



April 29, 2003

## **Background Paper**

# **The Need for Class Action Reform**

Class action lawsuits allow plaintiffs whose injuries might not be worth enough to justify bringing individual suits to combine their damages into one lawsuit against a common defendant. Class action lawsuits can facilitate the fair and efficient resolution of legitimate claims of numerous parties. For those reasons, federal and state courts' rules of civil procedure enable litigants to proceed on a class basis in appropriate cases.

In recent years, however, a relatively small number of class action plaintiffs' attorneys have abused the class action procedures. The effects have been dramatic: a distortion of our federalist system by the actions of a few rogue state courts; excessive compensation of attorneys at the expense of injured plaintiffs; unprecedented costs to the national economy; and an overall decline in public respect for our nation's judicial system.

Congress has been attempting to reform the class action rules for several years despite strong resistance from trial lawyers. On April 11, the Senate Judiciary Committee reported the Class Action Fairness Act (S. 274) after a favorable, bipartisan vote. The RPC will release a Legislative Notice when S. 274 is to be debated on the floor. Until then, this background paper examines why class action reform is necessary.

## ***The Role of Federal Courts in Multi-State Class Actions***

The U.S. Constitution provides for federal jurisdiction over all lawsuits between citizens of different states, i.e., those cases where the parties are of "diverse" citizenship.<sup>1</sup> The first Congresses enacted legislation narrowly construing "diversity jurisdiction" – long before the class action procedure had been contemplated.<sup>2</sup> Today, the most obviously "national" types of litigation – multi-million-dollar class action cases involving national companies engaging in interstate commerce with citizens of many states – are often stuck in state court. This is so because Congress has narrowly construed constitutional diversity to require *all* plaintiffs to be diverse from *all* defendants: "complete diversity." Consequently, national class actions with plaintiffs from all 50 states and defendants from multiple states are rarely eligible for federal

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<sup>1</sup> U.S. Constitution, art. II, sec. 2, cl. 1.

<sup>2</sup> See *Strawbridge v. Curtis*, 7 U.S. (3 Cranch) 267 (1806) (explaining that the requirement of "complete diversity" was a creation of Congress, not of the Constitution).

court. The result is that a few state courts are deciding cases with great national significance and effectively regulating national industries and professions beyond their state borders.

Much has been written accusing these state courts of incompetence, anti-business biases, and outright corruption. The Constitution provides for federal jurisdiction over cases between citizens of different states precisely so that parties never have to deal with questions of local bias. As Chief Justice Marshall once observed, “[H]owever true the fact may be, that the tribunals of the states will administer justice as impartially as those of the nation, to parties of every description, it is not less true that the Constitution itself either entertains apprehensions on this subject, or views with such indulgence the possible fears and apprehensions of suitors, that it has established national tribunals for the decision of controversies between aliens and a citizen, or between citizens of different states.”<sup>3</sup> The Senate need not pass judgment on the quality of state court judges – most of whom are undoubtedly of high integrity and competence – to recognize that parties to litigation should have a right to the protection of the constitutional safeguard, and that nationwide class actions should not be barred from the federal courts.

### ***The Growing Abuse of Coercive Interstate Class Actions***

A literal class action industry devoted to finding opportunities to extract financial payments from American business has developed in the past few decades. This class action industry is dominated by a focused group of class action plaintiffs’ attorneys who “shop” throughout the nation for the friendliest courts to hear possible cases. As a result, businesses operating in the United States are increasingly at risk of being hauled into select state court jurisdictions where judges are quick to certify a class and where juries are wont to render extravagant awards.<sup>4</sup> Moreover, because each state is sovereign, the same defendant often faces copycat cases in different states, which frequently result in inconsistent judgments.

Forum-shopping has enabled clever attorneys to file in state court many lawsuits that implicate citizens of many states and interstate commerce – precisely the kinds of lawsuits best suited to the federal courts. However, due to the antiquated requirement of “complete diversity” in citizenship among plaintiffs and defendants, these attorneys have been able to craft their pleadings to evade federal court jurisdiction. For example, in Madison County, Illinois – one of the most notorious of the plaintiff-friendly class action jurisdictions in the nation<sup>5</sup> – a South Carolina law firm filed a purported class action on behalf of three named plaintiffs, none of whom lived in Madison County, against 31 defendants throughout the United States, none of whom were located in Madison County.<sup>6</sup> Instead, they base jurisdiction on the mere allegation that some as-yet-unknown class members live in Madison County.

The effect of encouraging such forum-shopping has been dramatic. One study estimates that “[v]irtually every sector of the United States economy is on trial in Madison County, Palm

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<sup>3</sup> Bank of the United States v. Deveaux 9 U.S. (5 Cranch) 61, 87 (1809).

<sup>4</sup> Under the current legal system, “national class actions can be filed just about anywhere and are disproportionately brought in a handful of state courts whose judges get elected with lawyers’ money.” “Making Justice Work,” editorial, Washington Post 25 Nov. 2002, at A-14.

<sup>5</sup> See, e.g., John H. Beisner and Jessica Davidson Miller, “Class Action Magnet Courts: The Allure Intensifies,” Class Action Litigation Report, Vol. 4, No. 2 (BNA 2003).

<sup>6</sup> Beisner and Miller, “Class Action Magnet Courts: The Allure Intensifies,” at 62.

Beach County [Florida], and Jefferson County [Texas] – long distance carriers, gasoline purchasers, insurance companies, computer manufacturers and pharmaceutical developers.”<sup>7</sup>

### ***Current Class Action Abuses Continue to Harm Plaintiffs***

Injured plaintiffs can also suffer due to insufficient judicial oversight of lawsuits that have come to be dominated by class action attorneys. The costs of litigation and the windfall profits to attorneys have produced a legal system that returns less than 50 cents on the dollar to people it is designed to help, and only 22 cents to compensate for actual economic loss.<sup>8</sup>

As a by-product of attorney-dominated class action litigation, many class action settlements consist of disproportionate payments of attorneys fees to plaintiffs’ attorneys and nothing of real value to the injured plaintiffs. Indeed, in some settlements, the plaintiffs receive no cash whatsoever, while the attorneys purporting to represent them receive millions of dollars. For example, in a case against Blockbuster, Inc., customers who alleged they were charged excessive late fees for video rentals were to receive \$1 coupons while their attorneys received over \$9 million.<sup>9</sup> In an Illinois case about cellular phone charges, settling class members received coupons to buy future products (but not to pay current bills), while their attorneys received more than \$1 million in fees.<sup>10</sup> In a similar “coupon” case settlement in California, class members received a \$13 rebate towards the purchase of new computer monitors, while their attorneys received \$6 million.<sup>11</sup> Given the unlikelihood that many class members will ever be able to convert these “coupons” into much of value, these settlements have the effect of granting the attorneys the vast majority of the economic value of the settlements.

Injured parties also suffer when they receive complicated settlement notices that do not adequately explain their right to challenge the settlement or to enjoy the full benefits of the settlement. Even more troubling, some have accused defendants of conspiring with plaintiffs’ attorneys to produce confusing notices in order to ensure that the actual economic value of the settlement to the class members is lower than reported to the court.<sup>12</sup> Relatedly, some settlements have been crafted to provide very large payments to the “named” plaintiff – the original plaintiff who brought the suit prior to class certification – in order to persuade that plaintiff to agree to a settlement that will give fellow class members far less compensation (if any). Additional judicial scrutiny is necessary to ensure that the class members – those who allegedly have been injured, as opposed to their attorneys – understand their rights.

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<sup>7</sup> John H. Beisner and Jessica Davidson Miller, “They’re Making a Federal Case Out of It,” Civil Justice Report, No. 3 (Center for Legal Policy at the Manhattan Institute 2001), at 27.

<sup>8</sup> Tillinghast-Towers Perrin, U.S. Court Costs: 2002 Update, Trends and Findings on the Costs of the U.S. Tort System, at 1, available at [http://www.tillinghast.com/tillinghast/publications/reports/2002\\_Tort\\_Costs\\_Update/Tort\\_Costs\\_2002\\_Update\\_rev.pdf](http://www.tillinghast.com/tillinghast/publications/reports/2002_Tort_Costs_Update/Tort_Costs_2002_Update_rev.pdf). Tillinghast is an international actuarial and management consulting company that has been examining the U.S. legal system’s costs in published studies since 1985.

<sup>9</sup> “Blockbuster customers to be reimbursed for late fees,” Associated Press, 11 Jan. 2002, discussing Scott v. Blockbuster, Inc., No. D162-535 (Jefferson County, Texas, 2001).

<sup>10</sup> Michelle Singletary, “This ‘Settlement’ Doesn’t Ring True,” Washington Post 5 Sept. 1999, at H-01.

<sup>11</sup> Michelle Singletary, “‘Coupon Settlements’ Fall Short,” Washington Post 12 Sept. 1999, at H-01.

<sup>12</sup> Genine C. Swanzy, Using Class Actions to Litigate Mass Torts: Is There Justice for the Individual?, 11 Georgetown Journal of Legal Ethics 421, 428 (1998); Arthur Bryant, “Class Actions for Settlement Only: An Invitation to Collusion,” Legal Times 17 June 1996, at 19.

## ***The Costs of Runaway Litigation to the National Economy***

Over the past decade, class action lawsuits have grown by over 1,000-percent.<sup>13</sup> This growth in class action litigation contributes to the increasing burdens that civil lawsuits place on the American economy.<sup>14</sup> While some of that increase in class actions may be due to legitimate increases in injuries to innocent plaintiffs, it is also due to a myriad of lawsuits filed with the intent of forcing early settlements. Plaintiffs' attorneys have manipulated the class action legal procedures in certain states to force early settlements on even the most frivolous of claims, especially if a pliant judge can be persuaded at an early stage to certify the case as a class action. Because class actions aggregate many potential claims into one lawsuit, and because many unfair, or even unconstitutional, certification rulings cannot be appealed until after an expensive trial on the merits, defendants often face the risk of a single judgment in the tens of millions or even billions of dollars.

The risk of a single, bankrupting award often forces defendants to settle the case with sizable payments even when the defendant has meritorious defenses. As one federal court explained, "The risk of facing an all-or-nothing verdict presents too high a risk, even when the probability of an adverse judgment is low. These settlements have been referred to as judicial blackmail."<sup>15</sup> Thus, defendants facing non-meritorious class action lawsuits must decide whether to assume even a slight risk of an unfavorable jury award that could bankrupt the company. This "judicial blackmail" imposes increased costs on the economy, causing higher prices and lower wages (along with the enrichment of those attorneys who brought the weak claims in the first place).

Noting this drag on the American economy and the difficulty that insurers have in accounting for litigation risk, the chairman of Lloyd's of London recently remarked, "In such an environment, what hope is there to keep the spirit of risk-taking alive, to fuel the appetite for innovation and creation? Would those who trekked their way across the dusty plains, or built up vast commercial empires, or realised the dream of putting man on the Moon – would they have achieved any of this if they had to face the threat of being sued?"<sup>16</sup> When litigation costs become too unpredictable, the effect will be to dissuade investment, discourage entrepreneurship, increase the costs of risk planning, and threaten the core economic activities that have long characterized American capitalism.

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<sup>13</sup> Class Action Watch, Vol I, No. 2 (Spring 1999), available at <http://www.fed-soc.org/Publications/classactionwatch/classaction1-2.pdf> (finding increase of 1,315 percent over previous decade); Tillinghast-Towers Perrin at 1.

<sup>14</sup> In 2001, total damages, litigation expenses, and court-related costs amounted to \$205 billion. Tillinghast-Towers Perrin at 3.

<sup>15</sup> Castano v. American Tobacco Co., 84 F.3d 734, 746 (5th Cir. 1996); see also Coopers & Lybrand v. Livesay, 437 U.S. 463, 476 (1978) ("Certification of a large class may so increase the defendant's potential damages liability and litigation costs that he may find it economically prudent to settle and to abandon a meritorious defense"); In the Matter of Rhone-Poulenc Rorer, Inc., 51 F.3d 1293 (7th Cir. 1995) (noting the "intense pressure to settle" rather than "roll[ing] the[] dice" by taking the case to a jury).

<sup>16</sup> Lord Levene (Chairman, Lloyd's of London), Speech to Union League of Chicago, 8 April 2003, at 12-13, available at <http://www.lloyds.com/index.asp?ItemId=4776>.

## ***S.274's Reforms Will Address These Problems***

As will be discussed more fully in the forthcoming Legislative Notice, S.274 remedies the problems discussed in this background paper. First, it expands federal jurisdiction over class actions by eliminating the need for “complete diversity.” The effect of this change will be to drive those cases that are multi-state, or national, in scope to federal court, while keeping state courts involved in adjudicating matters that primarily involve the forum state. This expanded federal jurisdiction will also eliminate the allure of forum shopping for the most favorable forum because defendants will be able to avail themselves of unbiased federal courts in high-dollar, multi-state cases.

The bill also has several consumer-protection provisions. It requires that notices be clear and not bogged-down with “legalese” so that plaintiffs can better understand their rights. It also requires that state attorneys general, or other relevant state officials, be notified of pending class action settlements so that these elected officials can protect their citizens. The bill also requires federal judges to scrutinize non-cash settlements to ensure that plaintiffs are treated fairly when their lawyers get cash settlements but they get coupons. And, it requires that the Judicial Conference study ways to ensure that lawyers are not getting unfair, outrageous fees at the expense of consumers.

### **Conclusion**

Class actions are an important part of our litigation system that, when used properly, should produce a net savings to the litigation system and just recoveries to injured parties. But without reform, the class action process will remain a system ripe for exploitation, and the harm to the fundamental fairness of the civil justice system will continue to grow.

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