USE OF A PRELIMINARY HEARING IN A 23(b)(3) CLASS ACTION

Alameda Oil v. Ideal Basic Industries, Inc., 326 F. Supp. 98 (D. Colo. 1971)

Plaintiff stockholders sought to determine whether their litigation could continue as a class action under Federal Rule 23(b)(3)[1] against a corporation and its directors. The action was based on alleged violations of the Securities Exchange Act[2] and breach of state common law fiduciary duty. The district court allowed the class action to tentatively proceed, but ruled that a preliminary hearing should be held before issuing notice on the threshold issues of fact to determine if a cause of action existed.[3]

Due process guarantees that a person will not be deprived of his

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1. FED. R. CIV. P. 23(b)(3):

(b) Class Actions Maintainable. An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:

. . .

(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action.

The prerequisites of 23(a) are: 1) the class must be so numerous that joinder of all members is impractible; 2) legal and factual questions must be common to the class; 3) the claims or defenses of the representatives must be typical of those of the class; 4) the representative parties must adequately protect the interests of the class. FED. R. CIV. P. 23(a). For a history of the class action in the federal courts prior to the present rule see Kaplan, *Continuing Work of the Civil Committee: 1966 Amendments of the Federal Rules of Civil Procedure* (I), 81 HARV. L. REV. 356, 375-86 (1967).

2. Act of June 6, 1934, ch. 404, § 10(b), 48 Stat. 891, 15 U.S.C. 78j(b) (1970); ch. 404, § 14(c), 48 Stat. 895, 15 U.S.C. 78n(a) (1970).

3. Alameda Oil Co. v. Ideal Basic Indus. Inc., 326 F. Supp. 98, 105 (D. Colo. 1971). The court noted, however, that if facts should develop which would warrant a change in the pre-trial procedure, it would entertain variations suggested in its approach. The case proceeded to trial and resulted in a directed verdict for defendant. Alameda Oil Co. v. Ideal Basic Indus. Inc., 337 F. Supp. 194 (D. Colo. 1972). There was no mention of the earlier suggestion of a preliminary hearing or the fact that the case was originally brought as a class action.

property without an opportunity to protect his rights in that property.[4] In class actions this requires that the interests of absent parties be adequately protected.[5] Although notice may not be essential in all class actions,[6] Rule 23, designed to satisfy the requirements of due process,[7] provides that members of a 23(b)(3) class action receive the best practible notice under the circumstances.[8] The notice provisions of Rule 23 have given rise to several problems:[9] what is adequate

4. Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306, 313-15 (1950). Since a chose in action is property, this guaranty protects the right of plaintiffs to present their claims in court. *See* Chemical Foundation, Inc. v. E.I. DuPont de Nemours & Co., 29 F.2d 597, 602 (D. Del. 1928), *aff'd sub nom.* Farbwerke vormals Meister Lucious & Bruning v. Chemical Foundation, Inc., 39 F.2d 366 (3d Cir. 1930), *aff'd*, 283 U.S. 152 (1931); Martinez v. Fox Valley Bus Lines, 17 F. Supp. 576 (N.D. Ill. 1936).

5. Hansberry v. Lee, 311 U.S. 32, 40 (1940); *see* Comment, *Manageability of Notice and Damage Calculation in Consumer Class Actions,* 70 MICH. L. REV. 338 (1971).

6. *See* FED. R. CIV. P. 23. Rule 23 does not require notice in actions properly brought under sections (b)(1)&(2). The notice provisions of Rule 23 were designed to comport with due process. *See* note 7 *infra* and accompanying text. *See also* Northern Natural Gas Co. v. Grounds, 292 F. Supp. 619 (D. Kan. 1968) (the essence of due process is adequate representation); Maraist and Sharp, *Federal Procedure's Troubled Marriage: Due Process and the Class Action,* 49 TEXAS L. REV. 1 (1970); Note, *Proposed Rule 23: Class Actions Reclassified,* 51 VA. L. REV. 629, 640 (1965). For a view that due process requires some type of notice in all actions see Eisen v. Carlisle & Jacquelin, 391 F.2d 555 (2d Cir. 1968), *rev'g* 41 F.R.D. 147 (S.D.N.Y. 1966), *decided,* 52 F.R.D. 253 (S.D.N.Y. 1971); *accord,* Pasquier v. Tarr, 318 F. Supp. 1350, 1353-54 (E.D. La. 1970).

7. *See* Eisen v. Carlisle & Jacquelin, 391 F.2d 555 (2d Cir. 1968); Advisory Committee's Note, *Proposed Amendments to Rules of Civil Procedure,* 39 F.R.D. 69, 106-07 (1966); Note, *The New Federal Rules of Civil Procedure,* 54 GEO. L.J. 1204, 1217 n.57 (1966).

8. FED. R. CIV. P. 23(c)(2):

> (2) In any class action maintained under subdivision (b)(3), the court shall direct to the members of the class the best notice practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort. The notice shall advise each member that (A) the court will exclude him from the class if he so requests by a specified date; (B) the judgment, whether favorable or not, will include all members who do not request exclusion; and (C) any member who does not request exclusion may, if he desires, enter an appearance through his counsel.

§ 23(c)(2), although directing the court as to how the judgment should read, does not attempt to predetermine the res judicata effect of the judgment. *See* Frankel, *Some Preliminary Notions Concerning Civil Rule 23,* 43 F.R.D. 39, 47 (1967); Kaplan, *supra* note 1, at 393; Advisory Committee's Note, *supra* note 7, at 106-07. *See also* RESTATEMENT OF JUDGMENTS § 86 Comment 1, at 116 (1942).

9. For a general discussion of these problems see Note, *Class Actions Under Federal Rule 23 (b)(3)—The Notice Requirement,* 29 MD. L. REV. 139 (1969).

notice;[10] who is to bear the cost of issuing notice;[11] and when notice should issue.[12] The *Alameda* court faced the narrow issue of when to notify potential class members of a class action of questionable merit.[13]

10. *See* Eisen v. Carlisle & Jacquelin, 391 F.2d 555 (2d Cir. 1958), *rev'g* 41 F.R.D. 147 (S.D.N.Y. 1966), *decided*, 52 F.R.D. 253 (S.D.N.Y. 1971); City of Philadelphia v. American Oil Co., 53 F.R.D. 45 (D.N.J. 1971); Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 684 (N.D. Ind. 1966); Note, *supra* note 9, at 141-50 ("individual notice to all members who can be identified through reasonable effort" is not required by due process); Comment, *Adequate Representation, Notice and the New Class Action Rule: Effectuating Remedies Provided by the Securities Laws*, 116 U. PA. L. REV. 889 (1968); Note, *Notice in Class Actions—Mullane Reconsidered*, 43 TUL. L. REV. 369, 375 (1969) (Rule 23 should be amended to delete the phrase "including individual notice to all members who can be identified through reasonable effort").

11. *See* Green v. Wolfe Corp., 406 F.2d 291, 301 n.15 (2d Cir. 1968); Dolgow v. Anderson, 43 F.R.D. 472 (E.D.N.Y. 1968), *remanded for further consideration*, 438 F.2d 825 (2d Cir.), *decided*, 53 F.R.D. 664 (E.D.N.Y. 1971) (defendant might be required to bear the cost of notice); Richland v. Cheatham, 272 F. Supp. 148 (S.D.N.Y. 1967) (initially plaintiff must shoulder the burden); School Dist. v. Harper & Row Publishers, Inc., 267 F. Supp. 1001 (E.D. Pa. 1967) (the court may have to bear the burden). *See also* Booth v. General Dynamics, 264 F. Supp. 465 (N.D. Ill. 1967) (expense involved in individual notice should not inhibit an otherwise proper class action). *But see* Buford v. American Fin. Co., 333 F. Supp. 1243, 1250 (N.D. Ga. 1971) (court knew of no authority under which it could assume cost of providing notice).

12. *See* note 13 *infra*. *See also* Frankel, *supra* note 8.

13. In attempting to deal with this problem courts have devised various approaches: 1) allow class status but postpone notice pending a preliminary hearing of the merits to determine who should bear the cost of notice, Eisen v. Carlisle & Jacquelin, 52 F.R.D. 253 (S.D.N.Y. 1971); 2) conditionally allow class status but delay notice through discovery, Herbst v. Able, 278 F. Supp. 664 (S.D.N.Y. 1967); Siegel v. Chicken Delight, Inc., 271 F. Supp. 722 (N.D. Cal. 1967); Fischer v. Kletz, 41 F.R.D. 377 (S.D.N.Y. 1966); 3) delay determination of the propriety of a class action pending a preliminary hearing to determine the possibility of plaintiff's success at trial, Dolgow v. Anderson, 43 F.R.D. 472 (E.D.N.Y. 1968), *remanded for further consideration*, 438 F.2d 825 (2d Cir.), *decided* 53 F.R.D. 664 (E.D.N.Y. 1971); *cf.* Surowitz v. Hilton Hotels Corp., 383 U.S. 363 (1966); Philadelphia Elec. Co. v. Anaconda Am. Brass Co., 43 F.R.D. 452, 458 (E.D. Pa. 1968). *But see* Miller v. Mackey Int'l, Inc., 452 F.2d 424 (5th Cir. 1971) (preliminary hearing on the merits before determining propriety of the class action held improper).

Delaying notice through discovery may limit use of the class action by placing the costly expense of discovery on the class representative. Note, *Federal Rules of Civil Procedure—Evidentiary Hearing on Merits Required in Class Action Under Rule 23(b)(3)*, 5 GA. ST. B.J. 278, 285 (1968). *See also* 40 U. COLO. L. REV. 462, 466 (1968). A preliminary hearing to determine who should bear the cost of notice has been criticized as an indirect method achieving the same result as a preliminary hearing on the merits to determine the propriety of a class action. Dolgow v. Anderson, 53 F.R.D. 664 (E.D.N.Y. 1971). The approach adopted by the court in *Alameda* seems for all practical purposes identical to the method used in *Dolgow*.

Rule 23 neither explicitly authorizes nor forbids a preliminary hearing before issuing notice,[14] and although questioned,[15] preliminary hearings have been approved by other courts and commentators.[16] There are several advantages to such an approach. If the claim is insubstantial, the action will not be pursued as a class suit, resulting in a considerable saving of time and expense since no notice is issued to the class.[17] A preliminary hearing may also be used to avoid nuisance suits[18] and to eliminate the adverse effect on the price of a corporate defendant's stock which may result from widespread notice and publicity.[19] Further, early issuance of notice may imply that a potentially unmeritorious claim is well founded and thereby produce unnecessary controversy.[20] Finally, a preliminary hearing prevents attorneys from using notice simply to solicit clients.[21]

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14. FED. R. CIV. P. 23.

15. *See* Miller v. Mackey Int'l, Inc., 452 F.2d 424 (5th Cir. 1971); City of Philadelphia v. Emhart Corp., 50 F.R.D. 832 (E.D. Pa. 1970); Berland v. Mack, 48 F.R.D. 121, 132 (S.D.N.Y. 1969) (rejected use of preliminary hearing to determine who should pay for notice); Mersay v. First Republic Corp. of America, 43 F.R.D. 465 (S.D.N.Y. 1968).

16. *See* Milberg v. Western Pac. R.R., 51 F.R.D. 280 (S.D.N.Y. 1970); Dolgow v. Anderson, 43 F.R.D. 472, 501 (E.D.N.Y. 1968), *remanded for further consideration*, 438 F.2d 825 (2d Cir.), *decided*, 53 F.R.D. 664 (E.D.N.Y. 1971); 40 U. COLO. L. REV. 462 (1968); Note, *Federal Rules of Civil Procedure—Evidentiary Hearings on Merits Required in Class Actions Under Rule 23 (b)(3)*, 5 GA. ST. B.J. 278 (1968).

17. *See* Alameda Oil Co. v. Ideal Basic Indus., Inc., 326 F. Supp. 98 (D. Colo. 1971); Dolgow v. Anderson, 43 F.R.D. 472 (E.D.N.Y. 1968), *remanded for further consideration*, 478 F.2d 825 (2d Cir.), *decided*, 53 F.R.D. 664 (E.D.N.Y. 1971); 40 U. COLO. L. REV. 462, 465 n.23 (1968).

18. *See* Dolgow v. Anderson, 43 F.R.D. 472, 488 (E.D.N.Y. 1968), *remanded for further consideration*, 438 F.2d 825 (2d Cir.), *decided*, 53 F.R.D. 664 (E.D.N.Y. 1971); 40 U. COLO. L. REV. 462 (1968).

19. Dolgow v. Anderson, 43 F.R.D. 472, 501 (E.D.N.Y. 1968), *remanded for further consideration*, 438 F.2d 825 (2d Cir.), *decided*, 53 F.R.D. 664 (E.D.N.Y. 1971). *See also* Green, *Civil Liability to Stockholders Under the Securities Act of 1933 and Remedy by Class Action*, 2 SAN DIEGO L. REV. 34, 48 (1965); Note, *Federal Rules of Civil Procedure—Evidentiary Hearings on Merits Required in Class Actions Under Rule 23 (b)(3)*, 5 GA. ST. B. J. 278 (1968); 40 U. COLO. L. REV. 462 (1968).

20. *See* Berley v. Dreyfus & Co., 43 F.R.D. 397, 399 (S.D.N.Y. 1967); 40 U. COLO. L. REV. 462, 466 n.23 (1968). *See also* Comment, *Recovery of Damages in Class Actions*, 32 U. CHI. L. REV. 768, 777 (1965).

21. *See* 40 U. COLO. L. REV. 462, 465 (1968). This may be the most substantial justification for a preliminary hearing. Other courts have expressed concern over the problem of client solicitation. *See* Eisen v. Carlisle & Jacquelin, 41 F.R.D. 147, 152 (S.D.N.Y. 1966), *rev'd*, 391 F.2d 555 (2d Cir. 1968), *decided*, 52 F.R.D. 253 (S.D.N.Y. 1971); Baim & Blank, Inc. v. Warren-Connelly Co., 19 F.R.D. 108, 111 (S.D.N.Y. 1956). For a discussion of notice and solicitation problems in class ac-

Courts rejecting use of a preliminary hearing contend that it is not authorized by Rule 23,[22] that it leads to multiple adjudication of the merits,[23] and may deprive the plaintiffs of the right to a jury trial.[24] Further, it is argued that the thrust of Rule 23(b)(3) is that notice should issue as soon as possible after the commencement of the action.[25] An additional objection to the use of a preliminary hearing is that it may permit "one-way intervention," which Rule 23 was designed to prohibit.[26] The rule was drafted to prevent class members from intervening after a final determination on the merits and benefiting from a decision in their favor, though remaining unaffected by an adverse decision.[27] The preliminary hearing, however, is not a final determination of liability. If the plaintiff is successful, notice will be sent to the class, and those who fail to opt out will be bound by the ultimate decision.[28] If the preliminary decision favors the class defendant and also results in a successful motion for summary judgment,[29] the potential

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tions generally see Note, *Federal Rules of Civil Procedure: Rule 23, The Class Action Device and Its Utilization*, 22 U. FLA. L. REV. 631, 639 (1970). *See also* Frankel, *supra* note 8, at 44-47.

22. Miller v. Mackey Int'l, Inc., 452 F.2d 424 (5th Cir. 1971); Philadelphia v. Emhart Corp., 50 F.R.D. 232, 234 (E.D. Pa. 1970). *See also* Kronenberg v. Hotel Governor Clinton, Inc., 41 F.R.D. 42, 44 (S.D.N.Y. 1966) (propriety of class action must be determined solely on the basis of the requirements enumerated in Rule 23); Advisory Committee's Note, *supra* note 7, at 104.

23. Cannon v. Texas Gulf Sulphur Co., 47 F.R.D. 60, 65, 66 (S.D.N.Y. 1969).

24. Mersay v. First Republic Corp. of America, 43 F.R.D. 465, 469 (S.D.N.Y. 1968); *accord*, Weiss v. Tenney, 47 F.R.D. 283, 294 (S.D.N.Y. 1969). A jury trial is guaranteed by the seventh amendment "in suits at common law." *See* F. JAMES, CIVIL PROCEDURE 337 (1965).

25. Fogel v. Wolfgang, 47 F.R.D. 213, 214 (S.D.N.Y. 1969); Kronenberg v. Hotel Governor Clinton, Inc., 41 F.R.D. 42 (S.D.N.Y. 1966); Frankel, *supra* note 8, at 41. *But see* Green v. Wolf, 406 F.2d 291, 301 (2d Cir. 1968) where the court held that the trial court could, if it determined individual reliance is an essential element of proof, order separate trials on that subject as well as the subject of damages. The issues of reliance or damages have not, however, been considered central to the maintenance of a class action, *see* Dolgow v. Anderson, 43 F.R.D. 472, 488 (E.D.N.Y. 1968), *remanded for further consideration*, 438 F.2d 825 (2d Cir.), *decided*, 53 F.R.D. 664 (E.D.N.Y. 1971); Mersay v. First Republic Corp. of America, 43 F.R.D. 465, 469 (S.D.N.Y. 1968). *But see*, Ernst & Ernst v. United States Dist. Ct., 439 F.2d 1288, 1293 (5th Cir. 1971).

26. Advisory Committee's Note, *supra* note 7, at 105-06.

27. *Id.*

28. FED. R. CIV. P. 23(c)(3). The judgment would, of course, be subject to collateral attack if representation was inadequate or due process was denied in any other manner. *See* Advisory Committee's Note, *supra* note 7, at 106-07.

29. *See* Dolgow v. Anderson, 53 F.R.D. 664 (E.D.N.Y. 1971).

class members will probably not be bound by the decision[30]—clearly Rule 23 would not purport to bind them since there was no notice.[31] Consequently, a corporate defendant may have to defend other suits based on the same facts, but it was partially in its interests that notice was delayed.[32] Moreover, the likelihood of other individual suits is not great, and they probably can be eliminated without great expense or inconvenience to the corporate defendant.[33]

The approach in *Alameda* appears to be a desirable method of handling the problems in a class action of questionable merit. The court, however, should have sharply delimited the issues to be covered at the hearing to avoid pre-trying the case, and also should have indicated what the class representative must show to avoid a motion to dismiss the class action, i.e., a substantial possibility of success. A strict interpretation of Rule 23 or the policy against "one-way intervention" should not be allowed to frustrate this or other innovative attempts to effectively administer the complex machinery of a class action.

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30. *See* Dolgow v. Anderson, 53 F.R.D. 664, 690 (E.D.N.Y. 1971); Note, *Federal Rules of Civil Procedure: Rule 23, The Class Action Device and Its Utilization*, 22 U. FLA. L. REV. 631, 639 (1970).

31. FED. R. CIV. P. 23(c)(2) & (3). *See* note 4 *supra* and accompanying text.

32. *See* note 18 *supra* and accompanying text.

33. *See* Note, *Class Actions Under Rule 23(b)(3)—The Notice Requirement*, 29 MD. L. REV. 139, 155-56 (1969). The claims of individual members of a 23(b)(3) class are likely to be negligible and can probably be settled out of court.

Rule 23 may permit another type of one-way intervention. In a jurisdiction which has abandoned the doctrine of mutuality of estoppel, a member of 23(b)(3) class who has opted out may still be able to take advantage of a favorable judgment in the class action while remaining unaffected by an adverse decision. Cohn, *The New Federal Rules of Civil Procedure*, 54 GEO. L.J. 1204, 1225 n.88 (1966); Note, *Proposed Rule 23, Class Action Reclassified*, 51 VA. L. REV. 629, 652-54 (1965). For a view that the policy against "one-way intervention" should give way to the policy against repetitious litigation see Homburger, *State Class Actions and the Federal Rule*, 71 COLUM. L. REV. 609 (1971). *Cf.* Comment, *The Requirement of Mutuality in Patent Cases*, 1971 WASH U.L.Q. 658.