign rights of the United States are involved or where the common law of the states would conflict, federal common law should logically apply.

Significantly, the Court held that contribution among antitrust defendants did not involve any “uniquely federal interests”:

[C]ontribution among antitrust wrongdoers does not involve the duties of the Federal Government, the distribution of powers in our federal system, or matters necessarily subject to federal control even in the absence of statutory authority. In short, contribution does not implicate “uniquely federal interests” of the kind that oblige courts to formulate federal common law.

98. Id.
99. Id. at 639-40.
100. Id. at 640-41 (quoting Wheeldin v. Wheeler, 373 U.S. 647, 651 (1963)).
101. Id. at 640.
103. Federal common law has also been applied in the area of admiralty, because admiralty is a unique area of federal concern. Federal common law rules of contribution in the admiralty sphere are accordingly not predicates for common law rules in other areas of federal law.
104. Texas Indus., 451 U.S. at 642 (citations omitted).
The Court then looked at the statutory history of the antitrust laws in order to see whether Congress had given judges the power, under those statutes, to develop common law remedies such as contribution. It found the introductory language of the Sherman Act to be sufficiently broad to provide courts with a good deal of power to "give shape to the statute's broad mandate by drawing on common-law tradition." Nevertheless, the Supreme Court found nothing in the statutory history which would give courts the power to create a new remedy, such as contribution.

The Court concluded that the policy decision as to whether a right of contribution should exist was so close and complex that it should be decided by Congress.

Commentators have criticized the Texas Industries decision because it takes too conservative a view of federal judicial power. Nevertheless, the opinion remains the expression of the law by a unanimous Supreme Court and, as it is an exercise in judicial restraint, it is doubtful that its reasoning would be altered much by the present Court. Accordingly, even though the cases and commentators have brushed by the issue, it is necessary to examine whether the Kaypro court and other courts exceeded their common law powers when they created settlement bar and judgment reduction rules.


Under Texas Industries, common law rules may be created in cases where they are necessary to protect "uniquely federal interests" or where Congress has given courts the power to develop substantive law. As the next two sections will show, neither factor warrants judicial creation of settlement bar rules in the securities context.

105. Id. at 643 (quoting National Soc'y of Professional Eng'rs v. United States, 435 U.S. 679, 688 (1978)).
106. Id. at 642-45.
107. Id. at 647.
1. A Settlement Bar Rule Does Not Involve Any Uniquely Federal Interests

Applying the first factor, extinguishing contribution rights does not involve any "uniquely federal interest" which would permit judges to create new common law rules. No rights of the United States, conflicts between states, or admiralty matters are involved. Moreover, *Texas Industries* held that the antitrust laws did not affect "federal interests" in a way sufficient to permit federal courts to create new common law rules of contribution. If allowing antitrust defendants to seek contribution from one another does not implicate a "uniquely federal interest," it is difficult to see how extinguishing contribution rights under the securities laws would implicate such an interest. Both issues mainly involve the rights of private business litigants against each other. No interest of the Federal Government is involved. The federal interest which is present under both laws is quite similar, the regulation of the economy. If this consideration was insufficient to warrant federal common law jurisdiction in the antitrust context, it is similarly insufficient in the securities law context. Therefore, the first basis for implying federal common law suggested in *Texas Industries* will not support the creation of settlement bar and judgment reduction rules.

2. There Is No Evidence of Congressional Intent Sufficient to Empower Courts to Create a Settlement Bar Rule

The second basis for creation of federal common law is the intent of Congress to give courts the power to develop substantive law. The securities laws, like the antitrust laws, contain introductory language which has been interpreted to give courts the power to construe them broadly to effect their remedial purpose. Under *Texas Industries*, such broad language was held insufficient to give judges power to create new antitrust remedies. Similarly, the broad provisions of the securities laws contain no language indicating that Congress

intended to give courts added common law powers to create significant new remedial rules under the Acts.

Unlike the antitrust laws, the federal securities laws contain a specific grant of a right to contribution. There is nothing in the contribution sections, however, which indicates that Congress intended courts to have power to alter or extinguish this expressly created right. Moreover, the main goal of the proposed settlement bar rule is the promotion of settlement. The securities laws are silent as to settlement, and Congress gave no clear signs that it wished to empower federal judges to tamper with the remedies created under the securities laws to promote settlement.

As in Texas Industries, it appears that there is no specific basis in the securities laws or their history for giving courts the power to create new settlement bar and judgment reduction rules.

D. Authority to Create Settlement Bar Rules May Arise from the Court's Interstitial Powers

While the authority to create a settlement bar rule does not arise from any federal interest or from any clearly stated or implied intent of Congress, the basis for such a rule might be found in courts' "interstitial powers." Thus, in Northwest Airlines, the Supreme Court confirmed that when Congress enacts any federal statute, it grants federal courts the common law power to set the contours of the law and fill in the "interstices" between the specific provisions which it has enacted. The following discussion examines the scope of this power.

The search for the boundaries of this "interstitial" power yields several place markers. As discussed above, the Supreme Court held in Texas Industries that this power does not include the authority to create a right to contribution. However, the Court has also held that it does include the power to bor-

114. Id. at 97; Texas Indus., 451 U.S. at 646; Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 748-49 (1975).
row state, and sometimes federal, statutes of limitations and apply them to federal laws that lack limitations periods of their own.116 Finally, the Court has held that the interstitial power includes the authority to "delimit and set the contours of" judicially created causes of action.117 As the following sections show, none of these place markers provides a firm basis for judicial creation of settlement bar rules in the securities context.

1. The Statute of Limitations Cases

While the first place marker, Texas Industries, provides little support for courts' power to create a settlement bar rule, the second place marker, the statute of limitations cases, might seem more promising.

Statutes of limitation, like settlement bar rules, cut off statutorily created rights. If courts have "interstitial" power to cut off such rights by borrowing statutes of limitations, it can be argued that they also have the power to adopt settlement bar rules. This analogy, however, is too simplistic. It is generally accepted that a court's power to borrow statutes of limitations is based on congressional intent. Congress has been enacting private rights of action for over a century and it frequently omits limitations periods. Courts, however, have consistently supplied limitations periods by borrowing them from state law and, more recently, from federal law. Accordingly, when Congress passes a law without a statute of limitations, it does not expect that the right of action it is creating will go limitless. Rather, it expects and intends that courts will borrow a limitations period from state or federal law.118 The power to borrow statutes of limitation is thus firmly grounded in congressional intent.

The same cannot be said of settlement bar rules. Congress created the rights to contribution in question over fifty years ago. Until Kaypro, the circuit courts which faced the issue had consistently refused to apply any settlement bar rule.119 Ac-

117. Blue Chip Stamps, 421 U.S. at 723.
119. See, e.g., Laventhol, Krekstein, Horwath & Horwath v. Horwitch, 637 F.2d
Accordingly, there is no basis to conclude that, when Congress enacted or amended the securities laws, it expected the courts to create such bar rules.\textsuperscript{120}

Moreover, in statute of limitation cases, courts borrow statutes, i.e. they adopt an existing limitations period from state law or other federal law. With minor exceptions,\textsuperscript{121} courts which have adopted settlement bar rules have not borrowed them but have created whatever rule the judge considered optimal. The power of courts to create such new rules is far more dubious than the congressionally sanctioned borrowing of statutes of limitation which were in existence and generally applicable at the time Congress created the given right of action.

E. The Authority to Extinguish Contribution Rights May Depend on Whether Those Rights Are Statutorily Created or Judicially Implied

Since the statute of limitations analogy does not support the existence of any "interstitial power" to create settlement bar rules, it is necessary to examine this power further.

In Blue Chip Stamps v. Manor Drug Stores,\textsuperscript{122} the Supreme Court was asked to decide whether persons who were not purchasers or sellers of a security could be plaintiffs in a 10b-5 action. After examining the statutory history, the Court held that only purchasers and sellers could be plaintiffs. In reaching this conclusion, the Court noted that since the 10b-5 right of action had been judicially created, it would have to be judicially delimited:

We quite agree that if Congress had legislated the elements of a private cause of action for damages, the duty of the Judicial Branch would be to administer the law which Congress enacted; the Judiciary may not circumscribe a right which Congress has conferred because of any disagreement it might have with Congress about the wisdom of creating so expansive a liability. But as we have pointed out, we are not dealing here with any private right created by the express

\textsuperscript{672, 675} (9th Cir. 1980); Smith v. Mulvaney, 827 F.2d 558 (9th Cir. 1987).
\textsuperscript{120} See 2A SUTHERLAND, STATUTORY CONSTRUCTION § 49.09, at 200.
\textsuperscript{122} Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).
language of 10(b) or Rule 10b-5. No language in either of those provisions speaks at all to the contours of a private cause of action for their violation. . . . [W]e are dealing with a private cause of action which has been judicially found to exist and which will have to be judicially delimited one way or another . . . . ^139

Several of the rights to contribution under the securities laws were expressly created by Congress. ^124 Justice Rehnquist's opinion in Blue Chip suggests that courts' power to "circumscribe" these rights is very limited. A settlement bar rule would not merely circumscribe these rights, it would summarily eliminate them, prior to trial. Accordingly, a court's power to adopt such rules in the face of an expressly legislated right to contribution is very dubious.

The right to contribution under Rule 10b-5 was, of course, judicially created, and the Blue Chip holding therefore gives courts the power to delimit and set the contours of this right. This power is not unlimited. The right to contribution implied under Rule 10b-5 arises from Congress' specific intent to afford a right of contribution to persons sued under the securities laws. ^125 While courts have power to fill in the interstices surrounding this remedy, it is less clear that they have the power to overrule the will of Congress and extinguish this right without a trial.

With regard to settlement bar rules under Rule 10b-5, then, we return to the same question: in adopting such a rule, does a court merely delimit, set contours, and fill interstices of the law? Or is it performing a much more serious judicial calisthenic, similar to the creation of the right of contribution rejected in Northwest Airlines and Texas Industries? The answers to these questions may vary according to which judgment reduction rule is chosen. As the next section will show, a court's exercise of power is much more limited when it extinguishes a

123. Id. at 748-49 (emphasis added).
right under the proportional reduction rule than when it does so under the *pro tanto* rule.

F. A Settlement Bar Entered Under the Pro Tanto Rule Involves a Greater Use of Judicial Power than One Entered Under the Proportional Reduction Rule

Under the *pro tanto* rule, the non-settling defendant’s rights to contribution are extinguished, often after a summary, pre-trial good faith hearing. The non-settling defendant is therefore deprived of a trial on his right to contribution and may have to pay huge sums to plaintiff which, under the securities laws, he should have been able to recover in contribution from his co-defendants. If measured by its effect on the parties and on federally created rights, the *pro tanto* rule amounts to a rather drastic exercise of judicial power.

Under the proportional reduction rule, in contrast, the non-settling party is not deprived of a trial on its rights to contribution. On the contrary, he can go to trial and argue to a jury, as he would in a contribution action, that the settling defendant is responsible for part of the plaintiff’s damages. As with contribution, the non-settling defendant does not have to pay the portion of damages attributable to his settling co-defendants; that portion is deducted from the judgment against him. Accordingly, in most cases, the proportional reduction rule has a far more limited effect on congressionally created contribution rights, and in creating this rule, judges are, arguably, merely setting the contours of the law.

However, in some cases involving an insolvent non-settling defendant, extinguishing contribution rights can be very costly to other solvent, non-settling defendants, even if the proportional reduction rule is applied. The following example illustrates the problem.

Assume that SD, NSD-1 and NSD-2 are liable to plaintiff under the securities laws for a $100,000 loss. SD settles by paying $10,000 and a settlement bar is entered. Plaintiff goes to trial against NSD-1 and NSD-2. The jury sets plaintiff’s dam-

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126. This is the statutorily mandated procedure in California (CAL. CIV. PROC. CODE § 877.6 (Deering 1991)). In addition, this procedure has been used by some federal district courts. See, e.g., In re Nucorp Energy Sec. Litig., 661 F. Supp. 1403 (S.D. Cal. 1987).
ages at $100,000 and finds that SD is 10% liable, NSD-1 is 10% liable, and NSD-2 is 80% liable. Under the proportional reduction rule, the $100,000 judgment is reduced by the 10% of fault attributable to SD. A $90,000 judgment is therefore entered against NSD-1 and NSD-2. Assume, however, that NSD-2 is insolvent. NSD-1, whose contribution rights have been extinguished, must pay $90,000, representing his own share of the damages ($10,000) plus (because of joint and several liability) all of NSD-2's share ($80,000). Without the settlement bar, NSD-1 would need to pay only $50,000 (his $10,000 share and half of NSD-2's share) because NSD-1 could recover the remaining half of NSD-2's share in contribution from SD.

Thus, while the proportional judgment reduction rule is a lesser exercise of judicial authority than the pro tanto rule, in some instances even the proportional reduction rule will result in the destruction of important congressionally created rights to contribution.

In cases where all the defendants are solvent, however, the non-settling defendant is not harmed in any substantive way by application of the proportional reduction rule. Such a defendant retains the right to a trial where he can shift his liability to the settling defendants. The application of the proportional reduction rule will only affect the timing and composition of that trial. Since the power to control the timing and composition of trials falls within the interstitial powers of the court, judges may have the power to apply a proportional reduction rule in cases where all defendants are solvent.

The varied results of the above analysis can be summarized as follows.

First, courts' interstitial power gives them some leeway in fashioning rules that affect judicially implied rights (as opposed to statutorily created rights). Accordingly, courts may have the power to apply the pro tanto rule or the proportional reduction rule to the judicially implied right of contribution under Rule 10b-5.

Second, courts' interstitial power does not include the authority to extinguish statutorily created rights. Accordingly, courts lack the power to extinguish statutorily created contribution rights.

Third, in cases where all defendants are solvent, the proportional reduction rule does not deprive non-settling defendants of their statutorily created rights because, at trial, the
non-settling defendant's liability will be limited to his share of the fault. Accordingly, in such cases, courts may have the power to apply the proportional reduction rule to statutory or judicially implied contribution claims.

Lastly, in cases where a defendant is insolvent, the proportional reduction rule will extinguish the contribution rights of a non-settling defendant who must pay damages caused by the insolvent non-settling co-defendant. Consequently, in cases involving insolvent defendants, courts lack the power to apply the proportional reduction rule at least to statutory claims, because doing so would deprive the non-settling defendant of his statutory right to obtain full contribution.

In many securities actions, the plaintiffs file claims based on both statutory and judicially implied causes of action. In most cases, at least one of the defendants is insolvent. In addition, many cases contain pendent state law claims. Applying the list of rules set forth above to any securities case could therefore result in significant confusion.

One way of avoiding this confusion would be for the judge in each case to adopt one settlement bar rule from the law of the forum state and apply it to all of the claims in the case. The following sections discuss the applicability of state settlement bar rules.

G. The Applicability of State Law

In the absence of a clear expression of congressional intent concerning what courts should do when an aspect of a statute has not been fleshed out, it may be appropriate for them to apply state law. This section discusses (1) cases which hold that courts should apply state law when filling in the interstices in a federal law, except in cases where a uniform national rule is necessary, (2) an approach suggested by Justice Scalia for adopting state law, and (3) the Rules of Decision Act, which may require courts to apply state law rules. The article concludes that courts should apply state settlement bar rules if they are applicable.

1. Federal Courts Must Use State Laws to Fill in Interstices in Federal Statutes, Unless a Uniform National Rule Is Necessary

As the previous sections explain, courts have traditionally applied federal common law to fill in the gaps or interstices in federal statutory schemes. Those sections also note that creation of settlement bar rules involves extinguishing congressionally created rights and that courts' "interstitial power" may not be sufficient to permit them to create rules with so drastic an effect. For the purposes of this section, it is assumed that this interstitial authority does empower courts to create settlement bar rules. Given this assumption, this article concludes that courts should borrow these rules from state law.

The recent case of Kamen v. Kemper Financial Services, Inc. is instructive. There, plaintiff Kamen filed a class action suit against defendant Kemper, alleging violations of the Investment Company Act of 1940 ("ICA"). The district court dismissed the suit because the plaintiff failed to make a pre-litigation demand on Kemper's board of directors. In affirming dismissal of Kamen's suit, the Seventh Circuit used its common law powers to adopt a "universal demand rule." This rule required any plaintiff suing a company under the ICA to make a pre-litigation demand on Kemper's board of directors. In certiorari, the Supreme Court was asked to decide whether the circuit court had properly adopted this rule or whether it should have applied Maryland's law, which contains an exception for cases where pre-litigation demands against a company are futile. On certiorari, the Supreme Court reversed the circuit court's decision, concluding that rules regarding pre-litigation demands should be borrowed from state law.

Writing for an unanimous court, Justice Marshall first noted that because the ICA was a federal statute "any common

130. Kamen, 111 S. Ct. at 1713. Such demands are not required by the Investment Company Act of 1940. Federal Rule of Civil Procedure 23.1, however, requires plaintiffs to allege the pre-litigation efforts they have made to obtain the action they desire from the defendant company. Rule 23.1 does not specifically mandate pre-litigation demands in all cases. Fed. R. Civ. P. 23.1.
131. Kamen, 111 S. Ct. at 1713.
law rule necessary to effectuate a private cause of action under that statute is necessarily federal in character.” Justice Marshall went on to observe that it “does not follow, however, that the content of such a rule must be wholly the product of a federal court's own devising.” He concluded that the federal courts should “fill the interstices of federal remedial schemes with uniform federal rules only (in cases where):

1. the scheme in question evidences a distinct need for nationwide legal standards; or
2. express provisions in analogous statutory schemes embody congressional policy choices readily applicable to the matter at hand.”

Only the first of these factors is relevant to the issue of settlement bar rules. Accordingly, pursuant to Kamen, courts must adopt state settlement bar rules, unless there is a distinct need for a uniform nationwide settlement bar rule.

Certain commentators have concluded that a uniform national rule is needed to prevent forum shopping. These commentators note that differing settlement bar rules may have vastly different effects on plaintiffs and, if settlement

132. Id. at 1717.
133. Id.
134. Id.
135. The second factor is inapplicable because there are no express provisions in analogous federal laws in which Congress chooses one settlement bar rule over another. Most statutes are silent as to such rules. While Congress did include a pro tanto rule in the Comprehensive Environmental Response Compensation and Liability Act, 42 U.S.C. §§ 9601-9675, 9613 (West 1988), this rule applies only to settlements entered into with, and approved by, state or federal agencies. It therefore bears little relevance to private suits filed under the securities laws. In fact, several district courts have refused to apply the pro tanto rule to private suits filed under CERCLA. See, e.g., Lyncott Corp. v. Chemical Waste Management, Inc. 690 F. Supp. 1409 (E.D. Pa. 1988) (applying the proportional reduction rule to private settlements of CERCLA cases). CERCLA, unlike the Securities Acts, provides that contribution claims “shall be governed by federal law.” 42 U.S.C. § 9612(e)(1). Nevertheless, in concluding that a “uniform federal rule should be adopted,” Lyncott at 1417, Lyncott and similar CERCLA cases do not adequately discuss why courts have the power to adopt such a settlement bar rule. This question is especially troubling in the CERCLA context, where these courts are “adopting” a different rule than the one which Congress expressly placed in the statute. Cf. Lampf v. Gilbertson, 112 S. Ct. 27 (1991).
137. See infra notes 185-203 and accompanying text (Section IV) for a discussion of the burdens which the proportional reduction rule places on plaintiffs.
bar rules are borrowed from state law, some plaintiffs may choose to file their suits in the state which has the most favorable settlement bar rule. It is doubtful, however, that this threat of forum shopping is sufficient to warrant a uniform national rule. Rules of venue and jurisdiction and the simple economics of hiring a lawyer in a distant state can be expected to limit forum shopping to some extent. Moreover, adoption of state law creates benefits which outweigh any advantages offered by a uniform federal rule.

First, if state law is adopted, the same rule will apply to federal and pendent claims in any given case. This will prevent the problems that can arise in cases where one settlement bar rule applies to the federal claims and another applies to the pendent state claims. The problem of forum shopping may pale in comparison to the law-shopping that could occur in such cases, as the parties attempt to attribute their losses to a federal claim or to a state claim to take advantage of whichever settlement bar rule is more favorable to them.

Second, the states in which the bulk of these cases will arise have specific statutory procedures applicable to settlement bar rules.138 These procedures are more developed and efficient than any rules that federal courts may invent using their common law interstitial power.

Finally, until the Supreme Court or Congress enunciates a single federal rule, the circuits are likely to choose differing settlement bar systems. Forum shopping among the circuits is likely.

For these reasons, the need for one national legal standard does not appear to be compelling. Assuming courts have the common law "interstitial" power to create settlement bar rules, they should borrow these rules from applicable state law.

2. Justice Scalia’s Approach Suggests that State Settlement Bar Rules Should Be Applied

Justice Scalia has suggested a five step approach for determining whether state law may be applicable to cases brought under federal law.139 While arguing this approach was the


139. Agency Holding Corp. v. Malley-Duff & Assoc., 483 U.S. 143, 161-64
original basis for federal courts' borrowing of state statutes of limitations, he concedes it is no longer the basis for borrowing them. This is because Scalia's approach has been superseded by reliance on congressional expectation that courts will borrow existing state statutes of limitations. However, since no congressional intent is apparent with respect to settlement bar rules, Scalia's five step approach is worth examining.

Scalia first notes that state rules "whose terms appear to cover federal statutory causes of action apply as a matter of state law to such claims, even though the state legislature that enacted the statutes did not have those claims in mind." On its face, the California settlement bar statute applies to any settlement where "one or more co-obligors [are] mutually subject to the same contribution rights." On its face, then, the California settlement bar statute applies to contribution claims under the federal securities laws.

Second, Scalia notes that imposition of the state rule is "within the States' powers, if not pre-empted by Congress." Thus, in the California instance, the state has the power to enact settlement bar rules which apply to federal contribution rights unless that power is preempted.

Scalia's third point is that the obligation to apply state rules "does not spring from Congress' intent in enacting the federal statute. Rather, that intent is relevant only to the question whether the state [rule] had been pre-empted by Congress' failure to provide one." In the case of settlement bar, Congress expressly created four rights of contribution and implied another right under Rule 10b-5. However, Congress was silent as to settlement bar and as to the goals of settlement which motivate the settlement bar rule. Conceivably, this silence may establish congressional intent to pre-empt state settlement bar statutes. However, if Congress' intent was to prohibit settlement bar rules, this intent would be sufficient to preclude federal judges from creating settlement bar rules of their own.

140. Id. at 161.
141. CAL. CIV. PROC. CODE § 877 (Deering 1991).
143. Id. at 162 (citing Campbell v. Haverhill, 155 U.S. 610, 619 (1895)).
Fourth, Scalia addresses this question of Congressional silence and observes that "Congressional silence on the ... issue is ordinarily insufficient" to preempt state statutes; "special provision" by Congress is required to do that.\textsuperscript{144} Congress' silence as to settlement bar rules is thus probably insufficient to preempt state settlement bar laws.

Finally, "the federal statute - its substantive provisions rather than its mere silence - may be sufficient to pre-empt a state statute that discriminates against federal rights or [does not] permit the federal right to be vindicated."\textsuperscript{145} It is possible that settlement bar rules preclude the vindication of contribution rights under the securities laws (by extinguishing these rights prior to trial). Under Justice Scalia's reasoning, the state settlement bar rules would therefore be preempted. However, by the same reasoning, federal courts probably lack the interstitial power to create such rules because this power does not permit them to create rules which preclude the vindication of the federal rights in question.

Justice Scalia's analysis thus yields two possible results. First, the better analysis is that applicable state settlement bar rules have not been preempted and that they apply to contribution claims under federal securities laws. If this is the case, federal courts should borrow these rules rather than creating rules of their own.

Alternatively, state settlement bar rules are preempted because they conflict with congressional intent to allow contribution among liable parties and because they undermine federally created contribution rights. If this is the case, however, settlement bar rules are sufficiently at odds with the congressional intent and statutory purpose that they may not be adopted by federal judges exercising their interstitial powers.

3. \textit{The Rules of Decision Act}

Further support for applying state law settlement bar rules is found in Section 34 of the Judiciary Act of 1789, commonly known as the Rules of Decision Act. While this federal statute

\textsuperscript{144} Id. at 162 (citing Campbell v. Haverhill, 155 U.S. 610, 616 (1895); McCluny v. Silliman, 3 Pet. 270, 276-77 (1830)).

\textsuperscript{145} Agency Holding, 483 U.S. at 162 (citing Campbell v Haverhill, 155 U.S. 610, 614, 615 (1895) (Scalia, J. dissenting)).
is facially quite relevant to the settlement bar issue, it has been virtually ignored by the courts and commentators who have addressed the issue. The Rules of Decision Act provides, "[T]he laws of the several states, except where the constitution or treaties of the United States shall otherwise require or provide, shall be regarded as rules of decisions in civil actions in the courts of the United States in cases where they apply."\textsuperscript{146}

If given a literal reading, this language would mandate use of state settlement bar laws. The Constitution, treaties and statutes of the United States are silent as to whether a settlement bar rule should apply to contribution actions under the securities laws. Thus, the laws of the states should provide the rules of decision on this issue.

The applicability of the Act to settlement bar rules may, however, turn on how broadly the Court reads the language "except where the constitution or treaties of the United States shall otherwise require or provide."\textsuperscript{147} The Supreme Court has read this exception with varying degrees of expansiveness.

One reading arises in a footnote in \textit{DelCostello v. Teamsters}.\textsuperscript{148} In that case, the Court was asked to determine the proper limitations period for suits by an employee against an employer or union under 29 U.S.C. § 160(b).\textsuperscript{149} The Court noted that the usual practice when a federal statute lacked a limitations period was for the Court to borrow the most closely analogous state law limitations period.\textsuperscript{150} The Court held that there was no state law closely analogous to the federal claims available under the section in question. Furthermore, the most comparable state limitations period would be in conflict with the congressionally stated intent of providing rapid resolution of labor disputes.\textsuperscript{151} The Court concluded that Congress would not intend courts to borrow a state statute when it undermined the purpose of a federal law.\textsuperscript{152} Therefore, it refused to borrow state law and instead borrowed the

\textsuperscript{147} Id.
\textsuperscript{148} DelCostello v. International Bd. of Teamsters, 462 U.S. 151, 159 n.13 (1983).
\textsuperscript{149} Id. at 154.
\textsuperscript{150} Id. at 158.
\textsuperscript{151} Id. at 167-68.
\textsuperscript{152} Id. at 161.
limitations period from section 10(b) of the National Labor Relations Act.

In footnote 13 of DelCostello, the Court concluded that the Rules of Decision Act did not require the federal courts to apply state law, noting that the Act authorizes "application of state law only when federal law does not 'otherwise require or provide.'" The footnote went on to construe the terms "otherwise require or provide" in an extremely broad way:

[T]he choice of a limitations period for a federal cause of action is itself a question of federal law. If the answer to that question (based on the policies and requirements of the underlying cause of action) is that a timeliness rule drawn from elsewhere in federal law should be applied, then the Rules of Decision Act is inapplicable by its own terms.

Under this reasoning, no specific statute or congressional intent is needed to permit a court to use a federal rather than a state rule. The fact that the "polices and requirements" of the federal cause of action require a federal rule of decision is sufficient to override the Rules of Decision Act requirement that state rules be used. Thus, whenever federal courts feel that federal limitations periods better fulfill the policies and requirements of an act, these periods can be used in place of state ones. Under the DelCostello footnote, this would apparently be true even with respect to rules created by federal judges to fill interstices in the law. Footnote 13 thus continues:

[T]he inevitable incompleteness presented by all legislation means that interstitial federal lawmaking is a basic responsibility of the federal courts. 'At the very least, effective Constitutionalism requires recognition of power in the federal courts to declare, as a matter of common law or "judicial legislation," rules which may be necessary to fill in interstitially or otherwise effectuate the statutory patterns enacted in the large by Congress.'

When the Supreme Court next addressed the issue of what statute of limitations to apply to a complicated federal
statute, the opinion was written by Justice O'Connor, one of dissenters in DelCostello, and the Court apparently took a subtle step back from footnote 13.

In Agency Holding, the Court was asked to determine what statute of limitations is applicable to cases filed under the Racketeer Influenced and Corrupt Organizations Act (RICO). The Court concluded that borrowing a state law statute of limitations would be inappropriate because RICO was unlike any state law cause of action and applying state law would cause great confusion and uncertainty. Under footnote 13, it could have adopted a statute of limitations from a similar federal statute on the sole grounds that the "policies and requirements" of RICO required it to do so. The Court, however, did not base its holding on such reasoning.

Instead, Justice O'Connor emphasized language in DelCostello in which the Court based its borrowing of federal law on a finding of congressional intent. She noted that when Congress passes statutes without limitations periods, it generally intends for courts to borrow the most analogous state law period, but where the state statutes of limitations are "unsatisfactory vehicles for the enforcement of federal law it may be inappropriate to conclude that Congress would choose to adopt state rules at odds with the purpose or operation of federal substantive law."

Under Agency Holding, a finding that the state law is inconsistent with congressional intent may be necessary before a court adopts a federal rule of decision rather than a state one. If DelCostello's footnote 13 is a correct statement of the law, it is possible that the courts have interstitial power to reject state law and create their own settlement bar rule if the "policies and requirements" of the federal securities laws require it. As noted above, however, the securities laws specifically enunciate a right of contribution and they do not set forth any policy of encouraging settlement at the expense of those rights. While other federal statutes and rules recognize the importance of settlement, even under DelCostello, it is not readily apparent that this policy is sufficient to warrant judicial

158. Agency Holding, 483 U.S. at 147.
159. Id.
creation of rules which extinguish these statutorily created rights.

If the Agency Holdings interpretation is applied and some expression of congressional intent is required before courts are permitted to ignore the Rules of Decision Act and create interstitial federal rules of their own, it is very unlikely that federal courts have the power to create settlement bar rules of their own. The securities laws are silent as to the issue and during the time since they became law Congress has maintained silence on the matter, while some states have enacted settlement bar rules and others have not. Thus, there is little basis upon which to divine Congress' intent in failing to enact a settlement bar for securities cases. In the absence of any ascertainable congressional intent, courts would be required to adopt applicable state law settlement bar rules.

H. The Choice of a Settlement Bar Rule Is a Decision that Should Be Made by Congress

Given the lack of expression of congressional intent on this point and the many competing policy considerations on both sides, the question of whether and how to fashion a settlement bar rule is one best answered by Congress.

In concluding his opinion in Texas Industries, Chief Justice Burger noted:

The range of factors to be weighed in deciding whether a right to contribution should exist demonstrates the inappropriateness of judicial resolution of this complex issue. Ascertaining what is "fair" in this setting calls for inquiry into the entire spectrum of antitrust law, not simply the elements of a particular case or category of cases. Similarly, whether contribution would strengthen or weaken enforcement of the antitrust laws, or what form a right to contribution should take, cannot be resolved without go-

160. If one assumes that settlement bar rules were intended by Congress, then courts may be justified in creating federal rules, rather than adopting state ones. The reasoning would be similar to the statute of limitations reasoning in Agency Holding. State settlement bar rules vary from state to state, some states have no rules (some states have no right to contribution) and application of state rules would thus be confusing. Since Congress would not intend the adoption of confusing rules, it would have intended judges to create uniform national settlement bar rules.
ing beyond the record of a single lawsuit.\textsuperscript{161}

As the later sections of this article will show, an immense range of factors must be weighed in deciding which contribution rule to adopt. Resolution of this problem is, therefore, better left to Congress.

Prior to suggesting what kind of rule Congress should adopt, it is necessary to examine the alternatives. While the merits of the \textit{pro tanto} rule have been discussed in detail, the proportional reduction rule has not been examined as closely. Accordingly, the next section will examine important aspects of the proportional reduction rule in greater detail.

IV. THE MERITS OF THE PROPORTIONAL REDUCTION RULE

The courts and commentators who have discussed the relative merits of the \textit{pro tanto} and proportional reduction rules have passed over some important considerations which must be taken into account before courts or Congress choose one rule over the other. This section examines some of these considerations.

Part A discusses deterrence and concludes that in most cases the \textit{pro tanto} and proportional reduction rules should deter fraud and deceit to roughly the same extent. However, there is one significant exception. The proportional reduction rule provides substantially less deterrence to minor participants in securities transactions.

Part B will discuss why adoption of the proportional reduction rule will discourage certain kinds of settlements.

Part C deals with judicial economy and notes that the proportional reduction rule eliminates the costly and time consuming pre-trial hearing which is often required under the \textit{pro tanto} scheme. However, part C concludes that many of the issues that would have been raised at that hearing are simply deferred until the plaintiffs' trial against the non-settling defendant and that there is no net savings of judicial time or effort.

Section D examines the special burdens which the proportional reduction rule places on the plaintiff.

A. Deterrence

A major goal of contribution is deterrence, that is, to deter participants in securities transactions from fraudulent conduct. Surprisingly, this goal is not discussed in much detail by the courts or commentators who propose a proportional judgment reduction rule. Adoption of such a rule, however, can make vast differences in the way damages are allocated among settling and non-settling defendants. Such differences are bound to have differing deterrent effects on the conduct of parties who might, someday, be the targets of a securities action. The extent of these differences is not easy to gauge.

A useful exploration of the differing deterrent effects of the pro tanto and proportional reduction approaches is possible if certain distinctions are drawn between the actors who may be deterred by the securities laws. Thus, in examining the difference between the two approaches, one should distinguish “major” from “minor” participants in securities fraud schemes. Typically, a major participant will be a corporate “insider” who, on a comparative negligence basis, will be responsible for a large percentage of the damages suffered by plaintiffs. A minor participant would likely be a law firm, bank, accounting firm or securities underwriter, who might be guilty of passing on an untruth created by the major participant.

In evaluating the deterrent effect of the pro tanto and proportional reduction approaches, a distinction should also be made between “risk neutral” and “risk averse” parties. A risk neutral party takes into account only the predicted value of a potential risk. This is the magnitude of the risk multiplied by its probability. Thus, a risk neutral party would be indifferent between a 100% certainty of losing $250,000, and a 25% chance of losing $1,000,000, since the predicted value of both

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163. This distinction was first made by Professor Adamski in differentiating between the deterrent effects of contribution based on pro rata and proportional fault systems. See M. Patricia Adamski, Contribution and Settlement in Multiparty Actions Under Rule 10b-5, 66 IOWA L. REV. 533, 558 (1981).
losses is the same (100% x $250,000 = $250,000; 25% x $1,000,000 = $250,000).

A risk averse party is more influenced by the total magnitude of the risk. Thus, in the situation described above, the risk averse party would not be indifferent between the two risks. Rather, he would take into account that the magnitude of the risk posed by the first alternative is $250,000 and that posed by the second is $1,000,000. The risk averse party would avoid the second situation because, while the predicted value of the two risks is the same, the magnitude of the second risk is larger.

This section will compare the difference between the *pro tanto* and proportional judgment reduction rules as that difference affects major and minor participants and risk neutral and risk averse parties. First, this will be done mathematically, based on certain arbitrary assumptions and simple probabilities. This section will discuss the intuitive reasons for the mathematical results.

Comparison of the deterrent effects of the two judgment reduction rules will be based on the following assumptions:

1. An alleged securities fraud will cause $1,000,000 in damages to plaintiffs.
2. Eighty percent of these damages will be attributable to the major participants in the fraud and 20% will be attributable to the minor participants.
3. There is a 50% chance that the fraud will be detected and that plaintiffs will recover the $1,000,000 at trial.
4. Under the *pro tanto* rule, any settlement will be subject to a "good faith" test with a "ball park" standard as to the fairness of the settlement amount paid by the settling defendant. Under this ballpark standard, courts will reject any settlement in which the settling defendant pays less than 25% of his fair share of the damages. Settling defendants will act efficiently and will therefore pay 25% of their fair share of the damages in order to settle out of the case.

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5. The jury will efficiently allocate damages and all defendants will be solvent and fully able to pay any verdict entered against them.

1. Deterrence to Major Participants

a. The Proportional Reduction Rule (Deterrence to Major Participant)

Using these assumptions, the deterrence which the proportional reduction rule poses to a major participant will be calculated as follows: The extent of the damages is $1,000,000. If the case goes to the jury, the major participant's share of these damages will be 80%, or $800,000. Plaintiff is unlikely to settle with the major participant for much less than this amount because, under the proportional reduction rule, plaintiff will have to absorb any shortfall herself (since the major defendant's 80% of fault would be deducted from any judgment plaintiff obtains against the non-settling minor defendants).

The major participant's share of the damages is thus likely to be 80% of $1,000,000 or $800,000. The major participant knows that he faces a 50% risk of being caught and successfully sued. The predicted loss, or deterrence, presented to the major participant under the proportional reduction rule is his $800,000 share of the damages multiplied by the 50% probability of suffering that loss, or $400,000. The magnitude of the possible loss is $800,000.

b. The Pro Tanto Rule (Deterrence to Major) Participants

While the same assumptions will be used to calculate the deterrence posed to major participants by the pro tanto rule, it is necessary to make further assumptions, which were unnecessary above, regarding which party settles first.

The pro tanto rule gives both plaintiffs and major participants the incentive to enter into an early settlement. The major participant will want to settle first in hopes of paying less than his fair share of the damages, leaving the minor defendant to pay the balance after trial. The plaintiff may believe that settling with the major participant first is a good settlement tactic because it increases settlement pressure on the
minor defendant, who is left alone to face the bulk of the damages in the case.

For the sake of discussion, percentage probabilities have been assigned to three different settlement or trial scenarios and an attempt to estimate deterrence by a simple evaluation of these probabilities will be made: 165

(a) There is a 20% chance that the major participant will settle first by paying plaintiff $200,000, the minimum amount that the court will approve under the good faith “ballpark” test. 166

(b) There is a 20% chance that the case will go to trial and the major participant will pay $800,000, his 80% share of the damages.

(c) There is a 10% chance that the minor participant will settle first by paying plaintiff $50,000, the minimum amount that the court will approve under the good faith “ballpark” test. 167 This will leave the major defendant to pay the remaining $950,000.

(d) In line with assumption three, above, there is a 50% chance that the fraud will not be detected or that plaintiff will not prevail at trial.

Deterrence could then be roughly estimated as follows. Under assumption (a), the major participant faces a 20% probability of paying $200,000 in settlement. The predicted value of the risk is 20% x $200,000 or $40,000.

Under assumption (b), the major participant faces a 20% probability of paying $800,000 after trial. The predicted value of this risk is 20% x $800,000 or $160,000.

165. The percentages are based on the assumption that it is more likely for the major participants to settle first. The reasons for this assumption are discussed throughout the section. These percentages represent the risks that exist at the time the fraud is contemplated.

166. Under assumption four at page 90, using the pro tanto rule, courts will allow settling a defendant to escape the action if he pays at least 25% of his share of the damages. Here, 25% of major defendant's $800,000 share of the damages is $200,000.

167. As noted in the previous footnote, under assumption four, courts will reject any settlement in which the settling defendant pays less than 25% of his own fair share of the damages. Here, 25% of the Minor Participant's $200,000 share of the damages is $50,000.
Under assumption (c), the major participant faces a 10% probability of paying $950,000 after trial. The predicted value of this risk is 10% x $950,000 or $95,000.

Under assumption (d), the major participant faces a 50% probability that the fraud will not be detected and he will pay nothing. The predicted value of this risk is 50% x 0 or $0.

The predicted value of the major participant's loss will thus be: $40,000 + $160,000 + $95,000 + $0 or $295,000.\(^{168}\) The magnitude of the risk will be the $950,000 that the major participant must pay if the minor defendant settles first.

In summary, this is a comparison of the deterrence posed to the major defendant under the assumed facts:

<table>
<thead>
<tr>
<th>Predicted value of loss (i.e. deterrence to risk neutral actor):</th>
<th>$400,000</th>
<th>$295,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Magnitude of possible loss (to be considered by risk averse actors):</td>
<td>$800,000</td>
<td>$950,000</td>
</tr>
</tbody>
</table>

A risk neutral major participant is thus moderately more deterred by the proportional reduction system because this system makes it more likely that he will pay his fair share of the damages.

The effect on a risk averse party, however, is mixed. While the predicted loss posed under the \textit{pro tanto} system is less than that posed under the proportional reduction rule, the total possible loss is greater. Since it is unclear whether potential major defendants in securities actions are risk neutral or risk averse,\(^ {169}\) it is impossible to say whether moderately differing

\(^{168}\) While the various alternatives cannot occur at the same time, it is proper to add the probabilities because the result yields the total probable risk at the time of the securities transaction. At that time, the major participant faces a 10% risk of losing $950,000, a 30% risk of losing at least $800,000 and a 50% risk of losing at least $200,000. Averaging the risks, the major participant faces a 50% risk of losing $590,000, or a risk of $295,000.

\(^{169}\) See, Polinsky & Shavell, \textit{supra} note 164.
deterrent values caused by the two rules will have any real effect on these potential major defendants.

Intuitively, these results are logical. On balance, the \textit{pro tanto} rule poses somewhat less deterrence to major participants because it gives them the opportunity to settle out cheaply and pass a large portion of their liability to non-settling minor defendants. True, in some cases, the opposite will occur and the minor participants will settle first, shifting some of their liability to the major defendant. For the major participant, however, the possible benefits of passing a large portion of liability to the minor defendants will exceed the risks of absorbing some of the smaller damages which the minor defendants may cause. The probable costs to major defendants are thus likely to be slightly less under the \textit{pro tanto} rule.

2. \textit{Deterrence to Minor Participants}

The difference between the two approaches to settlement reduction has a far greater effect on minor participants.

\textit{a. The Proportional Reduction Rule (Deterrence to Minor Participants)}

Using the assumptions, the deterrence which the proportional reduction rule poses to the minor participant will be calculated as follows: The damages are $1,000,000. If the case goes to the jury, the minor participant’s share of these damages will be 20%, \textsuperscript{170} or $200,000. Plaintiff is unlikely to accept less than this amount in settlement because she will have to absorb any shortfall herself. The minor participant’s share of the damages is thus likely to be 20% of $1,000,000 or $200,000. The minor participant knows that he faces a 50% risk of being caught and successfully sued. The predicted loss, or deterrence, presented to the minor participant under the proportional reduction rule is thus his $200,000 share of the damages multiplied by the 50% probability of suffering that loss or $100,000. The magnitude of the possible loss is $200,000.

\textsuperscript{170} \textit{See supra} text accompanying note 164 (assumption two) stating that 80% of the damages will be attributable to the “major” participants in the fraud and 20% will be attributable to the “minor” participants.
b. The Pro Tanto Rule (Deterrence to Minor Participants)

Applying the added assumptions for the pro tanto rule, deterrence would be calculated as follows:

Under assumption (a), there is a 20% chance that the major defendant would settle first for $200,000,171 leaving the minor participant to pay the remaining $800,000. The predicted loss to the minor participant is 20% x $800,000 or $160,000.

Under assumption (b), there is a 20% chance that the matter will go to trial and the minor participant will be ordered to pay his $200,000 share of the damages. The predicted loss to the minor participant is 20% x $200,000 or $40,000.

Under assumption (c), there is a 10% chance that the minor participant will settle first for $50,000.172 The predicted loss is therefore 10% x $50,000: $5,000.

Under assumption (d), there is a 50% chance that the minor participant will pay nothing. The predicted loss is therefore 50% x 0 or $0.

The predicted loss to the minor participant is thus $160,000 + $40,000 + $5,000 + $0, or $205,000. The magnitude of risk to the minor participant under the pro tanto rule is $800,000. This is the amount he must pay if he is left to pay the remaining damages after the major participant settles out for $200,000.

In summary, this is a comparison of the deterrence posed to the minor defendant under the assumed facts:

171. Under assumption (4), this is the minimum settlement amount the major participant can pay while still satisfying the “ballpark” test (25% x major participants’ $800,000 share of damages = $200,000).

172. Under assumption (4), this is the minimum amount the court will approve under the “ball park” test (25% x $200,000 = $50,000).
Predicted value of loss (i.e. deterrence to risk neutral actor): $100,000 $205,000

Magnitude of possible loss (to be considered by risk averse actors): $200,000 $800,000

The *pro tanto* rule thus presents twice as much deterrence to the risk neutral minor participant as does the proportional reduction method. In the case of a risk adverse defendant, the magnitude of the risk presented by the *pro tanto* method is $800,000, *four times* the risk presented by the proportional reduction method. The *pro tanto* approach presents significantly more deterrence to minor participants, whether they are risk neutral or risk averse.

3. *The Pro Tanto System Threatens Minor Participants With Huge Liability*

Intuitively, these results are not surprising. Under the *pro tanto* rule, if plaintiff decides to enter into a cheap settlement with the major participant in order to fund the litigation, the non-settling minor defendants face the prospect of paying any inadequacy in this settlement. At least two courts have recognized that this prospect gives the “guiltier defendant” great incentive to “get off cheaply by settling first.”

a. *The Nucorp Example*

The *Nucorp Energy* litigation presents a case study of the risk and deterrence presented to minor defendants if the plaintiff settles first with the major participant. There, the plaintiffs, who estimated their “baseline” damages at $230 million, settled with the major participants first for $41 mil-

The court approved this settlement, extinguished the contribution rights of the non-settling defendants and adopted a *pro tanto* reduction standard. The minor participant defendants (a bank, a securities underwriting firm, and a big eight accounting firm) were thus exposed to liability for the remaining "baseline" damages of $189 million.

Under the *pro tanto* rule, law firms, accounting firms, and other professionals know that the settlement process may play out this way. A client may become a major defendant in a securities case and may settle out of the ensuing litigation first, leaving the professionals "holding the bag" for the vast bulk of damages. This possibility is likely to present significant deterrence to "minor" defendants.

If the proportional reduction rule is adopted, the settlement process cannot play out in this way. First, the minor defendant is less likely to be left out in the cold during the settlement process. In fact, if the plaintiff needs a settlement to fund the litigation, he will probably prefer to settle with the minor defendant first. This is because plaintiff takes a larger risk in settling with the major participant. Since the major participant's portion of damages is greater, underestimation of these damages, and the resulting loss when the major defendant's proportional fault is deducted from the verdict, could be very costly to the plaintiff.

Second, and more importantly, if the minor defendant does find himself in the position of a non-settling defendant, he is not in quite as unfortunate a situation as he would be under the *pro tanto* rule. At trial, he will have the opportunity to prove his own innocence and to prove that all liability should be shifted to the settling major participant, who will likely appear at trial as an empty chair.

The proportional reduction rule thus gives the minor defendant every opportunity to limit his liability to his minor share of fault. The *pro tanto* system, in contrast, threatens to burden minor defendants with huge damages caused by others. This threat is likely to be an appreciable deterrent to unlawful conduct by minor participants in securities transactions.

175. *Id.* at 1409.
176. *Id.* at 1405-06.
177. *Id.* at 1409.
4. The Effects of Insolvency

There are, however, several factors which may lessen the differential in deterrence between the two systems. First, for the purposes of the discussion above, it was assumed that all defendants would be solvent. This is frequently not the case. In many securities actions, the major participant in the fraud is defunct or unable to fully respond in damages. Minor participants know this, and also know that under the rules of joint and several liability they will be responsible for any portion of the judgment which the major participant is unable to pay. If there is any chance that the major defendant will become insolvent, the magnitude of damages presented to the minor defendant will be all of the damages. Even under the proportional reduction system, minor defendants will thus be deterred by the possibility of being forced to pay for damages attributable to an insolvent co-defendant. This prospect will be present in both systems of judgment reduction and will thus reduce any difference in deterrence which may exist between the approaches.

5. The Effects of Insurance

The above hypotheticals do not take into account the effects of insurance. It is unclear what proportion of damages are likely to be paid by insurers, but the insulating effect of insurance and other legal obstacles to personal liability are likely to reduce the deterrent effect of either system of settlement offset.

6. Efficiency

The hypotheticals also assume that the system is efficient, and that the jury will thus properly allocate damages under the proportional reduction rule. The reliability of this allocation, however, is called into question in section IV(D)(2) below. The prospect of inaccurate allocation of damages is likely to reduce the difference in deterrence which may exist between the two rules.
7. Deterrence and Retribution

Deterrence should not be confused with retribution. Retribution involves allocating punishment (here damages) in proportion to the fault of the respective wrongdoers. Deterrence is the threat of harm which should deter actors from engaging in violations.

The proportional reduction rule is more effective in meting out retribution. The rule, after all, is the culmination of a trend toward fair division of fault among joint tortfeasors, and a main purpose of the rule is to prevent defendants from foisting their liability onto others through the tactic of an early settlement. The pro tanto rule, however, is more effective at deterrence because it presents each defendant with the threat of being excluded from an early settlement and thus being left to pay for damages caused by someone else.

B. The Proportional Reduction Rule Discourages Settlement

The primary purpose of a settlement bar rule is to promote settlement by allowing one co-defendant to escape the litigation completely when he settles with the plaintiff. The Kaypro court claimed that the proportional reduction rule satisfies this “policy goal of encouraging settlement” because “defendants that are inclined to settle may do so without penalty or risk.”

This conclusion presents only a portion of the picture. It ignores the fundamental fact that it takes more than one party to settle. While the Kaypro approach may allow a defendant to settle, it provides serious settlement disincentives for the plaintiffs and non-settling defendants.

This section will discuss the effect of the proportional reduction rule from the perspective of the settling defendant, the non-settling defendant, and the plaintiff. The section concludes that while an incentive remains under that rule for defendants to settle, the proportional reduction scheme makes non-settling defendants less inclined to settle and affirmatively discourages plaintiffs from settling. This section then suggests

178. Franklin v. Kaypro Corp., 884 F.2d 1222, 1231 (9th Cir. 1987).
179. Id. (emphasis added).
methods of making settlement more attractive for the plaintiffs under the proportional reduction rule.

1. The Settling Defendant

The proportional reduction rule meets the basic needs of the settling defendant: the court enters a contribution bar order which frees the defendant from the action. Indeed, under the Kaypro scheme, the settling defendant is even spared the trouble of proving that the settlement was reached in good faith. Under federal cases which adopt the \textit{pro tanto} approach\textsuperscript{180} and under the California system,\textsuperscript{181} a "good faith" hearing is held. This can require a major litigation effort, especially when the non-settling defendant challenges the good faith of the settlement. As the court in Kaypro noted, "in order to be truly efficacious, the good faith hearing would require a full evidentiary hearing on all of the parties' relative culpabilities."\textsuperscript{182} Under the proportional reduction rule, the settling defendant can, for the most part, buy its peace without facing this time-consuming and expensive procedural obstacle. Settlement therefore remains attractive to defendants.

2. The Non-Settling Defendant

The proportional reduction rule gives the remaining, non-settling defendants much less incentive to come to the bargaining table than the \textit{pro tanto} approach. Under the latter, when one defendant settles, he leaves the remaining defendants responsible for any inadequacy in the settlement. In \textit{Nucorp}, for example, the non-settling defendants argued that the settlement left them to pay hundreds of millions of dollars in damages caused by the settling defendants.\textsuperscript{183} Each partial settlement thus increases the exposure of the non-settling defendants and increases the pressure on those defendants to settle, lest they be left alone to face a trial and possible liability for all of plaintiff's remaining damages.\textsuperscript{184}

\textsuperscript{180} See \textit{supra} notes 52-55 and accompanying text.
\textsuperscript{181} CAL. CIV. PROC. CODE § 877.6 (Deering 1991).
\textsuperscript{182} \textit{Kaypro}, 884 F.2d at 1230.
\textsuperscript{183} \textit{In re Nucorp Energy Sec. Litig.}, 661 F. Supp. 1403, 1405-06 (S.D. Cal. 1987).
\textsuperscript{184} See \textit{supra} notes 174-77 and accompanying text.
The proportional reduction rule sharply reduces the risk the non-settling defendant faces by taking the case to trial. Under that rule, the trial gives the non-settling defendant two chances to avoid liability: (1) he can refute the plaintiffs' claims and (2) he can argue that if there is any liability, the jury should assign a large portion of it to the defendant who settled. Chances that the latter argument will succeed are magnified by the fact that the settling defendant will often not be present or represented at the trial. Contrary to the assumption in Kaypro, settlement pressures on defendants are greatly lessened by the proportional reduction rule and settlements (especially partial settlements) are made correspondingly less likely.

3. The Plaintiff

Kaypro's claim that the proportional reduction rule will promote settlements is at its weakest when applied to plaintiffs. The rule makes it extremely risky for plaintiffs to enter into partial settlements and, since partial settlements are an important means by which judges simplify or eliminate securities cases, the proportional reduction rule may severely limit the number of cases which will be settled.

The pro tanto system minimizes the risks plaintiffs face in accepting a partial settlement. Even if they accept too small an amount from the settling defendant, plaintiffs remain free to collect all the rest of their damages from the non-settling defendants. Under the pro tanto rule, the risks of settlement are thus placed on the party who is not involved in the settlement, the non-settling defendant. When the settlement is too cheap, this non-settling party is left to pay an inordinate percentage of the damages after trial.

Part of the appeal of the proportional reduction rule is that it shifts the risk of a bad settlement to a party who is involved in the settlement, namely, the plaintiff. Plaintiff decides how much to accept from the settling defendant and assumes the resulting risks. If the jury later decides that the settling defendant was responsible for a greater percentage of fault than plaintiff anticipated, plaintiff will be the loser when this percentage is deducted from his recovery against the other defendants. Courts have found this placement of risk attractive not only because the risk falls on a party to the agreement, but
also because it gives the plaintiff the "incentive to obtain a 'good' settlement and to secure from each settling defendant a share of damages proportionate to fault."\(^{185}\)

In many cases, however, the risks imposed by the proportional reduction rule may be too great for the plaintiff to take. Following are the specific effects this rule may have in discouraging settlement.

a. **Plaintiffs Will Hesitate to Settle Claims Which Are Difficult to Estimate**

Plaintiffs will be discouraged from settling with defendants whose fault is difficult to estimate because any error in plaintiffs' calculations will be deducted from the recovery against the remaining, non-settling defendants. Cases where comparative liability or damages are uncertain or difficult to gauge will thus be less likely to settle.

b. **Settlement with Impecunious Defendants or for Policy Limits Will Be Severely Discouraged**

Plaintiffs will also be discouraged from settling with any defendant who cannot afford to pay his full proportion of fault because any shortfall in plaintiffs' recovery from such defendants will be deducted from plaintiffs' recovery from the other defendants.

This factor may forestall a great number of settlements. Major defendants in securities cases are often insolvent or nearly so. One practice has been for the plaintiff to settle with such defendants first, accepting whatever funds they can pay. Plaintiffs can then use this recovery to fund the remaining litigation and to provide a partial recoupment of plaintiffs' losses. In many cases, a defendant's only asset is an insurance policy with liability limits which are significant but far less than plaintiffs' damages, and plaintiffs often settle with impecunious defendants by accepting their policy limits.

The proportional reduction rule makes this type of settlement nearly impossible. Under this rule, plaintiffs will never want to settle with major defendants for less than their propor-

tional share of damages, even if the defendants are offering every cent they, and their insurance companies, can muster.

The chilling effects of the proportional reduction rule are exemplified by *Nucorp*. There, plaintiffs, whose "baseline" damages were $230 million, entered into a $41 million insurance-sponsored settlement with the "insider" defendants. In approving this settlement, the court noted that if the case went to trial against the "insider" defendants, "it is entirely possible that the proof which establishes the liability of the inside directors may also exempt their wrongful acts from coverage under the terms of the polices and prevent [the polices] from covering the acts of any of the directors and officers." The settlement thus locked in insurance coverage that otherwise might not have been available to the injured plaintiffs. The judge approved the settlement, entered an order extinguishing contribution rights against the settling party, and gave the non-settling defendants credit for the settlement on a *pro tanto* basis. Under this ruling, the plaintiffs thus received the $41 million settlement from the "insider" defendants and were free to collect the remaining $189 million in damages from the "deep pocket" defendants after trial.

If the proportional reduction rule had been in effect, such a settlement would have been unlikely. Thus, assume that plaintiffs entered into the same insurance-sponsored $41 million settlement with the "insider" defendants, and that at trial plaintiffs were able to prove their case against all defendants and that their damages were, in fact, $230 million. Assume also that, under the proportional reduction rule, the jury attributed 80% of the fault to the settling "insider" defendants (these defendants would not be parties to the trial and, having settled, would have no great incentive to defend their actions there). Under these assumptions, plaintiffs' recovery against the non-settling defendants would be $230 million, reduced by the 80% of fault attributable to the settling defendants, leaving a recovery of $46 million. Added to the $41 million received in settlement, plaintiffs' total recovery would be $87 million of the $230 million of damages they suffered.

187. Id.
188. Id. at 1405-06.
189. Id. at 1409.
Under the proportional reduction rule, plaintiffs would have had a much more favorable result if they had elected not to settle with the "insider" defendants and instead forced all the defendants to trial. If plaintiffs had done so and had proved the same damages and liability against defendants, plaintiffs would have been able to recover their entire $230 million from any, or all, of the defendants.

The proportional reduction scheme thus ignores the economic factors which influence settlement decisions. If a defendant has great liability but limited assets, continuing the litigation against him is a waste of plaintiffs' resources. Under the proportional liability rule, however, plaintiffs will be forced to keep culpable but impecunious defendants as parties to ensure full recovery.

There will, of course, be some cases which settle under this rule. In some instances, plaintiffs will be able to reliably gauge a defendant's portion of fault and will feel comfortable in accepting this amount, with some discount for settlement. In other cases, a defendant's proportion of fault may be so minor that plaintiffs' miscalculation of that portion will not pose too great a threat. In still other cases, plaintiffs may be so desperate for cash that they will settle with a defendant and take their chances that their final recovery against the non-settling defendants will be reduced by an unknown amount. In many cases, however, the uncertainties inherent in the proportional reduction rule will prevent the plaintiffs from settling.

c. Delay of Settlement

Furthermore, the proportional reduction rule may delay the settlements which it does not prevent entirely. Plaintiffs will feel constrained to do the discovery necessary to establish whether the prospective settling defendant is a major or minor player and what percentage of damages he should be obliged to pay. Early settlements will thus be discouraged, and, as plaintiffs conduct the discovery necessary to establish the factual basis necessary for an informed settlement decision, their costs will rise, as will the amount they must demand to economically settle the case. Settlements which do occur can thus be expected to come later and be more costly.
d. **Empirical Evidence**

There is some evidence that where the proportional reduction rule has been applied, the number of settlements has decreased. In 1974, New York adopted a proportional reduction rule for all civil cases.\(^{190}\) Although it is difficult to accurately assess the number of partial settlements,\(^{191}\) the consensus among the commentators is that this scheme has reduced the number of settlements.\(^{192}\) The risks to the plaintiff of a partial settlement, as described above, are considered to be too great.\(^{193}\)

190. N.Y. GEN. OBLIG. LAW § 15-108 provides:

Release or covenant not to sue:

(a) Effect of release of or covenant not to sue tortfeasors. When a release or a covenant not to sue or not to enforce a judgment is given to one of two or more persons liable or claimed to be liable in tort for the same injury, or the same wrongful death, it does not discharge any of the tortfeasors from liability for the injury or wrongful death unless its terms expressly so provide, but it reduces the claim of the releasor against the other tortfeasors to the extent of any amount stipulated by the release or he covenant, or in the amount of the consideration paid for it, or in the amount of the released tortfeasor's equitable share of the damages under article fourteen of the civil practice law and rules, whichever is the greatest.

(b) Release of tortfeasor. A release given in good faith by the injured person to one tortfeasor as provided in subdivision (a) relieves him from liability to any other person for contribution as provided in article fourteen of the civil practice law and rules.

(c) Waiver of contribution. A tortfeasor who has obtained his own release from liability shall not be entitled to contribution form any other person.


This section reduces the judgment by the amount of the settlement or the amount of the settling defendant's equitable share, whichever is greater. This prevents a windfall recovery to plaintiffs in cases where the settling defendant pays a large amount in settlement and the court then attributes a smaller than expected share of fault to the settling defendant. *See supra* note 81.


4. Class Action Settlements May Be Discouraged

Under the proportional reduction rule, a settlement is always risky for the plaintiffs because they can never be sure of its consequences. While the plaintiffs know the dollar amount they will receive, they do not know the true cost of the settlement until trial, when the jury determines the percentage of the fault attributable to settling defendants. Such uncertainty may be reasonable in a typical lawsuit where the individual plaintiff is responsible for protecting only his own interests and is theoretically free to absorb any risks he chooses in connection with the settlement. In a class action, however, the stakes are different, as most of the plaintiffs do not participate in the litigation on a regular basis and have no means of assessing the adequacy of the settlement.

Since the proportional reduction rule makes the good faith hearing unnecessary, the only court review of a partial settlement required in a class action is that required by Rule 23(e) of the Federal Rules of Civil Procedure which provides, "A class action shall not be dismissed or compromised without the approval of the court . . . ."

Operates to discourage settlements in that it places litigants at more risk than they are willing to assume." (quoting Carolyn D. Gentile, chair of the New York State Law Revision Commission); see also, Green, supra note 192, at 29 ("A maxim is now prevalent among the plaintiff's bar in multi-party litigation: Settle with every defendant, or settle with no defendant.").

195. The Manual for Complex Litigation recognizes that:
   The fairness of partial settlements may be particularly difficult to assess. Because . . . the adequacy of the settlement depends in part upon the relative exposure of the other parties . . . this assessment may be almost impossible to make if discovery is incomplete or has been conducted against only a few of the defendants.
196. Many cases brought under the federal securities laws are class actions. Indeed, it is federal policy to encourage the use of the class action device in securities cases. "In a securities case, the requirement of Rule 23 should be liberally construed in favor of class actions." In re United Energy Corp. Sec. Litig., 122 F.R.D. 251, 253 (C.D. Cal. 1988); Eisenberg v. Gagnon, 766 F.2d 770, 785 (3d Cir. 1985), cert. denied sub. nom, Wasserstrom v. Eisenberg, 474 U.S. 946 (1985).
While courts generally hold hearings before approving a class action settlement, a Rule 23(e) hearing does not determine whether "the proposed settlement [is] fair in light of the comparative liability of the settling defendants." Without this information, neither the court nor the absentee plaintiffs have any way of estimating the consequences of settlement under the proportional reduction rule.

The proportional reduction rule causes notice problems as well. Rule 23(e) provides that notice of a proposed settlement "shall be given to all members of the class in such manner as the court directs." The point of the notice requirement is to "protect absent class members against prejudice from discontinuance of litigation brought on their behalf." Under the proportional reduction rule, however, it is very difficult to give effective notice because it is impossible to predict the consequences of the settlement before trial.

Drafting a notice which "fairly presents the merits" of the settlement also causes practical problems for the class attorney. If an attorney's optimistic view of the effect of the settlement is not vindicated by the final judgment, the attorney may risk exposure to a malpractice action. If an attorney frames a notice that presents too pessimistic a view of the effect of the settlement, that lawyer runs the risk that individual class members will seek to have the settlement rejected.

The proportional reduction rule may, therefore, severely discourage settlement of class actions.

5. Methods to Neutralize Risk to the Plaintiff

In order to spread the risk of settlement among the parties, plaintiffs may attempt to enter into sliding scale agreements with settling defendants. Typically, in a sliding scale agreement, one defendant will pay plaintiff a certain amount

199. FED. R. CIV. P. 23(e).
201. As the court noted in the case of In re Atlantic Fin. Management Inc. Sec. Litig., 718 F. Supp. 1012, 1028 (D. Mass. 1988): "Particularly in class actions this [proportional reduction] method generates significant practical difficulties as well, in that the indeterminate impact of any partial settlement would make it difficult to frame a notice to the class which fairly presents the merits of the proposed settlement."
in settlement and will guarantee a further payment if plaintiff's actual recovery from the other defendants is less than expected. Thus, in the proportional reduction rule setting, the settling defendant would make an initial payment to plaintiff and would agree to pay more if the plaintiff's recovery at trial is small because the jury attributes a large percentage of fault to the settling defendant. Thus, the less the plaintiff recovers from the non-settling defendants, the more the settling party will have to pay the plaintiff, up to the limit of the guarantee. Under such a sliding scale agreement, the risk of misjudging the settling defendant's degree of liability is shared between the plaintiff and settling party.

The plaintiff and settling defendant will negotiate these agreements, which will only be signed in cases where plaintiffs have enough bargaining power to induce the settling defendant to make the sliding scale guarantee. Plaintiffs will not get such a guarantee for free. They can expect to receive less cash from the settling defendant because they are receiving the value of the guarantee instead.

Finally, the most tangible effect of a sliding scale agreement may be seen at trial, where the settling defendant will have every incentive to prove his innocence so that he will not have to make any payment under the guarantee. Unlike most trials conducted under the proportional reduction rule, the settling defendant will be present and will actively defend his actions.


203. One commentator has noted:
Settling parties may find Mary Carter agreements very attractive in comparative contribution jurisdictions, because the settling defendant's negligence only reduces the plaintiff's recovery by the percentage of fault attributed to him. The settling parties attempt to decrease the settling defendant's percentage of liability, while increasing both the total judgment and the non-settling defendant's percentage of fault. Because the plaintiff has agreed that he will not require the settling defendant to pay more than the amount set in the agreement, he will execute against the settling defendant only to the amount to jury has attributed to him. In terms of actual damages paid, the non-settling defendant is thus likely to pay more, and the settling defendant less, than their allocated percentage.

John E. Benedict, Note, It's a Mistake to Tolerate the Mary Carter Agreement, 87 Colum. L. Rev. 368, 375 (1987).
To summarize, under the proportional reduction rule, the risks of settlement are heightened to such a degree that plaintiffs will refuse many settlements, especially those with impecunious major defendants or defendants whose share of liability is difficult to predict. While a plaintiff can lessen this risk by demanding a sliding scale guarantee, he may not have enough bargaining power to obtain such a guarantee. If he does obtain the guarantee, his cash recovery from the settling defendant will be somewhat less.

C. The Proportional Reduction Rule Does Not Promote Judicial Economy

1. Elimination of the Good Faith Hearing

Another purported advantage of the proportional reduction rule is that it saves court time, by eliminating the need for a "good faith" hearing. The basic inquiries at such a hearing are whether the settlement is tainted by fraud or collusion and whether the settling defendant paid his proper share of damages. The difficulties inherent in making this determination before trial have been the subject of much criticism.

No matter when the hearing occurs, it poses problems. If the settlement and hearing occur early in the litigation, before the completion of discovery, it may be difficult for the settling party to prove that the settlement was fair. If the partial settlement is reached later in the lawsuit, the non-settling defendant may have to reveal defense strategy and evidence to show the unfairness of the settlement.

204. This is the conclusion of the Ninth Circuit in Franklin v. Kaypro Corp., 884 F.2d 1222 (9th Cir. 1989). Interestingly, one legal commentator has suggested adoption of a proportional reduction type rule without elimination of the good faith hearing requirement. See Davis, supra note 7, at 1277.

205. See In re Sunrise Sec. Litig., 698 F. Supp. 1256, 1259-60 (E.D. Pa 1988); see also Donovan v. Robbins, 752 F.2d 1170 (7th Cir. 1985).

206. In Donovan, 752 F.2d 1170, the court noted that conducting a hearing: means bogging down the settlement process in a miniature trial before trial, for "in determining good faith the court could consider the risk of victory or defeat, the risk of a high or low verdict, the unknown strengths and weaknesses of the opponent's case, the inexact appraisal as to the elements of danger, the defendant's solvency and the amount of insurance coverage."

Id. at 1181 (citation omitted).
Elimination of this troublesome hearing would appear to save a good deal of time for both court and counsel. However, the time-saving benefits of this approach may be illusory. Although the proportional reduction rule obviates the need for a good faith hearing prior to trial, it does not eliminate the need for the court to determine the issue that would have been adjudicated by the good faith hearing, i.e., whether the settlement was, in a general sense, proportional to the settling defendant's fault. Rather, by requiring the jury to find the settling defendant's percentage of fault, the proportional reduction rule "pushes the same issues forward into an already complex and confusing trial."\(^{207}\)

Indeed, rather than reducing the scope of judicial inquiry, the rule transforms what could be a summary determination before a judge into an issue for full trial before a jury. Under this scheme, the precise percentage of the fault of the settling defendant, who is no longer a party to the action, is subject to full proof at trial. As one trial judge has noted, "in a complex securities litigation, the burden of the jury's time and perception is already considerable. To add to this burden the task of apportioning fault between absent and present defendants would obviate much of the advantage of partial settlement to the judicial system itself."\(^{208}\)

2. Pendent Claims

Any time-saving benefits of eliminating the good faith hearing may be outweighed by the difficulty of dealing with pendent claims which may be subject to a differing state law judgment reduction rule.\(^{209}\) The court in *Nelson v. Bennett*\(^{210}\) viewed this as a minor problem:

> [P]ractical difficulties in application will arise not in the majority of cases, but only in those particular instances where (1) both state and federal claims are asserted in a single action, (2) the state provides a settlement bar stat-

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208. *Id.*


ute, and (3) the state statute and the federal statute vary significantly. In all other instances, the application of a federal settlement bar rule presents no practical difficulties whatsoever.\textsuperscript{11}

The Nelson court, however, understates the problem. Pendent claims are common in securities actions. Due to the availability of punitive damages\textsuperscript{212} and a lower standard of culpability, state law claims are often very attractive to injured investors. Plaintiffs' lawyers may, therefore, feel obliged to include pendent state law claims in most securities fraud actions. Moreover, plaintiffs who wish to avoid the harsh effect of the proportional reduction rule may file pendant state law claims in states where the more attractive \textit{pro tanto} rule will apply to these claims.

The difference between the federal and state judgment reduction rules makes pendent claims difficult for both the judge and jury to handle. Consider the following example. P, a resident of California, files a federal complaint under Rule 10b-5 against defendants SD and NSD. Plaintiff also asserts a pendent claim for common law fraud, based on identical facts, against the same defendants. The 10b-5 action would be governed by the federal proportional reduction rule while the common law fraud action would be governed by the \textit{pro tanto} rule of the State of California.

Under these facts, while there would be no need to hold a pretrial good faith hearing on the federal cause of action, California law requires that such a hearing be held as to the state claim.\textsuperscript{213} At that hearing, the judge would be required to summarily determine which portion of the settlement is attributable to the state cause of action. Given that the same facts will

\textsuperscript{11} Id. at 1337.

\textsuperscript{212} The federal securities statutes do not provide for punitive damages. 15 U.S.C. §§ 77a-78ll (1978). The proof of a state punitive damage claim and a violation of the securities laws may be similar. A claim for punitive damages requires willfulness; most claims for securities fraud require proof of scienter. \textit{See} Ernst and Ernst v. Hochfelder, 425 U.S. 185 (1976).

\textsuperscript{213} \textit{CAL. CIV. PROC. CODE} § 877.6(a) (Deering 1991) provides:

Any party to an action wherein it is alleged that two or more parties are joint tortfeasors or co-obligors on a contract debt, shall be entitled to a hearing on the issue of the good faith of a settlement entered into by the plaintiff or other claimant and one or more alleged tortfeasors or co-obligors.
likely give rise to both the state and federal causes of action, this determination would be largely conjectural. The judge would then have to determine whether the settlement attributable to the state cause of action is within settling defendant's reasonable range of liability.\textsuperscript{214}

As the case proceeds to trial, the practical problems would be shifted to the jury. Presumably, it would have to determine the total amount of damages and apportion these damages between the federal and state claims. Again, this apportionment would be difficult, since the proof of the two claims would be virtually identical. The jury would then need to determine the settling defendant's percentage of fault on the federal claim alone and reduce the federal component of the verdict by that percentage.

The difficulty of the jury's task would be increased by the fact that, in order to maximize recovery, the plaintiffs, who do not benefit under the proportional reduction rule, will want the settling defendant's liability to be shifted to the state claim. In contrast, non-settling defendants would argue that their liability is under the federal claim because this liability will be reduced more significantly under the proportional reduction rule. There may be a heated debate at trial over defendant's liability and damages, and the non-settling defendant's liability. Additionally, the debate may include what portion of damages should be assigned to which claims. Given this added debate, it is not clear how the proportional reduction rule serves the goal of judicial economy.

D. The Proportional Reduction Rule Places Heavy Burdens on the Plaintiff

The proportional reduction rule is intended to produce a fair division of liability among tortfeasors by ensuring that each defendant pays damages according to his or her degree of culpability.\textsuperscript{213} In fact, these goals may be undermined by the elimination of the good faith hearing and the absence of

\textsuperscript{215} In Franklin v. Kaypro Corp., 884 F.2d 1222, 1231 (9th Cir. 1989), the Ninth Circuit concludes that the proportional reduction rule satisfies the "goal of equity."
the settling defendant at the trial where his liability is determined.

1. Plaintiffs Are Deprived of Settlement Leverage

With the elimination of the good faith hearing, there is no judicial means of determining whether the amount paid by the settling defendant bears any relationship to that defendant's "fair share" of damages.

 Plaintiffs, of course, always have an incentive to obtain the most lucrative settlement possible from the settling defendant, and under the proportional reduction rule this incentive is increased because plaintiff knows that he bears the risk of a "cheap" settlement. However, for this incentive to be meaningful, the plaintiff and the settling defendant must be in comparable bargaining positions. Oftentimes, this is not the case. In fact, plaintiffs may accept a small settlement because they need the money or wish to simplify the litigation.

At a good faith hearing held under the pro tanto rule, the non-settling defendants will object to any settlement that is too cheap, and the threat of such an objection will give plaintiffs bargaining leverage to obtain larger settlements from the settling defendant. Under the proportional reduction scheme, plaintiffs receive no such bargaining leverage and an impecunious plaintiff is free to settle with a defendant for next to nothing. In cases where the plaintiffs are desperate, the proportional reduction rule thus provides no guarantee that the settling defendant will pay anything approaching his fair share of the damages.

2. Jury Confusion and Prejudice to Plaintiff

One criticism of the California style good faith hearing is that the judge must make some determination of the sufficiency of the settlement payment without the benefit of trial. Un-

216. See, e.g., Tech-Bilt, Inc. v. Woodward-Clyde & Assoc., 698 P.2d 159 (Cal. 1985); see also Smith v. Mulvaney, 827 F.2d 558 (9th Cir. 1987).

217. In securities class actions, there would be some inquiry into the fairness of the settlement under the Federal Rules of Civil Procedure, Rule 23(e), but "the different nature of the two proceedings does not allow a finding that a 'fair' settlement was obtained under Rule 23(e) to be used as conclusive proof that a settling defendant has paid its proper share of damages relative to the non-settling defendants in an action for contribution." Smith, 827 F.2d at 562.
der the proportional reduction rule, the determination of relative fault is made at trial, presumably with more evidence at hand. Proponents of the proportional reduction rule argue, therefore, that it results in a more accurate allocation of fault.218

In fact, however, the trial will be skewed in fundamental ways. It will include a determination of the liability of the settling defendant, which may have little relevance to the trial of plaintiff's claim against the non-settling defendants. The settling defendant, who is in the best position to litigate his or her own liability, will have been dismissed from the action and, in most cases, will not be present or represented at the trial. The plaintiff will, therefore, be placed in the awkward position at trial of taking on the settling defendant's role in addition to its own. It is easy to see how these contradictory roles could make the plaintiff appear deceitful.

For example, consider the case where the liability of the settling defendant and the liability of the non-settling defendant rests on the same set of facts and very similar conduct. To optimize his recovery, plaintiff must vigorously attack the conduct of the non-settling defendant while attempting to minimize very similar conduct by the settling defendant (who has been dismissed from the litigation).219 Plaintiff's apparently two-faced position will be doubly confusing to a jury which has not been informed of the circumstances of the settlement and has no means of placing plaintiff's apparently selective prosecution into perspective or of scrutinizing the evidence presented at trial in the context of the true interests of the parties.

218. Davis, supra note 7, at 1253-55.
219. See Mielcarek v. Knights, 375 N.Y.S.2d 922, 926 (1975): After partial settlement of a case under New York General Obligations Law section 15-108, see supra notes 172-75 and accompanying text, "the 'true adversary' . . . is not the settling tortfeasor with no monetary interest or substantive liability, but the plaintiff who will seek to prove that the settling tortfeasor was only slightly at fault and that the greatest percentage of fault should be attributed to the non-settling defendants."
3. Problems of Proving the Case of an Absent Party

Moreover, the plaintiff will be required to present the settling defendant’s defenses without easy access to the necessary information or the ready cooperation of key witnesses. Although the settling defendant may be called as a witness, he or she will have no financial incentive to cooperate with the plaintiff. The jury cannot judge the veracity of such a witness accurately if it has no opportunity to know why he is not a party to the action.

A main purpose of the proportional reduction rule is to allow the settling defendant’s liability to be determined at trial, with the result that “the non-settling defendants never pay more than they would if all parties had gone to trial.” While this may occur, the above-described distortions of the adversarial process may be quite prejudicial to plaintiffs. It is, therefore, possible that the non-settling defendants will pay significantly less than if all parties had gone to trial.

E. Conclusion

The purpose of the proportional reduction rule is to harmonize the goal of fairly allocating damages among defendants with the goal of promoting settlement. The rule does succeed in providing a fairer allocation of damages by removing the incentive for more culpable defendants to settle first and shift their liability to the less liable non-settling defendants.

In other respects, however, the rule is not so successful. While it allows a defendant to settle with the plaintiff and escape the action, it severely discourages plaintiffs from settling. Significantly, it causes plaintiffs to reject settlements where insolvent defendants offer every cent they and their insurance companies can ever be required to pay.

In addition, while deterrence is a major goal of the securities laws, the rule decreases deterrence to a large class of actors, namely, minor participants in securities transactions. Similarly, while the purpose of settlement is to simplify the trial,

220. Franklin v. Kaypro Corp., 884 F.2d 1222, 1231 (9th Cir. 1989) (emphasis added).
the rule fails this purpose by keeping the liability of the sett-
ing defendant as an issue to be decided by the jury.

Finally, while the rule does allocate liability more fairly
than the *pro tanto* rule, its method of doing so, by means of a
trial at which the settling defendant is absent and the plaintiff
must put on a defense for that party, is so cumbersome and
skewed that any allocation of fault produced is likely to be far
less than exact.

Any attempt to harmonize the conflicting goals of fair
allocation of fault and promotion of settlement raises close
and difficult questions. Accordingly, the proportional reduc-
tion rule cannot be the "neat solution" it has been touted to
be. Its greatest weakness may be that, because it extinguishes
contribution rights which were explicitly created or implied by
Congress, its enactment is beyond the powers of the federal
courts.

V. PROPOSED SOLUTIONS

In this section, a proposed solution to the problems raised
by the need for settlement bar rules in federal securities cases
is discussed. How courts can apply settlement bar rules consist-
tently without exceeding their interstitial powers is discussed.

A. Options For Courts

1. Courts Should Borrow Applicable State Laws Rules

In the absence of congressional action, courts which feel
that a settlement bar rule is necessary should turn to state law
first. Borrowing these rules from state law has two distinct
advantages.

First, the same rule will apply to federal and pendent
claims in any given case. The parties will, therefore, not be
tempted to attribute plaintiff's losses to one type of claim or
another in order to take advantage of the judgment reduction
rule which is most favorable to them.

Second, some states, including California and New York,
have specific statutory procedures and rules of court applicable
to settlement bar rules. These procedures are far more stream-
lined and developed than anything which the federal courts
could create using their interstitial powers. California, for ex-
ample, has a statutory "good faith" hearing procedure which
has been refined by judicial decision into a fairly efficient means of determining whether a settlement bar order should be entered.\textsuperscript{221} Prior to \textit{Kaypro}, some U.S. district courts had adopted this California procedure on a de facto basis and it worked fairly smoothly.

The main drawback in borrowing state law is the threat of forum shopping. This threat is heightened by the fact that New York and California (the two states which presumably spawn the most securities actions) have very different settlement bar rules. California has a \textit{pro tanto} rule, while a proportional reduction rule is applicable in New York. However, it remains to be seen whether the difference in settlement bar rules would be sufficiently important to cause a California plaintiff, for example, to bring his or her suit in New York. Moreover, forum shopping may pale in comparison to the intra-case claim shopping which will occur if one settlement bar rule applies to the federal claims and another applies to the state claims in the same case. Finally, forum shopping will occur even if federal courts use their interstitial powers to create their own rules. Until the Supreme Court finally decides the issue, the circuits are likely to choose varying rules, and, thus, there will be forum shopping among the circuits.

Accordingly, borrowing of state law is not likely to lead to a greater lack of uniformity than already exists. Borrowing will cause more uniformity in any given case and will allow the court to use relatively efficient, existing statutory systems, rather than cumbersome rules of the court's own making. Accordingly, if state settlement bar rules are applicable, federal courts should borrow them.

2. \textit{Options When No State Rule Is Available}

Some states do not have applicable settlement bar rules. As discussed above, a court's interstitial power is insufficient to permit federal courts sitting in such states to create rules which extinguish the congressionally created contribution rights of such non-settling defendants. Courts must carefully design settlement bar rules that do not deprive non-settling defendants of their statutorily created rights. Two proposals for such rules follow.

\textsuperscript{221} CAL. CIV. PROC. CODE § 877.6 (Deering 1991).
a. A Limited Pro Tanto Rule

Courts could create a *pro tanto* rule which extinguishes contribution rights against a settling defendant only on a showing that the settling defendant had paid its full share of the damages. Non-settling defendants have no rights to obtain contribution from a settling defendant who has paid his full share. An order extinguishing contribution rights under these circumstances would, therefore, not deprive the non-settling defendant of any significant rights and would fall within the court’s interstitial powers. Interestingly, this was the procedure suggested by the Ninth Circuit prior to *Kaypro*. As noted in Section II(G) above, the Ninth Circuit was presented with two settlements which purportedly met this rigorous standard and rejected both of them. It is extremely difficult for a settling defendant to make a pre-trial showing that he has paid his “full share,” and such a showing will be impossible in many cases where the facts surrounding comparative liability are complicated. Therefore, this limited *pro tanto* rule is not likely to produce very many settlement bar orders.

b. A Limited Proportional Reduction Rule

The second option for courts which cannot borrow a state settlement bar rule is to adopt the proportional reduction rule. As discussed in section III(E), above, in most cases the proportional reduction rule does not deprive the non-settling defendant of its rights to contribution. On the contrary, at trial, the non-settling defendant can argue to the jury, as he would in a contribution action, that the settling defendant is responsible for a part of plaintiff’s damages. Subsequently, the non-settling defendant will be relieved of the portion of damages attributable to the defendant who settled. In many cases the proportional reduction rule is within the interstitial powers of those courts which have no state law alternative because it does not deprive non-settling defendants of any substantive right. As shown in section III(E), above, however, this is not true in cases involving insolvent defendants. In such cases, the propor-

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222. *Smith v. Mulvaney*, 827 F.2d 558, 560 (9th Cir. 1987); *Laventhol, Krekstein, Horwath & Horwath v. Horwitch*, 637 F.2d 672 (9th Cir. 1980).
tional reduction rule may strip a non-settling defendant of his rights to obtain contribution from perfectly solvent settling defendants, leaving him to pay huge damages caused by a third, insolvent party.

Any judicially created proportional reduction rule will fall within the court's powers only if it does not deprive non-settling defendants of their rights to obtain contribution on paying damages caused by an insolvent co-defendant. Since insolvent parties are common in securities actions, such a rule would seldom lead to effective settlement bar orders.

Judicial action, be it borrowing or creating settlement bar rules, is not likely to produce any uniform national standard. Accordingly, it is up to Congress to create such a standard. The next section proposes, for discussion, a uniform settlement bar rule which Congress could enact to apply to settlements of all securities law cases.

B. A Proposal for a Settlement Bar System

The settlement bar systems discussed in this article share one underlying flaw: Each system fails to give courts the flexibility necessary to make the partial settlement process fair. Under *Kaypro*, for example, courts must apply the proportional reduction rule in every case, even though it discourages settlements, complicates trials and places heavy burdens on the plaintiff. Under the *pro tanto* system (as it exists in California) a court reviewing a settlement is given two choices, and in some cases both of them will be unfair. First, the court can order a *pro tanto* judgment reduction which, depending on the terms of the settlement, may be horribly unjust to the non-settling defendant. Alternatively, the court can reject the settlement completely, which will complicate the trial and deprive the injured plaintiff of a sure recovery.

The settlement bar system which this article proposes is intended to give judges some needed flexibility by allowing them to determine whether the *pro tanto* or proportional reduction rule should apply. This decision would be based on the particular circumstances of each case. Under this proposal, in cases where plaintiffs have induced the settling defendant to pay a reasonable amount, plaintiffs will be rewarded by entry 223. Franklin v. Kaypro Corp., 884 F.2d 1222 (9th Cir. 1989).
of a \textit{pro tanto} judgment reduction order. However, plaintiffs who accept a settlement which is grossly inadequate will not be entitled to the more favorable \textit{pro tanto} judgment reduction: In cases involving such a deficient settlement, the judge will apply a modified proportional reduction rule. The details are as follows.

First, a pretrial hearing will be held to examine the partial settlement. If the settlement is not tainted by fraud, collusion or an improper motive, the court will enter a settlement bar order, extinguishing contribution claims against the settling defendant. The court will then turn to the issue of which judgment rule to apply—the \textit{pro tanto} rule or the proportional reduction rule.

At the hearing, the court will examine the amount to be paid by the settling defendant. If this amount is within a reasonable range of the settling defendant's fair share of the damages, the court will order a \textit{pro tanto} judgment reduction. In making this decision, the court will consider the financial condition and insurance resources of the settling defendant. A settlement which is otherwise inadequate will warrant a \textit{pro tanto} reduction if it represents the bulk of the settling defendant's assets and insurance coverage.

Finally, if the settlement is not within a reasonable range of the settling defendant's fair share of the damages, the court will order judgment reduction according to the proportional reduction rule. The percentage of fault attributable to the non-settling defendant will be determined by the trial judge at a post-trial hearing and this percentage will be deducted from plaintiff's recovery.

This proposed rule is very similar to the system currently in effect in California, with one significant change. As in California, a pretrial hearing would be held in which the court would examine whether the settlement is tainted by fraud, collusion or an improper motive\textsuperscript{224} and whether the settlement amount is "not grossly disproportionate to what a reasonable person, at the time of the settlement, would estimate the settling defendant's liability to be."\textsuperscript{225} As under the Cali-

\textsuperscript{224} For a discussion of improper motives, see Torres v. Union Pacific R.R., 203 Cal. Rptr. 825, 828-29 (Ct. App. 1984).
\textsuperscript{225} \textit{Id}. at 832.
fornia system, the court would consider the settling defendant’s financial condition and insurance coverage in deciding whether the settlement amount is “in the ballpark.” The proposed rule differs from the California system in that in cases involving inadequate settlements, courts will have the option of approving the settlement but applying the proportional reduction rule. The following sections explain the merits of the proposed system.

1. *Fair Settlements Are Encouraged*

The proposed system offers plaintiffs the incentive to obtain a reasonable settlement from each defendant. If plaintiffs negotiate such a settlement, the *pro tanto* rule will be applied and, as explained in section IV(A)(1)(b) above, the risks of that settlement will be passed from plaintiff to the non-settling defendant.

2. *Settlements with Impecunious Defendants Are Encouraged*

The proposed rule also permits courts to take economic reality into account in determining whether the settlement is reasonable. Courts will apply the *pro tanto* rule to a settlement that might otherwise seem inadequate, if the settling defendant is paying a sizable portion of his assets and insurance coverage. The proposed system is thus superior to the proportional reduction rule, which encourages plaintiffs to reject settlements with impecunious major defendants even where the proposed settlement would give plaintiffs a greater recovery than they would receive if they prevailed at trial and then tried to collect a judgment. By applying the *pro tanto* rule in such situations, the proposed system encourages plaintiffs to enter into fair settlements with impecunious defendants.

3. *Fairness to Non-Settling Defendants*

The proposed system is also concerned with fairness to the non-settling defendants. Before their contribution rights can be extinguished, non-settling parties will be given a day in court in which they will have the opportunity to prove that the settlement is too cheap and, thus, leaves them exposed to paying an unreasonably large portion of the damages caused by the settling defendant.
4. The Proposed System Will Encourage Judges to Examine Settlements Carefully

A major advantage of the proposed system arises in cases where application of the *pro tanto* rule would be demonstrably unfair to non-settling defendants. In such cases, judges will have the option of rejecting the *pro tanto* rule without throwing out the entire settlement. The proposed system is thus an improvement over the California system, where courts have only the following two options when a non-settling defendant challenges the good faith of a settlement. First, the court can find that the settlement is in good faith, in which case the settling party is removed from the action, the trial is simplified and the injured plaintiff receives immediate compensation. Second, the court can reject the settlement, in which case the trial goes forward with all defendants present and plaintiff receives no sure recovery. Given these choices, the court's desire to simplify the case and ensure some recovery to plaintiffs will often outweigh the non-settling defendant's claims that the settlement is unfair. The unfortunate result of the current California system is that the *pro tanto* rule may be applied to some very dubious settlements.

The system proposed here spares judges this Hobson's choice. The court is not required to decide between approving or rejecting a settlement. Instead it decides which judgment reduction rule should apply. Courts thus have an incentive to weigh settlements carefully and to apply the proportional reduction rule in cases where application of the *pro tanto* rule would be unfair to the non-settling defendant.

5. Judicial Economy Will Be Served

Under the proposed rule, the pretrial hearing will not place too great a burden on the judicial system. Similar hearings are held under the California system on practically a daily basis and they are fairly short and streamlined and often are decided on the basis of declarations.226

Nor will the trial be unduly complicated in cases where the court applies the proportional reduction rule. The jury will

226. CAL. CIV. PROC. CODE § 877.6(b) (Deering 1991).
not be called upon to gauge the comparative fault of the settling and non-settling defendants. Rather, this will be done at a post-trial hearing conducted by the trial court judge. Since this judge will have heard all of the evidence in the case, this hearing should be neither too long nor too complicated.

Finally, the proposed rule will add some complexity by requiring a pretrial hearing and post-trial hearing in those cases where the judge selects the proportional reduction rule. Even so, the proposed system will not be as complicated as that proposed in Kaypro, which requires that the fault of the absent, settling defendant be fully litigated at the trial of every case involving a partial settlement.227

6. **The Proposed System Does Not Lessen Deterrence Appreciably**

The proposed system should retain the deterrent effect of the *pro tanto* rule. As explained in section III above, under the *pro tanto* rule minor defendants are deterred by the knowledge that a major defendant may enter into a cheap, early settlement with plaintiff, leaving the minor defendant exposed to paying the bulk of the damages. The proposed system, while lessening it somewhat, retains this deterrent effect.

Thus, under this proposal, the prospect of the pre-trial hearing will encourage the major defendant to pay a settlement price that is within a reasonable range of its fair share of the damages. This range, however, can be quite broad, especially in cases involving impecunious defendants. Accordingly, courts will apply the *pro tanto* rule to many settlements where the settling major defendant pays only a fraction of his share of the damages. Minor defendants will continue to be deterred by the prospect of such settlements, which would leave them to pay most of the damages caused by the major defendant.

Under the proposed rule, courts will apply the proportional reduction rule in cases where the settlement is *unreasonably* low. Deterrence will therefore be decreased because minor participants in securities transactions will know that this rule provides them with some protection against being left "holding the bag" if the victim enters into an unreasonably cheap settlement with the major participant. As a policy matter, however,

227. *Kaypro*, 884 F.2d at 1231.
deterrence should not rely on the threat of unreasonable settlements. The marginal decrease in deterrence under the proposed rule is the result of the fact that this rule will be fairer in some cases. This increased fairness warrants the slight decrease in deterrence to a limited group of actors.

7. The Nucorp Example

In examining the proposed solution, a final look at Nucorp will be helpful. There, the plaintiffs who suffered “baseline” damages of $230 million accepted a $41 million pretrial settlement from various “insider” defendants. This left the non-settling defendants, including accountants, bankers, and underwriters, exposed to the remaining liability of approximately $180 million.

Applying the proposed rule to these facts, a judge would first examine whether the settlement payment was reasonably related to the settling defendants’ fair share of the liability. The answer to this question would have to be in the negative, because the settlement allowed apparently primarily liable “insider” defendants to escape the action by paying only 18% of the damages, while the secondarily liable defendants were left to pay the remaining 82%.

After making this determination, the court would examine whether the settlement was fair in light of the settling defendants’ financial condition. This inquiry might lead to a different result. In Nucorp, Judge Irving found that most of the settlement payment came from the settling defendants’ insurance policies. Judge Irving also found that there was evidence that the settling “insider” defendants might have committed acts of dishonesty, which if exposed at trial, would not be subject to coverage. The settlement thus represented all plaintiffs’ insurance coverage and, if the matter went to trial, this coverage might not have been available at all. It was not clear whether the settling defendants had other assets sufficient even to replace the insurance coverage in the event this

229. Id. at 1410.
230. Id.
231. Id. at 1409.
232. Id.
233. Id.
coverage was lost. Assuming they did not, the settlement would satisfy the rule proposed here, since the settlement price would give plaintiffs a recovery equal to what they would receive if they tried to collect a verdict against the settling defendants. Accordingly, the pro tanto judgment reduction order would be applied.

This would not be the result if the settling defendants had significant assets. If that were the case, it would be unreasonable to leave minor defendants exposed to 82% of the damages when the major defendants were fully capable of paying for all the harm they had caused. Under the proposed system, the court could therefore apply the proportional reduction rule and, after trial, plaintiffs' recovery from the non-settling parties would be reduced by the percentage of fault attributable to the settling defendants.

As mentioned, it is not clear from the record in Nucorp what the assets of the settling defendants were, although the non-settling defendants claimed that they were very substantial. It is clear that Judge Irving felt intense pressure to approve the settlement for the purposes of streamlining a very long, complex trial. Had the proportional reduction rule been available to him, he might have imposed it, thereby allowing the settlement to go forward while refusing to expose the non-settling defendants to the prospect of shouldering 82% of the damages.

8. Criticisms of the Proposed Rule

Both plaintiffs and non-settling defendants can be expected to criticize the proposed rule.

Plaintiffs will argue for a pure pro tanto system, claiming that application of the proportional reduction rule in any case places too great a burden on them. The proposed rule, however, places this burden only on plaintiffs who agree to a settlement which is so unreasonable as to be "out of the ballpark." Plaintiffs should not be allowed to recover the inadequacies of such demonstrably unreasonable settlements from non-settling defendants.

234. Id. at 1410.
Non-settling defendants will complain that the proposed system protects them only from the patently unreasonable settlements. They will complain that in many cases the court will approve a settlement which on its face may seem reasonable, but which will prove to be wholly inadequate when an unexpectedly large verdict is entered. In such cases non-settling defendants will be left to pay a huge share of the damages caused by the settling defendant.

The proposed rule, however, gives sufficient protection to the non-settling defendant. It gives them standing to challenge any settlement and to show that it is unfair or that the settlement price is unreasonably low. It also gives courts a palatable alternative in cases where the settlement does, in fact, appear to be unreasonably cheap.

This is all that is due to the non-settling defendants. In cases where these defendants are held to pay a disproportionately large share of damages, they are at least somewhat at fault, while the plaintiff-investor will often be entirely without fault. Moreover, officers, directors, accountants, lawyers, and underwriters may be in a better position to insure themselves against losses than are investors. Insurance against such losses may be considered part of the cost of doing a type of business from which a substantial profit is derived.

Given these considerations, courts cannot be expected to mathematically tailor each defendant's liability to his or her precise mathematical percentage of fault. The proportional reduction rule is an attempt to apportion liability in this way. Application of this rule in all cases is likely to prevent partial settlements, lessen deterrence, lower recovery to plaintiffs, and prolong and complicate trials.

While the trend toward fair allocation of damages is a healthy one, the proponents of the proportional reduction rule have taken this trend to an unfair extreme. Congress should limit the applicability of this rule to only those cases where it is appropriate and necessary.