S. HRG. 104–157

SECURITIES LITIGATION REFORM PROPOSALS
S. 240, S. 667, AND H.R. 1058

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

ON

THE IMPACT OF SHAREHOLDER LAWSUITS ON PUBLICLY-HELD COMPANIES AND TO DISCOURAGE THE FILING OF NUISANCE OR "STRIKE" SUITS BY ENTREPRENEURIAL LAWYERS CREATING A LUCRATIVE INDUSTRY FROM THE FILING OF MERITLESS LITIGATION AND THE EXTRACTION OF SETTLEMENTS

MARCH 2, 22, AND APRIL 6, 1995

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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U.S. GOVERNMENT PRINTING OFFICE

93–767 CC WASHINGTON : 1995

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-047651-8

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SECURITIES LITIGATION REFORM PROPOSALS—S. 240, S. 667, AND H.R. 1058

THURSDAY, MARCH 2, 1995

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, DC.

The Subcommittee met at 9:06 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Phil Gramm (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF SENATOR PHIL GRAMM

Senator GRAMM. The hearing will come to order.

Let me thank everybody for coming this morning. I especially want to thank people for shifting their time. We are having a Republican Conference at 10:30 a.m., which means that at that point, not only do we lose all our Republican Members, but also we lose the Chairman. So I wanted to try to start earlier this morning.

I think we're undertaking hearings on a very important activity. As all of you know, the House Republican leadership in the campaign, and the Contract With America, promised legislation in this area of securities litigation reform.

I can assure you that it will be my first priority as Chairman of this Subcommittee to report a bill from this Subcommittee, to get the bill through the Full Committee and to the floor, providing for meaningful reform of securities litigation.

We have two of our colleagues this morning that are going to testify. I know they're busy. And so, I will make more of a detailed statement later.

Out of courtesy to my colleague and dear friend, Chris Dodd, who has to go to a meeting later this morning to figure out how to defeat me in 1996——

Senator DODD. That's correct.

[Laughter.]

Senator GRAMM. Which I know is going to be difficult, will require long hours and great concentration.

Senator DODD. Long meetings. Long meetings. Maybe an all-day meeting.

[Laughter.]

Senator GRAMM. So let me call on our dear colleague and friend, Chris Dodd.

Senator DODD. I thank you, Mr. Chairman, and I suspect you'll be leaving a little later to go——

Senator GRAMM. Chris, if you can hold for just a second, our Chairman of the Full Committee has come in. He wants to say just a word.

Senator DODD. Good morning, Mr. Chairman.

OPENING COMMENTS OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Good morning, Mr. Chairman.

Before we hear from Senator Dodd, I would like to make a brief statement.

Senator DODD. That's all right.

Senator D'AMATO. I would like to commend my colleagues, Senator Dodd and Senator Domenici, for their leadership in securities litigation reform.

They make a valuable contribution to this process by presenting this Subcommittee with well-balanced legislation when working toward reform, I think Congress has a tendency to go to extremes. In this case one extreme would debilitate lawyers by cutting off their legs and arms to stop them from filing suits. This obviously goes too far.

However, there are also those who think everything is honkey dorey, that there is no need for reform. This extreme doesn't go far enough because there are faults in current litigation practices.

Senator Dodd and Senator Domenici have presented the most balanced vehicle to date, by which to start this reform process.

Again, I thank Senators Dodd and Domenici for their leadership.

Senator DODD. Thank you very much, Mr. Chairman.

Senator GRAMM. Senator Dodd.

OPENING STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Mr. Chairman, thanks very, very much. I appreciate your courtesy this morning.

I'll ask that the full text of my remarks be put in the record and I'll try to paraphrase this for you.

Pete Domenici, I think, will be here shortly.

Senator GRAMM. He has a sister who is ill, so I'm not sure exactly when he will arrive. If you could just go ahead and make your statement.

Senator DODD. I'll do that.

Senator GRAMM. When he arrives, at that point, we'll just stop and let him speak.

Senator DODD. I appreciate that and I would ask that any remarks that he may have be included in the record as well.

Mr. Chairman, over the last 18 months, the process by which private individuals brings securities lawsuits has been under the microscope, to put it mildly.

I'm very happy to say that as a result of the unprecedented and much needed scrutiny that securities litigation has received in Congress over the last several years, and academia as well, the media, and the investor and business community, the debate has shifted dramatically. We are no longer arguing about whether the current system is in need of repair. The discussion is now centered on how best to fix it.

Even those who 1 year ago steadfastly refused to admit that the system needed to be reformed, now concede that substantial

changes are needed. The flaws in the current private securities litigation system are simply too obvious to deny. The record is replete with examples of how the system is being abused and misused.

The message has finally, I think, gotten through. The fact that there is finally consensus about the need for securities litigation is enormously significant. Because this consensus now exists, I believe we will see comprehensive legislation enacted in this Congress. With this hearing, the Senate begins the process to develop the best legislative solutions for the problems that have been identified.

S. 240, the proposal that my good friend, Senator Pete Domenici, and I introduced on January 18, 1995, is a carefully crafted, balanced approach, we think, to fixing the current system. It is identical, I would add to my colleagues, to the legislation that we introduced in the 103rd Congress, although I would now point out that my colleague from New Mexico has top billing on the legislation.

But most importantly, it is a broadly bipartisan effort. Nineteen of our colleagues joined us as original cosponsors. Another 8 or 9 Senators have cosponsored the bill since we introduced it. The supporters include Senators Mikulski, Moseley-Braun, Murray, Johnston, Conrad, Pell, and Rockefeller.

We do not claim that this bill is the definitive or perfect solution, Mr. Chairman. Since we first introduced it in March 1994, numerous hearings have been held in both Houses of Congress. Many studies have been completed, including a comprehensive report by the Securities Subcommittee staff.

Every word of the legislation, I think, has received in-depth analysis. In addition, there have been a number of judicial decisions that have altered the private securities litigation landscape. The most significant of these was the U.S. Supreme Court decision last year in Central Bank of Denver versus First Interstate Bank of Denver, which eliminated private liability for those who aid and abet securities fraud.

Many constructive suggestions have been made about ways to improve the legislation. The fact that we did not incorporate any of these changes into this year's proposal should not be taken as a sign that we are unwilling to modify our bill. We simply prefer to begin this year where we left off last year, so as not to create additional controversy or confusion.

I am eager to work with my colleagues to refine and perfect the proposal as it moves through this process. My main goal is to have a bill that carefully balances rights of plaintiffs and defendants, as Senator D'Amato has said in his opening remarks.

Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely on Government action. I cannot possibly overstate, Mr. Chairman, just how critical securities lawsuits brought by private individuals are to ensuring the integrity of our capital markets. These private actions help deter wrong-doing and ensure that corporate officers, auditors, directors, lawyers, and others properly perform their jobs.

Yet, private litigation has evolved over the years mainly as a result of court decisions, rather than legislative action. Private actions under 10(b) were never expressly set out by Congress, but

have been construed and refined by courts with the tacit consent, I would point out, of Congress.

The lack of congressional involvement in shaping private litigation has created, I believe, conflicting legal standards and has provided too many opportunities for abuse of investors and companies.

First of all, securities class actions have grown vulnerable to abuses by entrepreneurial lawyers who put their own interests ahead of their clients.

Many critics charge that plaintiffs' attorneys appear to control the settlement of the case with little or no influence from either the named plaintiffs or the larger class of investors. For example, in one case, which is cited to the Subcommittee by an attorney as a showcase of how the system works, the case was settled before trial for $33 million. The attorneys asked the court for more than $20 million of that amount in fees and costs. The court awarded the plaintiffs' lawyers over $11 million and lawyers for the company, $3 million. Investors recovered only 6.5 percent of their recoverable damages.

A second area of abuse is frivolous litigation. Companies, especially in the high-tech sectors, face groundless securities litigation days or even hours after adverse earnings announcements. There are new examples almost every week. The Philips' case, which I think most of my colleagues are aware of, is a good example, where courts have echoed this concern as the Supreme Court pointed out in Blue Chips Stamps versus Major Drug Store.

Let me just quote from that opinion. It says:

> In the field of Federal securities laws governing disclosure of information, even a complaint, which by objective standards may have very little success at trial, has a settlement value to the plaintiff, out of any proportion to its prospect of success at trial, so long as he may prevent the suit from being resolved against him by dismissal or summary judgment. The very pendency of the lawsuit may frustrate or delay normal business activity of the defendant which is totally unrelated to the lawsuit.

A third area, Mr. Chairman, the current framework for assessing liability is simply, in my opinion, unfair and creates an incentive to sue those with the deepest pockets.

Unlimited liability is simply not the most effective deterrent of wrong-doing. We need to more directly police the conduct of officials like accountants and do so, I think, in a more effective manner in this legislation.

Let me just point out to you what the legislative solutions are, what the bill contains, and four major initiatives. First, it empowers investors so that they, not their attorneys, have greater control over class-action cases. Second, it gives investors better tools to recover losses and enhances existing provisions designed to deter fraud. Third, it limits opportunities for frivolous litigation. And fourth, it rationalizes the professional liability of accountants in exchange for stronger regulation in that area.

The bill addresses abuses of investors by their attorneys by ensuring that investors, not their lawyers, decide whether to bring a case, whether to settle, and how much the attorneys should receive. The bill requires courts to appoint a plaintiff steering committee or a guardian to directly control lawyers for the class.

The bill requires that notices of settlement agreements sent to investors spell out very clearly the important facts, such as how

much the investors are giving up by settling and how much their attorneys will receive in the settlement.

The bill requires that courts tie awards of attorneys' fees directly to how much is recovered by investors, rather than simply how many hours the attorneys billed or how many pages of briefs that they filed.

The bill further establishes an alternative dispute resolution procedure to make it easier to prosecute a case without the necessity of slow and expensive Federal court proceedings.

This idea, I would point out, is very similar to a provision in the products liability bill passed by the Commerce Committee last fall and, like that bill, it is intended to speed up the recovery process for plaintiffs who have strong cases.

These provisions, Mr. Chairman, should ensure that defrauded investors are not cheated a second time. It also should help victims of fraud to recover damages more quickly with less of their recovery drained off in attorneys' fees.

The bill would extend the statute of limitations, and this is the other side of the equation, Mr. Chairman. The legislation that Senator Domenici and I have introduced would extend the statute of limitations for implied actions to 5 years from the date of violation or 2 years after the violation was discovered, or should have been discovered through the exercise of reasonable diligence. Current law is 1 year and 3 years, respectively. So we're providing more opportunity for plaintiffs out there to bring their actions.

The bill also incorporates pending legislation, the Wyden-Kerry legislation, requiring auditors to report and detect fraud. A similar bill, I would point out, passed in past Congresses has been supported by the SEC and the accounting profession.

The bill requires that in order to bring a securities case as a class action, the plaintiffs in whose name the case is brought must have held either 1 percent of the securities which are the subject of litigation or $10,000 worth of securities.

We believe that this should help stop the problem pointed out by several courts in which "professional plaintiffs" who own small amounts of stock in many companies try to bring class-action lawsuits whenever one of their investments goes down.

The bill clarifies how an attorney should plead a securities fraud claim. Plaintiffs' lawyers should have no trouble, we believe, meeting these standards, even if they have legitimate cases and have looked at the facts.

These and other reforms, we believe, should end the race to the courthouse by attorneys eager to file a case without investigating the facts or finding a real client. Certain professionals, particularly accountants, are frequently named, Mr. Chairman, in securities suits simply because they have a deep pocket. That's the only reason.

Under the current system of joint and several liability, their liability exposure is frequently totally out of proportion to their degree of fault. I believe that this is not fair and will have the effect of discouraging them from providing auditing services to many companies, especially the new start-up companies and high-technology companies.

This legislation establishes a liability system for less culpable defendants that is linked to a degree of fault. At the same time, Mr. Chairman—I want to emphasize this—the bill establishes a self-disciplinary organization for accountants under the direct supervision of the SEC. This entity would be very much like the self-regulatory organizations such as the New York Stock Exchange or the National Association of Securities Dealers.

The net effect should be more direct and a rational way of dealing with the bad apples in the accounting profession without punishing the entire profession.

There is tremendous support, I believe, Mr. Chairman for this legislation within Congress and from a large variety of private organizations, and I certainly look forward to working with my colleagues on this Committee to enact comprehensive, bipartisan reform as soon as possible.

I thank you for listening and I notice that my colleague from New Mexico has arrived.

Good morning, Peter.

Senator GRAMM. Senator Domenici.

OPENING STATEMENT OF SENATOR PETE V. DOMENICI

Senator DOMENICI. Thank you, Mr. Chairman.

I have a prepared statement I would ask you to put in the record, please.

Senator GRAMM. It will be put in the record.

Senator DOMENICI. Mr. Chairman, and Members of the Committee, Senator Dodd has done a marvelous job explaining this legislation. So, I'm going to be very brief.

But I do want to suggest that I feel very optimistic about the chance for reform. Last year and the year before and the year before that, as I tried to get reform in this area of law in the United States, I didn't see a chance because there were major differences of philosophy between the two bodies and the opportunity to get something done was very limited.

I think we have a rare opportunity, Mr. Chairman, to pass some legislation that will return some fairness to litigation that surrounds securities class-action lawsuits.

I think we must make it very clear that we're just talking about the class-action lawsuits that are the creature of the courts implied private rights of action, that have permitted plaintiffs in securities cases to pool their action in an effort to seek recovery from a myriad of defendants.

It is clear from studies done by academics and the hearing record of this Subcommittee and what you find out there in the field that this area of class-action securities cases cries out for reform.

I'm amazed from time to time how the jury system of the United States has been turned on its head by the legal profession. The threat of a jury trial has been effectively used by some plaintiffs' lawyers to force innocent defendants to settle.

We have testimony from one of the biggest plaintiffs' law firms in this field that they did not try a lawsuit in this field in 3 years. They file class-action securities cases on average 1 every 4 days and, obviously, under the duress and expense of discovery and put-

ting the stock company in jeopardy and the media, these lawyers extract settlements from the companies regardless of culpability.

The system isn't serving defrauded investors very well either.

It ends up that the plaintiffs don't get compensated very much. They receive very, very little. It ranges from something like 6–11 percent of their losses. In many cases, they don't even get that much.

Essentially what we have is lawyers acting more like entrepreneurs rather than fiduciaries engaging in entrepreneurial litigation. The plaintiff's lawyer is the entrepreneur. He's the businessman seeking to profit in this area.

This legislation will go a long way to better align the interests of the lawyer with his client. It will put some commonsense in various areas that cry out for reform.

I'm hopeful you won't delay action on this bill because I think the House is ready to move, and this might be the first in a series of many kinds of litigation where we attempt to restore some sense of fairness in the litigation system and in the role of a jury. Innocent defendants should have enough confidence in the jury system to be willing to defend their case in court every now and then so that a jury will set the standards of conduct from which everyone else will be judged.

I doubt our Founding Fathers intended jury trials to be used to threaten parties into settling frivolous cases based on complex laws like our securities laws. But that permeates the plaintiffs' bar, and especially in these kinds of cases.

Thank you very much.

Senator GRAMM. Thank you, Senator Domenici.

Let me call up our panel. Both our Members are under a time constraint, one for personal reasons and one for business reasons.

Does anybody have a question they want to ask either of them? If not, let me——

Senator BOXER. I don't have a question. I just wanted to call both of your attention to the Bond Buyer today—is it today? No, it is February 24, 1995: "House Panel's Bill Could Prohibit Class Action Suits in the Muni Market." And given the Orange County problem, I just want to make sure you look at this, if you would, and let me know what your reaction is.

Senator DODD. Thank you.

Senator BOXER. Thanks.

Senator GRAMM. And thank you.

If our panel would come on up. While they're coming up, I would like to complete our opening statements. Let me begin and I'll be brief.

First of all, we are going to move legislation out of this Subcommittee, through the Full Committee. I believe that we are going to enact this year in the Senate and the House, work through conference, and make securities litigation reform the law of the land.

As Chairman of the Subcommittee, I want to work with everybody who has an interest in this area. And I can assure any group that is willing to work with us to try to produce legislation that can be productive in dealing with very real problems that we're willing to work with you.

Now, obviously, there are some people who are going to oppose action. We, to the extent possible, will still try to accept their input. But the bottom line is, my number-one priority is, to move in this area because I think it's important.

I don't think anybody anywhere is proposing limiting the ability of people to seek justice through the courts. I see no evidence whatsoever of any movement in that direction.

I do believe, however, that there's a very real concern here that current practices are limiting the ability of the financial markets to work because companies are making decisions based on potential litigation costs instead of decisions that are driven by the marketplace to create jobs, growth, and opportunity for our people.

I think it is clear that many companies now fear sharing information. One of the primary functions of the marketplace is being harmed, the dissemination of information on which investment decisions can be made, investment decisions that affect growth and job creation, that affect the value of pension funds.

This whole system is being affected by the fact that people can go into the courthouse knowing that one of two things will happen. One, they are going to get a lot of money or; two, they are going to walk away with nothing. And generally, because of that, the decision is rarely ever made or resolved in the courthouse. There is very little potential under the current system that they are going to be losers.

I think it is important that we look at every idea that is before us. Certainly, in trying to put together a markup document, I am going to look at Senator Domenici and Senator Dodd's bill. But we're going to look at a broad range of other ideas.

We have before us today a panel of people who are experts, both through the practice of business, their practical experience here, and people who have served in high positions in the Government. What we want to do today is to give them an opportunity to make their case. I would like to ask everybody to try to limit their opening statement to about 5 minutes so that we can have some time to ask questions before our conference.

Later this month we will have another hearing where opponents of the bill will have an opportunity to make their case. We want to be sure that we hear from everybody before we act.

Let me now turn to the Chairman of the Full Committee, my colleague, Senator D'Amato, for his opening statement.

OPENING STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Thank you very much, Mr. Chairman.

Securities litigation reform is one of the most important issues facing the Committee this year.

The American people are sick and tired of a legal system that costs too much, takes too long, and too often does not provide justice to those who are injured by the wrongdoers. They want the Congress to curb abuses, particularly those abuses that clog our courts with frivolous lawsuits. However, it is vital that we not destroy the incentives for bringing meritorious suits.

Over the past two Congresses, this Subcommittee has held hearings on abuse in security class actions. There is broad agreement

on the need for reform. Shareholders' groups, corporate America, the SEC, and many lawyers want to curb these abusive practices.

Lawyers who bring meritorious suits do not benefit when strike-suit artists wreak havoc on the Nation's boardrooms and courthouses.

Our economy does not benefit when the threat of litigation deters capital formation.

So again, I wish to commend my colleagues, Senators Domenici and Dodd, for introducing the Private Securities Litigation Reform Act of 1995. Senators Domenici and Dodd have long been at the forefront of the efforts to reform securities litigation, and I support many of the proposals in their bill. We need to get professional plaintiffs out of the picture by banning the absurd practices of referral fees to brokers and bonus payments to named plaintiffs.

As Senator Dodd mentioned in his statement, it is very important that we adopt procedures to give shareholders a greater say in the litigation of class actions and certainly in their settlement. We also need enhanced disclosure of settlement terms to injured investors.

I'm particularly troubled by the imposition of joint and several liability in securities cases. The threat of such liability often forces innocent, so-called deep-pockets defendants to settle frivolous suits.

The Domenici-Dodd bill would address this problem by requiring defendants to pay only that share of the damage which they cause. I believe that this approach is intrinsically fair, particularly as it relates to class-action suits.

While I strongly favor securities litigation reform, I will not support reform that is excessive. Congress must not get so carried away that we remove all incentives for filing class-action litigation. We cannot let reform cut off responsible litigation aimed at protecting the stockholders.

I look forward to working closely with my colleagues on legislation that strikes the right balance. We must curb frivolous class actions, but not leave victims of securities frauds without the proper remedies.

Thank you, Mr. Chairman.

Senator GRAMM. Senator Boxer.

OPENING STATEMENT OF SENATOR BARBARA BOXER

Senator BOXER. Thank you very much, Mr. Chairman.

I want to associate myself with the tenor of the remarks of Chairman D'Amato. I think what we're looking for here is a balance: to eliminate frivolous suits, but not destroy the ability of investors to get the protection they so deserve.

I want to make a point that if the original language that was in the Contract With America had passed and made law, it would have made it very difficult for the people of Orange County to pursue their claims.

We're not doing this in a vacuum. There are real people out there who will suffer real consequences.

So when we do, quote, unquote, reform, let's not throw everything out that is necessary.

The U.S. capital markets are the strongest and the safest in the world. It is no accident. U.S. markets are a model for the world be-

cause of strong and dedicated SEC enforcement of Federal securities laws and because of Federal laws that grant private investors the right to sue for fraud.

The importance to our capital markets of private remedies against securities fraud cannot be underestimated. Let me quote Chairman Arthur Levitt, and I think it's very important what he has stated:

> Besides serving as the primary vehicle for compensating defrauded investors, private actions also provide a necessary supplement to the Commission's own enforcement activities by serving to deter securities law violations.
>
> Private actions are crucial to the integrity of our disclosure system because they provide a direct incentive for issuers and other market participants to meet their obligations under the securities laws.

Secretary Levitt has said, private actions are crucial to the integrity of our disclosure system.

It certainly doesn't mean that the law is perfect. I absolutely abhor frivolous lawsuits. I know because I represent Silicon Valley. There are too many of those. We have to stop those.

But, I also know and am very familiar with a suit by San Jose, where the city had a similar situation to Orange County. If the "Contract" reforms had been in effect when San Jose experienced enormous losses, the city would not have been able to recover. There would be no action for those people.

So I'm with the Chairman D'Amato. Let us fix what is broken and let us not destroy what is not broken.

Mr. Chairman, I look forward to working with you on this.

Senator GRAMM. Thank you. Your statement will be put in the record.

Senator Faircloth.

OPENING STATEMENT OF SENATOR LAUCH FAIRCLOTH

Senator FAIRCLOTH. Thank you, Mr. Chairman.

Senator GRAMM. Why don't you pull up that mike?

Senator FAIRCLOTH. And thank you for chairing this Subcommittee, it's your first meeting, I think.

I am very interesting in the securities litigation reform. I was a cosponsor of the bill with Senator Dodd and Senator Domenici last year, and I was the original cosponsor of the S. 240 in this Congress.

I simply want to repeat what we've already heard here, that nothing we're doing here will hurt the right of legitimate investors to go after fraud, or protect their interests, or abuses in the security laws. But what we're doing here should be the beginning of going after frivolous lawsuits in all areas of business. It is not only in the securities. We're talking about the securities industry today. But frivolous lawsuits have become an absolute major cost of trying to do business. Regardless of what you're doing, somebody's always out there to sue you.

What this effort's going to do is put an end to professional plaintiffs and the cottage industry of lawyers that has built up that do nothing else but sue people. They don't ever want to go to court. They aren't even prepared to go to court. But it costs so much to hire lawyers, until they always settle and take the money and go home.

The money that companies are spending on reckless lawsuits and fighting lawsuits and preparing the defense against them is cutting the productivity of the country. And this is no small matter. The money could be used for research, development, expansion, and the creation of jobs.

I looked at Mr. Lackritz's testimony and he's going to point out that there was $28 billion in pending class-action lawsuits at the end of 1993.

As I say, this should be the beginning, just the very beginning of a lot of legislation to eliminate frivolous, unnecessary, and dishonest lawsuits.

The House of Representatives will act on this legislation next week. I would urge this Committee to act in the very near future.

Thank you, Mr. Chairman.

Senator GRAMM. Thank you. Under the old system, we generally started on the left. But under the new system, we're going to start on the right.

[Laughter.]

So, Mr. Lackritz, you're going to be first. I would like to ask the witnesses to introduce themselves and, in addition to representing themselves, tell us who they represent. If you could try to keep your statement to around 5 minutes, we'll have time to go through at least one round of questioning.

I want to thank each and everyone of you for coming. We seek your input. This is an area where we know action is needed. We're trying to come up with the right action to deal with the problem we face.

OPENING STATEMENT OF MARC E. LACKRITZ
PRESIDENT, SECURITIES INDUSTRY ASSOCIATION
WASHINGTON, DC

Mr. LACKRITZ. Thank you, Mr. Chairman. I would ask that my full statement be made a part of the record, please.

Senator GRAMM. It will be.

Mr. LACKRITZ. Mr. Chairman, Members of the Subcommittee, my name is Marc Lackritz. I'm the President of the Securities Industry Association, and it's a privilege and pleasure for me to be here today to testify about necessary reforms of the private liability system under the securities laws.

The SIA is firmly committed to effective enforcement of the Federal securities laws, both by the Securities and Exchange Commission and through private securities litigation. If any investors are defrauded or misled, they should be fully and quickly compensated, both to preserve confidence and to deter fraud.

Today, however, private securities litigation lends itself too easily to abuse. A small group of entrepreneurial lawyers have created a lucrative industry out of the filing of meritless claims and the extraction of settlements. Litigation of this sort serves solely to enrich counsel, not to redress investor injury. Not surprisingly, the coterie of plaintiffs' trial lawyers who enjoy the rewards of this abusive process insist that the system is functioning just as it should. But the facts belie this self-serving assertion.

In the 4 years from 1990 to 1993, roughly the same number of securities law class actions were filed as during the previous 10

years. One scholar has calculated that the aggregate damages sought in the 723 securities law class actions pending at the end of 1993 was $28.9 billion. During the same period, the total number of civil cases brought under the securities laws substantially declined. Class actions are clearly mushrooming, while actual instances of securities fraud are not.

Between 1985 and 1994, approximately 650 Rule 10(b)(5) lawsuits alleging fraud-on-the-market were settled, and 185 such lawsuits were dismissed. The trendline is startling. In 1985, approximately 25 such suits were settled. In 1994, the figure was over 100. The fraud-on-the-market theory affords the best vehicle for alleging the sort of astronomical damages most likely to coerce a settlement.

These suits reflect precious little in the way of investor recovery and much in terms of a wealth transfer—in the capital base of corporations and into the coffers of lawyers and law firms. The Senate Banking Committee has already received testimony that plaintiffs receive only an average of 14 cents for every dollar of damages. By contrast, their attorneys take away 39 percent of the settlement. In 1 year alone, Mr. Chairman, the lawyers who specialize in bringing this litigation are reported to have repeated over $250 million.

The impact of abusive securities litigation is felt disproportionately by emerging technology and other entrepreneurial companies—exactly the firms on which our economy is most dependent for creating jobs and maintaining our competitive position in the world economy. According to National Economic Research Associates, almost one-third of the settlements in securities fraud litigation involve high-tech companies. A survey by the National Venture Capital Association found that 62 percent of survey respondents that went public in 1986 had been sued by 1993.

In short, meritless securities law class actions have skyrocketed. The need to defend unfounded litigation imposes a litigation tax on capital formation that must ultimately be paid by the investing public. This tax weakens the U.S. economy by transferring capital from creating new products, expanding plants, or hiring more workers, into the pockets of a small group of trial lawyers.

Other consequences of the litigation tax are less obvious. The securities industry fees and charges must increase to cover litigation expenses. The cost of capital rises, reducing its supply, especially for small and start-up entities and other businesses that expose their professional advisors to a disproportionate risk of litigation.

Increasingly, securities market participants look for opportunities to conduct their activities offshore and out of the reach of U.S. trial lawyers.

The real question is not whether a problem exists, but how to solve it.

In our view, the civil litigation system should discourage, not encourage, the filing of nuisance or strike suits. When meritless cases do make it into court, the system should afford defendants the opportunity to bring them to a quick end.

Finally, in cases that have merit, liability should be imposed only on those who intentionally violated the law. In order to address these issues and restore balance and fairness to the litigation process, reform legislation should accomplish six goals.

First, to refocus securities class actions on investor protection instead of lawyer enrichment.

Second, curb "lottery ticket" litigation by requiring the loser or the losing party's attorneys to pay the prevailing party's attorneys' fees. Another step which deserves consideration is limiting the availability of the fraud-on-the-market theory.

Third, impose liability on real wrong-doers, not deep-pocketed innocent bystanders, first, by clarifying indemnification agreements, and on the other hand, the reinstatement of aiding and abetting liability is unnecessary, Mr. Chairman, and would be counterproductive in this environment.

Fourth, protect and promote the dissemination of forward-looking information by providing a meaningful statutory safe harbor for all persons.

Fifth, discourage meritless lawsuits from being filed and require those which are brought to be filed promptly and resolved without needless litigation costs.

The Supreme Court's ruling in the Lampf case that implied Rule 10(b)(5) claims must be brought within the same limitations period which Congress specified for the expressed cause of actions strikes the right balance and should not be disturbed.

Finally, reforms should apply equally to all of the Federal securities laws in order that the plantiffs' bar will not simply shift its energy to other provisions as the standards for Rule 10(b)(5) recovery become more balanced.

Mr. Chairman, the SIA appreciates the Subcommittee's attention to the important problem of abusive securities litigation and I would be pleased to respond to any questions that Members of the Subcommittee have.

Thank you.

Senator GRAMM. Carter.

OPENING STATEMENT OF J. CARTER BEESE, JR.
CHAIRMAN
CAPITAL MARKETS REGULATORY REFORM PROJECT
CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES
WASHINGTON, DC

Mr. BEESE. Mr. Chairman, Members of the Committee. I am delighted to have the opportunity to appear before the Subcommittee on Securities once again. This is my first appearance since leaving the Securities and Exchange Commission in November. This is also my first appearance testifying as Chairman of the recently formed Capital Markets Regulatory Reform Project sponsored by the Center for Strategic and International Studies.

Mr. Chairman, from my vantage point at the SEC, I became concerned that the costs of regulation and litigation were placing an unnecessary drag on the competitiveness of U.S. companies and our capital markets.

For this reason, in addition to returning to the investment bank of Alex. Brown and Sons, I also became a Senior Adviser at CSIS and agreed to chair the Capital Markets Project.

Finding the optimum regulatory cost of capital is a delicate balance. Investors rightfully demand certain basic protections before they commit their savings to a particular market. Lacking a regu-

latory and legal structure that promotes liquidity, transparency, honesty, and efficiency, most investors will select one of the myriad other choices at their disposal. By the same token, a market that tends toward regulatory or legal overreach will dissuade issuers by needlessly increasing the cost of capital in that market. We must strike the proper balance between the needs of the investor and the needs of the issuer.

Mr. Chairman, there are few issues that are as important to the capital formation process in the United States as reforming the securities litigation system, and once again making America safe for capitalism.

Senator Boxer, I associate myself with your remarks and as a former member of the Securities and Exchange Commission, let me make clear that strict enforcement of Federal securities laws, by the SEC, and, where appropriate, by private parties, is crucial to maintaining the fairness and integrity of our capital markets.

Providing investors with the means to recover losses when they are defrauded is an important element in maintaining investor confidence and deterring fraudulent conduct.

But, by the same token, we must recognize that litigation by its very nature imposes certain costs. Those costs are borne not only by the participants in the litigation, but by the shareholders of the defendant, and ultimately, the public at large. If not controlled, these costs can result in a substantial litigation tax that raises the costs of capital, chills desirable behavior, and impairs productivity and competitiveness.

Unfortunately, the current private securities litigation system is severely out of balance. In our view, it fails to achieve its fundamental purpose of compensating investors and deterring misconduct. In addition, it imposes enormous costs on market participants and on society.

This imbalance is not surprising in view of the economic incentives that drive litigant behavior under the current system. Plaintiffs and their lawyers have a powerful incentive to initiate securities fraud class-action suits. The potential rewards are enormous and there is little downside risk. By the same token, because the downside risks are so large for defendants, they're encouraged to settle cases rather than litigate them, even when they believe the case to be frivolous.

Therefore, we support prompt enactment of specific reforms that appropriately address the counterproductive incentives that drive litigation under the current system. As a general matter, we support measures that eliminate the most egregious abuses of the class-action process, modified fee-shifting, and the imposition of greater sanctions on parties who initiate frivolous lawsuits, and the allocation of liability among defendants on a proportional basis in certain cases.

These reforms are discussed in greater detail in our prepared statement and I ask that it be made part of the record.

Senator GRAMM. It will be.

Mr. BEESE. Thank you. There are also other remedies that would address the abuses of the current litigation system, but we believe that reform should be as simple and straightforward as possible.

We would encourage the Subcommittee to address the securities litigation problem by simply changing the incentive structure that drives this process. A system with balanced incentives will allow the market place to separate the serious from the frivolous.

The bottom line, Mr. Chairman, is that the current system is broken. The relevant question for regulatory and congressional policymakers is best how to fix it. And while reasonable minds may disagree about specific solutions, we believe the reforms that we have outlined in our full testimony constitute an appropriately measured response and merit support.

By helping to separate the wheat from the chaff—that is, meritorious claims from the meritless—meaningful securities litigation reform will reduce systemic costs, encourage more meaningful disclosure by companies, and enhance the prospects that investors who are actually the victims of fraud will be compensated for their losses.

Thank you, Mr. Chairman, and I would be happy to answer any questions.

Senator GRAMM. Thank you.

Ms. Minow.

OPENING STATEMENT OF NELL MINOW
LENS, INCORPORATED, WASHINGTON, DC

Ms. MINOW. Thank you very much, Mr. Chairman. And thank you to all of the Members of the Committee for your work in this area and for inviting my participation.

I am a principal of LENS, Incorporated, an investment firm, and I've been working for the last 8 years with large institutional shareholders on a wide variety of corporate governance issues. So I am here on behalf of the consumers, essentially, of shareholder litigation, whether they want to be or not.

I'm a lawyer myself, although I often say that I've achieved my ultimate ambition and have now become a client. So I can speak from the perspective of an unwilling client of some of these cases.

In one, for example, a judge, reluctantly approving a settlement, announced that the claims made by the plaintiff were of heliumweight.

In another, in January 1995, the U.S. District Court for the Southern District of New York issued a decision dismissing a group of shareholder class actions against the Philip Morris Company.

What was the dreadful activity undertaken by Philip Morris?

They had announced, very responsibly, that they were going to be reducing the price of Marlboro cigarette packages by 40 cents in order to be competitive and that they wanted the investment community to understand that this could reduce its operating earnings by as much as 40 percent.

The first class action was filed 5 hours later. Within 24 hours, 9 were filed. Two of the complaints that were filed referred to Philip Morris as a toy company. The reason for this was that, in the race to the courthouse, the lawyers had neglected to change all of the terminology from the previous complaints, which apparently was against a toy company.

In another case, the judge said that the law firms involved had over billed by 80 percent. Exaggeration, rather than restraint, has

been the watchword of the plaintiff counsel's entire exercise. Even a Michelangelo should not charge Sistine Chapel rates for painting a farmer's barn. That is what we as investors are paying for. We are paying Michelangelo rates for painting the farmer's barn that doesn't need to be painted.

The theory of these lawyers is, if it moves, sue it. If it moves up, sue it. If it moves down, sue it. And if it doesn't move, you might as well sue that, too, because you might get some fees out of it.

These lawyers exploit the problems of collective choice, and the problem is that it's not economic for the corporation, for the insurers, or for the other shareholders, the people I work with, to stop them.

This is most appalling in the context of forward-looking information, and I particularly appreciate the efforts of the Senate and of the SEC in this area.

What we as investors want is more information in the markets. As Senator Boxer knows, many of her constituents have finally decided that the only thing they can do is simply not say anything. And that is the last thing in the world that the capital markets need.

I want to emphasize that the current efforts to protect and to provide some kind of a safe harbor for forward-looking information, which everybody knows is speculative by definition, in no way impinges on any liability for fraud. There's no reduction of liability there and, therefore, I think it's a very, very important change.

The current rules and procedures for securities class actions and derivative actions were designed to overcome the problem of collective choice. Of course, no one shareholder can justify the time and expense necessary to bring a lawsuit for only a pro-rata share of the rewards.

But the system fails to take into account the unusual make-up of the class of potential securities plaintiffs. The shareholder community is too diffuse, too diverse, and subject to change too frequently to be addressed meaningfully as a group, and that's why they've been so easily exploited.

More important, the disincentives for participation are strong. Do you see the trustees of the IBM Corporation's pension fund joining as plaintiffs in a shareholder against the management of General Motors? I don't think so. And therefore, it leaves room for these people with two or three shares, as in one case where the holder of 15 shares got a $35,000 settlement, the lawyers got $2 million, and the rest of the shareholders got nothing.

I very much support, in addition to the protection for forward-looking statements, the requirement that plaintiffs should bear the burden of proving that the defendant had actual knowledge that the statement was false or that a relevant statement was omitted. And I especially endorse all of the efforts to bring other shareholders into the determination of the appropriateness of a lawsuit or the appropriateness of a settlement.

But just as we have to address the problem of too many bad suits, we do need to address the problem of too few good ones. We need to encourage large shareholders to take on the task and the commercial risk of filing suit in cases where there has been fraud

and we may need, therefore, to compensate them for the time and the resources that they expend.

I am very much in favor of this effort and I think it's important to point out that just because some corporate executives do commit fraud does not mean that we should create a whole industry that exploits the shareholders even more.

Thank you very much. I'm delighted to answer questions.

Senator GRAMM. Thank you.

Mr. Morgan.

OPENING STATEMENT OF JAMES F. MORGAN
GENERAL PARTNER, MORGAN, HOLLAND VENTURES CORP.
PRESIDENT-ELECT
NATIONAL VENTURE CAPITAL ASSOCIATION, BOSTON, MA

Mr. MORGAN. Thank you, Senator.

I'm James Morgan. I'm President-elect of the National Venture Capital Association and I'm the Founder and Chairman of Morgan, Holland Ventures, based in Boston. I've been a venture capitalist for about 28 years.

The National Venture Capital Association is an association of 200 professional venture capital firms. Professional venture capital firms have over $35 billion invested principally in small and emerging companies across the United States. And as many of you have seen in the economic data we've provided, it's these very firms that have been the economic engine that have been driving employment, the tax base, development of technology, and the development of exports in the economy of our country as the larger firms have been downsizing.

In addition, the American Entrepreneurs for Economic Growth, which is an associated organization of the National Venture Capital Association, represent 8,000 CEO's, again, principally CEO's from emerging growth companies, the very companies that this country needs.

Mr. Chairman, you have my prepared statement. I will not read the entire statement. With your permission, I'll just excerpt some highlights of it. But I would like the entire statement placed in your record.

Senator GRAMM. Let me say that all the formal statements will be made a part of the record.

Mr. MORGAN. Thank you, sir.

I would like to comment that there's been a major change since the initial securities laws were passed and since a lot of the litigation that has implemented those securities laws have been handed down. This major change, of course, is the sea change in this country, from major corporations to growth companies, and the rapidity of change in the marketplace. With product life cycles, international competitiveness, there's a gigantic acceleration of change taking place.

It's against this rate of change that the plaintiffs' attorneys are holding company management, trying to hold company management accountable for having a crystal ball. And in a time of accelerating change, it's virtually impossible to predict the future.

I think that you would agree that predicting the future is difficult under any circumstances.

The second point from my testimony that I would like to emphasize and underline is the virtual impossibility that our companies, the small companies have of adequately defending themselves.

The American way is to defend your rights in the courtroom, defend your honor. It's simply not possible for a company that has five, six, seven, eight key executives, all of whom would be involved in a lawsuit, a company that might be growing at 20, 30, 50, 100 percent a year, finding new markets, coping with competition, that company simply can't take the time for the depositions, for the full prosecution of a case.

You have heard occasional stories about companies that have paid that price. The cases drag on and on and on. Very often, the outcomes are not acceptable and meanwhile, the business has been hurt terribly badly.

There's an example provided by a member of the National Venture Capital Association to the Securities and Exchange Commission hearings on this subject in San Francisco a few weeks ago. And it's a venture capitalist, a leading venture capitalist from San Francisco, John Dorr, who described the outcome of three pieces of litigation that he was personally involved with. They were all settled. The names of the companies are names probably well known to you—Compaq, who is a constituent of the Chairman of this Subcommittee, Sun Micro Systems and Semantech, three marvelous companies.

These three companies were sued. They all settled. The payments to settle these cases aggregated $66 million. That doesn't count the legal cost to defend the cases, again, more than $12 million, and the time of the management is estimated to be 20 person-years. The total over 10 years? $120 million for three wonderful companies just to get out of the courtroom and get on with their very rapidly growing businesses. And what's been realized by the shareholders? Pennies on the dollar, virtually nothing.

I would like to comment, Mr. Chairman, and the witnesses that follow me will dramatize this even more personally, that $120 million buys a lot of engineers. It buys a lot of new products and a lot of new jobs and a lot of new exports.

What is the lawyer's role in all of this?

And Mr. D'Amato, my father was a lawyer and I appreciate, we don't want to tear arms and legs off lawyers. In fact, my father was very proud that although he was an orphan in New York City, he became a lawyer by going to night high school and night law school. He passed the bar when many members of the graduating class from Harvard did not.

But he impressed on me that lawyers have a serious responsibility to serve the society that holds them in professional esteem. And he spoke with disdain about ambulance-chasing lawyers.

I think we have now not ambulance-chasing lawyers chasing accidents, but we have lawyers causing accidents. That's a system that feeds upon itself. These are not law firms. These are entrepreneurial businesses that several people have mentioned.

I would like to mention one other thing as my time draws to a close here, and that is the harmful effect of these lawsuits on the work force in these companies.

The Congress over the last 2 years is aware of the pervasiveness of stock options and employee ownership in the growth companies that we back. And many companies, particularly in Silicon Valley, virtually 100 percent of the companies' employees own stock in the company. These are the people who are taking the risks, with their jobs, with their time, and these are the people that are hurt by these lawsuits because they get very, very modest settlements and yet, the very companies that they work for and which provide them with employment are jeopardized by the amount of capital that is being drained by these lawsuits.

I thank you, Mr. Chairman, for holding these hearings. The National Venture Capital Association stands ready to support you in any way that we can as these hearings proceed.

Senator GRAMM. Thank you, Mr. Morgan.

Mr. Murphy.

OPENING STATEMENT OF CHRISTOPHER J. MURPHY, III CEO, 1ST SOURCE CORPORATION, SOUTH BEND, IN CHAIRMAN, ASSOCIATION OF PUBLICLY TRADED COMPANIES WASHINGTON, DC

Mr. MURPHY. Thank you, Chairman Gramm, Chairman D'Amato. I appreciate the opportunity to testify today.

I'm President and CEO of 1st Source Corporation, a bank-holding company, a publicly-held bank-holding company headquartered in Indiana. I represent the Association of Publicly Traded Companies, which has over 500 active members that are a cross-section of America's public companies, from large to small, from biotechnology and communications to greeting cards and financial services, and oil and gas to restaurants.

Our primary goals are maintaining access to fair and efficient capital markets for our companies and assuring fair treatment of our shareholders and promoting investor confidence and appropriate dialog between the owners, shareholders, and management.

Accordingly, we thank you, Mr. Chairman, for addressing the issue of securities reform early in this legislative session.

Securities fraud class-action suits have become a deadly virus, sapping the strength of many new and growing companies, diverting the attention of managers, and reallocating dollars from productive activities to legal defense.

Rather than protect investors, many of these cases hurt the very investors they are supposed to be helping. Many cases are nothing more than a fabricated action designed to transfer wealth from investors to plaintiffs' lawyers.

The economics of the class-action business have turned legal representation into an entrepreneurial business.

We welcome your review of this very important area. For many of our small- to mid-sized companies, one of the most critical concerns is the high risk that stock price fluctuations alone will make them targets of securities fraud strike suits.

It is important to note that anything less than the prompt identification and dismissal of frivolous cases will not alleviate the burden of such cases for smaller companies.

The mere filing of a case, which costs virtually nothing for the plaintiff, against a small or fast-growing company brings significant cost and potentially irreparable harm.

Today, the cost of time, reputation and money and the risk of loss at the trial level, even with the full confidence of eventual success on appeal, is so high to the defending company, that most of these cases are settled with no adjudication of the merits, with little compensation to the supposed aggrieved party, as you have heard estimates range from 4 cents to 14 cents on the dollar, and big fees to the plaintiffs' lawyers. I've heard averages of $2 million or more, and up to 39 to 40 percent of the award.

The opportunity to prove a company innocent at trial, or even to obtain summary judgment after extensive discovery is now largely theoretical.

A meaningful defense of a securities fraud suit, even after achieving the reform that we all seek, may still require companies to win two motions to dismiss, the second on amended complaint, and one appeal. Even this will still be expensive.

The abuse and cost of securities laws is well documented in the record. I would like to add a new one.

One of our members, a fast-growing company, the type any of us would like to have in our market areas, which is growing and employing people, in this case, the company decided to stand on principle when it was sued—and defend it's reputation.

Instead of settling, as is done in 92 percent of the cases, the company fought the suit. And it won at every level of the judicial process, but at great expense. The company was sued when its stock price dropped because the company's distribution system was unable to handle the demand for its product. They were a victim of their own success.

Natural problems. They were eventually able to solve them, but an overheated stock market reacted negatively and the company got sued as the stock went down.

Its market capitalization at the time was $16 million. When it was sued, it won a motion to dismiss the case. Then it won a second motion to dismiss an amended complaint. And then it won an appeal of the dismissal. I applaud that. We would all applaud that.

Were they successful? Yes, but it cost $850,000 in legal fees alone and distracted management for over a year. They ended up having to fight rumors of the company's demise. They had a qualified statement. It diverted 80 percent of their R&D budget in that year.

How can we expect companies to be competitive in America or across the world? How do we expect to spawn and encourage new companies and how do we expect investors to share in the success if we allow a system to stay in place which diverts resources and productive activity to legal maneuvering only because the stock price dropped?

In another case familiar to us, a company in the computer business announced that its quarterly earnings were going to be below its projections because several huge orders were not booked before the end of the quarter. The stock price dropped 30 percent.

Five class-action suits were filed immediately. Damages claimed were $300 million. The company had allegedly defrauded the market by saying such innocuous things as: We have confidence in the

future despite disappointing results. We expect continued improvement in the results of our company through next year.

A $300 million claim?

The prospects of a loss at a jury level, even though they would win eventually, just a 10-percent prospect, $30 million in present value, caused them to take the prudent way out, to settle.

What happened? The shareholders got less than 2 cents on the dollar and what did the plaintiff's lawyers get? $4 million. And the company's own defense lawyers got another million.

No matter how much the company might have wanted to fight the case, a $300 million claim was more than it could or should risk. They followed the prudent rule.

So who loses here? The company, surely. And the investor. The investor truly loses.

Who wins? The lawyer. Certainly the plaintiffs' lawyers and in some cases, the defendants' lawyers.

In our opinion, the group that gets the most shabby treatment here are the investors, the real investors, those who put up their money for the long-term, who are backing innovation and growth, those who understand that there are short-term risks and they're willing to wait patiently for the long-term benefit.

Our present system encourages wealth transfer from the patient investor to the trader, to the plaintiffs' lawyer and diverts resources away from the growth of the enterprise. The system is an open invitation to litigation and must be changed.

We encourage you and support you in the reform you have been pursuing. We thank you and we stand ready to help in any way we can. And we look forward to questions.

Senator GRAMM. Thank you.

Mr. Sollman.

OPENING STATEMENT OF GEORGE H. SOLLMAN
PRESIDENT AND CHIEF EXECUTIVE OFFICER
CENTIGRAM COMMUNICATIONS CORPORATION, SAN JOSE, CA
ON BEHALF OF THE
AMERICAN ELECTRONICS ASSOCIATION

Mr. SOLLMAN. Good morning, Mr. Chairman, and Members of the Committee.

My name is George Sollman and I am the Chief Executive Officer of Centigram Communication Corporation. I am pleased to be here today to present my views on the effect that abusive securities lawsuits are having on high-growth, high-tech companies.

My testimony this morning is on behalf of the American Electronics Association or the AEA, an organization that represents some 3,000 high-tech companies located in 44 States.

Centigram Communications is a leading provider of integrated messaging products. Centigram solves multimedia communication problems by integrating voice, data, and fax in our Adaptive Information Processing platform.

We were founded in 1980, went public in October 1991, and currently have approximately 350 employees, revenues of about $80 million, and have demonstrated an annual growth of about 35 percent over each of the last 4 years. I've been President and CEO of Centigram since February 1985.

U.S. capital markets function efficiently and effectively because of a strong and balanced enforcement system. The AEA believes the right of private action to mitigate fraud is an important adjunct to SEC enforcement. A balanced enforcement system against fraud protects investors, and ensures the free-flow of capital to the most productive sectors of the economy. High-tech, high-growth industries benefit from such a system. But while AEA is for a strong system of private action, it is readily apparent that the current system is no longer functional nor balanced.

In recent years, U.S. high-tech companies have become the target of speculative, abusive securities litigation which enriches lawyers at the expense of shareholders and our economy. High-tech companies—particularly young high-growth companies—are disproportionately becoming targets of this litigation because our stock price usually experiences greater-than-average fluctuation. Unfortunately, the entrepreneurial culture of our industry and the pace at which we develop new products, new technologies, and new innovations, has made us very easy prey for lawyers lurking to cash in on our volatility.

Mr. Chairman, abusive securities lawsuits are brought by a relatively small number of lawyers specializing in initiating this type of litigation. In many cases, the plaintiffs are investors who own only a few shares of the defendant corporation. And the corporations are frequently technology companies whose share price volatility precipitates a lawsuit.

The plaintiffs do not need to allege any specific fraud. Indeed, many of these suits are brought only because the market price of the securities dropped. The plaintiffs' attorneys name as individual defendants the officers and directors of the corporation and proceed to engulf management in a time-consuming and very costly fishing expedition for the alleged fraud.

What drives these lawsuits? We believe the answer is clear. Even when a company committed no fraud, indeed, no negligence, there is still the remote possibility of huge jury verdicts, not to mention the cost of litigation. In the face of such exposure, defendant companies inevitably settle these suits rather than go to trial, as many of the prior testimonies indicated.

We believe the plaintiff lawyers understand the coercive psychology of the system and many of these suits are filed without just cause and solely for the purpose of extracting settlements.

Mr. Chairman, there are approximately 300 securities lawsuits filed each year. Nearly 93 percent of these suits settle for an average of $8.6 million apiece. That makes a $2.4 billion industry with a third of this amount, plus expenses, going to the lawyers.

This is not, I would represent, a small cottage industry in San Diego!

As a result of perverse economics driving these cases, meritless cases settle for far too much, and meritorious cases settle for far too little.

If anyone questions the existence of frivolous lawsuits, I invite them to visit Silicon Valley. A new survey conducted by the AEA confirms that one out of every two—one out of every two, more than 50 percent of Silicon Valley companies—have been the subject of a 10(b)(5) securities class-action lawsuit.

You can only reach one conclusion. There are only two kinds of high-tech, publicly held companies in Silicon Valley—those who have been sued and those who will be sued.

Mr. Chairman, the current securities litigation system is seriously impacting the competitiveness and productivity of America's technology companies. It is also directly impacting our ability to innovate and create jobs.

In summary, Mr. Chairman, we believe the current securities litigation system promotes meritless litigation, short-changes investors, and costs jobs. These jobs cost new product innovation and global competitiveness.

The showcase example of the legal system run awry. The AEA is convinced that legislative reform is needed to address the problem of abusive securities litigation.

Thank you, and I would be pleased to respond to your questions.

Senator GRAMM. Thank you. I'm going to forego questioning. If I do, we'll be able just to about finish with everybody getting 5 minutes. But let me make one comment.

I don't blame lawyers for exploiting a system that was structured with incentives for people to sue. I think if we ought to blame anybody, we ought to blame lawmakers for not fixing this system. I can assure you that before this year is over, lawmakers are going to have an opportunity to fix it. And if they don't fix it, then people will certainly know who to blame.

I do not think it's productive to single out one group of people who have responded to a set of incentives that we have created and that we have refused to fix. And I am hopeful that we are going to fix it.

Let me recognize the Chairman of our Full Committee, Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

I would like to ask each of the panelists which aspect of reform they feel is most important and to defend their choices.

I'm going to start with Mr. Lackritz as he is still getting coached. [Laughter.]

Mr. LACKRITZ. Well, you were asking a very good question, Senator, and I didn't want to give you five different priorities.

I think from the standpoint of the entire system, the proportionate liability is perhaps the most significant reform and would be the most easy to defend because the current system of joint and several liability clearly has gotten things way out of whack in terms of incentives and in terms of actually apportioning responsibility. And to the extent we want to encourage responsible behavior, which I think we do, it seems to me that would be the one.

Senator D'AMATO. In the current system if a person is found 10 percent culpable they can still be charged for the whole judgment, so the corporate officer has to decide whether to run the risk of being liable for $100 million, or to settle for a lesser amount. However, if there was proportionate liability the most they could be liable for is $10 million. Is that correct?

Mr. LACKRITZ. Yes, that's right, sir.

Mr. BEESE. Senator, I would also agree on proportionate liability. When there is fraud involved, when there is a clear active of fraud, somebody should be liable for the fraud.

But I certainly agree with the Supreme Court's decision last year in Central Bank of Denver, when somebody is an incidental participant to a fraud, not a perpetrator of fraud, that they should not have the full liability that somebody who clearly, consciously committed fraud does.

I would also support modified fee-shifting. And Senator Gramm, I agree exactly. The imposition of greater sanctions on parties who initiate frivolous lawsuits would change the incentive system that is driving the current process.

Senator D'AMATO. I would point out that I see a difficulty in implementing a fee-shifting system. The courts have the authority to place sanctions on parties which bring point frivolous suits, however, I feel there may be a need for clearer congressional guidance. In truly frivolous suits, I think that the plaintiffs' bar has got to be prepared for some kinds of sanctions. The difficulty lies with how to define "frivolous," to make sure that we don't discourage meritorious suits.

Ms. Minow?

Ms. MINOW. Continuing with the point that you're making right now, Senator, I think my top priority would be giving the meaningful shareholders of the company more of a role. Perhaps we could go with something along the lines of the bankruptcy model, where there would be a shareholder committee evaluating the merits of a case and the merits of any proposed settlement to determine whether it should go further. And I know that other proposals have included a guardian ad litem.

I think there are already adequate remedies for the filing of frivolous lawsuits and we don't need any more. But I would suggest that you might want to think about strengthening the provisions dealing with alternative dispute resolution as another way of handling these issues without allowing them to become expensive and overblown.

Senator D'AMATO. Mr. Morgan?

Mr. MORGAN. Senator, I'm not a lawyer, so I can't comment in technical terms or reply in technical terms to your question. I can only say that I would encourage very bold action here. There has been a lot of measured testimony that I hear emphasizing the need to keep the remedies open where there's really fraud.

I've been in the investment business for 28 years. I've invested in hundreds of companies. Some have done well, Some have lost everything I've put in them. I've never had to resort to the courts for any kind of action against any one I've financed or came close to financing. There just aren't that many crooks out there in the world in which I operate.

So my top priority would be raising the bar to bringing these actions because once an action is brought, a small company, and by small, I mean under $100 million, is cooked. They basically have to find a settlement path for the reasons that have been mentioned.

Anything that can keep these plaintiffs' lawyers out of the courtroom would be a step in the right direction, as far as I'm concerned.

Senator D'AMATO. Mr. Murphy?

Mr. MURPHY. Mr. Chairman, I couldn't agree more with Mr. Morgan. I think it's setting the bar, taking very bold action. Putting

the bar higher and taking very bold action is absolutely what's called for. There might be a higher level——

Senator D'AMATO. Mr. Murphy, don't you see as a great incentive for filing these suits the fact that large institutions with "deep pockets" can be brought in as co-defendants; thus creating a situation where a securities firm, financial institution, or large accounting firm can be liable for a large part of the settlement leaving the originally named company to pay a very small amount?

The large institutions are often forced to settle when they face a huge liability. However, if there were proportional liability the "deep pocket" institutions would only be liable for a small amount and would be able to take more cases to trial. Wouldn't taking more cases to trial deter frivolous actions?

Mr. MURPHY. That would help considerably. Clearly, allowing them to fish in a bunch of ponds is a problem.

Senator D'AMATO. Wouldn't proportional liability really raise the bar tremendously to stop much of the frivolous litigation?

Mr. MURPHY. Clearly, it would raise the bar considerably and we would applaud that and encourage further things.

So that just the allegation of fraud——

Senator D'AMATO. Let me interject—I am very concerned that we work toward reform of the current system, not the creation of a new one. Real reform is my goal—and I want to be careful and measure my words as I don't have the legal beagles here——

[Laughter.]

But I will not preclude actions against conduct which reasonable people think is inappropriate. I feel that there are provisions which would have this effect, and although we can debate it these provisions, I feel it would be irresponsible to adopt a loser pays position. Although it might be a popular provision you're not going to grab this Senator with it.

Mr. Sollman?

Mr. SOLLMAN. Mr. Chairman, I believe one of the areas that needs addressing—I'm going to speak as a businessman, not as a lawyer—is the way in which the economics of these cases are set.

I think there are many areas that are ripe for review. There are very easy ones, such as the issue of putting class-action shareholder suits up for bid, when it comes to selection of lawyers.

We don't do that. And therefore, you see some of the incredible legal fees of today, depriving the shareholders when awards are appropriate.

That's just a start. I think there are a number of different economic redresses that probably are appropriate as we begin to peel this issue back.

The fee-shifting area is another one. I appreciate your concern regarding it, but I think the fee-shifting area is an area that is worthy of careful contemplation, understanding there is a slippery slope that's involved.

If I could just take a second to maybe add to a comment you made earlier, Mr. Chairman.

That in the case of a settlement with the insurance company, there is no free lunch. The companies do pay.

In Silicon Valley, $5 million worth of director and officer liability coverage, will cost you about half a million dollars. A half-million

dollars is five engineers—and five engineers, as we seem to know, is one new product.

That's what we're giving up by the current situation that we're living in. Unfortunately, that's the world we inhabit today.

Senator D'AMATO. I thank the panel for their candor.

Senator GRAMM. Senator Boxer?

Senator BOXER. Thank you, Mr. Chairman.

Mr. Morgan, you said, "There are not that many crooks out there." Now I'm glad to hear you say that. Frankly, I don't know how many crooks there are out there. But let me read you what Arthur Levitt said last year. And I'm quoting directly.

Mr. Chairman, I really feel it is so distracting because some of these points I'm making, I would so appreciate if my Chairman would hear because I think they're important.

Arthur Levitt, to the point of how many crooks there are out there, said the following last year.

I thought during my service as head of Shearson and then head of the American Stock Exchange that I had seen just about every kind of public fraud that could possibly be perpetrated on individual investors. And then I came to the Commission and week by week, hearing cases, seeing what's going on in the country and how many people are out there taking advantage of innocent individual shareholders, dwarfed anything I had ever experienced before and convinced me in a way that no amount of experience or reading of anecdotal information could possibly have persuaded me of the vital and compelling importance and mandate of the Commission above everything else that it has to do in terms of governance issues and legislation.

He goes on to say, yes, there are abuses—and I think he means abuses against companies like those in Silicon Valley. We have companies settling cases because it is too expensive to go to court, so they settle the case just to get rid of it. These frivolous suits are costing a lot of money that could go into new products, R&D, and all of the things that we need to expand economic opportunity.

But, again, to associate myself with Chairman D'Amato, the loser-pays rule is very radical.

So I want to say, in my view, and I may lose out on this vote when it comes. I'm under no illusion that I represent the majority view now in the Congress, and I may find myself on the other end of it. But I think we have a way to get to those nasty, frivolous lawsuits, and that is by really strengthening Rule 11.

I wanted to ask Mr. Sollman if he has given any thought to that, ways we can improve Rule 11 to better weed out frivolous claims?

Mr. SOLLMAN. I'm personally not familiar with all the intricacies of Rule 11. I'm not a lawyer.

Senator BOXER. OK. Well, let me say that under Rule 11 of the Federal Rules of Civil Procedure, judges have the authority to impose sanctions on individuals who file frivolous lawsuits. It is used relatively infrequently and the Supreme Court in 1993 adopted significant amendments to Rule 11, including making sanctions discretionary.

I think there's a way to go after Rule 11 to really crack down on these frivolous lawsuits. I wanted to make that point.

I also would like to, in the time that I have, read something that was just written by Herbert Stein on February 15th. As you know, he was on the President's Council of Economic Advisers under Richard Nixon. He said:

The House Republican leadership also wants to limit court actions to cases where deliberate intent to mislead or reckless disregard for the truth can be proved. This would let responsible parties off the hook for failure to exercise the diligence that the law requires of them.

Again, I think we have to seek some type of a balance here, which is what I'm hoping to do.

Mr. Beese, I don't want to embarrass you or make this an embarrassing question, and I know that it won't be because you were not with this company when this occurred. But we just saw that regulators seized a credit union organization and that your company, Alex. Brown and Sons, the Baltimore-based brokerage firm that sold Cap. Corp. most of its derivatives is being looked at here.

So I feel that since you're before this Committee, would it not be to the advantage of your company if we did loosen these rules on these lawsuits?

Mr. BEESE. Senator, if you read further in that article, you'll probably see a quote from our CEO. And I would quote from him and it's not appropriate for me to say anything personally about this matter.

Senator BOXER. Yes.

Mr. BEESE. But I think you will find a quote in there that says that we have gone through this matter with a fine-tooth comb at our firm and we have found no wrong-doing on our part and clearly——

Senator GRAMM. If the gentlelady would yield.

If we don't have people before the Subcommittee who have an interest in this issue, then we are not going to have anybody here making a presentation. No lawyer could appear before the Subcommittee.

Senator BOXER. I understand that.

Senator GRAMM. The idea that people are not representing their own interest is an idea so alien to the American system, that I don't see——

[Laughter.]

Only I speak for the public interest.

[Laughter.]

I assume everybody else speaks for their narrowly defined, special interest.

[Laughter.]

Senator BOXER. Well, Mr. Chairman, if I could take back my time and maybe get an extra minute, since you interrupted me.

Mr. BEESE. Senator, could I respond on Rule 11?

Senator BOXER. Let me just continue my point here.

Look, I'm trying to find out from people who appear before us, including those who will appear on the other side. I'm asking you a question. If we do change the rules here—I don't even know if you have been sued in any way, shape, or form. Would it, in fact, be to the benefit of your company?

Mr. BEESE. No, Senator. Nothing that we are proposing here would in any way limit anyone who has been the victim of fraud to seek redress and sue if it is a meritorious claim.

Senator BOXER. Nothing, yes. But obviously——

Mr. BEESE. Nothing in our testimony and nothing we are proposing would limit access to the courts or limit redress.

Senator BOXER. Thank you.

Senator GRAMM. Senator Faircloth?

Senator FAIRCLOTH. Thank you, Mr. Chairman.

The time is running out and I really won't get into questions. I totally support the bill. I just don't think it goes far enough.

But I get the avarition I see to it is the Federal Government is probably the principal filer and the sponsor of the principal filer of frivolous lawsuits, through the Legal Aid Society, the Legal Service Corporation, and many, many others, through EPA, and OSHA and unlimited.

They are one of the principal perpetrators of unjustified lawsuits.

I strongly support this bill, but I think it would be well for the Federal agencies to get their own house in order before the Congress has to turn and put their house in order for them.

I thank you.

Senator GRAMM. Senator Bennett.

OPENING COMMENTS OF SENATOR ROBERT F. BENNETT

Senator BENNETT [presiding]. The Chairman has had to leave and you will soon see everybody else leave.

[Laughter.]

I simply want to make one——

Senator D'AMATO. Let me apologize to the Subcommittee and the panel but I need to leave for a Senate Finance Committee hearing.

I thank the panel.

Senator BENNETT. I have an observation that I would like you to respond to briefly because we all have another assignment we have to go to.

It strikes me that we have a very interesting dichotomy here. Shareholders are the ones in whose behalf the suits are being brought. Shareholders are the ones who are the most hurt by the lawsuit.

I think it's you, Ms. Minow, who indicated that maybe we ought to have some kind of higher threshold of consent here, that a class is being formed where a class really does not exist. Or in the language of the street, don't do me any favors.

Shareholders are being done favors that they do not want to be done. Have any of you crafted any kind of language or have any kind of proposals that would say that there must be a consent threshold established where X-percentage of the shareholders must consent to a class-action suit being brought in their behalf?

Ms. MINOW. Senator, may I address that?

I haven't practiced law for a long time, but my recollection is that there is an exemption to the normal requirement for notice of a class action in this context only, which I think really makes the problem much, much worse.

So I can have shareholder actions filed on my behalf and never know about it. Whereas, a class action against the manufacturer of some product or service would have to, I would be notified in that case and would have the opportunity to opt out.

That provides some additional legitimacy for the class-action system. And yet, because of the diversity and the anonymity that we give to shareholders by allowing them to hold in street name, the system has recognized that it's impossible to give notices to all the

shareholders for the best possible motivations and yet, with the worst possible consequences.

I believe that one of the bills does have some language in it about the creation of a shareholder committee to oversee this litigation and I think that would be the approach that I would favor.

Senator BENNETT. Anyone else have any comment on that?

Yes, sir.

Mr. LACKRITZ. Yes, Senator. We think that there ought to be some measures to ensure that the interests of shareholders are protected.

For example, like ensuring that the plaintiff has a certain investment in the firm. I don't know whether it's 1 percent or $10,000, or some significant threshold so that they have a significant economic interest, not just a one-share, ten shares of a firm that enables them to act on behalf of the entire shareholder class.

Now that's not the same issue as the one you raised in terms of how to assure that all the shareholders are going to be adequately represented. But we think if there's a narrowing of the funnel up front in terms of anybody owning a share getting into court, that by restricting that little bit to someone who has a significant economic interest, that will help to deter the filing of meritless claims.

Mr. SOLLMAN. I would also like to comment. I think it's another rich area for discussion. I know, from personal observation, suits have been filed with as few as 100 shares, and I guess there's some with even less than 100 shares. And it begs the question—when someone only owns 10 or 100 shares and they attempt to speak for an entire class, or initiate action for an entire class of shareholders, whether this is the right use of process?

Obviously, under the current legal system, the economic incentives for plaintiffs' lawyers are so high, that you would be foolish not to grab that complaint and run with it in response to Senator D'Amato's comments.

Senator BENNETT. Yes. As I said, it's just kind of interesting that shareholders, who are presumably protected by this procedure, are the ones that are being damaged by this procedure and they are not allowed to comment. They are not allowed to participate.

The other aspect, just coming out of my own personal experience, one of the reasons we delayed taking our company public was fear of this kind of exposure. We ultimately came to the conclusion that we had to take the company public, not because we needed the money. The company that I was CEO of was generating internal cashflow sufficient to finance the growth. But we, the original shareholders, had distributed shares to our employees and it was of no value to the employees because we weren't paying dividends. We were re-investing the earnings of the company to finance its growth. We were growing at the rate—well, for the first 5 years, we grew at 100 percent per year. Now we have slowed down. We're $300 million in sales. We're only growing at 30 percent a year.

But the only way the employees could get any benefit out of the shares we had distributed to them was to go public. And we recognized that in going public, we were exposing them to these kinds of dangers. It's a terrible thing in a circumstance where we want to encourage entrepreneurial activity and employee shareholdership to say, going public is the wrong thing to do on behalf of the

shareholders and your stake in the company. All that you have earned over the years is locked in, cannot be liquidated in case you need that capital simply because someone, in the name of protecting you, is going to destroy your value in a fashion.

Yes, sir.

Mr. SOLLMAN. If I could add a further comment to your experience, Senator, is virtually identical to the typical Silicon Valley company where almost always, 100 percent of the employees have shares in the company.

So that if the company holds back from going public, as you suggested, the employees are hurt in their ability to see some reward for which, typically, a very long, difficult, hard road. And at the same time, you go through the indignity of having someone who never went on that long road with 100 shares then file a suit representing or claiming to represent a class.

There's something terribly out of balance.

Senator BENNETT. Thank you.

Senator BOXER. Mr. Chairman?

Senator BENNETT. You've returned. I'm sorry.

Senator BOXER. I wonder if I could have another round, as long as we're here.

Senator BENNETT. Absolutely.

Senator BOXER. Thank you.

Senator BENNETT. Senator Boxer.

Senator BOXER. That is very kind of you. This is such a good panel and I appreciate all of you being here.

Mr. Lackritz, you said one of your top priorities would be to protect innocent bystanders. Could you explain, who is an innocent bystander, typically, that's getting hit, getting caught in this web of our litigation laws?

Mr. LACKRITZ. Oftentimes, Senator, as you know, in the process of bringing a company public, you have got a number of actors in that process, ranging from an issuer, to an underwriter, to an accountant, to a lawyer, to a marketmaker, whoever it happens to be.

When a fraud is perpetrated, often—I don't know. I won't characterize it as often—someone may perpetrate a fraud in that set of circumstances, an intentional act.

Senator BOXER. Yes.

Mr. LACKRITZ. A knowing act, where they have the intent of defrauding someone.

Senator BOXER. Yes.

Mr. LACKRITZ. The other actors in that process, whether it is the underwriter, whether it is the accountant, whether it is the lawyer, the bond counsel, whoever it happens to be, may have had no knowledge whatsoever of that fraudulent act, may not have been a participant in that fraudulent act. And therefore, we think that it's more appropriate if you're going to encourage responsible behavior, to target the liability at those who act intentionally or knowingly, not those who are merely innocent bystanders.

Senator BOXER. OK. The reason I raise this issue is, of course, I agree with you in terms of your sentiments. But I want to take it to the real world.

Let's look at the Charles Keating case. In the Lincoln Savings and Loan case, Charles Keating fleeced the savings of thousands

of elderly Californians with the assistance, or certainly they were involved, of attorneys and accountants and other professionals.

Judge Stanley Sporkin of the U.S. District Court in Washington, said the following after he heard part of the Keating case:

> Where were those professionals when these clearly improper transactions were being consummated? Why didn't any of them speak up or disassociate themselves with the transactions? Where also were the outside accountants and attorneys when these transactions were effectuated?

And in a subsequent speech, Judge Sporkin said:

> For this kind of massive, very sophisticated fraud to have occurred, it required the complicity of certain professionals that we all know of—CPA's, lawyers, and appraisers. I'm suggesting that perhaps these professionals did not discharge their responsibilities to the broader public interest.

I guess what I'm saying to you is, on the one hand, we're bashing lawyers, saying lawyers are causing these frivolous lawsuits, and, on the other hand, saying, they are "innocent bystanders" if, in fact, they were involved with people like Charles Keating.

I have a problem with that. I'm willing to hold people culpable all through it. I'm willing to strengthen frivolous lawsuit punishments, I'll tell you, way out beyond what anyone would believe I would do, because I think those people deserve to be hit. But I also feel, on the other side of it, if you're going to attack lawyers on that side, which in some cases they deserve to be attacked, then how can you say they're innocent bystanders in a case like the Keating situation? What I guess I'm bringing out to you is it's not so easy to define what an innocent bystander is.

Mr. LACKRITZ. I think you're right in terms of individual cases and individual facts and circumstances are going to determine who's in fact culpable. But when we're talking about fraud and we're talking about intentional and knowing acts to defraud, mislead, or fleece someone, we're also talking about other participants in that process who may have had no knowledge whatsoever, and may have exercised their duties fully appropriately.

Those are the kinds——

Senator BOXER. Shouldn't that be decided on a case-by-case basis, rather than writing something into the law that would be hard to define?

Mr. LACKRITZ. Obviously, you're going to have difficult situations where you're going to need some exceptions or you need some discretion. But from the standpoint of just generally creating a system and perpetuating a system where you're going to encourage responsible behavior and where you're going to hold people accountable for their actions.

We think it's much more appropriate to target the wrongdoers——

Senator BOXER. Absolutely. But what I'm saying to you——

Mr. LACKRITZ. —for liability, not for parties that are just providing services and performing their duties.

Senator BOXER. Well, you know, as I say, it's not an easy issue because I remember as a kid, my parents said, if Price-Waterhouse says this is what it is, this is what it is. And I became a stockbroker later in life and I really put a lot of faith into professionals to protect people.

So I guess—I think—everybody talks about today, we have to bring responsibility back. I don't want to see this idea of "innocent bystander" have a definition that lets people off the hook.

Mr. LACKRITZ. But, Senator, if I could just add one point.

Senator BOXER. Certainly.

Mr. LACKRITZ. I don't think anybody's characterizing the current system as being a situation where, in fact, people are escaping responsibility. The current system is not rife with situations where participants in behavior are escaping responsibility. The problem is more that the balance has gotten so out of kilter, that we're trying to right that balance a little bit more appropriately.

Senator BOXER. Let's talk about that balance because I don't know how out of kilter it is. Listen to what the standard is. You listen carefully and tell me what you don't think is right.

Here's what the standard is today.

A highly unreasonable omission involving not merely simple or even gross negligence, but an extreme departure from the standards of ordinary care and which present a danger of misleading buyers or sellers that is either known to the defendant or is so obvious, that the actor must have been aware of it.

So all I'm saying to you is we keep saying, let's just throw out everything. This is a pretty high standard. And I think in many of these cases—I see that Mr. Murphy disagrees.

I'm a reasonable person. This is what it would take to bring some of these people—we have to prove that they made a highly unreasonable omission. I mean, it's a pretty strict standard.

Mr. Chairman, I know we are anxious to go, but I have one more point.

Did you want to say something?

Mr. SOLLMAN. Yes, I very much would.

Senator BOXER. Yes.

Mr. SOLLMAN. You have a number of constituents in California who feel very strongly that the current system is broken. It's broken from virtually every aspect. It's broken from the aspect of being able to recover damages as a shareholder. I think a number of people here spoke with great authority on the statistics of how little money the shareholders who may have been meritoriously wronged receive at the end of the day.

You heard other comments from us on a system that today allows suits to go forward as a class-action suit with almost no basis whatsoever.

We need to have something that is reasoned, is fair, and has a balance to it. I think the dialog we've had this morning is really only a beginning to a dialog that we must have.

I know there are some bills here that very shortly need to be voted on. I think this is a very important area. I believe there are real issues. I think the AEA feels very strongly, not just in California, but the United States as a whole that there is a situation that needs to be fixed.

We are not out bashing lawyers. We are very constructively attempting to deal with a system that needs to be fixed.

Senator BOXER. Mr. Sollman, that's why I'm going to be voting for reform. But I also want to get that balance.

So I'm just talking here with Mr. Lackritz about the point of what is an innocent bystander? And I think we have to be very careful. We want to hold people accountable and responsible in a proportional way, for sure, OK? But we can't let people who have committed fraud off the hook. I'm not going to vote for anything that leaves a lawyer off the hook, either side of the equation. OK? Whether it's a frivolous lawsuit, on one hand, or protecting a Charles Keating on the other. No way. I'm not going to do it.

I want to make a point here that the CBO [Congressional Budget Office] estimated that the provisions in the contract, if the law goes forward as it is on the House side—which, my sense is it probably won't, it will be changed a little—would cost the Federal Government between $125 and $250 million over the next 5 years. And that is because there would be such a drop in the number of suits that the SEC would have to step up enforcement.

I want to ask Mr. Beese, with his other hat, his former SEC hat, to say, does he agree with what Chairman Levitt said, again, that the private lawsuits are crucial to the integrity of our disclosure system, and that they will have to step up their action and their expenditures if we change it too much in the other direction.

Mr. BEESE. Well, Senator, you're right. We're not just bashing lawyers here. I got bashed a little bit, I guess, from Senator Gramm when he said it's the lawmakers and the rulemakers, which I was for the last 3 years, that are part of the problem.

Senator BOXER. There are no sacred cows.

Mr. BEESE. That's right. Clearly, I don't know how to respond to the estimates, but as I said in my statement, I agree. I associated myself with your opening statement and I feel that private action is a very important adjunct to the work of the SEC. The SEC does not have the budget, will never have the budget, and will never have the resources to be everywhere, to police our markets. The private action is a very important adjunct to that work.

However, the system, from my observation in the last 3 years at the SEC, is clearly out of balance. What I saw from the SEC was not only a lot of crooks, but also a lot of frivolous lawsuits out in the marketplace. And I would submit that, unless you repeal the laws of human nature, there will always be crooks in our marketplace. But I submit to you that the system is so out of balance today, that it is more of a danger to our marketplace than any crook is today.

Senator BOXER. Mr. Chairman, thank you very much for your kindness. And I would say that, in my votes, I'm going to try to get the crooks and stop the frivolous lawsuits.

That's what I hope to do.

Senator BENNETT. So will we all. Thank you very much for your testimony.

The hearing is adjourned.

[Whereupon, at 10:50 a.m., the Subcommittee was recessed.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR CHRISTOPHER J. DODD

Over the last 18 months, the process by which private individuals bring securities lawsuits has been under the microscope. I'm very happy to say that as a result of the unprecedented and much needed scrutiny the securities litigation issue has received in Congress, academia, the media, and in the investor and business community, the debate has shifted dramatically. We are no longer arguing about whether the current system is in need of repair. The discussion is now centered on how best to fix it.

Even those who 1 year ago steadfastly refused to admit that the system needed to be reformed, now concede that substantial changes are needed. The flaws in the current private securities litigation system are simply too obvious to deny. The record is replete with examples of how the system is being abused and misused. The message has finally gotten through.

The fact that there is finally consensus about the need for securities litigation reform is enormously significant. Because this consensus now exists, I believe we will see comprehensive legislation enacted this Congress. With this hearing, the Senate begins the process to develop the best legislative solutions to the problems that have been identified.

S. 240, the proposal my good friend Senator Domenici and I introduced on January 18th, is a carefully crafted, balanced approach to fixing the current system. It is identical to the legislation we introduced in the 103rd—although he now has top billing. **But most importantly, it is a broadly bipartisan effort.** Nineteen of our colleagues joined us as original cosponsors. Another eight Senators have cosponsored the bill since we introduced it. Democratic supporters include Senators Mikulski, Moseley-Braun, Murray, Johnston, Conrad, Pell, and Rockefeller.

We do not claim that this bill is the definitive or perfect solution. Since we first introduced it, in March of last year, numerous hearings have been held in both Houses of Congress, many studies have been completed, including a comprehensive report by my Securities Subcommittee staff. Every word of the legislation has received in-depth analysis.

In addition, there have been a number of judicial decisions which have altered the private securities litigation landscape. The most significant was the U.S. Supreme Court decision last year in *Central Bank of Denver* v. *First Interstate Bank of Denver,* which eliminated private liability for those who aid and abet securities fraud.

Many constructive suggestions have been made about ways to improve the legislation. The fact that we did not incorporate any of these changes into this year's proposal should not be taken as a sign that we are unwilling to modify our bill. We simply preferred to begin this year where we left off last year so as not to create additional controversy or confusion. I am eager to work with my colleagues to refine and perfect the proposal as it moves through the process. My main goal is to have a bill that carefully balances the rights of plaintiffs and defendants.

Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely on Government action. I cannot possibly overstate just how critical securities lawsuits brought by private individuals are to ensuring the integrity of our capital markets. These private actions help deter wrongdoing and ensure that corporate officers, auditors, directors, lawyers, and others properly perform their jobs.

Yet private litigation has evolved over the years mainly as a result of court decisions rather than legislative action. Private actions under 10(b) were never expressly set out by Congress, but have been construed and refined by courts, with the tacit consent of Congress.

The lack of congressional involvement in shaping private litigation has created conflicting legal standards and has provided to many opportunities for abuse of investors and companies.

First, securities class-action cases have grown vulnerable to abuses by "entrepreneurial" lawyers who put their own interests ahead of their clients. Many critics charge that plaintiffs' attorneys appear to control the settlement of the case with little or no influence from either the "named" plaintiffs or the larger class of investors. For example, in one case cited to the Subcommittee by a lawyer as a showcase of how the system works, the case was settled before trial for $33 million. The lawyers asked the court for more than $20 million of that amount in fees and costs. The court awarded the plaintiffs' lawyers over $11 million and lawyers for the company $3 million. Investors recovered only 6.5 percent of their recoverable damages.

A second area of abuse is frivolous litigation. Companies, especially in the high-tech sectors, face groundless securities litigation days or even hours after adverse earnings announcements. There are new examples of this almost every week. Courts

have echoed this concern. As the Supreme Court pointed out in *Blue Chip Stamps* v. *Manor Drug Store:*

> "[I]n the field of Federal securities laws governing disclosure of information, even a complaint which by objective standards may have very little success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment. The very pendency of the lawsuit may frustrate or delay normal business activity of the defendant which is totally unrelated to the lawsuit."

Third, the current framework for assessing liability is simply unfair and creates an incentive to sue those with the deepest pockets. Unlimited liability is simply not the most effective deterrent of wrongdoing. We need to more directly police the conduct of professionals like accountants and do so in a more effective manner.

Legislative Solutions

The bill contains four major initiatives to deal with these problems:

(1) It empowers investors so that they—not their lawyers—have greater control over class-action cases.

(2) It gives investors better tools to recover losses and enhances existing provisions designed to deter fraud.

(3) It limits opportunities for frivolous litigation.

(4) It rationalizes the professional liability of accountants in exchange for stronger regulation.

1. EMPOWERING INVESTORS

- The bill addresses abuses of investors by their lawyers by ensuring that investors, not lawyers, decide whether to bring a case, whether to settle, and how much the lawyers should receive.
- The bill requires courts to appoint a plaintiff steering committee or a guardian to directly control lawyers for the class.
- The bill requires that notices of settlement agreements sent to investors spell out clearly important facts such as how much investors are giving up by settling, and how much their lawyers will receive in the settlement.
- The bill requires that courts tie awards of lawyers' fees directly to how much is recovered by investors, rather than simply how many hours the lawyers billed or how many pages of briefs they filed.
- The bill establishes an Alternative Dispute Resolution procedure to make it easier to prosecute a case without the necessity of slow and expensive Federal court proceedings. This idea is very similar to a provision in the Products Liability Bill passed by the Commerce Committee last fall, and like that bill it is intended to speed up the recovery process for plaintiffs who have strong cases.

These provisions should ensure that defrauded investors are not cheated a second time. It also should help victims of fraud to recover damages more quickly, with less of their recovery drained off in lawyers' fees.

2. ENHANCING DETERRENCE OF FRAUD

- The bill would extend the statute of limitations for implied actions to 5 years from the date of the violation, or 2 years after the violation was discovered or should have been discovered through the exercise of reasonable diligence. Current law is 1 year and 3 years respectively.
- The bill also incorporates pending legislation—the Wyden-Kerry Bill requiring auditors to report and detect fraud. A similar bill in past Congresses has been supported by the SEC and the accounting profession.

3. FRIVOLOUS LITIGATION

- The bill requires that in order to bring a securities case as a class action, the plaintiffs in whose name the case is brought must have held either 1 percent of the securities which are the subject of the litigation or $10,000 worth of securities. This should help stop a problem pointed to by several courts, in which "Professional Plaintiffs" who own small amounts of stock in many companies try to bring class-action lawsuits whenever one of their investments goes down.
- The bill clarifies how a lawyer should plead a securities fraud claim. Plaintiffs' lawyers should have no trouble meeting these standards if they have legitimate cases and have looked at the facts.

These and other reforms should end the race to the courthouse by lawyers eager to file a case without investigating the facts or finding a real client.

3. SECURITIES LITIGATION AND FINANCIAL REPORTING

Certain professionals, particularly accountants, are frequently named in securities suits simply because they are a deep pocket. Under the current system of joint and several liability, their liability exposure is frequently out of proportion to their degree of fault. I believe this is not fair and will have the effect of discouraging them from providing auditing services to many companies, especially new companies and "high-tech" companies.

- The bill establishes a liability system for less culpable defendants that is linked to degree of fault. At the same time, the bill establishes a self-disciplinary organization for accountants under the direct supervision of the SEC. This entity would be somewhat like self-regulatory organizations such as the New York Stock Exchange or the National Association of Securities Dealers. The net effect should be a more direct and rational way of dealing with "Bad Apples" in the accounting profession without punishing the entire profession.

There is tremendous support for this legislation within Congress and from a large variety of private organizations. I look forward to working with my colleagues to enact comprehensive bipartisan reform as soon as possible.

Philip Morris Case: Example of "Cookie Cutter Suits"

Recently, in a class-action case before the District court for the Southern District of New York, Philip Morris was accused of making fraudulent statements so as to raise the price of its common stock. In dismissing the case Judge Owen noted: ". . . in the few hours counsel devoted to getting the initial complaint to the courthouse, overlooked was the fact that *two* of them contained identical allegations, apparently lodged in counsel's computer memory of "Fraud" form complaints, that the defendants here engaged in conduct 'To Create and Prolong the Appearance of [Philip Morris'] Success in the **Toy** Industry.'" (Emphasis supplied).

As you know, Philip Morris is into a lot of businesses, but making toys is not one of them.

PREPARED STATEMENT OF SENATOR PETE V. DOMENICI

Mr. Chairman, thank you for the opportunity to appear today to testify about the Private Securities Litigation Reform Act. It is a pleasure to return to the Securities Subcommittee, where I was a Member during previous years. I wanted to stay on the Banking Committee for the 104th Congress, but unfortunately for me there were several new Members who wished to serve under the able leadership of you and Chairman D'Amato.

The Banking Committee has an important agenda this year, and I believe that securities litigation reform should be at or near the top of the list of issues to be addressed. The distinguished former Chairman of this Subcommittee, Senator Dodd, and I have recently introduced S. 240, legislation which we believe will return some fairness and commonsense to our broken Securities Class Action Litigation System, while continuing to provide the highest level of protection to investors in our capital markets.

There are at least three major problems I see with our current system. First, too many cases are filed too quickly without regard to their merits for the purpose of extracting settlements from issuer companies and other deep pockets. The business within 30 days of a "triggering event," like a missed earnings projection. Twenty-one percent of the cases were filed within 48 hours of the triggering. It is simply impossible to believe that attorneys can perform the necessary due diligence and research into the merits of these suits in 48 hours.

In case you do not believe that a "race to the courthouse" problem exists, I would point you to an article run by *The Wall Street Journal* earlier this year. I would like to submit a copy of the article for the record. It provides an excellent example of the rapid-fire "cookie cutter" complaints which often form the basis of these multi-million dollar lawsuits.

It documents ten lawsuits filed against Philip Morris within 48 hours of the company's announcement of a price cut on one of its brands of cigarettes. The first suit was filed within 5 hours after the announcement. The case was dismissed after the judge noticed that the plaintiffs' attorneys had filed two separate suits alleging that Philip Morris had engaged in fraud to create and prolong the illusion of their success in the **toy** industry. As you might well know, Philip Morris does not make toys.

Here is what the judge in the case had to say in describing the amount of research undertaken by the plaintiffs' lawyers before they filed their complaint:

> In each of these complaints, pleaded almost entirely on information and belief, plaintiffs accused defendants of having made fraudulent statements so as to artificially raise the price of Philip Morris' common stock. Supporting plaintiffs' conclusory allegations were a few public statements made earlier in the year with a comparison to the April 2 announcement, and the allegation that because of differences in the announcements the defendants must have committed fraud. I note that in the few hours counsel devoted to getting the initial complaints to the courthouse, overlooked was the fact that *two* of them contained identical allegations, apparently lodged in counsel's computer memory of "fraud" form complaints, that the defendants here engaged in conduct "to create and prolong the illusion of [Philip Morris'] success in the *toy* industry."

But this is how the current system works. Judges rarely dismiss these multi-million dollar cases without a blunder like the one which occurred in the Philip Morris case. Plaintiffs' lawyers race to the courthouse, file frivolous suits with little or no research into their validity, and companies normally must pay something to make them go away. Our bill will eliminate these poorly researched, "kitchen sink" complaints.

Hit particularly hard are the high-growth, high-technology companies which are the backbone of our economy and the foundation of our ability to compete in the new global marketplace. Defending against a securities lawsuit is often as expensive as starting a new product line, and there is immense pressure for small, start-up companies to settle even the most frivolous cases. We should not allow litigation based merely on the inherent volatility of a company's stock price to hamper the creativity and innovation of these important contributors to our economy. Simply put, stock price volatility is not stock fraud.

Even in cases of real fraud, normally the only "winners" are the class-action attorneys. The most generous estimate I have seen indicates that investors recover about 11 cents on the dollar of their losses, while plaintiffs' lawyers take on average between 30 and 33 percent of the settlement fund. One plaintiffs' class-action attorney boasted in *Forbes* magazine that securities cases are a great practice because "there are no clients."

Professor John Coffee of Columbia University has characterized the settlement process as "at its worst, a covert exchange of a cheap settlement for a high award of attorneys' fees." We need to put investors in control of these cases, and put an end to the plaintiffs' lawyers' practice of selling out clients in exchange for huge fee awards. Truly defrauded investors must have greater control of their litigation and receive a greater share of the settlement fund.

I have spoken only briefly about the problem because I wanted to spend most of my time today discussing how Senator Dodd and I propose to fix our broken securities class-action system. S. 240 has attracted 27 co-sponsors from both sides of the aisle, and I believe that the bipartisan support for this bill is indicative of the even-handedness we have employed in crafting a solution to the problem.

Senator Dodd and I had several goals in mind in developing this legislation. Primarily, we wanted to put an end to the abusive practices which have come to characterize securities class-action lawsuits, particularly the "race to the courthouse" to file complaints with little or no research into their merits. We also sought to ensure that in cases of real fraud, the investors, not their lawyers, were in control of the lawsuits. Finally, we wanted to encourage the flow of financial information to investors and analysts by requiring auditors to blow the whistle on financial fraud and creating an enhanced safe harbor for predictive statements.

In furtherance of these goals, our bill contains provisions to put plaintiffs in charge of the litigation, to weed out frivolous cases at their outset and to weed out bad auditors.

To put investor plaintiffs back in control of their litigation, S. 240 allows courts to appoint a guardian ad litem or a steering committee to represent the interests of the class. The guardian or committee will possess the power to direct class counsel, including the power to hire and fire counsel, to decide whether to enter into Alternative Dispute Resolution (ADR) and to accept or reject settlement offers. In short, the guardian or committee will ensure that, just like in every other case, the plaintiffs not the lawyers will be in control.

The Domenici-Dodd plan also requires plaintiffs' lawyers to provide clear disclosure of settlement terms to the class. Instead of a settlement shrouded in incomprehensible legal language, lawyers will be required to give class plaintiffs a clear statement of the amount of damages recoverable, which parties seek fees and costs, the amount of fees and costs sought on a per share basis, and a brief explanation of the basis for requesting fees. This will give individual class members accurate in-

formation and better allow them to assess the adequacy of the settlement. We believe plaintiffs need to know when they are presented with a settlement offer that leaves them with pennies on the dollar while providing a generous fee award to their attorneys.

Our bill also requires courts to tie awards of attorneys' fees to how much is recovered by investors. It eliminates damages awarded under the "lodestar" method, and requires awards to be based upon a percentage of the damages actually awarded as a result of the attorneys' efforts. No longer will plaintiffs' attorneys be able to request a fee award based upon the number of hours they billed or how many pages of briefs they filed.

To weed out frivolous complaints at the outset of litigation, Domenici-Dodd also requires plaintiffs to plead securities fraud with particularity by alleging specific facts which demonstrate the state of mind of each defendant at the time of the alleged fraud. The bill also requires plaintiffs to specify in their complaint all allegedly misleading statements which form the basis of the fraud claim and the reasons why the statements are misleading. This will provide a filter mechanism to screen out "kitchen sink" complaints filed with little or no research into their merits. This is not a novel concept: It merely codifies the approach taken by the Second and Seventh Circuit Courts of Appeals with respect to pleading in securities fraud cases.

In order to reduce the pressure to settle frivolous claims, our bill adopts the State law trend of proportionate liability. S. 240 creates a two-tiered system of liability, and courts will be required to issue a special verdict establishing the degree of responsibility of each defendant in securities fraud cases.

"Primary violators" and those who commit "knowing securities fraud" will always be held jointly and severally liable for their actions. All others who act with a lesser degree of culpability, namely those who act recklessly, will be held proportionately liable. These terms are explicitly defined in our bill to provide courts with some much-needed guidance in what has become a murky area of the securities law.

"Primary violators" are issuers and other market participants like underwriters, purchasers, sellers, and dealers who have breached a direct statutory or regulatory duty, had a principal role in the fraud, or intentionally assisted in the fraud. "Knowing securities fraud" means making a material statement or omission with actual knowledge that the statement is false and that the plaintiff is likely to rely on the statement or omission. Thus, if accountants or lawyers knowingly participate in a fraud, our bill will continue to hold them jointly and severally liable in the same manner as they are under the current system.

In cases where the "primary violator" is insolvent, and no other parties have committed "knowing securities fraud," our bill addresses the concern that small investors be fully compensated for their losses. If the court determines that all or part of a defendant's share is uncollectible, plaintiffs whose net worth is less than $200,000 who lost more than 10 percent of their net worth can recover the uncollectible amount from the remaining defendants. By establishing this system of proportionate liability, with special protection for the small investor, we hope to eliminate the pressure to settle on deep-pocket defendants who are only tangentially connected to the fraud.

S. 240 also encourages the use of Alternative Dispute Resolution (ADR). This will make it easier to pursue securities fraud cases without the necessity of slow and expensive Federal court proceedings. This benefits all parties. Under our bill, any litigant can request ADR. If the other party refuses to enter into ADR, loses at trial and a judge determines that the refusal to use ADR was not substantially justified, then the judge must assess attorneys' fees and costs against that party.

Unlike the House bill, which imposes fee-shifting in all cases found to be not substantially justified, our bill provides an incentive to enter into a less expensive and often more effective system of adjudication and shifts fees only after several factors have been established. Recognizing Senator Dodd's concern that the English Rule has a chilling effect on the willingness of small investors to bring these expensive class actions, our bill reaches a compromise. Of course, our bill makes it clear that fees may be shifted against the attorneys *on either side* who insisted on pursuing frivolous tactics. As an additional protection for small investors, in no event could any investor who owned less than $1 million in securities be liable for fee-shifting.

To better protect investors and encourage the dissemination of important financial information, the Domenici-Dodd Bill creates certain audit and financial disclosure requirements. Under our bill, auditors are required to establish procedures designed to detect fraud, and inform appropriate management upon the detection of fraud within a company. If an auditor approaches management to inform them of a fraud, and management and the board of directors refuse to act, our bill requires the auditor to notify the SEC and the Commission will take appropriate action. By limiting auditor liability for acts disclosed pursuant to this provision, our bill will allow audi-

tors to maintain their independence, and will facilitate the flow of important financial information to investors.

Our bill also directs the SEC to review its current safe harbor for predictive statements provision, Rule 175. As it currently works, the safe harbor discourages companies from making the types of predictive statements investors and analysts desire. Companies are simply afraid that if they make a prediction and it does not materialize, they will be sued. The SEC recently held hearings on the issue, and our bill directs them to complete their review process. However, our bill directs courts to stay discovery in predictive statement cases until after any summary judgment motions are decided. This will prevent parties from abusing the discovery process to drive up the cost of litigation.

Finally, our bill eliminates many of the egregious practices which have reduced confidence in our private enforcement system. It prohibits the payment of fees to brokers and dealers for referring clients to class-action lawyers. It also prohibits the payment of "pet plaintiff fees" to parties who buy a few shares of stock in various companies and stand ready to lend their name to the list of plaintiffs in exchange for $10,000 or $15,000. Everyone agrees that these practices are unfair, and have led to reduced awards to the class as a whole. They should be eliminated.

Mr. Chairman, I thank you for the opportunity to testify this morning. We currently have an excellent opportunity for a meaningful reform of our broken securities class-action system. I have been told that the House version of securities reform will go to the floor next week. I look forward to working with you, Senator Dodd, Senator D'Amato, and all of the Members of the Committee and hope that we can get a strong securities reform bill out of the Committee and to the floor of the Senate. Thank you.

PREPARED STATEMENT OF MARC E. LACKRITZ

PRESIDENT, SECURITIES INDUSTRY ASSOCIATION, WASHINGTON, DC

MARCH 2, 1995

Summary

- The SIA is firmly committed to effective enforcement of the Federal securities laws, both by the Securities and Exchange Commission and through private securities litigation. Today, however, private securities litigation lends itself too easily to abuse. A small group of entrepreneurial lawyers has created a lucrative industry out of the filing of meritless litigation and the extraction of settlements.
- The breakdown in our private securities litigation system is well-documented. In the 4 years from 1990 to 1993, roughly the same number of securities law class actions were filed as during the previous decade. One scholar has calculated the aggregate damages sought in the 723 securities law class actions pending at the end of 1993 was $28.9 *billion*. The growth in the number and magnitude of these cases illustrates the incentives to litigate, not the incidence of securities fraud.
- The filing, litigation, and settlement of meritless securities fraud cases imposes a "litigation tax" on capital formation that must ultimately be paid by the investing public. This "tax" weakens the U.S. economy by forcing the transfer of capital that otherwise would be available to create new products, expand plants, or hire more workers into the pockets of a small group of trial lawyers.
- To correct these problems, the civil litigation system should discourage the filing of nuisance or "strike" suits. When meritless cases do make it into court, the system should afford defendants the opportunity to bring them to a quick end. In cases that do have merit, liability should be imposed only upon those who intentionally violated the law.
- In our view, securities litigation reform legislation should accomplish six goals:

  Refocus securities class actions on investor protection instead of lawyer enrichment. The law should not hold out the promise of excessive rewards at low risk for attorneys, experts, or others with a professional interest in initiating and prolonging the litigation process.

  Curb "lottery ticket" litigation. One way of better balancing the scales would be to require the loser, or the losing party's attorneys, to pay the prevailing party's attorneys' fees. Another step which deserves consideration is limiting the availability of the fraud-on-the-market theory.

  Impose liability on real wrong-doers, not deep-pocketed innocent bystanders. Limiting liability in private actions for money damages to persons who have engaged in intentional wrong-doing would help accomplish this goal. Another measure which would be useful in facilitating the appropriate allo-

cation of damages would be to clarify the enforceability of agreements to provide indemnification or to share liability according to a formula. On the other hand, the reinstatement of aiding and abetting liability is unnecessary and would be counterproductive.

Protect and promote the dissemination of forward-looking information. The SIA supports a statutory safe harbor for forward-looking disclosure applicable to any person, including issuers, analysts, investment advisers, and other security professionals.

Discourage meritless lawsuits from being filed and require those which are brought to be filed promptly and resolved without needless litigation costs. The SIA supports strengthened requirements for explicit pleading and proof and procedures for the rapid dismissal of unsubstantiated cases before discovery costs are incurred. Another way of reducing the burdens of the litigation process is to require that cases be promptly brought, while evidence is easily available and memories are fresh. The Supreme Court's ruling in the *Lampf* case that implied Rule 10(b)(5) claims must be brought within the same limitations period that Congress specified for the express causes of action under the Securities Exchange Act strikes the right balance and should not be disturbed.

Create parity between the protections available under the various Federal securities statutes. Reforms should apply equally to all of the Federal securities laws in order that the plaintiffs' bar will not simply shift its attentions to other provisions as the standards for Rule 10(b)(5) recovery become more balanced.

* * *

I. Introduction

Mr. Chairman, Members of the Subcommittee: The Securities Industry Association ("SIA")[1] appreciates this opportunity to present its views concerning the important topic of securities litigation reform. I am Marc E. Lackritz, President of the SIA. Because of the unique role that the members of the SIA play in the capital formation process and in the operations of our Nation's secondary trading markets, we have a fundamental interest in the Federal securities laws. It is, therefore, both a pleasure and privilege for me to appear here today to discuss with you the need to reform the private liability system under those laws.[2]

Because of the importance of public confidence in the capital formation process, the SIA is firmly committed to effective enforcement of the Federal securities laws, both by the Securities and Exchange Commission ("Commission") and through private securities litigation. Today, however, the securities laws lend themselves too easily to abuse. A small group of entrepreneurial lawyers have created a lucrative industry out of the filing of litigation and the extraction of settlements, often based on nothing more than a sudden movement in share prices.[3] Litigation of this sort serves primarily to enrich counsel, rather than to redress investor injury.[4]

Not surprisingly, the coterie of plaintiffs' trial lawyers who enjoy the rewards of this abusive process insist that the system is functioning just as it should. But the facts belie this self-serving assertion:

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[1] The SIA is the trade association representing the business interests of about 800 securities firms in North America, which collectively account for about 90 percent of securities firm revenue in the United States. SIA member firms are active in all phases of corporate and public finance, serving individual and institutional investors, corporations, and Government entities.

[2] The SIA has previously testified concerning this issue on several recent occasions. *See* Statement of the Securities Industry Association Concerning the Securities Litigation Reform Act Before the Telecommunications and Finance Subcommittee of the House Committee on Commerce (February 10, 1995); Statement of Marc E. Lackritz, President, Securities Industry Association, Submitted to the Subcommittee on Telecommunications and Finance, Energy and Commerce Committee, U.S. House of Representatives (August, 1994); and Statement of Marc E. Lackritz, President, SIA, Before the Subcommittee on Securities, Committee on Banking, Housing, and Urban Affairs, U.S. Senate (July 21, 1993).

[3] *See In re Philip Morris Securities Litigation*, 1995 U.S. Dist. LEXIS 92 (S.D.N.Y. January 6, 1995) (within 2 days of an announcement by Philip Morris that it was reducing the price of Marlboros by 40 cents per pack causing its price per share to lose nearly 25 percent of its market value in one business day, 10 lawsuits were filed involving 34 law firms). *See also* Dunbar and Juneja, *Making Securities Class Actions More Responsive to the Modern Shareholder*, Chapter 7 of Securities Class Actions: Abuses and Remedies (1994) (arguing that the existing incentives for plaintiff attorneys result in unwarranted lawsuits in response merely to sudden drops in stock prices).

[4] *See, e.g.*, Vincent O'Brien, "The Class Action Shakedown Racket," *The Wall Street Journal*, September 10, 1991.

—In the 4 years from 1990 to 1993, the number of securities law class actions filed (1,180) was roughly the same as the total number of filings during the previous 10 years (1,198). During the same period, the total number of civil cases brought under the securities laws substantially declined.[5] Class actions are clearly mushrooming, while actual instances of securities fraud apparently are not.

—From 1985 to 1994, approximately 650 Rule 10(b)(5) lawsuits alleging fraud-on-the-market were settled. During that same time period, approximately 185 such lawsuits were dismissed. The trendline is startling: In 1985, approximately 25 such suits were settled; in 1994 the figure was over 100.[6] The fraud-on-the-market theory affords the best vehicle for alleging the sort of astronomical damages most likely to coerce a settlement. Professor Joseph Grundfest, a former Commissioner of the SEC, has calculated that the 723 securities law class actions pending at the end of 1993 sought approximately $28.9 *billion* in damages.[7]

—At bottom, these suits reflect little in the way of investor recovery and much in terms of wealth transfer out of the productive capital base of corporations and into the coffers of law firms.[8] The Senate Banking Committee has already received testimony that, while plaintiffs receive only an average of 14 cents for every dollar of damages, their attorneys take away 39 percent of the settlement.[9] Other studies suggest even lower investor recovery.[10] Yet, in 1 year alone, the lawyers who specialize in bringing this litigation reaped over $250 million.[11]

—The impact of abusive securities litigation is felt disproportionately by emerging technology and other entrepreneurial companies—exactly the firms on which our economy is most dependent for creating jobs and maintaining our competitive position in the world economy. According to National Research Associates, Inc., almost one-third of the settlements in securities fraud litigation involve high-tech companies;[12] a survey by the National Venture Capital Association found that 62 percent of survey respondents that went public in 1986 had been sued by 1993.[13]

In short, the breakdown in our private securities litigation system is real and well-documented, despite protests to the contrary by those who are profiting. As SEC Chairman Arthur Levitt recently said: ". . . [T]here is no denying that there are real problems in the current system—*problems* that need to be addressed not just because of abstract rights and responsibilities, but because investors and markets are being *hurt* by litigation excesses."[14]

The SIA's members and—more importantly—its members' customers and clients are among those adversely affected by meritless securities litigation. Accordingly, as the SIA has previously testified before this Subcommittee,[15] we believe it is essential that Congress take action to restore balance to the securities litigation system.

II. The Role of the Securities Markets

The services the securities industry performs—raising capital, managing risk, offering investment advice, providing and making liquid markets—are essential for the U.S. economy to grow and function efficiently. In the first 3 years of the 1990's, the securities industry raised $4.4 trillion for business and Government—more capital than was raised during the first two centuries of America's history. These levels

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[5] Source: Administrative Office of the United States Courts.

[6] K. Donovan, "GOP Threatens Securities Suits," *The National Law Journal*, February 13, 1995, at 1, 23.

[7] Grundfest, *Why Disimply?*, 108 Harv. L. Rev. 727 (forthcoming 1995).

[8] *The New York Times* has discussed this phenomena in an article by Kurt Eichenwald aptly titled "Millions For Us, Pennies For You." (December 19, 1993).

[9] *Private Litigation Under the Federal Securities Laws: Hearings Before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs*, 103rd Congress, 1st Session at 708 (Testimony of Edward McCracken) [hereinafter *Senate Hearings*].

[10] *See, e.g.*, O'Brien and Hodges, *A Study of Class Action Securities Fraud Cases* (1993); Dunbar and Juneja, *Recent Trends II: What Explains Settlements in Shareholder Class Actions*, National Economic Associates, Inc. (1993).

[11] *Senate Hearings* at 708.

[12] Dunbar and Juneja, *supra* note 10.

[13] National Venture Capital Association and America Entrepreneurs for Economic Growth, *The Impact of Securities Fraud Suits on Entrepreneurial Companies* (January, 1994).

[14] Levitt, "Between *Caveat Emptor* and *Caveat Vendor*: The Middle Ground of Litigation Reform," Remarks at the 22nd Annual Securities Regulation Institute, San Diego, California (January 25, 1995) at 2 (Emphasis in original).

[15] *See* note 2, *supra; see also* Statement of Stuart J. Kaswell, Senior Vice President and General Counsel, SIA, Before the Subcommittee on Securities, Committee on Banking, Housing, and Urban Affairs, U.S. Senate (May 12, 1994).

of capital formation are only possible because of the existence of strong, efficient secondary markets that afford liquidity to both individual and institutional investors, including mutual funds, retirement and pension plans, and insurance products.

In 1993 alone, the sale and distribution of securities for U.S. business and Federal, State, and local governments totaled over $2.5 trillion. These funds are used to conduct research, expand manufacturing capacity, and build infrastructure, thereby creating and maintaining jobs and fueling the economy. In fact, young, medium-sized high-technology firms, which are the greatest source of new-job creation in the U.S. economy, are often heavily dependent on the raising of capital to grow and prosper.

III. The Litigation Tax

Private remedies for fraud help to bolster investor confidence in our markets. However, not all alleged claims are meritorious, and the need to defend unfounded litigation imposes costs and burdens on issuers, underwriters, accountants, and other participants in the securities markets. In economic terms, meritless litigation results in an unproductive wealth transfer from entrepreneurs to professional plaintiffs and their lawyers.

Litigation costs take a variety of forms—some obvious, others less so. Securities industry fees and charges must increase to cover litigation expenses. In addition, the cost of capital rises, reducing its supply—especially for small and start-up entities and other businesses that expose their professional advisers to a disproportionate risk of litigation. Increasingly, securities market participants look for opportunities to conduct their activities off-shore and out of the reach of the United States judicial system.

There are also hidden costs in the form of lost opportunities. New or innovative ventures are foregone because of the litigation risks involved in capital formation. Some businesses may locate abroad, rather than in the United States. There is, of course, no good way to count the number of securities offerings not made or of business enterprises not formed. However, an article appeared last Spring in the *Financial Times* that illustrates the problem. That article reported that investment bankers had advised a high-tech company considering whether to go public to "write $2 million off to pay the lawyers to go away." Armed with this advice, the company decided against entering the capital markets.[16] The SIA's members tell me that this is not an isolated example.

Defense costs, settlements, and judgments, although paid in the first instance by the issuers, underwriters, accountants, and others named as defendants in securities fraud class actions, are naturally passed on to shareholders when corporate earnings are reduced and underwriting and accounting fees are raised. Similarly, as insurance payouts increase, so do premiums, the cost of which is borne by shareholders.[17] In short, the filing, prosecution, and settlement of meritless Rule 10(b)(5) class actions imposes a "litigation tax" on capital formation that ultimately injures the investing public and weakens the U.S. economy by draining funds that otherwise would be used to produce new products, expand plants, or hire more workers.

The pendency of Rule 10(b)(5) litigation also diverts corporate officers and other employees from their ordinary duties.[18] Unfounded lawsuits result in diminished opportunities for small investors, as corporations shy away from selling securities to the public.[19] In addition, public companies find it increasingly difficult to attract and retain experienced independent directors, resulting in a decrease in the quality of corporate guidance.[20] Those who remain willing to serve may find their decision-

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[16] Haverson, "Lawsuits Make U.S. Groups Publicity Shy," *Financial Times*, May 27, 1994.

[17] Since the mid-1980's, premiums for D&O coverage have risen approximately seven-fold. *See* Phillip N. Norton, "1992 D&O Liability Survey Summary" (Wyatt Co. 1993).

[18] "The very pendency of the lawsuit may frustrate or delay normal business activity of the defendant which is totally unrelated to the lawsuit." *Blue Chip Stamps, supra*, 421 U.S. at 740.

[19] Judge Kozinski eloquently stated the issue as follows: "[F]ear of this type of scorched earth litigation—the juridical equivalent of the firebombing of Dresden—will only discourage people like the sellers from entering into such transactions. That the plaintiffs were able to inflict major financial damage on their adversaries, using as their launch vehicle a case so thin it was never allowed to reach the jury, will surely send a chill down the spine of anyone contemplating selling securities." *Layman* v. *Combs*, 981 F.2d 1093, 1107 (9th Cir. 1992) (Kozinski, J., dissenting with respect to majority's refusal to award attorneys' fees under an indemnification clause contained in a private placement memorandum) [Footnote omitted].

[20] According to a 1993 Harris poll, some 507 of the outside directors of America's largest companies have been sued in connection with their board service; fewer than half of the directors and CEO's surveyed were "very confident" that the courts would exonerate them even if they did nothing wrong; and an overwhelming majority considered the phenomenon of qualified directors refusing to serve on board to be a problem. *See* "Outside Directors and the Risks They Face," at 53–55, 66 (Louis Harris & Associates 1993).

making impacted by the ever-present threat of litigation.[21] Finally, the ease with which Rule 10(b)(5) class actions can be filed and prosecuted raises the cost of even the most careful disclosure and thus discourages corporate managers from revealing any information not strictly mandated by law.

IV. The Need to Restore Balance to The Securities Law Private Liability System

In my view, the civil litigation system should discourage—not encourage—the filing of nuisance or "strike" suits. When meritless cases do make it into court, the system should afford defendants the opportunity to bring them to a quick end. Correspondingly, the law should not hold out the promise of excessive rewards at low risk for attorneys, experts, or others with a professional interest in maintaining and prolonging the litigation process. Finally, when cases do have merit, liability should be imposed only upon those who intentionally violated the law or on those who could and should have prevented violations by others.

Judged by these criteria, the existing securities law private civil liability system has serious flaws. At present, the system overwhelmingly benefits attorneys and "professional" plaintiffs, while imposing disproportionate and dysfunctional burdens on issuers of securities, corporate managers, underwriters, accountants and others, all to the detriment of the investing public and the economy. Moreover, in our view, these suits are often brought merely and solely to coerce a settlement.

During the past 15 years, a small group of aggressive and innovative lawyers specializing in securities litigation have perfected the marriage of the Rule 10(b)(5) implied action and the plaintiffs' class action. The Administrative Office of the U.S. Courts reports that the number of securities fraud class actions filed in the Federal courts (most of them alleging violations of Rule 10(b)(5) more than tripled between 1980 and 1990. Recoveries in Rule 10(b)(5) class actions offer substantial rewards to the attorneys for the plaintiff class. Further, the filing of such a case often places severe economic pressures to settle on those who find themselves named as defendants. These two factors combined mean that securities class actions are filed, prosecuted, and settled in a manner that often bears no direct relationship to whether fraud could be proven at trial and sustained on appeal.

An empirical study of shareholder class actions filed in the early 1980's found that every company with a market loss of at least $20 million was sued.[22] Securities fraud class actions are typically filed within days—sometimes hours—of any announcement which produces a sharp decline in the market price of a public company's stock.[23] Indeed, the pressure to file rapidly is such that it has been reported that complaints in these suits sometimes are merely pre-drafted forms into which the appropriate names and dates are inserted and then printed with modern word-processing equipment.[24] The law firm that files first is most likely to be named lead class counsel and thereby to receive the lion's share of the attorneys' fees awarded at the conclusion of the litigation.[25]

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[21] No matter how cautious corporate officers and directors are when structuring a transaction, litigation may be unavoidable. For example, a 1991 merger agreement between Borland International, Inc. and Ashton-Tate Corp. provoked two contradictory class actions, one alleging that the price paid was too high, the other claiming that it was too low. *See Securities Class Action Alert*, September 1991, at 62.

[22] Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497, 511–13 (1991). *See also* Note, *Using Rule 9(b) to Reduce Nuisance Securities Litigation*, 99 Yale L.J. 1591, 1594 (1990) (hereinafter *"Using Rule 9(b)"*).

[23] *See, e.g., In re Oracle Securities Litigation*, 131 F.R.D. 688 (N.D. Cal. 1990) (18 separate complaints were filed within 2 weeks after Oracle announced disappointing earnings and suffered a 31 percent drop in its stock price).

[24] *See In re Philip Morris Securities Litigation*, 1995 U.S. Dist. LEXIS 92 (S.D.N.Y. January 6, 1995) (Judge Owen, writing an opinion dismissing plaintiffs' consolidated amended class-action complaint, noted that "in the few hours counsel devoted to getting the initial complaints to the courthouse, overlooked was the fact that two of them contained identical allegations, apparently lodged in counsel's computer memory of "fraud" form complaints. . . ."). These allegations described Philip Morris as a toy company, rather than as a cigarette manufacturer.

[25] In testimony last year before this Subcommittee, William S. Lerach, a prominent securities fraud plaintiffs' attorney, conceded frankly, "We are very competitive. We want to control the case. We believe we can do the best job and we want to be the first to file so that we can control the case. . . . [T]he courts historically have rewarded the first filed case with control of the case as lead counsel. That's something the courts have done. We are reacting to that." *See* Staff Report Prepared at the Direction of Senator Christopher J. Dodd, Chairman, Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, United States Senate, May 17, 1994, at 24.

Once a class has been certified, defendants face powerful pressures to settle.[26] For one thing, it is far cheaper for a plaintiff to prosecute a securities class action than it is for a defendant to resist it. This "litigation differential," which "exists independently of the merits of the plaintiff's claim," is particularly marked in Rule 10(b)(5) cases, where massive one-way discovery and extensive motion practice is the rule.[27] In a Rule 10(b)(5) class action, if the case survives a motion to dismiss, the defendants may conclude that the economics of the litigation process leave them little choice but to settle.[28] As the Supreme Court itself has acknowledged, "litigation under Rule 10(b)(5) presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."[29]

V. The Elements of Securities Litigation Reform

While some would still like to debate the issue, we believe that the prevalence and consequences of abusive securities litigation are well-documented. The tougher question is how to address these problems without impairing legitimate investor recovery for intentional fraud. In order to effectively restore balance and fairness to the litigation process, reform legislation should accomplish six goals:

- Refocus securities class actions on investor protection instead of lawyer enrichment;
- Curb "lottery ticket" litigation;
- Impose liability on real wrong-doers, not deep-pocketed innocent bystanders;
- Protect and promote the dissemination of forward-looking information;
- Discourage meritless lawsuits from being filed and require those which are brought to be filed promptly and resolved without needless litigation costs; and
- Create parity between the protections available under the various Federal securities statutes.

Several of the pending bills now under consideration in the Congress contain elements of one or more of these measures. I want to briefly describe why each of these goals is important and how each could be accomplished.

A. Refocus Securities Class Actions on Investor Protection Instead of Lawyer Enrichment

First, the class action should be refocused on redressing real injury, rather than providing a small cadre of lawyers and professional plaintiffs with a license to appropriate wealth from the shareholders of public companies. As I have already discussed, today it is commonplace for multiple class actions to be filed immediately after a significant share price movement; astronomical damages to be alleged; and a settlement to be extracted, the lion's share of which ends up in the pockets of the plaintiff class' lawyer.

Professional Plaintiffs

One way of addressing this problem is to restore lawyers and clients to their traditional roles by making it harder for lawyers to invent a suit and then attach a

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[26] As the Supreme Court has explained, "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." *Coopers & Lybrand* v. *Livesay*, 437 U.S. 463, 476 (1978). In addition, the securities laws have been construed to prohibit defendants from enforcing indemnity contracts after an adjudication of liability under Rule 10(b)(5); thus, many defendants prefer to settle—with no admission of liability—in order to preserve the ability to use insurance (or the indemnity clauses in their underwriting agreements) to defray all or part of the settlement. *See* John C. Coffee, *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 Column. L. Rev. 669, 716–16 (1986). As a result of these factors, 96 percent of securities fraud class actions settle out of court, compared to a significantly lower percentage of other civil cases. *See* Vincent J. O'Brien, *supra* note 4.

[27] *Using Rule 9(b), supra* note 22, at 1596–97. A recent Ninth Circuit case provides a good illustration of this point. In *Layman* v. *Combs, supra,* plaintiffs sued numerous defendants under Rule 10(b)(5) and other theories for their losses resulting from investments in a horse breeding operation. Defendants obtained summary judgment on most claims, a directed verdict on others, and were completely exonerated as to all remaining claims by the jury. Defendants' victory, however, was no bargain. As Judge Kozinski explained (dissenting from the majority's rejection of seven defendants' counterclaims for legal fees), "This litigation—although it resulted in a complete defense victory, mostly on summary judgment—devoured a staggering quantity of productive resources. . . . The attorneys' fees, for the seven defendants who requested them, amounted to more than $3.5 million. This says nothing of the fees incurred by the 13 plaintiffs and the 14 defendants who didn't request reimbursement." 981 F.2d at 1107.

[28] From 1985 to 1994, approximately 650 suits Rule 10(b)(5) lawsuits alleging fraud-on-the-market were settled. During that same time period, approximately 185 lawsuits were dismissed. *See* K. Donovan, *supra* note 6.

[29] *Blue Chip Stamps, supra,* 421 U.S. at 739.

plaintiff as is now common. Prohibiting market participants from receiving referral fees from entrepreneurial lawyers looking for potential class-action plaintiffs would help to accomplish this goal. Similarly, limiting the number of times a person may serve as a named plaintiff in a class action would restrain the "professional plaintiff" phenomenon. In the same vein, investment thresholds for eligibility to serve as a named plaintiff would serve to ensure that the plaintiff has a real economic stake in the company and a real interest in considering whether inflicting the costs of litigation on the company is warranted under the circumstances.

Steering Committees

On the other hand, the SIA has great reservations about measures that would seek to curb plaintiffs' lawyers by injecting some new body, such as a "steering committee" or "guardian" into the litigation of class actions. Adding another entity with which the parties must interact in the class-action process would be counterproductive, since it would be costly and could contribute to delays. Moreover, rather than encouraging lawyers to find more productive uses for their time, this approach is likely to simply create a new legal specialty—class-action guardian or steering committee counsel—which will, of course, ultimately have to be paid for by the parties, including the public companies (and thus their shareholders) involved in litigation.

B. CURB LOTTERY TICKET LITIGATION

Second, the attraction in filing securities litigation based merely on large share price movements in the hopes of extracting a settlement must be curtailed. At present, filing a securities class action is too often a kind of heads-I-win, tails-you-lose proposition. Because of the "litigation differential" I mentioned earlier, the plaintiff's counsel has the opportunity to participate in a lucrative recovery, but not much down-side if the suit does not pan-out.

Attorneys' Fees

One way of better balancing the scales would be to require the loser—or perhaps the losing party's attorneys—to pay the prevailing party's attorneys' fees in securities litigation. This concept—which has long been the law in England and in many other jurisdictions—should serve as a significant deterrent to the filing of suits that have little chance of succeeding. By the same token, where the plaintiff has a meritorious case, this provision would protect the plaintiff from having to bear the legal costs of vindicating his or her rights.

But such a rule needs to be carefully drafted so that it does not turn into a "one-way" street—that is, applied routinely against losing defendants but rarely against losing plaintiffs. Further, an effective rule should provide for lawyers to be liable along with their clients for these costs. As a practical matter, it is the lawyer rather than the client who is best able to assess whether a case has merit. The SIA also believes that in certain cases, such as when there are reasonable grounds to believe that a party will not be able (or willing) to pay an attorneys' fee award that might be entered against him or her, it is appropriate to require that security be posted with the court.

Fraud-on-the-Market Theory

Another step which deserves consideration is limiting or abolishing the fraud-on-the-market theory. This doctrine has become the vehicle of choice for class actions alleging violations of Rule 10(b)(5).

The courts have long recognized that, to recover for securities fraud, the plaintiff must be able to show that he or she actually relied on a fraudulent statement or omission for which the defendant is responsible. However, in *Basic* v. *Levinson*, the Supreme Court substantially eliminated this requirement by holding that, in the case of a widely-traded security, the dissemination of allegedly false information to the trading markets necessarily affects the price of the security in question and therefore permits every person who subsequently trades in the security to assert that he or she "relied" on the allegedly false information even if it never actually came to the plaintiff's attention.[30] This concept has opened the door to class actions in which attorneys are able to allege damages on behalf of large classes of persons.

The fraud-on-the-market theory needs to be revised so that it focuses on meritorious cases in which false information, intentionally disseminated, has injured the investing public. Today, it is too often merely a lever to coerce a settlement by translating an amorphous fraud allegation into an astronomical damage claim. While the theory may have a proper place in the securities laws, it needs to be substantially pared back.

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[30] 485 U.S. 224, 250 (1988).

C. IMPOSE LIABILITY ON REAL WRONG-DOERS, NOT DEEP-POCKETED INNOCENT BYSTANDERS

Third, the SIA believes that care needs to be taken to ensure that the law does not encourage litigation against accountants, underwriters, attorneys, and other professionals where these persons have had only a limited or tangential connection to the alleged fraud, but are the most likely to settle in order to avoid the time and expense of litigation. The present system encourages plaintiffs to settle with those defendants who are more culpable but less apt to have money at the expense of those defendants who are less culpable but are thought to have "deep pockets." The SIA believes that, ultimately, investors and the national economy suffer from this practice. As discussed above, smaller companies, and particularly those engaged in the high-technology field, are likely to find it difficult and unduly costly to obtain professional assistance.

Scienter

One way to address this problem is to limit liability in private actions for money damages to persons who have engaged in intentional wrong-doing. While the Supreme Court has held that the plaintiff must show that the defendant acted with "scienter"—the intent to deceive or defraud[31]—many lower courts have interpreted this to encompass conduct which is not intentional, but merely reckless.[32] Because of the vagueness of this standard and the difficulty in applying it to specific situations, plaintiffs are typically able to survive a motion for summary judgment and force the defendant to agree to a substantial settlement even where it is clear that the defendant was not aware of some other party's false statements and did not intend to cause injury.

Aiding and Abetting

In one regard, the Supreme Court has already taken a major step in this area. In *Central Bank of Denver, N.A.* v. *First Interstate Bank,*[33] the Court held that there is no implied right of action against "aiders and abettors" under Section 10(b) of the Securities and Exchange Act of 1934 ("Exchange Act") and Rule 10(b)(5). The SIA participated as amicus curiae in *Central Bank of Denver* and believes, as we have previously testified before this Subcommittee,[34] that the Supreme Court made the right decision, both because it correctly interpreted Section 10(b) and because limiting secondary liability represents the best public policy.

Aiding and abetting liability should not be re-instated. Section 10(b) already provides liability for persons who "directly or indirectly" commit a violation. This language reaches the conduct of those who truly play a culpable role in securities law violations. Further, Section 20(b) of the Exchange Act prohibits persons from violating the law indirectly, through the conduct of others. Thus, the Exchange Act already imposes clear liability on real wrong-doers. Congress should let the courts consider, as they already are, what type of conduct justifies charging a professional as a "direct or indirect" primary violator.[35]

Indemnification

Another measure which would be useful in facilitating the appropriate allocation of damages would be to clarify the enforceability of agreements to provide indemnification, or to share liability according to a formula, in the event that the parties

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[31] *See Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976).

[32] *See e.g., Rolf* v. *Blyth, Eastman Dillion & Co., Inc.,* 570 F.2d 38, 46 (2d Cir.), *cert. denied,* 439 U.S. 1039 (1978); *IIT, International Investment Trust* v. *Cornfield,* 619 F.2d 909, 923 (2d Cir. 1980); *Sirota* v. *Solitron Devices, Inc.,* 673 F.2d 566, 575 (2d Cir. 1982), *cert. denied,* 459 U.S. 838 (1982); *Oleck* v. *Fischer,* 623 F.2d 791, 794 (2d Cir. 1980); *CL-Alexanders Laing & Cruickshank* v. *Goldfield,* 739 F.Supp. 158, 163 (S.D.N.Y. 1990); *Estate of Detwiler* v. *Offenbecher,* 728 F.Supp. 103, 137 (S.D.N.Y. 1989).

[33] 114 S. Ct. 1439 (1994).

[34] *See* Statement of Stuart J. Kaswell, *supra,* note 15.

[35] Since *Central Bank,* the lower courts have held that, in appropriate cases, primary liability under Rule 10(b)(5) still exists for outside advisers, such as accountants, who played a culpable role in a public company's commission of fraud.

Further, we do not believe that the Commission's enforcement program has been undermined by *Central Bank.* The Commission's enforcement staff has announced that the great majority of aiding and abetting cases have simply been re-pled as cases involving "direct or indirect" primary violations. Further, the Commission's General Counsel has concluded that the decision does not even apply to the agency's enforcement program. *See* 49 Bus. Law. 1467 (1994). The Commission itself is now arguing in a case pending in the Ninth Circuit that it can bring aiding and abetting cases notwithstanding *Central Bank.* Finally, in 1991, Congress gave the Commission broad authority to bring cease-and-desist proceedings against persons who "cause" violations of the securities laws. This authority gives the Commission broad authority to take action against secondary participants in securities law actions.

to the agreement are held liable under the securities laws. Agreements of this nature permit parties to allocate costs and to more reliably assess the risk of entering into a given transaction. Some court decisions have suggested that such agreements are not enforceable under the Federal securities laws.

D. PROTECT AND PROMOTE THE DISSEMINATION OF FORWARD-LOOKING INFORMATION

Fourth, the SIA believes that the threat of litigation has chilled disclosure by issuers and other market participants to the detriment of the market. We support a statutory safe harbor for forward-looking disclosure applicable to any person, including issuers, analysts, investment advisers, and other security professionals. In order to function efficiently, the markets depend on informed analysis concerning the future prospects of public companies, both from the company itself and the analyst community.

Commentators have recognized that the existing rules in this area are inadequate and that, as a result, companies are often reluctant to make statements which could be construed as predictive or forward-looking, regardless of how carefully or clearly the basis for and limitations on these statements are explained.[36] Since forward-looking disclosure can be of great value to investors in assessing a security's value, imposing stringent liability on good faith predictions which prove to be inaccurate is not in the best interests of investors. The Commission itself has recognized this fact and has recently published a concept release inviting comment on a variety of ways in which a more workable safe harbor could be created and convened a public hearing.[37]

E. REQUIRE CASES TO BE BROUGHT AND DISPOSED OF PROMPTLY AND WITHOUT NEEDLESS LITIGATION COSTS

Fifth, attention should be given to the costs and burdens of marshalling the evidence necessary to defend securities litigation.

Early Dismissal of Meritless Cases

Much of the fuel for meritless litigation is the coercive and costly nature of the pre-trial discovery process. In order to extinguish this fire, the SIA supports strengthened requirements for explicit pleading and proof and procedures that would provide for the stay of discovery pending a motion to dismiss. Similarly, mechanisms for limited discovery, targeted only at establishing whether a safe harbor is available, would make such a safe harbor meaningful and contain costs in cases where that issue is likely to be dispositive.

Limitations Periods

Another important way of reducing the burden of the litigation process is to require that cases be brought promptly, while evidence is easily available and memories are fresh. Like the question of aiding and abetting, this is an issue which the Supreme Court has recently addressed. In *Lampf, Pleva, Lipkind, Prupis & Petigrow* v. *Gilbertson*,[38] the Court held that the statute of limitations that Congress has specified for the express cause of action created in Section 9 of the Exchange Act (1 year after discovery, but not more than 3 years after occurrence) also governs implied Rule 10(b)(5) claims. This ruling strikes the right balance between providing an injured party with ample opportunity to bring a Rule 10(b)(5) claim and relieving issuers, underwriters, and other market participants involved in the capital formation process of the uncertainty associated with the risk that long-completed transactions may belatedly become the subject of litigation.

The need for a carefully limited period of repose is particularly acute in the arena of large-scale securities fraud litigation. As discussed above, Rule 10(b)(5) claims, even those of dubious merit, impose tremendous burdens on those accused of violations. A firm forced to defend itself against a stale Rule 10(b)(5) claim faces even greater disruption to its normal business activities, in that it must search for long-unused documents, contact employees who have retired or left for other positions, and attempt to reconstruct events that may be all but unknown to those currently managing the corporation.

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[36] *See, e.g.*, Staff of the Senate Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, *Report on Private Securities Litigation* (1994).

[37] Securities Act Release No. 7101, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶85,436 (October 13, 1994).

[38] 111 S. Ct. 2773 (1991).

As Congress recognized when it adopted the 1-year/3-year limitations period,[39] an unduly long statute of limitations would offer securities fraud plaintiffs unique opportunities to "play-the-market" by waiting to see how the price of the security involved behaves over a prolonged period. Moreover, since information travels even more quickly now than it did in 1934, plaintiffs may, in substance, have more time to bring suit than they had in 1934.

For these reasons, the congressional judgment that a 1-year/3-year period of repose should be applicable to the express private remedy provisions is fully appropriate in Rule 10(b)(5) actions. Any other construction would lead to the anomalous result that the statute of repose for a judicially-created implied right of action would be longer than those rights of action expressly created by Congress. One year is more than enough time for a plaintiff exercising ordinary diligence to file a Rule 10(b)(5) action.[40] Indeed, as noted above, many securities fraud class actions are now filed within days—even hours—of the event that allegedly permitted the named plaintiff to discover the fraud.[41] The SIA is confident that a 12-month period affords ample opportunity to investigate, draft, and file a complaint. In addition, the SIA believes that, in our contemporary information-based society, the 3-year repose period is more than sufficient for a cause of action to be brought to light after its occurrence.

F. Create Parity Between the Protections Available Under the Various Federal Securities Statutes

Finally, in enacting changes to the liability provisions of the securities laws, Congress should be mindful of not inadvertently creating new incentives for abusive litigation. While Section 10(b) of the Exchange Act and Rule 10(b)(5) thereunder are currently the primary vehicle for private securities litigation, the other Federal secu- rities laws also contain liability provisions. Reforms should apply equally to all of the Federal securities laws in order that the plaintiff's bar will not simply shift its attentions to other provisions as the standards for Rule 10(b)(5) recovery become more balanced.

VI. Conclusion

Efficient and effective recovery for losses caused by securities fraud is an important factor in maintaining public confidence in our capital markets. At present, however, the civil litigation system under which private securities cases are maintained imposes unnecessary costs and benefits a small group of plaintiffs' lawyers. These costs are borne by the economy as a whole and therefore by every citizen of our country. Accordingly, reform of private securities litigation should be a top congressional priority.

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[39] When Congress enacted the Securities Act, it established 2-year/10-year limitations period. Just 1 year later, in 1934, it enacted the current 1-year/3-year rule. As one Senator noted at the time: "[I]f a man buys something today and discovers tomorrow that some mistake has been made and perhaps he has ground for suit because of fraud, under the terms of the bill he must bring suit within 1 year. But suppose he thinks, 'Perhaps the bonds I have bought will go up. I will not bring suit until I find out about that. If the bonds go down then I will have the option of suing these people and trying to recover. If the bonds go up, then I will not sue because I can get a profit on them.'" 78 Cong. Rec. 8199 (May 7, 1934) (Statement of Senator Kean), reprinted in *Federal Securities Laws, Legislative History*, Vol I, at 1009.

[40] *See, e.g., Dodds* v. *Cigna Sec., Inc.*, 12 F.3d 346, 350 (2d Cir. 1993), *cert. denied*, 114 S. Ct. 1401 (1994) (holding that "discovery" includes "constructive and inquiry notice as well as actual notice," and explaining that a plaintiff "will be deemed to have discovered fraud for purposes of triggering the statute of limitations when a reasonable investor of ordinary intelligence would have discovered the existence of the fraud.").

[41] *See, e.g.*, note 3, *supra*.

PREPARED STATEMENT OF J. CARTER BEESE, JR.

CHAIRMAN, CAPITAL MARKETS REGULATORY REFORM PROJECT

CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, WASHINGTON, DC

MARCH 2, 1995

Mr. Chairman, Senator Dodd, Members of the Committee. I am delighted to have the opportunity to appear once again before the Subcommittee on Securities. This is my first appearance since leaving the Securities and Exchange Commission in November to rejoin Alex. Brown & Sons as Vice Chairman of the firm's international subsidiary. This also is my first appearance testifying as Chairman of the recently formed Capital Markets Regulatory Reform Project sponsored by the Center for Strategic and International Studies.[1] Accompanying me is Bradley Belt, Executive Director of the Project and a former counsel to this Subcommittee.

Mr. Chairman, from my vantage point on the Commission, I became concerned that the costs of regulation, and the costs of litigation, were placing an unnecessary drag on the competitiveness of U.S. companies and U.S. capital markets, and imposing needless costs on consumers. It is for this reason that I became a Senior Adviser at CSIS and agreed to chair the Capital Markets Regulatory Reform Project.

The goal of this project is to step back and undertake a complete rethinking of the ways that markets are regulated. With the assistance of an advisory board comprised of leading business and finance executives and members of the legal and academic communities, the CSIS Capital Markets Regulatory Reform Project will be reviewing all aspects of the capital-raising process with a view toward identifying needless or inefficient impediments to capital formation.

Finding the optimum regulatory cost of capital is a delicate balance. Investors rightly demand certain basic protections before they commit their savings to a particular market. Lacking a regulatory and legal structure that promotes liquidity, transparency, honesty, and efficiency, most investors will select one of the myriad other choices at their disposal. By the same token, a market tending toward regulatory or legal overreach will dissuade issuers by needlessly increasing the cost of raising capital in that market. Mr. Chairman, striking the proper balance between the needs of the investor and the needs of the issuer is, at its core, the fundamental issue before the Committee today.

When we sat down at CSIS and began to list the issues that warranted scrutiny, several things came immediately to mind. Stock option accounting, small business incentives, functional regulation, Glass-Steagall reform, listing requirements for foreign issuers, accounting treatment of derivatives, regulation of pooled investment vehicles, trading practice rules and the interplay between new technology and the securities laws are just a few of the things that made the list. Fortunately, we were able to take stock option accounting off the list after the Financial Accounting Standards Board finally ended its 2-year battle to require companies to expense stock options.

As important as these issues are, however, none is as important to the capital formation process in the United States as reforming the securities litigation system and once again making America safe for capitalism.

Much has been made about whether there is a litigation "crisis" in this country. Yes, there is a crisis. Unfortunately, however, the rhetorical characterization of the status quo tends to sidetrack us from the most important issues. Instead, we get bogged down in a numbers game, with both proponents and opponents of reform trotting out statistics to support their claims; whether the incidence of class-action suits brought under Rule 10(b)(5) has increased or decreased; whether the average jury award in these cases has increased or decreased.

What is inescapable, however, is that there is a serious problem that has to be addressed. When most of our major high-tech companies have been the target of a securities fraud class-action suit, when one out of eight firms listed on the New York Stock Exchange have been sued for fraud, when hundreds of millions of dollars are spent each year on direct litigation costs, we must stop and ask ourselves—is fraud in corporate America that rampant? Or is the system allowing, even encouraging, the initiation of litigation when there is no evidence of wrongdoing on the part of the defendant?

If fraud is endemic in corporate America, which I certainly do not believe to be the case, then the current system is not doing nearly enough to deter the kind of

[1] CSIS is a nonpartisan public policy research institute based in Washington, DC that provides policymakers with a strategic perspective on issues relating to international finance and economics, politics and global security matters. R. Blair Thomas, General Counsel to the Project, contributed to the preparation of this testimony.

conduct that undermines investor confidence in the fairness and integrity of markets, and the actual perpetrators of fraud are not being adequately punished for their misconduct. If, on the other hand, the incidence of fraud is not nearly so widespread, then the current system is allowing some plaintiffs and their lawyers to essentially extort payments from corporations and other professionals, without any fear of sanction. To put it simply, the current system can best be characterized as "heads I win, tails you lose."

Mr. Chairman, as a former member of the Securities and Exchange Commission, let me make clear that strict enforcement of the Federal securities laws, by the SEC, and, where appropriate, by private parties, is crucial to maintaining the fairness and integrity of our capital markets. Investors around the globe perceive, and we believe accurately so, that the U.S. markets are honest; it is that perception that gives investors the confidence to invest their hard-earned savings and fuel the engine of economic growth. Without this confidence, investors would likely choose to invest in other markets, or other financial instruments, imperiling the ability of businesses, especially smaller, start-up companies, to obtain the necessary capital to finance investment in new equipment, in research and development, and in their employees. Providing investors with a means to recover losses when they are defrauded is an important element in maintaining this confidence and deterring fraudulent conduct in the first place.

By the same token we must recognize that litigation, by its very nature, imposes certain costs. These costs are borne not only by the participants in the litigation, but by shareholders of the defendant, and ultimately, the public at large. If not controlled, these costs can result in a substantial "litigation tax" that raises the costs of capital, chills desirable behavior, and impairs productivity and competitiveness.

There must be an appropriate balance between competing interests. If we were to wholly eliminate private rights of action, as some commentators have suggested[2] and rely solely on State law and the SEC's limited resources for enforcement of the Federal securities laws, we run the risk of encouraging misconduct by market participants. Alternatively, if we allow investors and their counsel an unfettered right to sue whenever losses are suffered on an investment, then companies on the margin will be deterred from raising capital through the public markets, or, more likely, market participants will pay an inflated price for raising that capital. Neither extreme is conducive to efficient and effective capital formation.

Unfortunately, the current private securities litigation system is severely out of balance. In our view, it fails to achieve its fundamental purposes of compensating investors and deterring misconduct. In addition, it imposes enormous costs on market participants and society, as a whole.

The imbalance is not surprising in view of the economic incentives that drive litigant behavior under the current system. Plaintiffs and their lawyers have a powerful incentive to initiate securities fraud class-action suits. The potential rewards are enormous and there is little down-side risk. By the same token, because the down-side risks are so large for defendants, they are encouraged to settle cases rather than litigate them, even where they believe the case to be frivolous.

Therefore, we support prompt enactment of specific reforms that appropriately address the counterproductive incentives that drive litigation under the current system. As a general matter, we support measures that eliminate the most egregious abuses of the class-action process, modified fee-shifting and the imposition of greater sanctions on parties who initiate frivolous lawsuits, and the allocation of liability among defendants on a proportional basis in certain cases. There are other remedies that also would address the abuses of the current litigation system, but we believe reform should be as simple and straightforward as possible. As a former regulator, I know the tendency to try and address problems by creating new layers of bureaucracy, oversight, and rules. We would encourage the Committee to avoid this tendency and address this problem by simply changing the incentive structure that drives this process. A system with balanced incentives will allow the marketplace to separate the serious from the frivolous.

Mr. Chairman, I applaud the leadership both you and Senator Dodd have provided on this critical issue.

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[2] *See* Joseph A. Grundfest, *Disimplying Private Rights of Action under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 961 (1994) [hereinafter Grundfest I]. *See contra* Joel Seligman, *The Merits Do Matter*, 108 HARV. L. REV. 438 (1994). *See also* Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727 (1995) [hereinafter Grundfest II]; Joel Seligman, *The Merits Still Matter*, 108 HARV. L. REV. 148 (1995).

From Small Acorns—Rule 10(b)(5)

It is now a well settled matter of law that private parties have the right to sue persons for alleged violations of Rule 10(b)(5).[3] Moreover, the Supreme Court has, on repeated occasions, expressed the view that private civil suits are a necessary supplement to the Government's civil and criminal enforcement of the Federal securities laws.[4] As a result, Rule 10(b)(5) become the principal weapon in the arsenal of plaintiffs and the professional trial bar.[5]

Nonetheless, it is worth noting that many of the abuses of the current system largely stem from the fact that private actions under Rule 10(b)(5) have been *implied* by the courts. Congress never expressly provided for private rights of actions when it enacted section 10(b) of the Securities Exchange Act.[6] In addition, the SEC spent very little time considering Rule 10(b)(5) when it was first adopted,[7] and it is clear that the Commission had little appreciation of the mighty oak that would grow from such a small regulatory and legislative acorn.[8] As a result, none of the usual accouterments of a private right of action, such as a statute of limitation, allocation of liability, and rights of contribution, can be found in the statute. The lack of appropriate guidelines for the maintenance of these actions has itself engendered substantial ancillary litigation.

Moreover, what has been missing from the debate surrounding Rule 10(b)(5) since its adoption some 50 years ago is a discussion of the rule's benefits relative to its costs in the context of a private right of action. It simply has been assumed that the rule, as it has evolved, is necessary and appropriate.[9] We would agree that the rule serves important public policy purposes. By the same token, however, it should be clearly understood that the current litigation system imposes enormous costs on market participants and the economy in general. It is clearly easier to quantify the costs than the benefits. Nonetheless, as with the application of any rule or regulation involving markets and the conduct of rational market participants, it would be useful to have a better understanding not only of the costs and benefits, but perhaps equally important, the incentives driving behavior.[10]

Economic Incentives Driving Behavior Under the Current System

The lack of shape and definition to Rule 10(b)(5), as well as liberal pleading requirements and class-action certification standards under the Federal Rules of Civil Procedure, interact to create powerful economic incentives for plaintiffs to initiate securities fraud class-action suits, and to do so in a hasty and ill-considered manner. Similarly, current law and practice creates equally powerful economic incentives for named defendants, especially parties peripherally involved in an alleged fraud, to settle cases quickly rather than defend them, even when they believe the action to

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[3] *See* Note, *Transamerica's Implications for 10(b)(5)*, U. ILL. L. REV. 1045, 1047 (1982); Grundfest I at 965 ("No matter how contentious this debate becomes, no one challenges the existence of the implied Rule 10(b)(5) private right of action.").

[4] *See, e.g., J.J. Case* v. *Borak*, 377 U.S. 426 (1964); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 730 (1975); and *Bateman Eichler, Hill Richards, Inc.* v. *Berner*, 472 U.S. 299 (1985).

[5] *See* Grundfest I at 965 ("The private right of action implied under Rule 10(b)(5) has become civil plaintiffs' primary weapon in their battle against securities fraud.").

[6] *See Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 196 (1976) (Discussing lack of legislative intent to provide a private damage remedy.). The legislative history of section 10(b) is remarkable only for its lack of discussion regarding private rights of action; there is, however, discussion of Government enforcement of violations. *See* H.R. Rep. No. 1383, 73d Cong., 2d Sess. 1–7 (1934).

[7] One of the SEC staffers responsible for drafting Rule 10(b)(5) described the SEC's consideration of the rule as follows: "We called the Commission and we got on the calendar, and I don't remember whether we got there in the morning or after lunch. We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Summer Pike who said, 'Well,' he said, 'we are against fraud, aren't we?' That is how it happened." Freeman, *Conference on the Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967).

[8] *See Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 196 (1976) ("There is no indication that . . . the Commission when adopting Rule 10(b)(5), contemplated such a remedy [referring to private rights of action]."). Chief Justice Warren Burger described Rule 10(b)(5) as "a judicial oak which has grown from little more than a legislative acorn." *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 737 (1975). *See also*, LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 726 (2d ed. 1988) ("[I]t is difficult to think of another instance in the entire *corpus juris* in which the interaction of the legislative, administrative rulemaking, and judicial processes has produced so much from so little.").

[9] As Stanford Law Professor and former SEC Commissioner Joseph Grundfest has noted, "the social value of private enforcement of the Federal securities laws has become an article of faith in the Federal securities liturgy." Grundfest I at 969.

[10] Grundfest provides a thoughtful analysis regarding the tradeoffs involved in achieving the "socially optimal level of litigation." Grundfest II at 727, 732–33.

be wholly without merit. The result is that many securities fraud class-action suits are initiated and then settled with very little regard for, or relationship to, the underlying merits of the claim.

INCENTIVES TO FILE

Plaintiffs, and their attorneys, have powerful economic incentives to initiate a class-action suit under Rule 10(b)(5). First, quite simply, securities fraud litigation is big business, resulting in hundreds of millions of dollars of awards each year.[11] It is a particularly lucrative business for plaintiff's lawyers.[12] Second, filing a fraud suit is not an expensive exercise. Third, there is virtually no down-side risk to initiating an action, even when there is no specific evidence that a fraud has been committed.[13] In fact, complaints that are filed often seem to be of a cookie-cutter variety, with only the dates and the names of the defendants changed from one suit to another.[14] As a result, what has developed is a business with virtually unlimited markets, potentially huge rewards, little regard for the customer and no meaningful barrier to entry. The result is wholly predictable; this business grows like ivy.

Finally, to further aggravate matters, there exists a built-in incentive that encourages a race to the courthouse. As noted by renowned plaintiff's lawyer William S. Lerach in testimony before this Subcommittee last year, ". . . we want to be the first to file so that we can control the case . . . the courts have historically rewarded the first filed case with control of the case as lead counsel."[15] In fact, it is not unusual for cases to be filed within days or even hours of a decline in a company's stock price, clearly not sufficient time to investigate and ascertain whether a fraud had been committed.[16]

INCENTIVES TO SETTLE

Conversely, defendants have powerful economic incentives to settle these cases for reasons that have very little to do with the underlying merits of the claim. First, it is much less costly for a plaintiff to initiate a claim than it is for the party sued to defend against it. This stems largely from the operation of discovery rules.[17] Second, once a securities fraud action is certified as a class, the defendants potential liability exposure is greatly magnified. As the Supreme Court has noted, "certification of a class may so increase the defendant's potential liability and litigation costs that he may find it economically prudent to settle and to abandon a meritori-

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[11] *See* INV. BUS. D., February 28, 1995, at A1 (total amount paid to settle shareholder class-action suits in 1994 was $1.4 billion—citing Securities Class Action Alert); FREDERICK C. DUNBAR, NATIONAL ECONOMIC RESEARCH ASSOCIATES, INC., RECENT TRENDS IN SECURITIES CLASS ACTION SUITS, tbl. 1, at 7 (August 1992) (study of 80 settlements over a 1-year period found that total recoveries for plaintiffs was $847 million, an average of $10.6 million per case); *Hearings Before the Securities Subcommittee of the Committee on Banking, Housing, and Urban Affairs of the United States Senate* (June 17, 1993) (Testimony of Vincent E. O'Brien) (Over a 5-year period, 342 companies paid an aggregate of $2.5 billion in settlements.).

[12] *See* INV. BUS. D., February 28, 1995, at A1 (plaintiff attorneys earned $1.4 million on average on settlements of shareholder class actions during 1994); Dunbar study, *supra* note 11. A study of 77 class actions that were settled during a 1-year period found that the plaintiffs bar was awarded an aggregate of at least $252.5 million. *See also,* Grundfest II at 734 ("Plaintiffs' class-action counsel are entrepreneurs. They profit by filing litigation that, on average and over time, generates the risk-adjusted cost of pursuing class claims.").

[13] *See, infra* note 41 and accompanying text.

[14] In one recent case, a district court judge noted in his opinion dismissing the complaint that "in the few hours counsel devoted to getting the initial complaints to the courthouse, overlooked was the fact that two of them contained identical allegations, apparently lodged in counsel's computer memory of "fraud" form complaint . . ." In re Philip Morris Securities Litigation, 1995 U.S. Dist. Ct. LEXIS 92 (S.D.N.Y. January 6, 1995).

[15] *Hearings Before the Securities Subcommittee of the Senate Committee on Banking, Housing, and Urban Affairs* (May 17, 1994) (Testimony of William S. Lerach).

[16] *See, e.g.,* In re Oracle Securities Litigation, 131 F.R.D. 688 (N.D. Cal. 1990) (eighteen separate complaints were filed within 2 weeks of a significant decline in the company's stock price following a disappointing earnings announcement); John C. Coffee, Jr., *The "New Learning" on Securities Litigation,* N.Y. L.J., March 25, 1993, at 5 (notes that recent studies of securities fraud cases suggests that class-action complaints tend to be filed soon after significant stock price declines, and "[t]he inference that skeptics might draw from such a finding is that stock volatility, more than fraud, produces litigation"); Milt Policzer, *"They've Cornered the Market,"* Nat. L. J., April 27, 1992 (Of 46 cases studied, 12 were filed within 1 day and another 30 within 1 week of publication of unfavorable news about the defendant company.).

[17] According to the general counsel of an investment banking firm, "it has been our experience that discovery costs account for roughly 80 percent of total litigation costs in securities fraud cases. These costs are so substantial that companies often lose their will to fight the meritless allegations and opt to settle soon after receiving their first bill or series of bills from outside counsel." *Hearings on H.R. 3185 Before the Telecommunications and Finance Subcommittee of the House Committee on Energy and Commerce* (Testimony of Philip A. Lacovara).

ous defense."[18] Third, the uncertainty of a jury trial, particularly with respect to the size of possible damage awards, may make defending a suit an extremely risky proposition.[19] Although not a securities fraud suit, the recent case involving McDonald's, in which a plaintiff was initially awarded nearly $3 million dollars because the coffee she spilled in her lap was too hot, is indicative of this problem.[20] Just imagine the size of the award if McDonald's had to pay an award based on every cup of coffee sold during a given period of time. Fourth, defending a suit can be a long and time consuming process, diverting management attention from the core functions of their business.[21] Finally, the mere filing of a securities fraud suit can do grievous harm to a company's reputation—which can have adverse effects wholly apart from the merits of the underlying claim.

Given these incentives, it is really not surprising that one study of Rule 10(b)(5) class actions found that every company whose stock price declined with a market value loss of $20 million dollars or more was sued.[22] It is not surprising that a majority of the largest technology firms in the Silicon Valley, whose stock prices are particularly volatile, have been subjected to securities fraud suits.[23] It is not surprising that one out of eight firms traded on the New York Stock Exchange was sued.[24] It is not surprising that better than nine out of ten securities fraud class-action suits are settled.[25] It is not surprising that these cases were settled on an almost formulaic basis.[26]

Failure of the Current System to Meet Public Policy Goals

The purpose of private rights of action under Rule 10(b)(5) is to provide investors who have suffered losses as the result of fraud or other misconduct a means to be compensated for those losses.[27] An ancillary purpose is to deter misconduct and augment the SEC's limited enforcement resources.[28] These are laudable goals. Unfortunately, Rule 10(b)(5), in practice, fails to meet either of them.

First, the current system does not efficiently or adequately compensate victims of securities fraud for their losses. The vast majority of securities fraud class-action suits are settled, with the result that, after attorneys' fees and costs are extracted, plaintiff investors receive only a small fraction of their potential recovery. Studies have found that the actual recovery by plaintiffs is as little as six cents on the dol-

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[18] *Coopers & Lybrand* v. *Livesay,* 437 U.S. 463, 476 (1978).

[19] "[F]rom the defense standpoint, a company is under hydraulic pressure to settle" because a securities class action is often a "bet your company" litigation. "You find that paying 5, 15, or even 20 percent of the total claim out as a settlement is worth it to avoid the jury risk and that sometimes the merits don't mean very much." Nancy Rutter, *Securities Class Action Scandal,* UPSIDE, April 1990, at 30 (quoting Edward Balabanian). Another factor making the outcome of a jury trial a risky proposition is the uncertainty surrounding the standard of recklessness. Because the standard of recklessness is a vague one, and its interpretation by both the court and the jury difficult to predict accurately, defendants that may not have acted in a reckless fashion cannot be assured of being vindicated at a trial. *See* Letter from Jake L. Netterville, Chairman of the Board, AICPA, to Senator Christopher J. Dodd (September 20, 1993) (Citing, in part, A. A. Sommer in testimony before the Senate Banking Committee.).

[20] *Liebeck* v. *McDonald's,* Docket No. 932419, 2d Judicial District Court of County of Bernadillo, New Mexico, August 17, 1994. *See also, A Case for Iced Coffee,* WALL ST. J., August 26, 1994, at A10.

[21] *See, e.g., Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723, 740 (1975) ("The very pendency of the suit may frustrate or delay business activity of the defendant which is totally unrelated to the lawsuit.").

[22] Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions,* 43 STAN. L. REV. 497, 511–13 (1991).

[23] Floor Statement of Senator Pete Domenici introducing S. 240, the "Private Securities Litigation Reform Act of 1995," CONG. REC. S1075, January 18, 1995 ("19 of the 30 largest companies in Silicon Valley have been sued since 1988"); *Hearings Before the Commerce Subcommittee on Telecommunications and Finance* (February 10, 1995) (Statement of Rep. Norman Mineta) ("Twenty-six of Silicon Valley's top forty companies—63 percent—have had 10(b)5 securities suits brought against them in recent years."). *See also* Vanyo and Feldman, *Biotech Securities Litigation is Running Rampant,* 11 BIO/TECH. 664 (1993) (Almost one-third of all publicly-traded biotechnology companies have been sued in securities class actions.).

[24] *Hearings Before the Securities Subcommittee of the Committee on Banking, Housing, and Urban Affairs of the United States Senate* (June 17, 1993) (Testimony of Vincent E. O'Brien).

[25] *Id.* (93 percent of securities fraud class-action cases in one study sample were settled.).

[26] *See supra* note 22.

[27] *See, e.g., Hearings Before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs of the United States Senate* (June 17, 1993) (Testimony of William R. McLucas) ("Private actions under section 10(b) of the Securities Exchange Act of 1934 serve as a primary vehicle for compensating defrauded investors.").

[28] *See J.I. Case Co.* v. *Borak,* 377 U.S. 426, 432 (1964) (The Court noted that have private civil suits are a "necessary supplement" to the Government's civil and criminal enforcement of the Federal securities laws.).

lar.[29] Even then it is a case of robbing from Peter to pay Paul—a wealth transfer from new shareholders to old shareholders. In the meantime, the trial lawyers have extracted a huge transaction fee in the process. It should also be noted that the plaintiff's interest in the best possible recovery may be in conflict with the economic interests of the plaintiff's lawyers.[30]

Second, rather than deter misconduct, Rule 10(b)(5), as currently applied, deters exactly the kind of conduct that will benefit markets and the investing public, namely providing honest assessments of a publicly-traded company's plans and prospects. The mere specter of 10(b)(5) liability chills free and open communications among management, analysts, and investors.[31] The SEC has expressly acknowledged this problem.[32] In order to make sound investment decisions, investors need useful and relevant information about a company. Unfortunately, however, companies go out of their way to disclose every conceivable bit of innocuous information, but very little useful forward-looking information. At the same time, legions of lawyers scrub required filings to ensure that disclosures are as milquetoast as possible, so as to provide no grist for the litigation mill.[33] SEC Chairman Arthur Levitt deserves credit for his advocacy of expanding a "safe harbor" rule for the disclosure of forward-looking information, but this is only a first step in the right direction.

Costs Imposed by the Current System

Not only does the current system fail to achieve its desired objectives, it is tremendously costly. The direct costs of litigation are substantial and borne directly by issuers, directors, underwriters, lawyers, accountants, and insurers. However, these are not the only parties that bear the costs of a litigation system run amok. Ultimately, these costs are indirectly borne by shareholders in the form of reduced earnings and lower stock prices, and by the general public in the form of higher prices on goods and services. There are a number of ways in which the current litigation system burdens market participants and the economy:

Litigation is a drag on productivity.[34] Corporations, especially start-up and innovative, high-tech companies that are most frequently litigation targets,[35] must devote substantial time, energy, and resources to forestalling or defending strike suits, which sidetracks them from focusing on their core businesses.[36] Every dollar spent on legal fees is a dollar not available for the research and development and capital investment that is so vital to our national economic productivity.

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[29] *See supra* note 24. *See also* FREDERICK C. DUNBAR AND VINITA M. JUNEJA, RECENT TRENDS II: WHAT EXPLAINS SETTLEMENTS IN SHAREHOLDER CLASS ACTIONS, NATIONAL ECONOMIC RESEARCH ASSOCIATES, INC. (1993) (Study found that the average investor recovers only 7 cents for every dollar lost, even before an award of attorneys' fees.).

[30] *See* Grundfest I at 970 (Noting that the incentives of plaintiffs may diverge from those of their lawyers, encouraging counsel to settle for amounts that are too low or fees that are too high.). *See also* Letter from State of Wisconsin Investment Board to Senator Pete V. Domenici, September 27, 1993 ("It is clear that the current system gives plaintiffs' attorneys a far greater interest in shareholder class actions than any of the plaintiffs they represent. This creates an inherent conflict of interest . . .").

[31] *See* VENTUREONE, THE IMPACT OF FRAUD SUITS ON ENTREPRENEURIAL COMPANIES (January 1994) (71 percent of all respondents reported being more reluctant to discuss company performance with analysts or the public.).

[32] In its concept release on forward-looking information, the Commission noted that the "threat of mass shareholder litigation, where real of perceived" has had adverse effects, especially in "chilling . . . disclosure of forward-looking information." Safe Harbor for Forward-Looking Statements, Exchange Act Rel. No. 33-7107 (October 13, 1994).

[33] *See* Mark Hoffman, *Why Class Action Attorneys Stalk High-Tech Companies,* WALL ST. J., January 18, 1995, at A15 (". . . the openness that once characterized the high-tech industry is being replaced by circumspection. News about business developments is carefully scrubbed.").

[34] *See Hearings Before the Securities Subcommittee of the Committee on Banking, Housing, and Urban Affairs of the United States Senate* (June 17, 1993) (Testimony of Richard J. Egan) ("Companies will not take sound risks but will manage their operations so as to maintain steady performance and avoid stock fluctuations, thereby eliminating opportunities for innovation, growth, new jobs, and long-term investment.").

[35] *See supra* note 23. *See also,* Hoffman at A15 ("High-growth, high-tech companies are natural targets for class-action securities suits because the inherent risks in rapidly changing, technology-driven industries lead to significant stock price volatility"); *Hearings Before the Securities Subcommittee of the Committee on Banking, Housing, and Urban Affairs of the United States Senate* (June 17, 1993) (Testimony of John G. Adler) ("Technology companies are especially vulnerable because their stock usually sells at a high multiple of earnings.").

[36] This concern was expressed by the Supreme Court in *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723, 740 (1975) ("The very pendency of the lawsuit may frustrate or delay normal business activity of the defendant which is totally unrelated to the lawsuit.").

Litigation is a threat to our competitiveness.[37] The direct and ancillary costs associated with suits brought under Rule 10(b)(5) significantly increases the cost of capital for U.S. companies; costs that are not borne by our foreign competitors. As a result, American companies are paying a "litigation tax" that disadvantages them in the global marketplace.[38] Moreover, world-class foreign companies that might otherwise list their shares on U.S. exchanges think twice due to liability concerns. Investor demand for the securities of such companies still gets satisfied, but the business goes to overseas exchanges (and with the perverse result that U.S. investors that purchase these securities have less legal protection).

Litigation drives away the best directors. The fact that a director of a publicly-held company faces the prospect of being sued regardless of how well he or she performs is driving some directors off corporate boards, and precluding other companies from attracting qualified board members.[39] While some commentators have criticized our system of corporate governance, it will become exceedingly difficult to improve oversight of corporate managements without independent, qualified directors.[40]

Specific Issues

Most of the debate regarding securities litigation reform has centered on a few key issues. Many of these issues were the subject of extensive discussion during consideration of H.R. 10 in the House Commerce Committee. While we discuss some of the policy issues involved with certain specific reforms, it should be noted that from a legislative standpoint, these reforms need to be considered jointly; only by crafting a consistent and complete package of reforms can the abuses of the current litigation system be adequately addressed.

FEE-SHIFTING

There is no more polarizing issue in the securities litigation reform debate than that surrounding fee-shifting, or so called "loser pays" or "English rule" provisions. The heated rhetoric that often accompanies discussion of this issue is perhaps reflective of its critical importance in dealing with the abuses of the current system. There is no other issue that so directly addresses the incentives that govern behavior in the civil litigation system.

Under the current system, the only risk in commencing a frivolous lawsuit is the possibility of sanctions under Rule 11 of the Federal Rules of Civil Procedure.[41] In

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[37] As one chief executive has observed, the incidence of strike suits "places U.S. corporations at an unfair disadvantage because we must constantly think "short-term" in order to deliver acceptable financial results every 90 days rather than focusing on the long-term development of new technologies and processes—a disadvantage with which most of our foreign competitors do not have to contend." *See* Egan testimony, *supra* note 34.

[38] *See* Adler testimony, *supra* note 35 ("When Government adds to the cost of doing business, firms function less well, and hire fewer people. In that context, you should think of abusive securities litigation as a particularly onerous cost of doing business—a litigation "tax"—that brings no countervailing benefits.").

[39] *See* Testimony of Arthur Levitt, Chairman, SEC, *Hearing Before the Subcommittee on Telecommunications and Finance, Committee on Commerce, U.S. House of Representatives,* February 19, 1995 ("There's the dozen of so entrepreneurial firms whose invitations I turn down because they could not adequately insure their directors."). In one survey of business executives, 71 percent indicated that they have found it more difficult to attract directors because of potential liability from litigation. Sixty percent said that the prospect of litigation has forced them to weigh more carefully the decision to join a corporate board. Another 24 percent refuse to serve on corporate boards of start-up firms or other companies vulnerable to securities litigation. *See* Adler testimony, *supra* note 35 (Citing a report of the American Business Conference.). According to another poll, 507 outside directors of American companies have been sued and fewer than half of the directors and corporate executives surveyed felt "very confident" that they would not be held liable even if they did nothing wrong. *See* LOUIS HARRIS & ASSOCIATES, OUTSIDE DIRECTORS AND THE RISKS THEY FACE, at 53–55, 66 (1993).

[40] As one chief executive has noted, "At a time when policymakers are urging the boards of publicly-held companies to take on greater responsibilities, it is becoming much more difficult for firms—particularly smaller companies—to find qualified people to serve on their boards. The reason is simple: the prospect of being sued." *See* Adler testimony, *supra* note 35.

[41] Federal Rule of Civil Procedure 11, as amended in 1993, provides in pertinent part: By presenting to the court (whether by signing, filing, submitting, or later advocating) a pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances—(1) it is not being presented for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation; (2) the claims, defenses, and other legal contentions therein are warranted by existing law or by a nonfrivolous argument for the extension, modification, or reversal of existing law or the establishment of new law; (3) the allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investiga-

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practice, however, Rule 11 does not operate to deter the filing of meritless claims, as it is wholly discretionary and rarely invoked.[42]

In order to address the incentive imbalance in the current system, we believe that it is critical to enact a modified form of fee-shifting in appropriate cases. In this regard, it should be emphasized that we are not recommending strict application of the English rule, that is, automatically requiring the losing party to pay the prevailing party's costs. Such an approach would run the risk of deterring injured parties from pursuing legitimate claims and swinging the pendulum too far in the opposite direction.

We believe that allowing the losing party to demonstrate that the case was substantially justified and that the imposition of fees and expenses would be unjust strikes us an appropriate way to balance competing interests. In order to further insulate litigants of limited means from being saddled with court costs, it might also be appropriate to go a step further and require that fee awards be paid by the losing party's lawyers in those instances in which the court determines that the lawyers were principally responsible for the maintenance of an unjustifiable action.

Defendants of the status quo have cried foul, arguing that any form of fee-shifting provision will close the courthouse door to wronged investors, especially those of limited means. This is nonsense. Putting reasonable limits on the maintenance of a private action under Rule 10(b)(5) only places narrow limits on the maintenance of a private action under Rule 10(b)(5) and only places narrow limits on the availability of one Federal remedy. Wronged investors still have the full panoply of common law and State "blue sky" remedies available to them.[43] Moreover, the SEC has the authority to bring a civil action and order disgorgement on behalf of injured investors.[44]

It should also be noted that fee-shifting is a concept that is already contained in the Federal securities laws. Section 11(e) of the Securities Act of 1933 expressly provides courts with the ability to require an undertaking and assess costs, including reasonable attorney's fees, against an unsuccessful party to the litigation if the court finds the suit or the defense to have been without merit.[45] While Section 11 is limited to suits involving an untrue statement or omission of a material fact in a registration statement, we support building upon this concept in the 10(b)(5) context.

It might also be useful to note that SEC Chairman Arthur Levitt recently testified that, "the Commission supports measures that would . . . provide for greater sanctions or a modified form of fee-shifting in appropriate cases . . ."[46] In addition, in 1991, former Chairman Richard Breeden testified that the Commission supported "a provision for attorney's fees whereby losing parties in some circumstances would be required to reimburse a portion of the prevailing party's legal fees."[47]

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tion or discovery; and (4) the denials of factual contentions are warranted on the evidence or, if specifically so identified, are reasonably based on a lack of information or belief.

If the court determines that the representations outlined above have been violated, Rule 11 provides that the court *may* impose sanctions against the responsible attorney.

[42] Opponents of securities litigation reform frequently cite Rule 11 as providing an effective mechanism to combat the filing of frivolous suits. *See, e.g., Hearings Before the Securities Subcommittee of the Committee on Banking, Housing, and Urban Affairs of the United States Senate* (June 17, 1993) (Testimony of William S. Lerach). In practice, however, Rule 11 has never been an effective deterrent and was further weakened in amendments adopted in 1993. *See* Duncan, *Sanctions Litigation Declining,* 81 ABA J. 12 (1995). The article cites a recent study by Jenner & Block which concludes that motions for Rule 11 sanctions have dropped 34 percent since adoption of the 1993 amendments. *Id.* "At this point, Rule 11 is pretty much dead." *Id.,* quoting Senior U.S. District Judge Milton Shadur of the Northern District of Illinois.

[43] *See, e.g., Chrysler Capital Corp.* v. *Century Power Corp.,* 91 Civ. 1937 (RPP) (S.D.N.Y. June 24, 1992).

[44] *See Hearings Before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs of the United States Senate* (June 17, 1993) (Testimony of William R. McLucas) ("Private actions under section 10(b) of the Securities Exchange Act of 1934 serve as a primary vehicle for compensating defrauded investors.").

[45] Section 11(e) of the Securities Act of 1933 provides in pertinent part: In any suit under this or any other section of this title the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit.

[46] *Hearings Concerning Securities Litigation Reform Proposals Before the Subcommittee on Telecommunications and Finance, Committee on Commerce, U.S. House of Representatives* (February 10, 1995) (Testimony of SEC Chairman Arthur Levitt).

[47] *Hearings before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives* (November 21, 1991) (Testimony of SEC Chairman Richard C. Breeden).

ALLOCATION OF LIABILITY

Current law provides that when two or more defendants are responsible for a plaintiff's indivisible harm, each defendant is liable jointly and severally for the damages incurred by the injured party.[48] This principle has a legitimate public policy purpose, but, in practice, it encourages plaintiffs to name as many deep-pocket defendants as possible, even though some of these defendants may bear very little responsibility for any injuries suffered by the plaintiff.[49]

As a result, whenever a company is sued under Rule 10(b)(5), there is a strong likelihood that lawyers, accountants, underwriters, and directors will be sued, as well. Not only is the prospect of liability that is so clearly disproportionate both to the harm caused the plaintiff, as well as any pecuniary benefit realized by these secondary market participants, unfair, it encourages these market participants to behave in a manner which is not conducive to the efficient and effective functioning of the capital markets. In fact, professional service providers may well choose to limit the nature and scope of the services they make available to public companies.[50]

Start-up and small cap companies, especially those in the high-technology field are particularly susceptible to any restriction on services. As noted previously, the earnings volatility and uncertain prospects of these enterprises, particularly in the start-up phase, makes them choice litigation targets. By the same token, these companies generally will not have the resources to defend against securities fraud class-action suits. It is in the interests of plaintiffs, therefore, to name secondary market participants, who have deeper pockets, when suing these smaller start-up companies. To the extent that professional services providers decide that the liability risk is too high and choose not to offer their services to certain industry segments, companies within those sectors may have a more difficult time raising investment capital in the public markets. At a minimum, the cost of retaining professional services providers will certainly be higher.

Allocating liability on the basis of the proportion of each defendant's contribution to a plaintiff's harm would address this and other related problems by changing incentives. Plaintiffs may be less likely to name secondary market participants if the potential recovery from these entities was relatively small. Secondary market participants who are nonetheless sued would be more willing to defend those cases they believed were without merit, rather than entering into a quick settlement in order to avoid broader liability exposure.

We would not recommend, however, that liability be strictly proportioned among all defendants. Primary tortfeasors, that is, any defendant which has engaged in knowing and willful fraud, should continue to be jointly and severally liable for plaintiffs damages. However, defendants who have not knowingly participated in a fraud should be liable only to the extent of their contribution to the plaintiff's losses and should not be required to shoulder the liability of those who were directly responsible for the fraud.

PLEADING REQUIREMENTS

Pleading requirements in the Federal Rules of Civil Procedure are intended to serve as a gatekeeper, helping to screen out frivolous and vexations suits by requiring that the circumstances giving rise to the fraud be pleaded with particularity. In practice, however, these rules have been applied rather liberally to allow cases based on general averments of wrongdoing.

Pleading requirements have recently taken on heightened importance as a result of a recent decision of the Ninth Circuit Court of Appeals. In *In re GlenFed Inc. Securities Litigation*[51] the court held that plaintiffs may satisfy the requirement that a complaint allege an intent to defraud or deceive simply by asserting such intent. The Court's decision stands in sharp contrast to the practice followed in the Second Circuit, where a complaint may be dismissed unless it pleads facts that give rise to a "strong inference" that the defendants acted with intent to deceive or de-

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[48] *Musick, Peeler & Garrett* v. *Employers Insurance of Wausau*, 113 S. Ct. 2085 (1993) (Parties who have violated securities laws share joint liability for that wrong under a remedial scheme established by the Federal courts.).

[49] Accounting firms have been particularly hard hit by this phenomenon. *See* Task Force on Joint and Several Liability Under Rule 10(b)(5), American Bar Association, Section of Business Law, August 8, 1994, notes 43–72 and accompanying text.

[50] *See* Lee Berton, *Legal-Liability Awards are Frightening Smaller CPA Firms Away From Audits*, WALL ST. J., March 3, 1992, at B1; Walters, *Accounting Firms Must Watch Their P's and Q's*, L.A. TIMES, June 4, 1994.

[51] U.S. App. Lexis 34334, No. 92–55419 (1994).

fraud.[52] The Ninth Circuit's decision is especially problematic because it will apply to cases brought against high-tech companies based in California.

Unless the Supreme Court resolves swiftly the dispute among the circuits, differing standards will apply depending on where a case is brought, and there will almost certainly continue to be ancillary litigation on this question. Congress should take this opportunity to establish the appropriate standard that will govern pleading requirements under Rule 10(b)(5). At a minimum, the standards followed in the Second Circuit should be adopted for all private rights of action for fraud under the Federal securities laws. Such action would help to dissuade the trial bar from engaging in "fishing" expeditions.

STATUTE OF LIMITATIONS

The Supreme Court recently settled the issue of the appropriate statute of limitations for implied private rights of action under Rule 10(b)(5).[53] The Court's ruling settled decades of uncertainty. We see no reason to revisit the Court's decision in this area.

This is an area where current law strikes an appropriate balance between the interests of investors, issuers, underwriters, and other market participants. On the one hand, injured investors must be afforded a reasonable opportunity to bring a claim for securities fraud. One year from the date of discovery of a violation, and 3 years from the date a violation occurred, generally is a sufficient time period within which to initiate an action under Rule 10(b)(5).

On the other hand, it would be difficult for individuals and companies to operate effectively in the marketplace without some sense of finality with respect to commercial transactions. Moreover, claims can quickly become stale, with probative evidence lost and memories dimmed. The quest for truth is enhanced when parties are encouraged to resolve legal disputes as quickly as possible.

* * *

In your invitation to testify, Mr. Chairman, you asked that we comment on legislation that has already been introduced addressing the issue of securities litigation reform, particularly the "Securities Litigation Reform Act," which is Title II of H.R. 10, the "Common Sense Legal Reform Act of 1995," and S. 240, the "Private Securities Litigation Reform Act of 1995," introduced in the Senate by Senators Domenici and Dodd, and cosponsored by thirteen Members. Rather than provide a section-by-section analysis of each of these measures, we have proffered more general comments and concerns about these bills as drafted, as well as the specific items outlined above. We would be pleased to discuss further the specific provisions of any legislation with you or your staffs.

Title II of H.R. 10, the "Securities Litigation Reform Act"

The Securities Litigation Reform Act, which has now passed the House Commerce Committee with strong bipartisan support, would, in our view, address many of the abuses which are found in the current private securities litigation system. While there are provisions which we believe could be improved, we recognize that the political process dictates accommodation of diverse interests, and therefore believe that this legislation in its current form, on balance, represents a reasonable and measured response to existing problems.

S. 240, the "Private Securities Litigation Reform Act of 1995"

Mr. Chairman, this bill, which was first introduced by Senators Dodd and Domenici during the 103rd Congress, contains a number of provisions that address many of the issues that arise in the context of the securities litigation reform debate. Most importantly, the bill expressly acknowledges the compelling shortcomings of the cur-

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[52] *Decker* v. *Massey-Ferguson, Ltd.*, 534 F. Supp. 873 (S.D.N.Y. 1981), *aff'd*; 681 F.2d 111 (2d Cir. 1982). Federal Rule of Civil Procedure 9(b) requires that all averments of fraud shall be stated with particularity. Rule 9(b) serves several salutary goals. First it is intended to provide defendants with fair notice of the grounds on which such a serious claim as fraud rests. *Ross* v. *A.M. Robins Co.*, 607 F.2d 545, 557 (2d Cir. 1979) *cert. denied*, 446 U.S. 946 (1980). Second, it is intended to protect defendants from the harm to their reputations and goodwill that results from unwarranted charges of serious wrongdoing. *Id.* In addition, the rule serves the important purpose of diminishing the possibility that: A plaintiff with a largely groundless claim [will be able] to simply take up the time of a number of other people [by extensive discovery], with the right to do so representing an in terrorem increment of the settlement value rather than a reasonably founded hope that the process will reveal relevant evidence. . . . *Id.*, quoting *Denny* v. *Barber*, 576 F.2d 465, 470 (2d Cir. 1978), quoting *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 741 (1975).

[53] *Lampf, Pleva, Lipkind, Prupis & Petigrow* v. *Gilbertson*, 111 S. Ct. 2773 (1991).

rent securities litigation system. It is therefore an important step forward in developing a consensus on the best approach to dealing with the acknowledged problems. Nonetheless, while we applaud the general thrust of the bill, we have a few general comments and concerns that we would like to bring to the Committee's attention:

First, the bill is extraordinarily complex and addresses a number of issues that are not central to the securities litigation reform debate. The bill adds seven new sections to the Securities Exchange Act of 1934, and also includes significant amendments to Sections 13, 15(c), and 21. The principal abuses of the current system can, and should, be dealt with in a much more straightforward fashion. We would recommend that the extensive provisions dealing with auditing requirements and the establishment of a public auditing self-disciplinary board be considered separately. Many of the provisions dealing with abuses of the class-action process should be made to the Federal Rules of Civil Procedure, so as to be applicable to any class action.

Second, the bill as drafted is applicable only to implied private rights of action. While express private rights of action provisions already have some of the parameters necessary to guide maintenance of an action, legislation in this area should be made generally applicable to all private actions initiated under any of the Federal securities statutes.

Third, the so-called "loser pays" or fee-shifting provision of the bill, Section 102(b), is so limited as to be practically meaningless. The losing party can be made to pay the costs of the prevailing party only if alternative dispute resolution is sought. Thus, a defendant who moves to dismiss a meritless suit for failure to state a claim, and is successful, apparently cannot recover costs. In addition, costs cannot be recovered from any plaintiff, or group of plaintiffs, that has never owned more than $1 million of the securities which are the subject of litigation. While it is entirely appropriate to protect the ability of plaintiffs of limited means to be able to sue for violations of the Federal securities laws, it is unclear why they should have an unfettered ability to bring a vexatious or meritless claim.

Fourth, we do not believe that the statute of limitations for private rights of actions should be changed. The current limitations period offers sufficient time for an injured investor to bring a claim for violation of the Federal securities laws. In this regard, it should be noted that the limitations period only applies to private litigants for claims brought under the Federal securities laws. The ability of plaintiffs to maintain actions under common law or the State blue sky laws is not affected. In addition, there is no limitations period on the SEC from bringing an action. Thus, an injured plaintiff, who fails to bring a claim within the time period for a private action, may petition the SEC to initiate such an action, and the SEC can establish a disgorgement fund for the benefit of the plaintiff and all similarly situated investors.

Addressing the SEC's Concerns

SEC Chairman Arthur Levitt has raised a number of concerns regarding H.R. 10. While we agree with the Commission's general proposition that "the important task at hand, therefore, is to identify ways to make the system more efficient while preserving the essential role that private actions play in supporting the integrity of our markets," we disagree with some aspects of the Commission's stance regarding H.R. 10.

That said, Mr. Chairman, we do support several initiatives currently under consideration by the SEC. As previously discussed, the recent review of the Rule 175 safe-harbor for forward-looking information,[54] as well as the filing of *amicus* briefs to support motions to dismiss or Rule 11 sanctions[55] and the establishment of a Litigation Analysis Unit[56] are all steps in the right direction. They do not, however, obviate the need for meaningful legislation.

Necessary Elements of Meaningful Securities Reform Legislation

Mr. Chairman, in the final analysis, we believe the following reforms are essential to change the incentives driving behavior under the current system:

- *Modified Fee Shifting:* Absent a finding by the court that the suit was substantially justified or that assessing fees would be unjust under the circumstances, the

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[54] Securities Act Release No. 7101, [Current Transfer Binder] Fed. Sec. L. Rep. (CCM) 85,436 (October 13, 1994).

[55] *See, e.g., Frank* v. *Cooper,* Southern District of Texas, Civil Action No. H–94–0280 (1994). The General Counsel of the SEC filed a letter with the court in support of the defendant's motion to dismiss. The court denied the defendant's motion.

[56] *See* Remarks by Arthur Levitt, Chairman, U.S. Securities and Exchange Commission before the 22nd Annual Securities Regulation Institute (January 25, 1995).

losing party should be required to pay the prevailing party's litigation costs. In addition, the court should have the discretion to impose costs against the losing party's counsel in appropriate circumstances.

- *Allocation of Liability:* Persons who knowingly and intentionally engage in fraud should continue to be jointly and severally liable for an injured plaintiff's losses. With regard to other defendants, liability should be allocated on the basis of their proportionate responsibility for the plaintiffs' damages. Defendants who are jointly and severally liable should have the right to contribution from similarly situated defendants.

Other reforms that Congress should consider in the context of securities litigation reform, as well as broader civil justice reform, include:

- *Pleading Fraud with Specificity:* Plaintiffs should be required to plead with specificity the circumstances from which fraudulent intent may be reasonably inferred.
- *Class Action and Process Reforms:* There should be a prohibition on the payment of bounties or bonuses to named plaintiffs, on referral fees and on attorney's fees paid from Commission disgorgement funds.
- *Civil RICO:* Violations of the Federal securities laws should not be a predicate offense under the Racketeer Influenced Corrupt Organization Act.

Conclusion

The bottom line is that the current system is severely out of balance. The relevant question for regulatory and congressional policymakers is how best to fix it. While reasonable minds may disagree about specified solutions, we believe the reforms outlined above constitute an appropriately measured response. In terms of legislation that is already on the table, we believe that the "Securities Litigation Reform Act" currently moving through the House of Representatives, as modified by the House Commerce Committee, represents a significant improvement over the status quo. H.R. 10 makes it more difficult to bring frivolous claims without impairing the ability of a wronged investor to initiate a legitimate action.

By helping to separate the wheat from the chaff, that is, the meritorious claims from the meritless, meaningful securities litigation reform will reduce systemic costs, encourage more meaningful disclosure by companies, and enhance the prospects that investors who are actually the victims of fraud will be compensated for their losses.

Ultimately, shareholders, *all* shareholders, and markets in general, will benefit if companies spend less on liability insurance and more on research and development, if companies are able to attract qualified boards of directors that will responsibly oversee the actions of management and look out for the shareholders' interests, and if shareholders have access to the best judgment of management regarding their company's plans and future prospects.

PREPARED STATEMENT OF JAMES F. MORGAN

GENERAL PARTNER, MORGAN, HOLLAND VENTURES CORP.

PRESIDENT-ELECT, NATIONAL VENTURE CAPITAL ASSOCIATION, BOSTON, MA

MARCH 2, 1995

Chairman Gramm, Senator Dodd, Members of the Subcommittee: It is a pleasure to present the views of the National Venture Capital Association (NVCA) regarding the current state of securities fraud litigation, and, in particular, how these suits affect small, emerging growth companies.

The NVCA is an association of nearly 200 professional venture capital organizations located throughout the United States. Professional venture capitalists have over $35 billion invested in small and emerging companies across America in today's cutting-edge technologies and new ideas. NVCA's affiliate, the American Entrepreneurs for Economic Growth, represents 8,000 CEO's who run emerging growth companies and employ over 1 million Americans. Venture capitalists sit on the Board of Directors of a large portion of these companies, and thus know firsthand the problems growing enterprises face in regard to the increasing number of groundless securities suits.

I am James Morgan, president-elect of NVCA and a founder of Morgan, Holland Ventures, a Boston-based venture capital firm which has investments in companies throughout the Nation. I appear before you today as an investor and board director with personal experience of how deleterious these cases are to emerging companies.

Emerging Growth Companies in the Nation's Economy

America's economy is undergoing a profound transformation. Our giant corporations, long-time leaders of the world economy, have lost their edge while emerging growth companies are expanding and prospering. The Fortune 500 is downsizing its workforce while emerging growth companies are creating jobs. In fact, the Fortune 500's share of nonfarm employment declined from 20.1 percent in 1971 to just 10.9 percent in 1991. Small and emerging businesses have simultaneously increased their share of employment to two-thirds of all new jobs in America.

To put this in perspective, NVCA recently completed its Fifth Annual Economic Impact of Venture Capital study which in part documents the job creating power of venture-backed emerging growth companies. The study found that the 500 young companies surveyed, which average just 4.8 years of age, demonstrated 25 percent employment growth annually in their first 5 years of life. As these companies mature, their workforce grows even more dramatically. In fact, 56 of the fastest growing 100 small public companies compiled by *INC.* magazine in 1994 were venture-backed companies and another 41 of *Fortune* Magazine's fastest growing 1994 public companies received venture capital.

These very companies are the key to America's economic future not only because they are the primary source of U.S. job creation, but because they are significant exporters, innovators, taxpayers, and international competitors. These companies play a critical role in discovering and opening new markets, in developing and accelerating technology, and in producing goods faster and more efficiently than ever before.

For better or worse, these entrepreneurial businesses are shaped significantly by the policies and practices of all levels and branches of Government. Since emerging growth companies are essential to economic growth, it is imperative for our Nation's policymakers to take the entrepreneurial viewpoint into account when discussing issues of national concern, such as abusive securities litigation, and before enacting legislation to remedy the situation. Your invitation for NVCA to present testimony today is strong evidence of your concern to produce meaningful legislation to address this significant problem.

A Game of Time and Money Which the Attorneys are Winning

While large corporations certainly have had their fill of abusive securities suits, typically it is the start-up or high-technology company which is subjected to these meritless actions simply because their stock price volatility is often much more pronounced than larger corporations. Too often an unexpected or sharp drop in a company's stock price is all it takes to spark a lawsuit.

Since high technology and emerging companies do not employ the number of people that Fortune 500 companies do, facing an abusive securities fraud suit is a particularly onerous problem. Outside counsel, experts, and financial consultants must be hired, and of course paid. Discovery requests must be answered. The Board of Directors must be kept apprised of the situation. And, during this entire protracted process an emerging company still has the fiduciary duty to maintain its operating capability, most often with the existing small number of employees.

Time, the most precious commodity of an entrepreneur, must be allocated to lengthy and consuming discovery, legal conferences, and court proceedings. This necessarily diminishes the amount of hours the entrepreneurial CEO can provide to his/her company, and therefore to the company's investors. The emerging growth company, which we have characterized as employment generators, exporters, taxpayers, and technologists, must now move its focus away from "growing the company" and toward mitigation of losses caused by a suit brought most often by a small group of professional investors. For this reason, as well as the fact that newly public companies cannot endure the negative publicity of a shareholder lawsuit, Boards of Directors are more often than not forced to settle these suits. Simply put, this is not a fair fight: it is almost impossible to operate a small, entrepreneurial company when faced with one of these suits.

You have a choice: settle the abusive suit and go about growing the business or fight for what is morally and legally right, but lose your competitive edge and possibly the entire enterprise in the long run. This is plainly and simply legal extortion.

In a recent survey of young venture-backed companies in operation only since 1986, NVCA found that one in six had been sued at least once. On average, the companies surveyed spent 1,055 hours of management time and $692,000 per case in legal fees defending each lawsuit. Many of these suits are still pending, and thus the management hours devoted to the case and the legal costs will continue to grow.

Silicon Valley, largely built on venture capital and the envy of the world, has been particularly hard hit by these suits. Venture capitalists recently testified before the Securities and Exchange Commission in San Francisco on this matter, and their tes-

timony regarding the scope of the abusive litigation problem is staggering. I quote from the testimony of venture capitalist and NVCA member John Doerr of Kleiner Perkins Caufield & Byers regarding three securities fraud suits he personally has been involved in:

> What are the hard, specific costs? The payments to settle their cases totaled $66 million. That doesn't count the direct legal costs to defend these cases: more than $12 million. Or the direct cost of management and employee time: 20 person years. Total, over 10 years: $120 million dollars, for just three companies. And what has been realized by the shareholders, the beneficiaries of these actions? Pennies on the dollar.
>
> $120 million will employ 200 first-rate engineers *for a decade.* creating faster, cheaper, better products.

While these entrepreneurial companies are under the "10(b)(5) litigation cloud" funds that would have been allocated to research and development and plants, property and equipment go instead to pay for legal and accounting expenses that do not assist in the growth of the company. NVCA's economic impact study, discussed earlier, also found that young venture-backed companies spend twice as much on R&D per employee as Fortune 500 companies and invest in capital equipment at three times the rate as large corporations. These needed financial commitments are curtailed severely when a company faces a meritless securities fraud suit, as it must conserve resources during the period it is under the "litigation cloud." Is this what we want as our foreign competitors, which typically do not have these suits to contend with, work on better product design and new technologies at America's expense?

Unlike our Japanese and European counterparts, American high-technology companies spend a disproportionate amount of time managing litigation instead of managing business. This is bad for entrepreneurs and bad for America.

Venture capitalists confer with lawyers on virtually a daily basis in large part because of our society's increasing reliance on attorneys to protect ourselves from all sorts of novel litigation. However, in their role attorneys have a duty to work for the good of society and not to prey on victims or potential clients. Abusive securities fraud suits take this ethical responsibility to its very limit. The speed which plaintiffs lawyers file these suits implies that they are "at the ready" to file suit, regardless of the merits, whenever a stock's price drops significantly. Recent evidence bears this out: cases filed by the same law firm, cases filed with glaring mistakes, and cases filed using cookie-cutter complaints. "Professional" plaintiffs allow lawyers to file cases in such a manner that it is the lawyer who hires the client rather than the other way around. Even defense lawyers, allegedly our protectors, have made a business out of defending these cases. There is something pernicious about the fact that everyone appears to lose in securities fraud cases save the attorneys who have built huge practices on both sides of the aisle.

Abusive Securities Suits Harm Investors

Venture capitalists have a unique perspective on this issue because we are both investors and board directors. This often puts us at odds with ourselves. As board directors, in constant fear of these meritless suits, we urge our companies never to make a forecast, to disclose everything immediately, not to go public and to audit aggressively. As investors, we urge our companies to produce the most detailed and far-reaching forecasts possible, to go public in order to tap capital for further growth, and to have a cost-effective auditing process.

The problems faced by the company, and hence by board directors, already has been explained, but the cost to investors has not, and this is as great, if not a greater, issue.

Abusive "cookie cutter" securities suits erect ever larger obstacles on our Nation's growing companies which directly affect investors. For example, it is becoming increasingly clear that experienced investment bankers and accounting firms are less willing to work with growth companies because of the higher risk associated with them. A recent *Accounting Today* survey found that the six largest firms are aggressively winnowing out clients. Many of these are the small, high-technology and high-growth companies that often are the target of meritless securities litigation. In addition, *The Wall Street Journal* has reported that two large investment firms were defendants in 60 and 73 lawsuits respectively as a result of public offering they had underwritten. These suits are driving away the influential bankers and talented business advisors who are needed to build tomorrow's leading corporations.

A diverse, intelligent, experienced, far-sighted and interactive Board of Directors is absolutely required by emerging growth companies if they are to reach their potential. They serve an extremely important role as a company transitions from

private- to publicly-owned. Also, outside directors often are the source of new leads for additional sources of financing, and these sources dry up when potential directors feel they cannot serve.

The threat of private securities litigation has affected companies' ability to attract competent board members, and is putting existing directors at greater risk because of the severely curtailed availability of Director and Officer insurance. NVCA conducted a survey in 1994 of public, venture-backed companies to measure the impact of these suits. A summary of the results are attached. The survey results were striking. Almost two-thirds of all responding companies reported substantial increased costs for D&O insurance—a 94 percent increase in premiums on average. Within the past 2 years, several of the major D&O insurers have priced D&O insurance out of existence for many companies, or have stopped writing policies for companies in particular industries, such as the technology sector. All investors are at risk as these growing companies put increasingly large sums of money into D&O policies instead of into developing the long-term strength of the company.

Much has been said about the fact that investors receive little, "pennies on the dollar," in terms of the actual settlement between the company and plaintiffs attorneys. However, just as important is the point that the vast number of investors lose in these cases because during the period an emerging growth company is being sued its stock becomes moribund. Investors, large and small, are forced to wait the process out, sell off at a price that does not accurately reflect the company's true status and potential or exert pressure on company officials to settle the suit regardless of the fact that the suit is meritless.

Increasingly stock options are being distributed to employees broadly throughout the very high-technology companies that are most often the targets of these abusive suits. The very employees who have put their heart and soul into growing these enterprises also are investor/owners of the company through the exercise of stock options. However, as these employee/investor/owners work to build a business, a small group of specialized law firms and their stable of "professional clients," who buy a small number of shares in companies to gain standing to sue, capitalize on stock price volatility with abusive securities fraud suits. The very idea that this cadre can place the financial security of employee shareholders and option holders at risk, whether the company fights it out in court or feels forced to settle, is truly an anathema of our existing legal system.

These meritless lawsuits have had a chilling effect on the amount of financial information high-technology companies will provide investors across the United States. NVCA's securities fraud survey of venture-backed companies, previously discussed, found that over two-thirds of all responding companies reported being reluctant to discuss their performance with analysts or the public because of the threat of shareholder litigation. Fearful that financial forecasts will be thrown back at them in court, young companies are deciding it is better to say nothing. In this environment, projections about the future—the very information most critical to investors—seem particularly foolhardy. The lack of information, in turn, likely dilutes the enthusiasm of investors to invest in emerging businesses.

What Can Be Done?

As you are well aware, on February 16 the House Commerce Committee voted out a bipartisan bill, H.R. 10 (Title II), by a vote of 33–10. NVCA strongly supported this effort, and is very proud of those Representatives from both parties who voiced their support in returning America's entrepreneurs to their traditional role of creating jobs and ideas from their increasing role as pawns in a legal system gone awry. We understand that the full House likely will consider the Commerce Committee-passed legislative vehicle in a matter of days, and again we support these efforts.

The Private Securities Litigation Reform Act of 1995 (S. 240), now pending in the Senate addresses many of the concerns we have raised in today's testimony. However, NVCA believes even more should be done to give lawyers pause before they file abusive securities fraud lawsuits based on minuscule facts. While S. 240 prohibits several abusive practices currently in use and requires lawyers to plead specific facts, it does not change the economics of the situation. Under S. 240 plaintiff's lawyers still have purely self-serving reasons to file these suits. NVCA believes that until you change the economic incentive of lawyers to file these cases, abusive lawsuits will continue. H.R. 10 goes a longer way toward controlling the phenomena of these meritless suits while retaining for investors the projections they need.

The critical issue is that we need a strong bill passed by both Houses of Congress and signed by President Clinton NOW. Investors, employee/shareholders, emerging growth CEO's and venture capitalists have lived with this odious problem for too long. We strongly urge you to move forward on this matter as expeditiously as possible.

In conclusion, emerging growth companies are the key to America's economic future, and thus policymakers must take their view into account when legislation is considered. A need of growing companies, and thus the Nation, is to be free of abusive securities fraud litigation while preserving the rights of investors to correct actual wrongs through the judicial process. The current system is simply not working. Legislation to address this issue must be enacted as soon as possible to allow new high-technology and high-growth companies to reach their potential, which venture capitalists know from experience is huge.

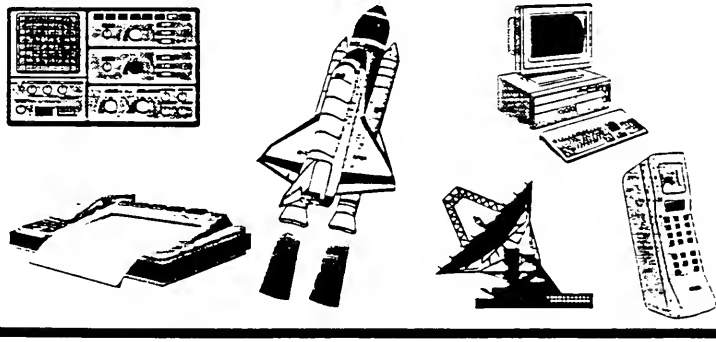
The National Venture Capital Association thanks the Securities Subcommittee for the opportunity to present its views on this matter.

The Impact of Securities Fraud Suits on Entreprenuerial Companies

A Survey

Final Report

January 1994



Conducted by VentureOne for:

National Venture Capital Association and American Entreprenuers for Economic Growth

Survey Purpose & Description:

At the request of the National Venture Capital Association (NVCA) and American Entrepreneurs for Economic Growth (AEEG), VentureOne conducted this survey in an effort to quantify the impact of shareholder lawsuits on publicly-held venture-backed companies. VentureOne faxed this survey to the CEO or CFO of each of 607 publicly-held entrepreneurial companies based in the United States. All of these companies had been privately funded by venture capitalists prior to their initial public offerings. As of November 30th, a total of 212 responses had been received (a 35% response rate).

Highlights of Results:

Findings from the survey are summarized below:

17% of respondents (36 companies) have been defendants in shareholder lawsuits. Several companies have been sued repeatedly. Data was provided on a total of 43 cases.

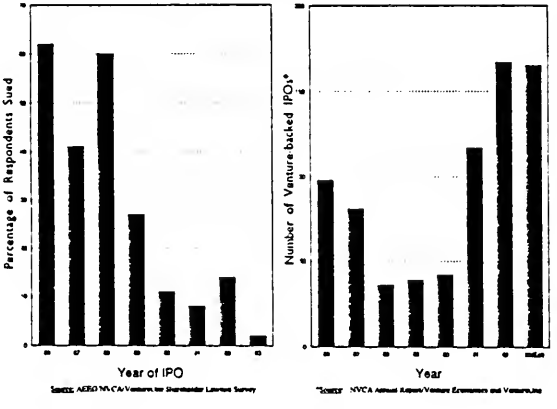
Even companies that have not been sued reported feeling the impact of these suits. 71% of all respondents reported being more reluctant to discuss company performance with analysts or the public. 30% of respondents reported difficulty attracting or retaining outside directors. 61% reported increased costs for D&O (directors and officers) liability insurance. For these companies, D&O premiums almost doubled (up 94%) on average.

These suits took a heavy toll on the companies being sued. On average, each case has taken 1,055 hours of management time. On average, companies being sued have spent $692,000 per case in legal fees defending themselves. The majority of suits reported in this survey are still pending, so additional expenditures of time and legal fees will be incurred prior to final resolution.

In none of the 43 cases reported has a verdict been awarded to the plaintiffs: the majority of suits reported are still pending. Of the cases that were settled, an average of 39% of the settlement was received by the plaintiffs' law firm(s). Settlement amounts averaged $4.5 million.

Response Analysis by IPO Date:

The longer a responding company had been publicly-held, the greater the likelihood the company had been the target of a shareholder lawsuit. Only 2% of responding companies that went public in 1993 had been sued. By contrast, 62% of responding companies that went public in 1986 had been sued. The lefthand graph below illustrates this finding. The graph on the right, by contrast, shows the total number of venture-backed IPOs by year. Should historical rates of lawsuit activity continue, these graphs suggest that unprecedented numbers of newly public companies are likely to be sued in the coming years.



Detailed survey results can be found on the next page.

Introduction to VentureOne:

VentureOne was founded in 1987 to promote the financing and growth of America's most enterprising new companies. As a research firm, VentureOne systematically tracks investment in entrepreneurial companies. The firm, headquartered in San Francisco, maintains a regular dialogue with 4500 venture-backed companies in the United States in order to keep its client base abreast of upcoming financing opportunities. VentureOne's clients are influential venture capital investors worldwide who manage over $6 billion of venture capital assets.

Detail of Survey Results:

Number of surveys sent (as of 11/15/93): 607
Number of surveys returned (as of 11/30/93): 212
Response rate: 35%

1. Has your company been sued for securities fraud under SEC Rule 10b-5 since January 1, 1980?

Yes: **36 companies (17%) reporting data on 43 lawsuits**
No: **176 companies (83%)**

2. Either because of your company's experience as a defendent or as a result of your awareness of these suits:

a. Have you been more reluctant to discuss company performance with analysts or disclose information to the public?
Yes: **150 companies (71%)**
No: **62 companies (29%)**

b. Have you had any difficulty attracting or retaining outside directors?
Yes: **63 companies (30%)**
No: **149 companies (70%)**

c. Has the cost of D&O insurance gone up?
Yes: **130 companies (61%); percentage increase averaged 94%**
No: **82 companies (39%)**

3. How was the case resolved?

Dismissed voluntarily by plaintiff:	**3 cases (7%)**
Dismissed on motion to dismiss:	**5 cases (12%)**
Verdict for defendant or plaintiff	**0 cases (0%)**
Settlement	**9 cases (21%)**
Still Pending	**26 cases (60%)**

4. What was the approximate total amount of legal fees your company incurred in defending itself from the suit?

Average response: $692,000

5. Please estimate how much management time was devoted to the suit, including time spent by the CEO and other managers?

Average response: 1,055 hours

6. For cases that were settled:

Average settlement was $4.5 million
Average percentage of settlement received by plaintiffs' law firm: 39%

PREPARED STATEMENT OF CHRISTOPHER J. MURPHY, III

CHIEF EXECUTIVE OFFICER, 1ST SOURCE CORPORATION, SOUTH BEND, IN
CHAIRMAN, ASSOCIATION OF PUBLICLY TRADED COMPANIES, WASHINGTON, DC

MARCH 2, 1995

Chairman Gramm, Senator Dodd, Members of the Committee and staff. I appreciate the opportunity to testify today on behalf of the Association. Thank you, Mr. Chairman, for addressing the issue of securities litigation reform early in this legislative session. And thank you, Senator Dodd, for your leadership last year and for your continuing efforts together with Senator Domenici on S. 240.

APTC Represents the Broad Growth Sector of the Economy—The Small and Mid Capitalization Public Companies

The Association of Publicly Traded Companies consists of over 500 active members who represent a broad cross-section of America's public companies. APTC Member Companies are exemplary of the breadth and diversity of American business ranging from biotechnology to greeting cards, financial services, oil and gas, restaurants, computer software, transportation, construction, etc. Many of APTC Members are the new businesses that are hiring people, creating new products, and exporting goods and services in every industry. APTC's Members represent entrepreneurial dreams realized and creative business strategies in practice.

As an Association, we emphasize those concerns common to all public companies and one of our primary goals is maintaining fair and efficient capital markets. Efficient access to capital through the public equity markets is a critical interest to all public companies. We recognize that investor confidence affects the cost of capital, liquidity in the markets, and investment opportunities. Therefore, APTC is careful to urge no cure to frivolous litigation that is worse than the disease. We oppose any action that would erode investor confidence in the fairness of the equity markets.

Speaking for many small and mid-cap companies, I assure you that one of the most critical common concerns of these companies is the high risk that stock-price fluctuations will make them a target of securities fraud strike suits.

For nearly 2 years, APTC has participated actively in the effort to bring about comprehensive reform of the system for adjudicating securities-law disputes. We have participated in the SEC's ongoing evaluations of safe harbor rules, submitting our own proposal which I have attached.[1] We have filed a brief with the U.S. Supreme Court, also attached, in an effort to improve the ability of district courts in the Ninth Federal Circuit to dismiss frivolous suits.[2]

For Smaller Companies, a Single Securities Fraud Class Action Suit Is a Disaster

In all our efforts, the Association has been guided by a clear principle: *Anything short of prompt identification and dismissal of frivolous cases will not alleviate the burden of such cases for smaller companies.* The mere filing of a class-action fraud complaint against a small or fast-growing company brings significant cost and potentially irreparable harm. The opportunity to prove the company innocent at trial, or even on summary judgment after extensive discovery, is a largely theoretical improvement. Moreover, it is small comfort to be able to prove a case frivolous and seek Section 11 or Rule 11 sanctions after years of litigation, attorneys' fees, disruptive discovery, and management distraction. Indeed, it is the frustrating experience of many companies that neither Rule 11 nor Section 11 is a useful tool of judicial discipline.

Therefore, a meaningful defense against such a suit must allow for (1) a prompt determination of its basis and (2) a fair certainty that a dismissal will withstand appeal. The fluid and ill-defined character of the law in this area makes any trial court dismissal subject to an expensive appeal and the possibility of reversal.

It should be noted that even if we achieve our reform goals, companies may still be required to win two motions to dismiss (the second on an amended complaint) and one appeal. (There is at least one case still pending where there have been four

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[1] APTC has proposed a ban on private rights of action based on forward-looking statements made by "seasoned issuers." APTC is participating fully in the SEC process and is hopeful that the SEC will expeditiously enact a truly safe harbor for forward-looking statements.

[2] The law in the Ninth Federal Circuit is a special problem. In that circuit, the mere pleading that executives within a company had a "motive and opportunity" to commit fraud is sufficient to withstand a motion to dismiss and warrant extensive discovery. It is no surprise, therefore, that the Ninth Circuit is the forum of choice for many class-action cases. Indeed, a study of 135 settlements totalling $1.056 billion shows that 43 of those cases were in the Ninth Circuit with a total value of $342 million and attorneys fees of $109 million.

amended complaints.) However, such a change will hopefully avoid the most costly of legal proceedings, discovery, and trial. Lowering the risk of discovery and trial will make it more prudent to fight frivolous actions, promoting disposition based on merits rather than economic factors such as litigation costs and insurance limits.

Investors Will Be The Beneficiaries of Meaningful Reform

In the long run, both innocent companies and defrauded investors will benefit from actual adjudication of private actions. Where there is real evidence of fraud and genuine deceit, there will be recoveries by investors. Where there is no fraud, an appropriate, clear standard of pleading and liability will allow for early and final disposition of frivolous complaints prior to pensive discovery.

In our efforts to seek reform, we are particularly mindful of the interests of the individual investor. For most newly public companies, the core of their equity capital is the patient individual investor.

The individual investor—often the involuntary "plaintiff" in a securities fraud class action—is in fact the victim in most of these suits. It is their company, their potential dividends and their economic security that suffers the inherent damage of such litigation and bears the inevitable costs of legal fees and settlement. In exchange for these costs, they receive pennies on the dollar from the settlement of cases.[3] Given the shabby treatment that shareholders receive in the current securities class-action system, and the degree to which litigation diverts resources for productive activities, we believe that a significant reduction in securities class-action suits will actually benefit shareholders and improve investor confidence.

As APTC has testified at the SEC, the threat of frivolous litigation impedes meaningful dialogue between issuing companies and the market. The market is hungry for this information and is not getting it.[4] The survey of issuers conducted by the American Stock Exchange bears this point out as well.[5]

Opponents of reform have argued that both legislative reform and improved SEC safe harbor rules win sanction "lying" about the future prospects for a company. They argue that the risk of private securities class-action suits is the only deterrent to this conduct. Such arguments ignore the real world of the actively traded public company.

Myriad forces discipline public companies. The marketplace, broadly defined, provides the bulk of deterrence against improper disclosure by companies who rely heavily on their credibility to reduce their cost of capital. Companies with a continuing need for patient capital and/or continuing infusions of new capital are subject to significant practical constraint in their dealings with the market. Companies literally cannot afford to lose credibility in the eyes of analysts, brokers, shareholders, creditors, and the financial press. These disciplining forces leave no room for companies to be cavalier in their statements about their companies. Companies are rewarded for meeting or beating projections and are punished for underperforming or not meeting projections.

The Burdens of Securities Class-Action Suits Are Well Known

The abuse of the securities laws is well documented in the record of hearings held in the Senate Securities Subcommittee in the last Congress. Allow me, however, to cite a few more examples.

An APTC Member company in the technology field—a small public company with great products that were in high demand—was sued when its stock price dropped. The stock price dropped because the company's distribution system was unable to handle the demand for its products and the stock market's high expectations were dashed.

The company fought the suit, succeeding at every level of judicial action. It won a motion to dismiss. It won a second motion to dismiss an amended complaint. It won on an appeal of the dismissal. This sounds like a success story. Well, almost.

The company's market capitalization was $16 million at the time of the suit. To win, it had to spend $850,000 on legal fees alone. Its management was completely distracted for over a year from running the business. Its business became an increasingly defensive matter: denying rumors passed on to its customers of the company's imminent bankruptcy; diverting the equivalent of 80 percent of its R&D budget to pay legal bills; defending the reputations of its managers; defending the company's integrity.

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[3] Dunbar & Juneja, National Economic Research Associates, Inc. Recent Trends II: What Explains Settlements in Shareholder Class Actions? Table 3.

[4] Tom Moore, Jr., Chairman, AIMR Corporate Information Committee, testimony before the Securities and Exchange Commission, February 17, 1995.

[5] American Stock Exchange CEO Survey, April 1994.

For companies like this, working on the cutting edge of innovation and struggling on the fine line between success and failure, every dollar of cash is precious and every ounce of management talent is critical. A securities fraud class-action suit works like a deadly virus, sapping the vitality of these companies, forcing the company to draw on every strength just to survive.

Many say that the judiciary has the tools to deal with these types of suits by sanctioning the lawyers who bring them. That is the theory of Federal Rule 11. In practice, the informal codes of various courts strongly discourage use of Rule 11. Moreover, attempting to use Rule 11 only results in another legal proceeding with the company's lawyer having to defend against a counter motion. Since the company has to pay its lawyers for this proceeding as well, it is no surprise that this redress is seldom sought.

In another case, a company in the computer business announced that its quarterly earnings would fall short of projections because several large orders had not been booked before the end of the quarter. As is often the case, the company was not aware of this problem until 3 weeks before the end of the quarter.

When the company announced the news, the stock price dropped 30 percent and five class-action suits were filed. Because the period of the alleged fraud was 10 months, the damages claimed exceeded $300 million.

This company allegedly defrauded the market with statements like: "we have confidence in the future despite disappointing results," "our prospects for growth and improved performance are very encouraging," and "we expect continued improvement in the results through next year." (Thus the importance of a safe harbor for forward-looking statements.)

Facing protracted litigation and exposure to a $300 million claim, the company settled. Shareholders received $.02 for every dollar of loss and the plaintiff lawyers collected a fee of $4 million. The company's legal bill was $1 million. No matter how much the company may have wanted to fight the case, a $300 million claim was simply more than it could risk.

These stories are anonymous because companies that have been sued know the cost involved and they also know that all it takes is a surprise to the market for them to be a target once again. While to many lawyers such a suggestion would be slander, it is the sad truth in this area of practice.

This current system drains companies of significant resources that should be used to add shareholder value and build a stronger economy. It also undermines the credibility of the judicial system and the capital markets. Because nearly every suit that is not dismissed quickly is settled, fraud is never proven, only alleged. Therefore, truth is never known.

Remedies

APTC has always supported vigorous SEC enforcement of the securities laws. Private rights of action can be an effective supplement to the SEC's enforcement program. However, the social costs associated with private policing of fraud under the vague standards and excruciating procedures outweigh the deterrent effect such actions provide, since they have become so misused by an entrepreneurial bar. Appropriate substantive policing is fine; specious suits are not. In other words, our goal is not to eliminate the private class action; it is to make it work properly.

As APTC sees it, the real question for the Congress is what can be done to change the perverse economic incentives in the current system of enforcing securities laws by private class-action suits. As business people, we do not profess expertise in the law, but we know a real money maker when we see one. The current system is an open invitation to litigation. The risks to plaintiff lawyers are minimal and the potential rewards are huge. Moreover, a "reformed" system where cases are harder to win but still relatively cheap to bring may only result in more suits being filed. Only a change in these economics will appreciably increase the benefits to all market participants—issuers, active traders, patient investors, venture capitalists, and the economy in general.

We believe that market participants will certainly benefit through a significant reduction in the risk of an issuer's ruin through a frivolous suit. Reduction of this risk will create other benefits, besides more and better forward-looking information, by eliminating many of the problems that frivolous fraud claims have created for *all* public companies, particularly for small companies—difficulties in obtaining liability insurance, difficulties in finding good directors who are willing to serve, time wasted in deliberations over the risk of such suits.

Legislative Reform Must Change the Underlying Economics of Securities Class Action Suits—Cosmetic Reforms Will Not Work

APTC has supported most legislation that has been introduced to reform the securities litigation system. We supported H.R. 417 in the last Congress, the Tauzin bill. We had significant input on and supported S. 1976, the Dodd-Domenici bill, in the last Congress. We support both of the current versions of those bills as well as Title II of H.R. 10 which was introduced in this Congress.

We have supported each bill as a "vehicle" for reform rather an exact prescription. We recognize securities litigation reform as a complex, multi-variable problem that will require much effort to craft a solution that preserves appropriate private rights and eliminates frivolous suits. One may in the long run have to err on one side of a difficult choice or the other. Arguments for erring in favor of shareholders suits will always urge caution, citing egregious examples of fraud and the plight of defrauded investors. Let me argue for bold action. The reason for this is that the other side of these cases is not the widow or the orphan. It is the skilled, dedicated, and highly-compensated attorneys who rush to the courthouse to gain control of these enormous class-action suits. As with any law designed to address an abuse of the law, reform in this area will have to withstand the concerted and creative efforts of the very lawyers who have made such a lucrative business out of these cases.

We at APTC and many in the Congress have fought long to get to a point where there is actually a chance for reform. This opportunity will be lost if a bill passes that leaves too much opportunity for the plaintiff lawyers to simply bring the same kind of suit under a slightly different theory or procedure. Therefore, erring on the side of real reform is what I must urge.

Specific Recommendations

Tiile II of H.R. 10 addresses many of these concern directly. Therefore, we support its provisions on fee-shifting, on the standard of liability, on pleading requirements, on proof of reliance, and on proportionate liability.

S. 240 is the product of much work on the procedural aspects of securities litigation. Many of its provisions, especially those dealing with pleading reform, will offer effective remedies to some of the most difficult problems of getting frivolous cases dismissed.

I pledge APTC's continued support for this effort and our sincere desire to help strike the right balance. APTC's President Brian Borders is available full time to work with you and your staff in evaluating and crafting legislation. Thank you again for the opportunity to testify.

* * *

EXECUTIVE SUMMARY

APTC Represents The Broad Growth Sector Of The Economy—The Small and Mid Capitalization Public Companies. These Companies have provided the job growth of the past 20 years. They are the future of America's economic growth and the prime targets of predatory securities class-action strike suits. APTC companies rely on the integrity of the equity markets and the confidence of the investing public to raise capital.

Investors Will Be The Beneficiaries Of Meaningful Reform. The current system fails to distinguish cases of actual fraud from frivolous cases. Typical class members receives less than $.14 for their losses. A system where private attorneys have an incentive to seek out cases of genuine fraud and litigate them to conclusion will compensate investors properly and will not coerce settlements which are paid by the shareholders of innocent companies.

For Smaller Companies, A Single Securities Fraud Class Action Suit Is A Disaster. The cost in legal fees, executive time, and harm to the company's reputation can threaten the survival of a small, high-growth company. Even the clearest type of frivolous case, one that is dismissed on the complaint, usually costs several hundred thousand dollars.

The Burdens of Securities Class Action Suits Are Well Known. The average settlement of such a case is in the millions of dollars. So are the attorneys fees. Hundreds of millions of dollars that might have gone to productive purposes have been spent on legal fees, document discovery, and settlement. Such suits have sadly become a cost of doing business as a public company.

Legislative Reform Must Change The Underlying Economics Of Securities Class Action Suits—Cosmetic Reforms Will Not Work. Changing the economics of securities class actions means breaking up the perverse incentives of the current system. The critical flaws are:

- Lawyers who bring these suits face minimal cost if they bring a frivolous suit but significant up-side potential if they can survive early dismissal;
- Plaintiff lawyers, not investors, drive the litigation and the settlement;
- The standard of liability for fraud is so vague that any evidence of oversight on the part of the defendant company can create a significant risk of a huge jury verdict;
- Liberal standards of pleading make it extremely difficult for defendant companies to avoid expensive and intrusive discovery through early dismissal;
- Forward-looking statements too often provide the basis for a fraud-by-hindsight fishing expedition case.

Specific Recommendations

Title II of H.R. 10 addresses many of these concern directly. Therefore, we support its provisions on fee-shifting, on the standard of liability, on pleading requirements, on proof of reliance, and on proportionate liability.

S. 240 is the product of much work on the procedural aspects of securities litigation. Many of its provisions, especially those dealing with pleading reforms, will offer effective remedies to some of the most difficult problems of getting frivolous cases dismissed.

In the important area of safe harbor for forward-looking statements, APTC encourages the Subcommittee to maintain close communications with the SEC. The SEC's recent hearings on safe-harbor proposals established a strong record for significant improvement to the SEC rule which could be accomplished administratively provided appropriate legislative authority is assured.

Attachment One

APTC Proposal for a Safe Harbor for Forward-Looking Statements

APTC
The Voice of the Issuer

Association of Publicly Traded Companies
1200 19th Street, N.W., Suite 300
Washington, D.C. 20036-2401
202.857.1114 FAX: 202.223.4579

September 29, 1994

APTC PROPOSAL
SEC SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS

(a) A forward-looking statement made by or on behalf of an issuer, or an omission to state a fact necessary to make the statement not misleading, shall not serve as the basis for a private action for damages under The Securities Act of 1933 or The Securities Exchange Act of 1934 if:

(1) The forward-looking statement is made in connection with a listed equity security or Nasdaq security for which transaction reports are required to be made on a mandatory real-time basis pursuant to an effective transaction reporting plan of an issuer which has been subject to the requirements of Section 12 or 15 (d) of the Act and has filed all the material required to be filed pursuant to Sections 13, 14 or 15(d) for a period of six months;

(2) The issuer is not an issuer of penny stock as defined in Section 3(a)(51)(A) of the Act and Commission regulations;

(3) The issuer has not been convicted within five years prior to the making of the statement of any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the Commission;

(4) The issuer is not subject to any order, judgement or decree of any court of competent jurisdiction temporarily or preliminarily restraining or enjoining, or is not subject to any order, judgement or decree of any court of competent jurisdiction, entered within five years prior to the making of the statement, permanently restraining or enjoining the issuer from engaging in or continuing any conduct or practice in connection with the

purchase or sale of any security or involving the making of any false filing with the Commission;

(b) The term "forward-looking statement" means:

(1) A statement containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure, growth rates, order rates, margin performance, price performance, backlog or other financial items whether stated in quantitative or qualitative terms;

(2) A statement of management's plans and objectives for future operations;

(3) A statement of future economic, product or business performance; or

(4) Disclosed statements of the assumptions underlying or relating to any of the statements described in paragraph (b)(1), (2) or (3) above.

APTC
The Voice of the Issuer

Association of Publicly Traded Companies
1200 19th Street, N.W., Suite 300
Washington, D.C. 20036-2401
202.857.1114 FAX: 202.223.4579

September 29, 1994

APTC Proposal
SEC Safe Harbor for Forward-Looking Statements

Scope of Coverage

1. Applies only to implied private rights of action. Does not alter SEC's enforcement authority. Issuers making forward-looking statements must meet the Rule 3b-6/175 standard, good faith and reasonable basis, in an enforcement action by the Commission.

2. Does not change the standard of liability under any Statute, Rule or Regulation.

3. Applies to all forward-looking statements whether written or oral.

4. Covers omissions as well as forward-looking statements.

5. Applies only to equity securities traded in the after-market.

6. Available on an earned-privileged basis to companies that have an established disclosure record. In addition, this privilege is unavailable for a period of five years if the issuer unfavorably concludes an enforcement proceeding involving the securities laws or regulations.

7. Available only to companies which by virtue of their publicly traded history, stock price, need for continuing market capital and other relevant factors, are fully subject to the disciplining forces of the marketplace, analysts and financial press.

8. Corporate issuers as well as insiders remain subject to the substantial threat of criminal penalties, Commission civil enforcement and private actions for trading while in possession of material, non-public information.

Association of Publicly Traded Companies
1200 19th Street, N.W., Suite 300
Washington, D.C. 20036-2401
202.857.1114 FAX: 202.223.4579

September 29, 1994

The Honorable Arthur Levitt, Jr.
Chairman
Securities and Exchange Commission
450 Fifth Street, NW
Mail Stop 6-1
Washington, DC 20549

Re: APTC Proposal for a Safe Harbor for Forward-Looking Statements

Dear Mr. Chairman:

The Association of Publicly Traded Companies (APTC) is pleased to submit our proposal for a new Safe Harbor for Forward Looking Statements (hereinafter "APTC Safe Harbor"). On behalf of APTC, we thank you and your fellow Commissioners for your attention to the safe harbor issue. In particular, Commissioner Carter Beese's forthright criticism of the current safe harbor, expressed in his speech to APTC's Washington Conference this past June, has helped focus the attention of many fine minds among issuers, academics and the securities bar on the safe harbor issue. It is a major concern of our Members.

The APTC Safe Harbor is intended to shelter issuers from private action liability in fraud-by-hindsight lawsuits concerning missed projections and other forward-looking statements. Enhanced safe harbor protection will promote shareholder and investor benefit in two ways: (1) by promoting greater disclosure of forward-looking information and (2) by reducing litigation costs and promoting merit-based resolution of suits.

For more than a year, APTC has endeavored to bring about comprehensive reform of the system for adjudicating securities-law disputes. The Association has been guided in our efforts by a few clear principles. These same principles are reflected in our safe harbor proposal.

1. Anything short of prompt identification and dismissal of frivolous cases will not alleviate the burden of such cases on the small and mid cap group of public companies primarily represented by APTC. The goal of our reform efforts has been the prompt identification and dismissal of frivolous securities fraud class action suits. For small or fast-growing companies such as those APTC represents, the mere filing of a class action fraud complaint brings significant cost and potential irreparable harm. It is small comfort to be able to prove a case frivolous and seek Section 11 or Rule 11 sanctions after years of litigation, attorneys fees, disruptive discovery and management distraction. Moreover, the fluid and ill-defined character of the law in the area of forward-looking statements makes any trial court dismissal subject to an expensive appeal and the possibility of reversal.

Therefore, a meaningful defense against such a suit must allow for (1) a prompt determination of its basis and (2) a fair certainty that a dismissal will withstand appeal.

It should be noted that even under the best safe harbor protection proposed, companies may still be required to win two motions to dismiss (the second on an amended complaint) and one appeal. However, a change such as APTC is advocating will hopefully avoid the most costly of legal proceedings – discovery and trial. Furthermore, lowering the risk of discovery and trial will make it prudent for companies to fight frivolous actions, promoting disposition based on merit rather than economic factors such as litigation costs and insurance coverage.

2. An effective safe harbor, based on objective criteria, will promote more and broader disclosure. We believe the case has been made that publicly traded companies are unwilling to make forward-looking disclosures to the market because of the fear of litigation.

In order for a safe harbor to function properly– to be truly *safe* – it must be clear and straightforward. Clarity is essential to its usefulness in judicial proceedings. Objective standards of applicability are necessary to achieve clarity. Current law on the standard of liability for forward-looking statements is such that even corporate counsels and securities litigators must scrutinize appellate court decisions in attempts to harmonize conflicting decisions within an applicable federal circuit. The conflict is even more apparent among federal circuits. Any safe harbor provision that relies on subjective criteria will probably not alleviate this problem.

Objective criteria, such as those set out in the APTC Safe Harbor, will be understandable not just to judges and lawyers but to the non-lawyers who operate in the real-time world of forward-looking information. The market benefits of a safe harbor – more candid and timely information – can be realized only if corporate executives, CEOs and CFOs, can be certain they will not be sued for making a statement about the future that ultimately proves wrong. Therefore, APTC proposes a safe harbor based on objective criteria which will prove practical both in court and in the marketplace and which can be applied immediately and effectively.

3. While private rights of action may be necessary supplements to the SEC's enforcement program, the social costs associated with private policing of corporate projections outweigh the deterrent effect such actions provide. APTC has always recognized the link between enforcement, investor confidence and the cost of capital. However, the *incremental* deterrent value of private rights of action based on forward-looking statements is outweighed by the great expense of defending or settling class action lawsuits and the resulting diminishment of forward-looking information.

The social utility of private rights of action is further diminished when viewed against the backdrop of the other forces that discipline disclosure practices. The marketplace, broadly defined, provides the bulk of deterrence against improper disclosure by companies who rely heavily on their credibility to obtain equity capital. Companies that need patient capital, or those that need continuing infusions of new capital, are subject to significant practical constraints in their dealings with the market. These companies literally cannot afford to lose the confidence of analysts, brokers, shareholders, creditors and the financial press in their truthfulness and integrity. Such disciplining forces leave little room for companies to be cavalier in their projections.

4. APTC recognizes that our priorities may not match those of other interested parties. We understand that safe harbor is a complex area and that the APTC Safe Harbor may be criticized as not adequately addressing every issue raised by this difficult problem. However, we view our mandate at this time as requiring us to describe an approach that will work for the thousands of small and mid cap companies that APTC represents.

We note here that APTC has worked in concert with other parties, particularly two issuer groups, the Business Roundtable and the National Association of Manufacturers. While APTC, for reasons expressed above, believes that a new approach to the safe harbor dilemma will be more effective than revision of the current safe harbor, we are pleased to commend the BRT/NAM group's recent submission to you as a sound effort to revise Rule 3b-6. The BRT/NAM paper, "Improving U.S. Capital Market Efficiency by Encouraging Corporate Disclosure of Forward-Looking Information: A Proposal for Rulemaking by the Securities and Exchange Commission," dated September 2, 1994, contains a thorough analysis of the safe harbor problem. In the interest of brevity, APTC generally incorporates Sections I through V and VI.A. of that document by reference.

APTC recognizes that our proposal raises policy questions of considerable magnitude. In preliminary meetings with your fellow Commissioners and senior Commission staff, we have benefitted from a frank dialogue on these important issues. We view this submission as a continuation of that dialogue. We are confident that this approach will receive the Commission's careful consideration and look forward to working with you, other members of the Commission and the Commission staff on this extremely important matter. We stand ready to meet and discuss our proposal or any other means of accomplishing the goals of the APTC Safe Harbor.

Very truly yours,

Christopher J. Murphy III
Chairman

Brian T. Borders
President

cc: Richard Y. Roberts
Mary L. Schapiro
J. Carter Beese, Jr.
Steven M.H. Wallman
Simon M. Lorne
Linda C. Quinn
William R. McLucas

Attachment Two

In Re Wells Fargo Securities Litigation

On Petition For Writ of Certiorari to the
United States Court of Appeals for the Ninth Circuit

No. 93-1993

In The

Supreme Court of the United States

October Term, 1994

IN RE WELLS FARGO SECURITIES LITIGATION

WELLS FARGO & CO., *et al.*,

Petitioners,

v.

HOWARD GREENWALD, *et al.*,

Respondents.

On Petition For Writ of Certiorari To The United States Court of Appeals For The Ninth Circuit

MOTION FOR LEAVE TO FILE BRIEF and BRIEF AMICI CURIAE OF THE AMERICAN ELECTRONICS ASSOCIATION and THE ASSOCIATION OF PUBLICLY TRADED COMPANIES IN SUPPORT OF THE PETITION FOR WRIT OF CERTIORARI

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**Counsel of Record*

No. 93-1993

In The

Supreme Court of the United States

October Term, 1994

IN RE WELLS FARGO SECURITIES LITIGATION

WELLS FARGO & CO., *et al.*,

Petitioners,

v.

HOWARD GREENWALD, *et al.*,

Respondents.

On Petition For Writ of Certiorari
To The United States Court of Appeals
For The Ninth Circuit

MOTION FOR LEAVE TO FILE BRIEF AMICI CURIAE

Pursuant to Rule 37.2, the American Electronics Association ("AEA") and the Association of Publicly Traded Companies ("APTC") move the Court for leave to file the attached brief, as *amici curiae*, in support of the petition of Wells Fargo & Co. and others for a writ of certiorari to the United States Court of Appeals for the Ninth Circuit. Counsel for petitioners has consented to the filing of the brief. Counsel for respondents has refused to give consent.

The AEA represents some 3,000 companies in 44 states, spanning the breadth of the electronics industry, including the semiconductor, software, computer, telecommunications, networks and systems fields.

APTC consists of over 500 corporations. APTC's membership includes the newest and smallest publicly traded companies, as well as larger, more mature corporations. Since its founding in the 1970's, APTC has represented thousands of companies before the federal government and regulatory agencies. As the name implies, APTC represents companies in every industry and concentrates on issues of concern common to every public company, rather than those which affect a certain region, economic sector, or industry. APTC strives to: (1) enhance fair and efficient access to the capital markets; (2) increase the opportunity to maximize investment return to long-term investors; and (3) preserve the ability to manage corporate affairs responsibly, free from unnecessary governmental regulation and frivolous litigation.

The members of the AEA and the APTC, like other similarly situated corporations, face the prospect of securities class action litigation virtually any time there is a significant decline in the price of their stock. *Amici* submit that the decision of the court of appeals in this case will exacerbate the trend by preventing district courts from subjecting allegations of securities fraud to meaningful scrutiny. Many members of the AEA and the APTC are located within the jurisdiction of the Ninth Circuit and thus stand to be particularly affected by the decision below.

Although this motion is "not favored" under Rule 37.2, it is presented in the belief that the brief *amici curiae* may assist the Court in its Rule 10 consideration of whether *certiorari* should be granted.

1. Since the petition was filed, the Second Circuit has expressly declined to follow the decision of the Ninth Circuit in this case, announcing that "the dissent by Judge Trott in *Wells Fargo* [is] more consonant with case law in this Circuit." *Shields v. Citytrust Bancorp. Inc.*, ___ F.3d ___, 1994 U.S.App. LEXIS 13465 (2d Cir. June 2, 1994). Thus, one office of the *amici curiae* brief is to discuss *Shields* and the widened, patent circuit conflict that has developed since the petition was filed.

2. The Ninth Circuit's decision minimizes the requirements for pleading a securities fraud case. This minimalist view of pleading strictures is antithetical to Rule 9(b) of the Federal Rules of Civil Procedure and to well-informed viewpoints expressed in Congress and by those Executive Branch officers charged with responsibility for the development and enforcement of the nation's securities laws. The Ninth Circuit has made it easier to charge securities fraud at a time when informed sentiment favors greater protection to defendants by discouraging unjustified charges of fraud and dampening the increasingly automatic filing of securities fraud litigation whenever stock prices decline. Thus, another office of the *amici curiae* brief is to show that the Ninth Circuit's liberal hospitality toward general allegations of fraud is at cross-purposes with other developments in the nation's securities laws.

CONCLUSION

This motion should be granted.

Dated: July 14, 1994

Respectfully submitted,

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No. 93-1993

In The

Supreme Court of the United States

October Term, 1994

IN RE WELLS FARGO SECURITIES LITIGATION

WELLS FARGO & CO., *et al.*,

Petitioners,

v.

HOWARD GREENWALD, *et al.*,

Respondents.

On Petition For Writ of Certiorari
To The United States Court of Appeals
For The Ninth Circuit

BRIEF AMICI CURIAE OF THE AMERICAN ELECTRONICS ASSOCIATION and THE ASSOCIATION OF PUBLICLY TRADED COMPANIES IN SUPPORT OF THE PETITION FOR WRIT OF CERTIORARI

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BRIEF AMICI CURIAE OF THE AMERICAN ELECTRONICS ASSOCIATION and THE ASSOCIATION OF PUBLICLY TRADED COMPANIES

This brief *amici curiae*, accompanied by motion for leave to file under Rule 37.2, is presented by the American Electronics Association ("AEA") and the Association of Publicly Traded Companies ("APTC") in support of the petition of Wells Fargo & Co. and others for a writ of *certiorari* to review the decision of the United States Court of Appeals for the Ninth Circuit in this cause, reported below at 12 F.3d 922.

DESCRIPTION AND INTEREST OF AMICI CURIAE

The AEA represents some 3,000 companies in 44 states, spanning the breadth of the electronics industry, including the semiconductor, software, computer, telecommunications, networks and systems fields.

APTC's membership includes more than 500 corporations, ranging from the newest and smallest publicly traded companies, to more mature corporations of medium size, to some corporations of Fortune 500 dimension. Since it was founded in the 1970's, APTC has represented the interests of its members before branches of the federal government. As the name implies, APTC represents companies in every industry and concentrates on issues of concern common to every public company, rather than those which affect a certain region, economic sector, or industry. APTC strives to: (1) enhance fair and efficient access to the capital markets; (2) increase the opportunity to maximize investment return to long-term investors; and (3) preserve the ability to manage corporate affairs responsibly, free from unnecessary governmental regulation and frivolous litigation.

The members of the AEA and the APTC, like other similarly situated corporations, face greater prospects of securities class action litigation if the Ninth Circuit decision remains in effect. Indeed, many members of the AEA and the APTC are located within the geographic region covered by the Ninth Circuit.

SUMMARY OF ARGUMENT

The decision of the Ninth Circuit in this case is manifestly in conflict with the decisions of other circuits and the conflict has widened since the petition was filed. The Second Circuit has now expressly declined to follow the Ninth Circuit's decision because it represents a departure from the heightened pleading standard required in securities fraud actions under F.R.Civ.P. Rule 9(b). *Shields v. Citytrust Bancorp, Inc.*, ___ F.3d ___, 1994 U.S. App. LEXIS 13465 (2d Cir. June 2, 1994).

The Ninth Circuit's decision diminishes the role of pleading rigor as a tool to curb unmeritorious securities fraud allegations at a time when an informed consensus is moving in favor of greater protection for defendants. Congress and the SEC perceive intolerable costs imposed on publicly-traded companies by excessive numbers of securities fraud cases, blithely filed on a near automatic basis in response to any stock market misfortune. If such suits are not subject to effective, early merit screening, they impose undesirable *in terrorem* effects, including litigation costs and coerced settlement payments. Rigorous pleading requirements for fraud and safe harbor protections for forward looking statements made by securities issuers are devices that impose merit screening. These rules of law balance shareholder rights of redress against the need to deter unmeritorious "strike" litigation. The Ninth Circuit multiplies the costs of unmeritorious litigation and begets more of the same when it relaxes fraud pleading standards and makes forward looking statements broadly actionable.

ARGUMENT

I. *Certiorari* Should Be Granted to Resolve a Conflict Among the Circuits Concerning the Application of F.R.Civ.P. Rule 9(b) to the *Scienter* Requirement for Implied Rights of Action Under Section 10 of the Securities and Exchange Act (15 U.S.C. § 78j(b))

The conflict among circuits ably described by petitioners is now blatant. In *Shields v. Citytrust Bancorp, Inc.*, ___ F.3d ___, 1994 U.S. App. LEXIS 13465 (2d Cir. June 2, 1994), the Second Circuit expressly declined to adopt the reasoning of the Ninth Circuit in *Wells Fargo,* preferring Judge Trott's dissent as a correct statement of the law.

In *Shields,* plaintiff's "pleading technique" was described by the court as "coupl[ing] a factual statement with a conclusory allegation of fraudulent intent." 1994 U.S. App. LEXIS 13465 at *15. The court found that these allegations did not contain facts which "would indicate conscious fraudulent behavior or recklessness," or alternatively would "demonstrate both motive and opportunity to commit fraud." *Id.* at *16. Among other things, the court rejected plaintiff's contention that "motive and opportunity" could be inferred from the allegation that defendants artificially inflated the price of Citytrust stock "to protect their executive positions and the compensation and prestige they enjoy thereby" (*id.* at *18-19). The Second Circuit held that establishing an inference of motive requires a plaintiff to do "more than merely charge that executives aim to prolong the benefits of the position they hold," and explained the consequences of a rule to the contrary:

> If motive could be pleaded by alleging the defendant's desire for continued employment, and opportunity by alleging the defendant's authority to speak for the company, the required showing of motive and opportunity would be no realistic check on aspersions of fraud, and mere misguided optimism would become actionable under the securities laws.

Id. at 20.

The Second Circuit declined to follow what plaintiff characterized as "the less demanding view of the pleading requirements in securities fraud cases" enunciated by the Ninth Circuit in *Wells Fargo*. 1994 U.S. App. LEXIS 13465 at *24-25. After noting that the *Wells Fargo* majority opinion did not address the specificity requirements of Rule 9(b), and that "there is some tension" between *Wells Fargo* and *In re GlenFed, Inc. Securities Litigation*, 12 F.3d 893 (9th Cir. 1993), *reh'g en banc granted*, 1994 U.S. App. LEXIS 3331 (9th Cir. Feb. 25, 1994), the Second Circuit concluded:

> In our view, the opinion in *GlenFed* and the dissent by Judge Trott in *Wells Fargo* are more consonant with case law in this Circuit.

Shields, 1994 U.S. App. LEXIS at *26.

Shields is therefore instructive on three counts: (1) it illustrates the divergent approaches adopted by various courts regarding the requirements for pleading scienter; (2) it confirms that the issues presented by the petition are not merely academic, but rather ones with significant repercussions; and (3) it rejects the proposition that averments about job security similar to those asserted by the

plaintiffs in the *Wells Fargo* case are sufficient to allege scienter.

For the reasons explained by the Second Circuit, the heightened pleading standard of Rule 9(b) serves the vital function of providing a "realistic check on aspersions of fraud. . . . " *Shields*, 1994 U.S. App. LEXIS 13465 at *20. By contrast, allowing plaintiffs to proceed with extraordinarily costly class action litigation without offering anything more than conclusory (and often illogical) averments of "motive" and "opportunity" will increase the flood of lawsuits alleging "fraud by hindsight," and create additional "opportunities for 'undeserved settlements.' " *Id.* at *20-21, citing *In re Time Warner, Inc. Securities Litigation*, 9 F.3d 259, 263-64 (2d Cir. 1993).[1]

II. *Certiorari* Should Be Granted Because the Decision of the Ninth Circuit is at Cross-Purposes with a General Trend Favoring More Protection Against Unmeritorious Securities Fraud Allegations, Not Less

A. There Is a Need for Effective Devices to Curb Unmeritorious Securities Fraud Allegations

Arthur Levitt, Chairman of the SEC, has publicly commented on the problems posed by automatic allegations of securities fraud filed when the price of traded stock falls. "The proponents of litigation reform deserve

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[1] *See also Greenstone v. Cambex Corp.*, 975 F.2d 22, 25 (1st Cir. 1992), in which Chief Judge Breyer noted that allowing plaintiffs to circumvent Rule 9(b) in pleading scienter would sanction "fraud by hindsight."

to be taken seriously, however, because there are indications that our current system is flawed." He further stated that "the Commission also recognizes that the current system imposes substantial costs on issuers."[2]

There is a strong empirical basis for these observations. One study indicates that over the last five years, more securities fraud cases have been brought in California federal courts than any other state in the country.[3] Another study indicates that technology companies are sued far more frequently than any other industry, pay the highest average settlements of any industry – over $9 million – and pay the highest percentages of settlement dollars in relation to investors' market losses.[4] Even so, the average settlement recovery in the cases studied was less than 7% of investor losses.[5] Still another study of several hundred public companies reveals that on average, companies which have been sued for securities fraud spent almost $700,000 on legal fees, and had their premiums almost double for Director & Officer insurance.

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[2] Chairman Arthur Levitt, "Private Litigation Under the Federal Securities Laws," Remarks at the Securities Regulation Institute, University of California, San Diego, Coronado, California (January 26, 1994 at pp. 3-4).

[3] *See* Vincent O'Brien and Richard Hodges, "A Study of Class Action Securities Fraud Cases, 1988-1993," (Law & Economic Consulting Group Inc., 1993), at pp. 1-10 (hereinafter "O'Brien and Hodges").

[4] Frederick Dunbar and Vinita Juneja, "Recent Trends II: What Explains Settlements in Shareholder Class Actions?" (NERA 1993), Tables 5, 6, and 7 (hereinafter "Dunbar and Juneja").

[5] *Id.*, Tables 6 and 7.

The great majority of companies also reported being more reluctant to publicly discuss company performance as a result of being sued.[6]

Chairman Levitt has concluded, "a litigation system imposes tremendous unnecessary costs when it is abused by investors or their attorneys. Our challenge is to find ways to minimize its costs while preserving the rights of defrauded investors."[7]

Others studying the situation have reached the Chairman's view. Senator Domenici concluded after months of investigation that "these frivolous lawsuits are such a menace to publicly traded companies on the NASDAQ that the NASDAQ Self Regulatory Organization decided to recommend reforms to Senator Dodd and me."[8]

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[6] Survey conducted by Venture One for National Venture Capital Association and American Entrepreneurs for Economic Growth, *The Impact of Securities Fraud Suits On Entrepreneurial Companies* (January 1994).

[7] A. Levitt, *Private Litigation*, pp. 1-2.

[8] Statement of Senator Domenici on Introduction of the Private Securities Litigation Reform Act, S. 1976, March 24, 1994. "Proceedings and Debates of the 103rd Congress, Second Session," 140 Cong.Rec., S3685-01, S3706-S3707, 1994 WL 95349 (Cong.Rec.), at 156-64 (March 24, 1994).

Underscoring Senator Domenici's remark, a recent study of 500 companies sued for securities fraud between 1988 and 1993 showed that 38% were NASDAQ traded companies. California was the headquarters for nearly a third of the companies in the study. *See* O'Brien and Hodges.

B. The Current Debate on Securities Reform and "Safe Harbor" Provisions Underscores the Importance of Heightened Scrutiny of Securities Fraud Suits

The need to strike a reasonable accommodation between the legitimate rights of investors to seek redress for fraud and the deterrence of meritless strike suits has been recognized within Congress and the SEC. While Congress considers the possibility of legislative reforms, the SEC is contemplating changes to the "safe harbor" rules governing certain forward-looking statements made by issuers.[9] The Ninth Circuit's decision, which would inhibit meaningful analysis of securities actions at the pleading stage, affects these important issues and therefore merits consideration by this Court.

1. F.R.Civ.P. Rule 9(b) requires specificity in the pleading of fraud allegations. Apart from the court of appeals' decision here, where the whole concept of specificity seems to have been abandoned outright, the debate has been over whether the pleading rigor required under Rule 9(b) should be increased.

On March 24, 1994, in response to the problems noted by Chairman Levitt and others, Senators Dodd and Domenici introduced Senate Bill 1976. The Bill was the product of extensive testimony and fact-gathering in 1993 and

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[9] Petitioners define a "forward-looking statement" as "any statement used by a corporation or its management regarding future developments. For example, disclosures of financial forecasts, predictions or economic trends, and management's plan for future operations are types of forward-looking statements." *See* Pet., p. 5, n.6.

1994 from a wide range of industry experts, academicians, economists, public company executives, and shareholder advocates. The testimony before the Subcommittee on Securities of the Senate Banking Committee focused particular attention on whether existing statutes, rules and regulations, including the Federal Rules of Civil Procedure, provided sufficient safeguards against frivolous securities litigation. Mr. William Lerach, a leading member of the plaintiffs' securities bar,[10] testified that *no* reforms were needed, and that "there are ample legal safeguards in place to protect against unwarranted actions." He expressly cited Rule 9(b) as one of those safeguards: "Federal Rule of Civil Procedure 9(b) requires that securities fraud claims be pleaded with particularity and that each defendant's role in the illegal fraud be set forth in detail."[11] To buttress his argument that Rule 9(b) is working, and that more securities fraud lawsuits are being dismissed on the pleadings, he relied on a 1992 *Wall Street Journal* article describing a purported trend of more frequent dismissals of securities suits. Ironically, one of the principal cases discussed in the *Wall Street Journal* article was the trial court's decision in this case.[12] Later, the *Journal* was reporting an opposite trend,

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[10] Mr. Lerach is one of the counsel for Respondents in this case.

[11] William S. Lerach, Testimony Before the Subcommittee on Securities, Senate Committee on Banking, Housing, and Urban Affairs (June 17, 1993), at p. 5.

[12] Richard B. Schmitt, "More Companies Succeed in Defending Charges That They Defrauded Investors," *Wall St. J.*, April 30, 1992, at B1-2.

namely, that *more* frivolous suits are being brought, particularly against smaller companies.[13]

Consistent with his argument that Rule 9(b) is working, Mr. Lerach urged reform of a different kind, namely, that Congress adopt a "mandatory rule" that plaintiffs in securities class actions can obtain discovery from a defendant corporation whenever a stock price decline is preceded by insider selling.[14] The reason given for this suggested reform is informative. Mr. Lerach argued that this "modified pleading requirement" is required because "in most jurisdictions, a plaintiff cannot survive a motion to dismiss even if he or she shows that such trading took place immediately before such a stock drop."[15]

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[13] B. Bowers and V. Gupta, "Shareholder Suits Beset More Small Companies," *Wall St. J.*, March 9, 1994, at B5.

[14] William S. Lerach, Testimony, June 17, 1993, *supra*, at 26-27.

[15] *Id.* at 26-27. Other advocates who testified or submitted statements to Congress similarly have argued that Rule 9(b) is an adequate safeguard, and that legislative reform is not needed. For example, Professor Joel Seligman of the University of Michigan Law School responded to criticisms about the ineffectiveness of Rule 9(b) by arguing in conclusory fashion that Rule 9(b) was effectively used to dismiss complaints in approximately 60% of some 46 motions studied. Professor Seligman offered no data, however, indicating either that any of the dismissals in question were without leave to amend, or that there was any uniformity, geographic or otherwise, to the cases studied. In the vast majority of cases, particularly in the Ninth Circuit, motions to dismiss are either denied, or, if granted, are granted with leave to amend. According to a 1993 study of some 280 cases over a two year period, only *five* cases in the Ninth Circuit were dismissed without leave to amend. *See* Dunbar and Juneja, *supra*.

Congress has moved to expand Rule 9(b) to require pleading of scienter with particularity. Senators Dodd and Domenici include in Senate Bill 1976 a provision to add a new section to the 1934 Act. New section 39(a) would provide:

> INTENT – In an implied private action arising under this title in which the plaintiff may recover money damages from a defendant only on proof that the defendant acted with some level of intent, the plaintiff's complaint shall allege specific facts demonstrating the state of mind of each defendant at the time the alleged violation occurred.

Although it cannot be predicted whether Congress will enact reform legislation, or what form that legislation will ultimately take, the discussion reveals the idiosyncratic nature of the *Wells Fargo* opinion. The Ninth Circuit has lowered the required pleading specificity just as debate has focused on whether *more* specificity should be mandated.

2. This case demonstrates the fate-tempting hazards facing a company which makes forward-looking statements. If months after they are made, such statements turn out to be inaccurate, the threat of a class action lawsuit looms large, even if the statements were entirely reasonable at the time they were made. As the Second Circuit noted in *Shields*, unless allegations of fraud are subject to meaningful scrutiny, "mere misguided optimism would become actionable under the securities laws." 1994 U.S. App. LEXIS 13465 at *20.

Senate Bill 1976 contains a provision which would direct the SEC to consider the need for rulemaking or

legislation to strengthen the Commission's so-called "safe harbor" rules, and to provide trial courts with appropriate procedural devices for dismissing securities suits based on forward-looking statements otherwise protected by such "safe harbor" rules. Senate Bill 1976, Section 201, reads as follows:

> SEC. 201. SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS.
>
> (a) CONSIDERATION OF REGULATORY OR LEGISLATIVE CHANGES – In consultation with investors and issuers of securities, the Securities and Exchange Commission shall consider adopting or amending its rules and regulations, or making legislative recommendations, concerning-
>
> (1) criteria that the commission finds appropriate for the protection of investors by which forward-looking statements concerning the future economic performance of an issuer of securities registered under section 12 of the Securities Exchange Act of 1934 will be deemed not to be in violation of section 10(b) of that Act; and
>
> (2) procedures by which courts shall timely dismiss claims against such issuers of securities based on such forward-looking statements if such statements are in accordance with any criteria under paragraph (1).
>
> (b) COMMISSION CONSIDERATIONS – In developing rules or legislative recommendations in accordance with subsection (a), the Commission shall consider-
>
> (1) appropriate limits to liability for forward-looking statements;

(2) procedures for making a summary determination of the applicability of any Commission rule for forward-looking statements early in a judicial proceeding to limit protracted litigation and expansive discovery;

(3) incorporating and reflecting the scienter requirements applicable to implied private actions under section 10(b); and

(4) providing clear guidance to issuers of securities and the judiciary.

Fast upon the heels of this proposed legislation, the SEC announced that it would begin actively reviewing its safe harbor rules and considering rule-making to strengthen the existing safe harbors for forward-looking statements.[16] SEC representatives have publicly commented on the need for reform in this area.[17] Similarly, several commentators recently have expressed the view that greater protections should be extended to companies making forward looking statements – even to the point of "implying" a private right of action for such statements, and amending Rule 10b-5 to require a showing of "knowing" securities fraud sufficient to demonstrate "actual

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[16] Christi Harlan, "SEC Seeks to Beef Up Safe Harbor Provisions," *Wall St. J.*, May 17, 1994, at C1, C18.

[17] SEC Commissioner Carter Beese publicly complained that the safe harbor rules are not working, and that procedural rules modeled after the business judgment rule should be promulgated by the SEC in order to encourage more forward-looking disclosures, and to grant public companies "the freedom to be wrong." *See* J. Carter Beese, Jr., "Investor Protection Through Better Disclosure," Keynote Address at the Association of Publicly Traded Companies, 1994 Government Relations Conference, Washington, DC (June 6, 1994), at p. 4.

knowledge that the projection is false" as a precondition to bringing suit.[18]

Once again, the Ninth Circuit's opinion is diametrically positioned. The court of appeals held that dismissal was improper because the complaint adequately alleged misrepresentations in Wells Fargo's Annual Report regarding management's "belief" that loan loss reserves were "adequate." 12 F.3d at 930. Thus, allowing the *Wells Fargo* suit to go forward strikes at the heart of the concerns motivating Congress and the SEC, namely, the ability of plaintiffs to predicate a securities fraud suit based on statements of this kind.

3. It cannot be disputed that there is a strong public policy of deterring litigants from bringing frivolous cases which (a) tie up federal court dockets, (b) force defendants to spend millions of dollars on legal fees (or an equivalent amount to settle the case), (c) result in little or no benefit to investors on whose behalf these cases ostensibly are brought, and (d) cause public companies to provide less forward-looking information to the financial markets. If the court of appeals' decision is an aberration, then the public policy interest has necessarily been pinched by the inappropriately broad allowance of securities fraud damage suits.

Rigorously and uniformly enforced, existing Rule 9(b) represents a powerful deterrent against abusive shareholder class action suits. Indeed, the failure of the

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[18] J. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 Stanford Law Review 961, 1011-1015 (1994).

lower courts consistently to impose stringent pleading standards under Rule 9(b), as exemplified by the court of appeals' decision in this case, has sparked the call for legislative reform. While the proposals embodied in Senate Bill 1976 confirm the seriousness of the problem, it has traditionally been the province of this Court to promulgate and enforce uniform Rules of Civil Procedure. Granting the petition would provide the Court with the opportunity to discharge its oversight function regarding threshold pleading requirements in the federal courts.

CONCLUSION

Filing a class action lawsuit has almost become a Pavlovian response to a declining stock price. The court of appeals' decision inhibits the power of federal courts to curtail this disturbing and undesirable phenomenon. Accordingly, *amici* respectfully ask the Court to grant *certiorari* and reverse the decision of the Ninth Circuit.

Dated: July 14, 1994

Respectfully submitted,

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AMERICAN ELECTRONICS ASSOCIATION

U.S. Senate Subcommittee on Securities

Hearing on Abusive Shareholder Lawsuits

Testimony of
George Sollman, President & CEO
Centigram Communications Corporation
San Jose, California

on behalf of the
American Electronics Association

March 2, 1995

American Electronics Association

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Good morning, Mr. Chairman, Senator Dodd, and Members of the Committee. My name is George Sollman and I am the Chief Executive Officer of Centigram Communications Corporation. I am pleased to be here today to present my views on the effect that abusive securities lawsuits are having on high-growth, high-technology companies.

I am testifying this morning on behalf of the American Electronics Association (AEA)—an organization that represents some 3,000 U.S. technology companies. These companies are located in 44 States and span the breadth of the electronics industry, from silicon to software, to all levels of computers, communications networks, and systems integration. AEA was founded 50 years ago by 15 top technology firms in Silicon Valley, California.

Centigram Communications is a leading provider of integrated messaging products. Centigram solves communications problems by integrating voice, data, and facsimile on our Adaptive Information Processing (AIP) platform. This product family provides access to multimedia information through a telephone or PC. We were founded in 1980, went public in October, 1991, and currently have approximately 350 employees. I have been President and CEO of Centigram since February, 1985.

Mr. Chairman, the Federal Securities Laws were enacted by the Congress to prevent, among other things, investors from being defrauded by the companies in which they invest. The U.S. Supreme Court specifically authorized private lawsuits under Section 10(b) of the Securities and Exchange Act of 1934 to serve as the primary vehicle for compensating defrauded investors. In theory, these private actions were also intended to deter against securities law violations. In practice, the system is no longer serving to protect investors, and abusive lawsuits are now harming securities markets, making them less efficient and thereby making capital formation more difficult and more expensive.

U.S. capital markets function efficiently and effectively because of a strong and balanced enforcement system. The American Electronics Association believes the right of private action *to mitigate fraud* is an important adjunct to SEC enforcement. A balanced enforcement system *against fraud* protects investors, and ensures the free-flow of capital to the most productive sectors of the economy. High-technology, high-growth industries benefit from such a system. But while the AEA is for a strong system of private action, it is readily apparent that the current system is no longer functional nor balanced.

In recent years, U.S. high-technology companies have become the target of speculative, abusive securities litigation which enriches lawyers at the expense of shareholders and the economy. High-technology companies—particularly young, high-growth companies—are disproportionately becoming targets of this litigation because our stock price usually experiences greater-than-average fluctuation. Unfortunately, the entrepreneurial culture of our industry and the pace at which we develop new products, new technologies, and new innovations makes us easy prey for lawyers lurking to cash in on our volatility.

Mr. Chairman, abusive securities lawsuits are brought by a relatively small number of lawyers specializing in initiating this type of litigation. In many cases, the plaintiffs are investors who own only a few shares of the defendant corporation. And the corporations are frequently technology companies whose share price volatility precipitates the lawsuit. The plaintiffs do not need to allege any specific fraud. Indeed, many of these suits are brought *only* because the market price on the securities dropped. The plaintiffs' attorneys name as individual defendants the officers and the directors of the corporation and proceed to engulf management in a time-consuming and costly fishing expedition for the alleged fraud.

What drives these lawsuits? The answer is clear. Even when a company committed no fraud, indeed, no negligence, there is still the remote possibility of huge jury verdicts, not to mention the costs of litigation. In the face of such exposure, defendant companies inevitably settle these suits rather than go to trial. We believe plaintiff's lawyers understand the coercive psychology of the system and many of these suits are filed without just cause and solely for the purpose of extracting settlements.

Mr. Chairman, there are approximately 300 securities lawsuits filed each year. Nearly 93 percent of these suits settle for an average of $8.6 million apiece. That makes this a $2.4 billion industry with a third of this amount, plus expenses, going to the lawyers. As a result of the perverse economics driving these cases, meritless cases settle for far too much, and meritorious cases settle for far too little.

If anyone questions whether the existence of frivolous lawsuits, I invite them to visit Silicon Valley. A new survey conducted by the AEA confirms that *one out of every two*—more than 50 percent of Silicon Valley companies—have been the subject of a 10(b)(5) Securities Class-Action Lawsuit!

Mr. Chairman, the current securities litigation system is seriously impacting the competitiveness and productivity of America's technology companies. It is also directly impacting our ability to innovate and create jobs. Allow me to elaborate:

- *Abusive lawsuits restrict the amount of useful and available information that the companies are willing to disclose to the public.* Many company officials refuse to talk to analysts about their projections for fear of being sued if the estimates do not materialize. A survey by the American Stock Exchange reported 75 percent of corporate CEO's *limit* the information disclosed to investors out of fears of a meritless suit.
- *Defending against these types of lawsuits detracts management attention from the business at hand and costs the company millions of dollars in attorneys fees, whether the case is tried or settled.* One survey suggested that the average meritless lawsuit cost companies nearly $700,000 in fees and over 1,000 hours of management time, not including the actual costs of settlement which average $8.6 million.
- *As a consequence of abusive lawsuits, experienced, and respected members of the corporate community are reluctant to serve on corporate boards of high-technology companies.* This is primarily because the potential liability from securities litigation—in which they are named defendants—is just too great.
- *Massive settlements are causing D&O insurers to either stop underwriting policies for technology companies, or make such coverage prohibitively expensive.*

Let me give you two concrete examples of the impact of frivolous securities litigation—one on the West Coast and one on the East Coast:

Adept Technology, San Jose, California—Adept Technology is the only U.S. robotics company. Adept Technologies has sales of approximately $50 million and employs more than 275 individuals. They are currently contemplating an Initial Public Offering (IPO). As a private company, Director and Officer Liability Insurance cost approximately $29,000 a year for $3 million of coverage. As a public company, Adept was advised to carry a D&O policy of $5 million in coverage, which costs upward of $450,000 per year. Why $5 million? Because Adept will undoubtedly be sued within a year or two of their IPO. A Canadian publicly-traded company in a similar line of business pays $40,000 for $4 million of coverage, roughly the same rate Adept pays as a private company. So, Adept pays a "litigation tax" and Adept's foreign competitors enjoy a significant advantage. How do we quantify this "litigation tax?" In simplest terms, it represents a team of five or six engineers—a new product or new technology.

CMX Systems, Wallingford, Connecticut—CMX Systems was started by two optical physicists with a concept for producing the most precise measurement tool in the world. CMX, with the aid of less than two million dollars in investment capital, had by 1993 blossomed into one of the world's fastest growing companies. Revenues grew from $500,000 in 1990 to $8.3 million in 1993; employment grew from 3 to over 50. In 1993, CMX discovered several technologies and markets that had the potential to produce another ten-fold increase in revenues and employment over the next 3 years. In order to realize this potential, CMX needed to raise $4 million through an IPO. CMX soon discovered that—because of its rapid growth—most of the prestigious high-technology underwriters were unwilling to participate in the deal. CMX CEO Bob Gilbertson was told, "We won't do the deal because we have deep pockets. Given the variability of your outstanding growth, you will have a down quarter in 1994. Within 24 hours, you will be sued. And so will we."

In summary, Mr. Chairman, we believe the current securities litigation system promotes meritless litigation, short-changes investors, and costs jobs. It is a showcase example of the legal system run awry.

The AEA is *convinced* that legislative reform is needed to address the problem of abusive securities lawsuits. In our view, Senate Bill 240, the Domenici/Dodd Bill, contains a series of structural and procedural reforms which will help slow the onslaught of securities cases, but we are concerned it may not go far enough. In order to truly reform the system we believe we need to explore proposals that fundamentally alter the economics that drive these cases. We believe H.R. 10, the Securities Litigation Bill currently pending in the House, moves us much closer toward that goal.

Thank you, I would be pleased to respond to your questions.

SECURITIES LITIGATION REFORM PROPOSALS—S. 240, S. 667, AND H.R. 1058

WEDNESDAY, MARCH 22, 1995

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, DC.

The Subcommittee met at 10 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Phil Gramm (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF SENATOR PHIL GRAMM

Senator GRAMM. The hearing will come to order.

I want to thank each of you for coming. We are engaged in what I believe to be an important activity in this Subcommittee, and that activity is an effort to determine how we should reform securities litigation in America, how we balance the legitimate rights of people who are defrauded to receive damages commensurate with the damage imposed on them, and how, at the same time, we prevent frivolous lawsuits and reform a system of litigation that, in the end, impedes our ability to create job growth and opportunity.

It is a classic decision that any society has to make in weighing the relative rights of people who live in that society. And I want to thank each of you for your participation in these hearings.

In our last hearing, we had at least the hint of a suggestion that we might question people's motives that appear before this Subcommittee. Let me say as Chairman, that as long as I'm Chairman here, we're going to respect anybody who appears before this Subcommittee. There is nothing wrong with special interests or individual interests or group interest. It has always been my contention that only I represent the public interest in Washington, DC. I always believe that anybody else representing any interest is doing so for the reason that they believe it needs to be represented. And certainly, we intend to respect your views here. We want to hear them.

I think there is a consensus on the Subcommittee that we need to make changes. But I think it's very important that we listen to people on all sides of this issue. It can never do anything but help us do our job better to know how people feel.

As I said when we had our last hearing, we used to begin on the left in this Subcommittee when we had a Democratic majority. Now we have a Republican majority. We begin on our right.

[Laughter.]

I want to give each of you time to make your statement. But if you can, try to be fairly brief because we want to spend most of our time with questions. Let me ask each of you as you make your opening statement to tell us who you are and about your affiliation.

I notice our Ranking Member has come in to the Subcommittee, and Senator Boxer is here as well. So while I was ready to begin, let me just hold off for a minute.

Senator Dodd, if you had an opening statement you wanted to make, we'd be happy to hear it.

OPENING STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. I'd like to, Mr. Chairman, and I'll try and keep it brief. I appreciate your determination to move this along, but I think it's important in a sense we sort of revisit the bidding a little bit on the issue, if I could. So if I can just take a minute or two.

Senator GRAMM. Sure.

Senator DODD. Thank you, Mr. Chairman for holding these hearings. I think it's extremely important that we hear from those in the country who have reservations, to put it mildly in some cases, about the bill before us. And I think it's important that we kind of repeat some of the ideas behind or the genesis that brought us to the legislation.

First of all, as I know the Chairman knows, the debate on securities litigation reform has shifted dramatically, I would point out, over the last year or so. There are very few people who still argue that the current system needs no repair. That was the position taken by a number of people a year or more ago.

The defects in our private securities litigation process I think are simply just too obvious to ignore. The malady has spread through the entire body. The question we now face is how major should the surgery be in this area?

Second, I think the reform effort here in the Senate has been and continues to be broadly bipartisan.

S. 240, the proposal that my good friend and colleague from New Mexico and I have sponsored, was introduced with 19 of our colleagues from both sides of the political spectrum. Another 16 Senators have cosponsored the bill since we introduced it.

The Democratic supporters include Senators Mikulski, Moseley-Braun, Murray, Johnston, Conrad, Pell, and Rockefeller.

The Republican cosponsors include Senators Hatch, Bennett, Mack, Frist, Faircloth, and Chafee, just to name a few.

I believe it's extremely important that we maintain this cooperative spirit going forward and I will do my best to continue in that vein.

Even in the House, the vote to approve the Comprehensive Securities Litigation Reform Act was overwhelmingly bipartisan. Three hundred twenty-five Members voted for final passage of a measure that makes more sweeping changes than we've recommended in S. 240. Only 99 Members voted against the proposal. The majority of Democrats voted for the final passage.

I continue to have a number of concerns about certain provisions in the House bill and I'm sure we'll hear from our witnesses today about those. However, I was pleased to see that an effort was made

to revise the original proposal, both in Committee and on the Floor of the House, in order to attract a broader bipartisan support.

Mr. Chairman, as we will hear today, there are still serious disagreements about what a securities litigation proposal should contain. However, I don't believe that we are far from consensus. If one looks at the Domenici-Dodd bill, there is widespread agreement on many of its provisions. There are really only three or four issues that may be difficult to find common ground over.

After this series of hearings is completed, Mr. Chairman, I hope that we'll begin the process of putting together a consensus bill to move out of Committee. And I'm eager to work with our colleagues to develop a comprehensive proposal that will carefully balance the rights of plaintiffs and defendants.

Resolving the remaining differences won't be easy. There are some critics on both sides, many of today's witnesses think that S. 240 goes too far. Others, including some of the witnesses at our last hearing, think our bill doesn't go far enough. Many constructive suggestions have been made about how we might improve the legislation. Some reworking obviously is going to be necessary. In the end, nobody is going to get everything they want, but we will see, I think, a comprehensive proposal unveiled.

There's certainly strong public support for securities litigation reform. Over the last 2 years, a broad spectrum of individuals and organizations have endorsed our efforts, everyone from large and small investors, large and small businesses, to public officials and private professionals.

The support continues to grow. According to a new survey to be released today, an overwhelming number of Americans aged 50 and over who invest in stocks and mutual funds say they favor legislation to prevent frivolous lawsuits against America's high-growth companies.

The poll conducted by Public Opinion Strategies for the National Investor Relations Institute found that 87 percent say that they worry that lawsuits are diverting resources that could be used on product research and business expansion to create jobs.

At any rate, Mr. Chairman, I again thank you for holding the hearing today. I would hope, and you may have already made note of this, but I would hope, and I gather there's some agreement on this, that we have an opportunity to hear from the Securities and Exchange Commission on this issue.

I think it's important that their views be expressed in our public hearing process and I gather it may be possible to have a morning in which we can get an hour or two and have the SEC come before the Subcommittee. I hope that would be the case. I think it's important that they be heard—you and I have talked about this—before we complete the hearing process.

Senator GRAMM. Well, Chris, let me say that when we had our last hearing, we heard from proponents of reform. We have tried to put a panel together today of people who either were requested by Members of the Subcommittee or people who made a strong argument that they should be heard.

I thought once we've heard from both sides, so to speak, that then we ought to look and ask whether we now need to go back to the SEC for their views? If so, should we have the SEC current

leadership, or should we have the current head of the SEC and maybe a couple of other people who have been SEC members?

I think that's up in the air. But I think one of the things I can assure you, Senator Dodd, is that we want to hear from everybody before we begin to write the bill. It's my objective to hold probably one more hearing, and the SEC would either be one of the witnesses or the only one.

Senator D'Amato.

OPENING STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Thank you, Mr. Chairman. I would like to commend you for holding this hearing and bringing in witnesses who have different perspectives on securities litigation reform.

Once again, I would like to commend Senator Domenici and Senator Dodd for introducing this legislation. While I have some concerns about various aspects of the proposed legislation, I believe it is the most balanced vehicle for reform introduced to date.

I look forward to working with my colleagues to put forth a bill that reforms the litigation system while preserving the rights of defrauded stockholders. However, I remain concerned with the "loser pays" concept which, although politically attractive, seems to restrict shareholders ability to seek redress.

Senators Dodd and Domenici have made a constructive proposal that goes a long way to free our capital system from burdensome, litigious suits without merit. While I support my colleagues efforts to stop frivolous cases, I think we need to carefully consider all the issues involved in order to present an effective and balanced bill.

I ask that my full statement be placed in the record.

Senator GRAMM. Senator Boxer.

OPENING STATEMENT OF SENATOR BARBARA BOXER

Senator BOXER. Thank you so much, Mr. Chairman, for holding these hearings.

I want to particularly thank you because I very much wanted Joan Gallo to be on this panel and you made that——

Mr. Chairman, I'm thanking you. I don't do that too often.

[Laughter.]

I'm thanking you for——

Senator GRAMM. Take your time. Don't spare any superlatives.

Senator BOXER. Mr. Chairman, thank you very much for making it possible for Joan Gallo to be here from San José. She is the City Attorney of San José, where they had a real problem with unsuitable investments. The city sued the broker-dealer on behalf of the taxpayers and were able to collect substantially and keep the city out of bankruptcy.

And I can assure you, Mr. Chairman, that had the Contract With America been the law of the land, Joan Gallo and the people of San José could never have even walked into the courtroom.

I agree with my Chairman. I think every David has a right to meet every Goliath. And I am trying to think of a comparable female term.

[Laughter.]

But the bottom line is everyone has a right to get into the courtroom if they have a reasonable case to be made.

I believe we do need reform here. But I don't want to go too far.

Again, I think the contract in the House, as it was originally written, goes too far. I think it would have made it very difficult for small investors to get into the courtroom and it would have created a number of loopholes that would open the door to securities fraud.

I think it's an important point to realize that we need to focus on fixing what's broken. U.S. capital markets are the strongest and safest in the world. Private securities fraud suits play an important role in fostering investor confidence in the markets, which, as a result, will encourage investments necessary for capital formation, economic growth, and job creation.

We have to take steps to limit frivolous lawsuits because they drain dollars that could be used for R&D or new hires. We've had that problem in the Silicon Valley. It has to be addressed. These meritless suits must be screened out and dismissed at the initial stages before they impose unnecessary discovery burdens and legal costs on honest companies and company officials.

I want to make one other point here.

Absolutely, Senator Dodd, you are correct that people are very much opposed to frivolous lawsuits. It irritates them and it should. But I don't think that the elderly who sued Charles Keating engaged in a frivolous lawsuit. And I don't think those investors in Orange County who will sue broker-dealers will be engaging in frivolous lawsuits. The fact is those are reasonable lawsuits.

And again, if the Contract With America had passed, Charles Keating would have gotten away with it. And these people in Orange County wouldn't have been able to get in the court.

So, in summary, I commend Senators Domenici and Dodd for putting forward, I think, the most reasonable of the bills that we've seen. I think there's room for improvement. I also share the views of the Chairman of this Committee and others on "loser pays." I think that's a bad way to go.

Our system is the greatest system in the world. Let's be careful when we fix it to fix what's broken but not to go too far.

Thank you very much, Mr. Chairman, for your kind attention.

Senator GRAMM. Senator Domenici.

OPENING STATEMENT OF SENATOR PETE DOMENICI

Senator DOMENICI. Mr. Chairman, I'm not a Member of the Subcommittee and perhaps the Subcommittee Members should go next.

Senator FAIRCLOTH. No, go ahead.

Senator DOMENICI. I'm not going to take much of your time. I thank you and Senator D'Amato for inviting me.

Senator Dodd, thank you very much for the 4 years of diligence you have put into this effort.

Actually, I'm very pleased that the House passed the bill. We can sit here and say we don't like parts of it. But, essentially, last year, the last Congress and the Congress before, this issue was not on the agenda. We didn't make an attempt at reform because there was little chance that anything would happen in the House. We all know that.

And now reborn is going to happen. I hope the lawyers at the witness table understand that we're not trying to get rid of legiti-

mate lawsuits or take away fees from lawyers. But something is wrong with the system.

Anybody that sits at this table and tells this Subcommittee that there's nothing wrong with the system and the current interpretations by the courts is self-centered about their own practice and the people they represent and not concerned about the broader public interest. And I regret to tell you that.

I was a lawyer once. You notice I say "once" because I'm not here today saying that I am. I guess I could be one again some day.

But I note, Mr. Chairman and friends on this Subcommittee, that when I was practicing law, I didn't have the luxury of having a firm with modern computers and 20 or 30 lawyers that did nothing but look around for what? For something like in this ad here that says: "Losses in the Financial Or Stock Markets—You May Have A Remedy." With a telephone number and the name of a law firm.

This sums it up.

When I had to file a divorce pleading, and I was not in a big city with big cases, so I took some divorce cases every now and then. It was almost impossible, Mr. Chairman, for me to file a divorce lawsuit within 48 hours of the time the clients came in because, normally, we'd say, go get these facts or bring me this.

However, 21 percent of these very factually intensive, legally complex securities cases, and none of you may be guilty of this, this may not be the way you practice, but 21 percent were filed—imagine—within 48 hours of the triggering event, like a missed earning projection.

Just think of it. A company announces a missed earning projection and a lawsuit is filed within 48 hours claiming fraud, suing the accountant, suing the bank, suing the lawyer. Then the case gets settled.

There are so many people in that lawsuit with insurance, that they just settle. But not after a huge amount of energy and resources get spent by the executives trying to defend the suit. There may be some litigation against major corporations or major firms. But most of the lawsuits are filed against start-up companies, in particular, high-tech companies. Eighty-five percent of the cases are settled without ever going to trial.

Now I learned as a lawyer, looking back on the practice, that when that happens, it does not mean what many may perceive, that they have great lawsuits. It does not mean that. Just as often it means that the deck is stacked against the defendants in our joint and several liability scheme in which these cases are bought. Thirty-three percent of the cases are filed within 10 days of the triggering event.

Frankly, we had a case thrown out of Federal court the other day. The judge critically chastised the law firm. When the firm punched the complaint out on their computers, they had punched in that the defendant was Philip Morris and that they had committed fraud to maintain the appearance of success in selling toys—t–o–y–s.

Philip Morris doesn't sell toys. The lawyer or his/her assistant just punched it in and put some numbers in. So the judge had them in front of him and found out about how it all happened, where it came from, when the computer spit out the information.

Lawsuit ready—beep, beep—lawsuit ready.

[Laughter.]

Stocks changed in value. Lawyers and their computers are so sophisticated, they're soon going to be able to monitor every event that would affect a company and the information will come out of the computer in a timely manner telling them it's time to file a lawsuit.

Now, frankly, I believe we have to have litigation. I believe there are times when nothing else will work, and there are plenty of them. But I don't believe the current system of securities class-action lawsuits is fair.

I want to put in the record, with your permission, Mr. Chairman, the major survey of American senior citizens to which Senator Dodd referred. Because we're all wondering, if we're not trying to protect them, and some will write letters to us, saying, we have got to protect the seniors.

The seniors are pretty smart. They don't think the current system protects them. And I will just tell you, in this poll, 79 percent, contrary to my good friend, Senator D'Amato, and his reasoning with reference to making sure that it's balanced and you don't make the loser pay all, 79 percent of the people polled, said, forcing defendants to pay damages for everyone when they're only partially responsible should not be the case. This means 79 percent support proportionate liability.

Eighty-one percent support requiring mandatory penalties for lawyers who aid in bringing a frivolous suit. Not bad.

We don't do that in this bill. It may be that we will include a provision where entrepreneurial lawyers filing frivolous cases get some punishment besides just going before the judge and he is loathe to do anything to discipline the lawyer. But 69 percent said that the loser should pay all in this poll of senior citizens.

Now I'm not suggesting that our bill does that. It does not. It's in between the House bill and leaving the system like it is now.

I want to close with one remark and then I ask that some statements be made a part of the record.

An article which appeared in Forbes magazine on October 11, 1993, summed up the kind of class-action suits that I'm concerned about. And the article said that the plaintiffs' bar's view of the profession is greatly affected by this statement.

One of the major plaintiffs' firms was asked about these suits and here's his statement. For any lawyers on this Subcommittee, just listen to this: "I have the greatest practice of law in the world, I have no clients." I have no clients.

Essentially at this point in history, that's the way many class-action lawsuits are conducted. It is an entrepreneurial legal business, and they have no clients.

The class has little to say about what's going on. The case has progressed pursuant to the entrepreneurial spirits of lawyers and has nothing to do with what the client wants. They are settled and letters go out all over the country saying, you're going to get 3 cents, but you would not have gotten anything if we had not sued for you.

People write back in and say, OK. The lawyer gets 40 percent, 50 percent. I know they're going to say they don't, but we've got a number of them where that's the case.

So, frankly, the time is now, in the next couple of months. And I urge that you do this, Mr. Chairman. The Senate is awaiting some reform in this area. It will pass the U.S. Senate.

Thank you very much.

Senator GRAMM. Well, Senator, let me share with you a piece of information that I asked the Congressional Research Service to provide to me.

Often, as we have conducted these hearings, Rule 11 has been raised as a means whereby judges can penalize frivolous lawsuits. I think it's interesting to note that when a company was sued, as you outlined, for the way it marketed toys and it turned out they weren't in the toy business, Rule 11 was not used to impose a penalty. In fact, the Congressional Research Service can find only three cases ever where Rule 11 sanctions have actually been imposed.

I want to assure you that the bill that I bring to this Subcommittee as the mark-up document is going to have mandatory penalties for frivolous lawsuits. Mandatory penalties.

You can debate many different parts of this bill. But, in my mind, if you're debating on the other side of that issue, you're making a very, very weak argument.

Senator DOMENICI. Mr. Chairman, I have letters from all over the country, from small companies, accounting firms. I'd like for them to be in the record in case anybody wants to read some of the stories as back-up.

Senator GRAMM. Without objection, it will be put into the record.

Senator DOMENICI. I thank you very much.

Senator GRAMM. Senator Faircloth.

OPENING STATEMENT OF SENATOR LAUCH FAIRCLOTH

Senator FAIRCLOTH. Thank you, Mr. Chairman.

As I said at the last hearing, I am a strong supporter of securities litigation reform. Litigation reform in general I am for.

These frivolous lawsuits, they're clogging the courts and they're simply sapping the productivity of the country. They're diverting personal responsibility for one's actions. And most of all, they're primarily transferring wealth to lawyers and not to the clients involved, anyway.

It has been estimated that the indirect cost to American consumers for all this litigation is $300 billion. In 1989 alone, 18 million civil suits were filed in State and Federal courts. Eighteen million suits that the people of this country are paying for.

And as has been mentioned earlier, they wind up being settled and they're settled not because the plaintiff has any grounds whatsoever. They're settled for one simple reasons—in most cases, the defendant, a company, it's simply easier to give them a little bribe money and get rid of it than it is to go into court and start hiring lawyers at the amount they charge today.

Senator you said you were no longer a lawyer. But if you have hired one lately, you would find you would be making a lot more money if you were one.

[Laughter.]

Senator DOMENICI. Senator, I am still a lawyer.

Senator FAIRCLOTH. I know that.

Senator DOMENICI. In fact, I have three children who are lawyers. I told the other five they ought to go do something else.

[Laughter.]

Senator FAIRCLOTH. But as has been mentioned, the most ludicrous of all was the Philip Morris suit. Literally, within hours of the stock dropping, because they lowered the price of cigarettes, they filed on a preprinted legal form, a preprinted legal form, they filed their complaint and, as has been mentioned before, they did not even know what Philip Morris made and identified them as a toy company.

It is totally out of control and I hope that we'll pass some legislation to bring it under control.

I am a cosponsor of S. 240, the Domenici-Dodd reform bill. I only have one complaint with it. I don't think it goes anything like far enough. And I sponsored it because it was the best we had at the time. But if somebody comes up with a tougher, better one, I'll support that, also.

I thank you.

Senator GRAMM. Senator Bennett.

OPENING STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman.

I've discovered since coming to the Senate that there's no such thing as repetition.

[Laughter.]

I remember a comment, I think it was from the Senator from Connecticut during the Whitewater hearings, who said: "Everything's been said, but not everybody has said it."

But I would repeat for this record the experience that I mentioned when we had this bill before us in the last Senate because I think it does illustrate the problem.

When my father retired from the Senate, he ended up on a number of boards of directors, one of them being a mutual fund. One day he was served with a large pile of papers. They were attacking all of the members of the board of directors and the directors were listed alphabetically and Bennett came first. So it was Wallace Bennett, et al., and he was the one served on behalf of all of the board.

He was very nervous about this. He hadn't seen such a pile of papers before. The lawyer for the firm on whose board he sat said, oh, Senator, don't worry about that. We will take care of that.

He said, what's it all about? And he said, well, there is a law firm in New York that automatically sues all of the directors every time the directors' compensation is changed. He has it built into his word processor. As soon as there is a change in the directors' compensation, he presses the button. The lawsuit comes out.

We send him a check for $100,000 to settle it and he goes away. We do this routinely. He has figured out that $100,000 is less than it would cost us to defend the suit and we have figured that out and Senator, we'll send him the check and don't worry about it.

Dad was stunned by this. And the general counsel of the firm said to him, this man makes his living doing that. He has picked out companies like ours to file these kinds of suits against. We all settle with him for less than it would cost us to litigate, and it's just a standard thing. Don't worry about it.

Subsequently, one of the firms, Merrill Lynch, decided to take this guy on and put him out of business. It cost Merrill Lynch about a million dollars in legal fees to do it, but they ultimately did it.

But the firm on whose board Dad sat felt they couldn't afford the million dollars, so they paid the $100,000 blackmail routinely and the fellow in New York went on.

That's why I'm delighted to be a supporter and cosponsor of the Domenici-Dodd bill and commend my two colleagues on the Subcommittee for their work on this issue. It's a very real issue and we shouldn't have to depend on somebody as big and powerful as Merrill Lynch to decide their going to deal with this nuisance. We should take care of it for the sake of all those others who don't have that much money.

Senator GRAMM. I thank Members of the Subcommittee.

Mr. Naylor, we'll start with you and then go directly across.

Let me say to everybody that I will put their full statements into the record, some of which are pretty thick. If each member of the panel would try to sum up their statement as quickly as they could, then we'll have plenty of time to ask questions and get into a general discussion.

Mr. Naylor.

OPENING STATEMENT OF BARTLETT NAYLOR NATIONAL COORDINATOR, OFFICE OF CORPORATE AFFAIRS INTERNATIONAL BROTHERHOOD OF TEAMSTERS WASHINGTON, DC

Mr. NAYLOR. Thank you, Mr. Chairman.

My name is Bart Naylor. I used to be a staff member on this Subcommittee. And for those of my colleagues that are still here, I think they'll be charmed that I've been identified as the one on the right.

[Laughter.]

Also, as other Senators have perhaps suggested, this is not necessarily the plaintiffs' bar here. I'm the National Coordinator for the Office of Corporate Affairs for the Teamsters.

This office was created in part to deal with the $48 billion of Taft-Hartley pension money that we have, which is the largest concentration of investment funds with a union.

Senator FAIRCLOTH. Would you pull the microphone up closer?

Mr. NAYLOR. We also have some 100,000 plus public sector employees who are the beneficiaries of the New York funds, or the California, the Oregon, the Washington public sector funds.

We are individual stock investors. We have payroll deduction plans. We receive options at Pepsico. In short, we are investors and we are concerned with the integrity of the market.

I'm a little discouraged at some of what I'm hearing today because I assumed the debate went beyond the assertion that Amer-

ican corporations are being crushed by litigation. I hear the number 18 million cases.

Senator BOXER. Mr. Chairman, excuse me, please.

I'm really having a hard time because there's so much conversation. I can't concentrate on this.

If we could just have some order.

Senator GRAMM. Well, I'm sorry, but we have a longstanding tradition in this Subcommittee that Members have a right to whisper in each others' ear.

Senator BOXER. Whispering is fine.

Senator GRAMM. I don't intend to see that changed.

Senator BOXER. I don't mind whispering. I'm just having a hard time hearing, that's all.

Senator GRAMM. Well, if the witness would pull the mike up a little closer that may help.

Mr. NAYLOR. The hypothesis is that there is a computer-driven crush of litigation that is harming capital formation and stifling the very words that corporate executives might speak. I had assumed the debate was beyond that. I had assumed that it was understood that the 18 million or whatever cases there are are largely corporations suing other corporations, that there are only 200 or 300 of 10(b)(5) securities cases brought each year.

That capital formation if harmed is certainly not showing up in the numbers. The numbers of IPO's are up. The Wall Street Journal reports that the United Nations' report last week shows that American firms actually attracted more capital than any other Nation last year—a record amount of capital last year.

So if our markets are somehow burdened by the securities litigation, it certainly isn't stopping foreigners from investing here. In fact, I would suggest to you that it's quite the opposite. Because of securities litigation it's keeping markets attractive—people feel safe when they invest in the United States.

If corporate executives are verbally constipated because of the chill of litigation, it certainly isn't showing up in the reports. Reports are full of forward-looking statements, full of forecasts, full of promises, prognostications and what good things are going to happen in the next couple of quarters.

I had thought the debate was going to be about just what provisions that are being discussed will help.

We are concerned with the integrity of the market. We purchase on the basis of disclosure and disclosure is kept honest because of deterrence.

When Congress last considered the huge problems of corporate corruption in the 1920's, they thought of Federalizing corporations and having directors and officers be liable under Federal law.

The compromise was to establish the Securities and Exchange Commission and establish disclosure as the method of policing.

The Securities and Exchange Commission was established. State securities administrators are there to police. But every one of them will always say that necessary to their effort is private enforcement.

We have brought instances of problems to the SEC and to State securities administrators. But they make it clear, they can't possibly deal with all the cases that are brought to them.

So when we see measures such as are before this body and that recently passed the House, we are frightened that we are suddenly going to have less enforcement of disclosure, that we are going to allow executives to feel free to speak dishonestly.

We hear so much about Silicon Valley firms and the hard-working chipmakers that are besieged.

The people that we see in trouble are the ones that are selling the stock. They are salesmen. They try to get you to buy stock. And to do that, they're going to say happy things about it. They're going to puff up their stock. That is the bias.

When you sell stock, it's the equivalent of getting a loan and you want a low-interest rate loan and a low-interest rate loan equates to a high-stock price.

That bias is built into the system. Securities litigation is the antidote, the agent that tries to stop that bias.

I thank you for the indulgence of your time.

Senator GRAMM. Thank you.

Mr. Guin.

OPENING STATEMENT OF DAVID J. GUIN PARTNER, RITCHIE & REDIKER, BIRMINGHAM, AL ON BEHALF OF THE NATIONAL ASSOCIATION OF SECURITIES AND COMMERCIAL LAW ATTORNEYS [NASCAT]

Mr. GUIN. Thank you, Senator Gramm, and Members of the Subcommittee, for the invitation to come up to Washington and speak with you today. My name is David Guin and I'm an attorney with the law firm of Ritchie & Rediker in Birmingham, AL.

Although my firm handles a variety of different matters, including taking corporations public and representing companies with publicly-traded stock, and representing municipalities in bond financings, my firm has been particularly active in representing investors in municipal bond defaults and stock fraud cases.

While the debate on the pending bills has focused on publicly-traded stocks, you should be aware that the municipal bond market is also threatened by this legislation. Even without considering the current Orange County fiasco, municipal bonds are defaulting at a rate of several billion dollars a year.

The SEC has very little oversight over the municipal markets, and Rule 10(b)(5) cases are investors only protection in the area.

Now although not every bond default is due to fraud, too many are. I fear that both S. 240 and H.R. 1058 will remove the few protections that municipal bondholders now have. To show you how this pending legislation hurts investors, let me just give you a typical case.

Gordon Billip and his wife Betty retired to Jaffrey, NH, a few years ago and decided to invest their retirement savings in municipal bonds so that they would have a secure investment and a regular source of income. They bought their bonds to finance the construction of a retirement home in Spartanburg, SC.

The project failed almost immediately and the Billips lost their money. Mr. and Mrs. Billip didn't know why the bonds failed, but they were afraid that there might have been fraud involved, so they retained my firm to investigate. We did, and we discovered that there was a representation in the prospectus that many units

of this retirement home had already been sold when, in fact, they had not and no one was moving in. There was no income there.

So we filed the case. But it was not until we were allowed to get into the case and conduct discovery before we found the documents and obtained the testimony that blew the case wide open and eventually resulted in criminal convictions.

We discovered that the developer of this project had lied, that the bond lawyers involved in the bond issue had covered up those lies, and that the accountants involved had rubber-stamped those lies.

Most importantly, after getting into discovery, we found hidden away in files of the underwriter in Jackson, MS, a memorandum of the underwriter issued before the bonds were ever sold that concluded that it would be, and this is their term, unconscionable to sell these bonds to the public, but that the fees were just too good to pass up.

With that document in our hands, we were able to recover 65 to 70 cents on the dollar for the bondholders and then we turned over our evidence to the U.S. Attorney and worked with the U.S. Attorney, worked with them at trial and assisted them in prosecuting this case in criminal court and obtaining convictions. The underwriter of that case is now serving 13 years in Levinworth.

Senators, if the pending legislation had been the law, we would not have been able to prosecute that case. The fraud would never have been discovered.

Senator GRAMM. I think you could save us time if you told us why.

Mr. GUIN. Yes, sir. I'm happy to. First of all, in H.R. 1058, with the "loser pays" rule, Mr. Billip testified——

Senator D'AMATO. Mr. Guin, are you going to address the Dodd-Domenici bill or just H.R. 1058?

Mr. GUIN. Senator, I'm happy to address both. I was asked to address both. I can address S. 240 as well.

Senator D'AMATO. Thank you.

Senator DODD. Domenici-Dodd. I like that.

[Laughter.]

Senator D'AMATO. Domenici-Dodd.

Senator BOXER. If it fails, it will be Dodd-Domenici.

Senator GRAMM. Let's go ahead. Let's let the witness——

Mr. GUIN. Several reasons. First, on H.R. 1058, and then I'll address S. 240.

In H.R. 1058, there is a "loser pays" rule and it requires an undertaking, which is actually a bond. Now Mr. Billip testified before this Subcommittee in 1993 that if a "loser pays" rule had been in place, he would have been intimidated and he never would have filed the case.

There was no talk at that time about a bond requirement, and I think he would just laugh if he heard about that today. He would never have filed that case.

In S. 240 and in H.R. 1058, the enhanced pleading requirement, or what I would call the more stringent pleading requirement, we couldn't have met it.

Now, once we got into the case and once we conducted discovery, we found that memorandum of the underwriter that talked about how it would be unconscionable to sell these bonds. We didn't know

about that until we got into those files. If you have to allege that before you file the case, we never would have known it.

Also, let me address this in S. 240.

Although it may not have the same as a "loser pays" rule as in H.R. 1058, the mandatory ADR provision has the same result.

Senator D'AMATO. Could you please elaborate on how an Alternative Dispute Resolution provision would be the same as a "loser pays" rule?

Mr. GUIN. Alternative Dispute Resolution, which I call ADR. It would require you, essentially, as the plaintiff, to go into this Alternative Dispute Resolution process without having the full panoply of discovery that was available to us that allowed us to find that document, and then would allow the defendant to make you a lowball settlement offer, something cheap. And if you refused that settlement offer, if you lose the case, you pay the other side's fees.

Well, that's like putting a gun to my head and saying, take this money or else, because I don't have the opportunity to conduct the discovery to make an informed decision.

Senator DODD. Mr. Chairman, because I think we're on a point here, maybe this can be done a bit more informally.

You're obviously familiar, I presume, with decisions in the 7th Circuit, I think the 2nd Circuit as well, regarding pleadings. Are you familiar with those? Aren't we in effect in S. 240 codifying what the courts are already requiring?

Mr. GUIN. Well, your Honor——

Senator DODD. I'm enjoying this more and more all the time.

[Laughter.]

Mr. GUIN. I'm used to being in court.

Senator DODD. I'm a judge.

Senator GRAMM. Go ahead.

Mr. GUIN. Senator, I do believe there are distinctions there. My practice is primarily in the Southeast, in the 11th Circuit and the 5th Circuit, not the 7th Circuit or the 2nd Circuit, to which you referred.

I have read some of those decisions. I am not that familiar with how the practice actually works there.

Senator DODD. I think they require them to plead facts to support.

Mr. GUIN. Absolutely. You have to plead facts to support. But you don't have to plead the actual state-of-mind. In other words, what is in somebody else's mind when something happens.

Senator DODD. We don't require that, either, in S. 240. We don't ask you to prove. We ask you to allege, but you don't have to prove. Not in the pleadings.

Mr. GUIN. That's part of the problem, Senator, in that you have to allege something that you can't know until you have the discovery. State-of-mind is something that I can't tell what any of you are thinking in your heads right now. Once I have discovery and I can get memoranda and correspondence, I can see what somebody wrote down.

Senator DODD. You've got to have some indication—I presume you believe that something is wrong.

Mr. GUIN. Absolutely.

Senator DODD. We don't require you to prove the state-of-mind, but you've got to have some facts so that when you allege a state-of-mind, that you have some facts to support that.

Now, no one is suggesting that we ought to have a bill here that requires you to establish the proof in your pleadings. But to have some facts which support your allegations, that's not asking too much, is it?

Mr. GUIN. Senator, what the law requires now is that you plead facts that would give rise to an inference of fraud. That is the law now and it is something that is not always easy to do and that even that may prevent some cases that you're not familiar enough with the facts. But that is what is required now.

What I'm concerned about is having to go beyond that and plead the state-of-mind of someone, which I cannot know until I've got at least some documents that give me an indication of what that person was thinking at the time the bonds or the stocks were sold.

Senator DODD. Well, I've made the point.

Senator BENNETT. Would the Senator yield for a further follow-up on that?

Senator GRAMM. Let me do this. I think it's only fair to other Members that this be your initial questioning time, if you want to do that.

I think that's fine.

Senator Bennett?

Senator BENNETT. Yes. Just briefly, Mr. Guin. As I understood what you said, you examined the prospectus and found a clear error of fact in the prospectus. Is that true?

Mr. GUIN. We found a clear error of fact in the prospectus. One error of fact in that prospectus. And that only applied to certain defendants.

Senator BENNETT. OK. I understand that. But that would to me be enough of a trigger to say, I'll go ahead with this suit. I found an error in fact in the prospectus. That's very serious.

I've been involved in writing prospectuses and I know the lengths to which you go to make sure you do not make any kind of error in fact. And I would think that that would meet the threshold that the Senator from Connecticut is talking about and would not be a chilling effect.

Mr. GUIN. Senator, the distinction is, I was aware of a fact that gave rise to an inference of fraud and I could plead that and that is what the law requires.

What this provision in S. 240, Section 39, requires in addition to that is alleging specific facts demonstrating the state-of-mind of that defendant.

Now, I'll give you an example that was from my written statement. Everybody else is talking about the O.J. Simpson trial, so we'll talk about the O.J. Simpson trial.

In this case, let's assume that Marcia Clark, the prosecutor, didn't have a grand jury, didn't have search warrants, didn't have subpoena power. All she knew, was that two people had been brutally murdered, that one of them was the former wife of O.J. Simpson, and that O.J. Simpson had a cut on his finger. Now could she have pleaded the state-of-mind of O.J. Simpson before she got the evidence that she obtained?

I think that might have made her case substantially unjustified if she had done that. Now once she was able to conduct her discovery in the criminal court and find other things, I don't think, although there may be a dispute even today over what we think the jury will do in that case, no one will dispute that the case is substantially justified. The concern is over state-of-mind. How can you plead someone's state-of-mind?

Senator BENNETT. Well, I won't pursue this. But as you went through your example, it struck me as materially being very different from the other testimony we have heard before this Subcommittee.

You found an error in the prospectus. You investigated the circumstance before you made the decision as a careful lawyer as to whether or not you wanted to pursue this case.

We've had evidence before this Subcommittee of people who have not given 10 minutes, maybe even 10 seconds' investigation into the circumstance. All they knew is that the stock fell and they filed suit immediately looking for a class. We've had clear testimony to that effect.

That's a very different process than a careful lawyer like yourself examining a prospectus and finding an error in it, which is a pretty good indication if there's that much smoke, there's got to be some fire someplace. That's my only point, Mr. Chairman.

Thank you.

Mr. GUIN. Senator, if I may respond.

There may or may not be that great a distinction between the type of case I was involved in here and what you've talked about in these stock-drop cases where a complaint is filed very quickly. It's not a matter of how much time passes, as to what facts are known.

I was lead counsel in a case in Alabama against a company called Comptronics. I filed a complaint very quickly after they made a disclosure. But what they disclosed was that the three top officers of that company had resigned in the wake of an investigation by the company into their——

Senator BENNETT. I don't want to pursue this farther, Mr. Chairman, but, again, that's a very different fact circumstance. You're talking about a company making a disclosure and you investigated it, came quickly to the conclusion that there was some lying. That's very different than the kind of abuse we're trying to solve here.

Thank you, Mr. Chairman.

Senator GRAMM. Senator Domenici wants to raise one question, make one remark, and then we have to go ahead.

Senator DOMENICI. Mister—how do you say your last name?

Mr. GUIN. Gu-win.

Senator DOMENICI. Guin. I noticed nobody else said it, so they must all have been having the same trouble I was having.

Mr. GUIN. It's not easy.

Senator DOMENICI. First, let me say that I'm very impressed with your testimony and your knowledge of the law and the way you explain it. But let me make sure that I have this right.

The kind of security you were talking about that brought you the broad and ultimate imprisonment for criminal fraud is a high-risk, tax-exempt security bond. By definition, it is a tax-exempt bond

where the revenue source is a private source provided by law, such as a nursing home. The municipal security rule-making board and the Congress understand that this kind of security is very risky and we need a reform of the disclosure laws.

As a matter of fact, Mr. Ramser, in previous testimony, acknowledged that these particular bonds are exempt from the registration requirements of the Federal Securities Act.

The point I make is, in order to get better performance and less fraud, litigation is not the only remedy. But, rather, in this kind of a situation, clearly, we should have more disclosure and I think it is obvious that if there had been disclosure in this case about the credit quality of one of the principals, nobody would have bought the bonds. That disclosure would be required if it were not a municipal-exempt bond.

In this case, I understand the facts were that Mr. Sutliff—now he's the promoter of this—had a sordid past and if that would have been disclosed, such as his bankruptcy and other criminal convictions, nobody would been buying them.

So it seems to me that, to use that case and say, we have to make sure that you protect us and give us the ability to get into court, assumes that the only way to straighten up this kind of security is to let you litigate, rather than use some other approaches like improved disclosure. You would have found out even more had we required disclosure.

It's a very precise kind of security. You would admit that, right? With very different qualities than many other securities. Wouldn't you admit that?

Mr. GUIN. It is a revenue bond, but disclosure is required now. The prospectus for Mr. Ramser's bonds was an inch and a half thick.

Senator DOMENICI. Well, is this——

Mr. GUIN. There was extensive disclosure. They just didn't do what they were supposed to do.

Senator DOMENICI. Now when we were inquiring of Mr. Ramser, at that point, disclosure was not required?

Mr. GUIN. Registration is not required with the SEC, but disclosure, a prospectus, is required.

Senator DOMENICI. OK. So the point of it is it's less stringent than others because you don't have to file with the Securities and Exchange Commission.

Mr. GUIN. The disclosure requirement is every bit as stringent. The difference is you don't send a copy to the SEC. You fill out the same kind of, disclose the same sort of information as in a public stock offering.

Senator DOMENICI. Thank you.

Senator GRAMM. Why don't you go ahead and finish your statement, then we'll go on to Mr. Elsen.

Mr. GUIN. Just to reiterate, Senators, that Mr. Billip did testify before this Subcommittee, as did Mr. Ramser, who Senator Domenici has mentioned, and they did testify that not only would a "loser pays" rule have prevented their case, the elimination of joint and several liability would have prevented their recovery.

Because without joint and several liability, they would have received almost nothing. The settlement funds were paid by the ac-

countants and the bond lawyers who looked the other way while these developers like Mr. Sutliff, who was a rather sordid character and has also been convicted, planned their schemes.

By providing new, broad-brush, what I view as excuses, for reckless and sometimes even deliberate conduct in financial frauds, and by raising the standards for liability rather than targeting particular areas of concern, this legislation makes it more difficult to bring meritorious, as well as the frivolous, cases.

I fear that this legislation, as a result of raising those standards, making it more difficult to bring meritorious cases, is setting our Nation up for new scandals, bigger even than the savings and loan crisis and bigger than anything we've seen since the Great Depression, which is what created the whole securities regulation scheme to begin with.

Senator D'AMATO. Mr. Chairman, if I could interrupt for a moment—Mr. Guin, if you dislike this legislation, but agree that the system needs reform; then what measures do you think should be taken?

Mr. GUIN. You pre-empted me. That was my next sentence.

I ask you, instead of passing this legislation, to craft new legislation, legislation that will maintain investor confidence in our markets by putting the teeth back into the securities laws, restore aiding and abetting liability, and maintain joint and several liability, as a deterrent.

In the Supreme Court's decision about a year or so ago, in the Central Bank decision, they eliminated liability for someone who assists someone else's fraud, like accountants or lawyers who look the other way, as Mr. Sutliff and Mr. Ramser's case, puts the scheme together.

Senator D'AMATO. Mr. Guin, I think you've done a great job in presenting your concerns, so I'd like to ask if you have any suggestions on how to improve the system and reduce the abuses of frivolous lawsuits.

Mr. GUIN. I do. The State Administrator, Mr. Griffin, will testify at the end of the table later for their position for the State administrators. There is a proposal for an early evaluation procedure. I think that the early evaluation procedure is a direct, targeted approach to the issue you've raised.

What it would require is that the parties for a certain time period after filing a case, sort of like the ADR provision in S. 240, but before a judicial officer, would exchange views and exchange some documents, but a limited amount of discovery, so as to reduce costs.

At the end of that period, this judicial officer, a magistrate or a special master would issue a conclusion as to each side—your position is clearly without merit and could only be pursued in bad faith, or defendant, your position, your defense is without merit and can only be pursued in bad faith.

Then, if I was the plaintiff's lawyer in that sort of procedure and a judicial officer told me my position could only be pursued in bad faith, and if I then chose to ignore that and go ahead with the case, then I should be hit with sanctions if I lose. No question. But that's a very different procedure from what's in S. 240 now.

I do believe that this early evaluation procedure is a more targeted way of addressing the concern.

Also, there's a provision in there that would require certification of complaints, which you've raised the issue of very fast complaints, and maybe not taking enough time to study the issue and get the facts before you file.

The State Administrators' statement raises this certification issue, where, like in a derivative suit, in some States, the plaintiff would have to verify the complaint. The plaintiff signs a certificate stating that he has read the complaint, he agrees with it, he understands what this lawsuit is about, he authorizes it, and it discloses some information about his purchases of the stock, when he bought the stock, and so forth, to ensure that there are no conflicts of interest and to ensure that this is a real plaintiff.

Senator GRAMM. Mr. Elsen.

OPENING STATEMENT OF SHELDON H. ELSEN
THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK
NEW YORK, NY

Mr. ELSEN. Mr. Chairman, Members of the Subcommittee, I'm here today on behalf of the Association of the Bar of the City of New York.

We are no strangers to the Subcommittee, as I know Senator Domenici and Senator Dodd knows. We have been working with the staff of both Senators Domenici and Dodd on the bill which is now before this Subcommittee for sometime. And at the end of last year, after a number of consultations, we issued a 43-page report on the then-Dodd-Domenici bill and the now-Domenici-Dodd bill.

We just issued last Friday an additional 35-page report on the bill that just passed the House. As you know, the issues we're going to talk about are of enormous importance, but they're of great complexity.

I want to proceed from the very detailed report prepared by lawyers who were from the heart of the securities bar, which is located largely in New York City, as I'm sure you know, although it's all over the country. The capital markets are there, the stock exchanges, the major broker dealers.

Those lawyers constitute our membership and I'm sure you know that the Association operates on the credo that the client is left at the door. That is, when you come into the Association, you're there, like Senator Gramm, for the public interest, if I may say so. And you're not there for your client.

I am here today for the public interest on behalf of the Association and not for any clients. In fact, I personally do not do any plaintiffs' work, class or derivative work.

You asked about my own background. I'm a former Vice President of the Association. I've chaired its committees on Federal courts and on Federal legislation. I learned the securities field prosecuting these cases as an Assistant U.S. Attorney in the Southern District of New York.

In fact, my last big case, a 6 months securities case, was done together with an old colleague and friend of Senator D'Amato's, Mike Armstrong, who has over the years spoken so highly of the Senator, that it's a great pleasure for me today to be before you.

I have long been an Adjunct Professor at Columbia Law School. I have written extensively in this field. I am a Fellow of the Amer-

ican College of Trial Lawyers. I am a member of the American Law Institute, but I am not here for myself, I am here for the Association.

Now, just to touch the most important points. That is all I can do in these statements.

There are things to be done. We agree that there are certain things in these bills that should go through. We came out, for example, for the principle of proportionality in the then-Dodd-Domenici, now-Domenici-Dodd bill, with certain modifications.

The defendant who was insolvent, that share should be flipped over to the remaining solvent defendants. But with that aside, and then there are some enormously complex discussions about what do you do when you settle a case, and I won't go into that now. That is all in our report.

But we do go along with your recommendation, your proposal for proportionality. We go along with your proposals that——

Senator D'AMATO. Mr. Elsen, did you say you support proportionate liability?

Mr. ELSEN. For proportionality.

Senator D'AMATO. In other words, the "deep pocket" institutions would no longer be liable for more than their share of the settlement.

Mr. ELSEN. You split it in accordance with the proportionate culpability. The Association comes out for that. With the modification, Senator that the guy who's off in Brazil, his share is picked up by the others.

If he's 80-percent culpable and it's a choice between the victims who will not be paid, nor the 20-percent remaining, the 80-percent share gets flipped over and divided up on a proportionate basis, so that the victim is made whole. That is the modification in our support.

But, basically, you have a solvent issuer or solvent accounting firm or whatever, solvent underwriter. We would go along with the proportionality, definitely.

Senator D'AMATO. What happens if you have 5 defendants and 4 of them settle. The only remaining defendant is an accounting firm which only has 2 percent liability. Now, under your proposed modification, would the accounting firm be liable for more than that 2 percent?

Mr. ELSEN. No. The analysis is that the plaintiff goes and settles with those who are out. That is all they get with those they settle.

Senator D'AMATO. So the accounting firm can take the case to trial with the knowledge that they will not be forced to pay a full settlement.

Mr. ELSEN. Yes, they're fighting for their share.

Senator D'AMATO. Two percent.

Mr. ELSEN. For their share.

Senator D'AMATO. I just wanted that to be completely clear.

Mr. ELSEN. I mean, Senator, there are changes that should be made here, some of them. Some of the abuses that are talked about——

Senator D'AMATO. Sorry for the interruption, please continue your testimony.

Mr. ELSEN. No, no. Senator, as any lawyer who has been before any appellate court, and this is as good an appellate court as there is in the country, I love your questions. Just ask me, because that's the only way in which I will accomplish the price of the airfare.

[Laughter.]

Which the Association has to pay. All right. Now, we do think that a referral fee should not be paid to brokers. I must say if we got a hold of any guy who paid a referral fee to a broker, he'd be before the disciplinary committee. But individual plaintiffs should not get bonus payments. The disclosure of settlement terms should be improved in accordance with the proposals in the bills.

The plaintiffs' counsel should not share in disgorgement funds created by the SEC without their participation. And Rule 23 of the Federal Rules of Civil Procedure, which puts obligations on courts to make sure there's adequate representation and settlements are carefully scrutinized, should be carried out. There's no question about that.

However, when we come to the enthusiasm for going after the problems of Silicon Valley—we are in the middle of the mainstream of securities litigation. Whatever goes on in Silicon Valley, and there are problems out there, I am sure, which are perhaps being dealt with at the pretrial—by the way, the Philip Morris case is a classic what we call 12(b)(6) motion.

A fellow lawyer, Senator Domenici, that case would be out in 2 minutes. And this is one of those cases where Rule 11 might very well be involved.

Now, why might it not be?

Because you come from a small town. Lawyers don't ask for Rule 11 sanctions against each other in smaller towns. But be that as it may, in New York, they do.

Senator GRAMM. There's only been three of them in history.

Mr. ELSEN. Well, not in New York, Senator. I know the statistics. There are lots of blood flowing from many throats in New York City, and Rule 11 has been widely used in New York.

But, unfortunately, and one of the reasons why the judicial conference, after listening to the bench and the bar, modified Rule 11 is that it has been disproportionate. It has been the plaintiffs in civil rights cases that have been knocked out. It has been the people who are considered outside the mainstream.

The mainstream, the fraternity and sorority, don't kill each other like that. It's not been handled right. And so, we put in these safe harbor provisions and the 20-day things and that's brought civility back into the practice and maintained things. There are cases where there's still Rule 11. But this reflects the process of the judicial conference, where they listen to judges. They listen to lawyers who work with these things on a daily basis and they came in and said, Rule 11 had to be modified. And I ask this body not to throw away all that experience, all that thought, because you feel that lawyers ought to be slammed.

Sure, lawyers ought to be slammed. We do a good job. I'm on the disciplinary committee. I spend a lot of my time helping to slam lawyers. But, nevertheless, you have to bear that proportionality and it's the same thing in the hands of pleadings. It goes out—I'll

get back to that in a minute, Senator Dodd, but your proposal goes way beyond anything the 2nd Circuit has ever done.

I'll get to that.

But let me get to "loser pays" because that is the heart of it. "Loser pays" means that's the end.

You take a man or a woman who has lost $10,000 and somebody comes in and says, I would like you to be a class representative. And they say, well, what are the risks? The risks are—I mean, you have a terrific case.

Mr. Lawyer, can you say I will win? Well, the Code of Professional Responsibility says to lawyers, don't tell your clients you are going to win because nobody knows whether you're going to win, no matter how good your case is. Every lawyer can tell you that and it's right in the code. You say, I hope, I think you're going to win. What are the risks? The risks are, if you lose, the defendant, of course, had hired an 800-lawyer law firm. They're charging $450 an hour for the senior partner, and so on.

Well, in two days, if I lose, I have to pay all those bills? What am I going to do with my savings that are left? How am I going to send my kids to college? What is going to happen to my house? Well, that's "loser pays." That's it.

Senator GRAMM. May I ask you a question?

Mr. ELSEN. Please, Senator.

Senator GRAMM. Under the general procedure, does the person who loses have to pay the lawyers' salary?

Mr. ELSEN. Under the proposal——

Senator GRAMM. What do they stand to lose? When I enter one of these suits, under the current procedure, what are my risks? What is the downside for me to file this suit?

Mr. ELSEN. On the plaintiffs' side? Those are always contingent cases. Those are contingent fees.

Senator GRAMM. I'm saying, I've lost $10,000.

Mr. ELSEN. Right.

Senator GRAMM. What happened is that I invested in a company and somebody made a decision. I say they did it because they wanted me to lose my $10,000. I enter into one of these suits. If I win, obviously, I get some money. If I lose, what happens?

Mr. ELSEN. If you lose, your lawyer—what has happened is this.

You haven't put 2 cents of anything into it. Your lawyer has expended thousands of dollars of time and thousands of hours and your lawyer doesn't get 1 cent.

That's what happens. That's the control, Senator.

Senator GRAMM. As the guy who is technically filing the suit, I have nothing at risk. Right?

Mr. ELSEN. No, that's right. You're not going to lose anything.

Senator GRAMM. But don't you think that's the kind of imbalance that we ought to be looking at?

Mr. ELSEN. No, Senator, because of the fact that what you are going to do is this.

There is a control there that the lawyer, the stockholder lawyer, and that's not me, Senator. I'm here on behalf of—most of our people, Senator, are defense lawyers. In fact, that's what I basically do. We defend people. But we are here for the public interest, Senator. What I'm telling you is this.

If we try to bleed these little guys, we'll just knock them out of court and that's what will happen and that's what the bill is intended to do, Senator. And that's wrong. That's absolutely wrong. It's immoral.

The idea that the lawyer can then say to the little guy who lost his $10,000 bucks—the lawyer is putting up thousands of hours at risk and that's a big control over this because you find the major stockholder firms. They don't take the cases that are lousy cases, by and large, because of the fact that they will make a——

Senator D'AMATO. Mr. Elsen, let me ask you something. Both my colleagues and the bar association support curbing these frivolous suits, correct?

Mr. ELSEN. Absolutely.

Senator D'AMATO. Do you think that if we enhanced Rule 11, so that it were used regularly and sanctions were common, we would deter frivolous suits?

Mr. ELSEN. Well, no, because Rule 11 has been widely used in the big cities. It has been used in New York. It has been used in Chicago. It has been used in Los Angeles. It's not used in the smaller towns where lawyers go to lunch together all the time.

Senator GRAMM. Mr. Elsen, when you get back to New York, would you send us some of this material, because the Congressional Research Service could find only three cases where Rule 11 has ever actually been imposed for a frivolous 10(b)(5) securities suit.

Now, I don't know about other suits and they are not within the jurisdiction of this Subcommittee. So if you have other information, it would be helpful to us. As I tell my children, never argue over facts. Go look them up.

Mr. ELSEN. That's exceptionally good advice. There's a professor at Fordham Law School who is an expert in this field. I'll contact her and see what she has.

I've been on a panel with Professor Viro, who is the expert on Rule 11, and there are lots of them being laid out.

But, you know, today, the Philip Morris thing, the defense lawyer says, in 21 days, you pull that rinky-dink complaint out or I will ask for Rule 11 sanctions.

That's the safe harbor.

And believe me, these complaints are sometimes pulled out, and they should be. If they're not, then Rule 11 still applies.

Now let me just go on.

The idea that the plaintiff can then come in before the judge after losing the case and say, if you find substantial justification for the case, then the judge cannot impose "loser pays," that was the mark-up in the Commerce Committee on the House side and it came through in the bill.

The problem with that is just envision the plaintiff that I described to you going to the lawyer and they saying, well, what is going to happen to me if I go ahead as the representative plaintiff? And the lawyer says, well, if we lose the case, you can go to the judge and say, maybe the case is substantially justified, and then you don't lose your house and then you don't lose your savings for your kids' college.

What does the plaintiff say? Well, what's the judge going to do if I lost the case and he has to find that it was substantially—maybe he'll find it was substantially justified and maybe it wasn't.

How many people are going to put everything they have in the world on that kind of gamble for a $10,000 loss? Damn few.

Now The Economist, which is no flaming left-winger, no matter what side of the table, The Economist said that the English Rule, which they lived with for a time, and they said this just recently, the worst aspect is that "loser pays" denies—and they mean the English Rule—denies access to justice to huge numbers of people. As lawyers admit, only the very wealthy can afford the cost and risks.

It's the risks. That's the interregnums effect, the risk, and that will drive the middle classes, which I gather everyone in this body is concerned about, that will drive the middle classes out of the courts.

The wealthy will still be able to do it. The big corporations will be able to fight with each other. The poor don't have anything at stake. In England, they're legally aided. Not in this country so much. But it's the middle classes who get knocked out of the courts.

Now, let me simply say, on the question of the fraud-on-the-market theory, you don't have that in Dodd-Domenici, but that came over on the House side.

We have a detailed analysis of the fraud in the market theory that came out. Now that's very technical. But the House originally said, you have to prove individual reliance for plaintiffs. You cannot have a class action if you have individual reliance for plaintiffs because of the fact that the facts are different in each case. The Supreme Court has said that.

The House came up with some compromises on fraud in the market, but there are so many problems, such as how can you prove reliance on an omission? The U.S. Supreme Court said in the Affiliated Youth Citizens case, you can't do that.

What the House bill did, with its efforts to deal with problems, has brushed aside detailed considerations in scores, in many appellate cases, in circuit courts all over the United States and it's just paid very little attention to that very technical and well thought out analysis.

Now let me just push on to another thing.

Senator GRAMM. If I may, Mr. Elsen, we have your testimony. I'm sorry but if you can stop. If you will just sum up the remainder of your statement.

Mr. ELSEN. Let me just tell two more things. I want to tell one anecdote. Pardon me an anecdote.

When I was an associate, a young associate in a large law firm, one of the old hands said to me, we're going to go over to a client. That client is hell-bent on doing something that we both knew was going to violate the securities laws.

There I was. I knew all the things that were wrong. And the old guy said to me, "This is how we're going to talk him out of it. Don't tell him about any of the cases in your memo. You'll put them to sleep. And don't lecture to them about ethics. Don't do that." He

says, "You just tell them, and I will tell them that if they go ahead, Abe Pomerantz will sue them."

Now Abe Pomerantz in those days was the leading stockholder—I guess he's not remembered any more. He was the great stockholder lawyer. We used Abe's name to advise clients and to keep them in line in a way that had nothing to do with his wishes. It was our wishes. We were trying to keep our clients clean. We were trying to have them obey the law.

Senator GRAMM. How do you spell it? We'll put it in this bill?

[Laughter.]

Mr. ELSEN. P-o-m-e-r-a-n-t-z.

Senator GRAMM. If you file a frivolous lawsuit, Abe Pomerantz will sue you.

Mr. ELSEN. Senator, I would have loved to have seen you and Abe Pomerantz in a room together. It would have been wonderful.

[Laughter.]

But let me just say this, Senator.

I can predict that if we kill the class action, as these bills will, there are going to be a lot more violations of the law.

Now when I speak, I am not speaking from the point of view of clients. I'm speaking from the point of view of the advisors. I have defended a number of people charged with securities fraud and there has never been a single one who said to me that it was a good thing that they were sued. Nobody has ever said, gee, that was a great thing. I did something and they sued me.

And when you hear from corporate executives who come in before you and they say, gee, this is a rotten, terrible thing, and I feel bad about Senator Bennett's father. I've represented people, the dean of a law school who was sued as the director of a company. It was a traumatic experience for him.

None of them have ever said that they did anything wrong. But when we come within these settlements, sometimes they did.

Be that as it may, the courts are pretty good at sorting it out. And Senator Dodd, the 2nd Circuit has never said, you've got to plead fraud with scienter with particularity.

You have to plead fraud with particularity. But scienter you can't do because nobody knows. And Judge Sands' standard jury instructions for fraud cases for 10(b)(5) cases expressly says you cannot plead scienter with particularity because you don't know what was in the person's mind and you probably never will know, but you certainly can't know it before the case because that's all circumstantial evidence.

Senator DODD. But there does have to be an inference.

Mr. ELSEN. The inference, but that's not what your bill says.

Senator DODD. Well, that's what we're trying to achieve. Now with some language——

Mr. ELSEN. The 2nd Circuit says—Senator Dodd, you know we worked with your staff, Professor Goldschmitt and others worked with your staff. We'd be glad to work with you on language, and at any time.

I thank you for your attention.

Senator D'AMATO. The pleading language is meant to codify the 2nd Circuit decisions. I believe you are absolutely correct that while it does not currently achieve that, it may create a standard

which is too high and will not allow any suits, even meritorious ones to be brought.

Mr. ELSEN. Absolutely, Senator. You have the point.

Senator D'AMATO. I think that is an issue the Subcommittee needs to look at closely.

Mr. ELSEN. Right. Thank you for your attention and I hope to be able to talk about——

Senator GRAMM. Mr. Elsen, let me get you now to sum up because we have to move on. Ms. Gallo came further than you did, and I don't know who paid for her ticket.

[Laughter.]

But I want to be sure it gets punched before she leaves.

Mr. ELSEN. I sum up by thanking you for your attention and I look forward to your questions because the devil is in the details and we've done some of them, but I have a lot more to go through.

Senator GRAMM. Ms. Gallo.

Senator DOMENICI. Mr. Chairman, I want to welcome Ms. Gallo here this morning. The same for you, Mr. Griffin.

Ms. GALLO. Thank you.

Senator DOMENICI. I might say, I'm very impressed with your testimony. I think, however, that what we are hearing in this erudite presentation is the view from the lawyers' side, the view that jurisprudence and litigation ought to be a big tool in the American marketplace.

I am a lawyer and filed my share of lawsuits, although none like this, because we didn't have any around. I believe the most inefficient and ineffective way to make people and companies comply with standards is litigation. I believe it is the most inefficient and least effective. I don't believe we necessarily have to continue with this being the principal way to keep people in line.

As to contingent fees and "loser pays," I merely suggest—it's not in my bill—that there would be no dearth of lawsuits if you had "loser pays" and the lawyers who took the contingency had to pay the fees if they lost.

There would be plenty of them around to do it and they would pay. That's my own thought. I don't have it in my bill. I don't think that that would be a terrible change in jurisprudence.

Mr. ELSEN. I think you would destroy the stockholders' bar, Senator.

But we worked with your staff and we want to work with you because this is a common problem.

Senator DOMENICI. Thank you.

Senator GRAMM. Ms. Gallo.

OPENING STATEMENT OF JOAN R. GALLO
CITY ATTORNEY, SAN JOSE, CA

Ms. GALLO. Yes. Thank you, Senator, and Subcommittee Members. I am happy to be here today.

I am the City Attorney of San José. That is the capital of Silicon Valley in California.

I am not a securities lawyer and I have absolutely no expertise in the securities area. But I have had an experience that I think you need to take into consideration as you develop reform to ensure that meritorious suits can go forward.

In May 1984, in a situation with absolutely shocking parallels to Orange County, the city of San José discovered that our investment portfolio was very heavily leveraged. The vehicle was financed reverse repurchase agreements.

When the city divested itself from this speculative position, in a single day, we lost $60 million.

The similarities between San José's situation and Orange County are particularly startling because the broker most commonly mentioned in connection with Orange County was also a broker who dealt with San José.

We were able ultimately to prove that the brokers had misled city staff into believing that this type of investment strategy was absolutely risk-free because the underlying bonds don't lose their face value and because the brokers would continue to finance the transactions.

We filed a lawsuit against 13 brokerage firms, as well as our independent auditor. All but two of the firms settled prior to going to jury. We went to jury. There was a 6-month trial and at the end, the jury found the remaining brokerage houses guilty of unsuitability—guilty is an unfair word—liable for unsuitable transactions, as well as illegal transactions under State law. We settled with those firms following post-trial motions to avoid the risks and delays that come out of an appeal.

We had been litigating at that point for 6 years. We collected, ultimately, $25 million. We spent on the lawsuit, we paid—there was not a contingency fee arrangement. We paid attorneys' fees and expenses that came to about $10 million. So, in the final analysis, we were able to provide $15 million in park improvements that had been canceled because of the bond loss.

Senator DODD. Ms. Gallo, does 42 percent of the settlement for attorneys' fees sound high to you?

Ms. GALLO. The attorneys' fees were high, but the costs were not only in the attorneys' fees. The attorneys' fees were about $6 million and, yes, they sound high to me.

Senator DODD. I thought you said the number was $10 million.

Ms. GALLO. The $10 million includes expenses. What I wanted to point out and one of the things that I do think is an expense that you have or that somebody bears in these things are the expenses of preparing for a trial.

We had to pay experts. We had—in our situation, just for the documents alone, we're still storing documents. They're now under subpoena by the SEC because of the Orange County situation. But we've been paying actually to store a garage-full of documents.

We had a lot of expenses in handling this case. Yes, I think it's high and I think it is a deterrent in the noncontingency fee situation.

My major concerns with the bill are the pleading requirements. In our situation, we had very limited access to specific detail. The treasurer and the investment officer who had been involved in the trading had lost their jobs. They were under investigation. There was a concern that there might have been kickbacks or bribes. There weren't. No gifts, nothing of that sort.

But they were being investigated. They were not very willing to talk to us as we prepared the lawsuit. They considered the brokers

to be their friends and they also were absolutely convinced we were wrong in divesting ourselves from these speculative transactions because they believed, and believe to this day, that if you only hold on, the brokers will continue to finance it until the market is good and you will be fine.

Senator BOXER. If I might. Ms. Gallo——

Senator DODD. I was just going to ask the question about an Alternative Dispute Resolution. We had that as a major provision to this bill. You talked about 6 years, which is a long time. Do you think an Alternative Dispute Resolution mechanism would have cut that back and saved some of those dollars?

Ms. GALLO. I think that some of the early evaluation type of solutions are workable. I think that what in our case was necessary was discovery. Without discovery, without full discovery, we would not have been able to convince anyone as to what had occurred.

Senator BOXER. Ms. Gallo, on that point, would you tell Senator Dodd and the other Senators about the document that you discovered when you did undertake discovery and why it was so important to the case, because I think that that will get right to the heart of some of the questions.

Ms. GALLO. Right. I provided the Subcommittee with a few documents which show that the brokerage houses were discussing San José among each other. They all knew how much each of them had financed. They knew that the situation was risky and speculative. They talked about it. They talked about how to protect themselves in that situation.

We found a letter that was drafted in February 1984 by a senior vice president of one of the firms. It was reviewed at the highest corporate level and it was reviewed by litigation counsel. It was addressed to the mayor and it would have told us that this risky, inappropriate kind of trading was going on. It was never sent. We discovered it in the course of discovery.

It took us several years to get to discovery. One of the things that was difficult was pleading because under the Federal rule, you do have to plead fraud specifically, even though you don't have to plead specifically the state-of-mind. It took us three amended complaints and several years in that process to get a complaint which was satisfactory to the Federal court. So that a lot of the time was prediscovery.

Discovery was very difficult, the volume of the documents, and it was not easy to get there. But the documents showed overwhelmingly that if we had been advised at any time between October, 1983, when we had documentation that the broker community knew what we were doing, knew it was wrong, and March 1984, we would have extricated ourselves without any loss at all. So for us, the discovery was critical.

The other aspect that I want to talk about is the "loser pays" concept.

There is no way the city of San José could have risked the additional dollars in attorneys' fees for each of the 13 broker-defendants. Counsel would not have been in a position to consider it at all. The language that has been added to H.R. 10 which says not substantially justified, that would have given no comfort.

How do we know what was substantially justified? Let me give you an example. We filed a churning claim because our records showed that from 40 trades per month, we had moved up to 460 trades per month. That sure sounds like churning to me.

However, when we got into discovery, we couldn't find any evidence of the control element. The element was missing. We produced absolutely no evidence of that. The jury did not find in our favor and we lost. I think the court, looking at it after the fact, could say that our churning claim was not substantially justified.

So there is no way we could have gone into that case if there had been risk of attorneys' fees. Our case was clearly not frivolous. I do agree, as somebody who tries a lot of cases not in the securities area, I have never seen—I think only in one case that I have ever seen Rule 11 attorneys' fees imposed, and I do think that Senator Gramm's suggestion that it be mandatory rather than discretionary is a good suggestion.

But I think that the standard of "frivolous" is the correct standard because I do think that it is very, very hard at the onset to know what the facts will really show.

Sometimes a case looks very, very strong at the onset and you get into it and you discover that your witnesses weren't telling you everything. A case that looks good, goes bad; and a case that doesn't look very strong, as ours didn't in the beginning, by the time we got through discovery, was a very strong case.

I think that both San José and Orange County experiences demonstrate that we need to strengthen the obligation of brokers. I realize that's not before you. But I do think that it is important in reform not to put a position where meritorious cases can't be brought because of the fear of attorneys' fees or the inability to plead.

Thank you.

Senator GRAMM. Thank you.

Mr. Griffin.

OPENING STATEMENT OF MARK J. GRIFFIN
DIRECTOR, DIVISION OF SECURITIES
UTAH DEPARTMENT OF COMMERCE, SALT LAKE CITY, UT
ON BEHALF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

Senator BENNETT. May I, as a point of privilege, welcome Mr. Griffin from the Great State of Utah.

Mr. GRIFFIN. Thank you, Senator Bennett.

Mr. Chairman and Members of the Subcommittee, good morning.

I don't know what concerns me more, whether it's the pending legislation that's before you or the fact that I happen to be warming Mr. Naylor's chair on the wrong end of the panel. I'm more comfortable on the right-hand side.

[Laughter.]

I'm the Director of the Utah Securities Division and Member of the Board of Directors of the North American Securities Administrators Association, or NASAA. In the United States, NASAA is the national voice of the 50 State securities regulators.

By now, the views of NASAA about the efforts in the House to deprive defrauded small investors of their day in court are well

known. Similarly, the views of most of the other participants on this panel are a matter of record. But one very important view has been ignored in the recent debate about securities litigation reform, and the view that I'm concerned about here is that of the small, everyday investor.

We did talk a little bit this morning, for example, about a new investors poll. You and I know that the poll's utility is based upon the questions that are asked. And the one that was asked as represented here this morning was would you favor doing away with frivolous lawsuits?

It might as well have been asked whether or not they favor doing away with auto accidents.

Where they asked, and did they more fully understand the provisions that are before us, the "loser pays" provisions, the means-testing provisions, heightened pleading requirements, heightened scienter requirements, how would the same investors have responded to a question of whether they would like to see a curb on meritorious lawsuits? How would they have responded then?

Those of us who oversee the markets are sometimes guilty of mistakenly assuming that money makes the markets work and that that money will always be there. The flaw in this assumption is that the markets run on money. They don't. The markets run on public confidence. And today, I want to encourage you to step back for a moment from all of the arguments that have been made dozens of times over in the last few months.

Instead, think about the confidence of small investors. As a State securities regulator who deals first-hand with the victims of investment fraud and abuse, I can tell you that the confidence that small investors have in the markets rises and falls on one thing—perceived fairness or lack thereof.

Until recently, small investors only had to worry about a lack of fairness in the conduct of investment professionals. And even here, the worry was mitigated by the fact that if worst came to worst, there would always be some sort of remedy, whether that meant the courts or arbitration.

But in a very few short months, small investors may have good reason to fear not only the misconduct of professionals, but also miscarriage of justice that would result from an overkill approach to securities litigation reform.

We should not underestimate the potentially devastating impact that could result from this two-front war on investor confidence.

My office works with small investors every day. I have no difficulty at all in imagining how many small investors will react to news that, first of all, they are still at serious risk of fraud. And second, they will have no real recourse to fight back against those who have victimized them.

Now I have no doubt that the Warren Buffets, the Peter Lynches, and the Henry Kravitzes will be more than happy to continue investing under these circumstances, but the small, everyday people are going to recognize that they have been stripped of key rights as financial consumers.

The truth is that many of them will not stay in the financial marketplace at least as far as uninsured products are concerned.

We may see some reaction in the foreign investment section as well.

Perhaps the most frequently voiced defense of the extreme proposals for the securities litigation reform is the claim that no defrauded investor with a meritorious case will be denied justice. Can we all agree that this is plainly and demonstrably untrue?

The American investors deserve to be told the truth in this matter. Yes, meritorious lawsuits will be curbed under the proposals that we see before us.

Let's look at just a couple of issues that will certainly cause most residents from my State to conclude that the Federal courts are off limits to them.

Consider the requirement that a security be posted by plaintiffs under the "loser pays" provision of the House-passed bill. Did anyone think about how this would play out in the real world?

This means that a defrauded grandmother in Salt Lake City would have to put up her property, literally bet her house in most circumstances, in the absence of a bond. And as a former prosecutor, I can tell you that there isn't a bondsman that is going to go anywhere near this rigged game about putting up a bond in one of these lawsuits.

That grandmother in Salt Lake City is going to have to bet her house that she is going to prevail over the best legal minds on Wall Street. Is there anybody here in this room that would take that bet, let alone someone in a position of an investor from Salt Lake City?

A second example of how extreme securities litigation reform would result in an erosion of investor confidence is to be found in the various degrees in the heightened pleading standards contained in both House and Senate bills.

The only people capable of meeting these standards are clairvoyants. We simply can't ask them to plead the scienter prior-to discovery. You might just as well come right out and say that the companies, the accountants, and the brokerage firms behind these bills have been totally immunized from litigation.

These pleadings standards really cannot be met, and I think we've gone over that adequately this morning.

Now take these pleadings standards and align them next to the previously mentioned "loser pays" provisions and you can see how present litigation reform measures strike at the very heart of defrauded investors.

First, we threaten to make you pay if you lose. Then we make it impossible for you to properly plead. And finally, if you do manage to get underway in your lawsuit, we'll raise the scienter standards to "knowing" instead of "reckless" to assure that you never succeed at trial.

And that's my third point. The scienter standard needs to remain "recklessness," not "recklessness" redefined to mean "knowing," as we saw in the House bill. That was just a word game. But the standard needs to remain recklessness as it's currently regarded in judicial opinions in all 11 circuits. It's the only standard which will assure the markets of due diligence, due care, and circumspection.

In closing, let me cite to a fourth example of popular reform that threatens to devastate investor confidence in the marketplace. And

I refer to the proposed house changes in relation to forward-looking statements.

Let me make it clear that NASAA is in favor of the constructive process of rule-making now underway at the SEC. But we do not support allowing companies to put forward whatever projections they wish and then shield themselves by standing behind some sort of disclaimer.

If you wish to flood our otherwise strong markets with volumes of soft information designed to levitate stock prices, by all means, endorse the House bill. But we would urge a different course. We would urge reliance on the rule-making authority of the SEC, which is keen in its deliberations on this difficult issue. I urge you in your reform efforts toward deliberation and circumspection and caution.

You and I agree that we have the finest markets this world has known. They operate in large part upon the confidence of everyday investors. And you can fix the problems that we've talked about here without sacrificing that investor confidence that is an essential element of our markets.

The rest of our remarks are contained in the written testimony.

Thank you, Mr. Chairman.

Senator GRAMM. Thank you.

Senator Sarbanes, I don't think you made an opening statement. I also think you're the only Member of the Subcommittee who has not said a word yet, so you're first in the questioning.

[Laughter.]

OPENING COMMENTS OF SENATOR PAUL S. SARBANES

Senator SARBANES. Well, thank you, Mr. Chairman. I, in fact, was listening very carefully to the panel. I'm very interested in their presentations.

I have just a brief opening statement.

I want to observe, first of all, that there's a broader issue here than the pros and cons on either side of the litigation. There is a strong national interest since our economic growth depends on a strong securities market, in which people can repose their confidence, the Nation's economic growth. Fortunately, our markets today are the largest and the most liquid in the world. We're proud of that fact.

Millions of American families invest in them, either directly or through their mutual funds and pension funds. These investors participate in the markets in large part because they are confident that remedies are available to them should they be swindled.

The condition, therefore, of our securities litigation system affects not just individual investors, the parties to lawsuits, but the economy as a whole. Therefore, we have to bear that in mind, I think, as we examine this issue.

Now we've heard from a broad range of people—accountants, securities regulators, high-tech executives, plaintiffs and defendants, lawyers, academics, and others—on this subject. They disagree over both the facts surrounding securities litigation and there I share the Chairman's view that we should look it up and ascertain what the facts are, and they disagree over the policy responses that are called for.

Some argue that the United States is experiencing an explosion of securities fraud litigation, much of it without merit. Companies, particularly growth companies, say they are sued whenever their stock drops. That's simply the basis of the suit.

Because the cost of defending such suits is high, companies assert they may settle regardless of the merits.

On the other hand, proponents of the current system note the private securities fraud suits are the most important method of compensating victims of securities fraud. They also deter additional violations.

I think, generally, over the course of time, it has been regarded that the private suits are policing mechanism for the operations of the market. And I was interested in the story that Mr. Elsen told us in that regard.

Proponents of the current system cite the record level of initial public offerings brought to market in 1992 and 1993, and reference, of course, is made to the safeguards which already exist to sanction parties and attorneys who bring suits without merit.

I was interested that this panel this morning, while critical of some of the proposals that are before us, did suggest other safeguards that might be put into place to address this particular problem.

The securities litigation system, in my view, should discourage frivolous suits while compensating legitimate victims of fraud. And obviously, the question is how do we achieve that?

There's disagreement over how well the current system achieves that goal and over how well various legislative proposals would promote that goal. Some of the proposals, however, with which we are confronted seem to have nothing to do with discouraging frivolous suits.

Limitations, for example, on joint and several liability could reduce the amounts recovered by victims in legitimate securities fraud cases. And I gather the report of the Bar Association of the City of New York, when it deals with proportionality, in that context, recognizes that the victim, in a sense, comes first. Then after that, you address the proportionality question, which I thought was a very interesting analysis.

Changes in pleading requirements and the possibility of paying the defendants' attorneys fees may well deter meritorious cases.

It seems to me that we need to analyze such changes very carefully. Now I thought we had a good panel here today in terms of trying to come to grips with these issues in a constructive way.

I do think, Mr. Chairman, that the input of the SEC on the subject of securities litigation is critical. They have a responsibility, obviously, for monitoring the securities markets and assistance to the SEC in doing that over the years has been the litigation by the private sector, which has acted as a very important, as I understand it, supplemental policing device to ensure the integrity of our markets and therefore, to justify the confidence of the investor in the market. And it's my understanding that they will be coming to testify at another hearing of this Subcommittee, and I'm very pleased to hear that.

Senator GRAMM. That's correct.

Senator SARBANES. Obviously, I anticipate we're going to have an extensive consideration and debate on this issue as we try to craft appropriate legislation to address this situation.

I want to express my appreciation to the members of the panel for their testimony today.

Thank you.

Senator GRAMM. Thank you.

I think Senator Boxer has had the least time and so, in trying to be fair, let me now call on her.

Senator BOXER. Thank you very much, Mr. Chairman.

First, I'd just like to thank the panel because what I think happened here is that some perhaps may have expected you not to offer any ideas on how we can reform the system and to defend the status quo until death.

But they didn't do that.

I think what they did is point out some of the limitations in the House bill and in the Domenici-Dodd bill and suggest other ideas.

I'm very, very hopeful that, with the remarks made by the Full Committee Chairman, that we will be able to make some changes here and get a bill that we all can feel comfortable with.

And I also feel that Senator Gramm's idea of mandatory punishment in a frivolous lawsuit is something that is very reasonable because that is, in my view, what this is all about.

You see, what I'm afraid is happening is that the whole notion of let's get rid of frivolous lawsuits is so compelling, that there are some who are using it. I don't suggest at all that anyone on this panel is doing that. But I would say, in some of the bills I've seen, and I really do feel the House bill uses this as an excuse to really harm the small investor. As I said, the idea of keeping the weak out of the courtroom goes against the very fabric of our Nation.

I wanted to ask Mr. Griffin—I was very impressed by your comments. I want to see if you bring a certain bias here.

What is your job and what is it that you're supposed to do in your job?

Mr. GRIFFIN. I'm the administrator of the securities division, kind of the mini-SEC for the State of Utah. And we investigate fraud claims and other things and we refer actions for prosecution.

My own background is I am an attorney, but I have never practiced in the private sector. My experience has always been with the State securities division either in Utah or in Nevada, where I served for 3 years as Deputy Secretary of State in charge of securities regulation there.

I have also been associated with prosecuting securities fraud claims for the Utah attorney general in a criminal context. I was very interested in the gentleman from Alabama's testimony about the current O.J. Simpson prosecution.

I, at my disposal as a prosecutor, had all the remedies, all of the powerful tools of subpoenas and other things to be able to discover my case before I filed my complaint. Had those tools not been available to me, you never would have seen me file cases.

Senator BOXER. Mr. Chairman, I think this is a very important point. Discovery is such an important part of all of this. I'm so familiar with the San José case and Joan Gallo has actually no axe to grind on any of this, telling us very clearly that without being

able to find the documents, you can't make a judgment on whether you do have a good case. You can't really know. And I think any effort to stop that process is going to be very harmful.

Mr. Elsen, you made an interesting point that the Chairman kind of joked about, which was good, how to put Abe Pomerantz into our bill so that we would, in fact, not have to worry. But aren't you really saying when you said Abe Pomerantz will file a lawsuit, wasn't that sort of a metaphor for the fact that the securities laws, if somebody competent is hired against you, that they're strong. In fact, a defrauded investor can go after people who have committed fraud. Isn't that basically what you mean by that?

Mr. ELSEN. That's right. It's the deterrent effect. And this was the point made by Herbert Stein in that op-ed piece in The New York Times. He was a member of the Nixon Council of Economic Advisers. And he said there were about 300 of these suits every year. But the impact is much greater because every time we go to one of these meetings, people remember those 300 suits. That's the metaphor.

Senator BOXER. Well, I want to pick up on that because Arthur Levitt, and I do hope that he does come forward here, who I really think a lot of, said that, if we weaken the laws too much, then the burden on the SEC is going to be enormous. It couldn't even keep up with it because the court system and the justice system act as a deterrent for fraud.

Mr. Guin made a comment, he's afraid if we go too far—I think I wrote his statement down here—that it would be a blow at the heart of defrauded investors. And eventually what will happen, and it gets to the points that were made by Mr. Naylor and others, that people will be afraid to invest. They will be afraid to invest their capital in our markets.

I was a stockbroker many, many years ago. And in that life, I relied on the statements. I relied on the price-earnings ratios. I relied on what management said in order to recommend a security.

Now if I couldn't have that sense of being able to rely on these statements and on these people who I felt were terrific entrepreneurs, I would just tell my clients, you'd better stay out of the stock market and put your money in a Treasury. But the bottom line is, I think, we're all looking for that balance here. I guess where there's differences is, you know, Senator Dodd feels he wants to move it a little bit further in one direction than I do. I am very hopeful that your testimony will help us.

In closing, I have one question for Joan Gallo, who did come so far on her own dollar, I might add.

First, a thank you again for being so clear, and I guess I want to ask one very direct question.

If we had securities reform the way it came out of the House and the way it was in the "Contract With America," do you feel you would have had a harder time getting into court to recover for the taxpayers of San José? It's a pretty direct question.

Ms. GALLO. I don't think we could have gotten into court. The case would never have gone forward.

Senator BOXER. Well, Mr. Chairman, I think that is important. Someone who really has no axe to grind in this debate says that if the House bill were to prevail here, she could not have gotten

into court to recover anything from the broker-dealers who made unsuitable investments for the city of San José.

I again want to thank you all. You are all really good and I think very, very fair. I couldn't be more pleased that the Chairman put this panel together as a balance to some of the others and I want to compliment the Chairman on his fairness.

Senator GRAMM. Thank you.

Senator Dodd?

Senator DODD. Briefly, Mr. Chairman, and I thank you.

As I understand, Mr. Griffin, and you have been before the Subcommittee. It's a pleasure to have you back again here before us.

Mr. GRIFFIN. Thank you.

Senator DODD. You have testified on numerous occasions.

There is some dissent among some States on this legislation. You're not speaking for every State in the country. There are States that are supportive of this.

Mr. GRIFFIN. I'm speaking for the Association. I only know of two, however, that have raised concerns. That's not to say that there wouldn't be others. I simply have only been aware of two States.

Senator DODD. I thank you for that. California wrote a letter in support of the House bill. I don't support the House bill. I have no problems with the House bill. But, nonetheless——

Senator BOXER. Who signed that? Do you know?

Mr. GRIFFIN. We can agree on that.

Senator DODD. Doza. I think that's his name. Ohio as well, I think.

Senator BOXER. Is this of the Wilson administration?

Senator DODD. I presume so, yes.

Senator BOXER. Well, I'm not surprised.

[Laughter.]

Senator GRAMM. He is governor, I might remind you.

[Laughter.]

Senator BOXER. Yes, and you know what he wants to be, Mr. Chairman.

[Laughter.]

Senator GRAMM. I'm not giving him free publicity because I'm concerned about him.

Senator DODD. Do you want to talk about that?

Senator GRAMM. Go right ahead.

Senator DODD. At any rate, as well, Mr. Guin, you, in your testimony, mention that your clients include a number of large institutional investors such as the employee retirement system of Alabama and the Washington State Investment Board, to name a few.

Just for the record, I'm sure you're aware that the director of the Washington State Investment Board and 9 other fund managers, including the head of the New York City Pension Funds, endorsed our initiatives in a July 19, 1994 letter to Senator Domenici and myself.

Mr. Chairman, I'd ask that that letter be included in the record.

Senator GRAMM. Without objection, it will be included in the record.

Senator DODD. I'd also like to include in the record a recent letter to Senator Domenici and myself from the Association of Private

Pension and Welfare Plans supporting our efforts. This organization represents the entire spectrum of the private pension employee benefit community. Their members either sponsor directly or administer employee benefit plans covering more than 100 million Americans.

The letter, I'd point out, Mr. Chairman, states in part: Your initiative is necessary to address the critical problems with today's securities litigation system. As you have correctly noted, investors are ill-served by the present system.

And I presume that you're aware that there was these other groups supporting the efforts.

Mr. GUIN. There's lots of different groups out there with views different ways and some supporting some things. And like I've said, I would support some proposals such as the early evaluation procedure and the requirement for certification of complaints, the requirement that a judge not give undue consideration to how quickly a case was filed, if there's a question of who should be made lead counsel in the case.

Senator DODD. You'll recall, though, about a year or so ago, that when we introduced the bill initially, that we were told that we shouldn't do anything. Do you remember that? There was nothing in the bill that was worthwhile.

Mr. GUIN. I'm not familiar with what you're talking about. I'm just here today.

Senator DODD. I can tell you categorically, having been through it, that I'm glad to hear that there are now a good part of the bill—and I understand that there are still provisions where there is some disagreement.

I'd also, Mr. Naylor, many major pension fund managers have also expressed support for the Senate version of the bill. The New York City Pension Funds, the State of Oregon Public Employees Retirement System, the Teachers Retirement System of Texas—they represent workers and retirees' pension funds who are not well served, I think, by the current system.

We also heard from other unions concerned about the abuses. The attorneys representing the employee shareholders of Pacific Enterprises, their union, Utility Workers' Union of America, Local 132 based in Los Angeles.

I won't go into all the details here, but there are a number of others who actually think that we're on the right track in this legislation.

So I wouldn't want the record to sort of reflect that there was just total opposition among organized labor.

And last, Joan, we thank you for coming and we appreciate that. The point I was making earlier is just that, on the fees collected as well as the time that went by, looking for means by which to try and resolve these matters and see that the injured parties get compensated.

I can say for my part here, this is an interest in trying to see to it that plaintiffs and defendants are treated fairly in the process and in an expeditious way as well, so that they don't have matters laying around forever.

I would just note that in this particular case, the one that you're involved in, and correct me if I'm wrong on this, but none of the defendants were insolvent.

Ms. GALLO. That's correct.

Senator DODD. That's correct. So there was no danger here in that particular case. You would have been fully compensated under the proportionate liability provisions. Is that not correct?

Ms. GALLO. Correct. That was never an issue.

Senator DODD. In fact, had we had a longer statute of limitations here, which we include in our bill, that would have also been of assistance.

Ms. GALLO. That would have been of assistance to some extent. But because of the peculiarities of our case, it really turned on changes in the market. The limitations in our damages didn't come from technical rules. It came from the evidence itself.

Senator DODD. No, I understand that. But I gather you would support the idea generally as an extension of the statute to give people more time to bring these matters.

Ms. GALLO. Yes.

Senator DODD. And if the pleading reforms of S. 240 had been in effect, the city's complaint would have had to present, quoting from the bill here, statements or omissions alleged to have been misleading and the reasons the statements were misleading.

Now, you point out that this is not terribly—it would have been difficult because the city treasurer in this particular case and the investment officer dealt directly with the dealers in the city, had no incentive to cooperate.

That sounds to me more like a problem with the city employees than an issue with the pleadings. Am I wrong on that?

Ms. GALLO. They were ex-city employees because of what had transpired. Just like in Orange County, the immediate aftermath was that these people lost their jobs.

Senator DODD. But that's more of a debate among present or former—or of investment strategies.

Ms. GALLO. I don't think it's so much a debate. What I think it stands for is that it is often very difficult to get the facts at the onset of the case.

Senator DODD. I understand.

Ms. GALLO. The plaintiff in any situation doesn't control most of the operative facts. Most of the operative facts are known to the defendant.

I primarily do defense work in other areas and we generally control the facts. The plaintiff has very minimal knowledge at the onset. And that was true in our case, both in terms of the fact that we didn't know what conversations had occurred. We weren't told what conversations occurred because they were ex-employees. But also, most of the evidence that we really used in trial came from both the deposition testimony and the documents that we got through discovery.

Senator DODD. I'm not suggesting, nor do I think any of us are here, that you ought to be in a position at the time the pleadings are made to have all the information. That would be ludicrous to suggest that. There ought to be a proper means by which people can discover.

I would just point out here you had—there was some disagreement over an investment strategy on the part of the city, present or ex-city employees over what the investment strategy ought to have been.

Again, I understand the importance of being able to proceed there. But under our pleadings in S. 240, certainly, statements, as we require, statements or omissions alleged to have been misleading and the reasons the statements were misleading would have allowed for those employees to step forward and avoid the kind of problem it seems we're talking about.

Ms. GALLO. Well, I think even under the current standards, my point was that the current standards are very difficult. They are not easy standards. It took us three amended complaints to pass the current standards.

We would not have had statements from those employees. Orange County will have the same kind of difficulty. I don't think those statements are always available. It may be more true if it's simply a single plaintiff against a defendant. But where you have an institution, or a large company, or a city, or government as the plaintiff, you're going to find that the employees who are involved in these kinds of transactions have probably lost their jobs in most situations, are under a cloud and are protecting themselves. Their interest is not the same as that of the people whose money they were investing.

Senator DODD. You're aware, of course, that nothing in S. 240 limits the number of provisions to a complaint.

Ms. GALLO. No, I'm aware that that's in the House bill and not in your bill. But the point is that even with the current pleading, it was very, very difficult. The pleading at the onset, to meet the fraud standard, even as it's written today, without having to plead to state-of-mind, is really difficult.

Senator DODD. Last, and my time has expired here. Let me just say to you, Mr. Elsen, on the 2nd Circuit, and the 7th, by the way, as I mentioned both circuits, our intention here is not in any way—we're trying to find where the bar ought to be here. We're using the bar in the sense not the trial bar, but the bar so that we avoid the frivolous and yet don't set it so high as to discourage or make it difficult for a person to file a complaint based on evidence and facts that can infer.

I'm more than willing to look at the language and how it may be written here as to meet that standard. I realize that there are those who will disagree as to what the level of that bar ought to be.

Let me just also state for the record, which I've stated over and over again over the years, I am flatly opposed to the "loser pays" notions.

Now what we've done here in this bill, I don't think—I know that's being raised here. In our bill, S. 240, and the question of the Rule 11 issue, it's vastly different. I presume you'd agree with what the House is suggesting. I have strong disagreements with the "loser pays" notion for all the reasons that have been identified by others in the past.

I just think that the potential benefits out of it are far outweighed by the liabilities and the burdens it places on people who

might have otherwise legitimate or believe they have strong, legitimate complaints.

So I am quite confident when we finish this process, it will be difficult to pass any legislation that has a strong "loser pays" provision in it. Many others disagree with that. But I'm more than willing to listen to some ideas on that.

Mr. ELSEN. Well, Senator Dodd, I appreciate what you say because I think it was clear to us that that was your intention.

We have a lot of pros working on this project. We'd like to work with you on that.

Senator DODD. We've always had that door open.

Mr. ELSEN. I think we have a joint objective. But while I have your ear for one second, I would like to ask you, please to scrub those guardian ad litem and stockholder protective committee provisions from your bill. They are terribly troublesome for reasons we set forth in detail.

If you want to take the time, I will give you the details now. But they are very, very troublesome. They will gum up the litigation process and create conflicts of interest that are very serious and very troublesome.

Senator DODD. Why don't you send us those?

Mr. ELSEN. It's in the report. Your staff has it.

I also want to point out what Mr. Griffin has said, that what the House did to the reckless and knowing standard I'm sure will not survive here because it's so rife with internal inconsistencies, that one, of course, will have a devil of a time figuring out what it means.

But the recklessness standard, which is what the House apparently wanted to come to, is what the standard should be. I don't know that you need a bill for that. But it wouldn't be a bad idea to say that that's the standard and just end the dispute. That would be a good thing.

Senator DODD. Thank you very much.

Thank you, Mr. Chairman.

Mr. ELSEN. Thank you.

Senator GRAMM. I'm going to recognize Senator Bennett in just a moment and leave him as the Chairman to finish out his questions and end the hearing. Senator Boxer has another question, and Senator Bennett can recognize her.

Let me just thank each of you. I think this was an excellent panel.

Mr. Elsen, I have one question. I want to go back to this stockholder who files this lawsuit. The stockholder has lost $10,000.

Mr. ELSEN. Right.

Senator GRAMM. He does not file a lawsuit. A lawyer comes to him and says, I can file this lawsuit. And he says, well, what can it cost me? And the lawyer says, it doesn't cost you anything. It could cost me my time, but I'm willing to risk it because I think I can get a settlement or I can get a judgment. But it doesn't cost you anything, and you might gain something. Does this situation in any way trouble you, with regard to trying to bring balance here? We know the lawyers are the active party in most of these class-action cases. They're shopping this thing. The other person,

the defendant, doesn't have a lawyer on contingency. He has to hire a lawyer and pay him, win or lose.

Does it trouble you that we have a system now that, for all practical purposes, no matter how frivolous the suit is, the plaintiffs stand to gain whatever they're filing the suit for, but they stand to lose nothing?

Shouldn't there be some stake for the plaintiff, that you have to have at least some credibility hurdle in order to file this lawsuit?

Mr. ELSEN. Well, Senator, let me say this. Let me talk about the real world, the way the system works.

A lawyer who takes a case and puts—there are some of the old-time lawyers who put on the wall, My Time Is My Capital. That's All I Have. A lawyer takes a case that's not a good case and they spend a lot of time and they get nothing. The landlord comes around and says, where is this month's rent? There's no money for the rent. The secretary says, I'm going to quit. And he says, I have no money to pay you.

Lawyers—there is a big internal control in the system. A lawyer's time is not spent hanging at the drugstore.

Senator GRAMM. What is a good case for the lawyer may not be a good case for society or for the stockholder.

Mr. ELSEN. Yes, it is, Senator. That's exactly the point. The lawyer has a case that the courts are not going to go for, that they're going to throw out, and society decides through its legal system whether it's a good case or not. That's what the lawyer judges. It's what we teach.

I've been a law school professor part time for years. We teach students, Senator, that the cases are decided. You take them, you settle them, or the like, based on their merits. That's what we spend all of our time on.

Senator GRAMM. Look. Let me——

Mr. ELSEN. And a lawyer who takes a bad case is a fool.

Look, you're talking about the contingent fee system. A longshoreman loses a leg in an accident. He has to go to a lawyer on a contingent fee and hasn't got anything to deal with. The English don't have the contingent fee system.

I think what Senator Boxer said earlier, that's one of the great strengths of America. We have our courts open to people who don't have money. The English Rule, the English system does not have the courts.

You, Senator, from a populist part of the United States, are the last person in the world who wants to throw out contingent fees and let the little guy get into court.

Senator GRAMM. Well, let me say this.

Mr. ELSEN. The Midwest and the Southwest used to throw hurdles, javelins at the East.

Senator GRAMM. My State is the litigation capital of the planet. [Laughter.]

But let me say this.

I invest in groceries and college tuition, so I never have the opportunity to sue on either investment.

Let me give a personal example. I was riding with a staff member last year, and we gently brushed up by the side of another car.

We stopped immediately. They went a half block and stopped. My aide got out, gave them a card, laughed, said hello. They drove off.

They filed a claim for soft tissue damage. Being a zealot, I called up the insurance for my aide and said, take these people to court. I would like to testify in D.C. court. I'll take my time off to prevent this rip-off.

Their lawyers, being a lot smarter than I was, said, you're crazy. We're not going to take this thing to court. They settled with one lady, who apparently had had another claim that year, and then they settled with this guy. They ended up walking off with about $15,000 for nothing. They literally pirated the system. They literally stole money from that insurance company, and they got away with it. It was a good suit for the guy who filed the suit. I don't know what he got.

But the point I want to make is that everybody's insurance is going to be higher. It did not cost me anything. It was just an outrage. I'm offended by it.

Mr. ELSEN. Senator, I would like to have you as a client. You're the kind of guy I like to work with because I would have taken this guy to court.

Senator GRAMM. So would I.

Mr. ELSEN. I have written many letters to a guy and I have said—I remember I represented a college professor who had liver cancer. And some SOB, he sold his apartment. The doctor said he couldn't move.

Some guy came in and he wanted a brokerage commission, a brokerage commission because he had brought him a buyer and the guy canceled because he had liver cancer. His doctor said he might die if he moved, right?

So I called the guy up and I said, "That's fine. We're going to go to court." Senator Gramm, I said to him, "I'd like your picture because I'm going to give this story to The New York Times. It will look beautiful and we're going to have a jury trial. You will make a marvelous lawyer out there." And that was the end of the case. You and I should work together, Senator.

Senator GRAMM. Well, we should.

Mr. ELSEN. That's the way to deal with it.

Senator GRAMM. I need to tell you, my one experience in a courtroom——

Mr. ELSEN. You have to stand up. That's what the legal system is there for. But what you want to do, Senator, is if you have a rat running in your kitchen and you have a little baby, you don't put poison everywhere, where you kill the baby along with the rat. That's what these bills are going to do.

Senator DODD. Just on that one point, though. And it's certainly very powerful testimony.

The impression here you're leaving in some ways, Mr. Elsen, is that sole practitioner sitting in that one room with a metal-top desk and a little dial phone there and a legal pad in front of him and he's got this one case and deciding whether or not he should take this so he can pay his secretary and keep the rent going.

Hell, I haven't seen a law firm in the securities field that looks like that in a long time.

[Laughter.]

Mr. ELSEN. Senator Dodd, let me tell you——

Senator DODD. Generally what you have are big operations and taking good cases and not so good cases and really weak cases is frankly all based, probably actuaries decide these things.

Mr. ELSEN. That's not true. That's not true. The firms that have grown on the plaintiffs' side, that's not me, on the plaintiffs' side, started out—Abe Pomerantz never got more than 14 lawyers in his firm.

Senator GRAMM. He didn't need them. All you had to do is mention his name.

[Laughter.]

Senator DODD. The other 13 guys would do it.

[Laughter.]

Senator GRAMM. Is this guy dead?

Mr. ELSEN. They were smart. But like any other thing, the more successful they are, the harder they look at these cases. The little guy can't get through the door of a firm like Milberg, Wise, which is probably the leader today, because they go against Keating. They go against Goodfriend or Salomon Brothers. That's the cases they take. The little guy doesn't get in there.

But you're talking about destroying a whole industry. That's what you're talking about. And what you want to do is keep the rat poison away from the baby and that's what we're here to try to help you do.

Senator BENNETT [presiding]. I'm as anxious as you are to keep the rat poison away from the baby, Mr. Elsen. I came back from my other Committee assignment because there's a point I want to make here.

I think it got lost a little in the reaction to the example I gave in the case of my father, which is the case really that Senator Gramm is talking about with the insurance company.

My father wasn't distressed about being sued. He was a little surprised when the pile of papers showed up. He was delighted when they hired a new director with an A as his last name, so it was no longer B that got all the paper.

[Laughter.]

But it was the rip-off of the system with the lawyer making the same decision that Senator Gramm's aide's car insurance lawyer made, which is that it's cheaper to settle than it is to fight. And this thing went on until somebody decided they were going to put an end to it.

So this exists. We've had plenty of testimony that it exists. We've got plenty of evidence. The facts, I think, are fairly clear.

This is the point I want to make to everybody, and Mr. Elsen, we'll get you to respond because it's late and my beeper is just going off.

Senator BOXER. Is that a vote?

Senator BENNETT. Three votes occurring at 2:00 p.m. today. So we're safe.

Senator BOXER. OK.

Senator BENNETT. There's a lot of talk here about the little guy. A lot of talk about protection.

Let's go to the case of one of these strike suits, a term that has been used to describe it here, and focus on the person who really

gets hurt. Mr. Naylor, it's the shareholder who gets hurt. It's the shareholder in whose name suit is being brought, who does not want suit to be brought. It's the shareholder who has invested his money in a company, which company is now being damaged. The shareholder's interest is being damaged because the system allows this to go on.

I have gone through it personally. I have received the stack in the mail saying, because you bought shares in X,Y,Z corporation, and the stock fell in a certain circumstance, you may have recovery. Please write to us. And I look through this and I say, this lawsuit is going to devastate this company in which I have invested some money.

Now, I invested money with my eyes wide open. I knew full well there was an opportunity that the stock would go down. I've never seen a stock yet in which there's not the opportunity that it would go down. I'm saying, where do I get to vote as a shareholder that I do not want this representation, quote, on my behalf, unquote?

Mr. ELSEN. Well, I'll tell you, Senator. What you shouldn't do, Senator, is to throw out the first package. You just took the settlement package.

The first package that comes to you tells you that the suit started and you have the right under the Federal rules to opt out. You don't want to be part of this group. You file a piece of paper and you write back——

Senator BENNETT. I did that. I automatically do that.

Mr. ELSEN. You didn't because you wouldn't have gotten the settlement package. So you didn't opt out.

Senator BENNETT. The first pile of paper I got.

Mr. ELSEN. You're a busy man.

Senator BENNETT. OK.

Mr. ELSEN. If you don't want to be part of this, you opt out. That's what the rules say. You don't have to. That's due process. That's based on constitutional questions. A stockholder who doesn't agree with the lawsuit doesn't have to be part of it. That's provided by the rules.

And the second thing, let me tell you about the rip-off in this situation. A lot of the blame falls on house counsel inside the companies that don't have the guts to stand up to these guys because it sure is cheaper the first time if it's a lousy case. But it's not cheaper the second time because you bash the head in in court of one of these people bringing you a strike suit, and you never hear from them again. And you don't hear from others because it's known that the Bennett Company or the A Company, or whatever it is, doesn't pay off.

You've got to make an investment.

There's too much—there's not enough strength in those house counsel offices.

Senator BENNETT. The testimony that we had prior, we found people who did that, who took them into court and beat them and killed the strike suit.

Mr. ELSEN. Right.

Senator BENNETT. But the names of the companies who did that were Intel, billion-dollar companies. There are companies who simply don't have the resources to follow through in court, whose

shareholders are the ones who are getting hurt. That's the driving force behind my interest in this thing, to do something that will take care of the shareholders.

You lawyers can take care of yourselves. You've demonstrated that capacity long since. It's the shareholders of emerging companies whose companies are getting hurt and whose investment, therefore, is getting damaged because the company is too small to stand the cost of going into court, so they settle and the shareholders get hurt.

When the strike suit makes the mistake of going after an Intel, they get their nose bloodied and we have seen that in the testimony before this Subcommittee. But we have had company after company after company come in here with the numbers, not hypothetical, that says, these are our sales, these are our margins, and this is how much money we have. We simply can't afford in this circumstance to keep the company doors open and fight this lawsuit. And the person filing the lawsuit knew that full well because of the disclosure.

Mr. NAYLOR. Mr. Bennett, can I make a couple of points?

You say as shareholders, we are hurt when there is a suit. By that argument, we are also hurt as shareholders when the IRS find that our company hasn't paid taxes or if we're shareholders of Exxon and they get nailed for the Valdez affair——

Senator BENNETT. Just a minute, Mr. Naylor. You are taking the position that there is, in fact, wrongdoing. Whenever there is wrongdoing, clearly, the shareholders need to be protected. Clearly, whenever there is fraud, the shareholders need to be represented.

I'm talking about people who are taking advantage of the system as it currently acts to bring lawsuits that are frivolous or they know they're going to get a settlement out of court, never have to prove anything because they can figure out the economics in advance. And we have had boatloads of testimony and specifics of examples of companies where the shareholders have been seriously damaged by those kinds of suits and those are the kinds of suits that this legislation is trying to fix.

Mr. ELSEN. But, Senator, you're assuming that in cases where it's been settled, nobody did anything wrong. That's fine for executives to come in to you and say, gee—you know, I represented people who have been sued and I've never seen one of them say to me, let's go down to the Senate and tell them we did something wrong. We got sued.

Maybe we did something wrong. But that's what the adjudicative process is. If your lawyers had the guts to say—look, I've seen lots of small companies defend themselves in lawsuits where they are sued over breech of contract over somebody else. They don't come crying and say, gee, they don't have the money to defend themselves. If they think they have a defense, they fight.

This is ridiculous. A lot of them settle because they did something wrong, Senator, and there's an assumption that they did nothing wrong. That just doesn't wash.

And you see, Professor Seligman's testimony before the House Subcommittee on Telecommunications and Finance last year, he points out the statistics on drops in the market prices. It's running around 5 percent. It hasn't changed. And a lot of those cases are

getting knocked out now by the 9th and 2nd Circuits because of the tougher pleading requirements. But the statistics don't show any increase.

Mr. NAYLOR. Senator Bennett, you suggest that the existence of computers somehow shows that the system is blind. But it's computer algorithms that allow the New York Stock Exchange to police errant companies.

When a company's stock moves outside of its normal range, they immediately investigate why. They see if there's insider trading and they pass hundreds of thousands of those instances off to the SEC for prosecution or further investigation.

Computers are the way we are following it, and it can be fast.

When there is a 10-percent stock price, it's because something has happened that contradicts what the market knew. Companies, big companies are followed by analysts. They know what the CEO has been saying. "Things are going to look great," the CEO says.

All of a sudden, if a company says, "Things look really bad. We've just discovered that we're losing $2 billion instead of gaining $2 billion," it's not rocket science to ask, why did they say they're going to make $2 billion last week and suddenly, they're losing $2 billion?

The cases are filed speedily, not because the computers are going after things arbitrarily, but because often there's a problem.

Senator BENNETT. Well, we're into the lunch hour. I won't pursue that with you.

If you're talking $2 billion, I think you're right. If you're talking an emerging company in an emerging industry where they're thinly capitalized to begin with and doing the very best they can, and something totally unknown to everybody comes along and hits the market and is immediately disclosed, the last thing in the world they need and the stockholders need on top of that is an automatic strike suit. And we had plenty of testimony of examples of that.

I'll turn the time over to Senator Boxer.

Senator BOXER. Thank you so much, Mr. Chairman.

Mr. GUIN. Excuse me. May I address that before we leave this subject?

Senator BENNETT. Sure.

Mr. GUIN. Because I would have to agree that a true strike suit where there was no merit to it at all doesn't benefit anybody.

Senator BENNETT. It benefits the lawyer.

Mr. GUIN. Well, I have not seen situations where companies paid off settlements like that. I just haven't witnessed it and I'm not talking about that.

I want to cut to the chase, is that if that's a problem, if strike suits, as you've described, are a problem, there's nothing in either of these bills that particularly addresses that issue.

Whereas, the proposal that the State securities administrators have made for an early evaluation procedure goes straight to the heart of that issue and does address it, as does the certification issue, the certification requirement of a complaint.

Senator BENNETT. I'm glad to have you point that out. I want to make it clear before I do turn the time over to my colleague from California, that I think this has been a very useful panel.

The one thing that does touch my hot button are people who suggest there isn't a problem. There is a problem and it has to be ad-

dressed, and I think the proposals that have been made here in the panel are helpful and useful. But when the impression comes across that, gee, we can solve everything with Rule 11 and the shareholders are all being protected and this isn't really happening, to quote the Chairman, look it up. The evidence in the last Congress when this bill was introduced as the Dodd-Domenici bill was overwhelming.

And I will say, Mr. Elsen, I know at least one CEO who settled solely on economic basis and told his lawyer who wanted to fight, I'm sorry. In order to preserve this company, I am not going to sustain $25,000-a-month legal bills, when I can swallow my ego and settle for $2,500 a month and save the company. And you're looking at him. I did it.

Mr. ELSEN. Oh, you did it.

Senator BENNETT. Yes, sir. So I know that it happens. I know why it happens. The shareholders were very grateful to me for doing it. It comes as a great surprise to a lawyer that there are other circumstances in the survival of a business sometimes than the legal aspect.

Mr. ELSEN. Not to lawyers who represent companies, including me. What you've said to me is perfectly comprehensible. But there are lots of cases where you've got to fight, Senator.

Senator BENNETT. I understand that. As I say, in the case of what was happening to my father, he was delighted that Merrill Lynch decided to fight and end the practice. And once Merrill Lynch did, that particular lawyer went away and there was never another lawsuit filed by anybody against the firm on whose board he sat.

Mr. ELSEN. On a large scale, that's the only way to deal with it.

Senator BENNETT. Yes. Senator Boxer, I apologize.

Senator BOXER. That's perfectly all right, Mr. Chairman.

I think that Merrill Lynch stood up for its rights in that case. Merrill Lynch also has a couple of problems in terms of San José and in Orange County. So it ought to work both ways.

My view is this. Representing Silicon Valley, I do agree that there are some of these suits going on which are boilerplate and the minute something happens, no merits, a suit is filed, and I think we've got to make reforms to prevent that. But I don't want to use that egregious problem as an excuse to gut the securities laws of this country. And it's very serious if you do that. Very serious if you do that.

Let me tell you what Arthur Levitt said, Mr. Chairman, because you are a reasonable man. I believe Mr. Levitt really doesn't have an axe to grind. He comes from the private sector. He says:

I thought during my service as head of Shearson and then head of the American Stock Exchange that I had seen just about every kind of public fraud that could possibly be perpetrated on individual investors. Then I came to the Commission and week by week, hearing cases, seeing what is going on in this country and how many people are out there taking advantage of innocent individual shareholders dwarfed anything I could ever experience before and convinced me in a way that no amount of experience or reading or anecdotal information could possibly have persuaded me of the vital and compelling importance and mandate of the Commission—that is the SEC—above everything else that it has to do in terms of governance issues and legislative issues, the critical importance of protecting individual investors.

So anything that is suggested which raises the hurdle for those investors to right these wrongs is something that I have to look at with great care and circumspection.

Now, I know that Arthur Levitt is going to support reasonable reform. I am going to support reasonable reform. I know you will, too. I just hope that we can come together on it because I think what we've heard today gives us some very good ideas. The early intervention is going to stop those boilerplate kind of lawsuits because legal counsel are going to make a better case for going forward. And any person in charge of this investigation is going to know immediately if this was a case of meritless litigation.

I feel we have come up with some good ideas here. Mr. Elsen says something that gets me upset. It's the old-boy network, maybe old boy or old girl network now, in the courtroom, that lawyers don't want to push Rule 11 sanctions on each other. Well, maybe we have to do that. I don't have any problem with that.

And I want it clear—I happen to like lawyers as a group. I am not a basher. I have seen lawyers come to the aid of poor people, give up huge amounts of money to work for legal aid to the poor, come to the defense of women who were suffering from silicone breast implants and DES and all kinds of things where it was really unclear that there would ever be a recovery and gamble, their own resources.

Now, that doesn't make every lawyer good. We certainly know that not all lawyers are good. We know that not all Senators are good. We know that not all people are good. But the kind of bashing that goes on here because it happens to be popular is a problem. I think it's wrong, and I'm saying something now that's unpopular.

I do, I must admit, have a conflict of interest in some senses. My dad was a lawyer. My husband is a lawyer and my son is a lawyer. But I truly believe that there are good lawyers and not so good lawyers. And I truly believe that there are some who take advantage of situations.

I am ready to go the extra mile to resolve that problem. I think the panel here today has given us some excellent ideas. There are other good ideas that my colleagues have. But I take to heart what Arthur Levitt says, "Let's be mighty, mighty careful."

By the way, when the author of the "Contract With America"—I won't mention his name because I don't want to get political here—put out his bill as part of the Contract, the securities reform bill, he didn't know that his own constituency was going to have to sue Merrill Lynch. Under his bill, it was retroactive. There could have been no lawsuit for the people of Orange County. He changed the retroactivity date to protect Orange County.

Well, I was glad of that. I represent Orange County, too. But I have a question for him. If it wasn't good for Orange County, why is it good for Utah and all the rest of the country?

The answer is it ain't. It's bad and I'm going to continue to point that out. We can't act around here to protect our own constituencies and throw everyone else to the wind.

As I say, I bring to the table experiences like my good colleague here, not the same experiences, but a set of experiences. My experiences were as a stockbroker advising people. I relied on those state-

ments. I relied on the goodwill of the people running those businesses so I could, in good conscience, recommend a security.

One of the things—I didn't know it at the time—that was really protecting those investors was a decent set of laws, the best in the world. Do they have to be reviewed? Yes. Should they be reformed? Absolutely. And I'm going to work very closely on this Subcommittee to make sure that this rewrite is done with proper balance. And I'm going to try in my closing minute to summarize what I think I heard from all of you, and I just want to see if there's any disagreement.

The things that give you the most anger about what you see coming out of the Congress right now is the "loser pays" and also the state-of-mind issue, that those two are the worst.

And although, in Mr. Elsen's case, you support proportional liability, you feel if somebody's flown the coop and the victim could get nothing, then dividing the rest of that, that absent parties responsibility, among the others. Now, does that about sum it up? Could you add if I've left something out?

Mr. Elsen.

Mr. ELSEN. Senator, those are the big ticket items, but there are other things that are very destructive. The stockholders protective committee would put the control of litigation in the hands of the big institutional stockholders who chose not to sue, without any fiduciary duty to the class. They'll have control over the case and they usually are in bed with the management and the like.

That's a very bad idea, as is guardian.

Senator BOXER. You see that as a conflict.

Mr. ELSEN. Very, very bad idea. And Senator, I commend to you our report, which has somewhere—I don't know if you were on this Subcommittee when we issued it.

Senator BOXER. No.

Mr. ELSEN. But I've given copies to the staff today.

Senator BOXER. Good.

Mr. ELSEN. And it's laid out in great detail. That's very bad. The knowing and reckless stuff is very bad as it presently exists.

Senator BOXER. I ask unanimous consent that this document be placed in the record so everyone can have the benefit of it: "The Report on Private Securities Litigation Reform" by the Committee of Securities Litigation and the Committee of Federal Courts.

Senator BENNETT. Without objection.

Mr. ELSEN. Thank you. The other thing I wanted to say, Senator is that it's very warming to hear what you say, and I think Senator Bennett, who is indeed a fair-minded man, is going to be on your side eventually because, you know what I think?

You say it's unpopular. Not when the country finds out what's really going on.

Senator BOXER. There's a lot of dictators in the world that would like to get rid of the lawyers first, you know.

Mr. ELSEN. What's going on, your position is going to be the popular one.

Senator BOXER. Well, I don't know. All I know is I really hope that we can share each other's position because I don't think there's disagreement on what we're trying to end here. And what I hope there's agreement on is not throwing out the good things

about the laws. Did I leave anything else out, if I might just add the indulgence of my Chairman?

Mr. GUIN. Senator Boxer, I would just second the list of items that you have provided, and also, I agree with Mr. Elsen on the investor committees and the guardians. It creates tremendous conflicts of interest. I have written about it in my submission, as I'll just leave those statements there.

Senator BOXER. OK.

Mr. GUIN. And there are also, there are drafting issues, some that are just choice of language that are not that significant. There are some that I think are a matter of choice of language.

I think I understand what the intent of a proposal is, but that there's some language that ends up doing other things, that can have some pretty drastic effects.

One is the provisions that deal with fraud-on-the-market and class-wide reliance, that seems to try to preserve that for stock cases and does away with it in municipal bond cases.

Senator BOXER. Well, Mr. Guin, will you share that information with us because I would like to have that with specificity?

Mr. GUIN. Certainly.

Mr. GRIFFIN. Senator Boxer, let me just add one thing. This early evaluation procedure I think is the only provision that has been suggested to date that does have the potential of dealing with frivolous litigation, up front and in a way that both parties can be satisfied that there's fairness.

It has the effect, it may dovetail with something on "loser pays." I don't know. But it has merits and this Subcommittee should look at it as a just resolution to the dispute that's been brought, acknowledging all sides have a point of view on this.

Senator BOXER. Well, I like it because it sounds like it's a fair forum with which to determine if a suit should go forward and then it puts people who would wish to go forward in a situation—or perhaps in that situation, could they be knocked out of the box completely at that point.

Mr. Guin.

Mr. GUIN. It gives you the option. A judicial officer makes a determination of whether your case is frivolous. The judge may say your case is frivolous. You can still go ahead, but if you go ahead and lose, you pay the other side's fees.

Senator BOXER. I think that makes a lot of sense.

Thank you for your generosity, Mr. Chairman.

Senator BENNETT. Thank you, Senator.

We thank the panel. This has been a spirited and, I think, useful exchange.

I would hope all of us end up in the same place, that we're here to protect the shareholders.

Thank you.

The Subcommittee is adjourned.

[Whereupon, at 12:45 p.m., the Subcommittee was adjourned.]

[Prepared statements and additional material for the record follow:]

PREPARED STATEMENT OF SENATOR ALFONSE M. D'AMATO

MARCH 22, 1995

I would first like to note the presence of one of my constituents, Sheldon Elson, appearing on behalf of the Association of the Bar of the City of New York.

Since I spoke on securities litigation reform at the Subcommittee's hearing earlier this month, I will keep my remarks brief so we can hear from the witnesses.

Clearly, now is the time to act to reform securities litigation. Congress must curb abuses that clog our courts with frivolous lawsuits, while maintaining the incentives for bringing meritorious ones.

Over the past few years, this Subcommittee has considered a wide range of issues relating to securities class actions. During Senator Dodd's tenure as Chairman, the Subcommittee also prepared a comprehensive and informative report.

I commend Senator Gramm for moving quickly to convene hearings. He has indicated that litigation reform is his first priority as Chairman of the Securities Subcommittee.

I also wish to once again commend Senators Domenici and Dodd for introducing the "Private Securities Litigation Reform Act of 1994." Senators Domenici and Dodd have long been at the forefront of the effort to reform securities litigation, and I support many of the proposals in their bill.

I am committed to moving quickly to mark-up legislation.

During the next several months, I look forward to working with my colleagues to enact meaningful legislation that will effectively curb frivolous class-action lawsuits.

CHRISTOPHER COX
CALIFORNIA

CHAIRMAN
REPUBLICAN POLICY COMMITTEE

COMMITTEE ON COMMERCE
SUBCOMMITTEES
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OVERSIGHT AND INVESTIGATIONS

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CHAIRMAN
CONGRESSIONAL GRACE CAUCUS

VICE CHAIRMAN,
CALIFORNIA TASK FORCE

Hon. Phil Gramm:
Chairman, Securities Subcommittee
Committee on Banking, Housing, and Urban Affairs
U.S. Senate
Washington, D.C. 20510

Dear Phil:

As the author of the Securities Litigation Reform Act, I wanted to take the opportunity to correct for the record a number of inaccuracies in Senator Boxer's remarks at your March 22 hearing.

As you know, our Contract With America pledged that within 100 days we would bring to the floor a bill to facilitate valid shareholder claims and deter frivolous strike suits. We kept that promise with overwhelming bipartisan support. On March 8, the House passed the Securities Litigation Reform Act, H.R. 1058, by a huge and bipartisan vote of 325 to 99. More Democrats supported the bill than opposed it.

At your hearing, Senator Boxer repeated her earlier claims that the House-passed bill--and still more, the Contract bill as introduced--would obstruct valid claims arising from the current situation in Orange County. She could not be more wrong. As Senator Boxer is well aware, the Contract bill both as introduced and as passed would significantly advantage Orange County, were it applied to the County's claims. The bill's adoption of a "full recovery" rule would ensure that the County's legal bills, which could be quite expensive, would be borne by the guilty parties if the County prevails. Moreover, the House-passed bill exempts losers with substantially justified cases. Under these circumstances, it is difficult to imagine that Orange County, even if it were to lose a claim, would bear the other side's costs.

Similarly, the bill's provisions on recklessness and specific pleading are drawn from the current governing case law. The Contract bill would provide much needed certainty in this area, to the benefit of plaintiffs and defendants alike. John Moorlach, who prior to the bankruptcy challenged Robert Citron for County Treasurer and made Citron's imprudent investment strategy the centerpiece of his campaign, endorsed the Contract bill. Moorlach, who was recently appointed as the new Treasurer to clean up Citron's mess, said our Securities Litigation Reform Act "will strengthen the rights of real victims of fraud, while

preventing frivolous cases from victimizing responsible people. It will be good for the country and for Orange County."

By the same token, the bill's provisions deterring frivolous claims would work for Orange County. Since Orange County and its 2.5 million people have a GDP bigger than Singapore's--and comparable to Portugal and Greece--the County's taxpayers are the deepest pocket around. They are thus also the biggest potential target for abusive lawsuits arising from the bankruptcy. Although such suits against the County are currently stayed by its bankruptcy, they can be filed as soon as the bankruptcy terminates. The provisions in the Contract bill that deter strike suits will strongly benefit Orange County taxpayers, who under the current system could potentially have to pay not only damages from any meritorious cases against the County, but also the litigation costs and nuisance value of meritless cases.

Rather then disputing these points, Senator Boxer chose to repeat spurious allegations that I revised the Contract bill to "shield" the County from its supposedly onerous terms. The undisputed facts are to the contrary. As initially drafted in September 1994, the Contract bill would have applied to suits pending on the date of enactment. Senator Boxer criticized the draft for being retroactive. In fact, the initial effective date was a staff drafting error of which the bill's sponsors were unaware. It was thus revised prior to its introduction in January 1995 to conform to the usual practice on effective dates and to avoid disrupting ongoing litigation. Catching these types of mistakes is precisely the reason we took the care to circulate a draft for comments.

Senator Boxer knows all about this drafting error, since I made this point clear in earlier correspondence, which I have attached. That is why it is particularly unfortunate that Senator Boxer not only refuses to correct her earlier misstatements and omissions, but continues to compound them with new, obviously deliberate distortions.

I find Senator Boxer's exploitation of the Orange County bankruptcy highly ironic. The losses in Orange County's portfolio derived from the unreasonably risky investment strategy pursued by her fellow Democrat, Robert Citron. I served as campaign chairman in 1994 for John Moorlach, Citron's opponent. At a time when I was taking the lead in helping sound the alarm about Orange County's risky portfolio, Senator Boxer was conspicuously absent from the debate.

She was also AWOL from the debate on securities reform in Washington. As a member of the House, she refused to cosponsor the bipartisan reform bill sponsored by her Democratic colleague Billy Tauzin and subsequently supported by scores of other Democrats. As a Senator in the 103rd Congress, she refused to sponsor the Dodd-Domenici bill, recently endorsed by President Clinton's appointee to head the SEC. Despite the fact that our

home state of California has been hardest hit by the strike suit epidemic, she did not join our bipartisan California delegation letter to President Clinton urging reform. That letter, co-authored by my California colleagues Norman Mineta, a Democrat, and Carlos Moorhead, a Republican, told President Clinton that "frivolous securities litigation...[is] an issue of growing importance to the State of California," and that "California's high tech, high growth companies are particularly at risk" from such abusive litigation. And they noted that "the average settlement on these types of cases pays 14 cents on every dollar of recoverable damages, with one third of damages going to attorneys."

Such wasteful litigation directly destroys American jobs by forcing America's cutting edge, high-tech companies to divert investment capital from R & D and expansion to legal fees. By imposing asymmetric burdens on American producers, it cripples our ability to compete both at home and abroad. It raises the prices every American consumer pays for American products. And ordinary investors--the huge cross-section of Americans who have invested in securities through their union pension fund, ESOP, or IRA--can lose an important part of their life savings.

Worst of all, the status quo that Senator Boxer has until now defended grossly shortchanges people who have been victimized by real fraud. It consistently undervalues valid claims, because the handful of millionaire lawyers who stage-manage virtually all of this litigation earn more by churning frivolous claims than by vigorously pursuing valid ones. Recent studies have established that the current system rewards these lawyers for bringing as many lawsuits as possible and then settling all of them early for a fraction of the alleged damages--even when the plaintiffs would be better off going to trial.

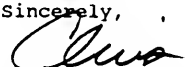
Senator Boxer should be aware of a prime example of this, which occurred recently in California. After the owners of energy partnerships lost half the value of their investments, their lawyers ignored clear evidence of their strong claims and sought to settle their suit for less than a third of the case's value. Both the Securities Exchange Commission and the California Corporations Commission objected that the settlement benefitted the lawyers, not the investors. No thanks to the eslf-interested lawyers, the settlement was ultimately tripled as a result of regulators' efforts. (The plaintiffs' own lawyers, who sought the quick settlement, then tried to get higher lawyers fees out of the higher amount the authorities obtained.) California, as well as the SEC, urged the court to slash the attorneys fees to "send a strong signal to the class action bar that, if they are to earn their fees, it is critical that the only interest they serve during a class action litigation is their clients' interest."

The gross unfairness of the current system--to investors and businesses alike--has led to bipartisan demands for reform. Even

Arthur Levitt, President Clinton's appointee to the SEC, has expressed strong concern over abusive class-action cases. Liberal Democrats less attentive to the needs of plaintiffs' lawyers, like Reps. Eshoo, Farr, Fazio, and Lofgren of our own State of California, all supported our reform legislation in the House.

Senator Boxer's attacks on the House legislation, itself bipartisan, go beyond partisanship. They are plainly inaccurate. I appreciate this chance to set the record straight, and wish you every success in passing a bill at least as tough on fraudulent securities suits as the House version.

Sincerely,



Christopher Cox
U.S. Representative

P.S. You may have missed the enclosed page-one Wall Street Journal article on California's notorious Bill Lerach. Our Senate delegation from California relies on him to recommend judges to President Clinton.

CHRISTOPHER COX
CALIFORNIA

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CHAIRMAN
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CHAIRMAN
TASK FORCE ON
CAPITAL MARKETS

January 19, 1995

Senator Barbara Boxer
112 Hart Senate Office Building
Washington, DC 20510

Dear Barbara:

Legalized extortion by self-interested, unethical "strike suit" lawyers is a national outrage that has become intolerable. Our subcommittee today held hearings on the depth of the problem. H.R. 10, the Common Sense Legal Reform Act, could finally redress these abuses and make our securities laws work for fraud victims--instead of their lawyers. That's why I'm particularly disappointed that you've chosen to defend the status quo, rather than endorse reforms that will solve the problem.

Bipartisan reform legislation was introduced in both the House and Senate during the 103rd Congress, and the Contract With America bill was introduced with bipartisan support. Nevertheless, you have chosen to oppose these reforms. Defeat of these reforms, however, would cheat workers, the general investing public, and consumers. It would destroy jobs, undercut American competitiveness--and hurt the victims of securities fraud.

(1) **Real reform would empower fraud victims.** Today, strike-suit lawyers call the shots in litigation, controlling (and often employing) the so-called "lead plaintiffs" who are supposed to look out for the victims. No wonder the leading strike-suit lawyer says, "I have no clients." No wonder lawyers run suits for their own benefit, not their clients': the average settlement gives investors 14 cents for every dollar lost; an average of about $2 million goes to their lawyers.

Real reform would take control of cases from the lawyers and give it to the victims. That's why the Senate's bipartisan Dodd-Domenici bill, co-authored by the new Democratic Party Chairman, provided for plaintiff steering committees. Our Contract With America bill does this by adopting that bipartisan provision verbatim. This will empower victims of fraud, by preventing strike-suit lawyers from settling valid claims of fraud for pennies to protect their million-dollar fees.

(2) **Real Reform Would Guarantee Full Recovery for Fraud Victims.** Today, no matter how valid their claim or how successful their lawsuit, fraud victims can't recover their full losses. That's

because their attorney's fees are deducted from any recovery for their losses. And the lawyers' share can be enormous.

Real reform would ensure full recovery by permitting those who are legally adjudged to be right to recover the costs of enforcing their rights. The House bill does just that. Under the status quo, plaintiffs have no choice but to pay all the expenses of a case even if they've got a good claim. The bipartisan Common Sense Legal Reform Act gives plaintiffs the option to proceed under either rule--loser pays at the federal level, or the winner pays rule at the state level. The status quo means defrauded investors and innocent victims of strike suits don't recover their attorney's fees--and thus are never fairly compensated for their losses.

(3) **Real reform would end abusive suits against innocent parties.** Current law permits strike suits virtually whenever share prices drop, even if the decline was caused by broad market changes. Because these suits are phenomenally expensive and disruptive to defend, often involving massive document requests, it's often cheaper for companies to settle even weak cases than it is to bear the continuing expense of the lawsuit. These extorted settlements cost jobs, curtail research and development, undercut our competitiveness, and raise prices for consumers--imposing a huge "litigation tax" on every American.

Regrettably, you have chosen to exploit the tragic situation in my home county in a partisan attempt to stop the Contract With America (see attached letter from Orange County's John Moorlach, who was there when you weren't to protect Orange County). As I've pointed out above, my bipartisan bill would help victims of real fraud and victims of meritless lawsuits. Under my bipartisan bill, any party who has been the victim of actual fraud will be able to fully recover. As you know, both the County in its suit against Merrill Lynch and the class-action plaintiffs in the suits against the County have alleged knowing fraud.

I should add that Orange County taxpayers, with a GDP larger than Singapore's and comparable to those of Portugal and Greece, are the deepest pockets in this case. They will be the target of every frivolous claim that can be dreamed up by the more unscrupulous members of the plaintiff's bar. My reforms would help them. Your endorsement of the status quo would permit the continued victimization of Orange County taxpayers.

Let me make one final point. As you've pointed out, the Common Sense Legal Reform Act, as introduced on the very first day of this Congress, applies only to cases filed after its enactment. It would therefore not apply to these Orange County cases. Contrary to your inference, a technical correction by staff before the introduction of the bill was made to conform to the prevailing drafting rule concerning the effects of statutory changes on ongoing litigation. (It generally is unfair and

counterproductive to change pleading requirements or the elements of an action after it is underway.)

Were it not for that fact, Orange County could gain the protection from abusive litigation under the fairer rules set out in the Common Sense Legal Reform Act. These reforms will promote fairness and justice for all of our constituents; maintenance of the status quo will promote the interests of a few wealthy, unscrupulous, and abusive trial lawyers.

Sincerely,

Christopher Cox
U.S. Representative

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THE WALL STREET JOURNAL.

WEDNESDAY, MARCH 29, 1995

Class-Action Clash

King of 'Strike Suits' Finds Style Cramped By Legal-Overhaul Bill

House Would Curb Litigation When Stock Prices Drop; Why Mr. Lerach Objects

CEO: 'I'd Punch Him Out'

By JILL ABRAMSON and AMY STEVENS
Staff Reporters of THE WALL STREET JOURNAL.

San Diego trial lawyer William Lerach is the king of the "strike suit," securities class-action lawsuits that hit when a company's stock drops. Executives from Wall Street to Silicon Valley routinely trade horror tales about being "Lerached."

Now Mr. Lerach's potent legal weapon is at risk of being "Newtered."

Part of the Republican legal-revision drive passed by the House this month under Speaker Newt Gingrich would put a big crimp in strike suits. So Mr. Lerach is leading the drive by trial lawyers to squelch the securities-litigation-overhaul bill in the U.S. Senate. No trial lawyer has been a more generous contributor to Democrats, whom opponents of the bill are counting on to block it or water it down. And none has more at stake in the outcome.

William Lerach

Mr. Lerach's law firm is involved in about one-quarter of all securities class actions; by his estimate, that is about 250 pending cases, alleging more than $10 billion in damages. In Silicon Valley, where more than half of the top computer and high-tech firms have been hit with strike suits, no lawyer is more feared or hated than Mr. Lerach.

"He is to this kind of lawsuit what IBM is to computers, but IBM has a smaller market share," says Brian Borders, president of the Association of Publicly Traded Companies, a group that includes companies that have been sued, sometimes more than once, by Mr. Lerach. GOP Rep. Christopher Cox, whose California corporate constituents have been on the receiving end of his lawsuits, calls Mr. Lerach's practice "an extortion racket"; he says meritless strike suits are filed mainly to extract settlements from companies fearful of litigation costs and big fees for lawyers.

Corporate Campaign

Now they are striking back. Mr. Cox introduced the legislation to revise securities litigation that passed the House as part of the GOP "Contract With America." Mr. Borders is one of the lobbyists involved in a multimillion-dollar corporate campaign to get a somewhat-altered version of Mr. Cox's bill through the Senate this year. The bill they want would halt fishing-expedition lawsuits by forcing lawyers to specify factual charges in their initial complaints, and it would protect executives from liability when they make forecasts that don't pan out. The bill also has a losers-pay clause.

The 49-year-old Mr. Lerach, who views himself as a protector of defrauded shareholders, isn't conceding the battle. And if he is a symbol of the excesses of the current tort system, he is also emblematic of the immense political clout that the trial bar still enjoys in Washington, even as Democrats, the major beneficiaries of its largess, have lost control of Congress. Until the Republicans swept in in November, the donations of Mr. Lerach and like-minded trial lawyers meant that Democrats provided an insurance policy against almost all tort-revision bills, including securities-litigation overhaul. Mr.

Lerach's total contributions to the Democratic Party and candidates at the federal and state level (including those from family members and law partners) exceed $1 million during the past five years.

'You Have to Give'

Mr. Lerach's sprawling Fairbanks Ranch estate has become a familiar site for Democratic fund-raising receptions. He says he doesn't link his contributions to his lobbying (indeed, that would be illegal). "There is no tie," he says, "but in this system you have to give."

And money, of course, does help win access, an edge Mr. Lerach is exploiting to the hilt. Mr. Lerach will soon be speaking with Christopher Dodd, the Connecticut Democrat who is a chief sponsor of the Senate's securities-litigation bill, in hopes of weakening some key provisions. Party officials were well aware that Mr. Lerach was unhappy over Mr. Dodd's appointment as co-chairman of the Democratic National Committee and worried that he might boycott party fund raising. Mr. Lerach says he hasn't closed his wallet and will soon host events for two Massachusetts Democrats, Sen. John Kerry and Rep. Joseph Kennedy.

According to one party official, Mr. Lerach attempted last year to enlist Democrats, including Sen. Bob Graham of Florida, who was deeply involved in party fund raising as chairman of the Democratic Senatorial Campaign Committee, to get Mr. Dodd to back off the overhaul bandwagon. Sen. Graham, according to a party official, refused. Mr. Lerach denies asking Sen. Graham to approach Sen. Dodd on his behalf, but confirms talking to him about securities-litigation change.

President Clinton and Vice President Al Gore have both been feted at lavish fund-raising events held at Mr. Lerach's home. Mr. Lerach and his wife, in turn, were on the guest list at last fall's state dinner for Ukrainian President Leonid Kuchma. If Mr. Lerach fails to get satisfaction in the Senate, he will probably try to make securities-litigation overhaul presidential-veto bait. "I will fight to the death and use every potential device known to man to stop the legislation if it's like what came out of the House," he says.

Because the Senate bill is in flux, the White House doesn't yet have a position, although in a letter this month, it did express some reservations about the House bill. The administration's final position won't be affected by Mr. Lerach's contributions, according to White House counsel Abner Mikva.

Powerful Alliance

Besides making campaign contributions, Mr. Lerach endows and provides the energy behind a Washington lobby group, the National Association of Securities and Commercial Law Attorneys, that includes other attorneys who specialize in shareholder suits. The group has knitted together a formidable lobbying alliance that includes the American Association of Retired Persons, the AFL-CIO, the Consumer Federation of America and several of Ralph Nader's groups.

Mr. Lerach says his contributions and lobbying muscle amount to "spit in the ocean" when compared with the resources his foes have pumped into the fight. The accounting profession, for example, has backed up its lobbying efforts with some $4 million in contributions last year. An alliance of 1,400 companies, from the Big Six accounting firms to the securities industry to much smaller high-tech companies, are pouring millions of dollars into a lobbying campaign to pass a securities-litigation measure this year.

"I'm afraid if I got too close to him I'd punch him out," says Alan Shugart, chief executive of Seagate Technology Inc., whose Scotts Valley, Calif., disk-drive company has been sued by Mr. Lerach three times. Mr. Shugart, who is leading an effort to get a securities-litigation revision on the California ballot, says Seagate "paid ransom" to settle the first case and is still fighting the other two. "These cases are all frivolous, and all identical," he says. "They just copy them over, even the misspellings." Mr. Lerach denies the lawsuits are copied, saying they are prepared for each specific case. Mr. Shugart, he says, "is a sore loser."

While Mr. Lerach says he has never been sanctioned for filing a frivolous lawsuit, a federal judge in Los Angeles fined him $2,400 in a 1992 case when Mr. Lerach tried to consolidate two securities cases and get himself appointed lead counsel. The judge also dismissed the suits. With characteristic bluster, Mr. Lerach blames the judge for being "an outspoken critic of class-action litigation."

Misplaced Toy

The speed at which Mr. Lerach's firm, Milberg, Weiss, Bershad, Hynes & Lerach, churns out complaints has also brought some embarrassing gaffes. For example, a 1993 complaint cited cigarette-maker Philip Morris Cos.' "success in the toy industry." He says his computerized spelling checker failed to pick up the error, and emphasizes that the New York tobacco and food company is identified correctly elsewhere in the document.

Apart from critics who complain that Mr. Lerach sometimes files lawsuits more for profit than for principle, the attorney has occasionally raised eyebrows over his legal maneuvers. In one case, he sued Pacific Enterprises, a Los Angeles utility holding company, on behalf of shareholders – and also sued former officers and directors on behalf of the company itself.

The Ninth U.S. Circuit Court of Appeals in Pasadena, Calif., said in February that it was "concerned about the potential conflicts" created by the dual representation, which netted Milberg Weiss $4 million in fees. Mr. Lerach says he acknowledges the court's concern, but says no conflict arose. He adds that having one law firm in both cases has tremendous advantages in helping to coordinate them.

Mr. Lerach prefers to highlight the millions of dollars he has recovered for defrauded investors and views himself as a civilian law enforcer. "We deter wrongdoing that's impossible to quantify," he says. "These companies are not afraid of the SEC; the worst they get in 90% of the cases is a consent decree. That's not the same as facing a multimillion-dollar lawsuit." He emphasizes that his firm refuses more cases than it files.

'Charming Rogue'

"I have enormous respect for him," says Tower Snow, a partner at the San Francisco law firm Brobeck, Phleger & Harrison, who has litigated against Mr. Lerach and describes him as a "charming rogue."

As the second-highest paid lawyer at Milberg Weiss, Mr. Lerach certainly makes millions of dollars a year. Last year alone, he and his partners were among the principal attorneys in cases that settled for a total of $295 million, according to Securities Class Action Alert. Since lawyers usually receive 25% to 35% of each settlement in contingency fees, the firm probably reaped the lion's share of $75 million last year – not including fees from its broad range of other legal work. (The firm refuses to disclose how much it shares with co-counsel.)

"If there's a criticism of us for making too much money," Mr. Lerach says, "it ought to be tempered by the knowledge that without well-capitalized, well-funded law firms willing to take these cases on a contingency basis, investors would never have obtained the recoveries they have."

Mounted on one wall of his San Diego law office, replete with its own bar, is a color poster depicting a rogues' gallery of 65 corporate executives named in lawsuits by his firm. "Look at these frauds from the past few years," it says. Among them: Michael Milken, David Paul and Charles Keating.

Ramona Jacobs, a plaintiff in Mr. Lerach's suit against Mr. Keating's Lincoln Savings & Loan, has come to Washington with him on several occasions and has testified against securities-litigation-overhaul legislation. She expects to recoup almost all of the $11,000 she and her daughter lost when they purchased Lincoln bonds in the late 1980s. "We would never have recouped anything without the lawyers that helped us," she says. On a recent Washington visit, Mr. Lerach had a group of angry Orange County investors in tow. "He parades around with his widows and orphans," grouses Rep. Billy Tauzin, a Louisiana Democrat and backer of securities-litigation revision.

Mr. Lerach himself was brought up by a widowed mother in Pittsburgh. Her government benefits helped send him to college. After graduating from the University of Pittsburgh Law School, Mr. Lerach joined the venerable local law firm Reed, Smith, Shaw & McClay. In 1976, the firm made him the youngest partner in its nearly 100-year history. At the time, he was handling a fraud lawsuit brought by investors in a San Diego financial institution. During the negotiations with fellow plaintiffs' attorneys, he met New York litigator Melvyn Weiss and soon joined his small law firm.

"He is extraordinarily articulate and resourceful," Mr. Weiss says. "He's always testing new theories and the parameters of people's rights."

Legal Merger

The firm has grown steadily to 90 attorneys, largely by adding young lawyers. Last fall, Mr. Lerach married one of them: Star Soltan, 32, whom he met several years ago when she was a Milberg Weiss associate in San Diego.

Mr. Lerach and his third wife are building a 10,000-square-foot villa plus a guest house and maid's quarters on 11 acres, complete with a tile-roofed doghouse matching the main structure. They need more space in part because Ms. Soltan is about to have their first child.

"We're going to have a little boy," Mr. Lerach says. "That ought to scare the corporate community."

PREPARED STATEMENT OF BARTLETT NAYLOR

NATIONAL COORDINATOR, OFFICE OF CORPORATE AFFAIRS

INTERNATIONAL BROTHERHOOD OF TEAMSTERS, WASHINGTON, DC

THE NEED FOR STRONG ANTIFRAUD ENFORCEMENT AT PUBLIC CORPORATIONS

MARCH 22, 1995

The International Brotherhood of Teamsters (IBT) Office of Corporate Affairs is pleased to submit the following comments regarding relaxation of private securities litigation.

My name is Bart Naylor, National Coordinator for the IBT's Office of Corporate Affairs. President Carey established this office to help Teamsters address their responsibilities and prerogatives as investors.[1]

> ***In sum:*** *Antifraud deterrence keeps corporate representatives honest, which keeps our markets clean and promotes capital formation. In the absence of full funding for public securities enforcement, the profit-making private plaintiff's bar serves a valuable role. Efforts to shackle the private bar will harm investors and companies alike. The price of relaxing private litigation and stopping frivolous suits as embodied in the main bills before Congress, comes at the expense of stifling legitimate suits, and is too dear.*

The Teamsters' bring many interests to this issue. The Teamsters represent some 1.4 million members, making us the largest labor union in the United States affiliated with the AFL-CIO. Teamsters are the collective beneficiaries of some $48 billion in Taft-Hartley pension plans, making this the largest pool of labor union funds in the Nation. We have sought to elevate the standards by which these funds are invested, managed, and governed to serve the interest of plan beneficiaries. Further, some 140,000 of our members are public sector workers and are beneficiaries of public pension plans, including funds in New York City, the States of Washington, Oregon, California, and others. We represent more than 1,000 members who are employed by agencies in Orange County, California, and primarily through the Orange County Transit Authority's unfortunate investment in the County Treasurer's investment pool, we are exposed to the bankruptcy there.

In addition, many of our members participate in company sponsored stock investment plans, such as ESOP's and payroll deduction plans. Teamsters who work for PepsiCo., for example, receive options. Several thousand Teamsters who work for Consolidated Freightways have elected to have money removed from their paychecks each month to be invested in CF stock. Many of our members are individual investors in companies, both in the companies where they are employed, and in separate companies.

Private Enforcement Deters Fraud

As investors, we depend on honest disclosure. The great reform that established the Securities and Exchange Commission resulted from the scandals of the 1920's when Wall Street snookered investors into purchasing giant pyramid schemes, or when banks pawned their non-performing loans off to unsuspecting investors as bonds. Congress weighed Federalizing corporations. As a compromise, it required tough disclosure laws, and provided various means of enforcement. Companies are now required to file documents that meet disclosure requirements. Before a bank pawns off a non-performing loan, it must declare up-front that the loan doesn't pay. Issuers must include the bad news as well as the good news.

Hand-in-hand with honest disclosure goes the deterrence that derives from enforcement actions against fraud. For this, private enforcement is vital. As Senator Dodd has written, "The longstanding success of our securities markets over many decades is due to the fact that investors here and abroad trust our markets to be fundamentally clean and fair. That trust stems in part from the SEC's role and in part from investors' access to our courts. We must continue strong enforcement of the Federal securities laws."[2]

The SEC is neither equipped nor designed to provide full policing services. By design, the SEC works in conjunction with Self-Regulatory Organizations (SRO's), primarily the exchanges, which are private entities run as associations of private sector companies. In fact, the SRO's are considered the frontline of defense. In addition, State authorities police the interests of constituents within their geographic boundaries. Finally, private parties can sue. The SEC fully appreciates this tool. Former

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[1] In the interest of full disclosure, I served this Committee as head of investigations under Senator Proxmire in the 1980's.

[2] "Securities Litigation Reform," House Energy and Commerce Committee, 103–156, p. 21.

Chairman John Shad emphasized that the "SEC isn't the sole defense . . . if anything is seriously amiss, he contends, 'You can be sure the private bar will be in there with class-action suits.'"[3] Former Chairman Richard Breeden testified in 1991 that private actions to remedy violations of the securities laws are "necessary to compensate defrauded investors" and save taxpayers the expense of hiring hundreds of additional attorneys for the SEC staff.[4] Current SEC Chairman Arthur Levitt has stated:

> Private securities fraud actions are clearly vital to the effectiveness of Federal securities laws. They serve as a complement to the SEC's enforcement program and together they go a long way toward maintaining investor confidence.

SEC enforcement Director William McLucas has repeatedly stated that the SEC cannot provide complete enforcement. "Corporate boards do not fear us," he noted at a recent hearing regarding safe harbor reform.[5]

Such manifold deterrence mechanisms are needed because of the propensity for company representatives to be less than forthright. Companies tap the public markets not as charity to investors or a feeling of public spiritedness, but because they want capital to expand. Once a company does tap the public market, it wants its stock price to rise. A high-stock price reduces its cost of capital. A high-stock price is the equivalent of a low-interest rate. A low-stock price is equivalent to a high-interest rate. Financial executives understand well this calculation, winning reward for their ability to reduce their company's cost of capital. Companies hire public relations employees, investor relations officers, and others to paint a bright picture. To be sure, the capacity for "positive spin" seems boundless. In the year Continental Illinois Bank collapsed, its board and top officers were banished, and the Government begrudgingly approved a bailout, the company annual report noted, "Nineteen eighty-four brought a new beginning for Continental Illinois Corp."

This bias can and does spill into deceit.

Merrill Lynch reaped hundreds of millions of dollars in the sale of risky derivatives to Orange County. These instruments were so risky that even the giant firm blushed, and offered to unwind the deals. Yet in underwriting $600 million in bonds for the County last summer—in which Merrill Lynch profited again—Merrill Lynch failed to insist that the risk be detailed in the bond prospectus. Instead, the prospectus contains a brief paragraph stating that the risks of the County's investment pool, which allows that "the price and income volatility of the [various fixed and floating rate] securities is greater than standard fixed-income securities and may serve to increase the volatility of the County Investment Pool's return and market value in various interest rate environments as well as serve as a hedge in other interest rate environments."[6] There's plenty about Prop. 13, about the County budget, about natural disasters, but nothing more on what's become the most notorious case of derivatives gambling in American history.

In January, the Senate Banking Committee called timely hearings on the bankruptcy of Orange County and the role of Merrill Lynch. The regulators who testified said that current enforcement tools were largely adequate. Those tools include private litigation.

As Presidential aspirants stalk voters in Iowa, they may find residents of this State concerned with keeping antifraud laws strong. A fast-talking money manager named Steven Wymer preyed on the Iowa Trust, leading to a $79.5 million loss on a fund with only $107 million in it. Wymer has since testified before Congress. In catching people such as himself, he advises far stronger enforcement rules.[7]

SEC Chairman Arthur Levitt explained the problem from his vantage point:

> I thought during my service as head of Shearson and then head of the American Stock Exchange, that I had seen just about every kind of public fraud that could possibly be perpetrated on individual investors. And then I came to the Commission, and week by week hearing cases, see what is going on in this country, how many people are out there taking advantage of innocent individual shareholders dwarfed anything I had ever experienced.[8]

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[3] "Inundated Agency," *The Wall Street Journal*, December 16, 1985.

[4] Cited in "The Interrelationship of Securities Class Action Litigation and Pension Plan Tax Policy," Securities Regulation Law Journal, Summer 1993, p. 134.

[5] Oral Comment, February 13, 1995.

[6] "Official Statement," $600,000,000, County of Orange, 1994–1995 Taxable Notes. The bonds were used to purchase notes which were underwritten for a fee by Merrill Lynch.

[7] "Defrauding Cities Easy," *Orange County Register*, March 5, 1993.

[8] Minority Views, "Common Sense Legal Reforms Act of 1995," Committee Report 104–50, ppg 57–58.

Litigation as a Remedy

Litigation also serves as a remedy. Investors who overpay for a stock based on fraudulent information can bring cases. Again, the SEC builds this into its approach. In its celebrated case against Drexel, the SEC required Drexel to set aside funds for private actions.

In San José, the City Attorney brought what amounted to a private action against Merrill Lynch and other firms to recover damages from the devastating securities case that cost San José citizens millions.

In Orange County, the SEC and other Federal enforcement agencies are hard at work. But the real avenue by which the citizens and taxpayers—including the 15,000 Teamster families—of Orange County can recover the $2 billion loss from the Merrill Lynch derivatives comes if the courts find in favor of the plaintiffs and force Merrill Lynch to pay.

Settlements as Zero-Sum: Some claim that while shareholders may be the victims of fraud, they are also the victims of the fraud suits, as owners of the company that must pay the settlement. Arguably, the investor who overpays because the company defrauded the market which overbid for the company stock, should be paid from the pockets of the investor who sold the stock. That, at least, would tap the pocket of the person who gained.

But the Real Culprit: The executive who puffed the stock. To solve this problem involves strengthening management liability. In fact, strong liability laws would probably serve as the best of deterrents, since currently, a comforting blanket of insurance coats the entire problem. (No doubt, the insurance industry angles intensely for relaxation of antifraud measures.)

Harming Capital Formation

Some critics[9] claim that securities litigation impairs the ability of American companies to attract foreign capital. But statistics fail to support this claim. In fact, in 1994, a year in which Merrill Lynch was sued for $1 billion, the United States "received more investment from foreign firms than any other country last year," according to *The Wall Street Journal.* Citing information from a United Nations report, investment from foreign sources actually doubled in 1994 over 1993, to $41 billion from $21 billion. Among the larger investments was SmithKline Beecham PLC's $3 billion acquisition of Sterling Winthrop Inc. What's more, this year's pace is already ahead of the record-setting 1993 levels.[10]

Lawmakers concerned with the prospects for American companies should beware that the ability of companies to attract capital turns on the integrity of the disclosure. Teamster investors rely on honest disclosure before we invest, and strong litigation laws that deter fraud and help reassure us when we make those investments.

Against this background, Congress considers various proposals. These proposals deal with just what the plaintiff must show, and the role of lawyers in the process.

Changing the Rules

Some proposals have progressed to various stages. Given that most elements of any bill will continue to change as the legislative process continues, the following remarks are generalized.

Fraud on the Market: Plaintiffs should not be required to rely on the fraudulent statement itself to sue for damages. If an investor overpays for a stock because it's been inflated by false statements, that should be enough to sue.

Several thousand Teamster truck drivers at Consolidated Freightways buy stock each month as part of the company's payroll deduction plan. The plan helps ally employee interests with the long-term prospects of the company. In late 1993, the company decided to establish a bonus plan for management of its Emery division, a troubled air freight company that had dragged down profits at the corporate parent. Under the plan, most of the profits for the first year from Emery would go to management. This plan wasn't revealed for several months. What company officials did disclose, on numerous occasions in press accounts, was Emery's bright prospects. During this period, CF's stock rose. Our members, buying the stock monthly, began to pay an accordingly higher amount for each share. When the bonus plan became public (as part of an appendix to the 1994 first quarter report) the stock fell precipitously. In other words, these Teamsters overpaid for their stock because it had been inflated by lack of disclosure about the bonus pool. But unless the defrauded inves-

[9] Former SEC Commissioner Richard Breeden, now an employee of an accounting concern that is pressing for relaxation of securities litigation, has testified to this point based on personal discussion with foreign executives.

[10] "Foreign Investment in U.S. Surges," *The Wall Street Journal,* p. A2.

tors can prove they bought because of the happy news about Emery, and in the absence of news about the bonus pool, then they cannot recover damages.

Similarly, Teamster interests hold Orange County bonds underwritten by Merrill Lynch. Should they be excluded from litigation because they examined only the bond's rating, and did not specifically rely on the absence of information in the bond prospectus about risk from Merrill Lynch derivatives underwritten by Merrill Lynch?[11]

Enhanced Pleading Requirements: Certain proposed pleading requirements would require a plaintiff, in one form, to "allege specific facts demonstrating the state of mind of each defendant at the time the alleged violation occurred." This is "totally unrealistic," as Harvard Professor Arthur Miller has argued. "Under the best circumstances, requiring plaintiffs to read the defendants' states of mind generally calls for the drawing of subtle inferences from facts available prior to institution, a task that is highly treacherous."[12]

Actual Knowledge: Under some proposals for relaxing securities law, plaintiffs must prove that a defendant had actual knowledge *(scienter)* that he was making a false statement, instead of simply being reckless. Surely, recklessness should not be condoned. Worse, H.R. 10 contains a safe harbor if an executive "forgets" to investigate relevant information. This is as ludicrous as, "I forgot to check that the speed limit was 25 m.p.h." or "I forgot to see if I was supposed to pay income taxes."

Beyond being ludicrous, such a standard would actually *promote* ignorance. Important executives might intentionally avoid reading disturbing reports, in the pursuit of plausible deniability.

Safe Harbors: We recently testified about safe-harbors before the Securities and Exchange Commission. That testimony is attached as an appendix. To summarize, we are skeptical about granting companies freedom to deceive investors. Disclosure of forward-looking information should be encouraged, perhaps even mandated, but not promoted by immunity from prosecution. Moreover, we don't detect any poverty of forecasts.

Liability: Joint and several liability constitutes an important element that motivates accountants, lawyers, and other consultants who help a company to keep that company honest. They can also be associated with fraud.[13]

If the issuer is bankrupt, the plaintiff should be made whole even if that means charging an accomplice more than what he profited from the fraud.

Selection of company auditors requires a shareholder vote, attesting to their importance. Keeping their feet to the fire figures fundamentally into deterrence. Requiring the audit firm must report illegal acts to the SEC helps strengthen the use of accountants.

Lawyer-Driven Suits

Some claim these suits are lawyer and fee-driven. In a sense, securities litigation has been privatized, and a byproduct of privatization is that some may get rich. If that's unseemly then the solution is for such public goods as securities enforcement to be provided at taxpayer expense.[14] Unless the Congress is willing to appropriate funds—in this age of budget cuts—for the SEC to accomplish the complete job, this is the price for practical antifraud enforcement.

English Rule: One inappropriate solution calls on the loser to pay, the so-called English Rule. Noted Senator Dodd, "The English Rule . . . is a dreadful idea. I'll be very blunt with you. The idea that we will require the losing side to pay the attorneys' fees has such a negative impact on your moderately financed plaintiff that you just discourage people from coming forward entirely."[15]

Would Orange County, already cutting back services such as library hours and student-teacher ratios, choose to gamble against the deep pockets of Merrill Lynch and its phalanx of lawyers under a loser-pay rule?

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[11] In the 12-car accident started by car No. 1, we wouldn't limit No. 9's ability to sue No. 1 even though No. 9 was hit only by No. 8.

[12] "Securities Litigation Reform," House Energy and Commerce Committee, 103–156, p. 162.

[13] "Accounting firms may have been responsible for many of the abuses which have led to this country's savings and loan crisis." Court, in *Director of the Office of Thrift Supervision* v. *Ernst & Young*, 786 F. Supp. 46. 52 (D.D.C. 1991).

[14] Conservative economist Herbert Stein, a fellow of the American Enterprise Institute and Nixon adviser, has remarked at how the securities litigation element conflicts with the other free market elements of the Contract On America. While most elements promote free market principles, this one goes in the opposite direction. Stein quotes Adam Smith: "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest." See *New York Times*, February 15, 1995.

[15] Hearings before Senate Banking Committee, 103rd Congress, at 291.

Our individual members would be daunted by such a prospect. After having lost money in the market, would they bet the house on a lawsuit?

Even the Silicon Valley firms who are pressing for relaxation of antifraud measures don't call for the English Rule.[16] And the English are not content with the English Rule; the conservative *Economist* recently inveighed against it: "Only the very wealthy can afford the costs and risks of most litigation. This offends one of the most basic principles of a free society: Equality before the law."[17]

Alternative Dispute Resolution: In some forms, the loser must pay after declining to enter alternative dispute resolution. While appealing on its face, ADR adds an additional layer of bureaucracy. It can also fall prey to bias, such as the use of the National Association of Securities Dealers, now employed in some broker-customer disputes. In the brokerage business, many clients and employees are required to enter such private mediation. Confidentiality agreements, however, challenge the ability to measure the virtue of such mediation.[18]

Finally, fraud is theft. If a person shoplifts and is arrested, he can't suggest that the retailer enter mediation with him.

Financial Requirements: Requiring fraud victims to hold a certain minimum aggregate in the stock, such as $10,000, defies the thrust of securities law, which is designed to protect the individual in the hopes of encouraging individual savings and investment.

Shareholder Committee: Some have called for "real" shareholders to guide such lawsuits. This deserves careful attention. Deals cut between corporations and lawyers undermines the point of shareholder litigation. In companies with sizable employee ownership, a representative such as a union official should be part of any settlement.[19] Generally, the judge should appoint a panel of perhaps three to five shareholders to participate in all settlement decisions.

We are currently working with the Council of Institutional Investors, where my Teamsters colleague William Patterson is an officer, on a way in which we could initiate, enter, or terminate cases where we have a substantial investor interest. A similar enterprise is underway in California.

The fact that these efforts are nascent, however, suggests that many shareholders have elected to remain disinterested in such disputes. The Wall Street walk still prevails, despite efforts by long-term investors such as some public pension funds, the Teamsters and others to become activist owners. Mandating such shareholder committees may result in slowing the enforcement effort.

Recently, the SEC announced it would enter cases with advisory letters. But in the first such letter, the SEC doesn't claim the case is frivolous, but "vaguely" argued.[20] In fact, the case appears troubling: Company officers repeatedly issued optimistic statements about the company while selling the stock, and while they were aware of some bad news; then they announced bad news, and the stock price fell 19 percent. Despite the SEC letter, the court ruled against the motion to dismiss.

Computer-Driven Suits: Some critics suggest that securities suits are generated by Quotron machines connected with a word processor: Whenever the machine identifies a stock moving outside a normal price trading, the information immediately moves into a pre-set complaint. Such suits apparently land on the target's desk within hours.

Despite alarms sounded by accounting firms and a number of issuers, and despite the emergence of the computer age, the level of securities litigation has actually declined significantly, when measured against virtually any index of stock market ac-

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[16] See *National Law Journal*, February 13, 1995.

[17] *Economist*, January 14, 1995.

[18] On a parallel front, a dozen employees of Merrill Lynch charged the company with race and gender bias. Because of alternative dispute agreements they'd signed when hired, they were denied access to the courts, a fact their lawyers considered a serious impairment. Instead, the case went to the National Association of Securities Dealers, Inc., a daunting forum given Merrill Lynch's dominance of the brokerage business. The claim contended that in assigning accounts, Merrill Lynch favored white brokers over black brokers with similar levels of experience. The claim also alleged that Merrill Lynch provided less training for black employees, resulting in fewer promotion opportunities. This case has now been settled, but it is difficult to judge the outcome because of a confidentiality cloak.—"Stock Brokers Accuse Merrill Lynch of Bias," *The Ethnic NewsWatch–Los Angeles Sentinel*, December 23, 1993.

[19] The recent case involving the Utility Workers at Pacific Enterprises demonstrates the importance of securities, and in this instances, shareholder derivative suits to employee welfare. Here, the company's Employee Stock Ownership Plan constitutes the union member's retirement. When the company engaged in unprofitable acquisitions, such as of Thrifty Drug, the corporation lost money and share value declined. Litigation represented a clear path to recover money for the corporation. Through aggressive litigation, the union's attorney was able to increase the award to the company.

[20] Frank V. Cooper.

tivity. For example, in 1974, there were 305 securities class-action suits filed. In 1993, there were 298 such cases. Yet NYSE share volume exploded 1,802 percent over this period.[21]

In a study by Princeton Venture Research of the 26,707 one-day price declines of 10 percent or more between 1986 and 1992, (excluding the October 19 crash), lawsuits followed only 2.8 percent of these precipitous changes.[22]

One case filed against a tobacco giant included reference to toys apparently copied from a previous suit filed by the attorneys against a toy maker. First, such typographical mistakes are regrettable.[23] Second, the case was dismissed. This demonstrates that suits don't automatically lead to generous settlements. In fact, a large number of cases are dismissed before trial.

Finally, that computers are used to pursue litigation should not be disparaged. While the image of the computer-driven strike suit is apocryphal, computers have served to help detect and prosecute market fraud. In fact, they are the bulwark of the self-regulatory organizations. New York Stock Exchange monitors follow unusual trading daily. When the trading price of a company moves outside a range and is not accompanied by disclosed material information that could explain such a move, the Exchange inspects the source of trading. They've built a database to explore links between the investors and insiders. In cases where an insider had an occasion to communicate with the investor, and where the company subsequently revealed material information to the public that "explains" the price move, these circumstances are relayed to the SEC for investigation. In fact, hundreds of such circumstances are relayed to the SEC each year. Yet the SEC can only pursue a fraction of these.

Much is made of the so-called attack on Silicon Valley firms. Senator Domenici cited suits against 19 of the 30 largest companies in Silicon Valley as evidence that these suits are frivolous. Perhaps some of them were frivolous. But some electronics firms have apparently crossed the line. Consider Media Vision Technology, whose stock plummeted from $46 to $25 after it acknowledged that it misstated earnings. Top executives resigned or were fired. The firm faced a criminal investigation. Then there's Micro Components, which was forced to restate earnings, and run through a number of financial officers. Or Platinum Software. Here's the *New York Times* account: "Class-action lawsuits for fraud against high-tech companies are usually frivolous attempts at bilking perfectly honest corporate citizens, right? Well, not quite right. The target of one such suit, Platinum Software, started an internal investigation after it was sued for fraud on January 19 (1994). And, lo and behold, somebody was cooking the books."[24]

Certain bankers made the argument that there can't be so many crooks in an industry to House Speaker Jim Wright when he visited grieving savings-and-loan executives in his district in 1986 on the eve of the first Federal bailout of the industry. One after another, these executives claimed that Federal regulators persecuted them, that bank cops descended on them like some kind of gestapo. Speaker Wright apparently concluded that they couldn't all be crooks, and that the Federal regulators might be overly zealous. So he stalled the bailout. We now know that they were crooks—hundreds of them were crooks.

Some were conspiring with their accountants. Notably, some of the accounting firms sued following the savings-and-loan crisis are the very ones pressing for a relaxation of securities litigation today. And Speaker Wright was forced to resign amidst allegations of favoritism to S&L executives.

Again, we think judges should select genuine shareholders to play a role in litigation, including settlements. We think forward-looking statements, especially on workplace practices, should be mandated. But most measures now on the table serve to weaken private securities suits.

Certainly, the Senate Banking Committee does not want to sow the seeds of the next S&L crisis.

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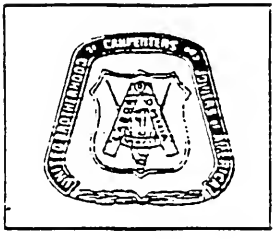
[21] From "The Great Debate," presentation before Council of Institutional Investors, October 3, 1994, p. 16.

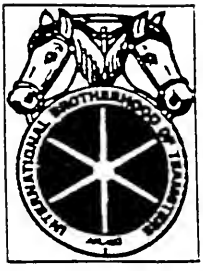
[22] As cited in "Testimony of Leonard B. Simon," before House Committee on Energy and Commerce, August 10, 1994.

[23] Fidelity Management Corp. the giant mutual fund company, recently acknowledged that misplacement of a minus sign led to a gross miscalculation of figures. This is certainly regrettable, but should mean that Fidelity isn't qualified to run mutual funds, or that mutual funds should be abolished.

[24] *New York Times*, April 25, 1994.

APPENDIX





To: Jonathan G. Katz, Secretary
Securities and Exchange Commission

From: Ed Durkin, UBCJA Office of Special Projects; Bart Naylor, IBT Office of Corporate Affairs

RE: File No. S7-29-94, Safe Harbor for Forward-Looking Statements

Date: February 1995

The International Brotherhood of Teamsters (IBT) Office of Corporate Affairs and the United Brotherhood of Carpenters and Joiners Special Projects Department hereby submit the following comments regarding File No. S7-29-94, Safe Harbor for Forward-Looking Statements.

PREPARED STATEMENT OF EDWARD DURKIN

CARPENTERS SPECIAL PROJECTS DEPARTMENT
UNITED BROTHERHOOD OF CARPENTERS AND JOINERS OF AMERICA

& BARTLETT NAYLOR
OFFICE OF CORPORATE AFFAIRS
INTERNATIONAL BROTHERHOOD OF TEAMSTERS

BEFORE THE SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, DC

FEBRUARY 1995

Encouraging Forward-Looking Statements on Workplace Practices Is a Safer Harbor Necessary?

Chairman Levitt, Commissioners Beese and Wallman, on behalf of nearly two million working men and women of the United Brotherhood of Carpenters and Joiners of America and the International Brotherhood of Teamsters, we would like to express our thanks for this opportunity to provide our comments on current practices relating to disclosure of forward-looking information and possible regulatory changes to existing safe harbor provisions. We commend the Commission for holding this hearing as the issue on which you have focused the investor and issuer communities affects both the quality of the information available to investors and the integrity of the issuer-investor communication process.

Our comments are presented on behalf of the millions of men and women who, through their pension funds, are today's largest shareholders. As pension participants and beneficiaries, our members retirement security is largely dependent on the health and growth of the corporations in which pensions are invested. As long-term investors and shareholders, it is critically important that the regulatory system that governs securities transactions promotes the issuance of reliable forward-looking statements so as to equip investors properly with the information that allows for interaction with corporate boards and management. The Carpenters and the Teamsters affiliated pension funds aggregate some $62 billion. Accurate projections inform our money managers. As labor unions, we are interested in maximizing the information that promotes an expanding economy.

Before making comments and specific suggestions about what's right and wrong with the current regulatory regimen that covers disclosure, allow us to state some general principles that guide our consideration of whether the current safe harbor for forward-looking statements should be expanded. We would support regulatory reform that achieves the following:

- Increases the amount of corporate information available to investors, specifically forward-looking statements;
- Enhances the reliability of the projections made by issuers;
- Expands the scope of forward-looking statements to include qualitative as well as quantitative aspects of an issuers' operations;
- And allows for effective redress by investors when projections are made without good faith and a proper factual basis.

Within these parameters, we believe, the Commission should craft its rules.

The Need for Workplace Practices Disclosure

One of the specific issues the Commission is seeking comment on is the type of information that should be promoted for investor consumption. We urge the Commission to encourage the communication of qualitative information, specifically forward-looking information relating to workplace practices.

The U.S. Department of Labor, under the leadership of Robert Reich and important investors such as the California Public Employee Retirement System, has achieved important goals in focusing public, corporate, and investor attention on the relation between workplace practices and the corporate bottom line.

Since labor expense constitutes a sizable percentage of a typical company's total expenses, workplace practices bear directly on share value. Already, corporations are required to describe at least the bare bones of labor relations, detailing, for example, the number of employees covered by collective bargaining, contract expiration dates, etc. Changes in workplace practices that similarly translate into changes in share value should also be disclosed.

Corporate executives themselves acknowledge the importance of workplace practices on the bottom line. A survey by Towers Perrin Co. found that 98 percent of

the 300 executives interviewed agreed that improving employee performance would significantly improve their company's productivity. Additionally, 73 percent claimed that employees were their company's most important investment.

Increasingly, shareholders have expressed keen interest in this subject. The report commissioned by the California Public Employee Retirement System, for example, details the need for investment information on workplace practices. The study found that firms with better workplace practices prove to be better investments.

A study by the Congressional General Accounting Office found that trucking companies with better paid employees are both safer and more profitable.

Already, companies that focus on employee training attract investors. Results from John Hancock Financial Services show that employee capital considerations embedded in the Domini Social Index (DSI), can serve as indicators of long-term corporate performance. The value of $1.00 invested in DSI 400 was worth approximately $0.11 more than $1.00 invested in S&P 500 for the same time period (May 1990 to August 1993). A study by Covenant Investment Management reaches similar conclusions.

In 1994, the Department of Labor published a detailed checklist of criteria that companies can use to measure their progress toward achieving a high-performance workplace. These criteria emphasize the importance of workplace democracy and meaningful worker participation.

Although the importance of forward-looking statements regarding workplace incentives is self-evident, there are glaring deficiencies among corporations in reporting such information. For a variety of reasons, many corporations have chosen not to communicate fully to the investor community about workplace strategies and practices.

The qualitative nature of this type of information may be one reason that corporations might not issue the kind of useful forecasts about how changes in workplace practices affect share value. Aims to improve employee morale, by nature, aren't always easily quantified.[1]

Add to this the threat of lawsuit hanging over those who might venture an estimate—so it's argued—and many corporations don't even try to inform shareholders of what internal reports they may have generated on the subject.

Can the threat of lawsuit be removed for those companies who want to issue useful, forward-looking statements regarding workplace practices?

Before addressing this question directly, a little background on the nature of securities litigation may be in order.

The Myth of the Litigation Explosion

Despite alarms sounded by accounting firms and a number of issuers, the level of securities litigation has actually declined significantly, when measured against virtually any index of stock market activity. For example, in 1974, there were 305 securities class-action suits filed. In 1993, there were 298 such cases. Yet NYSE share volume exploded 1,802 percent over this period.[2]

SEC Enforcement Director William McLucas has been quoted as asserting that the securities litigation boom "doesn't exist."[3]

Some argue that it is not the frequency of actual litigation, but the threat of litigation that "chills" managers from issuing forward-looking statements. This chilling effect appears especially virulent given the relatively few actual cases. In other words, if 300 cases a year can spook the Nation's corporations into silence, 200 cases may also accomplish the same. We appreciate the concept of such an effect, but question how it can be effectively managed with a safe harbor.

In fact, we don't find corporations particularly taciturn. On any subject, workplace practices or otherwise, you can open any company statement, whether or not it was filed officially with the SEC, and it will contain copious outlooks, prognostications, forecasts, promises, pledges, expectations, predictions, and projections.

If there's a problem with these forward-looking statements, it is that they are commonly optimistic. To be sure, the capacity for "positive spin" seems boundless. In the year Continental Illinois Bank collapsed, its board and top officers were banished, and the Government begrudgingly approved a bailout, the company annual report noted, "Nineteen eighty-four brought a new beginning for Continental Illinois Corp."

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[1] The factory managers, after all, found that changes in environment of any kind improve productivity, although of indeterminant level and duration.

[2] From "The Great Debate," presentation before Council of Institutional Investors, October 3, 1994, p. 16.

[3] *The Wall Street Journal*, June 18, 1993.

This natural inclination to issue optimistic, as opposed to pessimistic, statements underlies our hunch that a new safe harbor would only promote more one-sided, sanguine forecasts.

We worry that a safer harbor might inadvertently promote only additional optimistic forecasts, and would further insulate companies from securities litigation that presently serves to help keep all statements honest.

An analysis of some of the proposals included in the Concept release underscores our worry.

A. "SEASONED ISSUER:" This boldly precludes private actions, the merits of which are addressed below.

B. "BUSINESS JUDGMENT RULE:" In general practices, the business judgment rule is the great cloak that covers bad decisions. In general, the business judgment rule allows executives to make decisions that bankrupt a company, provided they took some care in making the decisions that led to the bankruptcy, and that they didn't personally profit from the company's demise. The proposed requirement of keeping a binder with projections could devolve into the production of perfunctory data with optimistic conclusions.

C. "HEIGHTENED DEFINITION:" Current law provides that recklessness, as opposed to actual knowledge, is sufficient to establish fraud. Requiring actual knowledge ignores the practical fact that it is extremely rare and difficult to find direct evidence of knowledge without discovery. Further, requiring "actual knowledge" will simply encourage accountants and lawyers to look the other way. In addition, the "heightened definition" proposal would require a plaintiff to prove that she "relied upon" the misinformation. This means that an investor who purchases Intel because of a favorable analyst's report, and not because of management promises about the Pentium chip which had inflated stock value, would have no recourse to recover damages for overpaying for her stock.

D. "BESPEAKS CAUTION:" This proposal envisions a declaration of *caveat emptor* before utterances. Such preludes will become perfunctory, and soon no longer serve the purpose of warning an investor sufficiently.

E. "FRAUDULENT INTENT:" This suffers the same deficiency as the "heightened definition" proposal in that proving actual knowledge outside of discovery is practically difficult.

F. "DISIMPLICATION:" See criticism of "C" and "B."

G. "REASONABLE BASIS:" This proposal permits litigation where the plaintiff can show the forward-looking statement "was seriously undermined by existing facts." Generally, 10(b)(5) suits spell out such contradictory facts. Moreover, lack of identification of such undermining facts formed the basis of the SEC's recent letter on the Cooper Industries case.

H. "OPT-IN:" This envisions the creation of a special review authority at the SEC. This is an attractive idea, but would require additional SEC resources. Since SEC resources already fail to monitor the veracity of all statements, it would be important to appropriate monies for staff before implemented.

What's Needed

In fact, we think the "Opt-In" provision strikes at the key to the problem. What's needed are stronger enforcement and swifter penalties for fraudulent projections.

Certainly, frivolous litigation launched by attorneys representing bogus shareholders should be stopped. Judges should apply strict sanctions where such practices are found.

But serious litigation should not be discouraged, neither by such misguided efforts as the Contract with America litigation reform effort now before the House of Representatives, nor by some safe harbor protection. In the absence of greater public funding of public securities oversight, private remedies for securities abuses should be streamlined, not hamstrung.

Securities litigation can help catch the violations that fall through the enforcement cracks of the Securities and Exchange Commission, State securities divisions, and Self-Regulatory Organization enforcement. Generally, the possibility of private litigation provides investors with much-needed confidence in the integrity of the marketplace and encourages investment in corporations. SEC Chairman Arthur Levitt has stated:

> Private securities fraud actions are clearly vital to the effectiveness of Federal securities laws. They serve as a complement to the SEC's enforcement program and together they go a long way toward maintaining investor confidence.

The fact that the SEC only brings a few cases each year for insider trading provides little comfort that it is catching all the crooks. In fact, between 1933, the birth

of modern Federal securities law, and 1986, the Federal Government successfully prosecuted fewer than 50 cases. In the next 2 years, the Government successfully prosecuted another 50. Either securities crimes are exploding, or the problem has always been immense and enforcers are only beginning to figure out how to prosecute them. Both explanations are troubling. Added to this is the measurable explosion in securities trading. It stands to reason that securities infractions should grow, perhaps a little more, perhaps a little less, than this pace, but grow nevertheless. In the wake of the growing number of securities violations, private securities litigation has hardly grown at all.

Public enforcement fails to police our securities market fully. The SEC should not interfere with the private sector in its efforts to police itself, nor provide safe harbors for miscreants.

What the SEC Can Do

As reiterated, we think forward-looking statements, especially those concerning workplace practices, are important and materially affect the company's market valuation. As such, such statements, when grounded in fact and made by management in good faith, *should be* disclosed. These statements of material importance should be required, not encouraged, by a safe harbor from antifraud laws. Companies should certainly not be excused for misrepresenting such information in a way that misleads and defrauds investors.

Finally, the mission of the SEC is to protect investors. While the Commission will hear cries from corporations and their accountants, your duty is to the investing public, from individual shareholders to institutions. Please apply the appropriate Wall Street discount to those cries. In *Hard Times,* the narrator noted the following characteristics of the business rulers of his mythical Coketown:

> Surely there never was such fragile china-ware as that of which the millers of Coketown were made. Handle them never so lightly, and they fell to pieces with such ease that you might suspect them of having been flawed before. They were ruined, when they were required to send laboring children to school; they were ruined, when inspectors were appointed to look into their works; they were ruined when such inspectors considered it doubtful whether they were quite justified in chopping people up with their machinery; they were utterly undone, when it was hinted that perhaps they need not always make quite so much smoke.[4]

PREPARED STATEMENT OF DAVID J. GUIN

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ON BEHALF OF NASCAT

NATIONAL ASSOCIATION OF SECURITIES AND COMMERCIAL LAW ATTORNEYS

MARCH 22, 1995

Summary

As a private practitioner whose firm does plaintiff and defense work and also advises public companies and municipalities, I believe the pending bills that aim to "reform" private securities litigation would harm investors and the long-term health of our capital markets. Using broad brush approaches to address narrow areas of supposed abuse will lead to problems that are far more serious than those the legislation seeks to remedy.

In particular, "loser pays" proposals and provisions raising the standards of liability will curtail, and in many instances eliminate, meritorious fraud cases.

Imprecise language in the bills will lead to lost rights, litigation delays, increased costs, and years of debate in the courts. For example, the guardian ad litem and shareholder committee provisions, while giving the appearance of being pro-investor, actually eliminate existing protections and create conflicts of interest and potential areas for abuse by defendants. Similarly, the language of the "safe harbor" provision in H.R. 1058 is manifestly overbroad, and will immunize defendants in many unintended types of cases.

Most importantly, the bills are not balanced, and unreasonably tip the scales of justice in favor of defendants, while offering essentially nothing of value to investors. In addition to the economic intimidation of the loser pays rule:

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[4] *Hard Times,* by Charles Dickens, Penguin Classics, p. 145.

- It will be virtually impossible under the new pleading standards to craft a complaint that can withstand a motion to dismiss.
- Defendants not immunized by the new "safe harbor" can hide behind an overly restrictive definition of "scienter."
- Reckless wrongdoers, particularly professionals like accountants and lawyers, will be exempted from joint and several liability, leaving victims with no chance to recover when someone like Charles Keating is bankrupt, in jail, or has fled.
- Investor recoveries will be *reduced* even if they choose to sue, overcome numerous new hurdles, and prevail, since joint and several liability will be severely restricted.
- Without the principle of market reliance and causation, it will be impossible for investors in municipal bonds and other investments that are not traded on a market exchange to form a class action.

NASCAT supports *targeted* efforts to address a number of issues involved in securities litigation, including measures in the pending bills that would:

- Eliminate bonus payments to named plaintiffs;
- Prohibit paying attorneys' fees from SEC disgorgement funds;
- Address possible conflicts of interest;
- Ban referral fees;
- Mandate a percentage approach to attorneys' fees;
- Require improved class notices; and
- Mandate auditor fraud detection and disclosure.

But NASCAT also believes that a number of protections for fraud victims not included in the pending bills must be added to achieve a fair balance. Among other things, Congress should:

- Overrule the Supreme Court's *Central Bank* decision and restore aiding and abetting liability;
- Extend the statute of limitations in securities fraud cases; and
- Disallow secrecy orders, which now prevent public disclosure of the details of corporate misconduct.

The pending bills will force the Federal Government to spend more money on securities enforcement, a job now done mainly by the private sector. As former SEC Chairman Richard Breeden testified in 1991, if private litigation is curtailed, the SEC will have to hire 800–900 new lawyers, at a huge financial cost to the taxpayers, to keep up with the caseload. The Congressional Budget Office has estimated that the House bill could cost the taxpayers up to $250 million over the next 5 years in increased enforcement expenditures for the SEC.

There is no justification for enacting broad-based legislation to weaken a system that has fostered the healthiest, best, and most honest securities markets in the world. Without meaningful remedies for investors who are defrauded, the perception that the markets are fair will be eroded and with it the confidence necessary to sustain investment and growth.

* * *

Chairman Gramm and Members of the Subcommittee, my name is David Guin, and I am a partner in the Birmingham, Alabama law firm of Ritchie & Rediker. Although I am here to speak on behalf of NASCAT, the National Association of Securities and Commercial Law Attorneys, my firm's practice includes not only the prosecution of securities fraud cases on behalf of defrauded investors, but also the defense of such cases. A substantial portion of my firm's practice also is devoted to securities regulatory and compliance matters (including the representation of corporations before the SEC), advising publicly-traded companies on disclosure matters (including the preparation of annual reports and prospectuses), and the representation of municipalities and underwriters in municipal bond financings.

Another aspect of our practice is that our representation of plaintiffs in cases alleging complex financial frauds is not limited to class actions on behalf of individual investors, but regularly includes the representation of large institutions, most recently including the Employees Retirement System of Alabama, the Teachers Retirement System of Alabama, the Washington State Investments Board, the State of Montana Board of Investments, the United Municipal High Income Fund, the South Carolina National Bank, and a number of other State retirement funds, mutual funds, banks and insurance companies.

Because of this varied background, I not only recognize the potential harm this legislation could cause to defrauded investors, large and small, but also I am

alarmed by the dramatic adverse effect that this legislation will have on our capital markets.

I have attached to my testimony a detailed provision-by-provision analysis of the primary legislative proposals that are pending, and I would like to spend my time now on three overarching areas of concern that I have with this legislation.

First, I am concerned both for investors and for the long-term health of our capital markets and our economy that the bills' approach of using broad brush provisions to address specific areas of supposed abuse will lead to problems that are far more serious than those that the proponents perceive and seek to remedy. Second, I am concerned by the bills' abundant use of imprecise and inaccurate terminology, which I believe will lead to lost rights, lost investor confidence in the markets, litigation delays, increased costs, and years of debate in the courts over the interpretation of these provisions. Finally, I believe the legislation is unbalanced, and unreasonably tips the scales of justice in favor of potential defendants, while offering essentially nothing of value to investors.

I. The Problems Engendered by Using Broad Brush Legislation to Address Narrow Issues

Having watched this debate for several months, I am concerned that this legislation attempts to address a few particular perceived problems in class-action securities litigation with overbroad solutions that will cause more problems than they solve, and that will curtail more meritorious suits than frivolous ones. I agree with the SEC, the State securities regulators and the others who have testified before Congress that these "problems" are more a matter of perception than of reality. But to the extent that problems do exist, the proposed solutions contained in these bills would take an axe to the best securities regulation system in the world.

A. The "Loser Pays" Provisions

The "loser pays" provision in each of these bills is an example of using a machete to cut off a hang nail. Securities litigation, like any fraud case, is too unpredictable for such a severe sanction.

How do you think the jury in the O.J. Simpson trial will rule? Are you willing to bet the fees of Johnny Cochran, F. Lee Bailey, Robert Shapiro, and O.J.'s other silk suit lawyers on the jury's ultimate decision? Would you be willing to bet how the judge would rule on the defense lawyers' pretrial motions to suppress such evidence as the bloody glove, the results of DNA tests, and the blood stains that were found on the Bronco and on the grounds of Mr. Simpson's estate? Without such evidence, the prosecution's case might not have been "substantially justified." But after having developed such evidence, no reasonable person would dispute that the case now is "substantially justified," although the outcome remains unpredictable.

An important distinction between the O.J. Simpson case and securities litigation that Congress should consider when analyzing the propriety of a "loser pays" rule, however, is that Marcia Clark and the other prosecutors had valuable tools available to them before indicting Mr. Simpson that are not available to securities litigators and the investors they represent—search warrants, subpoena power, and a grand jury. Before deciding whether to indict Mr. Simpson, the prosecutors were able to interview Mr. Simpson, to subpoena the contents of his household, and to question witnesses under oath in a grand jury proceeding. In a securities case, the defrauded investor cannot subpoena documents until after the complaint is filed, *i.e.*, after the decision that could subject him and/or his lawyers to the payment of the defendant's legal fees has been made, and there are ethical limitations on the ability of the investor's lawyers to talk with the defendants or their employees.

Now let's put prosecutor Clark in the shoes of a plaintiff's securities lawyer. No search warrants have been or can be issued, no subpoenas have been or can be served, and no testimony has been or can be taken. All she knows is that the brutally murdered bodies of Nicole Brown Simpson and her friend Ronald Goldman have been found, that O.J. had a history of domestic disputes with his former wife, that Simpson's demeanor upon being advised of the murders seemed distant and detached, and that Simpson had a cut on one finger. Without the ability to question witnesses or to review evidence until after a complaint is filed, do you think that prosecutor Clark would have been "substantially justified" in pursuing the case? Would you be so convinced that you would bet the "dream team's" legal fees on the jury verdict? if an ADR proceeding was imposed on you before completion of discovery, would you feel compelled to accept the defendant's settlement offer if a refusal would subject you to the risk of paying the "dream team's" fees? Why should an individual investor, faced with a major corporate wrongdoer with its own "dream team," be forced to take the same risk?

Lawyers already are required by Rule 11 of the Federal Rules of Civil Procedure, under threat of money sanctions, to certify that, under the circumstances of the case, their complaint is well grounded in fact and existing law, or that there is a reasonable basis for seeking a change in existing law. But rather than being mandatory in application and amount as are the "loser pays" provisions in the legislation, Rule 11 provides the Federal judge who is most familiar with the litigation the flexibility to insure that the sentence fits the crime. If the plaintiff's lawyer files a case that is known by him to be frivolous, or burdens the defendant with unnecessary and harassing discovery requests, the court is free to impose the full sanction of forcing the plaintiff's lawyer to pay the defendant's fees and costs. But if the plaintiff's lawyer files a less certain case, but was forced to do so to protect his client's interest before the limitations period expired or because he had no access to internal information of the defendant that would shed more light on the allegations, the court has the flexibility to deny an award of sanctions or to adjust the sanctions appropriately.

The flexibility contained in current Rule 11 provides a measure of protection to both defendants and plaintiffs, whereas a "loser pays" rule mandates the imposition in every case of the most severe sanction available. That lack of flexibility will intimidate many plaintiffs from pursuing legitimate claims.

Some of you may recall that I appeared before this Subcommittee in June of 1993 with two of my clients, Gordon Billipp and Russ Ramser, who testified that although their lawsuits were not viewed as "slam dunks" at the outset, they eventually won both cases. Even though those cases ultimately resulted in victories for the plaintiffs and criminal convictions for some defendants, both Mr. Billipp and Mr. Ramser testified to you that if a "loser pays" rule *had* been in effect, they would never have agreed to serve as class representatives, and the investors would have received little if any of their stolen money.

Mr. Billipp and Mr. Ramser would laugh if asked whether they would have pursued the litigation if they would have been forced to mortgage their homes to post a bond covering potential defense costs, as could be required under the House-passed H.R. 1058. This "hock your house" provision, which applies only to plaintiffs and not to defendant's, is worse than insidious.

Clearly, a "loser pays" rule would curtail meritorious as well as unwarranted litigation, and would favor wealthy litigants over those less fortunate. It should not be adopted.

B. PROVISIONS RAISING THE STANDARDS OF LIABILITY

Another area of the pending legislation that uses a blunt instrument to perform delicate surgery involves the bills' various provisions raising the standards of liability for securities fraud. If the goal is to protect companies from the expense of unnecessary litigation, while at the same time preserving investors' ability to go to court to fight for the return of their stolen money, the entire approach in these bills is flawed. Raising standards of liability, just like imposing a "loser pays" rule, affects *all* cases, meritorious or not, and makes it harder even in the most outrageous cases of fraud for investors to recover.

1. Definition of "Scienter"

Although every court in the country has adopted a standard for liability in Rule 10(b)(5) cases requiring at least "reckless" conduct—not just "negligent" or even "grossly negligent" conduct—the House legislation defines the "scienter" requirement for liability in even more restrictive terms. Does Congress really want to protect a financial officer of a corporation whose financial statements are so flawed that his conduct that resulted in those misstatements "involved highly unreasonable conduct, involving not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presented a danger of misleading buyers or sellers of the company's securities that was either known to the officer or that was so obvious that he must have been aware of it?" That is the courts' *current* definition of "reckless" conduct that is sufficient to establish scienter. I would be very surprised, and not a little disenchanted, if any Senator or Representative who understood that this "recklessness" standard is already the law would want to provide any greater shield from liability for anyone who meets that standard.

However, H.R. 1058 *does* restrict liability even further, by adopting language similar to this, and then adding language creating an "I guess I just overlooked it" defense. This sentence in H.R. 1058 states that "[d]eliberately refraining from taking steps to discover whether one's statements are false or misleading constitutes recklessness, *but if the failure to investigate was not deliberate, such conduct shall not be considered to be reckless.*" The financial officer can deliberately stick his head in

the sand, but if he testifies that he simply overlooked the problem, how can a plaintiff prove him wrong?

The recklessness standard is grounded in the real world—recklessness can be proved by reference to the officer's usual practice or to the standards followed by other officers. But the "deliberate failure to investigate" standard is grounded in subjectivity—it requires proof of state of mind, and is prone to abuse.

This unreasonably restrictive definition of reckless conduct would indeed protect defendants from non-meritorious lawsuits, but it would protect them from meritorious cases as well.

2. Impossible Pleading Standards

Although the significantly more demanding pleading requirements contained in the bills would serve to prevent unwarranted litigation from being filed, they also would provide a significant obstacle to pleading even a meritorious case by requiring plaintiffs to do the impossible—plead what is actually in someone else's mind. On rare occasions, that can be proved with circumstantial evidence, for instance, where a defendant writes a memorandum or letter that reflects his thoughts. But such documentary evidence cannot be obtained until after the complaint is pleaded and filed and the discovery process is begun. Some courts do not even permit plaintiffs to obtain discovery until after the defendants' motions to dismiss are decided, sometimes months or years after the filing of the complaint.

Let's go back to the O.J. Simpson example and see what Marcia Clark would have to know to allege a claim under these new standards. Even today, after weeks of testimony, would you be willing to go on CNN and allege what O.J.'s "state of mind" was on the night of the murders? Assuming you have decided that there is sufficient evidence to prosecute Mr. Simpson for a crime, what specific crime would that be? Before interviewing Mr. Simpson, before subpoenaing the evidence and searching his car and house, and before cross-examining witnesses in a grand jury proceeding, would you have been able to determine whether to allege "premeditation" or "intent to kill," or was it a "crime of passion"?

The more stringent pleading provisions are overbroad, and like so many others in this legislation, would force the dismissal of potentially meritorious cases before giving the investors an opportunity to learn the true facts.

3. Elimination of Joint and Several Liability

The limits on joint and several liability in this litigation also would apply to more meritorious than frivolous suits. My clients, Mr. Billipp and Mr. Ramser, testified before this Subcommittee that, without joint and several liability, they could not have recovered more than a small fraction of the amount they ultimately obtained.

Mr. Billipp and his wife Betty, who are now retired and living in New Hampshire, invested their retirement funds in a municipal bond issue that was supposed to finance the construction of a senior citizens' home in Spartanburg, South Carolina. In fact, the bonds were used to line the pockets of the developer (who, undisclosed to the investors, was then being prosecuted for Medicare fraud, and was later convicted of that offense), the marketer for the project (a minister), the underwriter (Bob Buchanan of Jackson, Mississippi), several South Carolina, Mississippi, and Alabama law firms, a Georgia accounting firm, and even a State Senator from South Carolina. After fighting the case for several years, we recovered 65–70 cents on the dollar for the investors, and were paid about a 3 percent attorneys' fee. We then shared the information we had learned about these characters with the SEC (which didn't have the personnel to pursue the case) and the local U.S. Attorney, who, with our assistance at trial, prosecuted and obtained criminal convictions of the developer, the minister, the State Senator, and the underwriter for securities fraud. The priest and the Senator plea bargained, but the case went to trial against the developer and underwriter, who are serving 13 years each for their crimes.

It is important to understand that the facts that broke this case open were only learned in discovery. From the minister, we found documents evidencing that he had falsified reservations for rooms in the senior citizens' home to make it appear as though there was significant interest in the facility, when, in fact, very few people ever wanted to move into it. Before obtaining access to his files, we could not have known that these indications of interest (which were highlighted in the prospectus) were fictitious. From the State Senator, we obtained documents evidencing that the $35,000 fee he was paid at the closing of the bond issue was actually a pay-off. The document that convicted these men, however, was an internal memorandum of the underwriter, in which the analyst who researched the feasibility of the bond issue before it was sold to the public concluded that selling these bonds to the public would be "unconscionable," but that his boss wanted him to go forward with the bond sale because the fees were so high.

Even in a case like Mr. Billipp's—involving deliberate, criminal fraud—without joint and several liability, the bondholders would have received almost nothing. The issuer of the bonds was a not-for-profit shell corporation formed solely for the purpose of issuing the bonds, and which had no assets of its own and no insurance. The developer transferred his assets to his wife, where they were protected under South Carolina law. The underwriter did the same. The priest spent his several hundred thousand dollar fee on remodeling his house and buying luxuries he had never been able to afford as a priest. The Senator only made $35,000, and paid it back and much more, but his settlement, although it stripped him of all he owned, still constituted a minuscule fraction of the bondholders' losses.

Most of the settlement funds came from the accountants and lawyers, who under the Supreme Court's *Central Bank* decision eliminating liability for aiding and abetting a securities fraud, could not even be sued today. Even if aiding and abetting liability were restored, their liability under S. 240 still would be limited to their proportional fault, even though the primary wrongdoers were insolvent. Indeed, in most any municipal bond issue, the "issuer" of the bonds is a non-profit shell corporation with no assets and no insurance.

Mr. Billipp's case is far from the exception (indeed, even without considering Orange County, municipal bonds are defaulting at a rate of several *billion* dollars a year), and under S. 240 or H.R. 1058, the case could not have been brought. At best, we would have been forced by the mandatory ADR provision in S. 240 to settle for a fraction of what we recovered.

Russ Ramser's fact situation was even worse, and national "Big Six" accounting firms, rather than a small local firm, were involved in his case. Mr. Ramser bought municipal bonds to finance the operation by a "Christian" senior citizens' organization of nursing homes in Terre Haute, Indiana and six towns in Illinois: Sullivan, South Beloit, Effingham, Forsyth, Atlanta, and Franklin Grove.

What neither Mr. Ramser nor the other 4,000 bondholders were told was that this "Christian" organization had no affiliation with any religious group, but was a shell corporation formed by the developer for the purpose of selling bonds. Moreover, the bond purchasers weren't told that the money they were paying for the bonds was not being used to fix up and operate the homes as had been represented, but was being used to buy the developer, Lee Sutliffe, a yacht in Fort Myers, Florida. Although the lawyers and accountants knew about Mr. Sutliffe's history, they hid from the bondholders the fact that Sutliffe, the man to whom they were entrusting their money, had been issued a "cease and desist" order by the Missouri Securities Division for selling fraudulent oil and gas investments, that he had been convicted of tax fraud, and that he had been caught falsely holding himself out as a bond lawyer in Colorado, even though he had never attended law school and did not have a license to practice law.

The truth was that Sutliffe and his cohorts raked off so much of the bondholders' money for personal or other improper purposes that the nursing homes did not have enough money to properly care for the residents of those homes. The Illinois Health Department found gruesome situations at some of the homes, including one senior citizen who had gangrene in his foot with visible maggots. Another resident had bed sores so severe that the bed sheets had to be cut away from her body with scissors. Due to the lack of money caused by Sutliffe's thefts, one of the nursing homes that marketed itself as having special treatment facilities for seniors with Alzheimers had to lay off employees, which led to the remaining employees leaving the patients in a room by themselves, tied to a wall to prevent them from tipping over or running away. Such measures did not always work. A resident of one of the homes did escape, and died of exposure.

Sutliffe's house of cards eventually collapsed, and after discovery and a 7-week trial against Deloitte & Touche and Sutliffe, the jury returned a verdict against the accountants and Sutliffe for common-law fraud, securities fraud, and RICO violations. The case settled before damages were assessed, and the bondholders recovered between 50 and 100 cents on the dollar, depending on the bond issue, *after* fees and expenses. Eventually, Sutliffe entered into a plea bargain and served 1 year in prison. One of the primary underwriters was prosecuted, and I am told, convicted, of an unrelated securities fraud.

Like Mr. Billipp, Mr. Ramser's ability to recover his stolen investment depended upon joint and several liability for aiding and abetting. The not-for-profit corporations that issued the bonds filed for bankruptcy, and Sutliffe had squandered all of his money.

I am concerned that this Subcommittee would, under the guise of protecting investors, eliminate joint and several liability, and refuse to restore aiding and abetting liability. I have heard the concern expressed by Members of this Subcommittee that lawyers act in securities cases only in an entrepreneurial capacity, and as a

result, obtain only pennies on the dollar for their clients. The cases of Mr. Billipp and Mr. Ramser demonstrate the extraordinary legal hurdles that an investor must overcome. If full recoveries are not as common as we would like, that result is not due to bad lawyers, but to bad laws.

Joint and several liability can actually benefit companies sued for securities fraud. In the Comptronix litigation, for example, the company admitted that three of its officers had engaged in a 3-year scheme to inflate profits, but the company had no insurance or other source of funds with which to settle the investors' claims. Joint and several liability permitted us to spread the liability among the other defendants, including the company's auditors who had ignored the fraud despite many "red flags." This arrangement allowed the company to survive, and hopefully, to return to a profitable business. But for joint and several liability, we would have had to force Comptronix into bankruptcy in order to squeeze out a settlement.

Abolishing or limiting joint and several liability would only make it more difficult to recover investors' lost monies, thereby penalizing investors still further, and hurt companies by forcing them to pay greater shares of investors' losses, even when the company's accountants or lawyers are equally at fault. If you want to make a positive difference, restore the teeth that the Supreme Court has pulled from the securities laws by restoring aiding and abetting liability and maintain joint and several liability, rather than yanking out the few teeth that remain.

C. GUARDIANS AD LITEM/INVESTOR COMMITTEES: A TROJAN HORSE

Provisions mandating the creation of investor committees or the appointment of guardians ad litem are replete with problems, and I am particularly concerned that little attention or debate has focused on these particularly pernicious provisions.

As the law currently stands, before a court can certify a case to proceed as a class action, it must first give the defendants an opportunity to conduct discovery into the backgrounds of the plaintiffs, often including forcing them to produce all documents regarding their investment history (sometimes even their personal tax returns) and subjecting them to intense cross-examination. Such detailed scrutiny is designed to ferret out any potential conflicts of interest or hidden agendas that might prevent the class representative plaintiffs and/or their counsel from zealously pursuing the investors' claims.

After that exhaustive examination is completed, the defendants present their findings to the court, which has the final say on whether a plaintiff and his or her counsel may represent a class of investors, and if so, how the class of investors will be defined. Additionally, the class representative and class counsel by law are considered fiduciaries for the class members, and are subject to the same responsibilities, and potential liabilities, as any other fiduciaries.

Most importantly, the current system provides that any class member who is unhappy with the court's decision on whether a plaintiff is an appropriate representative of the class may challenge that determination and ask to be added as an additional or replacement class representative. Dissatisfied class members also have the right, as a matter of law, to retain their own counsel to act on their behalf in the litigation. In class-action settlements, the investors, in addition to these rights, have the right to object to the settlement, in whole or in part, and the right to send the judge a letter expressing their views or to appear at a hearing on the propriety of the settlement. Investors have the unfettered right to object to requested attorney fees, and if they still are unsatisfied with the result, to "opt out" of the settlement and file their own case.

The investor committee and guardian ad litem provisions, however, remove many of these protections for the investors, and substitute a bureaucratic structure that amazingly gives the defendants the ability to exercise significant control over the plaintiffs' case. Under these provisions, the court *must* form a committee of investors, or under S. 240, appoint a guardian ad litem, to *direct* class counsel.

Now, who will pay this committee or guardian? The committee must serve free of charge. Accordingly, it will be composed only of the well-to-do, or institutions whose interests often conflict with those of individual investors. The legislation insures that only the wealthy will have a right to "direct" the litigation by requiring that the committee members cumulatively own huge investments in the company at issue.

Under S. 240, the guardian's fees will be paid on an hourly basis, thus encouraging delays in the litigation in order to permit the guardian to "milk" the case for more fees. Additionally, the guardian's fees will be split between the plaintiffs and the defendants. Thus, the guardian is charged with protecting the interests of the class, but is paid in part by the defendants. Moreover, since defendants have a right to nominate a potential guardian (a conflict of interest in itself akin to placing the

fox in charge of the hen house), the guardian may choose to keep those defendants happy in the hope of being nominated for future guardianship roles.

Permitting defendants to assist in selecting and compensating the guardian is incestuous enough, but forcing plaintiffs who file a lawsuit to have their decisions governed and "directed" by a committee of unknown investors, who have not produced documents, who have not testified about their agendas and background, and who have not agreed to submit themselves to cross-examination and to appear at trial, creates a situation rife with conflicts of interest and ripe for collusion.

When considered in conjunction with the loser pays rule and the mandatory discovery sanctions, it is particularly pernicious that this shareholder committee is made immune from suit, while the lawyer whose actions it directs is subject to mandatory sanctions. Add the fact that the committee can direct counsel's actions without having to pay for those services or for the costs incurred by counsel in performing such services, and it becomes quite obvious that this provision is unworkable and in many instances will be detrimental to the majority of class members.

Even viewed charitably, these provisions do nothing more than add unnecessary levels of bureaucracy to the plaintiffs' side of the case, much to the delight of defendants who will be rolling on the floor with laughter at the scene caused by having so many cooks in the kitchen. The laugh may be on the defendants, however, when they decide to settle the case rather than face a jury, and then find themselves having to negotiate with multiple representatives of the plaintiffs, each of whom may have different views on the propriety of such a course of action.

II. The Problem of Imprecise Language

I am certain that each Member of this Subcommittee has seen firsthand the detrimental consequences of imprecise or inaccurate legislative language. Sometimes, such problems simply generate a slight amount of confusion that is clarified by the courts or by corrective legislation. Other times, the ill-considered language takes on a life of its own, spurring years of litigation and still more rounds of Congressional hearings. This legislation will fall into the latter category.

A. The "Safe Harbor" for "Forward-Looking Statements"

The provision seeking to expand the "safe harbor" for forward-looking statements contained in H.R. 1058 is a clear-cut example of language that is so imprecise and so overbroad that it will prevent cases I do not believe anyone on this Subcommittee actually wants to curtail. Current law already provides significant protections for companies choosing to make predictions about their future prospects, and the SEC has solicited comment on a series of proposed revisions to SEC Rule 175 to provide still further assurances to such companies.

The danger arises where overbroad language is employed to provide such protections, as in H.R. 1058, which redefines "forward-looking statement" to include virtually any representation made by the seller or issuer of securities. It is one thing to permit companies to disclose their views as to their prospects for the future, so long as those views have some connection to reality. It is quite another thing to encourage companies to say anything they darn well please with impunity, as does H.R. 1058.

The unanticipated problems that would result from this provision demonstrate why Congress should defer, at least for now, to the SEC, so that the SEC can complete the rulemaking process it already has begun.

B. Elimination of Classwide Reliance and Causation

The provisions in the House bill that require individual proof of reliance, except in cases involving publicly-traded securities, ignore the fact that not all securities litigation involves stock. The Billipps' and Mr. Ramser's cases could never have proceeded to trial if these provisions had been in effect, because the municipal bonds they bought were not traded on an "open and efficient" market. As a result, the "fraud-on-the-market" doctrine was not available to them to demonstrate classwide reliance.

Instead, their cases, like many others, depended on the presumption of classwide reliance for cases involving primarily omissions to disclose material facts that was approved by the Supreme Court in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972). Alternatively, such cases rely on the "fraud-creates-the-market" presumption to establish classwide reliance. This doctrine is a more restrictive version of the "fraud-on-the-market" doctrine, which requires proof by the plaintiff that the bonds could not have been marketed at any price but for the fraud.

H.R. 1058's emphasis on the "fraud-on-the-market" doctrine, while ignoring the other types of securities that are bought and sold, sometimes fraudulently, in our markets, creates a loophole that would allow any municipal bond case to fall through the cracks.

III. A Fundamental Lack of Balance

Finally, the bills under consideration are fundamentally unfair and unbalanced. The legislation does a masterful job of protecting defendants, even those guilty of deliberate fraud, but offers nothing of substance for investors. Let's look at what these bills do for defendants:

- They close the courthouse doors to investors by economic coercion in the form of broadly worded "loser pays" rules and by creating unrealistic pleading requirements. Although the mandatory ADR provision in S. 240 at first blush seems less insidious, in the real world it packs the same intimidation factor as the "loser pays" rule in H.R. 1058, because the defendants will make low-ball settlement offers and force the plaintiff to decide whether to accept or reject them before having an opportunity to conduct meaningful discovery. In effect, S. 240 places a gun to the head of the plaintiffs' attorney, and says, "Settle for what I offer, or else."
- Plaintiffs who are willing to file a suit in the face of the threat of huge sanctions will be unable under the new pleading standards to craft a complaint that can withstand a motion to dismiss, thereby denying them access to the courthouse.
- Even if a defrauded investor is able to satisfy the new pleading standards, the defendant is given immunity from suit by the "safe harbor," now a "safe Gulf of Mexico," for forward-looking statements contained in H.R. 1058.
- If the defendant is not immunized by the "safe harbor," he can hide behind an overly restrictive definition of "scienter."
- Defendants are given the right to help select and pay for the services of a guardian ad litem, who will have authority to direct the other side's lawyers, and who, under S. 240, is given absolute immunity for his own wrongdoing, no matter how collusive, intentional, or deliberate.
- If an investor committee is formed instead of the court appointing a guardian ad litem, the plaintiffs' lawyers will spend their time squabbling over details with a committee of lay persons rather than devoting their time to prosecuting the case.
- Defendants also know that if an investor committee is formed, rather than having a guardian appointed, they still do not totally give up their ability to influence the decisions of that committee, because the committee under S. 240 must be composed of large institutions, most of which have their own relationship with the defendants and often have agendas different from the average class member.
- If a defendant chooses to give assistance to a swindler like Lee Sutliffe, who he knows to have a track record of fraudulent transactions, and who he knows has few assets that the investors can reach, he can find comfort in the fact that he will only be liable for his proportional share of the damages. He will also know that he can make Sutliffe look bad to the jury, thereby reducing his own share of the damages.
- Without the principle of market reliance and causation, it will be impossible for investors in municipal bonds and other investments which are not traded on a market exchange to form a class action, and defendants know that very few investors will have the financial capability of suing on their own.
- Defendants can also take comfort in the fact that, with the elimination of potential RICO liability and the fact that punitive damages are not available in securities fraud actions, they can commit intentional, deliberate fraud, blame a "fall guy," and at worst (if the plaintiffs are able to jump through every other hoop), they will be liable only for some fraction of the compensatory damages.
- Defendants will know that they can use the loser pays provision, the ADR provision, the requirement to form investor committees and similar provisions to make the litigation more costly for the plaintiffs, and to delay any resolution of the litigation in the hopes of wearing the plaintiffs down and persuading them to accept a cheap settlement.
- Finally, S. 240 creates a "sham" disciplinary board for accountants that allows CPA's to create the appearance of self-governance without the actual burdens associated with it.

Now, what benefits are in the legislation for investors? None. S. 240 extends the limitations period, but at the same time closes the courthouse door to investors. The guardian and investor committees, while designed to create the appearance of a benefit to class members, actually create a "front" for defendants to wield their influence over the plaintiffs, and create many potential areas for abuse. The enhanced notice requirements are inconsistent with other provisions of the legislation, and most class notices already provide the information mandated by this statute. So, the answer is nothing.

Conclusion

Our Nation's securities markets are the envy of the world because of their breadth and depth and relative credibility. For the first time in history, the Dow Jones Industrial Average recently broke the 4,000 mark. Our markets have attained their level of success only because investors have confidence in them. There are now over 50 million Americans who supply capital to entrepreneurs through the equity markets, and the majority of the several hundred billion dollars of outstanding municipal debt likewise is owned by individual Americans.

Without effective means of redress for investors when some unscrupulous promoter or accountant violates that trust, the markets will not be able to maintain this level of investor confidence. As *The Bond Buyer* wrote recently, and as argued in a column in *Business Week* a week ago, the "problems" that this legislation is designed to address are more a matter of perception than reality, and passage of this legislation will present new and unnecessary barriers to victims of deliberate or severely reckless frauds. Without a viable means of redress, it won't take many more scandals like Orange County, derivatives, Barings Bank, nursing home and retirement center bonds, penny stocks, wireless telephone limited partnerships, or the Savings & Loan crisis, before investors lose confidence in our markets.

There ***will*** be other major financial scandals. Just 2 weeks ago, the investors in Koger Properties obtained an $81 million jury verdict against Deloitte & Touche (the same Big Six accounting firm that was involved with Mr. Sutliffe) for securities fraud, and it has only been a few days since the Barings Bank derivatives trader was tracked down in Germany. As I am speaking to you today, I can guarantee you that the next major scandal is in the works. We just haven't learned about it yet.

The bills that this Subcommittee is considering will hurt more than plaintiffs' lawyers. These bills will affect the well-being of our Nation's capital structure. At a time when Congress is considering shifting much of the expense of governance from the Federal Government to State and local governments, these bills ironically will adversely affect local governments' ability to raise capital through the issuance of municipal bonds, thereby forcing States and municipalities to raise taxes.

These bills will also force the Federal Government to spend more money on securities enforcement, a job now done mainly by the private sector. In fact, Richard Breeden, who served as SEC Chief under President Bush, stated that if bills such as this are passed, the SEC will have to hire 800–900 new lawyers, at a huge financial cost to the taxpayers, to keep up with the caseload. The Congressional Budget office has estimated that the House bill could cost the taxpayers up to $250 million over the next 5 years in increased enforcement expenditures for the SEC, to make up for reduced private actions.

Likewise, at a time when the citizens of this Nation are demanding solutions to the crime that plagues us, these bills ironically create excuses for white collar criminals, and even go so far as to reduce the SEC's ability to police the markets. They are essentially the "Financial Fraud Protection Acts of 1995."

If this Subcommittee wants to pass legislation that helps investors, thereby maintaining investor confidence in our markets, it should go back to the drawing board and craft legislation that puts teeth back into the securities laws by overturning the Supreme Court's recent decisions in *Lampf* and *Central Bank*. It should create additional penalties in the form of treble damages for deliberate frauds, and it should maintain the courts' current flexibility to ferret out frivolous litigation and to match the sanction to the wrong. Finally, rather than passing legislation with imprecise terminology addressing complicated and technical areas of law, the Subcommittee should defer to the work done by the Judicial Conference to improve class-action procedures and notices and to the SEC in the area of "safe harbors" for "forward-looking statements."

Thank you.

PREPARED STATEMENT OF SHELDON H. ELSEN

THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

NEW YORK, NY

MARCH 22, 1995

Mr. Chairman and Members of the Subcommittee, on behalf of the Association of the Bar of the City of New York I wish to thank you for hearing us this morning on the important issues contained in S. 1976, H.R. 1058 (H.R. 10), and related bills.

The Association of the Bar is an organization of over 20,000 lawyers, located largely in New York City but including members located throughout the United

States and in over forty other countries. Since the Association of the Bar's founding, New York City has been the center of the Nation's capital markets, and particularly its securities markets. The New York Stock Exchange and the American Stock Exchange are located in New York City, and most major broker-dealers are headquartered in and around New York City. A large percentage of the Nation's lawyers who specialize in the practice of securities law are members of the Association of the Bar.

Accordingly, the Association of the Bar has both special expertise and a special interest in issues of securities law. We have studied and reported on the issues before you in a report on S. 1976, the Dodd-Domenici bill, and in another report on H.R. 10, Title II (now H.R. 1058). I offer those reports for the record. They were prepared by the Association's Committees on Securities Regulation and Federal Courts, which are comprised of corporate lawyers, litigators, in-house counsel, and faculty members with considerable experience in the securities field. They include many practitioners who represent primarily defendants in securities litigation, and others who represent primarily plaintiffs.

The Association and its members speak solely from the point of view of the public interest; our credo is that the client is left at the door. Therefore, while the reports which I submit and the remarks which I am about to make embody the experience of lawyers from all over the Bar, each of us speaks with a view to the public interest, regardless of how our views might affect the fortunes of our clients.

I come before you as the Chair of the Subcommittee which prepared these Reports. I am a former Vice President of the Association and former Chair of its Committees on Federal Courts and on Federal Legislation. I have served as an Assistant U.S. Attorney in the Southern District of New York, where I prosecuted securities cases, have long been an Adjunct Professor of Law at Columbia Law School, a Fellow of the American College of Trial Lawyers and member of the American Law Institute, and I have written extensively on the subjects which are involved before you. I am a graduate of Princeton and the Harvard Law School.

Neither I nor my firm acts for plaintiffs in class or derivative actions, though in individual securities actions we have served on both sides.

The Association joins the bills' sponsors in their wish to eliminate litigation abuses, but is also concerned to protect the viability of class actions, which we consider essential for the protection of investor confidence and the proper functioning of our securities markets. We are quite concerned that the provisions of S. 1976 and H.R. 1058, which have been drafted to control alleged abuses, be limited to such abuses. Thus we agree that referral fees should not be paid to brokers, that bonus payments should not be paid to individual plaintiffs, that disclosure of settlement terms to class members should be improved, that plaintiffs' counsel should not share in disgorgement funds created by the Securities & Exchange Commission, without their participation, and that courts should take very seriously their obligations under Rule 23 of the Federal Rules of Civil Procedure, to make sure that class representation is adequate and that settlements are fair. We also approve proportionate liability, provided that no victim is disadvantaged through the insolvency of a wrongdoer.

On the other hand, the shifting of fees in class actions will destroy the viability of class actions, since no reasonable person can or will take the risk of serving as a plaintiff to redeem their losses, when the risk of defeat could take away their home and their remaining savings, such as those for their children's college, to pay the expensive fees of defense counsel. The result would be to deprive defrauded investors of their only practical recourse to the courts.

The possibility of relieving investors from such charges upon a showing that their case was substantially justified does little or nothing to improve matters. It is the fear of ruin, and the uncertainty of litigation, even in meritorious cases, that will drive the middle classes out of the courts. As the respected conservative weekly, the *London Economist*, recently said, "The worst aspect . . . is that [loser pays] denies access to justice to huge numbers of people . . . as lawyers admit, only the very wealthy can afford the costs and risks. . . ."

Other provisions in S. 1976 and H.R. 10 also would destroy the viability of class actions. Thus plaintiffs cannot plead the state of mind of each defendant, before they have had any discovery; that information is known to the defendants but not to the plaintiffs. Any changes in the pleading and practice requirements of the Federal rules, moreover, should be developed through the careful procedures of the Judicial Conference, under the Rules Enabling Act, with the input of experienced judges and lawyers.

The House proposal to limit use of the fraud on the market theory, while an improvement over the original proposal to abolish that theory and require proof of individual reliance in all cases, nonetheless fails to consider numerous problems which

the courts have been grappling with and solving over recent decades. We have analyzed those provisions carefully in our report on H.R. 1058 and hope to be of help to you in putting together a bill that takes account of the many issues that H.R. 1058 does not.

Similarly, H.R. 1058's treatment of scienter and recklessness should be redone. In addition, proposals for guardians ad litem and a stockholders' protective committee should be dropped for the detailed reasons set forth in our Dodd-Domenici report. H.R. 1058's provision for forward-looking statements, moreover, inadequately disposes of complex problems, which should instead be studied by the SEC, as Dodd-Domenici proposes and we agree.

The proposed provisions which we criticize would create serious problems for conscientious corporate legal advisors, just as for plaintiffs' lawyers. Let me illustrate.

When I worked as a young associate in a large law firm, one of the most experienced and savvy partners took me to a meeting where we were trying to dissuade a client from a course which we knew would violate the securities laws. Before we went, he took me into his office and explained how to handle the meeting. "Don't tell them about the cases," he warned, "they are not interested. And don't, for God's sake, lecture to them about ethics." He paused and looked at me significantly. "If they insist on going ahead with the deal, tell them that, if they do, Abe Pomerantz will sue them. That's the only thing that will stop them."

I don't know how many of you remember Abe Pomerantz, but he was for many years the dean of the plaintiffs' stockholders bar in New York City. Corporate executives did not like to tangle with him; the threat of a class action by him was an enormous help to conscientious corporate lawyers who were trying to get their clients to obey the law. He has, of course, been dead for many years, but if you destroy the institution from which he worked, the class action, I can predict with certainty that the job of conscientious corporate legal advisors will be much harder and I would anticipate many more violations of the law.

I emphasize that I am speaking from the point of view of corporate advisors, not from that of clients. In all the cases I have defended, no client has ever told me he thought it was a good idea that he was sued. That persons who have been sued complain about securities class actions can hardly come as a surprise to this sophisticated body.

Let me turn, finally, to lawsuits against lawyers, accountants, underwriters, and other professionals. Experience in these cases has shown that securities frauds do not succeed very often without the aid of such professionals, but that it is almost impossible to prove the professionals' involvement if the standard is actual knowledge, rather than reckless disregard. Bear in mind that reckless disregard is not a light requirement but requires proof of an extreme departure from professional standards. Nevertheless, it is provable and it is essential for holding these important players responsible for their actions. Yet H.R. 1058's provision for reckless disregard requires substantial redrafting, for it is presently ambiguous and internally inconsistent.

The Association feels particularly strongly about matters of lawyer misconduct. In our view, the primary problem of abuse by lawyers lies in the conduct of securities lawyers involved in fraudulent transactions. Plaintiffs' lawyers can and should be reined in by the courts, where necessary, but the baby should not be thrown out with the bath water. Nor should we rush into unworkable innovations, such as guardians ad litem and plaintiffs' steering committees.

Let me say in closing that I have had the good fortune to appear many times before Congressional committees on behalf of the Association and I have always welcomed the exploration of issues here, through discussions with Members from both sides of the aisle. While the Association recognizes the strong feelings that accompany the issues under review, we know that you are trying to do the right thing by the country and we stand ready to assist you to the best of our abilities.

I look forward to your questions.

PREPARED STATEMENT OF JOAN R. GALLO

CITY ATTORNEY, CITY OF SAN JOSÉ, CA

MARCH 22, 1995

Summary

In May 1984, in a situation strikingly similar to that which faces Orange County, the City of San José lost **$60 million** when it divested itself of highly-leveraged transactions.

The City filed a lawsuit against 13 brokerage firms. All but two of the brokerage firms settled prior to the case going to the jury. In June 1990, after a 6-month trial, a jury found the brokerage firms liable on the grounds of unsuitability under the Federal securities law and *ultra vires*, or illegal transactions, under State law. The verdict was upheld by the trial judge after consideration of extensive post trial motions. The City ultimately settled with these firms to avoid the costs, delays, and risks of an appeal.

The total settlements with the brokerage firms equaled $24 million. The lawsuit cost, including attorneys fees and required out of pocket expenditures, was close to $10 million. The City also recovered almost $100,000 from its outside audit firm. At the end, the City was able to provide its citizens with $15 million in much needed park improvements that had been canceled because of the loss.

The City would not have been able to recover any of its losses if H.R. 10 was the law in 1984:

- Before discovery, there is **no** way that the City could have met the proposed pleading standard. However, discovery did provide evidence of the state of mind of the brokers.
- Even under current law, despite the fact that the City had very experienced legal counsel, a **third** amended complaint was required.
- The City would not have been able to bring this lawsuit if it had been exposed to the potential **risk** of attorney's fees for each of thirteen broker defendants.

The most needed change in the law is not addressed in H.R. 10 (H.R. 1058). It would be to strengthen the obligations of these brokers, most particularly when they are dealing with public money.

* * *

I am the City Attorney of San José. I am not a securities lawyer and I have no expertise in the securities area. I am merely here to tell you about the San José experience.

San José, California is a dynamic growing City. It has a population of over 800,000 people. It is the 3rd largest City in the State, larger than San Francisco, and the 11th largest City in the country. It is a beautiful City with a uniquely diverse community. The growing and redeveloping downtown is a model of revitalization. The City regularly wins recognition as one of the best managed cities in the country.

In a situation strikingly similar to that which faces Orange County, in May 1984, the then Assistant City Manager saw a financial report, prepared by the City Treasurer that showed zero (0) interest earnings on the City's investments. When he investigated, he learned that the investment portfolio consisted of highly-leveraged transactions—primarily what are called "financed open reverse repurchase agreements."

A reverse repurchase agreement is a sale of a security by the client from its own portfolio to a broker with an agreement to repurchase that security at a subsequent time at a fixed price. The purpose of this arrangement is to enable the client to continue to hold the security as an investment and at the same time generate short-term funds.

In other words, the security owned by the City was used as collateral for a loan to the City. The City then used the borrowed money to purchase another debt instrument with a higher interest rate return. These loans were "open" in that they had no fixed date and could be called by the brokers at any time.

When prices fell because of interest rate increases, in order to avoid having the City take a loss on the trade of the securities, the brokers would loan the City 100 percent of the purchase price except for the "haircut" which was the difference between the value of the instrument at purchase and on the date of the loan. This practice facilitated increased speculation.

At the height of the trading, idle funds of about $350 million were leveraged into a portfolio of about $700 million. The character of the City's entire portfolio, which is above all required to be safe and liquid, changed. While in 1982, the City had averaged around 40 trades per month; by the end of 1983 there were 460 trades per month. The average weighted maturity had gone from 2 years in 1982 to 20 years by the end of 1983.

When the City Manager and City Council became aware that this type of activity was occurring—they immediately divested the portfolio of these transactions, losing **$60 million** in a single day. Fortunately, this occurred before the down turn in the local economy and San José has traditionally maintained very prudent contingency reserves. Therefore, bankruptcy was never considered, there were no layoffs and

there was never even the slightest possibility of default on any of the City's bonds. However, many projects, critical to the development of the City and the quality of life of the residents had to be postponed or abandoned.

An investigation led City officials to believe, and ultimately a judge and jury agreed, that much of trading was then illegal under State law; that it violated the City's investment policy; and it was unsuitable under Federal securities law. The pattern of trading looked like a classic churning situation, although the City did not ultimately prevail on that theory.

As the City looked at what had occurred and tried to answer the question of how it could have happened, the City came to believe that the persons charged with responsibility for our investments had been convinced by the broker community that these highly-speculative transactions were actually **risk free** because the face value of the bonds remains stable.

The City knew at the time that it filed suit that the City Treasurer and his Assistant spoke to each of the brokers many times a day, beginning with calls made to the City employees at 6:00 a.m. at their homes. The brokerage houses paid for direct telephone lines. These City employees viewed the brokers as their agents and friends and trusted them completely. The brokers had both of these gentlemen convinced that this investment strategy was foolproof—that you cannot lose money because the long-term bonds never lose their face value.

The City Treasurer and his Assistant lost their jobs. They were investigated and were under suspicion until it was determined that no illegal gifts or bribes were involved. From a practical litigation standpoint, they saw their interests as being more aligned with the brokers than with the City.

The City Council concluded that, based on the facts known at that time, the brokers were very much responsible for convincing the City investment staff that these were safe and appropriate transactions and for encouraging and enabling this situation to occur. At a minimum, the brokers had knowingly recommended unsuitable transactions and had failed to advise appropriate City officials that this type of trading was unsuitable to the City's objectives. Also the City's independent auditor had culpability, for it had failed to identify these risky illegal transactions in the City's audits. The Council had an obligation to the citizens of this City to try to recoup some of the losses.

In September 1984, a lawsuit was filed against 13 brokerage firms. All but two of the brokerage firms settled prior to the case going to the jury. In June 1990, after a 6-month trial, a jury found those firms liable on the grounds of unsuitability under the Federal securities law and *ultra vires,* or illegal transactions, under State law. The verdict was upheld by the trial judge after consideration of extensive post trial motions. The City ultimately settled with these firms to avoid the costs, delays, and risks of an appeal. A list of the firms and the amounts of the settlements is attached as Exhibit A.

The total settlements with the brokerage firms equaled $24 million. The lawsuit cost, including attorneys' fees and required out-of-pocket expenditures, was close to $10 million. The City also recovered almost $100,000 from the outside audit firm. At the end, the City was able to provide its citizens with $15 million in much needed park improvements that had been canceled because of the loss.

The City would not have been able to recover any of its losses if the bills currently being considered were the law in 1984.

The first problem that the City faced was finding an attorney willing to take our case. The City found it difficult to find a law firm with securities expertise which would even look at the case. Most of the big California firms had conflicts of interest because they represented various of the brokers. Other firms told us that these cases were so difficult and time consuming to pursue that they were not interested. The City finally retained a firm which specializes in this type of litigation. The City paid them on an uncapped hourly basis, not on a contingency arrangement.

The City filed its lawsuit based on Federal securities fraud, including churning, and unsuitability, as the well as claims under State law. The brokers filed motions to dismiss the causes of action based on misrepresentation and omissions because of lack of the requisite factually specificity. Federal Rule 9(b) already requires that fraud be pleaded with particularity, even though the state of mind can be pleaded generally. **Under current law,** despite the fact that the City had very experienced legal counsel, it was not until February 1986, that our **third** amended complaint was finally found sufficient by the Federal Court.

It was only at this point that discovery began. Before discovery there is **no** way that the City could have *"specified each statement or omission alleged to have been misleading, and the reasons the statement or omission was misleading"* or *"made specific allegations which, if true, would be sufficient to establish scienter as to each defendant at the time the alleged violation occurred,"* as is being proposed.

The actual defendants in this case were the brokerage firms, not the individual brokers. Furthermore, our treasurer and investment officer were no longer employed by the City, they thought of the brokers as their friends and they did not ever really understand how they had been manipulated. They remain convince to this day that if the City had not extricated itself from this highly-leveraged position, eventually they and the brokers would have been proven correct. They had no incentive to co-operate with the City in the drafting of a lawsuit.

However, discovery did provide evidence of the state of mind of the brokers. A few illustrations of what the City found in discovery are provided below:

- In October 1993, an internal memorandum from one of the firms details "rumors" about how **speculative and risky** the City's position was. It showed that the firm had detailed knowledge about the City's position with the other brokerage houses and referenced conversations about San José with some of the other firms. It expressed concern about its own risk in this situation and the need to reduce the speculative trading. There was no attempt to advise the City Manager, Mayor, or City Council. Trading continued. See Exhibit B.
- In February 1984, a Senior Vice President of one of the firms **drafted** a letter to the Mayor of San José warning of the risky nature of the strategy. This letter was reviewed at the highest corporate level and by litigation counsel. The letter was **never** sent. The City was not warned. Trading continued. See Exhibit C.
- An internal memorandum, dated March 1994, expresses the broker's **concern about the volume and risky nature of the trading in light of its "fiduciary responsibility."** It referenced the fact that "another Wall Street firm has similar questions and is drafting a letter." This firm did not advise the City and kept on trading. See Exhibit D.

If the City had been advised at any time between October 1993 and March 1994—it would have been able to extricate itself from its leverage position with minimal or no loss.

The City would not have been able to bring this lawsuit if it had been exposed to the potential risk of attorney's fees for each of thirteen broker defendants. As someone responsible for trying numerous cases in areas other than securities law, I can tell you that even when the law seems certain and the facts seem clear, the old saw is true; a jury trial is always a "crap shoot." The City would not have been able to take the risk that, after the fact, the case would have been found *"not substantially justified."* As it turned out, our churning claim could have been considered not substantially justified because there was no evidence of the "control" element.

On the other hand, Federal Rule 11 should be amended to address the concern about frivolous cases, in all contexts, not just securities litigation, but without the undesirable chilling effect. Rule 11, as it reads today and as it has been interpreted and applied by the courts, is ineffective. Many of the cases filed against the City are patently frivolous. As an example, we are being sued by an individual who claims a constitutional right to have sex with minors. Although when the City, as a defendant, loses, it is subject to paying the plaintiff's attorney's fees in most Federal cases brought against it, I can only recall a single case in which the City was ever awarded attorney's fees pursuant to Rule 11. Making the fee award mandatory, rather than discretionary, when the suit is frivolous would directly address the issue.

In addition to the City Treasurer and his Assistant, the Director of Finance, the City's Internal Auditor and others with oversight responsibility lost their jobs. The elected officials were subjected to a grand jury investigation. They were vilified in the press. They ultimately had to face the voters. But no action of any sort was taken against the brokers or the brokerage firms. The SEC did not investigate them. No action was taken against them by any governmental agency. The local press did not do a single story critical of the brokers. The individual brokers did not lose their jobs. In fact, one of the brokers who dealt with San José is prominently featured in news stories as the broker who was the primary dealer with Orange County.

The most needed change in the law is not addressed in H.R. 10 (H.R. 1058). It would be to strengthen the obligations of these brokers, most particularly when they are dealing with public money. The brokerage houses and the individual brokers made enormous amounts of money from transactions with San José and Orange County which they knew were illegal, speculative, and unsuitable. It is unjust to allow them to keep those profits while the public suffers all of the losses.

EXHIBIT A

SETTLEMENTS

Salomon Brothers	$ 250,000
Drexel, Burnham, Lambert	$ 800,000
Lehman Brothers, Kuhn, Loeb	$ 315,000
First Interstate Bank	$ 1,250,000
Merrill, Lynch, Pierce, Fenner & Smith	$ 750,000
Prudential-Bache	$ 990,000
Citibank	$ 550,000
Carroll McEntee & McGinley	$ 2,000,000
Briggs, Schaedle & Co.	$ 300,000
Smith Barney, Harris Upham & Co.	$ 2,450,000
Willaim E. Pollack	$ 2,450,000
PaineWebber	$ 6,601,829
E.F. Hutton	$ 6.093.171
	$24,800,000

TO: File

FROM: Robert L. Hoffmann

DATE: October 27, 1983

SUBJECT: San Jose, City of

EXHIBIT B

E.F. Hutton

INTER-OFFICE MEMORANDUM

Chronology of events to date:

October 13, 1983- After rumors circulated regarding extent of City's trading, visited with Dick McCoy (City Treasurer) and A.R. Matthiessen (Assistant Treasurer), accompanied by Roland Stocke and Peter Morrison. Heard that:

- 0- Actively traded "W-I" market based upon McCoy's market judgement- successful to the extent of $13 million trading profits since 1/1/83, would generally go long and pair-off as soon as profits could be realized but would take down the securities if sale thereof would result in realized loss. Trades in block size- $2-10 million in agencies (building to $15-20 million positions), and governments (up to $25-50 million positions).
- 0- When securities taken-down, they would be put out on reverse (usually open) and attempt to gain carry profits while awaiting market recovery.
- 0- If continuing under water, additional purchases made to "average-down" the break-even point.
- 0- As spread, between cost and market, narrows, sell even if at small loss.

As a result of the above philosophy, recent trading (during which time the market moved away from their cost)produced a portfolio of trading securities in the $400 million range ($200 + of agencies). Reverse positions with E.F. Hutton, Merrill, Salomon, Citibank and Pollack.

October 14, 1983- Upon return to New York, discussed situation with W. Dunn, L. Morrannie, F. Bass, W. Mulhern. I stated that from a credit point of view, they could stand economic risk of trades but felt that this activity was not fully suitable for the City Treasurer. The agreement reached that we would not act precipitously but would work with the City to reduce not only our exposure, but the entire position. Credit limit will be $50 million for now, with overtrades to be reduced. This was passed on to Roland/Peter for relay to the City.

October 20, 1983- In the last week, a number of calls received from the outside regarding City and discrepancies have arisen. I called McCoy to get his list of reverses- comparative below:

	City	Street
E.F. Hutton	186	186
Salomon	35	50
Citibank	0	10
Merrill	100-	113
Pollock	0	0
Carroll McEntee	0	38
Lehman	20	20
Briggs Schaedle	-	3
Bache	-	NA
Total	331-	411+

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McCoy's plan of action:
0- To reduce to $100 million by 12/1/83.
0- To reduce below $100 million by 12/31/83.
0- To carry small amount into 3/84.
0- To reduce to zero by 3/31/84.

October 21, 1983- After discussions inhouse, we have decided to place "polite pressure", through continued calls and suggestions to induce the City to accelerate the reduction program.

October 24, 1983- Before we could call and begin pressure, McCoy called to inform us that Citibank and Salomon have asked that their open positions be terminated. This is being done. (P.S. McCoy is not in the office this week, but is attending a conference in Orlando and is staying at the Marriot

October 25, 1983- Due to rundown market, we requested: clean-up of all interest ($300,000 plus); additional free collateral (sent in $3 million agencies); and Roland added that we expect $25 million reduction this week. Follow-up call from Matthiessen-pressure from other dealers has forced the City to take large losses. Requested extension from $25 million cleanup thi week. I agreed to this due to their promptness in meeting margin call and to our belief that E.F. Hutton's best interest is to work with the City to avoid any unnecessary losses or embarrassment.

October 26, 1983-Roland talked with Matthiessen, who received instructions from McCoy, regarding liquidation of our open reverses. Sold today for settlement 11/2/83-$40 million 7 years and $10 million 10 years. Additiones sales into market to follow. Also, Citibank was paid-off today. Paine Webb (first time mentioned) has asked out of regular trading. They are appreciati of our efforts to help.

October 27, 1983 - In addition to pair-offs, Matthiessen bought $10 million 10 years late 10/26/83 (4:59 P.M. NY time) to settle 11/2/83. When Roland questioned him, he said that he liked the market and bought with objective of selling later at profit to cover some of the losses incurred to date. Roland stressed that we would not tolerate speculative trading and would under no conditions consider adding to reverses on the books. Matthiessen sold this position shortly thereafter at a 3/32 profit.

(P.S. on October 24, we told McCoy that no speculative trading, especially in next weeks many "W-I"'s would be tolerated).

cc: Dunn
Bass
Maranhio
Mulhern

EF000836

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Mirenda 10 for IV
11-22-83

PAINE WEBBER JACKSON & CURTIS
INCORPORATED

EXHIBIT C

Established 1879 Members New York Stock Exchange, Inc. and Other Principal Exchanges
1221 Avenue of the Americas, New York, N.Y. 10020 (212) 730-6332

James D. Mirenda
Senior Vice President

February 10, 1984

The Honorable Thomas McEnery
Mayor's Office
City of San Jose
City Hall
801 North First Street
San Jose, California 95110

Dear Mayor McEnery:

Our firm has enjoyed an active relationship with the City of San Jose in connection with trading of U.S. Government and other securities, including long term bonds, and has entered into repurchase agreements and reverse repurchase agreements with the City. Mr. Kent South, Director of Finance, has given us copies of the City Council's Resolution No. 56549, adopted in May 1983, which authorizes the City's recent investment activities, the City's Investment Policy dated May 1982, and a supplement to its Investment Policy effective January 1, 1984. I have attached copies of these documents for your convenience. We have a signed copy of the Resolution, indicating approval by the City of this document. We would appreciate similar confirmation that the attached copies of the City Investment Policy and its supplement have also been formally adopted by the City of San Jose.

We have received copies of some of the monthly reports to the Council, which indicate the transactions engaged in as well as the holdings of the City. They demonstrate that the City has had remarkable success with its current investment and trading strategies. We do note that the City's investment activity is based on a quite sophisticated use of long term bonds, repurchase agreements and reverse repurchase agreements taking advantage of substantial leverage and spreads in interest rates. This strategy is a sophisticated and aggressive one and involves some measure of risk, particularly if and when interest rates rise quickly. That risk increases as borrowed funds are used to purchase additional securities to increase the potential return.

We regard the City of San Jose as an extremely valued client and welcome the opportunity to provide investment transactional services to the City. If you would like any additional information about Paine Webber or would like to discuss our views with respect to the City's investment strategy or the risks involved in that strategy, we would be happy to meet with you and discuss them at your convenience.

Very truly yours,

James D. Mirenda
Senior Vice President
Government Institutional
Sales Manager

RPR/s
cc: City Manager
Kent South

bcc: Bill Urig

[bcc reflecting transmission of this copy to outside counsel redacted]

P-58

INTER OFFICE MEMOR

EXHIBIT D

FROM : Mr. Robert L. Huffmann

DATE : March 6, 1984

SUBJECT : City of San Jose - W16-97024-03

Attached is a record of trades done in their account for the month of January 1984. The volume of trading conducted with this entity disturbs us, particularly in light of last year's problems regarding reverse repo transactions.

It is our feeling that while the City has sufficient resources to withstand the economic risk of this level of trading, the nature of the account, ie. a fiduciary responsibility to the people of San Jose, puts such speculative activity into questionable status re suitability of trading.

We discussed with Peter Morrison the rationale used by the account and questioned him as to who put forward the "idea" of each transaction. The rationale continues to be the same as last year, in that the Treasurer and his assistant think they can outguess the market. "Ideas" come from the account and Morrison.

Additional information in our possession troubles us as well. We have been told that another Wall Street firm has similiar questions and is drafting a letter to the Mayor of San Jose specifically raising the suitability matter and requesting verification from the Mayor and the City Council that they recognize the risks inherant in speculative trading.

As such, we recommend that our Compliance and Legal staff be asked to examine this matter. Our belief is that we should cease such types of trading until the suitability question has been addressed.

For your information, we are attaching a copy of the report supplie by the Director of Finance to the City Manager for the month of January 1984.

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PREPARED STATEMENT OF MARK J. GRIFFIN

DIRECTOR, DIVISION OF SECURITIES, UTAH DEPARTMENT OF COMMERCE
SALT LAKE CITY, UT; ON BEHALF OF THE
NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

MARCH 22, 1995

Mr. Chairman and Members of the Subcommittee: My name is Mark Griffin. I am Director of the Utah Department of Commerce's Division of Securities and a Member of the Board of Directors of the North American Securities Administrators Association (NASAA). I also serve as chair of NASAA's Litigation Reform Action Group, a committee appointed in 1993 to study the issues involved in private securities litigation. In the U.S., NASAA is the national voice of the 50 State securities agencies responsible for investor protection and the efficient functioning of the capital markets at the grassroots level. On behalf of NASAA, I appreciate the opportunity to appear before you today to discuss legislative initiatives to reform the system of private litigation under the Federal securities laws. Specific comments will be directed to the key provisions of S. 240, introduced by Senators Domenici and Dodd; H.R. 1058, as approved by the House of Representatives; and Title II of H.R. 10, as introduced.

I. Executive Summary

This hearing has been characterized as one in which the "opponents" of securities litigation reform would be heard. And, although NASAA is appearing here today, we want to emphasize that the Association is *not* an opponent of securities litigation reform; what we do oppose are litigation reform measures that succeed in curbing frivolous lawsuits only by making it equally impossible to pursue rightful claims against those who commit securities fraud.

NASAA strongly supports the goal of deterring meritless securities class-action lawsuits. We agree that there is room for constructive improvement in the Federal securities litigation process. The record compiled by this Subcommittee and other congressional panels looking into this matter makes clear that these actions can be costly to defend and may needlessly distract corporate officials who work honestly and diligently to help their companies prosper in an increasingly competitive marketplace. But, the record also establishes that our system of private litigation under the Federal securities laws has functioned effectively as a necessary and essential supplement to the enforcement program of the Securities and Exchange Commission (SEC).[1]

As a result, NASAA believes it is essential that any reform measure achieve a balance between protecting the rights of defrauded investors and providing relief to honest companies and professionals who may find themselves the target of a frivolous lawsuit. Abusive practices must be deterred, and where appropriate, sanctioned. At the same time, care must be taken to keep open the doorway to the American system of civil justice for those investors who believe they have been defrauded. The challenge is to identify ways to make the litigation system more fair and more efficient, while preserving the essential role that private actions play in supporting the integrity of our financial markets.

NASAA will enthusiastically support legislation that strikes this crucial balance and meets this simple test of fairness. NASAA supports measures that would: (1) curb potentially abusive practices on the part of plaintiffs' attorneys; (2) establish an early evaluation procedure to weed out clearly frivolous cases; (3) require improved disclosure to class members of settlement terms; (4) grant discretionary authority to individual State securities agencies and the SEC to be heard in Federal class-action lawsuits on the subject of the fairness of proposed settlements; (5) restore aiding and abetting liability; (6) extend the statute of limitations based on actual notice; (7) encourage a reasonable safe harbor for forward-looking statements; and (8) require certification of complaints and improved case management procedures. Enactment of these proposals would significantly improve the litigation system without eradicating any of its benefits.

At the same time, the Association will oppose legislation that would work to shield the most egregious wrongdoers among public companies, brokerage firms, accountants, and insurance companies from legitimate suits brought by defrauded investors. NASAA believes that it is inappropriate to respond to ever larger and more complex financial scandals that recur too frequently on Wall Street by erecting pro-

[1] Report of the Commerce Committee, to accompany H.R. 10, the Common Sense Legal Reform Act of 1995," February 24, 1995, House of Representatives, Report 104–50, Part I, Minority Views, page 57.

tective barriers around corporate wrongdoers such as Drexel Burnham Lambert, Lincoln Savings and Loan, Prudential Securities, and the Washington Public Power Supply System, just to name a few.

As such, NASAA opposes the following reform proposals: (1) imposing a "loser pays" rule and/or requiring plaintiffs to post a security in order to be heard in court; (2) eliminating antifraud liability based on recklessness; (3) shielding certain professional groups from liability by narrowing the range of misconduct that is actionable; (4) abandoning the "fraud-on-the-market theory" of liability; (5) establishing heightened and unrealistic pleading requirements; (6) requiring the appointment of a guardian ad litem or plaintiff steering committee; (7) injecting financial "means tests" for judicial access; and (8) allowing overly expansive safe harbors for forward-looking information.

II. Private Securities Litigation: An Overview

The fundamental purpose of Federal securities laws is to provide investor protection and thereby foster the investor confidence that will encourage the investments necessary for capital formation, economic growth, and job creation. An admonishment made some time ago remains true today: Our financial markets do not run on money; they run on public confidence. This is perhaps best understood today by the captains of emerging financial markets in countries that recently have converted to a capitalist system. For example, the Chairman of the Russian Securities Fund demonstrated his understanding of this truism when he said: "Each scandal chips away at investors' trust, and trust is the only thing we can rely on to get more business."[2]

Vigorous enforcement of the Federal securities laws by the Securities and Exchange Commission is an essential part of the system that protects investors and thereby inspires confidence in the integrity of the markets. In addition, Congress, the courts, the Commission, and others all have consistently stressed the important functions of well-founded private investor lawsuits, which often are brought as a class action, not just as a means of recourse for victims of securities fraud, but also as a deterrent against those who might otherwise be willing to cross the line and violate the laws.

NASAA agrees with SEC Chairman Levitt, who, in previous testimony before Congress observed that:

> The class-action mechanism generally furthers judicial efficiency and makes it feasible for a broad group of investors who have relatively small individual claims to maintain an action for damages. This aggregation of claims causes class actions to have a powerful deterrent effect. Because the Commission cannot possibly take enforcement action to address all instances of securities fraud, the deterrence provided by class-action lawsuits is essential to the effective operation of the Federal securities laws.[3]

In short, private rights of action under the securities laws are essential to deter prospective wrongdoers, compensate the victims of fraud, and maintain public confidence in the marketplace. Preserving private actions as a source of deterrence and as the primary vehicle for compensating defrauded investors will be increasingly important as our capital markets continue to grow in size and complexity and as Government resources available to devote to securities law enforcement remain limited. As the authors of the report *Private Securities Litigation* concluded:

> American capital markets have maintained their preeminent position in the global economy due primarily to the view widely held by investors worldwide that American markets are generally very honest. Investor confidence in the fairness of the American markets is bolstered by a system that permits private lawsuits for securities fraud. Despite the claims by critics that securities litigation is hampering capital formation, initial public offerings have proceeded at a record pace in recent years, and a long list of notorious cases have recovered billions of dollars for defrauded investors.[4]

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[2] Remarks by Representative John Dingell on the floor of the House of Representatives, March 7, 1995, as found in the *Congressional Record*, page H 2774.

[3] Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, "Concerning Litigation Under the Federal Securities Laws," before the Subcommittee on Telecommunications & Finance, Committee on Energy and Commerce, U.S. House of Representatives, July 22, 1994, pp. 6–7.

[4] *Private Securities Litigation*. Staff Report Prepared at the Direction of Senator Christopher J. Dodd, Chairman, Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, May 17, 1994, p. 10.

While much of the attention in this securities litigation reform debate has centered on the allegedly abusive practices committed by plaintiffs' attorneys, it is worth pointing out that, despite the best, and successful, efforts of the Securities and Exchange Commission, the 50 State securities regulators and the Self-Regulatory Organizations (SRO's), there continues to be an unacceptably high level of fraud and abuse in today's capital markets. This was demonstrated in a recent survey of State-level activity which revealed that formal enforcement actions taken by the State securities agencies grew a hefty 37 percent between 1988 and 1992. Significantly, the biggest jumps in reported actions came in criminal actions *initiated*, which grew 167 percent (245 to 654) during the 4-year period, and criminal *convictions*, which were up 176 percent (141 to 390) over the same time period.[5]

Although the vast majority of those who work in the financial services industries are honest, hard-working individuals who take seriously their responsibilities, the damage inflicted by those who are prepared to defraud the market and investors can be tremendous. The excesses of the 1980's and early 1990's in the financial services arena have left investors with a deep—and all too well justified—sense of concern.

While it is important that regulators and self-regulatory organizations remain vigilant in aggressively policing the marketplace, it is equally important that we continue to have an effective private remedy so that victims of fraud may be compensated for their losses. When a State or Federal regulatory agency files an enforcement action, its principal objectives are to enjoin the wrongdoer from future violations of the law, to deprive violators of their profits by seeking orders of disgorgement, and generally to deter other violations. Private actions, by contrast, enable defrauded investors to seek compensatory damages and thereby recover the full amount of their losses.[6] Indeed, at times the interests of regulators in halting current and future wrongdoing may conflict with the interests of those who have already fallen victim.

Private remedies are perhaps most important in their deterrent effect. These actions are crucial to the integrity of the disclosure system under the Federal securities laws because they provide a direct incentive for issuers and other market participants to operate honestly and fairly. Although there is no precise way to measure the deterrent effect of private actions, Sheldon Elsen, testifying on behalf of the Association of the Bar of the City of New York before the House Telecommunications and Finance Subcommittee, vividly illustrated the beneficial and practical impact of these actions:

> When I worked as a young associate in a large law firm, one of the most experienced and savvy partners took me to a meeting where we were trying to dissuade a client from a course which we knew would violate the securities laws. Before we went, he took me into his office and explained how to handle the meeting. "Don't tell them about the cases," he warned, "they are not interested. And don't, for God's sake, lecture to them about ethics." He paused and looked at me significantly. "If they insist on going ahead with the deal, tell them that, if they do, Abe Pomerantz will sue them. That's the only thing that will stop them."
>
> I don't know how many of you remember Abe Pomerantz, but he was for many years the dean of the plaintiffs' stockholders bar in New York City. Corporate executives did not like to tangle with him; the threat of a class action by him was an enormous help to conscientious corporate lawyers who were trying to get their clients to obey the law.[7]

It is against this backdrop that the issues of litigation reform must be considered. NASAA believes it would be unwise, in the name of "reform," to further restrict the ability of defrauded investors to be made whole.

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[5] Philip A. Feigin, "Overview of Trends In State Securities Law Enforcement and a Comparison of Private Remedies Under State and Federal Securities Laws," presented to the 27th Annual Securities Regulation Seminar, Los Angeles County Bar Association, October 3, 1994.

[6] Testimony of William R. McLucas, Director, Division of Enforcement, U.S. Securities and Exchange Commission, "Concerning Private Litigation Under the Federal Securities Laws," Before the Subcommittee on Securities, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, June 17, 1993.

[7] Written statement of Sheldon Elsen, on behalf of the Association of the Bar of the City of New York, before the Subcommittee on Telecommunications and Finance, Committee on Commerce, U.S. House of Representatives, on the subject of private litigation under the Federal securities laws, February 10, 1995.

III. Private Actions and Frivolous Suits

Before commenting on the specific provisions of the bills that have been introduced on this matter, allow us to take a moment to briefly discuss the standards that must be met in order to pursue private actions under the Federal securities laws. Our interest here is to respond to the assertions that have been made on numerous occasions that it is "a simple matter to allege fraud and then move to a profitable settlement." This is not the case. In fact, existing case law clearly spells out when recovery is available. Plaintiffs seeking damages under Section 10(b) and Rule 10(b)(5) must prove that:

- The plaintiff was a purchaser or seller of securities;
- The defendant engaged in a fraud, manipulation, or deception;
- The fraud, manipulation, or deception was in connection with the purchase or sale of the securities;
- The defendant acted with scienter (an intent to deceive or a reckless disregard for the truth or falsity of statement);
- The defendant's misstatement or nondisclosure was material;
- The plaintiff reasonably relied upon the defendant's misstatement or nondisclosure;
- The plaintiff was damaged; and
- The defendant's conduct caused the plaintiff's damages.

Clearly, satisfying this burden of proof requires considerable evidence of wrongdoing. Unlike most of the express private actions to which Congress originally applied the 1-year/3-year statute of limitations, Rule 10(b)(5) liability is based upon deliberate and intentional fraud (including recklessness), and not merely negligent violations.

IV. Comments on Key Reform Elements

Mr. Chairman, as you and other Members of this Subcommittee may know, NASAA was among the critics of the securities litigation reform proposals[8] considered in the 103rd Congress. At that time, NASAA opposed bills that we believed would have accomplished the goal of curbing frivolous securities lawsuits only by extracting a steep price: Severely limiting, or even entirely eliminating, the ability of defrauded investors to obtain fair redress and full recovery of their losses. It was NASAA's view that the reform measures under consideration at that time threatened the viability of private litigation under the securities laws and, therefore, jeopardized a basic protection for investors and for our Nation's capital markets.[9]

As stated previously, NASAA recognizes that there is room for constructive improvement in the Federal securities litigation process. The critical question, we believe, is whether meaningful legislation can be developed that would eliminate the worst abuses in private litigation without eradicating its benefits. In the course of reviewing the legislation that has been proposed in this area, and after extended discussions with a variety of the individuals and organizations involved in this debate, NASAA has concluded that it is possible to craft effective litigation reform measures that target abusive practices without sacrificing remedies for legitimate claims.

NASAA also believes that legislation is necessary to correct two recent Supreme Court decisions that have narrowed the scope of private actions under Section 10(b) of the Exchange Act and Rule 10(b)(5). In *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*,[10] the Court held that investors do not have a private right of action against persons who substantially assist a securities fraud, even if those persons act knowingly or with a high degree of recklessness. Three years earlier, in *Lampf, Pleva, Lipkind, Prupis & Petigrow* v. *Gilbertson*,[11] the Court held that an action under Rule 10(b)(5) must be brought within 1 year after discovery

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[8] Specifically, NASAA offered comments on S. 1976, the "Private Securities Litigation Reform Act of 1994," and H.R. 417, the "Securities Private Enforcement Reform Act."

[9] NASAA's views on the importance of private actions and on the reform proposals considered during the 103rd Congress are discussed in greater detail in written statements submitted to the relevant House and Senate Committees. For more on NASAA's position, see: (1) Statement of Mark Griffin, Utah Securities Division Director, on behalf of NASAA, as found in *Private Litigation Under the Federal Securities Laws*, Hearings Before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 103d Cong., 1st Sess., S. Hrg. 103–431; and (2) Statement of Mark Griffin, Utah Securities Division Director, on behalf of NASAA, before the Telecommunications and Finance Subcommittee of the Energy and Commerce Committee, U.S. House of Representatives, August 10, 1994.

[10] 114 S. Ct. 1439 (1994).

[11] 501 U.S. 350 (1991).

of a violation, and within 3 years after the violation occurred. These two decisions are worthy of congressional scrutiny and action.

The balance of this section is devoted to a discussion of the major reform elements that are incorporated into the variety of litigation reform bills that have been put forward in the 104th Congress. In evaluating each of the proposed reforms, NASAA applied one test: Will it further the interest of investor protection? Those reforms that target frivolous cases without doing damage to critical investor safeguards will be found among the proposals NASAA supports. On the other hand, reforms that would have the practical effect of eviscerating investors' legitimate remedies against fraud will be found among those proposals to which NASAA stands in opposition. It should be noted, however, that among the reforms opposed by NASAA are proposals that, with further modification or refinement, potentially could be supported by the Association. Those items not found on either list are issues on which NASAA takes no position or does not have adequate information with which to make a proper evaluation.

REFORM MEASURES SUPPORTED BY NASAA

The following reform measures are endorsed by NASAA. It is the Association's view that, if enacted, these proposals would significantly improve the private litigation system without eradicating any of its benefits.

Establishment of an Early Evaluation Procedure

NASAA believes that perhaps the single best hope for resolving the litigation reform debate in a manner satisfactory to all the parties involved is to find an effective mechanism for screening out cases that lack merit early in the process, before the tremendous financial and time costs associated with discovery have been incurred. Toward this end, NASAA has endorsed the concept of what commonly is referred to as an "early evaluation procedure."

The idea here is that the parties to a dispute would voluntarily submit their case to a judge/magistrate or special master who would act as a mediator. During the mediation period, which would run for no more than 5 months, a freeze would be in effect on further discovery between the parties (and extending to third parties), except for the exchange of all nonprivileged core documents relating to the allegations in the complaint.

If, at the end of the early evaluation procedure, the action is not voluntarily withdrawn or settled, the mediator would make a determination as to whether the complaint is: (1) clearly frivolous and only could be further maintained in bad faith; (2) clearly meritorious and only could be further defended in bad faith; or (3) neither clearly frivolous nor clearly meritorious. If a party proceeds despite a contrary ruling by the independent mediator, that party would be subject to sanctions by the court.

Some have suggested allowing (or requiring, in some instances) parties to a dispute to submit to what is known as "Alternative Dispute Resolution" (ADR), a broad term encompassing a number of procedures for resolving legal disputes without utilizing the facilities of the judicial system. Such a provision is found in S. 240, the "Private Securities Litigation Reform Act," introduced this year by Senators Pete Domenici and Chris Dodd. While such a system may provide many of the same benefits as the "early evaluation procedure," NASAA is concerned that not all types of ADR are necessarily practical in all settings. As even some proponents of ADR have noted, while some types of ADR may result in lower litigation costs, expedited resolution of the dispute, better substantive outcomes and more controlled disclosure of sensitive information, it does not always produce these benefits relative to litigation and may sometimes result in higher costs and more delay than litigation would produce.[12] As a result, NASAA commends to Congress the "early evaluation procedure."

Improved Disclosure of Settlement Terms

Settlements between the parties to a dispute require court approval and notice to the class members, who may elect to opt out of the settlement and pursue individual claims. The court-approved notice to class members must fairly apprise the prospective members of the class of the terms of the proposed settlement. However, courts generally have not imposed strict requirements for the type of notice required or the method by which the notice is sent.

In the process of working with investors involved in one major case, State securities regulators became aware that investors found it extremely difficult to understand the notice documents they receive as a participant in a class action. The no-

[12] *Private Securities Litigation*. p. 51.

tices sent to class members often are impenetrable—dense and filled with legalese—and of little value to an average investor trying to determine whether he or she should participate in the proposed settlement. One of the major deficiencies in the disclosure is that investors are not even told what they should expect in terms of recovery if the settlement is approved. It is NASAA's view that class members have a right to insist on understandable documents that clearly explain their options. Virtually every litigation reform measure before Congress contains this common-sense provision.

Authority to the States and SEC to be Heard in Federal Class Actions

Recently, individual State securities regulators have sought the right to be heard in court on the subject of the fairness of proposed settlements in instances where it had come to their attention that defrauded investors were not being well-served by their counsel. For example, while State and Federal regulators were investigating the massive fraud by Prudential Securities in the sale of limited partnerships, some investors hired counsel and sought redress in the courts. Unfortunately, one attorney hired to represent a group of plaintiffs in their pursuit of a class-action claim was prepared to settle the case for what would have amounted to only pennies on the dollar. Several other plaintiffs' attorneys objected to the settlement, as did many State securities regulators. The securities regulators in several States [13] intervened and were successful in convincing the judge presiding over the case to postpone action until the States and the SEC had completed their investigations into the matter.

While meeting with some success in this instance, State securities regulators currently have little authority to intervene and be heard on the subject of the fairness of proposed class-action settlements. In the case referenced here, the State securities regulators found that their objections to the settlement terms were listened to by the judge so long as there were plaintiffs' counsel who also were raising similar objections. Once all the attorneys signed off on the deal, there appeared to be little the State securities regulators could do to try and improve the settlement terms for the defrauded investors. As a result, NASAA encourages Congress to grant discretionary authority to the individual State securities agencies and the SEC to be heard in Federal class-action lawsuits on the subject of the fairness of proposed settlements.

We would note that SEC Chairman Levitt, in a recent speech on this topic,[14] indicated that the Commission was considering asking Congress for authority that would allow the agency to appear and be heard on any issue in a private action brought under the securities laws. Such authority would be modeled on the provision that already exists in the Bankruptcy Code, and, according to Chairman Levitt, would allow the Commission to express its views in the public interest.

Restoration of Aiding and Abetting Liability

In one of the most important securities-related decisions in many years, the U.S. Supreme Court on April 19, 1994, issued its decision in *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.* By a 5–4 vote, the Court's majority held that there is no private implied right of action for aiding and abetting under Section 10(b) and Rule 10(b)(5). In so deciding, the Court overruled decades of precedent from 11 Federal courts of appeals that had recognized a private cause of action against such aiders and abettors.

It is deeply troubling to NASAA that, as a result of the Court's decision, those professionals who substantially and knowingly assist a securities law violation may be in a position to avoid sanctions altogether. One consequence of the *Central Bank* decision is that it will be difficult, if not impossible, for investors in many cases to recover financial losses due to fraud. Investors who are defrauded often have found that the "primary violators" are unable to meet all or most of the losses incurred, and so plaintiffs have sought recovery from the professionals, such as accountants and lawyers, who have aided and abetted the wrongdoing. As a result of the Su-

[13] For example, see the January 22, 1993, letter from Idaho Securities Bureau Chief Wayne Klein to Judge Marcel Livaudais, Jr., United States District Judge, New Orleans, LA. In that letter, Mr. Klein states: "The State of Idaho writes to object to the proposed settlement of this class action. We feel that disclosure to class members has been ineffective; that the settlement is not fair, reasonable, and adequate; that public policy considerations suggest rejection of the settlement; and that this course may impede future regulatory enforcement actions." State securities regulators in California, South Carolina, Illinois, and Arizona concurred with the Idaho objection.

[14] "Between *Caveat Emptor* and *Caveat Venditor*. The Middle Ground of Litigation Reform," Remarks by Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, 22nd Annual Securities Regulation Institute, San Diego, California, January 25, 1995.

preme Court's decision, investors may no longer be able to recover from these professionals when they substantially assist in a securities fraud, even if these professionals act knowingly or with a high degree of recklessness.

NASAA respectfully encourages Congress to enact legislation to reverse the Supreme Court's *Central Bank* decision and to explicitly restore the authority under Section 10(b) and Rule 10(b)(5) for the SEC and private litigants to bring appropriate actions against persons who aid and abet securities fraud. The legislation should define aiding and abetting in traditional terms as involving: (1) a primary violation of the securities laws; (2) knowledge of, or recklessness with respect to, the primary violation; and (3) substantial assistance. Such a three-pronged test should adequately protect against the threat of vexatious litigation.

Such legislation is essential to maintaining the integrity of the marketplace and to providing defrauded investors with adequate means of redress. Absent aiding and abetting civil liability, many of the professionals who act as "gatekeepers," on whose credibility both buyers and sellers of securities depend, essentially may be immune from liability. More importantly, they may be free of the incremental spur to vigilance—the critical deterrent effect—that many need.[15]

Extension of the Statute of Limitations

Under current law as interpreted by the U.S. Supreme Court in its 1991 decision in the *Lampf* case, private actions under Section 10(b) must be filed within 1 year after discovery of the alleged violation, and no more than 3 years after the violation occurred. As a practical matter, this unduly short leash for securities fraud private actions eviscerates the rights of investors to seek recovery from those who participate in knowing and deliberate fraudulent activity. At the very time when U.S. policymakers are seeking to encourage long-term investing as a means of stimulating capital formation, NASAA would suggest that it is unwise to simultaneously send the signal that long-term investments are made at a significant risk to the buyer because of restrictions on avenues of redress should fraud occur.

It is the experience of State securities regulators that victims of investment fraud often have no way of knowing, nor reason to suspect for what may be many years, the truth about the mishandling or abuse of their investments. Even once a suspicion of wrongdoing does arise, bringing out sufficient facts to merit filing a lawsuit may take additional and substantial periods of time. In fact, the SEC has acknowledged that the Commission, even with all of its investigative resources and statutory powers, including compulsory investigative processes, does not complete its investigations, on average, in less than 2.25 years.[16] Therefore, the *Lampf* decision would have the effect of frustrating even the most organized and targeted investigations of fraud.

The increasing complexity of the securities markets facilitates the act of concealment that is inherent in most securities fraud cases. As a result, more and more investment vehicles are tailor-made to outlast the 3-year period of repose required under the Court's *Lampf* ruling. When sentencing financier Michael Milken, U.S. District Judge Kimba Wood underscored the ease with which securities fraud may be concealed and the damage inflicted by such behavior on both the capital markets and investors:

> . . . [there is] a legitimate public concern . . . that our financial markets in which so many people who are not rich invest their savings be free of secret manipulation . . . [Y]ou may have committed only subtle crimes not because you were not disposed to any criminal behavior but because you were willing to commit only crimes that were unlikely to be detected . . . You also committed crimes that are hard to detect, and crimes that are hard to detect warrant greater punishment in order to be effective in deterring others from committing them.[17]

NASAA's position is that it is reasonable to impose a statute which limits actions to within 3 years after one knew of the facts constituting the violation on which recovery is sought. If Congress determines that an outer limit is necessary to add certainty to commercial dealings, the Association suggests a 5-year limitation period. NASAA's view is that the statute of limitations should be tied to the *actual discovery* of the fraud, rather than to the time when a plaintiff *"should have"* discovered

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[15] *Report on Private Securities Litigation Reform Legislation*, by the Committee on Securities Litigation and the Committee on Federal Courts of The Association of the Bar of the City of New York, December 19, 1994.

[16] Brief of the Securities and Exchange Commission as Amicus Curiae at p. 24, *Lampf* v. *Gilbertson*, 90–333 (June 20, 1991).

[17] Comments by U.S. District Judge Kimba Wood, as excerpted by the *Washinaton Post*, November 23, 1990, p. B12.

the fraud. A "reasonable diligence" standard imputes to a plaintiff the knowledge that could have been learned about a fraud if all the acts at the plaintiff's disposal had been investigated with reasonable diligence. In financial markets, these signals may often be ambiguous. An absence of a duty of inquiry does not entitle investors to ignore clear evidence of fraud. In this respect, NASAA is in agreement with former SEC Chairman Richard Breeden who said:

> A "reasonable diligence" standard is unfair to fraud victims because almost every defendant can allege that a plaintiff "should have" discovered a fraud earlier. Thus, this requirement would prompt a considerable amount of needless litigation to resolve subtle shadings of what an investor could or might have done.[18]

A constructive notice standard no doubt would be raised as a matter of course by defendants and, ironically, could spur *more* litigation. The likely effect is that the courts would be deluged for years to come with suits aimed at defining what "the exercise of due diligence" means.

A Reasonable Safe Harbor for Forward-Looking Statements

It is NASAA's view that there is a value in preserving a system that provides incentives for public companies, in good faith, to accurately and honestly forecast future performance. There is no good way to measure the benefits to the marketplace of a system that encourages corporate managers, underwriters, and issuers of securities to be honest and reasonable in their statements. What we do know, however, is that by maintaining pressure on companies to report and speak truthfully, we will help to achieve a more efficient allocation of capital to honest entrepreneurs and away from those who might be willing to make misrepresentations in an effort to lure investment capital.

On the other hand, some corporate executives have suggested that the flow of information voluntarily provided to the marketplace has been sharply curtailed due to the threat of litigation. As a result, securities litigation may be working at cross purposes to the fundamental objectives of the Federal securities laws, which of course, is full disclosure.

The critical question here is how to provide meaningful protection to issuers acting in good faith, without also insulating companies that intentionally hype their stock by making unreasonable projections. NASAA commends the SEC for undertaking a thorough review of the issues involved here and for reaching out to the broadest possible range of corporate executives, plaintiffs' attorneys, investors, and others to seek their views on how to address these issues. The Commission issued a "concept" release soliciting comments on current practices relating to disclosure of forward-looking information and has held at least two public hearings on the issue. It is NASAA's understanding that the agency now is looking to developing a new safe harbor for projections that provides issuers with meaningful protection but also protects investors.

Certification of Complaints and Improved Case Management Procedures

As a package, these reforms would respond to the complaints that: (1) there are no real plaintiffs behind some class-action lawsuits; and (2) the current methods for the selection of lead counsel, in which the attorney to file the first case generally is appointed lead counsel, encourage a "race to the courthouse." NASAA supports reform in both areas in an effort to create a more rational system for the filing of these cases.

Under such reforms, plaintiffs would have to provide a signed certification to be filed with the complaint stating that the plaintiff: Has reviewed and authorized the complaint; did not purchase with the intent to litigate; did not purchase the security at the direction of plaintiff's counsel; is willing to serve as a class representative; and will not accept any special compensation for performing such a function, except as ordered by the court.

In addition, the certification would detail all of the plaintiff's transactions in the security that is the subject of the complaint and would identify all class-action lawsuits in which the plaintiff has participated in the prior year. NASAA believes that requiring such a certification would go a long way toward alleviating concerns about possible "phantom" plaintiffs. In this context, NASAA also supports measures that would require consolidation of cases in those instances where multiple actions are filed involving substantially the same transaction or occurrence and new methods

[18] Letter from Securities and Exchange Commission Chairman Richard Breeden to Senator Terry Sanford, August 12, 1992.

for the selection of lead counsel which do not give undue weight to the order in which the cases were filed.

Curbs on Potentially Abusive Practices

It appears that virtually everyone agrees that potentially abusive practices on the part of plaintiffs' attorneys should be curtailed, including: (1) lawyers should not pay referral fees to brokers who refer clients; (2) named plaintiffs should not receive bounty payments; (3) private plaintiffs' legal fees should not be paid out of SEC disgorgement pools; and (4) the court should make a determination as to whether attorney ownership of the securities in question constitutes a conflict of interest. First found in S. 1976, introduced in the last Congress by Senators Domenici and Dodd, these provisions have been incorporated into virtually every litigation reform bill that has been introduced in the 104th Congress.

REFORMS OPPOSED BY NASAA

NASAA is opposed to reforms that have the potential to cause substantial harm to our markets by eradicating the benefits of private litigation. In NASAA's view, the following measures would have such an effect and therefore are opposed by the Association.

Imposing a "Loser Pays" Rule and Requiring Investors to Post a Security

Because of a national policy in favor of access to justice, the United States has for 200 years used the "American Rule," with each side in a dispute generally paying its own fees and costs. Now, some reform proponents have suggested that we impose instead the so-called "English Rule," under which the loser in any private securities action would have to pay the legal fees and expenses of the prevailing party. Some have suggested that we make such fee-shifting automatic and mandatory, regardless of whether or not the suit had merit. Others would allow discretion to the court to determine whether the losing party's position was "substantially justified." In those instances, there would be no fee-shifting. Yet others would permit fee-shifting only in certain, more limited situations.

It is NASAA's view that fee-shifting would have a devastating and chilling effect on investor suits and would be especially oppressive in those cases where smaller investors are involved and have an action against a large, well-heeled corporation. Such a provision would inappropriately discourage defrauded investors with meritorious claims from seeking compensation. Because individual plaintiffs in class-action litigation often stand to recover only a relatively small amount, the risk of having to assume liability for a defendant's legal fees and other expenses would be totally disproportionate to the potential recovery. Few aggrieved investors—if any—would be willing to risk having to pay the millions in legal fees that such defendants easily can run up.

It is interesting to note that there now appears to be grumbling in Britain about the English Rule. The attack on the English Rule comes from a powerful and authoritative source, *The Economist,* the respected conservative weekly. *New York Times* columnist Anthony Lewis wrote recently:[19] "A conservative magazine skeptical of lawyers, urged in its January 14th issue that Britain abandon the loser-pay rule." Mr. Lewis went on to quote *The Economist:* "Enormous numbers of mostly middle-class people simply cannot use the courts because they must pay for the other side's lawyers if they lose. For most people that means they are risking financial ruin. Today, in Britain, only the very wealthy can afford the costs and risks of most litigation. This offends one of the most basic principles of a free society: Equality before the law."

Preeminent legal scholar Arthur Miller commented that, as a practical matter, "fee-shifting is almost invariably an intimidation device designed to inhibit people from seeking access to the courts."[20] Litigation success from the plaintiff's perspective is never certain at the point of institution. As a result, no one—except perhaps the extremely wealthy—would assume the risks of pursuing a class claim against well-resourced defendants. Moreover, the courts already have the authority under Rule 11 of the Federal Rules of Civil Procedure to order limited fee-shifting in abusive and meritless cases. If this authority is not being used frequently enough, NASAA would encourage Congress to inquire of the judiciary as to why that is the case.

More onerous than the fee-shifting provisions found in some reform measures is the security requirement found in H.R. 1058, the "Securities Litigation Reform Act,"

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[19] "Tilting the Scales," Anthony Lewis, *New York Times,* February 3, 1995, p. A19.

[20] Prepared statement of Arthur R. Miller, Bruce Bromley Professor of Law, Harvard University Law School, before the House Subcommittee on Telecommunications and Finance, August 10, 1994.

approved by the House of Representatives on March 8, 1995. That bill would impose a costly and hopelessly burdensome requirement applicable only to investors. Either the investors or their attorneys would be required to post security at the beginning of a case to provide for the payment of the defendants' attorneys fees and other expenses in the event that the fees are shifted at the end of the day. It has been explained to us that those investors unable to obtain a bond could simply put up their homes or turn over any remaining savings to satisfy the security requirement.

NASAA's members have extensive experience dealing with defrauded investors. We are here to tell you that this requirement would kill legitimate investor lawsuits. We are hard pressed to think of any defrauded investor who, after losing all or part of his or her investment, would be willing to risk losing his or her home in order to pursue a case in court. We sincerely doubt that many defrauded investors would be willing to "bet the farm" that they would prevail against some of Wall Street's finest (and most expensive) talent.

Let us emphasize that NASAA is unequivocally opposed to fee-shifting of any sort. However, if Congress determines to move forward with what we believe is a misguided policy, NASAA would recommend that such fee-shifting be limited in its application to claims and defenses that are held by a court to be clearly frivolous. If not so limited, a fee-shifting provision would inevitably deter defrauded investors with meritorious claims from seeking compensation for their damages.

Eliminating Antifraud Liability Based on Recklessness

Under current law, as interpreted by virtually every circuit court, recklessness—as opposed to actual knowledge—is sufficient to establish securities fraud. Nearly two decades ago, in *Ernst & Ernst* v. *Hochfelder,*[21] the Supreme Court held that a plaintiff cannot assert a private right of action under Section 10(b) or Rule 10(b)(5) in the absence of *scienter*—"an intent to deceive, manipulate, or defraud." The Court noted that the statutory text "strongly suggest[s] that Section 10(b) was intended to proscribe knowing or intentional misconduct." Merely negligent conduct would not meet this standard. The Court also noted, however, that "[i]n certain areas of the law, recklessness is considered to be a form of intentional conduct for the purposes of imposing liability for some act."

Since *Hochfelder,* Federal courts generally have accepted recklessness as satisfying the *scienter* requirement for primary violations of Section 10(b). The courts have agreed that a strict requirement of actual knowledge would cause many violators to escape liability under the Federal securities laws.[22] Recklessness also has been held sufficient to establish *scienter* for secondary liability under special circumstances, including instances in which the defendant owed the plaintiff a fiduciary duty or could foresee that the plaintiff would rely on his or her actions.

Common law has long recognized recklessness as a form of scienter for purposes of proving fraud. Under the common law, one who acts with reckless disregard for the potentially harmful consequences of his actions has long been regarded as equally culpable with one who acts with actual knowledge of the potential consequences. In part, this rule serves to discourage deliberate ignorance of facts suggesting fraud.

NASAA agrees with SEC Chairman Levitt's statements about why it is that recklessness is the appropriate standard for securities fraud cases:

> [s]uch a standard is needed to protect the integrity of the disclosure process—which is to say the integrity of our markets. We *want* corporations to worry about the accuracy of their disclosures, because it is the best way to assure the markets of a continuous stream of accurate information. In fact, an actual knowledge standard could create a legal incentive to ignore indications of fraud. The phrase "ignorance is bliss" would take on new meaning.[23]

Under current case law, the threshold for a finding of recklessness is rather high. Although the definition varies somewhat in different courts, most of the Federal courts of appeal follow the standard articulated by the Seventh Circuit in *Sundstrand Corporation* v. *Sun Chemical Corporation.* In that case, the court defined reckless omission as:

> a highly unreasonable omission, involving not merely simple, or even excusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers and sellers

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[21] 425 U.S. 185, 192 n. 7 (1976).

[22] Untitled, American Bar Association Section of Business Law, Task Force on Joint and Several Liability Under Rule 10(b)(5), delivered August 8, 1994, Annual Meeting, New Orleans, LA.

[23] Levitt, "Between *Caveat Emptor* and *Caveat Venditor.* The Middle Ground of Litigation Reform."

that is either known to the defendant or is so obvious that the actor must have been aware of it.[24]

Some reform proponents have suggested that the recklessness standard be abandoned in favor of a standard based on "knowing securities fraud." Under this proposed scenario, plaintiffs would have to prove that a defendant *knew* that a statement was misleading at the time it was made or intentionally omitted to state a fact knowing that such omission would render misleading the statements made at the time they were made. NASAA is opposed to such a change. It is extremely rare to find direct evidence that a fraud defendant actually knew a statement was false. The practical effect here would be to move from a standard of "due diligence" to a standard of "due ignorance."

Shielding Certain Professional Groups From Liability

Under current law, each defendant who conspires to commit a violation of the securities law is jointly and severally liable for *all* the damages resulting from the violation. The underlying rationale of this concept is that a fraud will fail if one of the participants reveals its existence and, as a result, all wrongdoers are held equally culpable if the fraud achieves its aims. This has been an extremely important concept with respect to the sophisticated financial frauds of recent years, many of which could not have succeeded without the active assistance of professionals such as accountants and lawyers.

It is important to remember that, above all else, the purpose of the current system is to protect the rights of defrauded investors. If forced to choose between innocent investors who are victimized in a scheme and professionals who have knowingly or recklessly assisted the fraud by failing to meet professional standards, the risk of financial loss rightfully is borne by the professionals, and not the innocent victims.

Federal District Judge Stanley Sporkin, in his opinion in one savings and loan case, summed up the theory behind joint and several liability:

> Where were these professionals . . . when these clearly improper transactions were being consummated? Why didn't any of them speak up or disassociate themselves from the transactions? Where also were the outside accountants and attorneys when these transactions were effectuated?

In a subsequent speech, Judge Sporkin elaborated:

> For this kind of massive, very sophisticated fraud to have occurred, it required the complicity of certain professionals that we all know of—CPA's, lawyers, and appraisers. I'm suggesting that perhaps these professionals did not discharge their responsibilities to the broader public interest.

An important lesson to be learned from the massive financial frauds of the 1980's is that these schemes often involve not only the primary wrongdoers who are central to the criminal enterprise, but also the professionals—such as lawyers and accountants—who assist the fraud. In many instances, these financial crimes could not have succeeded without the participation of the accounting firms and law firms that conferred credibility upon the enterprises. As a result, NASAA generally is supportive of retaining the concept of joint and several liability.

Having argued in support of joint and several liability, NASAA also acknowledges the concerns of some professionals, particularly accountants, who believe that they are being targeted in these securities fraud lawsuits because they serve as the "deep pockets" in the case. NASAA is willing to consider two alternative approaches here. First, NASAA would give further consideration to a system of proportionate liability for aiders and abettors, *except* in circumstances of an insolvent principal wrongdoer whose damages are not adequately insured.

Second, NASAA would suggest the perceived flaws in the existing system could be minimized by enacting a system of proportionate contribution. NASAA is willing to consider a proposal made by SEC Chairman Levitt that a rule be adopted that provides that, where one defendant settles a case, the liability of the co-defendants is reduced by an amount equal to the greater amount of the amount paid or the settling defendant's proportionate responsibility. While NASAA would prefer the earlier approach suggested here, we certainly are open to other ways of addressing this issue. However, let us be clear: When forced to choose between an innocent victim and reckless co-defendants, NASAA always will side with the innocent investors.

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[24] 553 F.2d 1033 (7th Cir.), *cert denied sub nom., Meers* v. *Sundstrand Corp.*, 434 U.S. 875 (1977).

Elimination of "Fraud-on-the-Market" Liability

The entire premise underlying the Federal securities laws and securities regulation is that in a free market investors make decisions based on full disclosure of material facts. Accordingly, the market will efficiently incorporate all the information provided to it and set a price for an individual security. Because of this "efficient market theory," disseminating false information to the market causes a "fraud-on-the-market," a concept that has been recognized as securities fraud.

In most instances, in order to prevail on a private claim under Section 10(b), a plaintiff must show that the defendant reasonably relied on a material misstatement or omission by a defendant, and that the defendant's conduct caused the alleged damages. However, in *Basic, Inc.* v. *Levinson*,[25] the Supreme Court indicated that in certain cases a plaintiff may establish reliance through the "fraud-on-the-market" theory. This theory holds that:

> [a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in the market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10(b)(5) action.

Essentially, the "fraud-on-the-market" theory embodies what common sense tells us is true: When an investor purchases a stock at a price affected by misrepresentations, the buyer has, in effect, bought the misrepresentations, whether or not the investor actually read the statements in question. To suggest that plaintiffs be required to prove that they read and relied upon a misleading statement by the defendant in order to bring an action is to suggest that we abandon the fraud-on-the-market theory. Here NASAA agrees with SEC Chairman Levitt, who suggested that such a course of action was "antithetical to our entire system of disclosure, which is premised on the notion that when information is disclosed generally, it is incorporated into market prices."[26] Otherwise, we will need a system in which every prospectus and every periodic disclosure will have to be directly distributed to all shareholders and prospective investors on a continuous basis.

Heightened and Unrealistic Pleading Requirements

Currently, Rule 9(b) of the Federal Rules of Civil Procedure[27] requires that the circumstances of the fraud in question be stated with particularity at the outset of the case in the complaint. Federal Rule of Civil Procedure 12(b)(6) provides defendants with a mechanism to challenge the legal sufficiency of the allegations of the complaint at the outset of a case, before an answer is filed. There appears to be widespread agreement that Rule 9(b) has been used with increasing frequency in recent years to weed out frivolous cases.

Some reform proponents have suggested that we go beyond what is required under Rule 9(b) to force plaintiffs to allege in the complaint "specific facts demonstrating the state of mind of each defendant at the time the alleged violation occurred." This proposal would appear to defy commonsense. As Professor Arthur R. Miller, author of the definitive treatise on Federal practice and procedure, testified:

> [the proposal] seems to suggest that at the outset of a case, the plaintiff must have the clearest proof of each individual defendant's state of mind. That is totally unrealistic. It is only in the rarest of instances that this type of evidence exists. Under the best of circumstances, requiring plaintiffs to plead the defendant's states of mind generally calls for the drawing of subtle inferences from facts available prior to institution, a task that is highly treacherous. It would be impossible in the vast majority of cases.[28]

Indeed, the Courts have recognized that it would be unworkable and unfair to require great specificity in pleading *scienter*, since a plaintiff realistically cannot be

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[25] 485 U.S. 224 (1988).

[26] Levitt, "Between *Caveat Emptor* and *Caveat Venditor*. The Middle Ground of Litigation Reform."

[27] Federal Rule 9(b) provides: "FRAUD, MISTAKE, CONDITION OF ThE MIND. In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally."

[28] Prepared statement of Arthur R. Miller, Bruce Bromley Professor of Law, Harvard University Law School, before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives, August 10, 1994.

expected to plead a defendant's actual state of mind.[29] The real danger here is that an onerous pleading requirement would eliminate meritorious cases.

Guardian ad litem or Plaintiff Steering Committee

Although initially intrigued by these concepts, both of which in NASAA's view have the appeal of sounding pro-investor, NASAA reached the conclusion that establishing such panels would be fraught with significant practical problems. As a result, NASAA is opposed to such a proposal. Several leading legal commentators have argued persuasively against these concepts, most notably The Association of the Bar of the City of New York and Harvard Law Professor Arthur Miller.

It has been pointed out both by the Bar of the City of the New York and by Professor Miller that Rule 23 of the Federal Rules of Civil Procedure already charges the courts with an obligation to closely supervise the litigation to ensure the fair, efficient, and effective prosecution of class actions. In addition, counsel owes a fiduciary duty to the class, and if counsel fails to discharge that duty, the court is required to act on behalf of the class. These commentators made several additional cogent points:

- Prosecution of these actions requires specialized expertise and considerable resources. How will the system be improved if we substitute the judgment of an inexperienced guardian ad litem or steering committee for that of experienced counsel and the court?
- Under Federal rules, the court has the power to appoint a magistrate judge to supervise the litigation without cost to the parties or class. But it appears that the guardian ad litem would be paid by the parties, adding another layer of expense in addition to the expense already involved in prosecuting class actions.
- As currently configured by the various proponents, the committees would be immune from liability. Thus, the committees would control the litigation totally free from any accountability for their decisions.
- If the concept is predicated on the notion that the lawyers for the class, who are its guardian, are not doing their job, then where will the process of second-guessing end? Who will guard the guardians?
- Finally, the concept runs contrary to the thrust of modern litigation reform, which is to simplify, streamline, and reduce the expense of litigation.

Financial "Means Testing" for Judicial Access

In a departure from the well-established tenets of American jurisprudence, under which all citizens are equal under the law without regard for their wealth or lack thereof, there now are proposals on the table that in several instances would introduce the concept of what we would call "means testing" to determine whether a plaintiff would be eligible for standing in court or to determine whether the plaintiff would be eligible to recover damages. NASAA opposes such provisions as being antithetical to our system of justice.

V. Comments on Bills Before Congress

Mr. Chairman and Members of the Subcommittee, as stated earlier, NASAA believes that it is possible to craft litigation reform measures that will curb abusive practices without sacrificing the opportunity for redress and recovery for defrauded investors. In the previous section of this testimony (Section IV), NASAA enumerated those reform proposals the Association supports and those to which the Association stands in opposition. Using those standards as our guidepost, NASAA has reviewed each of the major securities litigation reform bills introduced in the 104th Congress. For purposes of this discussion, our comments will be limited to H.R. 1058 as it passed the House of Representatives, Title II of H.R. 10 as it was introduced, and S. 240, introduced in January of this year by Senators Pete Domenici and Chris Dodd.

It is our hope that any reform legislation enacted by this Congress will achieve a balance between protecting the rights of defrauded investors and providing relief to companies and professionals who may find themselves the target of a frivolous lawsuit. NASAA recognizes that many of the reform proposals now under consideration are reasonable attempts to get at frivolous lawsuits. While we may differ on the specifics, NASAA is hopeful that good faith efforts on the part of all parties will help us arrive at a consensus on these complex issues. However, NASAA will vigorously oppose those provisions that we determine go beyond frivolous lawsuits and will have the practical effect of rolling back the investor protections afforded under the Federal securities laws.

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[29] *Stern* v. *Leucadia Nat'l Corp.*, 488 U.S. 852 (1988), quoting *Connecticut Nat'l Bank* v. *Fluor Corp.*, 808 F.2d 957, 962 (2d Cir. 1987).

H.R. 1058, THE "SECURITIES LITIGATION REFORM ACT"

Mr. Chairman and Members of the Subcommittee, NASAA remains deeply troubled by the reforms contained in H.R. 1058, despite the modifications made to the bill during the House process. In general, we believe the cure here is worse than the disease. It is NASAA's opinion that the bill would threaten the viability of Federal securities class actions. While it is true that you can eliminate frivolous lawsuits by eliminating *all* lawsuits, NASAA does not believe that such an approach is wise public policy.

Today, the Federal and State Governments are closely scrutinizing all Government programs to determine what functions may be curtailed and what functions may more appropriately be handled by the private sector. Yet, this bill would run contrary to current thinking and would severely limit the important role of private attorneys general in enforcing the securities laws. As a result, the Securities and Exchange Commission would be required to shoulder a greater responsibility for enforcing the Federal securities laws. In fact, the Congressional Budget Office, in a February 24th letter to Commerce Committee Chairman Thomas Bliley, Jr., estimated that this bill, as reported out of the Commerce Committee, "would cost the Federal Government between $125 million and $250 million over the next 5 years."[30] To our knowledge, securities-related bills very rarely have a fiscal impact.

NASAA believes that H.R. 1058, as passed by the House of Representatives on March 8, 1995, will have an adverse impact on defrauded investors and on the integrity of the capital markets. Specifically, NASAA has serious concerns about the following provisions of H.R. 1058:

Loser "almost always" pays and security requirements. First, it should be stated that, for the reasons enunciated in Section IV of this testimony, NASAA is opposed to loser pays provisions for securities fraud lawsuits. Fee-shifting under H.R. 1058 as passed by the House of Representatives would allow for some element of judicial discretion in the shifting of fees and expenses and for that reason it is preferable to the automatic fee-shifting contemplated by Title II of H.R. 10 as introduced. However, the bill sets up a presumption in favor of awarding of fees and expenses to the prevailing party. A court would be able to prevent the shifting of fees to the losing party only if each of three demanding and fairly complex conditions are met. First, the court must conclude that the losing party's position was "substantially justified."[31] Second, the court must find that imposing the fees and expenses on the losing party is not unjust. And third, the court must find that the cost of such fees and expenses to the prevailing party is substantially burdensome or unjust. Unless all three requirements are satisfied, the court must shift all of the prevailing party's fees and expenses to the losing party.

Worse yet, the bill sets up an intimidating hurdle that any plaintiff must clear in order to be heard in court: Either the investors or their attorney would have to post a security at the beginning of a case to provide for the payment of the defendant's attorneys' fees and other expenses in the event that the court determines at the end of the case to shift these costs to the plaintiff. And, although defendants theoretically could be forced to pay the fees and expenses of a prevailing plaintiff, the requirement to post a security is imposed only on plaintiffs. It has been suggested that plaintiffs unable to obtain a bond could simply put up their homes to satisfy this requirement!

Defrauded investors, including those with the strongest cases, will not be able to stand up and sue, either on their own, or as the champion of a class of similarly situated investors, if by doing so, they are exposed to the risk of paying millions of dollars in legal fees to large public corporations, brokerages, accounting firms, and law firms. NASAA respectfully suggests that this provision should be rejected by the Senate.

Gaping loopholes in the recklessness standard. Under current law, as interpreted by virtually every circuit court, recklessness—as opposed to actual

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[30] Report of the Commerce Committee, to accompany H.R. 10, the "Common Sense Legal Reform Act of 1995," February 24, 1995, House of Representatives, Report 104–50, Part I, page 35. The Majority took exception to the CBO estimate and claimed that the only costs involved would be the "negligible" costs the SEC may incur for promulgating rules.

[31] Apparently, the "substantially justified" terminology was borrowed from the Equal Access to Justice Act (EAJA), which provides that certain persons who prevail in a suit brought by the Federal Government may recover attorneys' fees and costs if a court finds that the litigating position of the Federal Government was not "substantially justified." The "substantially justified" standard under the EAJA applies only against the Government; the statute was designed to enable individuals and small businesses to defend their rights in litigation with Government agencies that have a superior ability to sustain the costs of litigation. We agree with those who have observed that it does not necessarily follow that the same standard should govern investor lawsuits brought against corporate defendants.

knowledge—is sufficient to establish securities fraud. The courts have agreed that a strict requirement of actual knowledge would cause many violators to escape liability under the Federal securities laws. While we appreciated the willingness of the bill drafters to move away from the language in the bill as introduced which would have required actual knowledge as the standard for liability, we believe that, in the final analysis, very little has been gained.

The first sentence in the definition of recklessness essentially codifies the standard adopted by the Seventh Circuit Court of Appeals in *Sundstrand,* a version which we are told is applied in at least 75 percent of the Nation's Federal courts. After the word "consciously" was deleted, NASAA had few concerns about the first sentence of the definition.

It is the second sentence of the definition that has caused NASAA considerable concern. As adopted by the Commerce Committee, the bill contained what was dubbed the "I forgot" defense. Under that version of the bill, a defendant would have been allowed to invoke as an affirmative defense against a claim of recklessness the following: *"For example, a defendant who genuinely forgot to disclose, or to whom disclosure did not come to mind, is not reckless.* This was the actual statutory language contained in H.R. 1058 as it was approved by the Commerce Committee. NASAA objected to this language by stating that we were unaware of any other area of law in which a defendant is permitted to argue that he or she is not liable because he or she "forgot" to obey the law or because fulfilling a legal obligation simply "did not come to mind."

After considerable objections to the "I forgot" language were raised, the bill drafters offered on the House floor a handwritten substitute. This replacement language may be characterized as the "I forgot to investigate" standard. The wording of the second sentence of the recklessness standard now contains this gaping loophole: "If the failure to investigate was not deliberate, such conduct shall not be considered to be reckless." As such, the bill drafters essentially redefined recklessness to mean deliberate misbehavior. If the failure of such individuals to properly carry out their duties is not deliberate, they cannot be held to be reckless. This sentence makes a mockery of the recklessness standard and should be deleted.

Appointment of a plaintiff steering committee. Despite its initial allure, NASAA believes that establishing such a panel would be fraught with significant practical problems, most notably that it runs contrary to the thrust of modern litigation reform, which is to simplify, streamline and reduce the expense of litigation. In its place, NASAA has suggested that State securities regulators and the SEC be given discretionary authority to be heard in Federal class-action lawsuits on the fairness of proposed settlements. We believe that such authority would accomplish, in less cumbersome fashion, the objectives of those who support the concept of a plaintiff steering committee or guardian ad litem. In addition, NASAA would support efforts to encourage the courts to exercise more fully their authority under the Federal Rules of Civil Procedure to closely supervise the litigation to ensure the fair, efficient, and effective prosecution of class actions.

Heightened and unrealistic pleading requirement. Under H.R. 1058, investors who bring securities fraud cases would have to plead specific allegations which, if true, would be sufficient to "establish" that the defendant acted knowingly or recklessly. What that means is prior to discovery, when it is virtually impossible for plaintiffs to establish the facts that would be necessary to meet this new requirement, somehow the plaintiff would have to have this information and file it with the case. Even governmental agencies with all of their investigatory and subpoena powers (which are *not* available to investors) would have difficulty meeting this standard.

The most stringent test used today is that of the Second Circuit Court of Appeals and requires that plaintiffs plead with some particularity facts giving rise to a "strong inference" of fraudulent intent on the part of the defendant. There is a significant difference between having to allege facts that give rise to a "strong inference" that the defendant acted knowingly or recklessly and having to plead facts that "establish" that the defendant had the requisite state of mind.

Congress should not adopt any standard that goes beyond that used by the Second Circuit Court of Appeals. The real danger here is that such an onerous pleading requirement as that in H.R. 1058 would eliminate many meritorious cases. Also of concern here is the provision that plaintiffs may file only one amended complaint. In some of our most notorious frauds, plaintiffs have had to file several amended complaints. In the Keating case, plaintiffs amended their complaint six times. In the ZZZZ Best case, in which the perpetrator and 10 others were convicted of crimes, there were five amended complaints.

Reliance and fraud-on-the-market liability. Although the bill was modified during the House process and fraud-on-the-market liability was restored, it was done in such a manner as to limit the availability of the theory for fraud cases involving securities that are deemed to be "illiquid." Among other consequences of this limitation are those suggested by John Coffee, Jr., a securities and corporate law professor at Columbia University Law School (and a widely quoted proponent of litigation reform), who told the *Bond Buyer* that this provision would "substantially restrict the feasibility of a class action for municipal securities . . . [would] reduce the prospect that there [could] be an economically feasible means of litigating fraud for an issue of municipal securities. . . . Future suits like [those involving] the Washington Public Power Supply System and Orange County would be much more difficult to bring in the class-action setting."[32]

NASAA believes that the preferable approach here would be to assign responsibility to the SEC to develop rules that determine when the fraud-on-the-market theory should be available to protect investors, and when it would be unfair to use it.

Overly broad safe harbor for forward-looking statements. As stated previously, NASAA supports a reasonable safe harbor for forward-looking statements. Several of the legislative proposals before Congress leave it to the SEC to undertake rulemaking in this area. The SEC has been extremely responsive to the concerns expressed by corporate executives in this area and has undertaken an extensive inquiry into the operations of the current safe harbor. The expectation is that new rules will emerge from this responsible and thoughtful process.

On the House floor, an amendment was approved which contained the following key passage: "A person shall not be liable with respect to any forward-looking statement if the risk that such projections, estimates, or descriptions may not be realized is made part of the statement." The disclaimer in no way has to be linked to the forward-looking statement. For example, under the language approved by the House of Representatives, a forward-looking statement could appear on page 5 of the document and the disclaimer could be included in a footnote on page 35 of the same document. This led one observer to comment that "this isn't a safe harbor; it is a safe ocean." NASAA suggests that Congress go back to language encouraging the Commission to engage in rulemaking in this area—a process that already is well underway.

Finally, we find it ironic that, although the bill's sponsors have professed great concern about how it is that defrauded investors fare in legitimate lawsuits, they have steadfastly refused to incorporate into the bill provisions that would work to the benefit of defrauded investors. For example, the bill sponsors declined to: (1) lengthen the statute of limitations for securities fraud suits; or (2) restore aiding and abetting authority to the SEC and to private parties. These glaring omissions call into question the commitment of the bill's major proponents to protecting the rights of defrauded investors.

H.R. 10, THE "COMMON SENSE LEGAL REFORMS ACT"

NASAA believes that the package of reforms contained in Title II of H.R. 10 not only would have weakened, but indeed would have devastated, the twin purposes of private rights of action: Recovery for past harm and deterrence of future harm. If, despite the present scheme of regulation and litigation, we still have witnessed the immense financial frauds of the 1980's and early 1990's, what should we expect under a "reformed" system, where co-conspirators are not held to account for the entire harm of the conspiracy, where even to get to court plaintiffs are exposed to loser pays liabilities that cannot be sustained by the average investor, or where recklessness would be licensed as appropriate conduct?

NASAA told the House Telecommunications and Finance Subcommittee that it was our view that Title II of H.R. swept far more broadly than what reasonably could be considered reform. Although NASAA remains opposed to H.R. 1058 as it passed the House, we recognize that the final version of the bill represented a modest improvement over what was in the bill as introduced. The most egregious provisions of Title II of H.R. 10 as introduced included:

- Imposing a mandatory and automatic "loser pays" rule;
- Moving from a recklessness standard for liability to a requirement of actual knowledge;
- Shielding certain professional groups from liability by greatly narrowing the range of misconduct that is actionable;

[32] Lynn Stevens Hume, "House Panel's Bill Could Prohibit Class-Action Suits in Muni Market," *The Bond Buyer*, February 23, 1995.

- Eliminating "fraud-on-the-market" liability;
- Establishing heightened and potentially unrealistic pleading requirements;
- Requiring the appointment of a guardian ad litem or plaintiff steering committee; and
- Injecting financial "means testing" for judicial access.

Finally, as is the case with H.R. 1058, Title II of H.R. 10 did *not* contain the following reforms recommended by NASAA: lengthening the statute of limitations in the wake of *Lampf* decision; and restoring aiding and abetting liability in the wake of the *Central Bank* decision.

S. 240, THE "PRIVATE SECURITIES LITIGATION REFORM ACT"

As discussed previously, NASAA was among the critics of S. 1976, the securities litigation reform proposal considered during the 103rd Congress. NASAA's objections to the provisions of that bill may now be applied to S. 240, which is identical to S. 1976. NASAA's concerns with S. 240 center around the following provisions:

- Limitations on joint and several liability;
- An extension of the statute of limitations based on a "reasonable diligence" standard;
- Requiring the appointment of either a guardian ad litem or a steering committee to direct the course of the litigation;
- Introducing the concept of "means-testing" for access to justice;
- Replacing, in certain instances, the longstanding national policy in favor of access to justice whereby each side in a dispute pays its own fees and costs with a "loser pays" provision;
- Imposing unreasonable standards for fraud pleadings; and
- Establishing a questionable system of self-regulation and discipline for accountants.

Each of these issues is discussed in greater detail in Section IV of this document. In addition, the bill continues to suffer from its failure to address the issue of aiding and abetting liability under Section 10(b) in the wake of the Central Bank decision.

Despite NASAA's concerns about certain provisions of these bills, we nonetheless believe that there is considerable middle ground and room for discussion on this important issue. NASAA would extend an offer to sit down and discuss reasonable reforms with any Member of Congress and staff who is interested in developing a reform initiative that balances the need to curb frivolous litigation with the need to preserve private remedies for defrauded investors.

VI. Conclusion

Mr. Chairman and Members of the Subcommittee, NASAA believes that it *is* possible to craft litigation reform measures that target abusive practices without sacrificing the opportunity for redress and recovery for defrauded investors. NASAA encourages Congress to seriously entertain the components of any bill that is designed to achieve this necessary balance. The Association looks forward to working with you and other interested Members of the Senate to resolve the debate over securities litigation reform. NASAA will evaluate any reform proposal based on the guideposts set out in Section IV of this statement. In the final analysis, NASAA will support the course of action that we determine is in the best interest of small investors.

NASAA understands that the issue of litigation reform did not appear overnight and that Members of Congress, regulators, the business community and others have been considering this issue for at least 2 years now, if not longer. However, it is fair to say that H.R. 1058, Title II of H.R. 10 and S. 240 each contain features that would radically transform the system of private enforcement of the securities laws and should not be dealt with in haste. Rather, NASAA respectfully encourages this Subcommittee to consider more carefully crafted legislation that would deter frivolous or meritless lawsuits while preserving the ability to litigate meritorious cases.

Thank you.

SECURITIES LITIGATION REFORM PROPOSALS—S. 240, S. 667, AND H.R. 1058

THURSDAY, APRIL 6, 1995

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, DC.

The Subcommittee met at 3:27 p.m., in room SD–538 of the Dirksen Senate Office Building, Senator Phil Gramm (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF SENATOR PHIL GRAMM

Senator GRAMM. The hearing will come to order.

Let me begin by apologizing to everyone. We had a Republican conference, and then we had to vote at 3:05 p.m. And so, I think my colleagues are going to be straggling in.

If Senator Mikulski is here, we will go ahead and begin with her. If not, let's begin with the Chairman of the SEC, Mr. Arthur Levitt, Jr.

OPENING STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Mr. Chairman, if he's coming up, I just ask unanimous consent to put some opening comments here in the record.

We now have, I think, 40 cosponsors on this bill, half the Members of this Committee. And hopefully, we can get a mark-up in the next month or so after we get back from recess.

But I want to thank you for holding these hearings. We've got a great record developed on this bill now with this third and final hearing.

Senator GRAMM. Let me say, Senator Dodd, I want to thank you for your leadership on this issue. I want to assure you, that as soon as we get back from the recess, it's my intention to start the mark-up process. We will begin informally, to get everybody together who is in favor of moving forward, see where we are, see how we might combine ideas on the House bill with your bill as the primary focus in the Senate. We will carefully consider any new ideas, see if we have a consensus, and try to move ahead.

I'm going to forego an opening statement. But certainly, my colleagues have the right to have one.

OPENING STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Well, Mr. Chairman, I'll be brief.

I first want to say that I'm pleased that this Subcommittee will be hearing today from Arthur Levitt, the Chairman of the SEC.

In prior public speeches and in congressional testimony, the Chairman has advocated a balanced approach on this issue. He has in fact put forth a number of specific reforms of the securities litigation system. At the same time he has stressed that any changes must preserve the system's ability to deter securities fraud and to compensate victims of fraud, and I think that's a very important balance, as I stressed on previous occasions.

So I look forward to hearing the views of the Commission on the bills passed by the House, the bill introduced by Senator Dodd and Senator Domenici, and the bill put in earlier this week by Senators Bryan and Shelby.

I listened to earlier testimony on this issue with a great deal of interest. A number of witnesses have described how easy it is to file frivolous lawsuits and how it is often cheaper for companies to settle such cases rather than fight them.

I don't know of much disagreement that the securities litigation system ought to deter frivolous cases from being filed and weed them out if they are filed.

I am concerned, though, that some of the provisions in the pending legislation would deter investors from filing meritorious cases. If we were to lose that element of private enforcement of proper behavior in the markets, I think we would well undermine investor confidence on which the securities market so much depends.

If investors don't have confidence in the markets, companies will find it more difficult to raise capital, thereby inhibiting economic growth and harming not just investors but the entire economy.

The American securities markets are pre-eminent in the world and they've achieved that status in part, at least in my judgment, because we have had a focus on safety and soundness.

Obviously, when it comes to crafting legislation, the very fine judgments between throwing the baby out with the bathwater are going to have to be made, and I think it's around that issue that the discussions will have to focus when we come to a mark-up.

I hope we'll be able to look at the various provisions in a very tough-minded, rational way and try to evaluate them on the basis of what the factual situation is, what the problem is, and how best to address it. And of course, in that regard, I and others, I think, look to the Securities and Exchange Commission, which has this very direct responsibility which it has carried out over its history with commendable ability. We look to the Commission for its views.

Thank you very much.

Senator GRAMM. Senator Bryan.

OPENING STATEMENT OF SENATOR RICHARD H. BRYAN

Senator BRYAN. Thank you very much, Mr. Chairman. I want to commend you for convening this hearing today on securities litigation reform.

To state the obvious, deliberations on this topic without hearing from the Chairman of the Securities and Exchange Commission would be missing, in my judgment, the individual who is most responsible in terms of public-sector responsibility for protecting the integrity of our financial markets.

I would like to welcome the Chairman here today and to commend him on his leadership and the outstanding job he has done

as Chairman of the SEC in terms of maintaining and assuring the world that our financial markets operated by the highest standards.

Earlier this week, Senator Shelby and I introduced the Private Securities Enforcement and Improvement Act of 1995. I would like to commend my colleague from Alabama for his help in crafting this legislation.

While that bill takes strong steps to deal with abuses such as referral fees, I believe it addresses the problems without damaging the system that is so critical in helping to police our financial markets.

Very briefly, Mr. Chairman, I would like to share a letter, a portion of a letter that I received from the North American Securities Administrators Association. As everyone knows, this is the association which represents the 50-State securities administrators in the respective States who have the responsibility for investor protection and the efficient functioning of capital markets at the grassroots level, and I quote:

> In NASAA's view, the challenge is to identify ways to make the litigation system more fair and more efficient while preserving the essential role that private actions play in supporting the integrity of our financial markets.
>
> The Bryan-Shelby bill, S. 667, is a responsible and fair reform proposal that targets frivolous lawsuits without undermining the entire system of private actions.
>
> S. 667 meets the challenges of achieving balanced litigation reform and, as such, is enthusiastically supported by NASAA.

Mr. Chairman, with your indulgence, I would like to ask unanimous consent that this letter be made a part of the record.

Senator GRAMM. Without objection, the letter will be printed in the record.

Senator BRYAN. I thank the Chair.

Most reasonable people believe that private litigation is a crucial adjunct to the SEC in policing our financial markets. Most reasonable people believe that key to the success of our financial markets is public confidence. Those are the two linchpins that should guide our consideration of any reform legislation.

When one asks the question—do we want to get rid of abuses and frivolous lawsuits?—my answer is emphatically, yes. But in so doing, we do not want to jeopardize the foundations that have made our financial markets the envy of the free world

I have some concerns, Mr. Chairman, that if we raise the bar too high in terms of the ability of investors to see recovery when they have been defrauded, we will put that public confidence in jeopardy.

Should, for example, a defrauded victim have to prove specific facts demonstrating the state of mind of each defendant? Imposing such a standard, in my view, would create an almost insurmountable barrier to recovery for legitimate losses.

Should we put the fear in small investors that they might have to pay the attorneys' fees for a huge corporation if they are unsuccessful in their litigation? My answer to that inquiry is equally emphatically, no. That is such a deterrent as to have a chilling effect on filing legitimate claims.

Should we force small investors to accept pennies on the dollar because they can't fully collect against professionals, maybe law-

yers or accountants or others who help scam artists perpetrate the fraud? Again, my answer would be an emphatic no.

At some point in time, this Subcommittee will have to decide whether to substantially reduce the amount victims can recover, in the all-too-common situation where a primary wrongdoer, like a Charles Keating, is bankrupt, jailed, or has fled the country.

I know we would not ask or expect the Government to accept those kinds of restrictions. And the SEC, in my judgment, has done an outstanding job in policing our financial markets to the best of their abilities and resources.

We ought not to handicap them in performing this function. But we also should not handicap individual investors in whom the SEC counts for their help and their assistance in making those free markets the world's safest and the most stable.

Mr. Chairman, Chairman Levitt will tell us today, and I quote:

Our first goal must be to protect investors and to preserve and strengthen our capital markets. Private litigation serves as a vital element in the enforcement of Federal securities laws.

Mr. Chairman, I thank you for your indulgence. I'm going to have to leave for another meeting shortly, so I may not be able to participate in the colloquy. But I would ask that my full statement be made a part of the record.

Senator GRAMM. It will be made a part of the record.

Senator Faircloth.

OPENING STATEMENT OF SENATOR LAUCH FAIRCLOTH

Senator FAIRCLOTH. Thank you, Mr. Chairman, and thank you for calling this hearing.

As I have said at the other two hearings on this same issue, I am a strong supporter of security litigation reform, and I am a supporter of overall legal reform in general.

These endless lawsuits are clogging our courts. They're sapping the productivity of the country. From 1980 to 1993, the number of civil cases in Federal courts increased by 73 percent. This does not even include State courts. Some have suggested that the indirect cost of this litigation is over $300 billion a year.

With respect to security litigation, the money that companies spend on fighting lawsuits could be used for the increase of productivity in this country. This is an important issue for the future of the country. The money could be used for capital projects, research and development and the creation of new jobs.

When the securities industry's association testified here before, they pointed out that at the end of 1993, pending class-action lawsuits against companies sought then at that point were $28 billion in damages.

This is a heavy tax on corporate America and it's being transferred to lawyers.

I have the highest respect for Mr. Levitt and I look forward to his testimony. I also would like to note that he is doing a good job by trying to develop a safe harbor for forward-looking statements. This will allow companies to honestly project their earning capabilities without being subject to lawsuits.

I urge him to keep moving on this issue and I thank you, Mr. Chairman.

Senator GRAMM. Thank you, Senator Faircloth.
Senator D'Amato.

OPENING STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Thank you, Mr. Chairman. Let me again commend you, Senator Dodd and Senator Domenici, for holding these hearings and for introducing legislation to deal with frivolous lawsuits.

I ask that my full statement be placed in the record as if read in its entirety. I am very interested in hearing from Arthur Levitt, the Chairman of the Securities and Exchange Commission, which aspects of reform he believes are most necessary to reduce frivolous lawsuits.

Also, I think it is important to learn which aspects of reform he is most concerned about, and why? This Subcommittee is working hard to produce a balanced piece of legislation, and will value Chairman Levitt's thoughts on litigation reform.

I thank the Chair.

Senator GRAMM. Thank you, Senator D'Amato.

We have our dear colleague, Senator Mikulski, here now. What I would like to do is to allow her to make her statement. Then we will go to Chairman Levitt's opening statement.

OPENING STATEMENT OF BARBARA A. MIKULSKI U.S. SENATOR FROM THE STATE OF MARYLAND

Senator MIKULSKI. Thank you very much, Senator Gramm.

Mr. Levitt, thank you very much.

I, too, must go to another hearing.

I'm here in support of the Dodd-Domenici liability reform. I'm here to do that because I think it is in the interest of the consumer. I think it's in the interest of American business. And I think it's also in the interest of enabling accountants to get on doing what their job needs to be, which is advising business on the best way to conduct their business rather than chasing all around on frivolous lawsuits.

Mr. Chairman, this Committee, I know, is deliberating reform and I hope that we would take a look at the fact that what we're now facing is an increase in lawsuits being filed alleging securities fraud that are based on nothing more than a dramatic change in the price of a company's stock.

Accountants in my own State of Maryland tell me that some attorneys are paying stockbrokers and others a bounty in return for identifying who they should sue. Accountants are being lumped into these securities lawsuits that are filed at the courthouse just hours after a change in the stock price.

Now, I'm opposed to the race-to-the-courthouse mentality that ends up in needless lawsuits that have huge litigation costs. I want to see the courthouse door always kept open for the little guy. But let's get rid of the bounty hunter law and let's get bounty hunter law under control.

That's why I support the Dodd-Domenici bill. I won't go into the aspects of the bill. I know they will go into it in a great deal of detail.

I do know that professional liability insurance is increasingly high. It disrupts the work of an accountant. It disrupts the work of a firm. And it even affects the companies that accountants are willing to take as clients.

My own State is an entrepreneurial State and we know that the new jobs will come from high-tech companies. But these are the companies most often in need of the breadth of services offered by accounting firms and also, these are exactly the firms that then are brought into these types of securities liability lawsuits.

So, Mr. Chairman, I could go through this in great detail. But I think this is a time that we look at liability issues and liability reform not on a partisan basis but in an American basis. And what is in the best interest of business, what is in the best interest of the consumer and we've got to get rid of bad law and bad lawyers who will essentially take advantage of these types of situations.

Senator GRAMM. Let me thank the distinguished Senator from Maryland, whose views are always respected by all of her colleagues. We appreciate your testimony.

Chairman Levitt, let me say at the beginning, that we will print your entire statement in the record.

I think it is clear that we are going to pass securities litigation reform in this Committee. I think nobody wants to deny people the right to go to the courthouse to get justice. But I believe we have a majority of Members in the Senate and in the House, who are determined to stop the piracy of the system, a piracy which not only takes money away from legitimate investors, but a piracy that slows economic growth and that hurts everybody in this country.

As one of our colleagues said here in a statement that I didn't fully agree with, but I agree with his point, obviously we want to try to find a balance. We want to try to find a balance between a runaway system, on one hand, where piracy yields great profits, the costs of which are spread among people who are trying to create jobs and generate growth.

And on the other hand, we don't want a reform that would limit the ability of people with legitimate cases from taking them to court. It's finding that happy balance that we seek. Your testimony is important to that effort.

So let me ask you to go ahead and give us your statement.

OPENING STATEMENT OF ARTHUR LEVITT, JR. CHAIRMAN, THE SECURITIES AND EXCHANGE COMMISSION WASHINGTON, DC

Chairman LEVITT. Chairman Gramm and Members of the Subcommittee, I appreciate this opportunity to testify on behalf of the Securities and Exchange Commission regarding proposals to reform the system of private litigation under the Federal securities laws.

Mr. Chairman, I begin by noting that although I find myself in the midst of one of the most contentious debates over legal remedies in our Nation's history, I am not now, nor have I ever been, a lawyer.

[Laughter.]

But in this case, that may be as much an asset as a liability.

My background is in business. And while I cannot address the fine points of legal history and court decisions that end up provid-

ing so much of the fodder for this debate, I guess I can speak of the practical impact of our system of litigation.

As you know, I've managed enterprises in fields as varied as finance, agriculture, and publishing. I've built small businesses into large companies. And I personally know the cost of meritless litigation—the time, the money, and the anxiety.

My experience on the boards of more than a half-dozen major public companies may also be instructive. In each case, my procedure in deciding whether or not to go on these boards was to make sure that the company had sound management, the board members had good reputations, and the company was able to insure its directors.

These questions arose from, I think, a healthy concern about liability. And indeed, the private right of action served those companies well by reinforcing the conscientiousness of their directors.

But there's yet another side to the story.

There's the dozen or so entrepreneurial firms whose invitations I had to turn down because they could not adequately insure their directors. Some of those companies later turned out to be huge successes. Some of them failed. While I like to think I would have made some small contribution had I been able to serve those firms, countless colleagues in business have had the same experience. The fact that so many people, so many qualified people have been unable to serve is to me among the most lamentable problems of all.

Mr. Chairman, I've seen so many charts that try to prove a point about our litigation system, charts that show there is a crisis, charts that show there is no crisis, charts that show there's an explosion in litigation and others that show there's no explosion.

I think from a businessman's point of view, the most important chart of all is one that I suspect we will never see. And that is the chart of opportunities missed, the knowledge and experience not applied, companies whose growth was hindered and the enterprises that folded or never were, all because of the fears and flaws connected with our litigation system.

And these flaws are magnified in their effect on entrepreneurs and professionals.

I think we've wasted too much time on the wrong question—is there a crisis? The right question is can the system serve our Nation better? And the answer, I suspect, is a resounding yes.

The SEC, of course, has a clear interest in this issue. We believe that private rights of action are fundamental to the success of our markets and that they are an essential complement to our enforcement program. They play a significant role in helping to ensure full and fair disclosure.

The Commission must oppose any measures that would eviscerate investors' legitimate remedies against fraud. But at the same time, there is no use in denying that there are problems, serious problems, in the current system, and that investors, markets and corporations are being hurt by systemic flaws.

We must do something to reduce the excessive cost of a litigation system that threatens the vitality and competitiveness of our U.S. economy.

I've made it clear that the SEC is prepared to work with any group, examine any idea, entertain any proposal, consider any per-

spective if it will help resolve this contentious issue without compromising investor protection.

Over the last year, I guess I've conducted a form of shuttle diplomacy with all parties to the debate—the National Association of Manufacturers, representatives of the plaintiffs bar, State securities administrators, the AICPA, the AARP, investor rights groups, Federal judges, the SEC's consumer affairs advisory committee, corporate executives and countless others, trying to move this dialog along.

The Commission supports a number of measures designed to eliminate abuses in class-action lawsuits. And I'm more convinced than ever that in these areas, a consensus can be reached.

Virtually all parties agree with us that lawyers should not pay referral fees to brokers who bring them clients, that named plaintiffs should never receive bounty payments. We need to set a class organization period or another method of eliminating that dreadful race to the courthouse. That disclosure to class members must be improved. And that the private plaintiffs' legal fees should not be paid out of SEC disgorgement pools.

Most parties also concur that civil RICO charges in and securities fraud cases, and their treble damages should be prohibited.

The Commission believes that meaningful improvement to the existing system can be accomplished through a combination of legislation, increased judicial activism in the case management process, and the Commission's use of its own rule-making and interpretive authority.

Any revisions of the law clearly should not apply to SEC enforcement actions, which, if anything, would rise in importance to the extent that private action is modified.

In terms of our own rule-making, the Commission is already engaged in the process of reviewing the adequacy of the safe harbor protections we grant companies for their disclosure of forward-looking information.

This action alone could have significant impact on the litigation practices. We hope to issue a proposal soon.

We will continue to file amicus briefs in support of motions to dismiss or requests for sanctions under Rule 11. We've also created a litigation analysis unit in the office of the general counsel.

Turning now to the legislation before us, we are concerned with some of the provisions in H.R. 10, the first securities litigation reform measure introduced in this Congress. While H.R. 1058, the measure that passed the House, was an improvement, we still have significant concerns about some of its provisions.

I view S. 240, the legislation introduced by Senators Domenici and Dodd, as a positive step toward improving the private litigation system. To a large degree, I am in accord with the objections of S.240, as well as a significant number of the measures chosen to accomplish them.

I urge all of us to work together to make certain improvements in the bill, including the adoption of the Second Circuit's pleading requirement that plaintiffs plead with particularity with facts that give rise to a strong inference of fraudulent intent by the defendant; the restoration of aiding and abetting liability; the adoption of

an expanded statute of limitations that is not limited by a should-have-been-discovered clause; the inclusion of specific language that confirms the Commission's authority to provide a safe harbor for forward-looking information; and finally, the adoption of the Sundstrand definition of recklessness.

Let me add that I am aware of the bill introduced earlier this week by Senators Bryan and Shelby. While I have not yet been able to thoroughly examine the bill, I believe it represents a very thoughtful approach to the problem.

My colleague, Commissioner Rick Roberts, who has examined the bill in detail, does endorse that legislation.

Mr. Chairman, both the Commission and the Congress recognize the dangers that flaws in the existing system pose to investors, to companies and to our Nation. We've come a long way toward crafting thoughtful legislation to address the problem.

I think we're really down to the last 5 yards. It would be a happy circumstance for this Nation if the Commission and the legislative and the executive branches were able to combine forces and move together to achieve a bill that protects investors and corrects these problems in the litigation system.

For my part, I have no doubt that if we continue to work together, we can and we will score a victory for all Americans.

Thank you.

Senator GRAMM. Thank you, Mr. Chairman.

Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Chairman Levitt, I want to thank you for your presentation.

First, what is the one area of reform that you think is most necessary?

Second, what concerns do you have, if any, with the current legislation?

Chairman LEVITT. Well, as far as the areas that I think need improvement or modification, I would say that the standards for pleading a defendant's state of mind should be conformed to the Second Circuit standard, that plaintiffs plead with particularity facts that give rise to a strong inference.

Senator D'AMATO. A number of witnesses have raised that concern, and I believe that section will be modified.

Chairman LEVITT. And I think that using the Sundstrand standard of recklessness would give a clarification that I think indeed would avoid the kind of confusion that would result from the present wording.

Those two areas are probably the most important. But also the others that I mentioned before, I believe that the Congress should give the authority to the Commission that my general counsel advises us that we may lack, to move ahead with the expansion of the safe harbor provision that we are presently in the process of doing.

I really believe that that would give a measure of flexibility to that process. By freezing the Commission out from being involved in the safe harbor procedure, I believe that we cannot be responsive to the kinds of changes that the future may bring.

Senator D'AMATO. OK. Is there any other area of concern? What is the area that you believe does the most to improve, or those areas that do the most to improve the present situation that we are operating under?

Chairman LEVITT. It's like splitting the baby into pieces. But I would say prohibiting the payment of additional compensation to plaintiffs, cutting out the race to the courthouse that I feel is so emblematic of what's wrong with the system.

Prohibiting the payment of lawyers' fees from Commission disgorgement pool. Eliminating the overlap between private remedies under RICO and the Federal securities laws. Providing procedures for accountants in detecting possible fraud, and reporting it to the issuers' board.

Senator D'AMATO. What about proportionate liability? Does the Commission view the present status as an abuse or one that holds, for example, accounting firms and others, to a higher degree? Not only to a higher degree, to a degree of payment that they would not otherwise be subject to if their liability is 2 or 3 percent, if they then are faced with picking up the balance, being the people who are so-called, the deep pockets. What about that?

Chairman LEVITT. I think there are clearly inequities in this area. As the bill is presently crafted, proportionate liability is extended for fraud-on-the-market in most instances. But joint and several is appropriately reserved again for willful misconduct and reserved for issuers. And I think that's an appropriate way of positioning it.

We'd like to work with the Subcommittee in terms of the precise language because we're going to be employing this for many years to come. And I think that I share your concern about accountants being unfairly charged for amounts that go far beyond their involvement in particular fraud. I think the bill is on the right track there. But I do think some of the wording is confusing and we would like to work with you to improve that.

Senator D'AMATO. I would just leave you with this thought. I think our staffs, and I know that we have been meeting now as a Subcommittee, Republicans and Democrats, work through some of these very highly-technical issues. But I think we're all headed in the same direction.

We want fairness.

Obviously, where there's fraud, where there is willful conduct by an issuer or by someone in a fiduciary responsibility or a very important capacity, that's a different matter. If they're the only ones left standing and they've occasioned this, then we should go after them. As distinguished by those who are in some cases brought in simply because they have some economic power.

I would hope that in the days ahead, our staffs could really set aside the time to work together to eliminate some of these difficulties and to have clarifying language and legislation.

And I want to thank the Chairman.

Thank you, Mr. Chairman.

Senator GRAMM. Senator Sarbanes.

Senator SARBANES. Senator Bryan has a meeting.

Senator GRAMM. Senator Bryan.

Senator BRYAN. Thank you very much, Senator Sarbanes.

Let me say, Chairman Levitt, that I agree with that list that you believe ought to be included that, at least on the printed part of your testimony, on page 3, the pleadings standard, the inclusion of expressed language confirming the Commission's authority to provide a safe harbor, all of those provisions.

I think that you are correct and I might just add parenthetically, that Senator Shelby and I have included those provisions in our proposal.

I think it would be helpful if we have some context. We all agree that there are suits that ought not to have been filed and that are frivolous. There is no disagreement, I think, with that fundamental premise. But in terms of drawing that balance that both the Chairman and I and others have commented, we need to get some perspective as to how serious the problem is.

Now I am told that in 1974, that was more than two decades ago, there was filed some 305 cases involving security class-action lawsuits, and that 21 years later, there were some 290 cases.

In other words, that does not set the premise for the litigation explosion. That is not to suggest that every one of those cases is meritorious. But this comes from the administrative office of the U.S. courts.

So 21 years ago, we had 305 cases filed. The last year in which we have data, 1994, we had 290 cases filed. And approximately 14,000 public corporations report annually to the SEC, and that on an annual basis, about 120 of those companies are the subject of these class-action litigations, 120 out of 14,000.

So my question to you is can you give us any sense, how much fraud is out there? Is this much ado about nothing? Or is fraud out there in the marketplace a very serious issue?

Chairman LEVITT. I suspect that the answer is probably somewhere in between. I have never seen an issue, never experienced an issue where claims on both sides were more overstated than this one.

From my exposure to the business community, I can say to you that this is clearly the number-one issue on their minds. And I've seen statistics which indicate that there is a great deal of misuse of the process and I've seen other statistics such as those that you've cited that suggest that the problem is not as great as has been expressed.

I simply cannot evaluate either of those claims, except to say that there are problems. I think that your bill appears to have a number of very constructive ways of addressing the problems.

I think it's just terribly important that whatever bill comes out of this, one would hope, would eliminate some of the worst problems, provide an opportunity for the Commission to continue its very important partnership with the self-regulating organizations, and continue to permit those private rights of action that make our system a good one.

Arriving at that balance in a way which the Congress and the Administration and the bar and the SEC can all support in harmony would be nirvana.

Maybe we won't all get there, but I hope most of us do.

Senator BRYAN. The former Chairman of the Securities and Exchange Commission, Mr. Breeden, in testimony before us sometime

back indicated, and this is my language, not his, I want to be clear on that, but in effect, if we raise the bar too high to private actions, that, in effect, and he served at the time, the SEC would have to hire some 800 additional people to, in effect, monitor the securities markets.

Give us your sense in terms of the consequence. If we strike this balance and we set that standard so high that, in effect, it has a chilling effect on legitimate claims, does that not create a substantial problem, not only for the securities markets, but particularly in terms of your ability to enforce?

Chairman LEVITT. I think it does create a considerable problem. I think it creates a problem in terms of resources. And I think the responsibility of the Congress, in my judgment, is to arrive at a balance that does not set that standard too high because if it does, I don't think there are resources that the Commission has available to it or could ever have available to it to remedy the damage that could be done by that.

Senator BRYAN. The Dodd-Domenici proposal has a "loser pays" provision in that. What is your opinion of that provision in terms of being a deterrent or a chilling effect on legitimate claims that might be filed through private action?

Chairman LEVITT. I think there are much better ways to arrive at solutions to this problem than the loser-pays formulation.

From the standpoint of my mission, my obsession, if you will, on behalf of investors, I cannot possibly condone a system which freezes out the right of access to the courthouse for individuals because of their economic circumstance.

But I believe that there are other alternatives in this legislation which can accomplish that same goal. I would hope that that would not include a loser-pays provision.

Senator BRYAN. Mr. Chairman, thank you very much. And Senator Sarbanes, for your courtesy.

Senator GRAMM. Thank you, Senator Bryan.

Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

First of all, I'm probably not going to be here for former Chairman Breeden. But the reference to which Senator Bryan made with some testimony before this Subcommittee, in fact, in which he said—well, today he's saying that the heart of the investor protection system is the SEC, not the professional plaintiffs. But then he said, as Chairman:

> Private actions under Sections 10(b) and 14(a) of the Exchange Act have long been recognized as a necessary supplement to actions brought by the Commission, and as an essential tool in the enforcement of the Federal securities laws.
>
> Because the Commission does not have adequate resources to detect and prosecute all violations of the Federal securities laws, private actions perform a critical role in preserving the integrity of our securities market.

I take it that you agree with that quote, as I hear your testimony here today.

Chairman LEVITT. Yes.

Senator SARBANES. And did I understand you to say that there's no way the Commission alone could in effect police the market adequately?

Chairman LEVITT. I think we have a remarkable balance between the Commission, self-regulating organizations, and private

rights of action in doing a job that certainly the Commission could not do alone.

Senator SARBANES. Now, on the joint and several questions that Senator D'Amato put to you, we had some interesting testimony at a previous hearing on this question of proportionality, damage and so forth, and the distinction, as I understood it, was that the investor who had been defrauded ought to be made whole first.

Assuming that, you would then have proportionality amongst those who would pay. But that there's a balance to be struck in the sense that if you have proportionality in such a way that the investor is not made—the investor has actually been defrauded and found to have had a meritorious claim. Then you have all these other parties that are liable that have been involved to one degree or another.

Amongst them, assuming that they're all in a position to pay, proportionality makes a great deal of sense and the investor is compensated.

But if they're not all in a position to pay, do you have a view, then, on where the burden ought to fall as between the investor, who had been defrauded and would not be compensated, and the various participants in the fraud who would share the payment?

Chairman LEVITT. I think that in those instances where conduct was willful fraud or in those instances where we're talking about an issuer, that joint and several liability should still apply.

I think when we're talking about other instances, such as a proportionate liability scheme that was limited to fraud-on-the-market cases where the conduct may have been reckless, I believe that that would be a fair way of balancing it. Perhaps you might even consider, to be responsive to instances where accountants are being assessed because of their deep pockets many times more than what their proportionate responsibility might have been, a possible cap of some sort.

I think you could use some of these formulations. I think the bill before us now is a step in the right direction in that it distinguishes between willful fraud and the interests of issuers, and other kinds of litigation where it assesses a proportionate formulation.

Senator SARBANES. The bar association of the city of New York, in reviewing S. 240, found that the bill's provision on alternative dispute resolution is neither voluntary nor nonbinding because the bill provides substantial sanctions for, A, not participating in the alternative dispute resolution procedure or, B, not accepting its results. What is your view on the alternative dispute resolution?

Chairman LEVITT. I think it's a very interesting notion. I don't know that I clearly understand its total application in this case, but I think it's one of a number of alternatives that should be explored to try to get this process moving and to try to eliminate some of the cases that really are burdensome and redundant.

Senator SARBANES. Now, as I understand it, it's your view that the pleading requirement more stringent than that adopted by the Second Circuit would be undesirable. Is that correct?

Chairman LEVITT. Yes, because I think this notion of state of mind is so vague and open to so many different interpretations, that I really believe that we should conform to the Second Circuit

standard that plaintiffs plead with particularity facts that give rise to a strong inference of fraudulent intent. And I think by codifying that, we accomplish pretty much what we intend to accomplish with respect to pleadings.

Senator SARBANES. Mr. Chairman, one final question, if I may. I see the red light is on. But I want to address the recklessness standard, which we've heard criticism of.

On the other hand, the standard as enunciated in the 7th Circuit in the Sundstrand case, and let me just quote it, defined a reckless omission as:

> A highly unreasonable omission involving not merely simple or even gross negligence, but an extreme departure from the standards of ordinary care, and which present a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

That seems to be a fairly stringent definition of recklessness.

Now, people are asserting, well, almost anything can be found to be reckless. But I don't see how under that standard, that one could say almost anything could qualify as reckless under the Sundstrand standard as I've just read it. As I understood it, you're in favor of the Sundstrand standard on the recklessness issue.

Chairman LEVITT. Yes, I am because I think using the standard of actual knowledge would be an extremely difficult standard to meet in almost any case.

I think, again, by codifying the 7th Circuit Sundstrand case, I think we really accomplish what the bill is intending to accomplish.

Senator SARBANES. Thank you.

Senator GRAMM. Thank you. Thank you very much, Mr. Chairman. We appreciate your testimony.

We next have two former members of the SEC, former Chairman Richard Breeden and former Acting Chairman Charles Cox. If they would come to the table.

Gentlemen, let me thank you for coming today. I will put your full written testimony in the record. And let me begin by turning to Richard Breeden.

Richard, I want to thank you for coming. I want to thank you also, Charles, for coming and testifying today. I think it's important that we hear from the current head of the SEC. But I think it's also important that we hear from people who not only have done that job, but that have had an opportunity to look back on it, reflect back on it. When I decided to have Arthur Levitt come today, I thought it would be helpful to the Subcommittee and helpful to me to have two people testify who have held that position before and who are now out in the real world, so to speak.

And so, Richard, go ahead and make your statement.

OPENING STATEMENT OF RICHARD C. BREEDEN
CHAIRMAN, INTERNATIONAL FINANCIAL SERVICES
COOPERS & LYBRAND L.L.P.
FORMER CHAIRMAN
SECURITIES AND EXCHANGE COMMISSION, NEW YORK, NY

Mr. BREEDEN. Thank you very much, Mr. Chairman. I appreciate the opportunity to be here with you. I also appreciate the opportunity to participate with Charles. Between the two of us, we have acted on nearly 3,000 enforcement actions brought by the SEC.

So I think there is a rather considerable base of real-world experience going from 1983 to 1993, between the tenure of our two terms.

I appreciate the opportunity to testify concerning an issue of the utmost importance for the health of our capital markets.

During my tenure at the SEC, I frequently spoke out through both speeches and testimony concerning the need for a vigorous program of investor protection.

However, I also spoke out frequently against the dangers of growing abuses in the system of private litigation under the Federal securities laws.

As early as 1991, I began to work with Senators Dodd, Domenici, Sanford and others on earlier versions of what is now S. 240.

At the risk of ruining any suspense and rendering moot the remainder of my testimony, let me get to the bottom line. While it doesn't go as far in some areas as I would like to see it go, as undoubtedly others might like to see it go, S. 240 is, in my view, an extremely thoughtful and well-balanced piece of legislation.

Our economy and our legal system are suffering every day from open and notorious abuses in private securities litigation and this bill will make long overdue corrections. You could pass this bill as is without changing a comma tomorrow—and incidentally, it would be nice if you did—and the country, in my opinion, would be better off.

In an attempt to perpetuate the rich spoils a few, a very few, lawyers reap under the status quo, there will be many dire predictions that various provisions in S. 240 will hurt investors severely. Those predictions, in my judgment, are wrong for at least three reasons.

First, this bill has had careful consideration for several congresses. There have been extensive and, I believe, successful efforts to balance and harmonize different competing interests. Ultimately, there is not any perfect formula for reconciling the competing concerns of all involved parties.

Given the sheer volume of case law under the securities laws, opponents—actually, opponents of doing anything at all—can endlessly raise detailed legal issues that ultimately involve similar questions.

Details are important, but after four years of work on this legislation, it's a very careful bill. To me, it's much more important that we summon the will to act and to begin to solve a real-world problem that damages the American economy every day of the week than that we let ourselves be immobilized too long by lawyers' debates.

Second, the heart of the investor protection system is the SEC, and I'm sorry Senator Sarbanes left because my two statements are quite consistent. I said before that private actions supplement in the quote he read the activities of the SEC, and they do in fact supplement it.

But the core of the investor protection system is the SEC in its very fine enforcement, critical enforcement program, not the professional plaintiffs and a handful of law firms who have made strike suits into an art form.

Having voted on all those enforcement matters I mentioned, in my judgment, this bill will not in any appreciable way curtail the SEC's ability to seek out and bring enforcement actions.

Nothing in this bill would take the marshal off duty. All it really does is to make the vigilante committee more accountable for stringing up the wrong person.

Third, we shouldn't be afraid to seek new ways to improve our current system. We have the broadest, deepest, and most transparent securities market in the world. We also have the markets that are the most fair to investors.

I don't want to see that change any more than I'm sure you do, Mr. Chairman, or others in this debate. I think the market's integrity is a comparative strength to our markets internationally and fundamental to our ethical beliefs.

But while we have a great market, we also have a serious problem. In countries all over the world, issuers, regulators, and investors used to ask me when I was chairman why the SEC encouraged so much costly litigation and why we couldn't control excessive litigation better than we do.

By failing to prevent undue cost of litigation, we lose some of the benefits of our market efficiency it generates that we would otherwise enjoy.

Frankly, there's too often a tendency for some to believe that the U.S. has the very best markets and the very best regulators and therefore, that nothing ought to change.

Well, I do agree with the predicate of that statement, but I don't agree with the conclusion.

Complacency is the real danger in such a rapidly changing and competitive world. We can't afford to stand still and say that we developed a great system in 1933 and we ought to be afraid ever to change it. The market changes around us every single day, and we shouldn't lose the capacity to innovate in law and regulation any more than we would want to lose the capacity to innovate in products and services.

So while private securities litigation has played a very important role in the past, and still does today, it doesn't necessarily mean it has to play such a role forever.

Protecting investors against fraud is very important. But protecting them against murder and burglary and assault probably also is important to them. Yet, in those latter areas, we leave the job to the police without issuing private legal hunting licenses.

The point is that the quality of our market and the strengths of our traditions shouldn't immobilize us from a willingness to change, to keep pace with events, and to find a better way forward.

We have a problem and S. 240 is, in my view, a highly thoughtful response. I think it could be improved. I would be happy to work with the Subcommittee as you go forward considering it.

But, fundamentally, if we do not successfully begin to reform the private action system, then some day we may be forced to eliminate that system entirely, and I prefer to get on with the job of reform.

Thank you.

Senator GRAMM. Thank you, Mr. Breeden.

Let me say that we will take you up on your offer of help.

Mr. Cox.

OPENING STATEMENT OF DR. CHARLES C. COX
SENIOR VICE PRESIDENT OF LEXECON INC.
FORMER COMMISSIONER AND ACTING CHAIRMAN
SECURITIES AND EXCHANGE COMMISSION, CHICAGO, IL

Dr. COX. Thank you, Chairman Gramm.

I appreciate the opportunity to testify about reform of private securities litigation.

I served from 1983 to 1989 as Commissioner of the SEC. During 1987, I was Acting Chairman. I'm now a Senior Vice President of Lexecon, Inc., a consulting firm located in Chicago, that specializes in the application of economics to legal and regulatory matters. I have a Ph.D. in economics and my research focuses on financial markets.

While I was at the SEC, I was involved in approximately 1,700 enforcement matters.

At Lexecon, I've studied the economic evidence regarding allegations in approximately 100 private securities cases. And I've testified as an expert witness in about a dozen private securities fraud cases.

From my experience, I believe that I have considerable expertise on securities litigation to offer the Subcommittee. My experience and research leads me to conclude that there are too many securities class-action lawsuits that achieve little, if any, deterrence of fraud or compensation of defrauded investors.

Elimination of abuses in private securities litigation would remove a counter-productive tax on public corporations, the proceeds of which go to lawyers and the burdens of which are passed on ultimately to consumers and stockholders.

I have observed a world of difference between SEC enforcement actions and many securities class-action lawsuits. The SEC enforcement staff would not ask the Commission to authorize action on the meritless class-action cases that I have seen.

Alternatively, if the staff did request authorization for such allegations, the Commission would not have authorized action and would have admonished the staff for asking.

Put simply, the incentives weed out meritless SEC enforcement cases, but do not do so for securities class-action lawsuits. I'm not saying that private securities litigation never sanctions and deters fraud. It does. I'm saying instead that because meritless class-action suits often settle with fees of several million dollars for the attorneys, there is an incentive to file a class-action suit whenever a company's stock price drops substantially for any reason. And those suits are not abandoned or dismissed when the evidence indicates that fraud was not why the stock price dropped.

The securities laws should be obeyed. Violators should be sanctioned to deter fraud and compensate investors who are damaged.

Therefore, the goal should be to eliminate abuses in private securities litigation and preserve effective remedies for real fraud. Current efforts at reform are consistent with this goal and I support them. In particular, I advocate four reforms.

First, a fee-shifting rule to focus plaintiffs on the costs that they impose on others relative to the merits of the case.

Second, a class certification rule to involve investors with a substantial enough stake to actively monitor plaintiffs' lawyers.

Third, a safe harbor for predictive statements, to make clear that forward-looking statements are not fraudulent just because they turn out to be mistaken.

And fourth, a change in the scienter rule to define recklessness that will suffice for scienter.

These reforms would better balance the costs and benefits of private securities litigation. They would reduce nonproductive litigation and counter-productive efforts to avoid being sued.

Private securities litigation would work better from the standpoint of investors and the companies in which they invest.

Moreover, my SEC experience leads me to conclude that these reforms would not impede the SEC's enforcement of the securities laws.

I thank you and I would be pleased to answer any questions you may have.

Senator GRAMM. Let me thank both of you for the excellent testimony.

In listening to all of the discussion and visiting with my colleagues, there are many things that I'm concerned about as we prepare to start after the recess to write this bill. I am not concerned that we are going to end up writing a bill that would limit the legitimate rights of people to sue. I think that that is a red herring. I do not believe that anyone here supports trying to do that. There is so much support on the side of those who basically don't want to do anything, who want to keep the current system, that reducing the legitimate right to sue is not a real concern. Not only is there no intent to do that, but there's no capacity to do so if there were intent. I think the real question is, what can we do to improve Domenici-Dodd?

I would like to raise with both of you two concerns. I would first like to ask you about Rule 11.

One of the things that everyone claims to be concerned about is the frivolous suit. We heard in prior testimony about a law firm that just spits these suits out. They sued a company that didn't make toys for toy manufacturing investment decisions. They'd gotten messed up with their word processor. We've all had computer problems and computer operators like that. But that case is a good example of what drives many frivolous lawsuits.

When the question was raised about fee-shifting or about "loser pays," or about simply a penalty for filing what the judge immediately determines to be a frivolous lawsuit, the point has been raised that, under Rule 11, judges can impose penalties on lawyers filing frivolous lawsuits.

I asked the Congressional Research Service to go back and find out how many times in American history that the filers of frivolous lawsuits have ended up being penalized or being forced to pay anything similar to the court's costs or the cost of the defendant for frivolous 10(b)(5) lawsuits. In terms of any penalty whatsoever, the Congressional Research Service could find only three examples in the history of the United States of America of the imposition of Rule 11 sanctions in cases having to do with 10(b)(5) security litigation.

Now, let me ask my first question related to that.

Does it seem reasonable to you that if somebody files a lawsuit that has so little merit that when the judge makes an initial ruling, throws this case out and says that it is a frivolous lawsuit, does it make sense to you that we should have a mandatory Rule 11 penalty at that point?

I'll just begin with Mr. Breeden, then Mr. Cox, and then we'll just do it in that order each time.

Mr. BREEDEN. Senator, you're saying if the defendant prevails on a summary judgment motion?

Senator GRAMM. That's right.

Mr. BREEDEN. I can't see any reason why there shouldn't be an award of costs at that time. But, to be fair, I would favor having some form of cost-shifting in any case where the defendant prevails because I don't think a system of justice in which you have supposedly been vindicated, that's found that you've done nothing wrong, but you're still out-of-pocket $2 or $3 million, that's not really justice.

Somehow, I think this entire area will not get fixed. We won't get to the balance that people keep talking about until there's some economic risk on the people who perpetrate these economic search-and-destroy missions.

So, I would do it in your case, but I would do it in others as well.

Senator GRAMM. Mr. Cox.

Dr. COX. I agree with your proposal, Senator Gramm. But I think you have to go further.

Very few of these cases get dismissed. So very few are decided on summary judgment, that there really has to be something that goes along the way, such as some decision that the costs will be shifted, that the loser will pay, if, after a trial, there can be a decision that the case was not substantially justified. It has to be more than just some kind of fee-shifting if the case is dismissed.

Mr. BREEDEN. You'd also, Senator, I think have to worry just a little bit, if you hung it just on that moment, you wouldn't want to create a deterrent to the judiciary granting summary judgment. You wouldn't want them to say, oh, if I put an end to the discovery now and issue summary judgment, then those guys are going to have to pay this big cost award. If I let it go a little longer, then they won't. And you might suddenly encourage some suits to be continued longer than it should.

Senator GRAMM. My position is that a major problem in the whole system of civil justice is that, for all practical purposes, when people go into the courthouse to sue somebody, only two things can happen to them. One, they can come away a winner or, two, they can walk away losing nothing. Clearly, this creates a bias in the system to sue.

What is needed to reform meaningfully the system in America is that there be the viable potential of a third possibility, that they can lose. That is the solution to this problem, and it is the solution to other problems in terms of civil litigation in America. I have no doubt about that.

On the other hand, the question is, where are the votes to do something about it?

I would say that it should be a relatively easy matter to address concerns by setting out asset and income standards below which

you begin to reduce the judgment against plaintiffs so that you don't exclude poor people from the courthouse. For example, you might say that if the plaintiff has assets below $1 million or an income below $100,000 a year, then the penalties can be no more than 10 percent of assets or 10 percent of income.

What is so appealing to me about reforming securities litigation is that primarily, at least in the minds of the general public, you have rich people suing rich people. If you ever have a situation where "loser pays" makes sense, it's in this particular case.

Let me ask you a question about proportional liability.

Mr. BREEDEN. Can I just add?

Senator GRAMM. Sure.

Mr. BREEDEN. I think you are dead on the mark of one of the core issues in this whole debate. And when people say, well, we can do some of these things that everybody really agrees on, some of the pleading reforms and so on, that's addressing the margins of the issue.

You are honing in on the core of the issue, which is that going back time immemorial to the beginnings of the common law, it has always been established that if I do something in the pursuit of gain on my property and it spills over and damages you on your property, that you have some claim of action against me.

And that's exactly what's going on here, except I'm not doing it on my property. I'm doing it on the joint property of the courthouse. But I'm damaging you. And if I end up having the court of law say I did it without reason, there ought to be some cost.

Say what that cost ought to be, but it shouldn't be something you can do very easily.

Dr. COX. Just one other comment on this, too, Chairman Gramm.

Often, it gets set up as looking to the plaintiff and whether it will dissuade poor or impecunious plaintiffs. But I think that it's also important to recognize here that the plaintiffs are really passive in these suits and it's the entrepreneurial law firms that direct the suits.

So any kind of fee-shifting here should take account of the law firm, not just the named plaintiff.

Senator GRAMM. Let me ask you a final question and then we can conclude the hearing.

I want to ask you your comments about proportionate liability. One of the issues on which we have an opportunity to be successful is to set out a standard whereby people are held accountable in terms of what they did wrong rather than on how deep their pockets are.

This is a very contentious issue because people who want to sue are not worried so much about the wrong. They're worried about recovery. It is clear in looking at this issue that we're going to have a real battle over it.

I would like as my final question to ask you about proportionate liability.

Mr. BREEDEN. First, I would indicate that not only do I think it's a concept that has real merit, though there are some cases where I believe joint and several should remain the law. But I actually wrote to Senator Domenici in the summer of 1992, while Chairman, expressing support for moving beyond what I think is the too

sterile state of the law today, where there's really only two possibilities. You either aren't liable at all because your conduct was found to be negligent, or you're liable for the whole shebang, even if you only were 1 or 2 percent of the problem because somebody concludes that you were reckless.

That line between negligence and recklessness, you can talk all day about Sundstrand. That line is a very loosey-goosey line. It's not easy to pin down and it's susceptible, of courts feeling a lot of pressure to try and help the defendants get something. Then, if they do that and say, well, there was some recklessness here, under current law, there's only one choice. And that is that the person who only was 1 percent responsible pays the whole thing.

And while I was at the Commission, I wrote over some considerable consternation of some lawyers on the general counsel's staff and other places in the Commission and said, look, I was prepared to try and work with the Congress to see if we could come up with a better and more flexible system.

So I think leaving joint and several for deliberate and willful conduct and having proportionate liability for nondeliberate, willful conduct is a very good starting point.

Senator GRAMM. Mr. Cox, do you want to comment?

Dr. COX. I support the idea of proportional liability. I think in S. 240, the way it's set out, however, to maintain joint and several for willful conduct with proportional liability for the other kinds of cases, is a good idea.

Senator GRAMM. And you agree with that, do you, Richard?

Mr. BREEDEN. Yes.

Senator GRAMM. I agree with that. If someone's involved in fraud and willful conduct, they ought to be liable. I have got no problem with that. I agree with that. If they did something wrong and they were willful in it, then I think that we want a system where we can get them. The problem is that today you have this absurd system. For example, in my State, you have got the janitor come in and unlock the operating room door at 6:00 in the morning and then at noon, he wins the lottery. A doctor comes into the operating room and cuts off the wrong leg that afternoon. The person who lost the wrong leg can sue the janitor. Clearly, that's the kind of practice we want to stop.

I want to thank both of you for coming. I'm going to yield to my colleague, Senator Dodd. I may need to leave at this point, but I'm sure that he won't mind if I leave him in charge of the hearing. [Laughter.]

Both of your testimonies were excellent. I would like to say to Senator Dodd, who has worked with me on this, that when we come back from the recess and we start to put together the final bill, I think we will have unquestionably benefited from having had an excellent set of hearings. I think it was a good idea to have the proponents of the reform, the opponents of the reform, and then the people who have been in a regulatory capacity. And I think that dividing them up into three hearings so we didn't get into any kind of shouting match has been very effective. The House tried to mix them and it produced chaos.

I am very hopeful that we're going to be able to do something meaningful in this area.

I would like to have the opportunity, and both of you have said that we would, to seek your advice as we get down to final decisions on this legislation.

Let me turn things over to Senator Dodd and thank him for his leadership. I'm convinced that we will legislate in this area, and I think Senator Dodd and Senator Domenici have provided the key leadership to get us to this point.

Senator DODD. Thank you, Mr. Chairman. I will be very brief.

I inadvertently got called away on other matters and I apologize to Arthur Levitt and to both of our witnesses here.

But I had a good sense of your testimony. I'm grateful for your support, not just conceptually, but also a good part of the specifics of what we've incorporated in the bill.

I'm delighted to hear, as I've known, that our Chairman, Phil Gramm, is committed to seeing us get the bill out of the Committee and I think we can. We're picking up cosponsorships almost on a daily basis on this issue and getting near 50 percent of the Senate supporting the Domenici-Dodd proposal.

I'm confident we will end up with a bill and I'm very confident that the Administration will be supportive. We've had very good and positive signals from the Administration on this proposal that Pete Domenici and I have put forward. They have some questions, as others do, and we're going to see if we can't accommodate, to the extent possible, those concerns without at all giving up on the major thrust of what we're trying to achieve and accomplish here.

So I'm very optimistic, Mr. Chairman, that we're going to have a good piece of legislation. It's been for some of us a 4- or 5-year effort in this regard. We began virtually almost alone on this question. There were very few people, except those directly affected, that were interested.

We're delighted to see the kind of bipartisanship we've been able to develop on this. And I think the hearing process is, as is always the case—if it goes through a good process, you learn a lot and you can find areas which you can improve and change and strengthen legislation.

So I'm, as I said a moment ago, very optimistic about the success of this and obviously, the involvement of both of you is tremendously helpful.

I'm very grateful to Arthur Levitt as well. He's been very constructive and very supportive of this effort and early on said that this was clearly an area in need of reform, when there were not many voices saying that. So I'm grateful to the Chairman of the SEC.

With that, Mr. Chairman, I thank you.

Senator GRAMM. Thank you very much. We're adjourned.

[Whereupon, at 4:45 p.m., the Subcommittee was adjourned.]

[Prepared statements and additional material for the record follow:]

PREPARED STATEMENT OF SENATOR RICHARD H. BRYAN

Mr. Chairman, I believe it is important that we are holding this hearing today on securities litigation reform. Deliberations on this topic without hearing from the Chairman of the Securities and Exchange Commission (SEC) would be missing the public official most responsible for the integrity of our financial markets.

I welcome Chairman Levitt here today. I believe you have done an outstanding job during your tenure at the SEC. Your leadership has been instrumental in assuring the World's confidence in our financial markets.

Earlier this week, Senator Shelby and I introduced the Private Securities Enforcement Improvement Act of 1995 [S. 667]. I want to commend my colleague from Alabama for his help in crafting this legislation.

While the bill takes strong steps to deal with abuses such as referral fees, I believe it addresses the problems without damaging the system that is so critical in helping to police our financial markets.

At this time I would like to read part of a letter I received from the North American Securities Administrators Association (NASAA) which represents the 50 State securities administrators responsible for investor protection and the efficient functioning of the capital markets at the grassroots level.

"In NASAA's view, the challenge is to identify ways to make the litigation system more fair and more efficient, while preserving the essential role that private actions play in supporting the integrity of our financial markets. . . . [S. 667] is a responsible and fair reform proposal that targets frivolous lawsuits without undermining the entire system of private actions. . . . S. 667 meets the challenges of achieving balanced litigation reform, and as such, is enthusiastically supported by NASAA."

I ask unanimous consent that the full text of this letter be entered into the record.

Most reasonable people believe private litigation is a crucial adjunct to the SEC in policing our financial markets. Most reasonable people believe the key to the success of our financial markets is public confidence. Those are the two linchpins that should guide our consideration of any legislation.

Do we want to get rid of abuses and frivolous lawsuits? Emphatically Yes! Do we want to jeopardize the foundations that have made our financial markets the envy of the free world? Of course not.

I am afraid, if we raise the bar too high for investors to seek recovery when they have been defrauded, we will put the public confidence in jeopardy.

Should a defrauded victim have to prove "specific facts demonstrating the state-of-mind of each defendant"? Imposing impossibly difficult pleading requirements for defrauded investors creates barriers to victims even getting into court to recover their losses.

Should we put the fear in small investors that they might have to pay the attorneys' fees for a huge corporation if they lose the case? What individual or attorney would be willing to step forward to represent a class in a case if the risk were paying millions in legal fees of large corporations.

Should we force small investors to accept pennies on the dollar because they can't fully collect against professional lawyers and accountants who helped scam artist perpetrate fraud?

At some point in time, this Committee will have to decide whether to substantially reduce the amount victims can recover in the all-too-common situation where a primary wrongdoer like Charlie Keating is bankrupt, in jail, or has fled the country.

I know we would not ask or expect the Government to accept these kinds of restrictions. The SEC has done an outstanding job policing our financial markets to the best of their abilities and resources. We should not handicap them. But we must also not handicap the individual investors in whom the SEC counts on for assistance.

As Chairman Levitt will tell us today: "Our first goal must be to protect investors and preserve and strengthen our capital markets. Private litigation serves as a vital element in the enforcement of Federal securities laws."

I look forward to hearing from the Chairman of the SEC and working with my colleagues to craft legislation that attacks the abuses while preserving the tools that have made our markets the finest in the world.

PREPARED STATEMENT OF SENATOR ALFONSE M. D'AMATO

Once again, I commend Senators Gramm and Dodd for convening hearings on securities litigation reform. Through these hearings, my colleagues have presented both sides of many of the complex issues raised by S. 240 and other legislative proposals. The witnesses' testimony has been very helpful in moving along the legislative process.

Today we will have the opportunity to hear from the ultimate gatekeeper of investor protection—the SEC. The SEC works everyday to ensure the integrity and transparency of our capital markets.

Investor confidence in market integrity is a critical factor in the depth and liquidity of our capital markets. By the same token, issuers, public companies, and other participants in the capital-raising process should have confidence that the legal system will protect them from frivolous securities lawsuits and not have to factor in the cost of defending this type of litigation as part of the cost of raising cost.

The continued vitality of our capital markets depends on the perception that it is a safe market for investors and issuers alike. To be effective, securities litigation reform must strike that balance. Legislation should discourage frivolous lawsuits without denying defrauded investors their day in court.

S. 240 goes a long way toward achieving that balance. With some tinkering, S. 240 will ensure that we continue to have a capital market with integrity and that we also have a legal system with integrity for securities class-action lawsuits.

Today's witnesses are unanimous in their support for reform of the system of private securities class-action lawsuits. Both the present and former SEC chairman urge a balanced approach.

I believe S. 240 can strike that balance. I look forward to working with my colleagues to achieve this goal.

PREPARED STATEMENT OF SENATOR BARBARA A. MIKULSKI

ON THE SECURITIES LITIGATION REFORM BILL

APRIL 6, 1995

I am pleased to work on a bi-partisan basis with my colleagues Senator Dodd and Senator Domenici as a cosponsor of this legislation and to renew my commitment to reforming securities litigation.

This bill addresses the problem of "bounty hunters" racing to the courthouse to be the first to file a lawsuit based on nothing more than a change in stock price—and then coerce innocent businesses to settle these lawsuits.

This bill eliminates the payment of bonus awards or "bounties" to representative plaintiffs in class actions. It gives people who are harmed extra time to consider who really harmed them before they have to file their case at the courthouse, by extending the statute of limitations to 2 years after the violation was or should have been discovered, and 5 years after the violation occurred. It also puts the investor in the driver's seat to control the litigation and recover more of their damages.

My constituents have told me that some attorneys are paying stock brokers and others a "bounty" in return for identifying who they should sue. High-tech companies, their accountants, and others are being lumped into these securities lawsuits that are filed at the courthouse just hours after a change in the stock price.

I am opposed to the "Race to the Courthouse" mentality that ends up in needless lawsuits that have huge costs for firms that should be focused on creating jobs.

I want to see the courthouse door kept open for the little guy, but let's get this "bounty hunter law" under control.

These needless law suits hit these firms through: expensive liability insurance premiums; disruption to the lives of those people who have been drawn into the suit—and is a tremendous distraction from the company's achieving its mission, contributing to the economy and creating jobs.

I am concerned about these costs to the private sector, and to communities across America—and especially the costs to the high-tech community who are our hope for jobs in the 21st century.

I am hearing loud and clear that the current "Bounty Hunter" mentality is putting these jobs at risk.

Rather than creating jobs, these high-tech jobs are having to put their efforts and their dollars into expensive litigation and insurance.

I know how the system works with these lawsuits. It doesn't matter who's right or who's wrong. Both the guilty and the innocent end up settling at some big cost, even if just to avoid the risk and to get on with life.

So, the good guys cut their losses and the bad guys get off the hook.

I am pleased to work on a bipartisan basis with Senators Domenici and Dodd and support this legislation that helps take care of the good guys.

PREPARED STATEMENT OF ARTHUR LEVITT

CHAIRMAN, U.S. SECURITY AND EXCHANGE COMMISSION

WASHINGTON, DC

APRIL 6, 1995

Chairman Gramm and Members of the Subcommittee: I appreciate this opportunity to testify on behalf of the Securities and Exchange Commission regarding legislative proposals to reform the system of private litigation under the Federal securities laws.

As you know, the Commission has for some time been concerned about abuses in the private litigation system that operate to the detriment of the markets and investors. In most securities law cases, investors are on *both* sides of the case. None of these investors is well served by a system that is unnecessarily costly to them.

We are also very mindful that private actions are critical to ensure that issuers and those who work with them bear appropriate responsibility for their actions. Our task, then, is to strike a balance and make policy choices that will fully serve those who will be affected by the outcome. When this Congress convened, it was clear that securities litigation reform would be one of the legislative priorities that would most affect us at the Commission. We were, and are, hopeful that the legislative process will bring needed improvements to a litigation system that has for too long been ignored.

Having said that, we were nonetheless concerned with some of the provisions in H.R. 10, the first securities litigation reform measure introduced in this Congress. While H.R. 1058, the measure that passed the House, was an improvement, we still have significant concerns about some of its provisions. We view S. 240, the legislation introduced by Senators Domenici and Dodd, as a positive step toward improving the private litigation system. To a large degree, we are in accord with the objectives of this bill, as well as a significant number of the measures chosen to accomplish them. This testimony suggests ways in which we believe the bill should be improved. In addition, Senators Shelby and Bryan introduced legislation, S. 667, on April 4th. The Commission has not yet had the opportunity to fully analyze the bill, but it appears to be a thoughtful approach.[1]

Subject to appropriate modifications, the Commission can fully support legislative proposals to eliminate the most prevalent abuses associated with class-action lawsuits under the securities laws; to provide courts with the discretion to award fees, including against counsel, in cases involving abuse; to eliminate civil RICO liability predicated on securities law violations; and to enact a proportionate scheme of contribution among defendants.

We believe that the Domenici-Dodd bill could be improved with certain modifications, including:

- The adoption of the Second Circuit's pleading requirement, that plaintiffs plead with particularity facts that give rise to a "strong inference" of fraudulent intent by the defendant;
- The inclusion of express language confirming the Commission's authority to provide a "safe harbor" for forward-looking information;
- The adoption of the *Sunstrand* definition of recklessness;
- The adoption of an expanded statute of limitations that is not limited by a "should have been discovered" clause; and
- The restoration of aiding and abetting liability.

It is clear that problems exist within our litigation system, and that constructive action is necessary. The Commission therefore urges the Subcommittee to examine the issues carefully and to craft appropriate legislation that improves the system without eliminating its benefits. Our staff, of course, remains available at any time

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[1] Commissioner Roberts has analyzed the provisions of the Shelby-Bryan bill, and is of the opinion that S. 667 is preferable to S. 240. He believes that S. 667 is more consistent with the historical Commission position in this area than S. 240.

to assist in the process of drafting provisions to accomplish your goals in the most effective way possible.

I. Proposals to Reduce Meritless Litigation

One of the most critical aspects of a fair and efficient litigation system is its ability to identify meritless cases early in the process, before the costs associated with protracted litigation are incurred. Critics of the current system contend that it does not effectively screen out the cases that lack merit. These cases are often referred to as "frivolous" in the rhetoric of the litigation reform debate, but the concern extends to cases that may more accurately be characterized as speculative.[2]

Meritless litigation may be addressed in a variety of ways. One method is to deter the filing of meritless cases by providing for fee-shifting or the imposition of sanctions against plaintiffs or their attorneys, while another method is to establish stringent pleading standards that only the strongest cases can satisfy. Each of the measures proposed to date has drawbacks as well as benefits.

A. Pleading Requirements

The device most frequently used in the present environment to screen out deficient securities fraud claims is Rule 9(b) of the Federal Rules of Civil Procedure, which requires that plaintiffs allege fraud with particularity.[3] Commentators have noted that Federal courts today are granting dispositive motions dismissing securities law cases with greater frequency than in the past. Although it is difficult to quantify the extent to which there has been an increase in the percentage of cases dismissed on the pleadings, there appears to be widespread agreement that a trend in this direction exists.[4]

Although Rule 9(b) requires that a plaintiff plead with particularity the circumstances constituting the fraud, it further provides that "[m]alice, intent, knowledge, and other condition of mind" may be pleaded "generally." This latter provision recognizes that, while it is fair to require a plaintiff to allege with some specificity what a defendant did and why it was fraudulent, it is unrealistic to expect a plaintiff, at the commencement of an action, to be able to present facts specifically demonstrating that a defendant acted with the requisite state of mind. Indeed, in most cases it may be impossible at the pleading stage, before any discovery has been taken, to meet such a burden.

At the present time, there is a split between the circuit courts regarding the manner in which Rule 9(b) should be interpreted. The Second Circuit Court of Appeals requires that a plaintiff pleading securities fraud allege facts that give rise to a "strong inference" of fraudulent intent on the part of the defendant.[5] This requirement may be satisfied either by alleging facts that establish a motive to commit fraud and an opportunity to do so, or by alleging facts that constitute circumstantial

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[2] In hearings held before the Telecommunications and Finance Subcommittee of the House Commerce Committee last summer, for example, Professor Langevoort testified that:

> The primary problem we face is not so much *frivolous* litigation. Ample mechanisms exist currently to deal with suits that have no merit whatsoever. Rather, the problem is an excess of *speculative* litigation, where there are small bits and pieces of evidence that, in hindsight, might suggest some possibility that defendants were not completely candid in each one of the many items of information that became available to the investing public. Yet they rarely add up to a serious claim of fraud.

Summary of Testimony of Donald C. Langevoort, Vanderbilt University School of Law, Before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives (August 10, 1994).

[3] *See* 10 Louis Loss & Joel Seligman, *Securities Regulation*, at 4526–27 (1993) (citing 5 Charles Wright & Arthur Miller, *Federal Practice & Procedure*, § 1297 at 613–14 (1990) ("courts have shown a tendency to be more demanding in their application of Rule 9(b) . . . [to] securities fraud actions.").

[4] *See* Joel Seligman, *Commentary—The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority,"* 108 Harv. L. Rev. 438, 446 (1994) ("Collectively these data demonstrate that in 1992 a substantial percentage of all Federal securities class actions filed were dismissed on motions before trial"); Jonathan Eisenberg, *Beyond the Basics: 50 Defense Doctrines that Every Securities Litigator Needs to Know*, in New Dimensions in Securities Litigation at 611 (ALI-ABA Course Materials 1994) ("many [securities] defendants are having significantly greater success than in the past in having cases dismissed at the motions stage"); Julie Triedman, *Class Warfare*, Corporate Counsel, July/August 1994, at 51, 55 ("The trend is toward more dismissals and more summary judgments. We don't like it, but it's a fact.") (quoting Leonard Simon of Milberg Weiss Bershad Hynes & Lerach).

[5] *Ross* v. *A.H. Robins Co.*, 607 F.2d 545, 558 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259 (2d Cir.), *cert. denied*, 114 S. Ct. 1397 (1994).

evidence of either reckless or conscious behavior.[6] At least three other circuit courts have adopted variants of the Second Circuit's approach in recent years.[7] Other courts of appeal, however, including most recently the Ninth Circuit, have rejected this approach on the grounds that it goes beyond the plain language of Rule 9(b).[8]

The pleading provision in the House bill would require a plaintiff "to make specific allegations which, if true, would be sufficient to *establish* scienter as to each defendant." (Emphasis added.) Unless facts giving rise to "a strong inference" of scienter are viewed as sufficient to "establish" scienter, this test is more stringent than even the standards currently imposed by the Second Circuit.[9]

The pleading requirement proposed in the Domenici-Dodd bill would require a plaintiff to "allege specific facts *demonstrating* the state of mind of each defendant." (Emphasis added.) This test may be less onerous than that provided in the House bill, but the use of the word "demonstrating" may still create a standard more stringent than the Second Circuit standard. If these provisions are intended merely to codify the Second Circuit's approach, the Commission recommends that the language be amended to conform with the language actually used by the Second Circuit, which has been clarified and refined by the case law and is therefore less likely to generate additional litigation.

Although the Commission believes that it would be beneficial to resolve the split between the circuits regarding the proper application of Rule 9(b),[10] it recommends that Congress seek the views of the Advisory Committee on Civil Rules of the Judicial Conference of the United States before enacting any legislation. The Judicial Conference was established by Congress in 1958 to make a continuous study of the Federal rules in order to make recommendations for changes to the Supreme Court. The Commission further recommends that Congress not enact any pleading requirements that go beyond those used by the Second Circuit, which are regarded as being the most stringent used today.

B. FEE-SHIFTING

The House bill provides that, if a private action under the Securities Exchange Act of 1934 is resolved on any basis other than settlement, the court shall award fees to the prevailing party if the prevailing party meets its burden in showing that:

- .The position taken by the losing party was not "substantially justified;"
- An award against the losing party would be "just;" and
- The cost of such fees to the prevailing party is "substantially burdensome or unjust."

The bill provides the court with discretion to determine whether fees should be awarded against the losing party, its attorneys, or both.

Although this fee-shifting provision is far less onerous than the type of strict "loser pays" provision that was proposed in the House bill as originally introduced,[11]

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[6] *See In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 268–69 (2d Cir.), *cert. denied*, 114 S. Ct. 1397 (1994).

[7] *See Greenstone* v. *Cambex Corp.*, 975 F.2d 22, 25 (1st Cir. 1992) ("The courts have uniformly held inadequate a complaint's general averment of the defendant's 'knowledge' of material falsity, unless the complaint *also* sets forth specific facts that make it reasonable to believe that defendant knew that a statement was materially false or misleading."); *Tuchman* v. *DSC Communications Corp.*, 14 F.3d 1061, 1068 (5th Cir. 1994) ("To plead scienter adequately, a plaintiff must set forth specific facts that support an inference of fraud."); *DiLeo* v. *Ernst & Young*, 901 F.2d 624, 629 (7th Cir.) ("Although Rule 9(b) does not require 'particularity' with respect to the defendants' mental state, the complaint still must afford a basis for believing that plaintiffs could prove scienter."), *cert. denied*, 498 U.S. 941 (1990).

[8] *See In re Glenfed, Inc.*, 1994 U.S. App. LEXIS 34334 at *16 (9th Cir. December 9, 1994) (en banc) ("We conclude that plaintiffs may aver scienter generally, just as the rule states—that is, simply by saying that scienter existed."); *Phelps* v. *Wichita Eagle-Beacon*, 886 F.2d 1262, 1270 n.5 (10th Cir. 1989) (strict approach cannot be reconciled with plain language of rule); *Auslender* v. *Energy Management Corp.*, 832 F.2d 354, 356 (6th Cir. 1987) ("[T]he allegation of 'recklessness' on the part of [the defendant] is adequate to satisfy the scienter requirement of Rule 10(b)(5).").

[9] The House bill also provides that "[i]t shall not be sufficient for this purpose to plead the mere presence of facts inconsistent with a statement or omission alleged to have been misleading." The contemporaneous existence of facts inconsistent with a defendant's statement is the type of evidence often relied upon by a plaintiff to establish an inference of scienter. Indeed, it may be the only evidence available to the plaintiff prior to discovery.

[10] Although the pleading requirements specified in the Domenici-Dodd bill would apply only to implied private actions and the House bill would apply only to private actions under Section 10(b), any resolution of the proper pleading standard under Rule 9(b) should be equally applicable to private actions under the other antifraud provisions of the Federal securities laws.

[11] In the Commission's view, a strict "English Rule" provision would effectively eliminate the private right of action for small investors. Although major corporations might continue to file

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the Commission has expressed concerns that using a "substantially justified" standard to test the merits of the losing party's position may be inappropriate.[12] The Commission has also expressed concern regarding the potentially harmful effect on meritorious cases of a provision in the House bill instructing courts to require an undertaking for the payment of fees and expenses, from either the plaintiff class or class counsel, once a securities fraud case is certified as a class action.

In order to avoid the chilling effect that a stringent fee shifting provision would have on investors with meritorious claims, the Commission has recommended that Congress simply provide courts with express authority to award fees and costs when the court determines that a case has been filed (or a defense raised) that is without merit. The Commission has also recommended that this be coupled with a requirement that courts make findings as to why fees should or should not be awarded whenever cases are decided by means of a dispositive motion. Congress should also make it clear, in such a provision, that a fee award may be awarded against counsel.

C. Use of Alternative Dispute Resolution

The Domenici-Dodd bill would provide for the use of alternative dispute resolution (ADR) mechanisms. The provision promotes ADR by shifting fees, but only where a losing party unreasonably refuses to accept an offer to use ADR mechanisms to resolve a case or, having accepted the offer, refuses to accept the result and then loses in court. Under such circumstances, the court would be required to order fee-shifting if it found that the losing party's position was not "substantially justified."

The use of ADR mechanisms could minimize certain of the problems associated with private securities litigation, and the Commission believes that provisions designed to encourage their use deserve serious consideration. As the Senate Staff Report points out, "[v]arious types of ADR may result in lower litigation costs, expedited resolution of the dispute, preserving a better working relationship among the disputants, better substantive outcomes, and more controlled disclosure of sensitive information produced in discovery."[13] At the same time, the Report cautions that, "even advocates of ADR recognize that it does not always produce these benefits relative to litigation, and may sometimes even result in higher costs and more delay than litigation would produce."[14] The Commission encourages efforts, in conjunction with the Judicial Conference and other groups, to develop alternatives to the litigation process, and supports incentives to use such alternatives as may be demonstrated to be fair, effective, and efficient.

D. Treatment of Forward-Looking Statements

Some of the most difficult cases to screen are those involving the disclosure of forward-looking or "soft" information. Issuers frequently complain that they are sued under the antifraud provisions simply because the corporation made a projection that failed to materialize. In addition to the courts' apparent willingness to enforce pleading requirements more strictly (as noted above), courts have applied substantive securities law principles for the purpose of promptly dismissing cases involving forward-looking statements that they suspect are meritless.[15]

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suits under Exchange Act Section 10(b) and Rule 10(b)(5), individual investors would inevitably be deterred from filing meritorious cases because they could not take the risk of being exposed to a fee award if they failed to prevail. In class-action lawsuits, in particular, individual plaintiffs frequently stand to recover only a small amount if they prevail. Their potential liability under an automatic fee-shifting provision would be totally disproportionate to their potential recovery.

[12] The terminology is borrowed from the Equal Access to Justice Act ("EAJA"), 28 U.S.C. § 2412(d)(1), which provides that certain persons who prevail in a suit brought by the Federal Government may recover attorneys' fees and costs if a court finds that the litigating position of the government was not "substantially justified." It is important to recognize that the "substantially justified" standard under the EAJA applies only against the Government. The statute was designed to diminish the deterrent effect of the cost of seeking review of, or defending against, Government actions by allowing certain individuals and small businesses to recover their attorneys' fees and costs in litigation with Government agencies. Unlike private litigants, governmental agencies have a superior ability to sustain the costs of litigation and usually conduct an investigation prior to filing suit. It does not follow that the same standard should govern investor lawsuits brought against corporate defendants.

[13] "Private Securities Litigation, Staff Report Prepared at the Direction of Senator Christopher Dodd, Chairman, Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs, United States Senate" (May 17, 1994) (hereinafter, the "Senate Staff Report"), at 51.

[14] *Id.*

[15] *See Luce* v. *Edelstein*, 802 F.2d 49, 56 (2d Cir. 1986); *Polin* v. *Conductron Corp.*, 552 F.2d 797, 806 n.28 (8th Cir.), *cert. denied*, 434 U.S. 857 (1977) ("We are not inclined to impose liability on the basis of statements that clearly 'bespeak caution.'"); *In re Donald J. Trump Casino*

The Commission recognizes the important role played by projections and other forward-looking statements, as well as the potential for abusive litigation based on a "fraud by hindsight" theory when such projections do not come true. To address this issue, the Commission recently published a "concept" release soliciting comments on current practices relating to disclosure of forward-looking information, with a view to developing a new safe harbor for projections that provides issuers with meaningful protection but continues to protect investors.[16] The Commission has received approximately 150 comment letters in response to the release, and public hearings on the issue were conducted in Washington, DC and San Francisco during February.

Because the Commission is in the midst of a rulemaking proceeding, it would be inappropriate to comment on the substantive scope of the safe harbor provision in the House bill. From the Commission's perspective, an appropriate legislative approach is contained in the Domenici-Dodd bill. This provision would allow the Commission to complete its rulemaking proceeding and take appropriate action after its evaluation of the extensive comments and testimony already received. Based on the Commission's experience with this issue to date, we believe that there is considerable value in proceeding with rulemaking, which can more efficiently be administered, interpreted and, if needed, modified, than can legislation.

Commenters have proposed a wide spectrum of approaches to enhancing the safe harbor protection for forward-looking information. Various proposals address disclosures in connection with securities offerings under the Securities Act, as well as statements which are subject to liability under the Exchange Act. Although the Commission has not yet determined what approach or combination of approaches to the safe harbor would best serve the public interest, it would like to be certain that it has the requisite authority to adopt whatever approach it believes will be most effective. The merits of the approach, not any perceived limitations on the Commission's authority to implement that approach, should determine the scope of the safe harbor. In order to ensure that it has the broad authority necessary to permit full flexibility in constructing the safe harbor, the Commission recommends that Congress provide clear authority under both the Securities Act and the Exchange Act for the Commission to adopt enhanced safe harbor protection for forward-looking information.

II. Proposals to Change Liability Standards

A. RICO Liability

For many years, the Commission has supported legislation to eliminate the overlap between the private remedies under the Racketeer Influenced and Corrupt Organizations Act ("RICO") and under the Federal securities laws.[17] Because the securities laws generally provide adequate remedies for those injured by securities fraud, it is both unnecessary and unfair to expose defendants in securities cases to the threat of treble damages and other extraordinary remedies provided by RICO.

Although a recent Supreme Court decision substantially narrowed the liability of professional advisers under RICO,[18] issuers and other market participants continue to be exposed to RICO claims in securities cases.[19] These claims tend to coerce settlements and force defendants to litigate issues that would not otherwise arise in securities cases. Congressional action continues to be needed, and we endorse the measures addressing this issue that are included in both the Domenici-Dodd bill and the House bill.

B. Recklessness

The Commission has consistently supported a recklessness standard for liability under Section 10(b) and Rule 10(b)(5) because such a standard is needed to protect

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Sec. Litig., 793 F. Supp. 543, 549 (D.N.J. 1992), *aff'd*, 7 F.3d 357 (3d Cir. 1993). *See also, Raab* v. *General Physics Corp.*, 4 F.3d 286, 290 (4th Cir. 1993); *Krim* v. *BancTexas Group, Inc.*, 989 F.2d 1435, 1446–47 (5th Cir. 1993) ("projections of fixture performance not worded as guarantees are generally not actionable under the Federal securities laws").

[16] Securities Act Release No. 7101 (October 13, 1994), 59 FR 52723.

[17] *See* Testimony of Mary L. Schapiro, Commissioner, Securities and Exchange Commission, Concerning H.R. 1717, the RICO Amendments Act of 1991, Before the Subcommittee on Intellectual Property & Judiciary Administration, Judiciary Committee, U.S. House of Representatives (April 25, 1991).

[18] The Court held that one must participate in the operation or management of an enterprise in order to be liable under Section 1962(c) of RICO. *Reves* v. *Ernst & Young*, 113 S. Ct. 1163 (1993).

[19] *E.g., Powers* v. *British Vita, plc*, 842 F. Supp. 1573 (S.D.N.Y. 1994); *Aizuss* v. *Commonwealth Equity Trust*, 847 F. Supp. 1482 (E.D. Cal. 1993); *Greenwald* v. *Manko*, 840 F. Supp. 198 (E.D.N.Y. 1993).

the integrity of the disclosure process. The law should sanction corporations and individuals who act recklessly in connection with their disclosure obligations, because that is the only way to assure the markets of a continuous stream of accurate information. Any higher scienter standard would lessen the incentives for corporations and other issuers to conduct a full inquiry into areas of potential exposure, and thus threaten the process that has made our markets a model for nations around the world. Moreover, because an actual knowledge standard would virtually foreclose recovery against attorneys, accountants, and financial advisers, it would reduce the degree to which such professional advisers encourage full and complete disclosure.

The House bill provides that liability in a private action under Section 10(b) may be based on conduct that satisfies a definition of recklessness based generally on the standard enunciated by the Seventh Circuit Court of Appeals in *Sundstrand Corporation* v. *Sun Chemical Corporation*,[20] the standard generally followed by most of the Federal courts of appeal.[21] In *Sundstrand*, the court defined a reckless omission as:

> a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.[22]

In the House bill, the *Sundstrand* definition has been altered by adding a second sentence which provides that:

> Deliberately refraining from taking steps to discover whether one's statements are false or misleading constitutes recklessness, but if the failure to investigate was not deliberate, such conduct shall not be considered to be reckless.

The extent to which this additional sentence would change the result in any particular case is unclear, but it suggests that deliberate action, rather than reckless behavior, may be required for liability. It may also suggest a duty to investigate greater than that heretofore recognized in the law. The Commission believes that it would be preferable simply to codify the *Sundstrand* definition as currently applied by a majority of the Federal circuit courts and to avoid the additional litigation that would inevitably result from the inclusion of additional language of uncertain meaning.

Critics of the recklessness standard assert that juries fail to make a meaningful distinction between recklessness and negligence. In response to this criticism, some reform proposals would require the jury to make a specific finding that the defendant had indeed acted with the required state of mind. This would serve to deter the jury from simply ignoring the stringent legal standard required in order to hold a negligent defendant liable.[23] Both the Domenici-Dodd bill and the House bill have provisions requiring such special verdicts. The Commission supports such a requirement and believes that it may be a useful means for ensuring the proper application of the recklessness standard.

C. Actual Reliance

The original version of the House bill would have required actual reliance on a fraudulent misstatement or omission, a requirement that would have effectively eliminated cases brought under a fraud-on-the-market theory of liability.[24] The

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[20] 553 F.2d 1033 (7th Cir.) *cert. denied*, 434 U.S. 875 (1977).

[21] *See Hollinger* v. *Titan Capital Corp.*, 914 F.2d 1564, 1569 & n.8 (9th Cir. 1990) (en banc) (citing cases).

[22] 553 F.2d at 1045 (citation omitted).

[23] The use of special verdicts, has generated a great deal of controversy. The most vocal proponent was Judge (and former SEC Chairman) Jerome N. Frank, who was an outspoken critic of the jury system. Judge Frank urged that a special verdict is "usually preferable to the opaque general verdict." *Skidmore* v. *Baltimore & O.R. Co.*, 167 F.2d 54, 67 (2d Cir. 1948), *cert. denied*, 335 U.S. 816 (1948) (footnote omitted). On the other side of the argument were Justice (and former SEC Chairman) Douglas and Justice Black who believed that the rule allowing special verdicts should be repealed. "One of the ancient, fundamental reasons for having general jury verdicts was to preserve the right of trial by jury as an indispensable part of a free government." 374 U.S. 861, 867–68 (1963) (dissenting from the adoption of amendments to the Federal Rules of Civil Procedure).

[24] Under the fraud-on-the-market theory of liability, a plaintiff who trades in a corporation's stock after the issuance of a material false statement by the corporation is entitled to a rebuttable presumption that he relied on the integrity of the market price in making his investment decision. The fraud-on-the-market theory rests on two propositions: That in an active secondary market, the price of a company's stock is determined by all available information regarding the company, its business and general economic conditions; and that investors rely on the integrity

House-passed bill, H.R. 1058, preserves fraud-on-the-market liability in cases involving securities that are listed on a national securities exchange or quoted on an automatic quotation system (e.g. Nasdaq). With respect to H.R. 1058, the Commission has concerns regarding the effect of the reliance requirement in cases involving securities, such as municipal securities, that are not traded on a national securities exchange or quoted on an automatic quotation system. The Commission has recommended that the language be amended to clarify that both direct and indirect reliance would suffice.[25]

D. Aiding and Abetting Liability

Last April, the Supreme Court held in *Central Bank of Denver*[26] that investors do not have a private right of action against persons who aid and abet violations of Exchange Act Section 10(b) and Rule 10(b)(5). The decision means that private investors may no longer be able to recover damages against persons who substantially assist the perpetration of a securities fraud, even if such persons act knowingly and intentionally.[27] In addition, the decision has created unnecessary uncertainty as to the Commission's ability to use the aiding and abetting theory of liability where it is not expressly provided by statute. For these reasons, the Commission has urged that Congress enact legislation addressing the *Central Bank of Denver* decision.[28]

Although the Commission can continue to reach secondary participants in a securities fraud by exercising its administrative authority,[29] private litigants do not have that alternative. Unless another theory of liability can be applied in a particular case, persons who knowingly or recklessly assist the perpetration of a fraud may be insulated from liability to private parties if they act behind the scenes and do not themselves make statements, directly or indirectly, that are relied upon by investors. Because this is conduct that *should* be deterred, Congress should enact legislation to restore aiding and abetting liability in private actions. Such legislation should also clarify the Commission's ability to use the aiding and abetting theory of liability where it is not expressly provided by statute.

III. Proportionate Liability and Limitation on Damages

A. Proportionate Liability Among Defendants

Securities fraud cases often involve multiple defendants with differing degrees of involvement in, and responsibility for, the fraudulent conduct. If multiple defendants are found liable to the plaintiff in a securities case, however, their liability is joint and several, and the plaintiff may collect the entire amount of the judgment from any one of the defendants. To mitigate the potential unfairness of this approach to defendants, courts have implied a right to contribution in actions under Exchange Act Section 10(b).[30] Under this equitable doctrine, a defendant against

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of market prices when making investment decisions. Misleading corporate statements or the failure to disclose material information are regarded as a fraud on all stock purchasers, even those who did not personally read the fraudulent information, because the price paid for the stock reflects the misrepresentations. The Commission believes that the ability of investors to rely on the integrity of the market is important for our system of securities regulation.

[25] It should be noted that much of the Commission's disclosure regulation is premised on the general assumption that the market will absorb all information filed with the Commission and incorporate it into a company's stock price. We do not, for example, require that companies mail all of their periodic SEC reports to every shareholder. Rather, we assume that analysts, brokers, and others will obtain and evaluate that information and rely on it in making recommendations to investors.

[26] *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 114 S.Ct. 1439 (1994).

[27] The ultimate impact of the *Central Bank of Denver* decision is uncertain today because it will depend on the manner in which the Federal courts develop the law of primary liability. The distinction between primary and secondary liability was not very important prior to *Central Bank of Denver,* since a person who was found to have aided and abetted a fraud had joint and several liability with the primary violator. The distinction is crucial today, however, since a participant in a fraud may be totally insulated from liability in a private action if primary liability cannot be established.

[28] Testimony of Arthur Levitt, Chairman, Securities and Exchange Commission, Concerning Litigation Under the Federal Securities Laws, Before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives (July 22, 1994), at 46.

[29] With respect to registered entities and their associated persons, the Commission has express authority to impose sanctions on the basis of aiding and abetting liability. The Commission can also exercise its cease and desist authority with respect to any person who acts as "a cause" of another person's violation. The scope of liability as "a cause" of a violation would appear to be at least as broad as aiding and abetting liability.

[30] *See Musick, Peeler & Garrett* v. *Employers Ins. of Wausau,* 113 S. Ct. 2085 (1993).

whom judgment has been rendered may seek reimbursement from other persons who are jointly liable with him for payments made in excess of his share of the liability.

The Commission has recommended that Congress enact legislation to specify that, as among the contributing defendants, liability should be apportioned on the basis of relative fault.[31] This departs from the practice which prevailed at the time the securities laws were first enacted, when liability for contribution (where it existed) was apportioned among defendants in equal shares or *pro rata*. Both the Domenici-Dodd bill and the House bill address this issue.

The Commission also supports legislation that would resolve a split in the circuits by providing that, where one defendant settles a case, the liability of the co-defendants is reduced by an amount equal to the greater of the amount paid or the settling defendant's proportionate responsibility.[32] The alternative approach would release the liability of the co-defendants on a *pro tanto* basis, that is, dollar for dollar based on the amount actually paid by the settling defendant.[33]

While the *pro tanto* method provides greater protection to plaintiffs, the proportionate reduction approach is arguably more fair to non-settling defendants. Under the proportionate reduction approach, defendants cannot be saddled with more than their proportionate share of liability simply because the plaintiff settled part of the case too cheaply. As a result, defendants who believe they have meritorious defenses can litigate a case without having to worry that their exposure will be increased due to settlements made by other defendants. The proportionate reduction approach would inevitably result in some cases where defrauded investors are precluded from recovering all of their damages, but that choice would be made by the investors and would be fully within their control.[34] Again, both the Domenici-Dodd bill and the House bill adopt the proportionate reduction approach, which the Commission endorses.

B. Effect of Defendant Insolvency

It is important to understand that, if Congress enacts a system of proportionate contribution which includes a proportionate reduction approach to partial settlements, a defendant will never be required to pay more than his fair share of the damages in a securities fraud case in which all responsible parties are solvent. The distinction between proportionate liability and joint and several liability will be relevant only in cases in which one or more bankrupt parties are unable to pay their fair share of the damages they have jointly caused. Under the existing system of joint and several liability, the solvent defendants in such cases must bear the share of the bankrupt defendants. Under a system of strict proportionate liability, the defrauded investors would be required to absorb the loss.

Advocates of proportionate liability argue that joint and several liability produces an inequitable result in such circumstances because it forces parties who are only partially responsible for harm to bear more than their proportionate share of the damages. The response to this argument is that, although the traditional doctrine of joint and several liability may cause defendants to bear more than their proportional share of liability in particular cases, this is because the current system is based on equitable principles that operate to protect innocent investors. Joint and several liability is based on the equitable principle that, as between defrauded investors and defendants who are found to have knowingly or recklessly participated in a fraud, the risk of loss should fall on the latter. The goal of ensuring that defrauded investors are fully compensated for their losses, in other words, overrides any distinction based on the relative culpability of the defendants.

Both the Domenici-Dodd bill and the House bill include forms of proportionate liability. The legislation introduced by Senators Domenici and Dodd would restrict the application of joint and several liability to defendants defined as "primary wrongdoers" and their controlling persons, as well as secondary participants who en-

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[31] Testimony of Arthur Levitt, Chairman, Securities and Exchange Commission, Concerning Litigation Under the Federal Securities Laws, Before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives (July 22, 1994), at 18.

[32] The Ninth Circuit has adopted such a proportionate contribution rule. *See Franklin* v. *Kaypro Corp.* 884 F.2d 1222 (9th Cir. 1989), *cert. denied*, 498 U.S. 890 (1990).

[33] The Second Circuit has adopted a *pro tanto* contribution rule. *See Singer* v. *Olympia Brewing Co.*, 878 F.2d 596 (2d Cir. 1989), *cert. denied*, 493 U.S. 1024 (1990).

[34] In *McDermott, Inc.* v. *AmClyde*, 114 S. Ct. 1461 (1994), the Supreme Court recently considered the choice between the proportionate reduction rule and the *pro tanto* rule in the context of an admiralty case. While noting that the arguments between them were closely matched, the Court chose to apply the proportionate rule, largely because it was deemed to be more consistent with the general policies of contribution.

gage in "knowing securities fraud." Other defendants would be only proportionately liable. The bill would also provide that, where all or part of the obligation of a joint and severally liable wrongdoer is uncollectible due to insolvency, individual plaintiffs who meet certain criteria may collect additional amounts from the other, proportionately liable defendants.[35]

The House bill would simply limit joint and several liability to defendants who act knowingly. Defendants found to have acted recklessly would in all events be subject to proportionate liability and would not be required to contribute any additional amount when another defendant is insolvent. Under the House bill, even the issuer could avoid joint and several liability in some cases.

Proportionate liability would inevitably have the greatest effect on investors in the most serious cases (e.g., where an issuer becomes bankrupt after a fraud is exposed). It is for this reason that the Commission has recommended that Congress focus on measures directly targeted at meritless litigation before considering any changes to the liability rules.

The Commission recognizes that there are competing policy considerations that are also derived from concern with the long-term interests of investors. Should Congress determine to adopt some form of proportionate liability for reckless conduct, the Commission would prefer the version set forth in the Domenici-Dodd bill to the broader application provided in the House bill. The Commission is particularly troubled by that aspect of the House bill that would provide proportionate liability to issuers. Among other things, that approach may harm the goal of litigation efficiency by effectively *requiring* that every professional and every involved person be named as a defendant in every case.

The Commission also notes that it would be possible to develop a compromise approach that would increase compensation to defrauded investors, while limiting the exposure of professionals, by placing a ceiling on the amount of damages that a defendant must pay to satisfy the obligation of a bankrupt co-defendant. Such a provision could provide, for example, that liability is joint and several except that no defendant shall be required to pay more than the greater of a specified percentage of the damages or a multiple of the defendant's proportionate share. This might be easier to administer than the procedures proposed in the Domenici-Dodd bill, and it would avoid affording disparate treatment to plaintiffs based on an economic needs test. There are many examples of such approaches in state statutes that relax the application of joint and several liability in negligence cases.

C. Limitation on Damages

The Domenici-Dodd bill and the House bill each have provisions which would limit damages in fraud-on-the-market actions under Section 10(b) to the lesser of: (1) the difference between the price paid by the plaintiff and the market value of the security immediately after dissemination to the market of information correcting the misstatement or omission, or (2) the difference between the price paid by the plaintiff and the price at which the plaintiff sold the security after dissemination to the market of information correcting the misstatement or omission.

These provisions are intended to bring greater certainty to the calculation of damages, a difficult issue in many securities cases. The Commission has concerns, however, that the proposed measures of damages will not reach the appropriate result in certain types of cases. Between the time that a misrepresentation is made and the time that information correcting the information is disseminated to the market, the price of a security may rise or decline for reasons totally unrelated to the violations. As a result, plaintiffs may be undercompensated under the first proposed measure of damages. In addition, the second proposed measure would reduce damages on the basis of unrelated stock price movements that occur *after* the dissemination of the corrective information.[36] The Commission agrees that plaintiffs should not recover damages based on stock price declines that are unrelated to the fraud, but, by application of the same logic, a plaintiff's losses should not be offset by stock price increases that are unrelated to the fraud.

IV. Class-Action Reform Proposals

Class-action lawsuits generally further judicial efficiency and make it feasible for a broad group of investors who have relatively small individual claims to maintain an action for damages. This aggregation of claims makes class actions a powerful

[35] Among other things, the plaintiffs must have a net worth of less than $200,000 and must have unrecoverable damages equal to or exceeding 10 percent of their net worth. While the goal of this provision is laudable, there are some questions as to its efficacy.

[36] We also note that the proposed measures are directed only at cases in which the plaintiffs' injuries result from the purchase, as opposed to the sale, of securities.

deterrent against fraud. Many critics of the private litigation system express concern, however, that the existing system contains inadequate safeguards against abuse.

Reforms designed to eliminate abuses in class-action lawsuits are an important area in which it appears that a consensus can be reached. Virtually all parties to the litigation reform debate agree that restrictions should be placed on the manner in which class counsel locate and enlist the "named plaintiffs" for class actions. The "race to the courthouse" phenomenon serves no useful purpose.

The Commission has previously endorsed a number of legislative measures included in both the Domenici-Dodd bill and the House bill.[37] These measures would prohibit the payment of additional compensation to a class representative, the payment of referral fees by an attorney seeking to act as class counsel, and service as class counsel by an attorney who has a beneficial interest in the securities that are the subject of the litigation unless specifically authorized by the court. The Commission believes that measures such as these would impose some discipline in the system and provide a check against the precipitous filing of class-action lawsuits that have not been adequately investigated.[38] The Commission also supports the prohibition on the payment of attorneys' fees from funds disgorged in a Commission action.

The bills would also require more specific disclosures designed to enable class members to evaluate the adequacy of a proposed settlement. The Commission strongly supports efforts to enhance disclosure to class members.

Several other class-action procedural reforms are proposed in the Domenici-Dodd bill. Among other things, these measures would restrict placing settlements in implied private class actions under seal unless good cause is shown; and require that attorneys' fees be calculated as a percentage of the amount actually paid to the class, rather than under the "lodestar" method in which courts review attorneys' time records and multiply the hours worked times a reasonable hourly rate.[39] Although the Commission does not oppose either of these proposals, it believes they may have implications outside the Commission's area of expertise, and for that reason does not affirmatively endorse them. The Commission recommends that the Subcommittee seek the views of the Judicial Conference of the United States on these points.

Both the Domenici-Dodd bill and the House bill contain provisions that would mandate that independent parties oversee class counsel in securities class actions. Under the provisions proposed in the Domenici-Dodd bill, the court would be required to appoint either a guardian ad litem or a steering committee of class members to direct class counsel and perform whatever other functions the court may specify. The guardian ad litem or the steering committee would have the authority to retain or dismiss class counsel and to reject offers of settlement or preliminarily accept offers of settlement.

The Commission recognizes that these proposals are designed to address potential conflicts of interest between class counsel and members of the class, as well as the difficulty that investors in a plaintiff class have in exercising any meaningful direction over the case brought on their behalf.[40] The Commission shares these concerns, and it supports greater involvement by investors, particularly institutional investors, in class-action suits brought on their behalf. The Commission is also concerned, however, that both the guardian ad litem and the plaintiff steering committee provisions have the potential to increase, rather than decrease, the case management

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[37] Although the provisions of the Domenici-Dodd bill are limited to certain types of actions, most of these proposals should be applicable to class-action lawsuits under all of the private causes of action provided in the Federal securities laws.

[38] *See* Testimony of William R. McLucas, Director, Division of Enforcement, Securities and Exchange Commission, Concerning Private Litigation Under the Federal Securities Laws, Before the Securities Subcommittee, Committee on Banking, Housing, and Urban Affairs, U.S. Senate (June 17, 1993).

[39] Proponents of the percentage-of-recovery method argue that it better aligns the interests of class members and their lawyers than does the lodestar method. At least two circuits mandate the use of the percentage-of-recovery approach in securities class action and other "common fund" cases. *See Swedish Hospital Corporation* v. *Shalala*, 1 F.3d 1261 (D.C. Cir. 1993); *Camden I Condominium Association* v. *Dunkle*, 946 F.2d 768, 774 (11th Cir. 1991). An expert task force appointed by the Third Circuit also recommended abandoning the lodestar method for a percentage fee method. *See* Report of the Third Circuit Task Force, *Court Awarded Attorneys' Fees*, 108 F.R.D. 237 (1985).

[40] For more extensive discussions of the agency problems in class actions, see Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. Chic. L. Rev. 1 (1991); John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 Colum. L. Rev. 669 (1986).

problems associated with class-action litigation. The Commission also notes that these proposals have been opposed by the securities industry, by attorneys representing both plaintiffs and defendants, and by other commentators. In light of such opposition, it may be more productive to focus on measures as to which a consensus can be reached.[41]

Finally, the Domenici-Dodd bill contains a provision that would restrict the right of investors to serve as class representatives unless they held a certain minimum amount of the securities at issue. This proposal has been strongly opposed by parties who believe that it is inconsistent with the goal of protecting the rights of individual investors to require that investors meet a minimum threshold of share ownership before being allowed to initiate an action on behalf of a class. Because there are other ways to ensure the suitability of class representatives, and because other provisions in the Domenici-Dodd bill would deter abuses in this area, the Commission recommends that the share ownership threshold be deleted.

V. Statute of Limitations

In 1991, the Supreme Court held that private actions under Section 10(b) of the Exchange Act must be filed within 1 year after discovery of the alleged violation, and no more than 3 years after the violation occurred.[42] The Commission has previously urged Congress to address the *Lampf* decision by enacting an express statute of limitations that would allow cases to be filed up to 5 years after a violation occurs, provided they are brought within 2 years after discovery of the violation. Extending the statute of limitations is warranted because many securities frauds are inherently complex, and the law should not reward the perpetrator of a fraud who successfully conceals its existence for more than 3 years.

The Domenici-Dodd bill includes a statute of limitations provision that incorporates the 5-year/2-year test. The 2-year period, however, would begin on the date on which the alleged violation was discovered or "should have been discovered through the exercise of reasonable diligence." Because, the Commission believes that the reasonable diligence qualification would simply lead to counterproductive litigation over a question unrelated to the merits of a particular case, it recommends that the qualification be deleted. In the Commission's view, even a requirement that cases be brought within 1 year of actual knowledge would be preferable to a provision that encourages a defendant to argue that investors should be foreclosed from recovery because they could have discovered the defendant's violation at an earlier point in time.

VI. Conclusion

Our first goal must be to protect investors and preserve and strengthen our capital markets. Private litigation serves as a vital element in the enforcement of the Federal securities laws. In crafting legislation, it is critical that Congress strike an appropriate balance between encouraging meritorious suits while attempting to deter frivolous or speculative litigation.

There are many proposals for improving private litigation under the securities laws that the Commission supports. We believe that carefully crafted legislation, if enacted, would significantly improve the system, balancing the need to eliminate abusive litigation practices with the need to preserve the benefits provided by private enforcement of the securities laws.

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[41] We note that there is evidence that institutional investors are becoming more actively involved in class-action litigation. *See* K. Donovan, *Pension Managers Speaking Up—Institutional investors ready for role in class-action securities suits,* National Law Journal, March 13, 1995, at A6. We also note that, as the current legislative debate draws attention to this area, other creative measures that address these issues may emerge. Professor Lester Brickman, for example, has recently advocated *excluding* institutional investors from participating in class actions, which would have the effect of forcing the institutional investors to bring their own suits if they believe the case has merit. *See* P. Passell, *Economic Scene—A simple proposal for cutting down on securities fraud suits,* New York Times, March 23, 1995, at D2.

[42] *Lampf, Pleva, Lipkind, Prupis & Petigrow* v. *Gilbertson,* 501 U.S. 350 (1991).

PREPARED STATEMENT OF RICHARD C. BREEDEN

CHAIRMAN, INTERNATIONAL FINANCIAL SERVICES, COOPERS & LYBRAND L.L.P.
FORMER CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION
NEW YORK, NY

APRIL 6, 1995

Chairman Gramm and Members of the Subcommittee, I appreciate the opportunity to testify today concerning an issue of the utmost importance for the health of our capital markets.[1] During my tenure at the SEC, I frequently spoke out through both speeches and testimony concerning the need for a vigorous program of investor protection. However, I also spoke out frequently against the dangers of growing abuses in the system of private litigation under the Federal securities laws.[2] As early as 1991, I began to work with Senators Dodd, Domenici, Sanford, and others on earlier versions of what is now S. 240.[3]

At the risk of ruining any suspense and rendering moot the remainder of my testimony, let me get right to the "bottom line." While it does not go as far in some areas as I would prefer, S. 240 is in my view an extremely thoughtful and well-balanced piece of legislation. Our economy and our legal system are suffering from open and notorious abuses in private securities litigation, and this bill would make long overdue corrections. You could pass this bill tomorrow—and you should—and the country would be better off.

In an attempt to perpetuate the rich spoils a very few lawyers reap under the status quo, there will be many dire predictions that various provisions in S. 240 will hurt investors severely. These predictions are wrong for at least three reasons.

First, this bill has had careful consideration over several Congresses. There have been extensive and I believe successful efforts to balance and to harmonize difficult competing interests. Ultimately, there is not any perfect formula for reconciling the competing concerns of all involved parties. Given the sheer volume of case law under the securities laws, opponents of doing anything can endlessly raise detailed legal issues that ultimately involve similar questions. Details are important, but after 4 years of work on this legislation it is a very careful bill. To me it is much more important that we summon the will to act and to begin solving real world problems than that we let ourselves be immobilized.

Second, the heart of the investor protection system is the SEC, not the professional plaintiffs and the handful of law firms who have made the strike suit an art form. Having voted on more than 1,200 SEC enforcement matters, in my judgment this bill will not in any appreciable way curtail the SEC's ability to seek out and bring enforcement actions. Nothing in this bill would take the Marshall off duty. All

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[1] I currently serve as Chairman of the worldwide financial services practice of Coopers & Lybrand, L.L.P., which like the other major accounting firms is strongly in favor of legislation to reform the litigation process under the Federal securities laws. However, I am appearing here in my personal capacity, and as the former Chairman of the U.S. Securities and Exchange Commission from 1989–1993. The views set forth herein do not represent those of Coopers & Lybrand, L.L.P., the accounting profession generally or anyone other than myself.

[2] "Excessive class-action settlements may deter companies from raising capital through the public markets and operating as public companies. In addition, litigation in all too many cases may be seen as the route for trying to recover what may have been market losses. In effect, some investors may seek a system of 'Heads I win, tails I sue.' The challenge, then, is to devise ways to reduce unwarranted securities litigation without closing the courthouse door for victims of *intentional* securities fraud." (emphasis added)

"Limiting the Cost of Securities Litigation," remarks before the Corporate Counsel Institute, Chicago, Illinois (October 16, 1991). *See also* Testimony of Richard C. Breeden, SEC Chairman, before the Subcommittee on Securities, Committee on Banking, Housing, and Urban Affairs, U.S. Senate (October 2, 1991) and before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives (November 21, 1991).

[3] During 1991 and 1992, the SEC suggested various concrete steps to help address the problem of abusive litigation. These proposed reforms included (i) "applying some form of the 'English Rule' in our securities litigation;" (ii) deleting securities fraud as a predicate offense under the civil liability provisions of the Racketeer Influenced and Corrupt Organizations Act ("RICO"); (iii) limiting the personal monetary liability of corporate directors in suits not involving intentional misconduct or improper personal benefit; (iv) substantially limiting the fees and expenses that a court could award to plaintiff's counsel in a settlement of a securities class action; (v) limiting the recovery of a named plaintiff in a class action; (vi) prohibiting the payment of counsel fees out of SEC disgorgement fees; and (vii) reforming abusive practices in the organization and management of class-action suits, including various unsavory payment practices.

it really does is to make the vigilante committee more accountable for stringing up the wrong person.

Third, we shouldn't be afraid to seek new ways to improve our current system. We have the broadest, deepest, and most transparent securities markets in the world. We also have markets that are the most fair to investors. I don't want to see that change, as I think the market's integrity is a competitive strength and fundamental to our ethical beliefs.

While we have a great market, we also have a serious problem. In countries all over the world, issuers, regulators, and investors asked me when I was SEC Chairman why the U.S. encouraged so much costly litigation, and why we could not control excessive litigation better than we do. By failing to prevent undue costs of litigation, we lose some of the benefits of our market and its efficiency. Frankly, there is too often a tendency for some to believe that the U.S. has the very best markets and the very best regulators, and *therefore that nothing ought to change.* While the predicate is almost certainly true, the conclusion is not correct.

Complacency is a real danger in such a rapidly changing and competitive world. We must not lose the capacity to innovate in law and regulation as well as in products and services. While private securities litigation has played a very important role in the past—and still does today—that doesn't necessarily mean it should play such a role forever.

Protecting investors against fraud is very important, but protecting them against murder, burglary, and assault is probably just as important to them. Yet the latter vital "protections" we leave to the police, without private legal hunting licenses. Similarly, in earlier times we supplemented the resources of the Navy with privateers operating under Letters of Marque. Though that system served us well, the privateer ultimately disappeared from the scene. Few today would wish to see yachtsmen armed with cruise missiles in order to be able to help out the Navy in a conflict. The point is that the quality of our market and the strengths of our traditions must not immobilize us from a willingness to change to keep pace with events or to find a better way forward. We do have a problem and S. 240 is in my view a highly thoughtful response. Furthermore, if we do not successfully reform private actions, then we may ultimately be forced to eliminate them, and I would prefer the former course.

The Need for Reform

Reforming the system of private litigation under the Federal securities laws is an issue that has become steadily more important as the current system has become more and more abusive. By driving up the cost of capital and limiting the access of some firms to the capital markets, the current system damages the growth of our economy and its ability to create jobs. Ironically, what was intended to help "protect" investors has become a system that itself often does great damage to the very investors it is supposed to protect.

In a sad parody of the original purposes of the securities laws, private litigation today is often filed without regard to actual wrongdoing by issuers, directors, or others. Particularly for small businesses and high-technology firms, whose stock prices are by nature more volatile, natural market price moves may become the subject of suits alleging that something important was omitted from disclosure, or that the disclosures that were made were misleading. Undoubtedly there are such cases, and there are all too many outright frauds. However, there are few if any realistic disciplines against the plaintiff's bar bringing lawsuits whether or not there are any facts and circumstances that reasonably suggest the existence of wrongdoing. A conclusory complaint is often quickly filed, and a legal dredging operation called "discovery" then begins, at huge cost to the defendants, searching for facts that might support the pre-existing allegations. The lawyers have every incentive to bring as many such cases as possible, and to drive the costs as high as possible in the expectation that many companies will resign themselves to settling even the most specious claims just to avoid further costs of litigation that they can never recover.

The people who are most badly hurt when this sadly familiar pattern happens are the company's shareholders, who indirectly pay all the costs of both prosecuting *and* defending these suits. When legal fees are paid to defend a suit, the company has less money to employ workers, to improve its efficiency or to pay dividends. When a settlement is reached, the amounts paid come from the company's current profits or net worth, which are owned entirely by the shareholders. The company's financial condition is weakened mostly to make payments to the lawyers who brought the case. Sometimes shareholders also recover, though even when this happens it is a transfer of resources from one body of shareholders to another, with most of the money going to the middlemen.

Shareholders are also damaged due to the chilling effect of the current system on the robustness and candor of disclosure. This is a particularly severe problem with respect to forward-looking discussions by a company. Understanding a company's own assessment of its future potential would be among the most valuable information shareholders and potential investors could have about a firm. However, it is almost 100 percent certain that descriptions of future prospects will ultimately prove inaccurate in some degree due to the infinitely variable world in which we live. The result is that in every such case there is a built-in opportunity for combining a subsequent price decline with an "inaccurate" statement to produce a high likelihood of litigation. Faced with this reality, many companies that might otherwise provide more assessments of their future business risks and opportunities decide that to curtail litigation risk they will not go beyond what is absolutely required. The result is that too many "disclosure" documents are actually legal tracts written by lawyers mostly to defend against other lawyers, and not by companies to inform investors.[4]

The damage does not stop with the shareholders of a company that undergoes a "strike suit." The likelihood of litigation against directors deters talented people from serving as directors of small or troubled public companies, exactly where good directors are most needed. Thus, investors in many companies are damaged because outstanding people are unwilling to serve as independent outside directors.

Going too far in pursuit of investor protection may be just as damaging to the economy and investors as it would be if we didn't go far enough. Among other things, under the current approach to private litigation too many people blithely equate "reckless" behavior, when in fact the two situations are strikingly different. Deliberate lying or falsification of financial information should never be excused. However, almost every small or struggling company—and many larger ones too—is subject to risks that even the most diligent businessman or auditor may not spot, or may see but not adequately evaluate as to its importance.

The problem is that almost anything can be said to be "reckless," and it is all too easy to apply 20/20 hindsight to a complex problem and conclude that *someone* behaved less than perfectly. The standard of "reckless" behavior has tended to expand in recent years as courts, and even at times the SEC, tried to reach out to compensate investor losses. I know from personal experience how tempting it is to try to make the "innocent investor" whole. However, to the degree that the threshold standards for proving "fraud" or "recklessness" decline—often imperceptibly in a given case but significantly over time—then we are to the same degree transforming "auditors" (and underwriters) into "insurers."

Over the long run, such a policy will be very damaging to investors. Since auditors don't get paid to be insurers, if that is the *de facto* result of the legal process they must charge much higher fees and ultimately decline to provide services in higher risk situations such as audits of smaller and less stable companies, or companies conducting IPO's, or restructurings. As a result, companies will pay more for audits than they should, and some will pay a higher cost for capital—or not find it at all. This will hurt their shareholders along with their competitiveness.

Potential investors may also have to rely on less qualified auditors in some transactions because many auditing firms will become unwilling to undertake engagements where the risk of being second-guessed later is simply too high. In addition to damaging companies, this will also reduce the quality of information available to potential investors. We won't know how many new frauds will occur because we drove the best auditors out of the market. However, if we stay on our present course that will happen, and it will hurt investors.

Securities markets inherently involve risk taking. We want to deter fraud, but investors must understand that we can never eliminate all wrongdoing no matter what we do. Investors who want a "zero risk" standard can always invest in short-term Treasury securities. Investors who seek higher returns inevitably also take higher risks, including the risk that an investment will result in significant losses, even with perfect disclosure. Investors should be free to take higher risks in search of higher gains, even where there are warning signs that something is amiss in a company. At the same time, at some point investors who take large risks may be engaged in "reckless" conduct themselves.

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[4] The SEC is currently considering this issue as part of a rulemaking proceeding. A reasonable safe-harbor provision for good faith predictive statements would benefit companies by limiting the potential for claims of misleading statements brought after-the-fact. Such a provision would benefit investors even more by removing strong disincentives for companies to discuss their evaluation of the future candidly with their shareholders. The safe-harbor provision adopted by the House in H.R. 1058 meets these objectives, while permitting the Commission to continue its ongoing proceedings regarding safe-harbor regulations.

Therefore, while we benefit from using the law to create strong deterrence against deliberate misconduct, trying to create absolute insurance against loss goes too far. Investors should have incentives to protect themselves through a combination of careful review of disclosures, diversification, selection of less risky instruments, reliance on professional managers, and other forms of prudent behavior. Reasonable and vigorous steps to protect investors against the most egregious conduct is good for the market, but beyond some point more is *not* better. Here the adage about the dangers of too much of a good thing needs to be remembered.

Benefits from Private Litigation

Though there are many faults in the current system, we must also be sensitive to its enduring purposes. If companies or their insiders were able to lie about their financial results or other important factors with impunity, then investors certainly would be deterred from participating in the market.[5] This, too, could drive up the cost of capital through a simple process of supply and demand.

Both explicit and implied private rights of action under the Federal securities laws have long been used to allow investors to seek redress from violators of the Federal securities laws.[6] In addition, these actions traditionally served to supplement the enforcement resources of the SEC by creating a healthy deterrent to wrongdoing by corporate insiders, market professionals, professional advisors and others. Though less important today because of the greater resources of the SEC, meritorious private actions still help to deter wrongful conduct and play an important role in maintaining the honesty and integrity of the markets.

Despite similar objectives in some respects, there is an enormous difference between private actions and SEC enforcement. In a case being considered by the SEC, potential defendants have the protection of prosecutorial discretion by an independent agency. More importantly, the SEC does not have a profit incentive to make allegations of wrongdoing, or to engage in more prolonged proceedings than necessary. These two vital protections are missing from private strike suits. Here the lawyers who bring class-action suits on a contingency fee basis have an immense conflict of interest. They are participating in a suit alleging wrongdoing under the law. At the same time, they are personally engaged in a profitmaking entrepreneurial enterprise much akin to an investment limited partnership. Thus, they are anything but impartial seekers of justice. By their acts, these lawyers may deliberately (or recklessly) impose unjustified costs on others largely with impunity.

Finding A Better Balance

Thus, this debate must ultimately determine an appropriate balance between protecting investors against fraud and protecting corporations, shareholders, directors, professionals, and others from costly damage due to unwarranted suits. We must also decide whether we are willing to settle for small changes at the margin that everyone can agree on, or whether fundamental and far-reaching change is necessary even if it cannot be achieved by consensus.

Given that there are strong and diametrically opposed financial interests at stake between the trial lawyers and their victims, waiting for consensus to develop may take longer than waiting for the next return of Halley's Comet.[7] In my own view, the economic stakes of this issue are high enough that the public should demand more than a legislative fig leaf. Congress should act promptly and firmly to restore more balance to our system.

Though S. 240 will address many of the abusive practices and perverse incentives in the current securities litigation system, I would like to comment generally on several of the specific policy considerations that are raised by S. 240 and by the House bill, H.R. 1058. These factors need to be considered in weighing the magnitude and nature of final legislative action.

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[5] "When corporate officers, accountants, lawyers, or others involved in the operation of a public company deceive investors for their own benefit, they should be held accountable for their actions. If this were not the case, investors would be far less willing to participate in our securities markets. This would limit the most important source, and raise the costs, of new capital for all American businesses." Letter of Chairman Richard C. Breeden to The Honorable Pete Domenici, August 12, 1992.

[6] "Section 10(b) of the Exchange Act and Rule 10(b)(5) thereunder are not technical or obscure regulatory provisions. Rather, they represent the core provisions of the Federal securities laws that prohibit deliberate fraud against investors."

Testimony of Chairman Richard C. Breeden before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives (November 21, 1991), p. 3.

[7] Indeed, urging a "consensus" approach may, in effect, amount to calling for no significant action at all.

1. *Role of the SEC.* As previously indicated, the SEC and the 50 State securities commissioners have an essential role in bringing antifraud or similar enforcement actions against wrongdoing under section 10(b) or under other statutory sections. Securities litigation reform legislation should not, and S. 240 would not, limit this authority or cause the SEC to abandon enforcement actions in any significant fraud cases.[8]

2. *The Damage Caused by Entrepreneurial Litigation.* Unfounded allegations of securities fraud or other violations of the law impose very significant costs on companies, directors or others, sometimes running into millions of dollars. A plaintiff's lawyer pursuing such a case on a contingency fee has become a co-venturer in an enterprise which by design will impose substantial costs on the defendants. If the same plaintiff and/or his or her counsel were to set fire to a company's plant and cause an equivalent dollar amount of damage, few would doubt that they should be liable for such damages. Interestingly, the same lawyers who insist that corporate officers, directors, accountants, underwriters, and others should be liable for "reckless" behavior assert that they should not have any responsibility for causing very large monetary damages to defendants they sue even though their own conduct may exceed any reasonable standard of recklessness.

3. *Cost Shifting Proposals.* Some form of the so-called "English Rule" (loser pays the costs of the winner) would create a substantial, direct and non-manipulable deterrent against baseless litigation or against theoretical but speculative cases. Any form of cost shifting would address the conduct of plaintiff's lawyers in imposing costs on defendants without meaningful risk to themselves. Any such rule also has the highly beneficial effect of putting a fully vindicated defendant back into his or her financial condition before the allegations made by the plaintiff.[9] Without any such rule, defendants found completely blameless may nonetheless have suffered millions of dollars in expenses that in a very real sense were deliberately caused by the losing party.

An unlimited "loser pays" system could result in small investors paying out a substantial portion of their net worth, even if they pursued an action that was based on facts that appeared to represent substantial justification for the action. The practical effect of that possibility would be to deter small investors from bringing a fraud action against a large corporation. That would be too draconian a solution.

There are a variety of ways to mitigate such risk of loss for the small investor while still retaining the benefits of a cost-shifting requirement. One way to do this would be to make counsel handling a case on a contingency fee liable for the same percentage of costs incurred as they were entitled to receive if the case was successful. In such a case, a law firm that stood to gain one-third of any recovery from the defendant if the plaintiff prevails, would be exposed to paying one-third of a successful defendant's costs. Alternatively, cost shifting could be mandatory except where a judge found that a claim was "substantially justified" when filed. We should not bar the courthouse door to those who are victims of deliberate wrongdoing. At the same time, the plaintiff's bar should not be able to turn all of American business into a free fire zone without accountability.

4. *Judicial Alternatives to Cost Shifting.* Judges have proven unable or unwilling to curtail abusive litigation. While Section 11(e) of the Securities Act of 1933 and certain provisions of the Federal Rules of Civil Procedure empower judges to impose various sanctions on parties and/or counsel who bring actions without adequate justification, these types of remedies have not worked in the past. Though in the early 1990's I thought that strengthening Rule 11 of the Federal Rules of Civil Procedure was one workable method of deterring abusive conduct, I no longer believe this to be the case. Indeed, in 1993 this rule was weakened rather than strengthened.

There is not any reason to believe that giving judges new authority to impose costs on nonprevailing parties would be any more effective than current law, which has utterly and completely failed to establish a sufficient deterrence against unjustified claims and fishing expeditions. The same would be true with giving the SEC the authority to participate in private actions where it believes a case is unwarranted. This would enlarge the Federal bureaucracy without any meaningful benefit.

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[8] The SEC has by far the largest and most effective force dedicated to combating securities fraud of any country. The Enforcement Division of the SEC is roughly 10 times the size of the entire staff of the Securities and Investments Board ("SIB") of the United Kingdom, the SEC's counterpart agency for the London market. On top of this powerful Federal resource, each of the 50 States also has the capability to pursue violators of State securities laws, which typically parallel and duplicate Federal law.

[9] It would also allow a victorious plaintiff to collect the entire amount of his or her damages without deducting litigation costs from recoveries.

5. *Recklessness.* In the past, I have argued for statutory action to redress the common law expansion of definitions of "reckless" behavior as a predicate for liability. However, I am no longer convinced that this would be the best course.

I continue to be greatly concerned with findings of "reckless" behavior for conduct of an increasingly minor nature. My position has been that it would be far better to limit private suits to intentional fraud than to allow suits any time a lawyer can dream up a reason to allege that someone's conduct was "reckless."

This, of course, raises the issue of whether limiting actions to intentional conduct would solve one problem but create another by raising the threshold of liability too high. Here again there are several potential steps that might be taken to strike the best overall balance.

First, any limitation of actions based on a "reckless" behavior standard should apply to private actions, but not to actions by the SEC. The risk of overuse of allegations of reckless behavior is not as great with actions by the Commission, since it exercises prosecutorial discretion in its selection of cases. In addition, decisions by the SEC to pursue an action are based on a view of the overall public interest, while private actions necessarily include a private entrepreneurial interest in the potential recovery from a case. Second, if the Congress decides to include statutory language curtailing private actions based on alleged reckless conduct—which I do not recommend—the language should attempt to specifically define "willful blindness" as intentional conduct. This would prevent parties from seeking to remain ignorant of wrongful conduct.

My concern, however, is that arriving at a definition of "willful blindness" that will in fact limit liability may be extremely difficult, as evidenced by the recent debate in the House Commerce Committee over just this issue. Given the risk that a statutory definition might do more harm than good, this issue is probably best left to the courts.

6. *Proportionate Liability.* The current application of "joint and several" liability results in a system that should perhaps be called "Disproportionate Liability." Often the most culpable parties to perpetrating a fraud may be unable to make meaningful restitution. Current law makes anyone else—like accountants or underwriters—who was deemed to be "reckless" liable for the entire amount of damages rather than simply whatever portion of damages they may have caused.

The argument for the system of joint and several liability has been described in testimony before this Subcommittee by the SEC's Enforcement Director. He stated:

> [A]s between innocent investors who have been defrauded and professional advisors who have access to information within the company and have knowingly or recklessly assisted the fraud by failing to meet professional standards, the risk of financial loss under the current system falls on the latter.[10]

With respect to intentional or deliberate conduct, this point is certainly valid. However, with respect to allegedly "reckless" conduct, where the line between "reckless" (joint and several liability) and "negligent" (not resulting in liability) conduct is much more difficult to draw, this argument is on weaker ground.

Among other things, this argument assumes that all investors are "innocent," when some investors may not be entirely blameless in that they too have access to information that could make it "reckless" or "negligent" to disregard risks in the pursuit of gains. Investors may not have read disclosures that were made, or may otherwise have taken risks knowingly and aggressively. This isn't always the case, but it is sometimes the case.

Second, this argument ignores the risks and costs discussed earlier of turning professionals into insurers. Over the long haul that will penalize other "innocent" investors and many honest companies.

Third, the argument suggests that it is much more clear than it usually is when someone "fails to meet professional standards." While in some cases a receiver catches a touchdown pass because the cornerback completely blows the coverage, other times the defender may have done his very best and the touchdown is scored anyway. Similarly, there is a large risk that courts and juries may assume that poor audit performance necessarily reflects a lack of professional standards, and disproportionate liability is the result.

Given all of these circumstances, joint and several liability should continue to be applied in cases of intentional or deliberate wrongdoing. However, where conduct is "reckless," liability should be limited to the actual share of a defendant's role in the

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[10] Testimony of William R. McLucas, Director, Division of Enforcement, SEC, Hearings Before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (July 21, 1993) at 118.

problem. Here courts would have considerable flexibility in determining a defendant's proportionate share in wrongdoing based on how integral such a person was to the conduct in question, or other factors.

While such a provision would reduce the liability that my firm and other accounting firms face when we are accused of not discovering a fraud that was hidden from us along with others, that reduction would bring a measure of fairness to what is today a world operating upside down. Paying your fair share, but no more than your fair share, of liability is hardly a radical proposal.

7. *Investor Responsibility.* We have moved much too far away from the inspired roots of the disclosure system embedded in the Securities Act of 1933 toward a system of *de facto* "no fault" investing. In too many cases, corporations, institutional investors or other investors may seek to resort to bringing suits alleging a lack of suitability, "fraud," or other factors when the market moves against them.

The whole point of making issuers publish highly detailed information is to make it possible for investors to make an informed investment decision, not to insure that they do so or that every investment will be profitable. Investors should have accountability for living with the risk/reward tradeoffs that they make when they invest.

We should not allow our system to become "Heads I win, tails I sue," because if we do, we would wake up to discover that we didn't really have a market at all. It will be healthy for Congress to reinforce the original intent of the law, which was never intended to guarantee investors a rose garden rather than a porcupine patch. Here, our focus needs to be on deterring truly abusive conduct, and in making sure that investors understand that they are taking significant market and other risks.

Conclusion

This entire area is not a world of black and white. Some shareholder suits are justifiable and desirable. Others are highly damaging to our system.

Today, the balance struck by current law promotes a level of litigation that is damaging our economy. We need to strike a better balance by eliminating clear abuses in the system, and we must do that in a manner that preserves America's commitment to capital markets in which honesty, integrity, and transparency are core values that we are prepared to protect. At the same time, we should be entitled to demand honesty and integrity from our legal system, and in this area the current state of affairs is deplorable.

I applaud the authors and cosponsors of S. 240, which goes a long way toward meeting these goals. I urge the Senate to act with dispatch to pass this critical legislation.

PREPARED STATEMENT OF DR. CHARLES C. COX

SENIOR VICE PRESIDENT OF LEXECON INC.

FORMER COMMISSIONER AND ACTING CHAIRMAN

SECURITIES AND EXCHANGE COMMISSION, CHICAGO, IL

APRIL 6, 1995

Introduction

Chairman Gramm and Members, I appreciate this opportunity to testify before the Subcommittee on the subject of securities litigation reform. I served from 1983 to 1989 as Commissioner of the Securities and Exchange Commission. During 1987, I was Acting Chairman of the Commission. Since 1989 I have been Senior Vice President of Lexecon Inc., a Chicago consulting firm that specializes in the application of economics to a variety of legal and regulatory matters.

During my service as Commissioner, I was involved in approximately 1,700 SEC enforcement actions. At Lexecon, I have studied the economic evidence regarding allegations in approximately 100 private securities cases. I have testified as an expert witness in about a dozen private securities fraud cases. As a result of my experience, I believe that I have considerable expertise on securities litigation to offer the Subcommittee.

From my experience and studies, I have concluded that the economic incentives under the current law result in social costs of class-action securities lawsuits that exceed their social benefits. Put simply, there are too many class-action securities lawsuits. The net result is a deadweight loss for the economy where substantial resources are diverted from productive uses to redistributing wealth without achieving much, if any, deterrence of fraud or compensation of defrauded investors. The prin-

cipal beneficiaries of class-action securities cases are not investors, rather the primary beneficiaries are plaintiffs' lawyers, and the secondary beneficiaries are other participants in the litigation process such as defendants' lawyers and consultants (including me). The costs of class-action securities lawsuits are high. There are direct costs of litigating—the costs incurred by law firms, consultant, corporations, insurance companies, and the courts. There are also indirect costs—adverse effects on business risk-taking, financing, and disclosure to investors. Class-action securities lawsuits have become a counterproductive "tax" on public corporations the proceeds of which go to lawyers and the burdens of which are passed on ultimately to consumers and stockholders.

The securities laws should be obeyed. Violators should be sanctioned to deter future violations and to compensate investors who are damaged. I am not arguing that securities fraud should be ignored because it is costly to prevent and sanction. I am saying instead that incentives should be set to discourage frivolous lawsuits and to deter real fraud. Consequently, I support legislation to reform private securities litigation. Either S. 240, the Private Securities Litigation Reform Act of 1995 or H.R. 1058, the Securities Litigation Reform Act, would reduce frivolous lawsuits and more effectively deter real fraud. Moreover, neither S. 240 nor H.R. 1058 would impair the ability of the SEC to enforce the Federal securities laws.

Economic Incentives for Class-Action Securities Suits

Under existing law there is an economic incentive to file securities class-action lawsuits when a company's stock price drops significantly for any reason because it is profitable for plaintiffs' lawyers. A company's stock price decreases in reaction to news that causes investors to reduce their anticipations about the firm's future profitability. That is, stock prices drop when there is "bad" news. Class-action lawsuits are filed the day of or shortly after the price drop claiming that the bad news should have been disclosed months or years earlier, the stock price had been artificially inflated, and investors who purchased the stock had been defrauded. For a company with several million shares of actively-traded stock, the estimated damages to all investors who purchased the stock during the alleged fraud are in the tens or hundreds of millions of dollars. The plaintiffs' lawyers' share of this amount of damage recovery would be several million dollars.

One might surmise that the frivolous and nonmeritorious class-action suits would be dismissed prior to trial or weeded out at trial when a jury decided if the evidence supports or contradicts the allegations of fraud. In my experience, however, that is not the way private securities litigation works. A few (approximately 1 percent) class-action suits are dismissed by a court before they get to a trial. For the cases that do go to trail, the verdict is often for the defendant. However, most (approximately 96 percent) class-action securities suits settle. The settlements which generally run about 8 to 10 percent of the claimed damages yield several million dollars of fees for plaintiffs' attorneys. Defendants choose to settle rather than litigate through a trial because their costs of litigating are high—millions of dollars—and they face the risk of a multimillion dollar damage payment if the jury finds that there was fraud. Moreover, a settlement usually involves a partial payment from the officers and directors' insurance company while the insurance does not pay if there is a finding of fraud. Individual defendants have a strong incentive to settle because they face the risk of a finding that they personally defrauded investors and violated the Federal securities laws. The plaintiffs' attorneys, too, prefer to settle because they are assured a substantial payment of fees from the settlement amount, but they would earn nothing if a jury finds for the defendant.

The class-action plaintiffs' lawyers do not have clients in the usual sense of plaintiffs who retain the lawyers and fund the litigation depending on an evaluation of the merits of the case and the probability of winning at trial. Instead, the securities class-action lawyers file suits when it is in their own self-interest regardless of the merits of a case. As it turns out, even weak class-action cases settle for millions of dollars. I have observed many cases in which the economic evidence contradicted the plaintiffs' fraud claims, but which settled with fees of several million dollars for plaintiffs' lawyers.

In summary, there are many companies that experience substantial stock price decreases during any time period. These companies are candidates for securities class-action lawsuits, and if the company has stock that is widely held and actively traded so the alleged damages are many millions of dollars, there usually are several suits filed. When class-action suits are filed, the evidence is mainly the decrease in the stock price which in and of itself says nothing abut fraud. Class-action suits that survive motions to dismiss usually settle and the settlement is generally for millions. Consequently the economic incentives lead plaintiffs' lawyers to file and pursue many nonmeritorious cases.

Costs and Benefits of Class-Action Securities Lawsuits

The direct costs of litigation class-action securities cases include plaintiffs' and defendants' attorneys' fees, costs of complying with discovery requests, and the courts' costs. These costs are millions of dollars per case. Even though most cases settle, there is generally extensive discovery and motion practice. Moreover, the direct costs are not limited to the plaintiffs' lawyers and the company that was sued because other defendants such as individual managers and directors, accountants, lawyers, and investment bankers are often named in the class-action complaint. For cases that are dismissed or decided at trial, there is often an appeal which increases the direct costs. There is some evidence that, on average, the direct costs are about the same as the amount of money distributed to class members.[1]

The indirect costs of class-action lawsuits are probably larger than the direct costs. Managers and directors of a company that has been sued are diverted from managing the company's business to managing the company's litigation. Insurance costs for all companies are higher because of the frequency of lawsuits and settlement payments by insurance companies. Accountants and other professionals' fees increase to account for the risk of a class-action lawsuit. Since class-action lawsuits follow stock price declines, some companies may even avoid risky projects that could cause a stock price decrease or make the stock price more variable even though the risky projects would otherwise be economically beneficial. Some companies will not become publicly-traded companies and forego the benefits of financing through the stock markets. Some public companies will secure additional financing through means other than issuing stock.

This counterproductive tax from private securities litigation falls especially heavily on new firms, young firms, firms that specialize in one or a few products, and entrepreneurial firms because these types of firms have volatile stock prices. Although securities class-action lawsuits cover the entire spectrum of industries and firms, I have observed that they are concentrated where stock prices are especially volatile.

Another area of indirect costs is companies' public disclosures. Disclosures may become less, not more, informative for investors because companies avoid forward-looking statements, adopt policies of no predictions, and say nothing at all about uncertain events. This happens because the companies face large potential liabilities in class-action lawsuits if the predictions turn out to be wrong. I have observed in class-action lawsuits that companies that say nothing about future prospects are better off than companies that announce predictions that later turn out to be wrong.

The social benefits of class-action lawsuits are deterrence of securities fraud and compensation of defrauded investors. However, the evidence that I have seen leads me to conclude that these benefits are far less than their costs under the current law. First, the concentration of class-action suits in industries with volatile stock prices indicates that class-action suits are focused more on stock price decreased than evidence of fraud. There is no reason to believe either that securities law violators congregate in industries with volatile stock prices or that an epidemic of fraud causes entire industries to exhibit volatile stock prices. Second, the lack of relation between merits and settlements in class-action suits indicates that the current system is not concentrating plaintiffs' efforts where the evidence of fraud is highest. The result is that only some securities class-action suits sanction fraud, but many do not.

Investors' compensation benefits from class-action settlements are substantially less than the settlement. First, fees for plaintiffs' attorneys and consultants take a large share (typically 25 to 30 percent) of the settlement. Second, there are costs of administering settlement claims that take an additional share of the settlement. Third, investors who are compensated with settlement funds and who still hold stock in the company are to some extent paying themselves since the settlement reduces the value of the company.

In general the settlements are a transfer of wealth from current shareholders in a company to past shareholders. Where investors are compensated for real fraud, it is not the beneficiaries of the fraud (shareholders who sold shares at an artificially inflated price) who pay. Where investors are compensated for stock price decreases that do not result from fraud, class-action suits function as an inefficient form of insurance against the risks of investing in stock. This kind of insurance is not a purpose of the Federal securities laws.

The main beneficiaries of securities class-action litigation are the attorneys and consultants involved in the litigation. Plaintiffs' attorneys and consultants are com-

[1] Alexander, "Do the Merits Matter? A Study of Settlements in Securities Class Actions," 43 Stanford Law Review, 573.

pensated for fees and expenses out of settlements. Defendant's attorneys and consultants are compensated by the corporation and other defendants such as accountants or by the insurance policies of the defendants. Thus, the defendants either directly through payments or indirectly through insurance payments support both sides of the class-action suits, and the defendants make these payments whether or not the class-action suit is meritorious.

Reform of Private Securities Litigation

The imbalance between costs and benefits of securities class-action lawsuits can be improved by charging the law that controls securities class-action litigation. The goal of reform should be to eliminate the current abuses of private securities litigation while providing an effective private remedy for cases of real fraud. For his purpose, I advocate four reforms: a fee-shifting rule, a class-certification rule, a safe harbor for predictive statements, and a change in the scienter rule.

A rule requiring the losing party to pay fees and expenses for the unsuccessful litigation would lead plaintiffs to consider the costs imposed on others by a class-action lawsuit. Under this kind of rule, plaintiffs would have an incentive to devote more efforts to meritorious cases, avoid frivolous cases, and abandon cases that turn out to be nonmeritorious. This kind of rule also provides more incentive for defendants with strong cases to litigate through trial.

A rule requiring class representatives to have had a substantial investment in the company sued would improve class representation and monitoring of class-action lawyers. In the current system it is not worthwhile for class representatives with a few shares of stock representing a small investment to spend much time representing the class or monitoring the lawyers. This kind of rule would restore some of the incentives that are lacking in class-action lawsuits where the lawyers make all of the substantive decisions and named plaintiffs play only a passive role.

A safe harbor for predictive statements would encourage companies to announce future prospects. Furthermore, a safe harbor would make it clear in the law that predictions may not be realized, but predictions that turn out to be off the mark are not necessarily fraud.

The scienter rule should be changed to set clear conditions under which recklessness will suffice for scienter. Scienter is an important element in securities fraud cases. In my experience, however, class-action securities lawsuits often apply recklessness in hindsight so as to cast mistaken statements made in good faith as reckless. Given that a negative event has occurred (and caused a company's stock price to decrease) it is easy to argue that prior statements were reckless because they were wrong and the negative event occurred. A proper standard would make it clear that statements should be evaluated on the basis of what was known when the statement was made.

These changes in the law would better balance the costs and benefits of private securities litigation by making a company's expected liability a function of its conduct. They would increase the weight of merits in securities class-action cases. They would reduce nonproductive litigation and counterproductive efforts to avoid being sued. These changes would also preserve the ability of investors to pursue real fraud through private litigation. Furthermore, these reforms to private securities litigation would not interfere with the SEC's ability to enforce the Federal securities laws.

S. 240, The Private Securities Litigation Reform Act of 1995

I support this Subcommittee's efforts to reform private securities litigation. The bill currently under consideration, S. 240, contains provisions on fee-shifting, class certification, and a safe harbor for predictive statements, but it does not change in the scienter rule.

The fee-shifting in S. 240 applies when alternative dispute resolution has been rejected. I recommend that the fee-shifting cover court losses without an alternative dispute resolution requirement. S. 240 should be amended to include fee-shifting provisions similar to H.R. 1058.

I support the securities ownership threshold for representative plaintiffs as presented in S. 240.

The safe harbor requires the SEC to consider a safe-harbor rule for forward-looking statements. I recommend that S. 240 be amended to include its own safe-harbor language similar to H.R. 1058.

S. 240 does not change the scienter rule by defining recklessness. I recommend that S. 240 be amended to include a definition of recklessness similar to the language in H.R. 1058.

Conclusion

Based on my experience as a consultant in private securities litigation and as a Commissioner of the SEC, I believe that reform of private securities litigation is an

important subject for congressional action. I enthusiastically support that goal. My suggestions for amendments to S. 240 are intended to improve the reform. I have focused my comments on areas that I consider most important, but by this I do not intend to minimize other provisions in the bill. Legislative reform of private securities litigation will make it work better from the standpoint of investors and companies in which they invest. Moreover, my experience at the SEC leads me to conclude that the reforms being considered in S. 240, including the amendments I recommended, will not impede the SEC's enforcement of the securities laws.

JOSEPH M. SUGGS JR.
TREASURER

State of Connecticut
OFFICE OF THE TREASURER

55 ELM STREET
HARTFORD CT 06106-1773

July 19, 1994

Honorable Christopher J. Dodd
United States Senate
444 Russell Senate Office Building
Washington, DC 20510-0702

Honorable Pete V. Domenici
United States Senate
427 Dirksen Senate Office Building
Washington, DC 20510-3101

Dear Senators Dodd and Domenici:

Recently I contacted several pension fund colleagues regarding your legislation, The Private Securities Litigation Reform Act of 1994 (S. 1976). As stated in the attached letter, these pension fund officers are joining me in supporting your initiative in addressing the problems of the securities fraud litigation system.

We look forward to working with you to try to reach constructive solutions to litigation related problems. These problems must be addressed to ensure that the system protects us as investors, employees, retirees and citizens.

Sincerely,

Joseph M. Suggs Jr.

JMS/klp

attachment

cc: Pension Fund Managers

July 19, 1994

Honorable Christopher J. Dodd
United States Senate
444 Russell Senate Office Building
Washington, DC 20510-0702

Honorable Pete V. Domenici
United States Senate
427 Dirksen Senate Office Building
Washington, DC 20510-3101

Dear Senators Dodd and Domenici:

As pension fund managers, we are responsible for safeguarding the investments of thousands of individuals in the securities markets. In making investment decisions on behalf of these individuals, our success depends on both the integrity of the market and the vitality of the American economy.

For these reasons, we are writing to applaud your initiative in addressing the fundamental problems of the securities fraud litigation system. We agree that the current system is not protecting investors and needs reform. Under the current system, defrauded investors are receiving too little compensation, while plaintiffs' lawyers take the lion's share of any settlement. Moreover, meritless litigation costs companies millions of dollars -- money that could be generating greater profit for the company and higher returns for investors. Finally, the fear of such meritless litigation has caused many companies to minimize the amount of information that they disclose -- the opposite of what we need to do our job effectively.

Thank you again for pursuing long overdue reforms of the securities litigation system. We look forward to working with you to make the system work for all investors.

Sincerely,

Mr. John J. Gallahue, Jr.
Executive Director
Massachusetts Bay Transportation Authority
Retirement Fund

Mr. Jim Hill
Treasurer
State of Oregon
Oregon Public Employees' Retirement System

Dr. Wayne Blevins
Executive Director
Teachers Retirement System of Texas

Ms. Patricia Lipton
Executive Director
State of Wisconsin Investment Board

Mr. Alan G. Hevesi
Comptroller
The City of New York
New York City Pension Funds

Mr. Kenneth E. Codlin
Chief Investment Officer
State Universities Retirement System of Illinois

Mr. John A. Ball
Senior Vice President
Champion International Corporation
Champion International Pension Plan

Mr. Gary P. Van Graafeiland
Senior Vice President, Secretary and General Counsel
Eastman Kodak Company
Eastman Kodak Retirement Plan

Mr. Joseph M. Suggs Jr.
Treasurer
State of Connecticut
Connecticut Retirement and Trust Funds

Mr. Basil J. Schwan
Executive Director
Washington State Investment Board

Massachusetts Bay
Transportation Authority
Retirement Fund
JOHN J. GALLAHUE, JR.
EXECUTIVE DIRECTOR

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FAX (617) 439-0374

Honorable Pete V. Domenici
United States Senate
427 Dirksen Senate Office Building
Washington, D. C. 20510-3101

Dear Senator Domenici:

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Thank you again for pursuing long overdue reforms of the securities litigation system. We look forward to working with you to make the system work for all investors.

Sincerely,

John J. Gallahue, Jr.
Executive Director

JJG:p

JIM HILL
STATE TREASURER

June 21, 1994

The Honorable Christopher J. Dodd
United States Senate
444 Russell Senate Office Bldg.
Washington, D.C. 20510-0702

The Honorable Pete V. Domenici
United States Senate
427 Dirksen Senate Office Bldg.
Washington, D.C. 20510-3101

Dear Senators Dodd and Domenici:

As pension fund managers, we are responsible for safeguarding the investments of thousands of individuals in the securities markets. In making investment decisions on behalf of these individuals, our success depends on both the integrity of the market and the vitality of the American economy.

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Thank you again for pursuing long overdue reforms of the securities litigation system. We look forward to working with you to make the system work for all investors.

Sincerely,

Jim Hill
State Treasurer

jh:jj:6.21.94:90

APPWP
Association of Private Pension and Welfare Plans

Lynn D. Dudley
Director of
Retirement Policy

March 17, 1995

The Honorable Pete V. Domenici
United States Senate
427 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Christopher J. Dodd
United States Senate
444 Russell Senate Office Building
Washington, DC 20510

Dear Senators Domenici and Dodd:

On behalf of the membership of the Association of Private Pension and Welfare Plans (APPWP), I am writing to commend your efforts in pursuing reform of the securities litigation system. The APPWP is a national trade association for companies and individuals concerned about federal legislation affecting all aspects of the employee benefits system. The APPWP's members represent the entire spectrum of the private pension and employee benefits community: Fortune 500 companies, banks, insurance companies, law, accounting, consulting, investment and actuarial firms. APPWP members either sponsor directly or administer employee benefit plans covering more than 100 million Americans.

Your initiative is necessary to address the critical problems with today's securities litigation system. As you have correctly noted, investors are ill-served by the present system. Because issuers fear abusive litigation, they have sharply curtailed the amount of information they are willing to disclose, leaving investors without information essential for intelligent decision making. To the detriment of shareholders, abusive securities litigation distracts companies from their principal tasks, discourages the development of new businesses and inhibits sound risk-taking. Finally, the existing litigation system encourages suit regardless of merit and the cost forces defendants to settle regardless of merit.

We support your efforts to change these skewed incentives, to encourage voluntary disclosure by issuers of securities and to transfer control of securities litigation from lawyers to investors. We look forward to working with you to make these reforms a reality.

Sincerely,

Lynn D. Dudley
Director of
Retirement Policy

1212 New York Avenue, N.W. • Suite 1250 • Washington, D.C. 20005 • (202) 289-6700 • FAX (202) 289-4582

Beacon
Properties
Corporation

50 Rowes Wharf Boston, Massachusetts 02110 617 330-1400

July 11, 1994

The Honorable John Kerry
United States Senate
One Bowdoin Square, 10th Floor
Boston, MA 02114

Dear Senator Kerry,

I am writing you to urge your support for the Private Securities Litigation Reform Act of 1994 (Senate, 1976).

This legislation would eliminate abusive practices that are far too common in class action lawsuits and would bring about other needed reforms to restore fairness to the securities litigation system.

As a progressive businessperson, I understand the terrible economic burden that fraudulent lawsuits create for publicly held companies. So often, these companies spend funds litigating or settling meritless lawsuits rather than reinvesting in our economy.

As a political leader who cares deeply about fostering growth, I ask that you consider co-sponsoring this important legislation.

Sincerely,

Alan M. Leventhal
President

AML/b

STATE OF OHIO
OFFICE OF THE TREASURER

J. KENNETH BLACKWELL
TREASURER OF STATE

March 10, 1995

Senator Alfonse D'Amato, Chairperson
Senate Hart Building - Room 250
Washington, D.C. 20510

Dear Senator D'Amato:

As Treasurer of the State of Ohio, my office regularly issues debt and purchases securities on behalf of the people of the State of Ohio. In addition, my office is designated by law as the custodian of the assets of the State's pension funds. In the exercise of my responsibilities, I have become concerned that securities litigations, and the threat of securities litigation has begun to negatively impact the capital formation process essential to the economic growth for my state and the nation.

Under present law, attorneys have an incentive to file unsubstantiated claims, because there are no penalties for the filing of a meritless claim. Attorneys will file first and then use the discovery process to see if there is any merit to continuing the claim. In many cases, defendants have settled even unsubstantiated claims because it is more cost efficient to settle an unsubstantiated claim rather than to defend a lawsuit.

Furthermore, the amount of damages that plaintiffs have typically recovered represents only a percentage of their initial claim; but the lawyers who bring the claim extract substantial fees from any lawsuit filed. A system that was intended to protect investors now primarily benefits their lawyers.

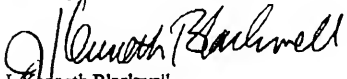
The fear of meritless lawsuits has also caused many companies to minimize the amount of information they disclose to the public which is the opposite intent of the federal securities laws. Moreover, the fear of meritless lawsuits has caused accounting, law, and insurance firms to increase their costs to clients, discontinue service in some cases, and cause outside executives to refuse to serve on company's board of directors.

Federal legislation is needed to restore the protections that the 10B-5 action is supposed to provide and to eliminate the abuses of the system. At a minimum, legislation should address the liability scheme that rewards lawyers bringing meritless lawsuits and reduce the costs that the system imposes on the capital markets and business expansion.

9TH FLOOR, 30 EAST BROAD STREET COLUMBUS, OHIO 43266-0421
(614) 466-2160 T.D.D. 1-(800) 228-1102

Pension fund participants and other investors depend on the integrity of the market and the prospects of the economy. The current securities litigation system undermines both. I urge the Congress to pass meaningful reform legislation to protect the economic security of millions of individuals who invest in the securities markets.

Sincerely,



J. Kenneth Blackwell
Treasurer of State of Ohio

PUNK
ZIEGEL
KNOELL

November 1, 1994

Pete V. Domenici
New Mexico's Senior Senator
434 Dirksen
Senate Office Building
Washington DC 20510-3101

Dear Mr. Domenici:

As investment bankers specializing in emerging growth companies, we are concerned by the increasing number of abusive securities class action lawsuits. With one in every six venture-backed young companies having been sued, we feel that it is time to take action on these abusive lawsuits. Often these lawsuits stem from lawyers who closely watch for major declines in stock prices and recruit "professional plaintiffs" who own small amounts of stock in the company, to bring on a lawsuit claiming fraud. Emerging growth companies are particularly prone to these lawsuits because of their high research and development costs and dependence on key contracts which often results in volatile revenue and earnings growth. These lawsuits often include their investment bankers and accountants as well. These groundless lawsuits are a waste of company time and resources and serve only to provide profit for the lawyers involved.

To this end, we would like to indicate our support for a number of measures currently being considered in Congress. S.1976, the "Private Securities Litigation Reform Act of 1994", is the bill introduced by Senators Dodd and Domenici which is aimed at curbing abusive securities lawsuits. This bill contains measures such as the "safe harbor" provision that allows companies to make predictive statements about the company in good faith, which is important for companies to garner support for equity offerings. H.R. 417, the "Private Securities Enforcement Act", introduced by Billy Tauzin is also a measure we support in that it bars the payment of bounties to plaintiffs in class action lawsuits, thereby ensuring that the lawsuit is brought on by genuine shareholder concerns, as opposed to lawsuits brought on solely for the chance to profit though an out-of-court settlement.

As evidenced by Legent Corp., which was involved in a securities class action lawsuit in 1993, the current system is ripe for abuse. Legent was sued within hours of acknowledging that it would not attain the estimated quarterly earnings. This caused a 60% drop in its stock price which undoubtedly triggered the lawsuit. During the course of litigation, Legent was made to provide over 290,000 pages of documents to respond to subpoenas and utilize 20 of its employees to answer the plaintiff's lawyers' questions. In an effort to end this business disruption, Legent attempted to settle the case out of court, but the plaintiffs did not accept its offers. The case went to trial, where it was dismissed by the judge. Legent officials stated that the trial cost the company over $2 million and several million more in "soft dollars."

These abusive lawsuits threaten the entrepreneurial growth which is a foundation of the American economy. If the system is not changed, the function of the equity markets in the United States will be compromised, as young, rapidly growing companies choose to remain privately held, to avoid the high costs associated with being a public company, the risk of becoming the target of a securities class action lawsuit. This will stifle business and employment growth, as private companies will not access the capital markets for the capital required to fund growth. Currently, public companies will not share their estimates for the future with the investment community for fear that they will be sued if those estimates are not exactly met. Generally speaking, the opportunity to create wealth for investors and employees will suffer if such abuses of the legal system are allowed to continue.

We urge you to support S. 1976 and H.R. 417. These measures will help to curb the abuse of securities class action lawsuits thereby supporting emerging growth companies that are the backbone of the American economy and capital markets. We appreciate your consideration of this matter.

Sincerely,

Gretchen J. Knoell
Managing Director

William Punk
Managing Director

Frederick D. Ziegel
Managing Director

EXABYTE

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March 18, 1994

WRITER'S DD#: (303) 447-7453

VIA FACSIMILE—(202) 272-3912

The Honorable Arthur Levitt, Jr.
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Mr. Levitt:

I would first like to thank you for the openmindedness you've exhibited on the issue of private securities litigation reform. As the general counsel to a high technology company, I would also appreciate the opportunity to share a few observations from the trenches.

Exabyte Corporation has had much good fortune in its five years of public life. Our 1,000-employee company has enjoyed an unbroken string of profitable quarters, reasonable revenue growth and a debt-free balance sheet. We've also suffered some misfortune. In late 1992, Mr. Lerach's firm sued the company and three officers for securities fraud. The elements of our story bear directly on the issues you are currently evaluating.

The cause of action arose out of the company's pre-announcement in mid-September 1992 that earnings for the quarter ending two weeks hence would fall short of the then street estimate. The facts were not complicated. Our analysis of the interim financial results for the first two months of the quarter revealed some revenue weakness in our higher-margin sales channels. The reasons for this weakness were not clear to us but that didn't make it any less real. We prepared a good faith financial estimate for the quarter and announced an expected earnings range. The stock dropped $9 per share in reaction. The actual results for the quarter came within that pre-announced range.

The parade of lawsuits commenced two days after our pre-announcement. There were several interesting features in these eight complaints. First, they all looked the same. I don't mean they all stated the same cause of action. I mean they all looked the same; some complaints even had the same typographical errors. It's as if there were this computer database from hell from which all the complaints were drawn. Second, the complaints were all pretty fuzzy. Yes, they were replete with citations to the Securities Act. But as far as any factual allegations, I honestly couldn't connect the complaints with any wrongdoing. To be sure, there were quotes galore (again, the database?) from our public filings and speeches. The quotes were accurate but irrelevant; further, any quotes of a predictive nature had turned out to be true. The third feature was the allegation of insider trading. The picture these complaints painted was that of a group of executives rubbing their hands with conspiratorial glee at the time of the pre-announcement proclaiming, "Well, boys, we sure got out of the stock just in time." The fact that there was no selling at all during the relevant period was only a slight inconvenience; the complaints simply expanded the claim period to an artificial fourteen months.

EXA

Our post-filing discovery experience was similar to that of other companies caught up in this process. And it is a process—one could almost feel the discovery machinery starting to grind. Even as the complaints were consolidated into a single action, we had offered to voluntarily disclose any and all information even remotely related to the pre-announcement, e.g., all of our internal financial results, plans and projections. Their response was a yawn. Instead, counsel subpoenaed documents from outside analysts and customers. It became clear that the legitimate search for the truth was, at best, only a secondary consideration; the important thing was the process and the attendant pain. No wonder over 90% of defendants guilty of nothing more than suffering a stock drop agree to settle their cases for millions of dollars. The discovery process itself is the judicial version of the Bataan death march.

We were fortunate that this whole mating dance never got past the first embrace. Our motion to dismiss the action for failure to state a claim was granted last June. Despite our early escape, the resentment still lingers. Don't let anyone cite our experience as an example of how the process should work—that the truly innocent are vindicated in court. We spent a half million dollars last year on directors' and officers' insurance and legal defense costs to fund their target practice. At a price/earnings ratio of ten, that works out to 25¢ a share or $25,000 for a 100,000 share institutional investor.

No one would dispute the fact that there are some instances of real fraud out there. There are. What I would maintain, however, is that the strike suit phenomenon does absolutely nothing to address those few real fraud cases. In fact, I submit that those who engage in real fraud are actually beneficiaries of the system. Statistics suggest that most of these cases settle and that the settlement amount falls within a relatively narrow range, i.e., the good guys and bad guys really don't fare too differently. Plaintiffs' counsel play the 30% contingent fee game quite efficiently. Better to create and badger a great number of defendants than to invest substantial sums being put to their proof as to a few. So many defendants, so little time. Yet, for a few cents on the dollar, the wrongdoers enjoy the benefit of a full and final settlement, cutting off their liability as to any real cause of action.

The case against U.S. Healthcare provides a glimpse of the skull beneath the skin of respectability. One of the named plaintiffs, who knew nothing about the case to which his name was attached, discovered to his horror that his son was a consultant to the target company. The named plaintiff tried to squirm out of the case but his counsel balked.. A hearing was held in which the named plaintiff described in detail the whole sordid process including the existence of a stable of professional plaintiffs who lend their names to the lawyers' suits while, in fact, knowing absolutely nothing or even caring about the case. The lawyers were sanctioned in that case. Big deal. It was just a cost of doing business. Move on and pluck the next turkey. As Mr. Lerach has reportedly stated, "I have no clients." That says it all.

Knowledgeable investors are finally waking up to these abuses. It takes two minutes with a calculator to figure out that, for an ongoing investor in a targeted company, more is lost in company valuation as a result of the action itself than is gained on the miniscule recovery. After all, where do people think the money comes from? To this end, I received a copy of a letter Mr. Lerach sent to members of Congress wherein he criticizes your San Diego speech. Among all the self-serving, self-righteous baloney you'll find a constructive suggestion—to meet with the investment community. I'd endorse that. It has been my experience that knowledgeable investors view the current system just as negatively. Only those who do not understand what is truly going on buy into the specious observations of the plaintiffs' bar.

What's also nauseating is that these lawyers pretend they're providing some valuable public service as though they're these little private attorneys general making the world safe from bad corporate disclosure

EXA

Nothing could be further from the truth. Meaningful disclosure is yet another victim to this strike suit phenomenon. Companies know to stay away from anything that smacks of a positive outlook until its outcome is an absolute certainty. They know that if a positive projection does not come to pass that it will later be called fraud in a line item of some complaint. Having just filed our Form 10-K, I felt like a paranoid scrivener. Yes, we have safe disclosure. But safe disclosure shouldn't be confused with good disclosure. As an investor, I'd much prefer to see a good-faith, evenhanded assessment of the business and its prospects than something that reads like an insurance policy.

I'd also submit that certain SEC disclosure rules themselves inadvertently feed into the private securities litigation scheme. All of us here are extremely mindful of the strict rules prohibiting selective disclosure. Material information is disclosed only in a broad-based public manner. Yet strict compliance with that rule, by its very nature, means that all investors act on the information at the same time. That feature, in turn, means there can and will be dramatic one-day swings in the stock price. Yet it is these step function price movements that typically trigger the complaints. In my heart of hearts I wonder whether we would have been spared the pain of the suits had we chosen not to pre-announce our earnings and had watched the stock drift down to the same level over a four-week, rather than one-day, period. The point here is not to question the selective disclosure laws: they are good rules which we have always followed and will continue to follow religiously. The point is that a stock movement, even a dramatic one, does not itself suggest fraud. The point bears repeating. A stock drop does not itself suggest fraud. Yet most complaints are initiated on nothing more.

The laws need to be changed. After all, birds fly, fish swim and lawyers sue in an accommodating legal environment. The legal environment itself must be altered. Of all the suggestions for legal reform, probably the best one deals with the claims certification process and damage calculation. In today's environment, the class is presumed to be every shareholder and damages are presumed to be the total number of shares times the stock drop. One of the ironies at work here is that, while these cases are about good disclosure, the abysmal disclosure is between plaintiffs' counsel and their purported clients. Shareholders are not informed in any meaningful way as to the substance or merits of a claim or the real financial effects of the typical settlement. I'd maintain that relatively few properly informed shareholders would support most actions. A requirement for meaningful counsel-to-shareholder disclosure, a positive election by shareholders to participate in the action, and a "proof of claim" approach to establish real damages would go a long way toward curtailing the abuses in today's system.

Thank you for your energy on this issue. It would be nice to see the legal process reconnect with reality.

Sincerely,

Stephen F. Smith
General Counsel

SFS:sis

cc Senator Hank Brown
Senator Ben Nighthorse Campbell
Congressman David Skaggs

information resources inc.
150 n. clinton st. • chicago, il. 60661-1416 • (312) 726-1221

July 8, 1994

The Honorable Carol Moseley-Braun
United States Senate
320 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator Moseley-Braun:

As you may recall from our conversation last July on an American Airlines flight from the Capitol, I am the Executive Vice President and Chief Financial Officer of Information Resources, Inc., a Chicago-based company that provides a variety of information and software services through 4,000 employees worldwide, 1,500 of whom work in Illinois. Given our recent experience with the securities litigation system, I am writing to thank you, on behalf of our entire organization, for agreeing to co-sponsor S.1976, the Private Securities Litigation Reform Act of 1994.

Our company offers computerized proprietary data bases, analytical models and software products to assist consumer-packaged goods companies in testing, monitoring, evaluating and executing their sales and marketing plans. Our software products, with applications for executive information systems, planning, marketing, sales, finance and operations, are licensed across a wide variety of industries and governmental agencies.

Only four weeks ago, on June 7, 1994, a federal district court jury returned a unanimous verdict -- at the conclusion of a seven-week trial -- in favor of our company and four individual director defendants. Plaintiffs in the class action had sought compensatory and punitive damages for alleged violations of federal securities laws. The allegations stemmed from comments made in 1989 about the company's earnings prospects.

The jury's verdict vindicated our position that this lawsuit had no merit. Sadly, there are imbalances in our legal system that encourage financial ambulance chasing in the hope of extracting a settlement favorable to plaintiff's lawyers. This case was pursued under the guise of shareholder's interests, but instead served to harm our shareholders by diverting our company's financial and human resources.

As you know, numerous public companies and executives, particularly in the high-tech and growth sectors of our nation's economy, are frequently the targets of these actions. Because of the enormous costs inherent in defending these cases, most companies feel compelled to settle, even when the charges are baseless. We are one of the few companies who chose to fight – and we are gratified that the jury, who heard testimony form all of our top managers, found that we had dealt honestly with the securities market.

But even our victory came at tremendous cost. Litigation costs were in the millions of dollars. Hundreds and hundreds of hours of executive time were devoted to the litigation and diverted management attention over a five year period. Absent the litigation, these resources would have been devoted to much more productive endeavors. Of course, as a result of this skewed system, our shareholders, employees and customers are the losers. They all deserve better from a securities litigation system that now, in part, tends to undermine the very purposes it originally was designed to serve.

We believe that the legislative solutions found in S.1976 are urgently needed. On behalf of our 1,500 Illinois-based employees, we applaud your leadership in co-sponsoring S.1976, and we appreciate your commitment to help the business community in this important way.

Sincerely,

Thomas M. Walker
Executive Vice President
Chief Financial Officer

STRATUS COMPUTER, INC.
55 FAIRBANKS BLVD.
MARLBORO, MA 01752
(508) 460-2000

Stratus

WILLIAM E. FOSTER
PRESIDENT & CEO

December 27, 1993

Senator Edward Kennedy
315 Russell Senate Office Building
Washington, DC 20510-2101

Dear Senator Kennedy,

I am sure you are aware of the problems many public corporations face dealing with abusive security suits. Stratus, a $500 million Massachusetts computer company, provides a fairly good example of what frequently happens. In 1988 we were hit with several suits from law firms that held only a few shares of our stock. In the fall of that year we had announced that sales for that quarter would be below Wall Street expectations, and as a result our stock fell from about $33 dollars per share to about $28. It was on the basis of this sudden decline in stock price that we were sued.

I was really bothered by this because I felt we had done everything right. Stratus is a company of very high integrity, and we have always tried very hard to be forthright with our stockholders, employees, and customers. In 1988 we went public with the knowledge that our projections would miss expectations as soon as we knew. Most companies in our industry wait until the end of the quarter, but we wanted to eliminate any chance that the information leaked out. However, in spite of being "good guys", we were immediately put in the position of looking like we had done something wrong. We spent about $400,000 defending ourselves until finally charges were thrown out of the courts. The SEC was prompted to investigate us because of an unfavorable article in the Boston Globe that made us look like a bunch of unsavory characters, and they eventually concluded we had done nothing wrong -- naturally, there was no story in the media when that occurred.

One of my outside activities is that of Chairman of the Massachusetts High Technology Council. The issue of abusive security suits is so great that our members asked us to hold a forum on it. At that meeting, we discussed some of our experiences, and looked for ways to minimize any given

corporation's chance of begin put in the position of receiving these types of suits. However, we all agreed that the only real help will come from legislation that will result in securities litigation reforms.

It is my understanding that Senator Dodd is intending to introduce such reforms. Senator Kennedy, all of us in the high technology community in Massachusetts would greatly appreciate your involvement in this matter. Today there is virtually no downside for someone to file a security suit against a company for almost any reason. Good companies like Stratus can spend significant amounts of money, much management attention that is counter-productive to improving our companies, as well as suffer unfair criticism in the media, because of these suits.

I would be happy to assist you in any way to make some progress regarding legislation on securities litigation reforms.

Best regards,

Bill Foster

William E. Foster
Chairman & CEO

C. SCOTT KULICKE
2101 BLAIR MILL ROAD
WILLOW GROVE, PA 19090
(215) 784-6741

July 8, 1994

The Honorable Marjorie Margolies-Mezvinsky
1516 Longworth House Office Building
New Jersey and Independence Avenues, S.E.
Washington, DC 20515

Dear Representative Margolies-Mezvinsky:

A few weeks ago I wrote you urging support of the Securities Private Enforcement Reform Act, H.R. 417. In the next few weeks the Telecommunications and Finance Subcommittee of the House Energy and Commerce Committee are scheduled for hearings on the Act.

I am sure that during those hearings, you'll hear stories similar to ours. For no other reason than an unforecasted decline in our stock price, we were targeted by class action lawsuits based not on fact, or real damages to shareholders, but rather on the cynical judgement that businesses will pay millions of dollars (most of which goes to attorneys fees), rather than running the uncertainty of arguing their case in front of the jury. Our company was unusual in that we felt strongly enough about our position that we did, in fact, go to trial and were able to convince a jury of the rightness of our position. However, because of the way the system is set up today, our company's day in court cost us well over $1 million in out-of-pocket costs, to say nothing of the defocusing of management's time and attention for the several years that the suit ran. It is interesting to note that this came on top of a partial summary verdict in our favor, and the judge's admonition to plaintiff's attorneys that they had a very difficult case to prove. And after a jury verdict in our favor, plaintiff's attorneys still appealed, which we also won.

All of this experience testifies to what is wrong with today's system. There is simply no down side to an attorney continuing to press unsubstantiated or outrageous claims against a company. The idea behind the majority of class action lawsuits is, I believe, to make so much aggravation that the company will pay the plaintiff's attorneys to just go away. This does nothing to protect the shareholders interests, since those payments come ultimatey out of the shareholders pockets. It also has nothing to do with justice.

H.R. 417 would restore some balance in the securities litigation area. Class action lawsuits would still be permitted, but plaintiff's attorneys would be a lot more careful about pressing unjustified strike suits that had nothing to do with shareholders best interests. And companies would be better able to focus their assets on productive uses; that is to say, creating jobs, developing new technologies, or paying dividends, instead of paying plaintiff's attorneys to go away.

I look forward to your support of the bill in committee, and I hope to see you add your name as a cosponsor.

Very truly yours,

KULICKE & SOFFA INDUSTRIES, INC.

C. Scott Kulicke
Chairman of the Board
Chief Executive Officer

bcc: J. Malins

VIA TELEFACSIMILE

June 16, 1993

Senator Patty Murray
302 Senate Hart Office Bldg
Washington, D.C. 20510-4704

Re: §10b-5 Reform -- One target's perspective

Dear Senator Murray:

My name is Michael L. Darland and I am the President and CEO of Digital Systems International, Inc. My company and I (plus two other officers of the company) were recently the targets of one of these so called "shareholder class action lawsuits." You might have read that this case was settled last month, with the company reluctantly agreeing to pay out of its own funds approximately $2 million (not including the proceeds of the company's Director & Officer (D&O) insurance policy), plus issue shares in the company worth an additional $2 million.[1]

I am writing to you today because you, as a member of the Securities Subcommittee of the Senate Banking Committee, will be conducting hearings commencing June 17, 1993 addressing needed reform of the §10b-5 (securities fraud) litigation process. In the strongest possible terms, I endorse the reforms currently under consideration and as reflected in H.R. 417, currently pending in the house (I know of no parallel legislation pending in the senate).

These lawsuits constitute a serious threat to the entrepreneurial spirit of this country. If I knew when I took this company public what I know now, I wouldn't have done it (and thus wouldn't have tried to raise the capital that was used to employ people, to grow the company and to enable it to conduct the research and development efforts critical to its continued existence).[2]

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[1] The total settlement was $7.5 million dollars. Attached is a copy of the press release issued by the company announcing the settlement. We present the terms in this fashion due to the confidentiality terms of the settlement agreement.

[2] Before taking the company public, I had the option of selling the company. I would have made more money from that sale than I ever made by taking the company public, in either the form of "paper profits" or actual profits from the actual sale of my stock in the company. This is important because I

If the laws are not changed, I would tell would-be entrepreneurs not to bother, or suggest that they invest their energies and creativity and courage in a country where "legal entrepreneurs"[3] are not allowed and in fact encouraged to destroy the country's business entrepreneurial foundation. It is even more frightening when you understand that the high technology industry, the future of this country, is the primary victim of this non-productive and destructive business.

Digital Systems is a high-technology company based in Redmond, Washington. We employ approximately 400 people and have annual sales exceeding $56 million. I started the company from nothing 14 years ago, working out of my basement in Bellevue, Washington. Between 1986 and 1990, Digital Systems was the fastest growing company in the Pacific Northwest, and in 1990, the year we went public, I was recognized as the High Technology Entrepreneur of the Year in the State of Washington.

Digital's stock price has always been volatile, like most of the high tech companies that have gone public in the past 5 years. That notwithstanding, when we announced in September of 1991 that our 3rd quarter results would be below the expectations of persons outside the company, our stock price dropped by nearly 50%. The lawsuit was filed very shortly thereafter, alleging that virtually everything the company had ever told the public from its initial public offering onward was a lie, that we had lied intentionally to defraud our shareholders by keeping the stock price artificially high so that I and other officers of the company could sell our stock at an illegal profit. I remain the largest single shareholder of the company, so I guess I was lying to myself at the same time, if you believe the plaintiff's lawyers.

I cannot go into the details of the lawsuit due to the terms of the settlement agreement, nor do I have the time or space in this letter to describe all of the costs and impacts of the suit on this company (all negative, and not the least of which was how our competitors used the lawsuit filing to frighten our customers). We denied and continue to deny the allegations of fraud and insider trading. Agreeing to settle the lawsuit by paying millions of dollars, of which a third goes to the lawyers (which simply encourages and enables them to file more lawsuits against other companies), was the most difficult decision I've ever made. I know that it was wrong, but I also know that I had no choice. I am responsible for this company and the people it

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was charged with being motivated by *greed* when I allegedly embarked on a 16 month program of systematically defrauding our shareholders. I was and continue to be personally terrified by the notion that the fact I made money was apparently *sufficient proof of fraud* in this case. I sometimes feel these actions represent a modern-day witch hunt, where the prosecutor merely points his finger and yells "RICH," and we are convicted. Of course, no one questions the profit motive of the prosecutor.

[3] A relatively small group of lawyers have made bringing these kinds of lawsuits essentially their sole "business." They are the primary beneficiary of the settlements, with the only significant stake in the outcome of each suit, and operate to an alarming extent as their sole client.

employs. I could not in good conscience "bet the farm" on the abstract principle of exercising my right to prove my innocence. The risk was simply too great that a jury would not be able to see through the distorted, hind-sight picture being drawn by the plaintiff's lawyers (wherein just about every day to day problem any business faces can be twisted into something that was alleged to be a "material" fact under the federal and state securities laws that should have been disclosed to the public)

Nor could we afford the continuing expense of the litigation and the distraction of senior management from the business in order to deal with the lawsuit defense.[4] We recently laid off more than 30 employees, and those we kept were asked to accept pay reductions. Our stock price is at a historical low point. In many ways, we are fighting for our survival in an extremely competitive environment. A major factor behind our decision to settle the case was the fact that we could not afford the continued distraction and diversion of resources to the litigation process. In the course of discovery the company was ordered to produce just about every single piece of paper generated over a two year period. In one instance, for example, we were ordered to produce, within a 10 day period, *every document referring or relating to the sale of equipment in 1990 and 1991*. Since we are an equipment manufacturer and seller, that covered just about everything. I felt like hanging a sign on our front door saying, "OUT OF BUSINESS WHILE DISCOVERY IN PROCESS."

The laws regulating disclosure of information by public companies need to be clarified and simplified. All along we have tried to do the right thing, only to be accused, after the fact and often on the basis of information we didn't have at the time, that we committed *fraud*. We've spent hundreds of thousands of dollars on attorneys fees over the years, trying to figure out how to comply with our securities laws and the court rulings interpreting and reinterpreting those laws, *and yet no one has ever been able give us any clear answer as to what we are supposed to do on an on-going basis*. We are left with doing the best we can, day-to-day and on a case-by-case basis, hoping we don't get sued by someone with 20-20 hindsight telling us what we *should* have done and accusing of being *criminals* for having done it (in their opinion) wrong.

We now worry about and agonize over just about every spoken and written word generated by this company on a daily basis, because we *know* how every little thing can be twisted out of context and used against us in a lawsuit. The lessons we have learned were extremely painful, and we are now doing everything we possibly can

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[4] The anguish of exposure to personal liability of potentially millions and millions of dollars is something I hope you never have to experience personally. I and two other officers of the company lived under such a cloud for almost two years. This exposure, the magnitude of which appears to be in the hands of the plaintiff lawyers, is a powerful disincentive against trying to run a business. I am almost prepared to say that no one in his or her right mind should want to be an officer or director of a publicly traded company

to avoid having to go through this nightmare again. The amount of information we now make public is limited and controlled, and I cannot help but feel that the general public is not benefited by this. I am very careful now not to say anything positive about the prospects of this company without also pointing out what the public should already know all too well, that doing business is hard, risky, unpredictable and often unrewarding. Far more ventures fail than ever succeed, but in the present environment, the laws operate to essentially guarantee that stock prices will always go up, so that, when they fall, *there must have been fraud*.

So the public gets less information than ever before, companies are driven to the brink of extinction, employees are laid off or never hired, and new business are not started. And for what? So a few lawyers can get rich and a few shareholders can get a few pennies on the dollar. This does not make much sense to me, and I hope it doesn't make any sense to you either. I urge you to use your position to do something about it.

Specifically, I would urge that:

- the burden of proof for securities fraud be raised to a *clear and convincing* standard (as opposed to a *preponderance of the evidence* standard, meaning just slightly more likely than not), which would enable more judges to dismiss these cases where warranted. It is a sad fact that, if these matters are permitted to proceed to trial, then the plaintiff has already won because no company can afford to take the risk of going to trial.[5]

- the plaintiffs be required to show some basis for their claims (rather than making sweeping and unfounded allegations) before they can start in motion the discovery process. Court rules say that fraud must be pled with particularity, but this is apparently interpreted to mean that all they must do is quote your public statements, identifying the date and place of each, and simply allege that the statement was false, *without alleging a single fact other than the stock price drop as a reason for why the statement was false*.

- use of the class action procedure be limited as a vehicle for these kinds of suits, with certification of a class requiring some showing on the merits.

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[5] I know it is unrealistic, but since I was accused of what in essence are crimes, it would have been nice to have the benefit of the presumption of innocence and the *beyond all reasonable doubt* burden of proof that persons charged with crimes by our government are entitled to under our constitution. In the civil action brought against us, we were presumed to be guilty for the purpose of justification of ever more discovery and mandating a trial).

- the legislature overrule or significantly limit the court created "fraud on the market" theory of liability which is the basis of these suits, in order to permit public companies greater freedom to make "forward-looking" statements about themselves and their prospects without constant fear of liability. The theory of liability relies on a number of assumptions that simply are not true. Furthermore, the market understands or should understand that predictions are unreliable *per se*. Companies should not be held liable for *fraud* when a prediction of the future does not come true.

- discovery be significantly limited in time and scope.

- finders fees to the "named-plaintiffs" be eliminated

- plaintiff attorneys be forced to face some risk if they lose, perhaps by having to pay the company's attorneys fees if they lose

Thank-you

Sincerely,

DIGITAL SYSTEMS INTERNATIONAL, INC.

Michael L. Darland
President & CEO

cc: Wm. Bradford Weller, General Counsel

(BW) (DIGITAL SYSTEMS INTL) (DGTL) Settlement reached in shareholder lawsuit.

Business Editors

REDMOND, Wash. – (Business Wire) – Digital Systems International, Inc. (NASDAQ: DGTL) and counsel representing a class of Digital shareholders today announced the settlement of a shareholders' class action lawsuit that had been filed against it and several of its officers. The action, originally entitled Quackenboss v. Digital, et al., was filed in federal court in Seattle in November 1991 and alleged violations of federal and state securities laws as well as certain other state laws. The class certified by the Court included purchasers of Digital common stock in the period October 25, 1990 to September 11, 1991. The lawsuit was scheduled for trial in June.

The basic terms of the settlement involve a payment of consideration to the class represented in this action of $5.5 million in cash and 444,444 shares of the Company's common stock valued at $2.0 million. Approximately $3.4 million of the settlement will be covered by the Company's director's and officer's insurance (which will, in addition, cover the Company's defense costs).

The settlement resulted in a charge to earnings of $4.1 million ($2.7 million after tax), or $0.44 per share ($0.29 per share after tax). Including this charge, final results for the first quarter were an after tax loss of $2.7 million, or, $0.29 per share.

Michael Darland, Chairman and CEO stated: "This trial would have been very complicated and lengthy. We believe this settlement is an appropriate resolution which has enabled us to limit the risks involved in presenting a complex case to a jury and to limit ongoing legal expenses. It also will permit senior management to stay focused on running our business rather than being physically absent for weeks in a federal court trial."

Steve Berman, lead counsel for the class, stated that he believes the settlement will approved by the Court: "The settlement resulted after many hours of negotiation with United States District Judge Thomas Zilly acting as a settlement judge. We believe that it is an excellent result for the class."

The settlement is subject to approval by the Court which approval is not expected to occur for several months.

DBG PROPERTY INVESTORS, INC.

The limited partnership industry is a favorite target for unwarranted lawsuits because the ventures are often risky and investors do not always make money. One law firm in particular specializes in representing plaintiffs in suits against limited partnerships. In fact, the firm routinely solicits investors that have lost money in limited partnerships as plaintiffs in securities fraud suits. A case involving DBG Property Investors is illustrative.

DBG was sued in 27 separate actions, with a total of over 200 plaintiffs, involving limited partnerships promoted by DBG. The suits claimed violations of the federal securities laws and alleged misrepresentations and omissions in the private placement memoranda. The law firm that participated in the preparation of the private placement memoranda was also sued.

In April 1992, the U.S. District Court for the Southern District of New York granted summary judgment for the defendants and dismissed all of the plaintiffs' claims. Judge Griesa noted that the court was "confronted with 27 equally frivolous complaints, filed by the same law firm." The judge commented that "it appears to the court as if the complaints were spun out of a word-processed original, with little attention to the details of each partnership. . . . Each complaint is as groundless as the next. Each ignores the substantial disclosure in the private placement memoranda. Indeed, it seems impossible that the drafters of these complaints could have read the memoranda. If they had read the memoranda, they would have discovered that their allegations were entirely frivolous. No set of facts has been pleaded which give rise to any inference that fraud has been committed."

The judge ordered Rule 11 sanctions in the amount of $25,000 to "compensate defendants to some extent for their efforts in defending this action" and to "serve as a warning to [the plaintiffs' lawyers] against further misconduct."

The New York Times
Business
Sunday, December 19, 1993
Section 3

Millions for Us, Pennies for You

The law [illegible] of Herbert Beigel has made millions in fees on settlements of class action [illegible] living limited partnerships.

Suits on behalf of investors enrich lawyers. But what of their clients?

By KURT EICHENWALD

BEATRICE GINDEA thought the lawyers were on her side. Now she's not so sure.

In 1988, the retiree invested $10,000 — a large chunk of her nest egg — in a real estate fund sponsored by Prudential-Bache Securities through the firm's Morristown, N.J., office. It seemed like a good investment — Prudential guaranteed her 12 percent annually for three years, and then all her money back. But the promises were false, and the investment collapsed.

Last month, when the check to settle her claim against Prudential and other defendants finally arrived, Mrs. Gindea was aghast. "Out of the $10,000, I thought I would only see 50 percent of it back," she said. Instead, she got $423.53. For every dollar she had invested, Mrs. Gindea received a bit more than four pennies.

"I was astonished," Mrs. Gindea said. "I thought I was being cheated."

Meanwhile, the law firm that represented Mrs. Gindea and thousands of others in the class action was paid as much as $6 million in fees, plus expenses. Adding to the sting, some investors in the same fund who sued separately came away with far more money — sometimes more than 100 percent of their investment, plus interest and legal fees.

Many thousands of limited-partnership investors like Mrs. Gindea are learning the troubling truth about class-action litigation brought in their names. Without ever going to the effort of a trial to fight for a better deal, the law firms representing these investors can win approval for settlements of a few cents on the dollar for their clients while pocketing millions of dollars — even tens of millions — in legal fees for themselves. The class-action lawyers argue that their clients could have done no better, but that is cold comfort for those who watch some fellow investors who have hired their own lawyers go to trial or arbitration and then come away fully compensated.

Even more frustrating for such investors, anyone who is part of a class-action settlement waives all rights to further claims, even if the Government later affirms accusations of fraud against the partnership. For example, investors who earlier settled with Prudential in class actions for a small fraction of their investment are excluded from sharing in a fund of $371 million set up in October to repay some losses by customers who had been falsely assured about the safety and returns of the partnerships.

The Players

A number of law firms have staked out business in class actions involving limited partnerships. Milberg Weiss Bershad Specthrie & Lerach, in New York City, for example, represented Mrs. Gindea. Bernstein Litowitz Berger & Grossmann, also in New York, is the lead counsel in the action involving the Prudential Bache Energy Income Funds.

But the most active in the field may well be the small Chicago law firm called Beigel & Sandler Ltd. Run by Herbert Beigel, a onetime prosecutor of mob members, it has made millions off the travails of limited-partnership investors. And some critics say the amounts it has made and the way it has done so epitomize what is wrong with this part of the legal system.

A review of cases involving the firm by The New York Times shows that Beigel & Sandler has never taken a significant class action to trial, settling rather than fighting for a bigger award even when it had a strong case. At the same time, the firm that so many investors are trusting to recover their investments has been repeatedly criticized by Federal judges for sloppy legal work and frivolous filings.

But Mr. Beigel said such criticism and setbacks are the price of playing in the class-action arena. He said the small amounts he wins for investors in class action settlements are better than what would come out of a case that goes to court, where many judges have no sympathy for those they view as having gambled on an investment and lost.

"That's the reason you see cheap settlements," Mr. Beigel said. "These cases have a chance of losing and they are thrown out constantly."

In the settlements that have been reached, Mr. Beigel said, "we like to think we have done a good job in some very difficult cases."

But Mr. Beigel does not dismiss critics out of hand. "No one should be in a class action who has a strong individual claim," he said, "except for a person whose claim is of such small monetary value that it would be economically unfeasible to bring a claim any other way."

Those kinds of small claim cases are

Continued on Page 1,

Millions for Us, Pennies for You

Continued from Page 1

largely responsible for the rapid growth in class actions over the last two decades. Such litigation has been used in many kinds of disputes, from product liability to price fixing, and lawyers often receive multimillion-dollar fees from the settlements. But class actions alleging fraud at investment partnerships are notable in that most plaintiffs have suffered huge losses rather than small ones, and therefore have a lot more to lose in an unsatisfactory settlement.

One problem is that lawyers representing investors in a class action don't need their approval of a settlement. Of course, investors can opt out of a class action and sue on their own. But most can't afford it.

Given the outcome of many of the limited-partnership class actions, some experts are asking whether the time has come for reform.

"Class actions are not an appropriate vehicle for people who have lost substantial sums of money," said Samantha Rabin, senior editor of Securities Arbitration Commentator, a newsletter in Maplewood, N.J. "The only people who make money in these are the claimants' lawyers, and the defendants themselves, who shut off a lot of potential liability."

Many critics hesitate to raise objections, in part because class actions are the only option for some investors, particularly those without money for legal fees or with losses too small to attract lawyers willing to work for a portion of what they win. Nevertheless, some are urging efforts to disclose more clearly to investors what they would receive in a settlement, to force higher standards in determining a deal's fairness, and to insure that fees reflect how clients fared.

"We don't want to turn back the clock and restrict plaintiff's attorneys from bringing suit," said Nancy Smith, New Mexico's securities regulator. "But we should take a sober view and make an assessment of how investors are faring in these kinds of class actions and determine what reforms might be necessary."

A GOOD place to begin that assessment might be at Beigel & Sandler. Flip through the filings in most major class actions against limited partnerships, and chances are its name will pop up.

Beigel & Sandler was the lead counsel in one of two 1991 settlements involving investments with VMS Realty that were sold through the firm now known as Prudential Securities. It was lead counsel in settlements involving Prudential deals sponsored by Clifton Harrison, a convicted felon whose past was not disclosed to investors. The firm also participated in the settlement involving the Prudential energy income partnerships. And it was lead counsel in reaching a settlement with Merrill Lynch over the Arvida partnerships.

Many of these deals have been widely criticized as inadequate. "From what I have seen of their previous cases, they have generally settled for a small fraction of the recovery sought," James Beckley, a Chicago lawyer who is a member of the Securities Industry Conference on Arbitration, said of Beigel & Sandler.

The class action involving VMS Realty illustrates how firms can accept low-paying settlements, sometimes sacrificing some investor protections, yet still collect large fees.

The $25 million deal Beigel & Sandler negotiated left investors with less than two cents on the dollar. But Beigel & Sandler walked away with more than $6 million in fees — the 25 percent typically authorized by the court in class actions — as well as $350,000 for expenses and additional fees for administering the settlement fund. For all that money, the firm did less court work than some lawyers representing individual clients who went to court or arbitration to fight for full compensation. Those lawyers made far less money for their efforts.

As part of the settlement, Beigel & Sandler waived the rights the investors had, through their partnership agreement, to approve of any future sales of properties held by the VMS partnerships. This created "the potential for sales that might benefit VMS and not provide cash to the investors, but instead leave them with a big tax bill to pay," said Jack VanWoerkom, a real estate consultant in Marblehead, Mass.

All in all, "it was a great deal for the defendant, and it was a great deal for Beigel & Sandler, but it was a pretty lousy deal for the investors," Mr. VanWoerkom said.

Mr. Beigel said the settlements were low because the cases would have been very hard to prove in a trial. Indeed, he said that shortly after some of the defendants settled part of the VMS case, suits against other defendants were thrown out.

But others see it differently. The problem, say legal experts, is that once a deal is on the table, any class-action lawyer would find it hard to walk away from the millions in fees

Edward A. Grossmann of the New York firm Bernstein

"THE lawyers' interest shifts from protecting the investor to protecting the deal," said John L. Grayson, a Houston lawyer who represents a number of plaintiffs involved in Prudential litigation. "If there is not a deal, the attorneys don't get paid, and the litigation drags on."

The only protection for investors comes from the judges who must determine that a deal is fair before

...oving it. But too often, lawyers ...the judges are under pressure to ...the deal done ...ily by writing to the court with a ...aration to opt out can an investor ...ect the settlement. Many of these ...ple are unsophisticated in finance ...law, yet must decide whether to ...e away on the basis of a disclo... notice written in thick legalese. ...People don't understand the class-... notices, even people who have ...relatively successful in busi...," Mr. Beckley said ...e notices are written by lawyers, ...approved by a judge. But every-...involved — from the plaintiffs' ...ers looking for fees, to the de...ant hoping to close off liability, to ...judge interested in cleaning out ...docket — has an interest in get...the deal approved. That, some ...ers say, causes all the parties to ...ove confusing language that ...investors to accept the deal.

HERBERT BEIGEL cut his teeth in Chicago in the early 1970's as part of the Justice Department's organized-crime strike force. A decade ago he formed his own firm — a single associate, just as Wall Street was quickening its drive to sell limited partnerships in assets like real estate and oil. With the collapse of many partnerships, Mr. Beigel found a niche.

Today, Mr. Beigel — with offices in New York and Los Angeles, and joined with Louis Sandler, a lawyer in Manhattan — oversees some 40 lawyers, with specialties not only in limited partnerships but also matrimonial and entertainment law.

Beigel & Sandler has re-invented the class action to what critics say is the firm's own benefit. Where in a traditional class action lawyers assume all risk, with payment fixed as a percentage of money won, Beigel & Sandler in some cases requires each investor to put up a retainer of as much as several thousand dollars.

Mr. Beigel said that clients in such cases, which he calls group actions, are better than those in class actions, because once there is a settlement, there are fewer people with whom to share the pot, because only those who have are part of the group.

But critics say that group actions allow Beigel & Sandler to pursue cases while shifting the risk onto the clients. Moreover, at the end, the firm's fees are not subject to court approval, as they would be in a traditional class action, because technically the lawyer and the client have already agreed on fees.

Beigel & Sandler at times spends more on a case than might have been expected, simply because the firm is ordered so often by judges to pay sanctions for doing a bad job.

Sometimes, the judges criticize the firm for submitting silly claims that evidence little work. "The court is confronted with 27 equally frivolous complaints filed by the same law firm, Beigel & Sandler," wrote Judge Thomas P. Griesa of Federal District Court in Manhattan in April 1992 in Kushner v. D.B.G. Properties (a limited partnership). "It appears to the court as if the complaints were spun out of a word-processed original, with little attention to the details of each partnership and its private placement memorandum. Each complaint is as groundless as the next."

Judge Griesa ordered the firm to pay some $25,000 to the defendants for legal costs.

Mr. Beigel makes no apologies for the case, and its outcome tells a good deal about the firm's method of operation. Even before Judge Griesa's decision, Mr. Beigel said, the defendants had settled for a sizable sum.

ANOTHER case where the firm took it on the chin is Crigler v. Pennzoil. In that case, Texaco bondholders claimed they had been damaged by Pennzoil's pursuit of its $10 billion judgment against the oil company for interfering with Pennzoil's contract to purchase stock in Getty Oil. The judge in the case dismissed the bondholders' case, saying that the claimants were essentially trying to punish Pennzoil for pursuing its legal claims.

"Thus is born a new star in our rogues' gallery of frivolous lawsuits," wrote Judge Gerard L. Goettel of the Federal District Court in Manhattan. "This case is a bit of nonsense, a transparent petition for a license to mine in Pennzoil's deep pockets, and I will not allow it. Indeed, we feel compelled to return the favor, and allow the defendants to rummage a bit in the plaintiffs' pockets." Beigel & Sandler was ordered to pay Pennzoil's legal costs for this case.

Mr. Beigel thinks his clients had a decent claim. "If you are not going to bring a case you believe has merit because a judge might take a look at it and penalize you, then you are not being a good lawyer," he said.

Questions about the quality of the firm's legal work were also raised last May by Judge James B. Zagel of Federal District Court in Chicago.

In this class-action case, Williams v. Balcor Pension Investors, Beigel & Sandler argued that the prospectuses of a number of partnerships were misleading. But while the firm had named six plaintiffs to represent the investors, Judge Zagel ruled that none met the necessary standard, which says that the plaintiffs must be typical of the class they represent.

Three of the plaintiffs had never read the prospectus in question. Another, identified as a trustee for a trust that had invested in the partnerships, in fact no longer held that job, so had no right to sue. Some plaintiffs were included in the case before the firm even spoke with them.

"Beigel & Sandler's investigation of the proposed class representatives was woefully inadequate," Judge Zagel wrote, adding that the troubles showed the firm's "inadequacy as class counsel."

Mr. Beigel was undeterred, saying that the case is still going, with a new set of class representatives.

For all the criticism, Mr. Beigel shows no signs of slowing down. "In this business," he said, "you have to have a thick skin." ■

Try, Try Again

NO CLASS action involving limited partnerships has attracted more debate among lawyers and regulators than the 3-year-old case involving the Prudential Energy Income Funds, a series of oil partnerships. Small wonder: The financial fate of hundreds of thousands of investors who put $1.3 billion into the deals hangs on the outcome.

When the case was filed in 1990, little was known about the widespread fraud in the sale of limited partnerships that the Government now contends took place. Over two years, the class-action lawyers, led by Edward A. Grossmann, uncovered evidence of wrongdoing.

By last year, the team of lawyers, which included Beigel & Sandler, reached a settlement with Prudential that some lawyers criticized as paying only a few cents on the dollar. But Mr. Grossman argued that investors would be hard pressed to do better. "The terms of the settlement provide for fair and adequate compensation," he said last February.

The deal would have provided $37 million in cash, and rolled up the partnerships into a single publicly traded entity that would give stock to the partners. The lawyers could expect $7 million in fees, but as a sign of good faith, Mr. Grossmann asked that his fee be half in the new company's stock.

But in June, Judge Marcel Livaudais Jr. of Federal District Court in New Orleans, who is hearing the case, sided with critics. He said he had "serious reservations about the fairness of the proposed settlement."

About that time, bidders emerged for the partnerships. The winner, the Parker & Parsley Petroleum Company, paid investors $481 million.

"Class members who wish to participate are guaranteed of getting money, and in my opinion will get it faster" than through either arbitration or the fund established in Prudential's settlement with regulators, Mr. Grossman said. "But if they want to go another route, they can."

Others criticize the deal. "There is no justifiable reason why class-action plaintiffs should be treated like second class citizens and receive only 15 percent of what they could in arbitration," said Stuart Goldberg, a lawyer in Austin with many Prudential cases.

By October, a new settlement had been struck for some $120 million in cash. Mr. Grossmann and the other lawyers again are arguing that this deal is fair, saying it gives investors the best of all worlds.

DOMINION BANKSHARES CORPORATION
Virginia

Between January 18, 1989 and July 18, 1990, stock in Dominion Bankshares Corporation fell from a high of $26 per share to a low of approximately $12. In October 1990, Dominion shareholders filed complaints against Dominion alleging that certain press releases and SEC filings issued between January 1989 and May 1990 misrepresented and concealed Dominion's deteriorating financial condition, causing investors to purchase stock at an inflated price that they would not have paid had they received truthful information disclosing Dominion's true financial state.

Chief District Judge Turk dismissed plaintiffs' claims, commenting that those claims merely "describe the substance of a public document published by Dominion and make the bald assertion that the documents [contain] untrue material facts and omit[] material facts necessary . . . to make the statement made . . . not misleading." Questioning plaintiffs' allegations of fraud generally, the court asked:

> How did defendants know the loan loss reserves were inadequate? How did defendants know certain accounts were not to be collected? Plaintiffs repeatedly make bold assertions of misrepresentations and omitted facts--but do not claim facts to explain why the statements are misrepresentations. Why were the statements false when made, and how were defendants to know? In hindsight, the reserves were not adequate, but this is not necessarily fraud. Indeed, this does not even imply fraud.

The court also expressed concern that plaintiffs' complaint was "nearly identical" to complaints filed in three cases in district courts in Rhode Island, Maryland and Massachusetts, "rais[ing] a suspicion . . . that the present suit is being forwarded for its settlement value."

National Investor Relations Institute
8045 Leesburg Pike, Suite 600
Vienna, VA 22182
(703) 506-3570 FAX (703) 506-3571

For more information: Beth Carty, NIRI, 703-506-3570; or Neil Newhouse, Public Opinion Strategies, 703-836-7655

NEW POLL FINDS SENIOR AMERICAN INVESTORS SUPPORT SECURITIES LITIGATION REFORM

WASHINGTON, March 22 -- By an overwhelming margin, Americans aged 50 and over who invest in stocks or mutual funds say they favor legislation that would make it harder for lawyers to file frivolous securities lawsuits against America's high growth companies.

Nearly seven out of ten investors surveyed say they favor legal reforms to crack down on lawsuit abuse. According to a new survey conducted by Public Opinion Strategies for The National Investor Relations Institute (NIRI), eight out of ten (81 percent) say they would like to see mandatory penalties against lawyers "who aid in bringing a frivolous lawsuit"; more than two-thirds (70 percent) say the loser of a frivolous suit should pay the legal fees of both sides; and 79 percent say defendants should only pay damage awards according to their percentage of fault. Only 21 percent of those polled oppose litigation reform.

The survey, completed shortly after a 325-99 bipartisan vote by the House of Representatives for securities litigation reform, was released in advance of Senate consideration of reform measures.

It shows that older investors are concerned that excessive lawsuits hurt American competitiveness. Some (87 percent) say they worry that lawsuits are diverting resources that could be used on product research and business expansion to create jobs.

- more -

A similar number (88 percent) believe lawyers, not shareholders, are the primary beneficiaries of securities lawsuits. Asked about a variety of legislative options, investors favored measures to penalize those who abuse the system:

Question Please tell me whether you would FAVOR or OPPOSE each of the following proposals.

TOTAL FAVOR	TOTAL OPPOSE	DON'T KNOW/ REFUSED TO ANSWER
Requiring the loser of a frivolous lawsuit to pay legal fees for both sides:		
69%	24%	7%
Requiring mandatory penalties for lawyers who aid in bringing a frivolous lawsuit:		
81%	12%	7%
Forcing defendants to only pay damage awards according to their percentage of fault, instead of forcing them to pay damages they are not responsible for:		
79%	12%	9%
Limiting so-called professional plaintiffs to five class action suits every three years:		
57%	25%	18%
Prohibiting participation in a suit by an attorney owning the stocks or mutual funds at issue:		
58%	31%	11%

Louis M. Thompson, NIRI President & CEO, said the survey demonstrates that many American investors are concerned that lawsuits erode the value of their investment savings as they near retirement age. More than one-third of those polled are age 65 or older and 70 percent said that at least one member of their household was a member of the American Association of Retired Persons.

"Frivolous lawsuits pose a direct threat to the financial well being of those Americans who are investing for their future, including retirement," Thompson said. "These lawsuits don't just target companies, they paste a bulls eye on American investors."

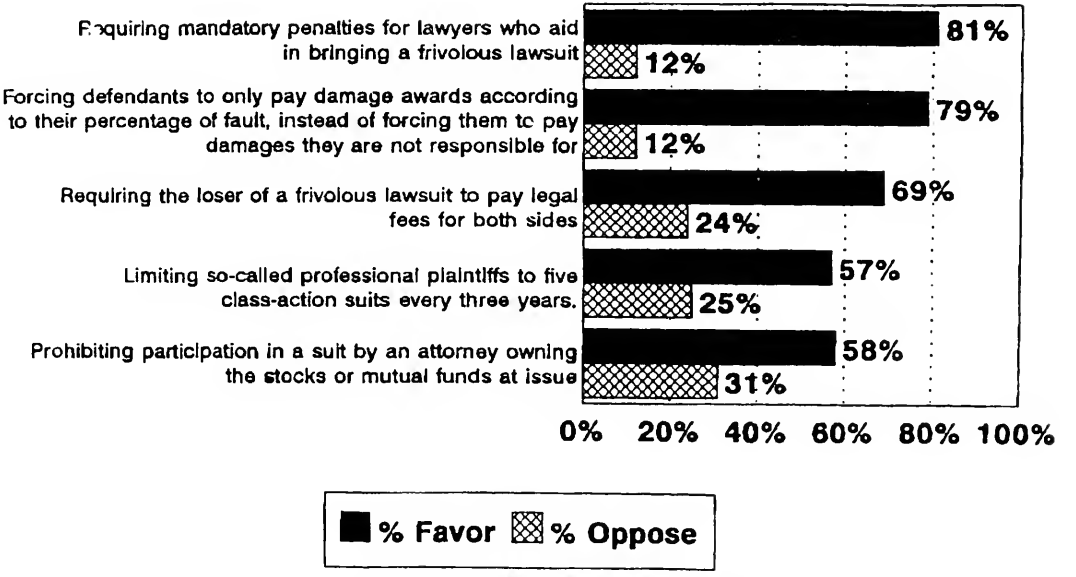
Survey respondents also say stock price declines are a normal investment risk and not, by themselves, evidence of fraud or grounds for a lawsuit. Only 15 percent say an annual decline of 50 percent in a stock's value was grounds for a lawsuit, and only one in ten believe a 10 percent decline in a few days is grounds for legal action. However, 85 percent say a company that knowingly provides false information to investors should be sued.

The survey of 800 American investors aged 50 or above was conducted by Public Opinion Strategies on March 18-21. The survey has a margin of error of plus or minus 3.5 percent. All those surveyed reported investments in stocks or mutual funds. Copies of the full study can be obtained by calling NIRI at 703-506-3570.

The National Investor Relations Institute, now in its 25th year, is a professional association of 2,650 corporate officers and investor relations consultants responsible for communication between corporate management, shareholders, security analysts and other financial publics.

# # #

Proposals to discourage frivolous securities lawsuits



PUBLIC OPINION STRATEGIES for NIRI
Investors National, N = 800 Stock or Mutual Fund investors 50 or older
March 16-21, 1995

86 Trinity Place
New York, New York 10006-1881
Tel.: 212 306-1686
Fax: 212 306-2041

Listed Company Council

American Stock Exchange

May 17, 1994

The Honorable Peter V. Domenici
UNITED STATES SENATE
Washington, D.C. 20510-0702

Dear Senator Domenici:

The American Stock Exchange Listed Company Council ("Council"), which represents the views and interests of the 904 companies listed on the Exchange, strongly supports your legislative efforts to reduce the number of meritless class action suits being filed against U.S. corporations.

It is imperative to deter suits that are based, not on specific instances of fraud, but rather on a company's stock volatility, the speculative nature of its industry, or its inability to defend against costly litigation tactics. These abusive suits divert capital away from job creation, research and development, and other activities which are essential for a company to be competitive in a global market. While it may be difficult to distinguish between legitimate and meritless cases, we believe your bill strikes a balance between investors' rights and the need for U.S. companies to be protected from frivolous suits.

Each Council member is a principal executive officer of a company whose securities are traded on the Exchange. As executive officers, we are obligated to maintain a continuous flow of accurate information to the markets. However, in today's litigious climate, many companies are striking a more restrictive and defensive posture regarding information released to the public. Your legislative efforts reflect your understanding of the mechanics of the U.S. securities markets and the need for a continued free-flow of information to these markets.

If the Listed Company Council or its members can be of any assistance, please contact Ms. Tamara Hirschfeld at (202) 887-6880.

Sincerely,

H. Wesley Hall

H. Wesley Hall
Chairman

HWH/lrc

AMEX

American Electronics Association AEA

5201 Great America Parkway, Santa Clara, California 95054 Telephone: (408) 987-4200
1225 Eye Street, N.W., Suite 950, Washington, D.C 20005 Telephone: (202) 682-9110

May 9, 1994

The Honorable Pete V. Domenici
United States Senate
427 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Domenici:

The Board of Directors of the American Electronics Association urge you to support the Private Securities Litigation Reform Act of 1994, S. 1976, introduced by Senators Dodd, Domenici, Dorgan, Johnston, Mikulski and Faircloth. The purpose of the bill is to protect investors and restore fairness to the securities litigation system. Attached is a resolution in support of S. 1976, which was passed unanimously on May 5, 1994, by the Board of Directors of the American Electronics Association.

The civil justice system is being abused by a small number of plaintiffs attorneys who file abusive class action securities suits. In 1990 and 1991, a record number of 614 securities class action lawsuits were filed -- more than in the previous five years combined. During the last 3 years, 1 out of every 12 corporations traded on the New York Stock Exchange was sued for securities fraud. Abusive securities suits discredit the legal profession and erode investor confidence in financial reporting and the U.S. capital markets.

The securities litigation system was originally designed to protect investors from those who would commit fraud. It is the investor, however, who now needs protection within the current system. Over 95% of all cases settle with the individual investor receiving only pennies on the dollar while the attorneys normally get one third of the settlement. Investors are frequently unaware of the attorneys' stake in the outcome of the litigation. At the same time, their investments are eroded when companies are forced to expend money to defend against and settle meritless suits.

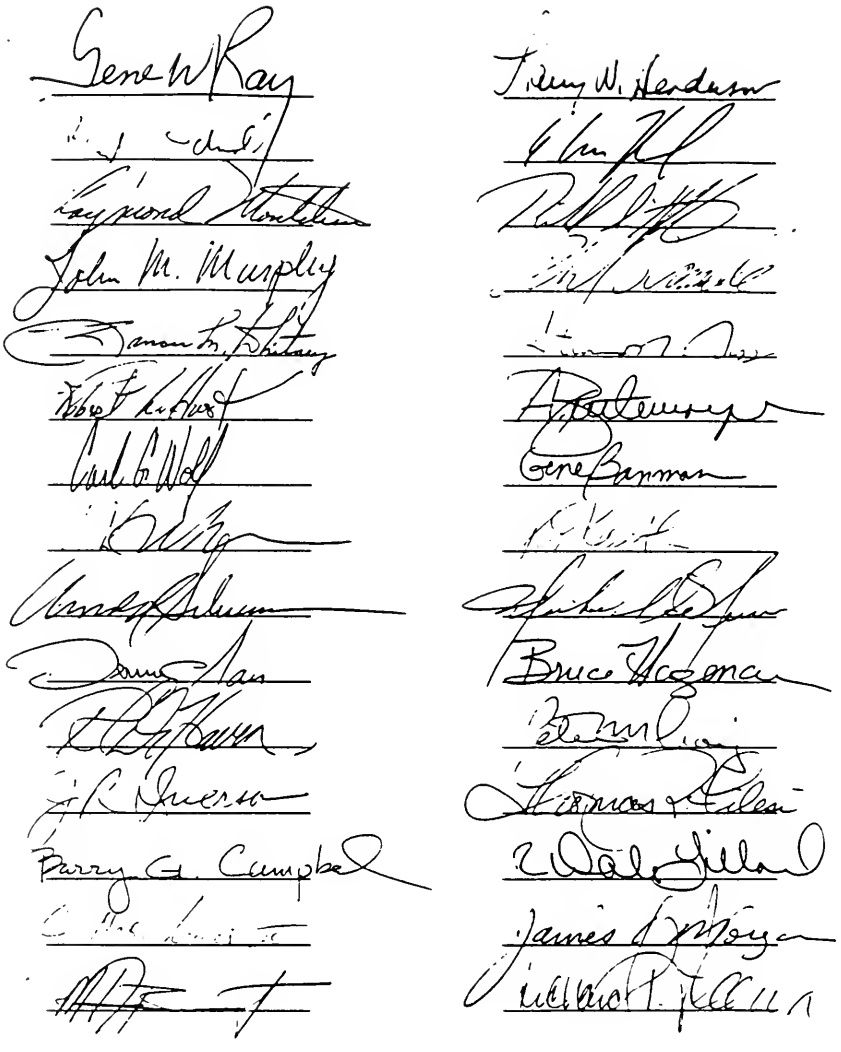
U.S. electronics companies are disproportionately the victims of these abusive suits. Since our member companies' stock prices tend to be volatile, they make easy targets. Abusive class action securities suits distract our companies from pursuing their business objectives. Meritless securities suits waste funds that could otherwise be spent on productive endeavors, such as new technology development, job creation, dividend payments and pay increases. The settlements alone in 60 suits filed against Silicon Valley companies in the last three years totaled over $500 million. Consequently, Director and Officer insurance is becoming prohibitively expensive, and many of our companies are finding it difficult to attract qualified individuals to serve on Boards of Directors.

S. 1976 is a balanced bill. It will discourage abusive lawsuits and will encourage the disclosure of accurate financial information, which will benefit all investors and improve the efficiency of the capital markets. We urge you to cosponsor S. 1976. Thank you.

Sincerely,

AEA 50 CELEBRATING YEARS

MAY 13



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International
AT&T, Basking Ridge, NJ

Mr. Anthony Zettlemoyer, Vice President
Global Planning
AMP Incorporated, Harrisburg, PA

RESOLUTION
OF THE
BOARD OF DIRECTORS

AMERICAN ELECTRONICS ASSOCIATION

***WHEREAS**, LEGISLATION HAS BEEN INTRODUCED IN THE U.S. SENATE AND HOUSE TO PROTECT INVESTORS AND RESTORE FAIRNESS TO THE SECURITIES LITIGATION SYSTEM: S. 1976 BY SENATORS CHRISTOPHER J. DODD AND PETE DOMENICI, AND H.R. 417 BY REPRESENTATIVE BILLY TAUZIN; AND*

***WHEREAS**, S. 1976 AND H.R. 417 WILL PROTECT THE RIGHTS OF INVESTORS, DISCOURAGE ABUSIVE LAWSUITS, AND ENCOURAGE THE DISCLOSURE OF ACCURATE FINANCIAL INFORMATION, WHICH WILL IMPROVE THE EFFICIENCY OF THE CAPITAL MARKETS;*

***THEREFORE**, THE BOARD OF DIRECTORS OF THE AMERICAN ELECTRONICS ASSOCIATION ENDORSES S. 1976 AND H.R. 417. WE COMMEND SENATORS DODD AND DOMENICI, AND REPRESENTATIVE TAUZIN FOR THEIR LEADERSHIP IN INTRODUCING THESE MEASURES. WE FURTHER RESOLVE TO WORK PERSONALLY FOR THE ENACTMENT OF S. 1976 AND H.R. 417, AND WE COMMIT THE RESOURCES OF AEA AND OUR COMPANIES TO THIS EFFORT.*

Thomas J. Joyce
Vice President
Investor Relations

Rockwell International Corporation
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USA

(412) 565-7436
Telex: 866213
ROCKWELL PGH A

April 21, 1994

The Honorable Harris Wofford
United States Senate
Washington, D.C. 20510

Dear Senator Wofford:

Now more than ever, American businesses and American workers are challenged by world market places to operate more efficiently and effectively, provide high quality products and reduce costs. Every day American businesses and their workers address this challenge. Yet, at the same time, our legal system allows for the erosion of these efforts by non-productive lawsuits which add costs to American products.

I urge you to take action on one of these areas and support the Private Securities Litigation Reform Act of 1994, S.1976. This legislation is sponsored by Senators Dodd and Domenici.

Let's restore balance and fairness to the securities litigation system which is currently being abused by some plaintiff class-action attorneys. Let's protect the investor, but let's not allow meritless class action suits to erode the efforts of your constituents, the American businessman and the American worker.

Sincerely,

Thomas J. Joyce
Vice President
Investor Relations
TJJ/cc

cc: The Honorable Christopher J. Dodd
The Honorable Peter V. Domenici
Mr. Arthur Levitt, Jr., Chairman, U.S. SEC

Meridian Bancorp, Inc.
35 N. 6th Street
P.O. Box 1102
Reading, PA 19603
(215) 655-3338

Meridian

David E. Sparks
Vice Chairman and
Chief Financial Officer

April 21, 1994

The Honorable Arlen Specter
United States Senate
530 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator Specter:

Recently, a legislative proposal, entitled "Private Securities Litigation Reform Act of 1994" (S. 1976), was introduced by Senators Christopher Dodd and Pete Domenici. We strongly urge your support of this legislation which is a win-win situation for the consumer, investor and business.

This bill would restore balance and fairness to the securities litigation system which is currently being abused by and solely benefits certain plaintiff class-action attorneys. This abuse has lead to: investors receiving only pennies on the dollar in recoveries; an erosion of shareholder values when corporate assets are wasted on defending or settling baseless suits; and an impediment to job creation and new technologies. Every independent study presented to the Senate's Securities Subcommittee concluded that securities class actions are virtually always settled, regardless of merit, and that these settlements yield very little money for investors.

The Act would more effectively protect the rights of investors regarding class action suits in the following manner:

- Courts would appoint a "plaintiff steering committee" or guardian to control the lawyers directly and to ensure that the lawyers act in the best interest of the class.

- Notices of settlement agreements would be sent to investors clearly spelling out important facts, such as the benefits to investors to be derived from settlement and how much their lawyers receive in the settlement.

- Alternative dispute resolution procedures would be established to make it easier to pursue a case without the typically slow and expensive federal court proceedings.

Our capital markets operate most efficiently and fairly when investors have as much information as possible about the companies in which they invest. That is why the SEC has historically encouraged companies to make voluntary disclosures of information beyond the required minimum. Unfortunately, disclosure is the grist for many ill-advised class-action lawsuits.

It is an unfortunate fact that lawsuits are filed:

- o within days or even hours of a drop in stock price or of news that a company missed an earnings projection;
- o in the name of "professional" plaintiffs who own small amounts of stock in many companies and lend their names to class-action lawsuits whenever one of their investments loses value; and
- o in "cookie cutter" fashion, with little factual support.

This bill seeks to increase the amount of voluntary disclosure by providing a "safe harbor" for forward-looking statements concerning future financial prospects. This would be in contrast to the current trend of less disclosure due to the threat of massive liability.

Please indicate your support of this extremely important effort by contacting Senators Dodd and Domenici. We will be contacting your staff to secure an indication of the level of support to be expected. Thank you for your anticipated positive efforts.

Sincerely,

DES/lbw

cc: A. Levitt, Jr., Chairman, Securities and Exchange Commission
Senator Christopher J. Dodd
Senator Pete V. Domenici

This letter also was sent to Senator Harris Wofford.

ORACLE

Legal Department

Oracle Corporation
500 Oracle Parkway
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California 94065

Phone +1 415 506 7000
Telex 176148
Fax +1 415 506 7114

December 18, 1993

Senator Dianne Feinstein
331 Hart Office Building
Washington, D.C. 20510

Senator Barbara Boxer
112 Hart Office Building
Washington, D.C. 20510

Representative Tom Lantos
2182 Rayburn Office Building
Washington, D.C. 20515

Dear Senators Feinstein, Boxer, and Representative Lantos:

We are writing to express our concerns about the adverse effects to the high technology industry resulting from the proliferation of securities class action lawsuits, and to offer our suggestions for reform. We understand that Senators Domenici, Dodd, and others have undertaken efforts to propose legislative reform in this area. We strongly urge that you consider presenting our proposals in furtherance of their efforts. Reforms must be enacted soon, before the damaging impact that securities class actions have on our industry's creativity, competitiveness in world markets, and ability to find individuals willing to serve as corporate directors becomes permanent.

Over the last decade, federal and state securities laws have been used by plaintiff's lawyers as a lucrative form of investor insurance rather than what they were designed for: a system that prescribes fair market practices for equitable risk taking. High technology companies operate in an environment in which management must be prepared to adapt to rapid technological changes and respond quickly to intense competitive pressures. As a result, the stock of many high technology companies tends to be very volatile -- the opportunity to earn a high rate of return on one's investment must be balanced against the risks that market conditions can change very rapidly. Unfortunately, while investors expect to reap high returns from their investments in high technology stocks, the lawyers who prosecute securities class actions have construed the securities laws as creating for them an entitlement of compensation if a stock declines. This is reflected in the fact that such lawsuits are filed only days after a stock price decline with the mentality of "sue now, investigate the reasons for the lawsuit later."

ORACLE

Our own company has experienced first hand the damaging impact of securities class action lawsuits. We recently underwent a very difficult, time consuming, and costly negotiation for renewal of D&O insurance we obtained after a securities lawsuit was filed against Oracle. As a result of securities class action litigation, no reasonable D&O insurance is available to the high technology industry to protect us against the high costs of defending such litigation.

In addition to insurance, our company has put in place over the past several years a number of measures to guard against the risk of securities class action lawsuits. Unfortunately, we feel that some of the steps we have been forced to take are not necessarily desirable either from our perspective or from the perspective of our investors. For example, we no longer provide forward-looking information to the investment community for the sole reason that statements containing forward-looking information present the greatest risk for being sued in the event of a stock price decline.

In our opinion, the underlying purpose of the securities laws would be better served if the following changes were made:

Require plaintiffs to meet a higher standard for pleading securities fraud. Lawsuits which are filed only days after a stock price decline (in our case, two days), cannot possibly have been adequately investigated. Yet these hastily-drafted complaints typically allege intentionally fraudulent conduct, liability in the tens or hundreds of millions of dollars, and are are used as a premise for conducting burdensome and costly discovery in hope of finding information to justify allegations that otherwise lack a factual basis. A requirement that plaintiffs' lawyers specifically allege the facts claimed to constitute the fraud would discourage frivolous filings and encourage early dismissal of meritless cases.

Require some degree of reliance as a prerequisite to maintaining a lawsuit. Unless a plaintiff is required to show that he or she relied on the alleged fraudulent information, then there is no real link between the alleged fraud and the claimed damages, and thus no accountability by the named plaintiff for the action being pursued. Absent a requirement of reliance, the named plaintiff is a mere figurehead, and the plaintiffs' attorneys are free to prosecute the lawsuit in a manner that maximizes their fee recovery.

MAY

ORACLE

Require a higher standard of proof for forward-looking statements. Voluntary disclosure of forward-looking information would be encouraged if plaintiffs' attorneys were required to show, in alleging that forward-looking statements were fraudulent, that a defendant had actual knowledge of the falsity and intent to deceive at the time the statement was made. Absent such a showing, the statement would be presumed not to be fraudulent. In addition, the truth or falsity of the statement should be assessed as of the time the statement was made, rather than at some later time period.

Require damages calculations to be determined with a reasonable degree of certainty and with reasonable limitations. Damages calculations must be made more predictable for defendants and for juries if defendants are to be motivated to try meritless cases. The wide discrepancies in the current methods for calculating damages, the lack of reasonable limitations and the unpredictable risk of unreasonably high jury awards (e.g. the $100,000,000 Apple verdict) discourages companies from trying cases they might otherwise have a reasonable chance of winning.

Require proportionate liability. Limit liability for defendants, including the personal liability of directors and officers, who are not found to have knowingly and intentionally participated in a fraud.

Allow defendants to recover some portion of their attorneys fees. Defendants should have the opportunity to recover their attorneys' fees from the plaintiffs' lawyers for being forced to continue defending a lawsuit if, at some point during the litigation, the court makes a determination that a lawsuit cannot be justified.

Limit the percentage that plaintiff's attorneys are allowed to recover as their attorneys' fees. Far too often it seems the principal motivation for prosecuting these lawsuits is the potential fee recovery for the plaintiffs' attorneys. This is wrong. The motivation should be the protection of the plaintiff class. Unless something is done to limit the fee recovery, plaintiffs' attorneys' fees will continue to be a principal motivating factor behind these suits.

We cannot emphasize enough the pressing need for legislative reform in this area. We believe these same sentiments are often shared by members of

ORACLE

the plaintiff class but go unheard because individual shareholders lack the political clout which can be brought to bear by the plaintiff's bar. We have attached, with their permission, a few letters sent by Oracle shareholders to the plaintiff's attorneys in our securities class action that reflect sentiments similar to those expressed in this letter. Please consider these letters, along with our own, in working to enact legislative reforms that will curb the current litigation abuses and better serve the purpose of the securities laws.

Very truly yours,

Jeffrey O. Henley
Senior Vice President and
Chief Financial Officer

Raymond L. Ocampo, Jr.
Senior Vice President,
General Counsel and Secretary

enc.

cc: Senator Pete V. Domenici
Senator Christopher J. Dodd

PROXIMA

September 23, 1993

The Honorable Pete Domenici
The United States Senate
Washington, D.C. 20510

Dear Senator Domenici:

I have learned that the Securities Subcommittee of the Senate Banking Committee is currently considering the issue of frivolous shareholder lawsuits.

Each year, numerous high-technology companies are burdened with defending spurious lawsuits brought by professional plaintiffs. The suits divert vast amounts of management time away from the business of running a company, and they rob companies of capital needed to create jobs, fund R&D, and compete with foreign companies not subject to these suits. They are typically triggered solely by stock price fluctuations and then a costly litigation process is used to coerce companies into settlements. By targeting high technology companies, whose stock prices are normally more volatile than the overall market, the plaintiffs and attorneys in these cases prey upon one of the most innovative segments of the U.S. and California economies, and profit at the expense of U.S. competitiveness.

As the leader of a $60 million, San Diego-based computer peripheral manufacturer, I have learned first-hand how distracting and debilitating these lawsuits can be. Following our recent initial public offering, my company and my management team have become the collective victims of one of these strike suits. A short term stock price decline has led to multiple lawsuits by multiple plaintiffs against multiple defendants, and I and my team find ourselves focusing on the details of a spurious lawsuit instead of managing our business in an increasingly competitive environment. While we are confident that we will eventually prevail, we are wasting time and money that could be better applied elsewhere.

I urge you to express your support for securities reform to Senator Dodd. In addition, I urge you to support any legislation that would reduce the number of illegitimate securities-based lawsuits. Initiatives such as these might spare other companies like Proxima the distraction of frivolous lawsuits, and by so doing help to improve the overall competitiveness of American enterprise.

Respectfully,

Ken Olson
Chairman & CEO

Proxima Corporation
6610 Nancy Ridge Drive San Diego CA 92121-3297 619 457 5500 FAX 619-457-9647

MAY 13

SIERRA TUCSON
COMPANIES

March 10, 1994

Senator Pete Domenici
427 Senate Dirksen Building
Washington, DC 20510

Dear Senator Domenici:

Although I am not a member of your constituency in New Mexico, I did have the opportunity to read an article in the March 9th issue of The Wall Street Journal indicating that you, along with Senator Dodd, will sponsor a bill aimed at curtailing shareholder class action lawsuits. The purpose of this letter is to express my support for that type of legislation.

As the president of a publicly traded company that has recently endured the long and expensive process of an unfounded class action lawsuit, I speak from experience when I say that suits of this nature represent a significant drain of both time and resources from the corporations and individuals involved. Ultimately, these suits impact the very fabric of American businesses and the millions of workers who weave that fabric.

I would appreciate receiving a copy of your bill once it is finalized. I intend to follow its progress and to lend my moral support. Should an opportunity arise to lend concrete support to you or this bill in some other way, I would appreciate being considered.

On a personal note, a few years ago I had the opportunity to work with your sister Thelma when she was living in Phoenix. In fact, I also briefly met you at a talk and dinner sponsored by SamCor and Stephen Morris.

Sincerely,

John H. Schmitz
President

JHS/bbk

MAY 13

16500 N. Lago del Oro Parkway Tucson, Arizona 85737 602/792-5800 800/624-9001 In AZ 800 624 4624 Fax 602/792-2916

3Com Corporation
5400 Bayfront Plaza, P O Box 58145
Santa Clara, CA 95052-8145

(408) 764 5000
345546 Telex

October 29, 1993

The Honorable Pete Domenici
U.S. Senate
Washington, D.C. 20510

Re: Frivolous Shareholder Class Action Lawsuits

Dear Senator Domenici:

I understand that the Securities Subcommittee of the Senate Banking Committee is currently considering the issue of frivolous shareholder class action litigation. Based on my understanding of the issues and the recent experience of 3Com Corporation as a defendant in such lawsuits, I strongly urge you to support initiatives for reforming abusive securities class action lawsuits.

With annual sales exceeding $600M, 3Com employs approximately 2,000 people worldwide. Our headquarters are in Santa Clara, California and, in addition to sales offices located throughout North America, Europe and the Pacific Rim, we also operate manufacturing and research and development facilities in Northboro and Waltham, Massachusetts and overseas facilities outside of Dublin, Ireland and London, England. 3Com is a large exporter, with approximately 50% of our sales outside of North America. 3Com is a leading global data networking company, committed to pursuing various essential technologies which will enable the creation of a U.S. National Information Infrastructure.

Since 1989, 3Com Corporation has been named as a defendant in three separate shareholder class action lawsuits. The first action was recently settled after four years of motions and discovery and millions of dollars of defense costs, without any adjudication of the merits of the alleged securities law violations. A second action was filed against 3Com in June 1993 following a sharp drop in the price of 3Com's common stock; however, the complaint in this action was never served on the company and was subsequently voluntarily dismissed by the plaintiff. A third action was filed against another company, Madge Networks, which had recently completed an initial public offering in which 3Com had participated only as a selling shareholder. The plaintiff in this action has agreed that it will dismiss 3Com from this case.

Frivolous securities lawsuits have become a huge burden on United States high-technology businesses. Such lawsuits divert capital away from job creation, research and development funding, and other vital activities essential for a company to be competitive in a global economy. Such lawsuits distract management attention away from running the company. Moreover, such lawsuits are typically triggered solely by stock price fluctuations, leading to a coercive and costly litigation process aimed at compelling a settlement frequently unrelated to the merits of the allegations.

Innovation, competitiveness, job creation and productivity are crucial to 3Com's strategic mission. Frivolous securities litigation is an extraordinarily costly and wasteful phenomenon which is potentially damaging to legitimate public policy interests, while providing scant benefit to any constituency other than the plaintiff's bar. Please support reform in this vital area.

Sincerely yours,

Eric A. Benhamou
President and CEO

VLSI TECHNOLOGY, INC.

April 22, 1994

The Honorable Pete V. Domenici
United States Senate
Washington, DC 20510-3101

RE: Private Securities Litigation Reform Act of 1994; Senate Bill 1976

Dear Senator Domenici:

In late March, Senators Dodd and Domenici introduced the Private Securities Litigation Reform Act of 1994. As a company that has been subject to several securities class action suits in recent years, VLSI Technology, Inc. ("VLSI") believes this bill will restore balance and fairness to the United States securities litigation system.

VLSI believes certain plaintiff class action attorneys have abused the system, ultimately leading investors to receive pennies on the dollar in recoveries. Use of resources to defend these suits has been an impediment to both job creation and the advancement of technologies vital to keep our country ahead in the global marketplace.

SB1976 protects the rights of investors and the value of their investments by insuring plaintiffs control their lawsuits. More importantly, it encourages disclosure by companies who are willing to give forward looking information and would ultimately generate larger recoveries for true victims of fraud.

The Dodd/Domenici bill would turn the securities systems right side up and put American investors and businesses first. While protecting investors, it discourages the filing of baseless suits that have harmful consequences for the American business community. Help keep the worldwide playing field level.

Senate Bill 1976 deserves your support, it is being supported by VLSI Technology, Inc. and its 2,600 employees. Please lend your assistance to Senators Dodd and Domenici in their efforts to make the Private Securities Litigation Reform Act of 1994 a reality.

Very Truly Yours,

Alfred J. Stein
Chief Executive Officer and President

AJS/lfh

1109 McKay Drive • San Jose, CA 95131 • 408-434-3000 • TLX 278807 • FAX 408-263-2511

THREE-FIVE SYSTEMS, INC.
10230 South 50th Place
Phoenix, Arizona 85044
TEL. 602-496-0035
FAX. 602-496-0168

July 12, 1993

The Honorable Pete Domenici
United States Senate
Washington, DC 20510

Dear Senator Domenici:

I understand that the Securities Subcommittee of the Senate Banking Committee is currently considering the issue of frivolous shareholder suits. I would like to strongly urge you to express support for securities reform to Senator Dodd.

Securities suits which have no basis have become a huge burden from not only a cost standpoint, but also in terms of time and productivity. These suits can extort funds from companies which could be put to much better use by the company as well as the country toward creating jobs, new research and development, and improved competitiveness with foreign companies not subject to these suits. These suits often follow stock price fluctuations and then squander management time and company resources.

We have been attacked in the past by this type of suit and unfortunately the cost of litigating the matter outweighed the cost of settling. It is a sad reflection on our legal system that allows this form of extortion.

Very truly yours,

THREE-FIVE SYSTEMS, INC.

David R Buchanan

David R. Buchanan
Chairman, President and CEO

/jg

April 29, 1994

The Honorable Pete V Domenici
United States Senate
Washington, DC 20510-3101

Dear Senator Domenici

The frivolous securities litigation which is all too popular today is one of the largest problems facing high technology American business. The amount of time and money being spent on this litigation (and on measures aimed at minimizing the probability of being drawn into such litigation) is staggering and, certainly, misplaced If we could redirect this time and money into increased efforts to make a superior product at a more competitive price, the nation would clearly be much better off. Instead, the system allows certain law firms to take staggering amounts of money out of the system and, in doing so, to damage the competitiveness of our high technology companies (with precious little benefit accruing to the "damaged" shareholders).

The problem is particularly severe for a small public company such as Actel where we find that the insurance policies and legal bills associated with simply protecting ourselves from such litigation are equal to a sizable fraction of our R&D budget. Of course, this amount pales compared to what we would be forced to spend if we were actually involved in such litigation. (And, as you know, well over half of the publicly held, venture capital backed companies are eventually sued for fraud by the above mentioned law firms.) If we could only spend this money on a new technology or a new product, Actel, our shareholders, and the entire nation would be better off.

Obviously, we at Actel are big supporters of the Private Securities Litigation Reform Act of 1994, S. 1976. We hope that you are too. Please give this bill your support.

John East
Chief Executive Officer
Actel Corporation

Actel Corporation
955 East Arques Avenue
Sunnyvale, CA 94086-4533
408 739-1010
FAX 408 739-1540

ANALOG DEVICES

RAY STATA
Chairman of the Board
Chief Executive Officer

May 3, 1994

The Honorable Pete V. Domenici
United States Senate
Washington, DC 20510-3101

Dear Senator Domenici:

I am the Chairman of the Board and Chief Executive Officer of Analog Devices, Inc., a manufacturer of integrated circuit products located in Norwood, Massachusetts. We employ approximately 5400 people worldwide, of which about 60% are located in the United States, mostly in Massachusetts, North Carolina, and California.

I am writing in support of S. 1976, the "Private Securities Litigation Reform Act of 1994." We, like many high technology companies, face the daunting task of continually and rapidly upgrading existing products and announcing new ones. The needs of our customers are continually shifting, as are, therefore, the markets for our products. This volatile environment can make the most honest and earnest representations by us and/or our financial accountants of prospects for the company's performance subject to possibly large and unforeseen variation, to the good or to the bad. Having to deal with these possible shifts in the performance of the company from forecasted performance is difficult enough from the standpoint of managing the company. If we are subject to frivolous and concocted litigation each time this happens, there is no real benefit to us, or shareholders or the public in general.

I believe that S.1976 is a fair and balanced approach to the above noted problems and it should be enacted as law. It preserves shareholders rights to litigate in cases of real deception or malfeasance and actually extends the period in which legitimate shareholders suits can be brought after the wrongful action occurs. It eliminates certain practices leading to and, in fact, encouraging baseless strike suits.

Please give S.1976 your wholehearted support.

Yours truly,
ANALOG DEVICES, INC.

Ray Stata

OMEGA FINANCIAL CORPORATION
366 Walker Drive · P.O. Box 619 · State College, PA 16804-619 · 814-231-7680

April 7, 1994

The Honorable Pete V. Domenici
U.S. Senate
Washington, DC 20510

Dear Senator Domenici:

We support your efforts to pass legislation to reduce frivolous law suits. To encourage support for your bill, we have sent letters to Senators Specter and Wofford and Representatives Clinger and Shuster.

The Dodd-Domenici Private Securities Litigation Act is a balanced bill that provides protection both for investors and companies from the affects of frivolous law suits. We appreciate your support of this legislation and hope you will continue your efforts to ensure its passage.

Sincerely,

Robert A. Frederick
Vice President

tlv

U S WEST, Inc.
7800 East Orchard Road, Suite 290
Post Office Box 6508
Englewood, Colorado 80155-6508
303 793-6398

Facsimile 303 793-6222

Doug Holmes
Executive Director
Investor Relations

U S WEST

May 4, 1994

Senator Pete V Domenici
SD-427 Dirksen Senate Office Building
Washington, D C 20510-3101

Dear Senator Domenici.

As the Director of Investor Relations for U S WEST, I'd like to add my voice to those of other corporations and individuals who are urging support for legislation which would restore a sense of fairness and reasonableness to the current system of securities litigation I urge you to give your support to pending legislation (S 1976/H.R 417) which raises the standard of proof for class action suits and discourages the filing of frivolous suits

An efficient market operates on the premise that companies will disclose to shareholders in a timely manner, any relevant information which will help them make informed decisions about their investments. Companies should feel free to disclose such information without fear of unwarranted, mindless litigation. In today's environment, however, because of the growing number of groundless suits being filed which claim to be for the good of the shareholders but, in fact, eat up corporate assets and reduce shareholder value, corporations can only become increasingly reluctant to disclose more than the bare minimum required. There is an urgent need and desire for better balance in what is clearly an unbalanced system today.

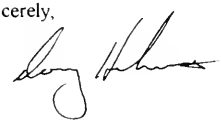
Recently, there has been a discernible pattern of abuse in the system, with "ambulance-chasing" attorneys filing frivolous suits against companies for the sole purpose of earning outrageously high fees. Many of the class action shareholder suits filed have been without merit and were filed simply to force companies to settle out of court at huge expense or incur the extraordinary costs of protracted litigation and lengthy court processes. Because valuable corporate assets were wasted in defending or settling these baseless suits, they have, indeed, often resulted in an erosion of shareholder value.

Contrary to their claimed intent, most of these cases were at the expense of the shareholder, not in his or her best interests. Plaintiffs' attorneys have collected huge fees while the shareholders have derived little or no benefit from the litigation Funds which could and should be used to enhance the value of the corporations are wasted instead, to support the whims of misguided attorneys who are incented to sue "deep pocket" companies without regard to merit These groundless claims have been damaging, not

only to the individual corporations involved, but to the American economy as a whole. The suits have limited job creation and expansion by companies who must spend millions to defend themselves instead of investing in growth opportunities for their firms or paying increased dividends to their shareholders. This comes at a time when American companies are struggling to make themselves more competitive in an increasingly global market, and when there is an urgent need for growth in job opportunities in the country.

We need comprehensive new legislation which will protect the rights of shareholders to redress **genuine** wrongs while making it more difficult for unscrupulous securities lawyers who misuse the system solely for their own gain

Sincerely,



cc: Senator Christopher Dodd
Representative William Tauzin
SEC Chairman Arthur Levitt
Louis M. Thompson - President/CEO NIRI

U.S. Public Affairs

Gary R. Jones
Director

CN North America
1333 Brewery Park Boulevard
Detroit, MI 48207-2699
Telephone: (313) 396-6586
Facsimile: (313) 396-6089

Representing:
Grand Trunk Western
Duluth, Winnipeg & Pacific
Central Vermont

April 14, 1994

File: Legislation - Misc.

The Honorable Carl Levin
459 Senate Russell Office Building
Washington, DC 20510-2202

Dear Senator Levin:

I am writing to ask for your support of S.1976, the Private Securities Litigation Reform Act of 1994. This bill was introduced on March 24 by Senators Dodd and Domenici.

As I understand it, this bill protects the rights of investors and the value of their investments by providing disincentives for the filing of baseless suits. It would give plaintiffs control over their lawsuit, encourage greater disclosure of forward looking information by companies and generate greater recoveries for victims of fraud.

Senator Levin, we are not a publicly traded company and thus have never been directly impacted by one of these class action suits. However, all firms are indirectly impacted. This impact may take the form of devalued investments or higher rates to our accounting/audit firms or other suppliers who are directly impacted.

Thank you for your attention. This legislation would be good for Michigan. I hope you will not only support it, but consider becoming a co-sponsor as well.

Sincerely,

CC: Senator Christopher J. Dodd
Senator Pete V. Domenici

U.S. Public Affairs

Gary R. Jones
Director

CN North America
1333 Brewery Park Boulevard
Detroit, MI 48207-2699
Telephone: (313) 396-6586
Facsimile: (313) 396-6089

Representing:
Grand Trunk Western
Duluth, Winnipeg & Pacific
Central Vermont

April 14, 1994

File: Legislation - Misc.

The Honorable Donald W. Riegle, Jr.
105 Senate Dirksen Office Building
Washington, DC 20510-2201

Dear Senator Riegle:

I am writing to ask for your support of S.1976, the Private Securities Litigation Reform Act of 1994. This bill was introduced on March 24 by Senators Dodd and Domenici.

As I understand it, this bill protects the rights of investors and the value of their investments by providing disincentives for the filing of baseless suits. It would give plaintiffs control over their lawsuit, encourage greater disclosure of forward looking information by companies and generate greater recoveries for victims of fraud.

Senator Riegle, we are not a publicly traded company and thus have never been directly impacted by one of these class action suits. However, all firms are indirectly impacted. This impact may take the form of devalued investments or higher rates to our accounting/audit firms or other suppliers who are directly impacted.

Thank you for your attention. This legislation would be good for Michigan. I hope you will not only support it, but consider becoming a co-sponsor as well.

Sincerely,

CC: Senator Christopher J. Dodd
Senator Pete V. Domenici

FHP

April 21, 1994

Senator Pete V. Domenici
United States Senate
Washington, D.C. 20510

Subject: Private Securities Litigation Reform Act of 1994, S.1976

Dear Senator Domenici:

I am writing to you in support of the Private Securities Litigation Reform Act of 1994, S.1976 which you and Senator Christopher Dodd have introduced. I am General Counsel for FHP International Corporation, a Delaware corporation, which operates a federally qualified multi-state licensed health maintenance organization ("HMO").

On behalf of FHP International Corporation, I will be sending letters to all senators and representatives in the states in which FHP operates, acknowledging FHP's support of this bill and providing the following information:

A broad National Economic Research Associates study of shareholder class action settlements between July 1991 and June 1993 showed that investors recover only approximately seven cents on the dollar sought -- before there is even an award of attorneys fees which average 30 cents on the dollar (Dunbar and Juneja, "Recent Trends II: What Explains Settlements in Shareholders Class Actions," National Economic Research Associates, 1993). It is an erosion of shareholder values when corporate assets are wasted in defending or settling baseless suits. Such waste has become an impediment to job creation and new technologies. This bill protects the rights of investors and empowers investors so they -- not their lawyers -- have greater control over class actions.

- S.1976 requires courts to appoint a "plaintiff steering committee" or guardian to control the lawyers directly and to ensure that the lawyers act in the best interest of the class.

- S.1976 requires that notices of settlement agreements sent to investors clearly spell out important facts, such as how much investors are giving up by settling and how much their lawyers receive in the settlement.

- S.1976 requires that courts link awards of attorneys' fees directly to how much is recovered by investors, rather than simply to how many hours the lawyers billed.

- S.1976 establishes an alternative dispute resolution procedure to make it easier to pursue a case without typically slow and expensive federal court proceedings. This should expedite the recovery process for investors whose claims have merit.

- S.1976 retains joint and several liability and therefore guarantees full recovery for every investor with a net worth of less than $200,000 who loses more than 10 percent of his or her net worth.

- S.1976 seeks to reduce the incidents of frivolous litigation fostered by today's system which creates incentives for plaintiffs' lawyers to sue high tech and growth companies as well as "deep pocket" defendants without regard to merit. In today's securities litigation system, lawsuits are often filed --

  * within days or even hours of a drop in stock price or of news that a company missed an earnings projection;
  * in the name of "professional" plaintiffs who own small amounts of stock in many companies and who lend their names to class-action lawsuits whenever one of their investments loses value; and
  * in "cookie cutter" fashion, with little factual support.

Shareholder class action litigation disproportionately affects high-tech and growth companies that generate the largest number of new jobs. To the extent that meritless claims are settled to avoid litigation, the current system imposes a tax on capital formation and obstructs job creation.

As you said upon introducing the bill, "The list of companies that have been sued reads like the who's who of high growth, high technology, and biotechnology companies. They are the backbone of our economy and the foundation of our ability to compete internationally in a changing world."

S.1976 seeks to increase the amount of voluntary disclosure by providing a "safe harbor" for forward-looking statements concerning future prospects, in contrast to the current trend of less disclosure created by the threat of massive liability.

Our capital markets operate most efficiently and fairly when investors have as much information as possible about companies in which they invest. That is why the SEC has historically encouraged companies to make voluntary disclosures of information beyond the required minimum.

JF01076.MMO

Forward looking information is of particularly significant value to investors in making informed decisions. Such information helps ensure that the market prices of publicly traded securities best reflect their intrinsic value.

In a 1993 study of 550 companies' pattern of information disclosure, two University of California professors (Kaznik and Lev) found that less than 50% of companies with earnings significantly above or below analysts' expectation released early information voluntarily. The study concluded that fear of litigation causes a widespread pattern of minimal disclosure.

In a recent study by the National Investor Relations Institute, almost half of investor relations officers surveyed (386) reported pressure from legal counsel and senior management to limit corporate disclosure and nearly four out of ten said they bowed to internal demands and provided less information due to the threat of shareholder lawsuits.

In a study of 212 companies released earlier this year, the National Venture Capital Association found that 71% were more reluctant to discuss company performance with market analysts.

In conclusion, it is my belief that this bill will certainly restore balance and fairness to the securities litigation system which currently is being abused by certain plaintiff class-action attorneys.

Yours very truly,
FHP INTERNATIONAL CORPORATION

Michael J. Weinstock
Senior Vice President
and General Counsel

JF01076.MMO

Berry Petroleum Company

Post Office Bin X
Taft, California 93268
(805) 769-8811

1994 APR 29 AM 1:06

April 20, 1994

The Honorable Pete Domenici
United States Senate
Washington, DC 20510

Re: The Private Securities Reform Act of 1994 (S.B. 1976)

Dear Senator Domenici:

We applaud your efforts in bringing forth this urgent legislation. It is time this country ends the wasteful and detrimental activities of frivolous lawsuits. American business desires to be competitive throughout the world, but a competitive and encouraging attitude towards capital formation is necessary.

For your information, we have this day sent the attached letter addressed to all the Senators on the Senate Banking, Housing and Urban Affairs Committee and our California Senator Diane Feinstein.

Again, we appreciate your efforts and offer our support.

Best regards,

Harvey L. Bryant
Chairman and
Chief Executive Officer

Jerry V. Hoffman
President and
Chief Operating Officer

Ralph J. Goehring
Chief Financial Officer

cc: Senator Dodd

Berry Petroleum Company

Post Office Box X
Taft, California 93268
(805) 769-8811

April 20, 1994

The Honorable Christopher Dodd
United States Senate
Washington, DC 20510

Re: The Private Securities Reform Act of 1994 (S.B. 1976)

Dear Senator Dodd:

We applaud your efforts in bringing forth this urgent legislation. It is time this country ends the wasteful and detrimental activities of frivolous lawsuits. American business desires to be competitive throughout the world, but a competitive and encouraging attitude towards capital formation is necessary.

For your information, we have this day sent the attached letter addressed to all the Senators on the Senate Banking, Housing and Urban Affairs Committee and our California Senator Diane Feinstein.

Again, we appreciate your efforts and offer our support.

Best regards,

Harvey L. Bryant
Chairman and
Chief Executive Officer

Jerry V. Hoffman
President and
Chief Operating Officer

Ralph J. Goehring
Chief Financial Officer

cc: Senator Domenici

Berry Petroleum Company

April 20, 1994

Post Office Bin X
Taft, California 93268
(805) 769-8811

The Honorable Donald Riegle
United States Senate
Senate Dirksen Office Bldg.
Constitution Avenue and First St. NE
Washington, DC 20510

Re: The Private Securities Reform Act of 1994 (S.B. 1976) .

Dear Senator Riegle:

As a small publicly traded company, ***we strongly urge your co-sponsorship and affirmative vote on S.B. 1976.*** This legislation is necessary to eliminate a growing abuse of frivolous lawsuits brought against U.S. public companies to enrich a handful of greedy attorneys. The abuse is on the rise: the number of such suits filed in federal courts rose roughly 57%, from 169 cases in 1989 to 265 cases in 1992.

The costs to American businesses are rising: averaging $8.6 million per settlement in recent years, with the average attorney fee of approximately 30% of the settlement amount. Just seven law firms filed 45% of all shareholder suits in 1992. This "game" is simply legalized extortion and is not in the best interest of American consumers, employers, or investors.

It is evident that public companies are increasingly being held hostage to this type of frivolous legal action. Such activity greatly impedes American growth and job creation. Small companies, which register the most significant gains in job creation, must seriously review the decision to "go public" in this type of litigious environment. All companies need capital to grow and as the cost of raising capital increases, businesses will stagnate.

We strongly believe S.B. 1976 is a major improvement and is well-balanced by protecting small investors from fraud and by focusing such efforts on true abuses. Small investors will also benefit by the fact that their investments in public companies will not be diminished by such frivolous lawsuits and that the management teams representing these investments can concentrate on growing the company and thereby adding jobs.

It is imperative that this legislation move forward so that U.S. economic growth can proceed and job creation will materialize. We encourage your avid co-sponsorship and support of S.B. 1976—The Private Securities Reform Act of 1994. Thank you for your support in restoring balance and fairness in the lawsuit arena.

Respectfully,

Harvey L. Bryant
Chairman and
Chief Executive Officer

Jerry V. Hoffman
President and
Chief Operating Officer

Ralph J. Goehring
Chief Financial Officer

GREATER BOSTON CHAMBER OF COMMERCE

July 14, 1994

The Honorable John F. Kerry
United States Senate
421 Russell Senate Office Building
Washington, DC 20510

Dear Senator Kerry:

On behalf of the Greater Boston Chamber of Commerce, I am writing in support of the principles contained in both H.R.417 (Securities Private Enforcement Act) and S.1976 (Private Securities Litigation Reform Act) which are presently before the United States Congress. These bills are a significant attempt to address the abusive practices that are far too common in class action lawsuits associated with securities fraud litigation.

The Chamber represents 1,600 employers from diverse industries in 33 Eastern Massachusetts communities. Our members include many emerging, publicly held companies whose growth could be seriously curtailed by extraneous suits promoted by professional plaintiffs. This region's economy is dependent upon the growth of these emerging industries. Therefore, every attempt should be made to eliminate extraneous lawsuits which drain resources from employers while protecting the needs of the public, consumers and shareholders. This legislation will achieve these goals.

The original Securities Exchange Act was written sixty years ago. Clearly, much has changed in our society and in the way we conduct business. The time has come, however, to reexamine securities litigation and support the necessary reforms contained in both S.1976 and H.R.417. If this legislation is adopted, the resources that are shifted from these baseless lawsuits will allow our members to reinvest their capital in areas that provide long term growth: new technologies, job retraining and product research and development. These capital investments will provide long term benefits by creating more jobs and returning dividends to investors right here in Massachusetts.

On behalf of the Chamber, I encourage you to support these two bills to reform the current securities litigation system. The Chamber's Director of Government and Regional Affairs, Joseph Newman, will follow up with your staff to discuss this issue further. If I may be of any additional assistance or if you have any questions, please contact me at (617) 557-7330. Thank you in advance for your attention to this important matter.

Sincerely,

William B. Coughlin
President

Senator -
You recall yesterday at Cong. Meehan's retreat were excellent, alone with the trip down. P.S. We're also working the Executive Board on the Empowerment Zone application.

ONE BEACON STREET, BOSTON, MA 02108-3114 617.227.4500 FAX 617.227.7505

State Street Boston Corporation
225 Franklin Street
Boston, Massachusetts 02110-2804

Marshall N. Carter
Chairman and Chief Executive Officer
(617) 654-3792

June 16, 1994

Honorable Arthur Levitt
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Levitt:

State Street Boston Corporation is a financial services holding company whose common stock is traded on the NASDAQ Natrond Market System. I am writing in support of S. 1976, the Private Securities Litigation Reform Act, because I believe that reform of private lawsuits brought under Rule 10b-5 is needed.

Preventing securities fraud and providing appropriate compensation to investors victimized by fraud is essential to the integrity of our capital markets. Private lawsuits under Rule 10b-5 are one means by which these goals may be accomplished. However, in assessing the effect of the current 10b-5 remedy, it is important to look beyond the investors who may be plaintiffs in a particular case and consider the overall effect of these suits on the millions of investors who are not plaintiffs and on our capital markets as a whole. It is just as critical to deter meritless private lawsuits and to encourage companies to disclose voluntarily the information which investors need to evaluate the risks and rewards associated with particular investment opportunities. I believe that our current system of private litigation stimulates meritless litigation and discourages voluntary disclosure of information. Reforms such as those contained in S. 1976 will go a long way toward correcting these problems, significantly improving the functioning of our markets for all investors.

Fear of an unjustified 10b-5 lawsuit affects the way companies provide information to the market. Available data indicates that fear of an unjustified suit is leading companies to curtail voluntary disclosures: For example, in a recent survey conducted by the American Stock Exchange, 75% of the CEOs said they have limited the amount of information provided to investors because of fear that greater disclosure would lead to a meritless lawsuit. Another survey of more than 200 entrepreneurial companies found that 70% were reluctant to discuss company performance with analysts or otherwise disclose information for fear that a lawsuit under Rule 10b-5 would result.

GAYLORD

EXECUTIVE OFFICES

Gaylord Container Corporation
500 Lake Cook Road
Suite 400
Deerfield, Illinois 60015-4921
708 405 5500

April 22, 1994

The Honorable Roy Rowland
U.S. House of Representatives
2134 Rayburn House
Washington, DC 20515

Dear Representative Rowland

Gaylord Container Corporation is a major national manufacturer and distributor of corrugated containers, containerboard, unbleached kraft paper, multiwall bags and grocery bags and sacks. The Company is headquartered in Deerfield, Illinois, has operations nationwide and employs more than 4,300 individuals.

The purpose of this letter is to urge you to support S. 1976, the Private Securities Litigation Reform Act of 1994 introduced by Senators Christopher Dodd and Pete Domenici. The reason for my interest in this legislation is based on personal experience with two shareholder lawsuits filed against Gaylord, which, after four years and hundreds of thousands of dollars in attorneys' fees, were eventually dismissed. These groundless lawsuits did nothing to enhance value for Gaylord shareholders. In fact, they were unfair to shareholders because corporate assets were used to defend the Company and management's attention was diverted from corporate business for the duration of the proceedings.

Enactment of S. 1976 will restore balance and fairness to securities litigation and stem the abuses of certain class-action plaintiff attorneys. These lawsuits are inhibiting the free flow of corporate information to the investment community, and this legislation would increase the amount of voluntary disclosure by providing a "safe harbor" for forward-looking statements concerning a company's future prospects.

Your support of S. 1976 is important if we are to provide protection for those shareholders who have been truly defrauded and provide reasonable protection for corporations which disclose the information necessary for investors to make informed investment decisions.

Speaking as someone who has experienced first hand the effects of frivolous litigation, I ask you to support S. 1976. Thank you for your consideration of this request.

Sincerely,

Marvin Pomerantz

Marvin A. Pomerantz
Chairman & Chief Executive Officer

cc: Senator Christopher Dodd
Senator Pete Domenici
Arthur Levitt, Jr., Chairman - SEC

HANDLEMAN COMPANY

April 14, 1994

The Honorable Donald W. Riegle, Jr.
United States Senate
Washington, D.C. 20510

Dear Senator Riegle:

On March 24, 1994, Senators Dodd and Domenici introduced the Private Securities Litigation Reform Act of 1994, S. 1976. The purpose of the bill is to restore balance and fairness to the securities litigation system which currently is being abused by certain plaintiff class action attorneys.

This abuse has lead to investors receiving minuscule amounts in recoveries, an erosion of shareholder values when corporate assets are wasted in defending baseless suits and has become an impediment to job creation and new technologies. Every independent study presented to the Senate's Securities Subcommittee last year concluded that securities class actions are virtually always settled regardless of merit, with little benefit to shareholders.

The bill protects the rights of investors and the value of their investments, provides disincentives for the filing of baseless suits, gives plaintiffs control over their lawsuits, encourages greater disclosure of forward looking information by companies and would generate greater recoveries for victims of fraud.

S. 1976 seeks to reduce the incidents of frivolous litigation fostered by today's system which creates incentives for plaintiff's lawyers to sue high tech and growth companies as well as "deep pocket" defendants without regard to merit. Our financial markets should not be held hostage to a small group of attorneys who enrich themselves at the expense of victims, employees, shareholders and management. The Dodd/Domenici bill would turn the securities system right side up and put American investors and business first.

Corporate Headquarters
500 Kirts Boulevard · P O Box 7045 · Troy Michigan 48007-7045 · 313-362-4400

The bill also deals fairly with professionals like accountants. It provides a process to punish accountants when they are wrongdoers and for liability based upon degree of responsibility while fully protecting small investors. The bill is clearly balanced. While protecting investors, it discourages the filing of baseless suits that have harmful consequences for the business community.

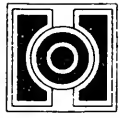
The bill deserves your support. It is good for Michigan and the country as a whole. Please co-sponsor S. 1976.

Very truly yours,

Stephen Strome
President and CEO

SS:cf/1414/may

c: Senator Christopher Dodd
Senator Pete Domenici
Chairman Arthur Levitt, Jr.
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549



HANDLEMAN COMPANY

April 14, 1994

The Honorable Carl Levin
United States Senate
Washington, D.C. 20510

Dear Senator Levin:

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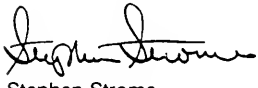
Very truly yours,



Stephen Strome
President and CEO

SS dtl/1414/mey

c: Senator Christopher Dodd
Senator Pete Domenici
Chairman Arthur Levitt, Jr.
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

New York, New York 10006-1881
212 306-1000

Richard F. Syron
Chairman of the Board

American
Stock Exchange

May 26, 1994

The Honorable Pete V. Domenici
United States Senate
Washington, D.C. 20510-3305

Dear Senator Domenici:

Thank you for taking the time out of your schedule to meet with me and allowing me to reintroduce myself on Tuesday, May 17.

If I can be of any assistance to you, your Committee, or your staff in regards to securities issues, please do not hesitate to contact me with such matters. In addition, I would like to extend an open invitation to have you visit the American Stock Exchange in New York any time your schedule will permit.

In the meantime, we look forward to working with you and Denise Ramones on the issue of securities litigation reform. I commend you on your efforts to date in this arena. From my longer term perspective of an economist, I also strongly believe you are on not only the correct but essential track on the consumption tax. Time will prove you right.

Please do not hesitate to contact Tamara Hirschfeld, Executive Director of Government Relations, if you or your staff have any questions or need assistance in any way.

Sincerely,

Dick Syron

RFS:des

Westvaco

May 16, 1994

The Honorable Pete Domenici
U. S. Senate
Washington D.C. 20510

Dear Senator Domenici:

This letter is to thank you for your co-sponsorship of S.1976, "The Private Securities Litigation Reform Act," which seeks to eliminate abuses in suits seeking recovery under Section 10b-5 of the Securities Exchange Act of 1934. These suits seem often to follow automatically upon changes in the stock price of public companies, and typically allege without specifics that the companies misled investors through inadequate or inaccurate disclosure.

The proposed legislation attempts to address abuses in a variety of ways. Among these ways are provisions making sure that suits are brought in a timely fashion, that allegations are specific and well-founded, and that suits are maintained and directed for the benefit of investors rather than professional plaintiffs. The bill also calls for reasonable protection for forward-looking statements by a company regarding its future economic performance so that investors can receive the benefit of such statements without undue exposure for the company.

Separately, the bill offers to improve investor confidence in financial disclosure. This would be done in part by improving prospects for fraud detection and disclosure, and by creating a professional self-disciplinary board for public auditors.

I believe that these reforms, particularly in regard to Section 10b-5 suits, are definitely needed and long overdue.

Very truly yours,

John W. Hetherington
Vice President and Secretary

JWH:jc

Westvaco Building
299 Park Avenue, New York, N Y 10171
Telephone 212 688 5000

MICHAEL J. TURILLO, JR.
47 SOUTH STREET
SOUTH NATICK, MASSACHUSETTS 01760

April 14, 1994

The Honorable Edward M. Kennedy
United States Senate
Washington, D.C. 20510

Dear Senator Kennedy:

I am writing to request that you support your colleagues, Senators Dodd and Domenici, by co-sponsoring their bill the ***Private Securities Litigation Reform Act of 1994*** which they introduced on March 24, 1994.

Our nation has many challenges and problems before us. Healthcare, education, and crime to name a few. All complex. These and others have, in my opinion, a common theme which will contribute to their resolution -- tort reform. Lawyers and the resultant litigation they have wrought on our nation are more scandalous and damaging to our society and economy than any abuse you will find on Wall Street, from a welfare recipient and, if I may say so, within the halls of Congress or the White House.

I have long advocated a simple solution which is not uncommon in other parts of the world. Those who sue and sue unsuccessfully should bear the cost incurred by those who had to defend themselves. Such an approach, in my opinion, will lessen the number of suits and speed resolution. People would still be free to sue, and lawyers free to pursue such cases, but the cost implications of such an approach will significantly alter the dynamics of our current litigious environment. While the ***Private Securities Litigation Reform Act of 1994*** does not propose such a solution, it nonetheless proposes other meaningful and constructive provisions which contribute to substantive tort reform. The Bill is a good and essential first step.

The Bill deserves your support and I ask for it. If you do not believe it does, I can only conclude that you do not believe we are in need of tort reform or you have an alternative to the Bill. If this be the case, I would ask you to write to me explaining why you do not believe we are in need of tort reform or outlining for me your alternative to the ***Private Securities Litigation Reform Act of 1994*** . Otherwise, I will assume I can count on your co-sponsoring Senators Dodd and Domenici's Bill.

Very truly yours,

Michael J. Turillo, Jr.

cc: Senator Dodd
Senator Domenici

NASCAT ANALYSIS OF PENDING LEGISLATION ON SECURITIES FRAUD LITIGATION

The "English Rule" on Fee-Shifting

NASCAT strongly opposes the fee-shifting proposals in H.R. 1058 and S. 240. We agree with the overwhelming judgment of experts that fee-shifting in securities class actions will intimidate potential plaintiffs and will eliminate these suits as a means of recovery. These provisions should not be included in any legislation.

Because of our national policy in favor of access to justice, for 200 years the United States has used the "American Rule," with each side in a case generally paying its own fees and costs. Under the House-passed bill, H.R. 1058, a court *must* impose fees and costs against the losing party in any private securities action if certain vague criteria are satisfied, including that the case was not "substantially justified." There is no limitation on the amount a fraud victim might owe under this formula. Moreover, the plaintiffs (and/or their attorney) must post a bond (an "undertaking") at the beginning of the case to cover the payment of the defendants' attorneys' fees and costs, but the defendants do *not* have to provide such a bond. The House-passed bill also includes an "English Rule" applicable to discovery proceedings, again putting the average plaintiff at a disadvantage against a corporate wrongdoer.

Under S. 240, a court also *must* impose fees and costs against the losing party or attorney in a securities action if the party unreasonably declined to proceed under Alternative Dispute Resolution (ADR) and the judge determines that "a claim" in the case was not "substantially justified."

These provisions would end all class actions by victims of fraud. By definition, a securities class action is a suit by one or a few investors who in general have lost relatively small amounts of money and who sue on behalf of all those similarly injured. No victim will stand up and sue as the champion of the class for his or her small loss if the risk—under the English Rule—is paying millions in fees of well-heeled insurance companies, corporations, investment banking houses, accounting firms, and law firms.

Because of the drastic effect a "loser pays" rule would have in the securities class action context, a number of Members of the Senate Banking Committee have already expressed their opposition to it. At the March 2, 1995 hearing, Full Committee Chairman Alfonse D'Amato stated flatly that such a provision would be "irresponsible" and said "you're not going to grab this Senator with it." Similarly, one of the two primary sponsors of S. 240, Senator Dodd, stated at a hearing on July 21, 1993 that:

> The English Rule, for instance, I just think is a dreadful idea. I'll be very blunt with you. The idea that we will require the losing side to pay the attorneys' fees has such a negative impact on your moderately financed plaintiff that you just discourage people from coming forward entirely.[1]

In the same vein, the current Chairman of the Judiciary Committee, Senator Orrin Hatch, has also publicly noted his reservations about a "loser pays" rule because of its impact on individual plaintiffs.[2]

SEC Chairman Levitt has opposed a mandatory "loser pays" rule as well. With respect to the provision in H.R. 1058, in a letter dated February 23, 1995 to House Commerce Committee Chairman Thomas Bliley, Chairman Levitt stated:

> We have concerns, however, about whether the undertaking provision would deter the filing of meritorious suits. Moreover, as pointed out in the Commission's testimony, the "substantially justified" standard is drawn from a statute that applies fee-shifting only against the Government in cases brought against individuals and small businesses. The use of such a standard in investor lawsuits may also deter the filing of meritorious suits, especially when combined with a requirement to provide security for costs.
>
> The Commission believes that it is important to deter frivolous lawsuits, but to do so in a manner that does not have a chilling effect on investors with legitimate claims. In our view, the key is to provide that judges exercise their discretion to award fees and costs in appropriate cases.

Virtually every other witness who has testified on the securities litigation issue in the House and Senate—academics, regulators, and practitioners—has agreed that

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[1] *Private Litigation Under the Federal Securities Laws:* Hearings before the Subcommittee on Securities, U.S. Senate, Committee on Banking, Housing, and Urban Affairs, 103rd Cong. 1st Sess. at 291.

[2] "Warily, Hatch Mulls Changes in Civil Justice," *The Wall Street Journal,* January 31, 1995.

the English Rule would eliminate meritorious, as well as "frivolous," suits. A sampling:

- The North American Securities Administrators Association (representing the State regulators in the 50 States) has stated:

  H.R. 10/H.R. 1058 would greatly undermine this concept of fair and equal access to justice by imposing a version of the controversial "English Rule." . . . Worse yet, the bill sets up an intimidating hurdle that any plaintiff must clear in order to be heard in court: Either the investors or their attorneys will have to post a security at the beginning of a case to provide for the payment of the defendant's attorneys' fees and other expenses in the event that the court determines at the end of the case to shift these costs on to the plaintiff. And, although defendants theoretically could be forced to pay the fees and expenses of a prevailing plaintiff, the requirement to post a security is imposed only on plaintiffs. It has been suggested that plaintiffs unable to obtain a bond could simply put up their homes to satisfy the security requirement! NASAA's members have extensive experience dealing with defrauded investors and we can tell you that this requirement would have a devastating and chilling effect on legitimate investor lawsuits. We are hard pressed to think of any defrauded investor who, after losing all or part of his or her investment, would be willing to risk losing their home in order to pursue a case in court.[3]

- The American Association of Retired Persons has said:

  AARP strongly opposes any form of a "loser pays" rule, and also opposes the requirement that plaintiffs post a bond to cover the fees and costs of the defendant. Under H.R. 10's "loser pays" provisions, investors who may have already lost their life savings or lump sum pension payments would still have to risk paying attorneys' fees that may be hundreds of times greater than their investment losses, even in cases of deliberate fraud. It also shields wrongdoers from responsibility or liability for their actions. The requirement that a plaintiff post a bond to cover potential expenses could mean that the investor's home might be taken should he or she lose at trial.[4]

- In a letter dated February 7, 1995 to the House Commerce Committee, 65 (subsequently augmented to nearly 100) prominent professors of corporate and/or securities law wrote that they were "particularly troubled by the cumulative effect of provisions in H.R. 10 that would . . . adopt the "loser pays" principle for Federal securities litigation. . . ."

- Arthur R. Miller, Bruce Bromley Professor of Law at the Harvard Law School:

  As a practical matter, fee-shifting is almost invariably an intimidation device designed to inhibit people from seeking access to the courts. Fee shifting would eviscerate all—or virtually all—plaintiffs' securities claims, the meritorious along with the meritless. . . . No one except the extremely wealthy—no matter how strong his or her claim appears to be—would assume the risks of pursuing a class claim against well resourced defendants with counsel who are compensated on an hourly basis if there was any risk of having to pay the defendants' attorneys' fees.[5]

- Professor John Coffee, Jr., Adolf A. Berle Professor Law, Columbia University Law School:

  Clearly, some proposed reforms—such as the English Rule under which the "loser pays" the winner's legal expenses—would probably end securities class actions in all except rare cases of flagrant fraud.[6]

- Professor Donald C. Langevoort, Lee S. and Charles A. Speir Professor of Law, Vanderbilt Law School:

  I am not in favor of [the English Rule] as the way of handling the problem . . . I think when you have as claimants small investors around the country, they cannot afford to pay the legal fees.

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[3] Letter to Members of the U.S. House of Representatives, March 3, 1995.
[4] Letter to Members of the U.S. House of Representatives, March 6, 1995.
[5] *Securities Litigation Reform,* Hearings before the Subcommittee on Telecommunications and Finance, House Committee on Energy and Commerce, 103d Cong. 2d Sess., at 153–4.
[6] *Id.* at 106.

> And if the message to them was, if you think you have a 50 percent chance of winning, a 50 percent chance of losing, and if you lose, you pay the defendant's legal fees, I don't think that suit gets brought.[7]

- Professor Harvey J. Goldschmid, Dwight Professor of Law, Columbia University School of Law has testified:

> "I think the chilling effect is much too great for any possible gain."[8]

- Stuart J. Kaswell, Senior Vice President and General Counsel, Securities Industry Association:

> Our members have not favored going to a "loser pays" formulation.[9]

- Private lawyer Eugene I. Goldman, who represents clients before the SEC and in private enforcement suits:

> Lose[r] pay[s], I believe, would result in good faith claims not being filed, claims which have merit not being filed.[10]

- Chief Justice Earl Warren:

> "[A]lthough some American commentators have urged adoption of the English practice in this country, our courts have generally resisted any movement in that direction. . . . In support of the American Rule, it has been argued that since litigation is at best uncertain one should not be penalized for merely defending or prosecuting a lawsuit, and the poor might be unjustly discouraged from instituting actions to vindicate their rights if the penalty for losing included the fees of their opponents' counsel."[11]

Severe Limits on Joint and Several Liability

NASCAT believes that public policy strongly counsels in favor of the concept of joint and several liability. To the extent Congress feels it appropriate to move toward a proportional liability system, we would urge that it assure that defrauded investors are protected in any situation in which a primary wrongdoer is insolvent or has fled—even if that means less culpable defendants must pay more than their proportional share.

Under current law, each defendant who conspires to commit a violation of Section 10(b) is jointly and severally liable for all the damages resulting from the violation. One important rationale for this concept is that a fraud cannot succeed if one of the participants reveals its existence; to that end, all the wrongdoers are equally culpable if the fraud achieves its aims. (Significantly, under current law, violators who believe they have laid victims more than their proportional share may seek "contribution" from other violators.)

Joint and several liability is particularly appropriate when the principal wrongdoer is bankrupt, in jail or has fled. In such situations, the policy has been that, as between the other participants in the fraud and the victims, the other wrongdoers should bear the loss and should fully compensate the victims. This has been extremely important in the sophisticated financial frauds of recent years, which could not have succeeded without the active assistance of professionals like accountants and lawyers. Yet, under the pending House and Senate bills, these professional assistors will for all intents and purposes be relieved of joint and several liability, even if their conduct was manifestly and unarguably reckless and the primary malefactor is judgment-proof. This will substantially *reduce* victim recoveries.

Under the House-passed bill, H.R. 1058, only a person who acts "knowingly" in committing securities fraud can be jointly and severally liable. A defendant acts "knowingly" if he "knew that the statement of a material fact was misleading at the time it was made, or knew that an omitted fact was necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading." The bill *exempts defendants who engage in reckless conduct from joint and several liability.*

The relevant provisions of S. 240 are extremely complex. Under S. 240, only a person who (1) was a "primary wrongdoer;" (2) committed "knowing securities fraud;" or (3) controlled any primary wrongdoer or person who committed knowing securities fraud can be jointly and severally liable.

Officers, directors and professionals like accountants and lawyers who assist in a fraud are not specifically mentioned in the bill's list of possible primary wrong-

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[7] *Abandonment of the Private Right Of Action for Aiding and Abetting Securities Fraud/Staff Report On Private Securities Litigation:* Hearing before the Subcommittee on Securities, U.S. Senate Committee on Banking, Housing, and Urban Affairs, 103rd Cong. 2d Sess., at 38.

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] *Fleishmann Distilling Corp.* v. *Maier Brewing Co.*, 386 U.S. 714, 717–18 (1967).

doers, and can only be considered such if a plaintiff can prove that they "intentionally rendered substantial assistance to the fraudulent conduct [of a listed primary wrongdoer] with *actual knowledge* of such person's fraudulent conduct or fraudulent purpose and with knowledge that such conduct was wrongful."

Similarly, to be jointly and severally liable for engaging in "knowing securities fraud," an officer, director, accountant, or lawyer must have *actual knowledge* of false statements and fraudulent conduct. Moreover, S. 240, like H.R. 1058, *specifically exempts lawyers, accountants, and others who engage in reckless conduct from joint and several liability.*

The pending bills would thus change the current system, in part, to "proportional liability." The Lincoln Savings and Loan/Charles Keating case provides an excellent example of the practical effect of such a change. Under proportional liability, in the Keating case, the jury would have had to apportion the wrongdoing among the defendants. If it decided that Mr. Keating was 75 percent responsible, the accountants 15 percent, and the lawyers 10 percent, that would cap the recovery from the professionals at a maximum of 25 percent. This would make a full recovery, by judgment or settlement, impossible, as the professionals with the assets or insurance to pay would have the trump card of proportional liability, and the victims would have the albatross of Mr. Keating, centrally involved but judgment-proof. In a case involving virtually unprecedented behavior by professionals in a fraud, such a result should be unacceptable to all of us. (Under the current system, the victims in that case have recovered some $240 million of their $288 million in losses at this point—the bulk from professionals.)

Quite simply, the changes to joint and several liability made by the pending bills would mean less accountability for those professionals involved in complex commercial wrongdoing—and less chance for fraud victims fully to recover what was stolen from them.

This is a bizarre result given the central role of professionals in the savings and loan crisis and other financial shenanigans of thee past decade. One fact will suffice here: According to the General Accounting Office, when all categories of professionals are considered, Resolution Trust Corporation attorneys suspect wrongdoing on the part of one or more professionals affiliated with over 80 percent of failed thrift institutions.[12]

SEC Chairman Levitt has been especially eloquent regarding the rationale behind, and the need for, joint and several liability. Last July, he testified:

> . . . Since securities fraud cases often involve insolvent issuers or individuals, however, some defendants in such cases may not be able to pay their fair share of the damages they have jointly caused. Advocates of proportionate liability argue that joint and several liability produces an inequitable result in such circumstances because it forces parties who are only partially responsible for the harm to bear more than their proportionate share of the damages. The accounting profession, in particular, argues that the current system provides plaintiffs with an incentive to join as many "deep pockets" as possible, and compels defendants to settle weak claims in order to avoid disproportionate liability.
>
> The response to this argument is that, although the traditional doctrine of joint and several liability may cause accountants and others to bear more than their proportional share of liability in particular cases, this is because the current system is based on equitable principles that operate to protect innocent investors. In essence, as between defrauded investors and the professional advisers who assist a fraud by knowingly or recklessly failing to meet professional standards, the risk of loss should fall on the latter. Defrauded investors should not be denied an opportunity to recover all of their losses simply because some defendants are more culpable than others.
>
> As noted at the outset, the Commission's primary responsibility is the protection of investors. Simply put, the Commission believes that defendants who engage in fraud should be held accountable for investor losses resulting therefrom. The Commission is concerned about proportionate liabil-

[12] A Federal judge wrote in 1991 that: "Accounting firms may have been responsible for many of the abuses which have led to this country's savings and loan crisis. In fact, [the Office of Thrift Supervision] advised the court that approximately one-third of the 690 financial institutions that have failed were audited by Ernst & Young or its predecessor." *Director of the Office of Thrift Supervision* v. *Ernst & Young*, 786 F. Supp. 46, 52 (D.D.C. 1991). More recently, *The Wall Street Journal* carried a lengthy article about the extensive role professionals played in the major fraud involving Towers Financial Corporation. "Where There's a Scam, Noted Professionals Can Lend It Credence—Lawyers, Politicos, Lobbyists Served Towers Financial While Investors Bled," *The Wall Street Journal*, July 27, 1994.

ity tests that leave investors without an effective remedy in situations where it can be proven that one or more defendants, through knowing or reckless misconduct, caused investor losses.[13]

What is particularly disingenuous about the proposals to restrict joint and several liability contained in the pending bills is that the proponents of litigation "reform" insist that they are concerned about recoveries by class members of "pennies on the dollar." Yet, these provisions would solve that perceived problem by taking the "pennies" away! They would make it virtually impossible for victims of fraud fully to recover their losses in cases in which the primary wrongdoer is insolvent, in jail or has fled. To the extent that one of the goals of Congress is to *increase* recoveries for victims, the evisceration of joint and several liability will have precisely the opposite effect.

Heightened Intent Requirements

NASCAT does not oppose codifying an appropriate recklessness standard for intent and believes the test adopted by the United States Court of Appeals for the Seventh Circuit in *Sundstrand Corp.* v. *Sun Chemical Corp.*, 553 F.2d 1033, at 1044–45 (1977), which has been adopted by the vast majority of circuits, is satisfactory. If Congress chooses not to adopt this standard, we would recommend enacting no provision, the approach taken by S. 240.

Under current law as interpreted by virtually every circuit court, recklessness—as opposed to actual knowledge—is sufficient to establish securities fraud.

H.R. 1058 as passed codifies recklessness utilizing the *Sundstrand* standard—but creates an exception for a defendant who did not "deliberately" fail to investigate whether his statements were false or misleading.

Creating such an "I forgot to investigate the fraud" defense to liability under the securities laws is patently absurd. It makes irrelevant the rest of the recklessness definition and gives wrongdoers a huge loophole through which to avoid responsibility for their actions; it will also lead to more litigation over each defendant's intent. Such a defense makes no more sense in the securities context than it would in the tax area. And imagine the response of the IRS if a taxpayer said: "I didn't *deliberately* fail to make sure my statements were honest."

NASCAT believes enacting any provision that would relieve professionals such as lawyers and accountants from responsibility for their reckless involvement in wrongdoing is bad policy for at least two reasons.

First, requiring actual knowledge of, or a deliberate failure to investigate, fraud by a professional would encourage accountants and lawyers to look the other way in order to avoid liability, rather than engage in rigorous questioning of their clients' books, records, and/or business plans. In view of the rampant white collar fraud of recent years, immunizing recklessness by professionals is not sensible public policy.[14]

Second, exempting any reckless conduct from liability is manifestly unfair to defrauded investors. There can be no justification for favoring a reckless professional over an innocent victim in deciding who should bear the risk of loss. If an accountant, lawyer, or other professional acts recklessly and thereby furthers a fraud, he or she should be answerable to the victims who suffered as a result.[15]

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[13] *Securities Litigation Reform, supra* note 5, at 40.

[14] The recent report by the Association of the Bar of the City of New York on S. 1976 (Senate legislation on securities litigation from the 103rd Congress which is identical to S. 240) urged Congress affirmatively to enact legislation to codify recklessness as the culpability standard under Section 10(b):

> The new section of S. 1976 should also reaffirm what every lower Federal court to deal with the issue has held, that recklessness is the culpability standard under Section 10(b) . . . A Supreme Court holding that only willful or intentional conduct violates Section 10(b) would have a potentially devastating effect on director, office, and professional behavior; the soundness of both our disclosure system and securities markets would be gravely endangered. Directors, lawyers, accountants, and many others, would have powerful legal incentives to simply ignore red flags suggesting fraud or egregious disclosure failures. Only actual intent would make them vulnerable.

Report on Private Securities Reform Legislation by the Committee on Securities Litigation and the Committee on Federal Courts, the Association of the Bar of the City of New York, December 19, 1994, at 7–8 (footnotes omitted). Importantly, those involved in the preparation of the report included corporate lawyers, litigators, in-house counsel, and academics with considerable expertise in the securities field, as well as defense and plaintiffs' counsel. *Id.* at 2.

[15] Perhaps an accidental, but nonetheless extremely problematic, impact of the heightened intent provisions in H.R. 10 as introduced and H.R. 1058 as passed is that they would limit Section 10(b) liability to false statements, thus eliminating liability for participation in a fraudulent scheme or pursuit of a course of business that operated as a fraud or deceit on any person. This

Continued

A Safe-Harbor Exemption From Fraud Liability For Forward-Looking Statements

As NASCAT has testified in the ongoing SEC rulemaking proceedings on the safe-harbor issue, we believe the claim by some executives that securities fraud class actions are chilling the disclosure of corporate information, particularly "forward-looking" statements regarding future economic performance, is wholly unsubstantiated. We believe the SEC should be allowed to complete its rulemaking on this issue before Congress decides what legislation, if any, is appropriate in this area.

Under the current safe-harbor rules, including SEC Rule 175, a company can be held liable for a forward-looking statement in a filed document *only* if the statement *lacks a reasonable basis* or is made in *bad faith*. There has been no evidence presented as to why "good faith" and "a reasonable basis" are not enough for a safe-harbor exemption from liability for fraud. Such a standard would hardly seem to impose an undue burden on corporate communications.

Forward-looking statements are critical corporate disclosures, since investors essentially are buying the future of the company. According to the SEC:

> Forward-looking information occupies a vital role in the United States securities markets. Investors typically consider management's forward-looking information important and useful in evaluating a company's economic prospects and consequently in making their investment decisions. Analysts and other market participants report that they view consideration of management's own performance projections, *i.e.*, earnings and revenues, to be critical to their own forecasts of a company's future performance. As such, forward-looking information is often considered a critical component of investment recommendations made by broker-dealers, investment advisers, and other securities professionals.[16]

In that light, it hardly seems unreasonable to require predictive statements, calculated to attract investment dollars, to at least be made in good faith and have some reasonable basis. Any weakening of the good faith/reasonable basis standard would be unwise public policy and could be devastating to the integrity of the securities markets.

The risk of severely damaging the securities markets is manifest. Forward-looking statements are naturally prone to fraud as they are an easy way to make exaggerated predictions of favorable developments in order to attract cash. They are a favorite tool of con artists who use false forward-looking statements as a technique to artificially manipulate the price of public company stock.

In addition, the Securities Act of 1933 and the Securities Exchange Act of 1934 were passed in large part because of speculative projections for stock pools that led to the stock market crash of 1929. Until 1979, forward-looking statements were not even permitted. This policy was based primarily on the SEC's determination that forward-looking predictive statements are inherently unreliable, and that unsophisticated investors could easily be misled by such statements. Since 1979, in recognition of the fact that good faith, reasonably supported predictive statements may be of significant value to investors, SEC rules have allowed limited forward-looking statements in public filings. Courts also have carefully crafted their own sets of liability exemptions for such statements. This history counsels a good measure of caution in dealing with these highly sensitive types of disclosure.

Nevertheless, the safe harbor in H.R. 1058 would overrule the good faith/reasonable basis standard. In its place, it would provide total immunity from liability in any private action under the Federal securities laws for broadly defined "forward-looking" statements so long as they are referred to as forward-looking statements and state that the prediction or projection might not come true. The exemption would apply regardless of how intentionally fraudulent the statements are and regardless of their market impact. It is a broader exemption from fraud liability than has ever been considered to date. The exemption is so broadly and vaguely defined that it could be more accurately described as a "safe ocean" than a "safe harbor."

First, the House bill vastly expands the definition of protected forward-looking statements. Under current law, SEC Rule 175 limits the definition of "forward-looking statements" to the following:

> (1) A statement containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items;

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would gut Rule 10(b)(5) by sharply curtailing (by two-thirds) the reach of its otherwise broad proscription against fraud. The Committee should seek the input of the SEC as to the impact of this provision.

[16] SEC Release No. 33–7101 (October 13, 1994), at 2–3.

(2) A statement of management's plans and objectives for future operations;

(3) A statement of future economic performance contained in management's discussion and analysis of financial condition and results of operations included pursuant to Item 303 of Regulation S–K or Item 9 of Form 20–F; or

(4) Disclosed statements of the assumptions underlying or relating to any of the statements described in (1), (2), or (3) above.

In addition, the current safe-harbor exemption applies only when the forward-looking statement is made, reaffirmed, or later published in documents filed with the SEC. As the SEC has stated, this "filing" requirement "would provide investors with better access to the information and a more reliable framework within which to evaluate the forward-looking statement, and would enable the Commission to maintain oversight of the accuracy and completeness of the disclosure."[17]

By contrast, the "safe harbor" in H.R. 1058 states that a forward-looking statement "shall include *(but not be limited to)* projections, estimates, and descriptions of future events, *whether made orally, or in writing,* voluntarily or otherwise." Thus, the definition of protected statements is extremely broad (in fact, unlimited) and applies to oral statements the accuracy and completeness of which cannot be evaluated by the SEC. If one wanted to exempt almost any corporate statement from fraud liability, this is an excellent way to do it.

Clever lawyers will undoubtedly recast almost everything as a forward-looking statement and thereby immunize companies from all private liability. This would not be difficult since virtually all balance sheet numbers represent "present value" estimates of future events. For example, for publicly-traded banks, bad loan loss reserves could be cast as a forward-looking statement. Yet, it is in this area of reserve calculations that so many of the problems occurred with the savings and loans during the late 1980's. In addition, virtually every statement in publicly audited financial statements calls for estimations and "forward-looking" judgments by accountants—accounts receivable, accounts payable, and bad debts all inherently involve some prediction. Under the provision in H.R. 1058, even intentional lies and deceits would get as much protection as good faith statements.

Second, H.R. 1058 eradicates virtually all limits or conditions on the exemption from liability. Whereas current law strictly limits safe-harbor protection to forward-looking statements that are made in good faith and with a reasonable basis, H.R. 1058 exempts forward-looking statements so long as they are referred to as such (or understood by the recipient to be forward-looking statements) and state that there is a risk that the prediction or projection may not materialize. Thus, a disclaimer buried in tiny print in a footnote is enough to render blatant fraud entirely legitimate. The general disclaimer need not even be directly linked to particular forward-looking statements. Rosy projections could be made prominent while the disclaimer could be in fine print in a footnote somewhere.

Under H.R. 1058's "safe harbor," therefore, a label and a disclaimer are all that is required to wholly exempt any predictive corporate statements from private fraud liability. The House bill thus replaces the "good faith/reasonable basis" test with a "no faith/no basis" test.

Third, H.R. 1058 totally eliminates any duty to correct forward-looking statements. When the SEC adopted the current safe-harbor rule, it warned public companies that, although it was not adding a formal requirement to update forward-looking statements, companies could be held liable if they failed to correct projections when subsequent events or discoveries rendered them false or misleading. H.R. 1058 expressly eliminates, without any substantiated justification, any private liability based on a failure to correct forward-looking statements that have become false or misleading.

By providing absolute immunity under many circumstances, even if false and misleading forward-looking statements are made intentionally, the House safe harbor essentially grants a free pass to commit fraud. The language would provide absolute immunity regardless of whether the statements had a reasonable basis, regardless of whether they were made in good faith, and regardless of whether they were made with the purpose of deceiving investors.

Given the weight of forward-looking statements in most consumers' investment decisions and the inherent tendency of such statements to mislead unsophisticated investors, rules designed to eliminate fraud liability based on such statements must be carefully crafted to ensure that would-be wrongdoers cannot easily manipulate them at the expense of the investing public. The safe harbor in H.R. 1058 fails dra-

[17] *Id.* at 14.

matically in that regard. It would move the rule, within about 15 years, from prohibiting the issuance of this type of information because of its potentially misleading nature, to immunizing such information from private liability no matter how fraudulently it may be issued. It is essentially a license to lie.

The safe-harbor provision in S. 240 is far superior to the provision in H.R. 1058, primarily because it would allow the SEC to promulgate an appropriate rule. However, NASCAT shares some of the concerns with the safe harbor in S. 240 expressed by the Bar Association of the City of New York in its recent report. In particular, we shard two of the Bar Association's criticisms that: (1) there is no reason to limit the flexibility of the SEC to consult with interested parties in appropriate ways; and (2) there is no reason to limit the flexibility of the SEC's substantive and procedural conclusions.

As noted, the SEC is now considering whether the current safe-harbor rule should be modified in any way. In a letter dated February 23, 1995 to House Commerce Committee Chairman Thomas Bliley, Chairman Levitt stated:

> The most appropriate solution to the issue, from the Commission's perspective, would be a provision directing the Commission to complete its rulemaking proceeding and report back to Congress. This would leave Congress with the option of revisiting the issue if it determined that the Commission had failed appropriately to address the issues. The provisions [in H.R. 1058 as reported out of Committee] mandating the Commission to promulgate rules are also problematic because they can be read to limit the Commission's flexibility.

Moreover, the Staff Report prepared for the Senate Subcommittee on Securities from last year concluded that, with respect to forward-looking statements:

> The testimony and submissions provided to the Subcommittee do not provide a clear answer. Since the relationship between private securities litigation and financial disclosure is integral to the success of the securities markets of the United States, it may be desirable for the SEC, academics or other disinterested parties *to further study* the impact of private securities litigation on the financial disclosure system.[18]

NASCAT believes that Congress should not preempt the SEC in the middle of doing exactly what it is supposed to be doing—applying its expertise in a rulemaking proceeding to evaluate the views of parties on all sides of the issue and to determine whether a new rule is warranted.

Enhanced Pleading and Procedural Requirements

H.R. 10 as introduced, H.R. 1058 as passed, and S. 240 create harsh new pleading and procedural requirements for fraud plaintiffs that are impossible to meet and that will lead to dismissal of meritorious cases. NASCAT urges that these provisions not be included in any legislation.

For example, H.R. 10 as introduced and S. 240 provide that in the complaint a victim would have to "allege specific facts *demonstrating* the state-of-mind of each defendant at the time the alleged violation occurred." H.R. 1058 provides that in the complaint a victim would have to make "specific allegations, which if true, would be *sufficient* to *establish* scienter as to each defendant at the time the alleged violation occurred." It then adds that "it shall not be sufficient for this purpose to plead the mere presence of facts inconsistent with a statement or omission alleged to have been misleading."

These provisions suffer from the same defects. Information about the "state-of-mind" of a defendant is not within the plaintiff's possession until *after* discovery—yet, these provisions would require the plaintiff to have that information at the *beginning* of the suit. Importantly, these provisions directly overrule Rule 9(b) of the Federal Rules of Civil Procedure. Rule 9(b), while requiring that fraud must be pleaded with particularity, states that "malice, intent and other condition of mind of a person" may be pleaded generally.

The SEC opposes these provisions. In his February 23, 1995 letter to House Commerce Committee Chairman Bliley, Chairman Levitt stated, with respect to the provision that is currently in H.R. 1058:

> In the Commission's view, however, the standard in H.R. 10 would place unrealistic demands on plaintiffs. The Second Circuit Court of Appeals currently requires that plaintiffs plead with some particularity facts giving rise to a "strong inference" of fraudulent intent on the part of the defendant.

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[18] *Abandonment of the Private Right of Action for Aiding and Abetting Securities Fraud/Staff Report On Private Securities Litigation, supra* note 7, at 215. (Emphasis added.)

> This test is regarded as being the most stringent used today, and the Commission recommends that Congress not enact any pleading requirements that go beyond those used by the Second Circuit.

In addition, the Association of the Bar of the City of New York opposes these provisions. In commenting on the pleading section in S. 240 (which was also in H.R. 10 as introduced), the Bar stated in its report that it "establish[es] more stringent pleading requirements for claims arising under Section 10(b) and Rule 10(b)(5) than is consistent with the philosophy underlying the Federal Rules of Civil Procedure. It also imposes unreasonable pleading burdens which may eliminate many meritorious cases. These onerous pleading standards are both unnecessary and harmful; they should not be enacted."[19]

Moreover, scholarly comment has strongly opposed heightened pleading requirements. For example, Harvard Professor Arthur Miller, the country's foremost authority on civil procedure, testified last year that the provision currently in S. 240:

> Seems to suggest that at the outset of the case, the plaintiff must have the clearest proof of each individual defendant's state of mind. But this is totally unrealistic. It is only in the rarest cases that this type of evidence exists. Under the best of circumstances, requiring plaintiffs to plead the defendants' states of mind generally calls for the drawing of subtle inferences from facts available prior to institution, a task that is highly treacherous. It would be impossible in the vast majority of cases in which those facts simply are unavailable prior to the lawsuit.[20]

Similarly, Professor Janet Cooper Alexander of Stanford Law School, certainly not known as a defender of the plaintiffs' trial bar, stated:

> [S]tringent pleading requirements . . . run the risk of eliminating good suits as well as bad ones. The essence of a securities violation is that it is hidden from the public. Plaintiffs can reasonably be required to make specific allegations about the nature of the misrepresentations they allege. But it is not reasonable to ask them to allege the facts of the concealment with particularity: Plaintiffs need discovery to flesh out these facts . . .[21]

H.R. 1058 also requires that the plaintiff plead "all information upon which his belief is based" at *the outset* of each case. This would force plaintiffs to reveal attorney work product information, which is otherwise protected.

Pleading offenses based on one's "information and belief" currently is permitted under the Federal Rules if the pleader sets forth the *facts* upon which the information and belief is based. *See, e.g., Wool* v. *Tandem Computers,* 818 F.2d 1433 (9th Cir. 1987). This is because "in cases of corporate fraud, the plaintiffs cannot be expected to have personal knowledge of the facts constituting the wrongdoing." *Id.*

The names of confidential informants, ex-employees, competitors, Government employees, members of the media and others who have provided important information leading to the filing of a case (especially those who have requested anonymity out of fear of retaliation) should be protected. Existing law already requires that a plaintiff set forth the *facts* upon which his information and belief is based and, if those *facts* are not adequately set forth, the court can dismiss the complaint.

In addition, H.R. 1058 imposes new procedural requirements that are entirely unjustified and unfair to defrauded consumers. For example, plaintiffs would be limited to a *single* amended complaint, regardless of whether new evidence of wrongdoing comes to light after a complaint is filed as the case proceeds. This blatant discarding of existing rules of civil procedure appears to be no more than a punitive and discriminatory measure against securities fraud claimants.

No class of cases in Federal courts is limited to a single amendment. Under Federal Rule of Civil Procedure 15, courts have discretion to permit more than one amendment of a complaint to allow plaintiffs to state a valid claim if it is justified under the circumstances. Courts can grant several amendments or more, depending upon the facts and circumstances of the specific case. This is a matter for judicial discretion, not national legislation.

Courts also have discretion to permit further amendments as the case unfolds and more evidence of wrongdoing is discovered or becomes public, or to add additional defendants. This flexibility is especially important in complex litigation like securities fraud cases.

As worded, this provision is particularly insidious. Defendants are aware that large securities fraud actions frequently arise out of the initial filing of multiple

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[19] *Report on Private Securities Reform Legislation, supra* note 14, at 22–23.
[20] *Securities Litigation Reform, supra* note 5, at 162.
[21] *Id.* at 134.

class-action complaints nationwide by different victims of the fraud, which then must be consolidated into one case via a consolidated amended complaint. Thus, the only amended complaint the bill would allow is a technical one, used just to consolidate the multiple cases into one.

This provision would limit the plaintiffs in even the largest, most complex securities fraud case to just one amended complaint. This is not adequate. For instance, in the *Lincoln Savings & Loan/Charles Keating* fraud, the plaintiffs were required to amend their complaint six times before it met all requirements for all defendants. (The case led ultimately to a recovery of $240 million for thousands of elderly victims.) In the *WPPSS* scandal, where thousands of victims of fraud ultimately recovered over $750 million, the plaintiffs were similarly required to amend their complaint several times before it met the requirements for all defendants.

H.R. 1058 also mandates stays of discovery, which are unfair to defrauded investors because they will slow down litigation and lead to the loss of evidence. The Federal Rules do not provide for an automatic stay of discovery upon the filing of a complaint. However, while stays of discovery generally are disfavored under the law, courts have discretion to grant complete or partial stays in appropriate circumstances. Federal Rule of Civil Procedure 16 allows district court judges broad discretion to control scheduling in cases, including discovery. Courts can stay discovery and/or limit discovery to certain issues.

Automatic stays of discovery in every securities fraud case, however, are unwise and unfair. Staying discovery while months (or even over a year) of pleading motions are briefed and argued only slows down the ultimate resolution of a case and increases the total legal expenses to all participants in the process. This would generate large fees for defense lawyers, but would disadvantage defrauded investors. Moreover, immediate and focused discovery can lead to the prompt voluntary dismissal of weak cases and the early settlement of strong cases. This beneficial opportunity is lost if discovery is automatically stayed in every securities fraud case.

In addition, staying discovery automatically will increase the incidence of the loss of evidence due to intentional or inadvertent destruction. For example, much evidence today is stored in computer memories (such as "E-mail") that are periodically erased; thus, evidence can be purged and lost. Destruction or loss of relevant evidence in the hands of third parties is an especially serious problem. If discovery is stayed at the outset of the case, a plaintiff will have no way to pursue discovery against such third parties, even if only to preserve their evidence.

H.R. 1058 also would limit discovery. The relevant provision changes the discovery procedures of the Federal Rules for just one type of case—securities class actions. (Some of the Rules were just revised and approved by Congress *last year* to streamline and expedite discovery.)

H.R. 1058 limits discovery "to the facts concerning the allegedly misleading statement or omission." As worded, this provision would completely eliminate discovery into many important parts of a securities fraud case, *e.g.*, insiders' stock sales, dealings with investment bankers, financial manipulation of the company's books and the like, which are relevant and critical evidence in many securities fraud cases.

Discovery has never been so narrowly limited as is proposed in H.R. 1058. Plaintiffs have traditionally been entitled to obtain materials relevant to the allegations of their complaint. If the scope of discovery should be narrowed, it should be narrowed by judges who preside over the cases. Judges and magistrates already have the power to control discovery, such as restricting its scope and timing.

Elimination of the Principle of Market Reliance and Causation

The entire premise underlying the Federal securities laws and securities regulation is that in a free market investors should make their own choices based on full disclosure of the material facts. Therefore, the government does not approve or disapprove of particular securities—no matter how risky—or set prices for them. Instead, we let the market decide—based on all of the information available to it—which securities are winners, which are losers, and what the price of them shall be.

According to the theory, through full disclosure and complete information the market will efficiently incorporate and set a market price. Because of this "efficient market" theory, disseminating false information to the market—so-called "fraud-on-the-market"—has been recognized as securities fraud, and individual investors do not have to prove that they knew of and relied on specific false statements.

The House-passed bill, H.R. 1058, substantially narrows the "fraud-on-the-market" theory and in many cases requires each victim to prove actual knowledge of and actual reliance on a defendant's misstatements or omissions. Moreover, it also requires that the misstatements or omissions must have "proximately caused" a victim's loss. These are impossible burdens of proof for individual plaintiffs, and would prevent many, if not all, class actions.

As SEC Chairman Levitt noted in his February 23, 1995 letter to Chairman Bliley, "requiring the plaintiff to establish actual knowledge of, and reliance on, a fraudulent statement . . . would eliminate the possibility of recovery for investors who indirectly rely on the misstatements." Many if not most, investors purchase a security based on the suggestion of a broker, the advice of a friend, or an article in a financial periodical. This type of *indirect* reliance is nonetheless reliance—and reliance on the market—yet, H.R. 1058 would not appear to recognize this basic fact. As Chairman Levitt's letter also recognized, H.R. 1058 would apparently overturn the Supreme Court decision in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972), which holds that proof positive of reliance on an omission is not necessary.

H.R. 1058 purports partially to codify fraud-on-the-market, but it actually sets up a highly burdensome and complex standard that bears little or no resemblance to the principle as applied in the courts. Under H.R. 1058's new standard, plaintiffs would be required to prove "that the market as a whole considered the fraudulent statement, that the price at which the security was purchased or sold reflected the market's estimation of that fraudulent information, and that the plaintiff relied on that market price." If the plaintiff can prove the first of the requirements, he or she is entitled to a presumption as to the other two, but even that presumption may be rebutted by defendants in many cases.

Moreover, the fraud-on-the-market theory is made totally unavailable under certain circumstances, *including, for example, many initial public offerings and municipal bond sales,* which rely on the "fraud created the market" theory. In these cases, there is frequently no liquid market for the security but the fact that the security is offered for sale at all is the result of a fraud on the public and/or Federal or State regulators. There is no basis for such wholesale carve-outs.

The abrogation of the "fraud-on-the-market" principle directly overrules the 1988 decision of the Supreme Court in *Basic, Inc.* v. *Levinson,*[22] which endorsed the principle and held that an investor need not prove direct reliance on misleading statements so long as the stock's market price (something virtually all investors rely on) was inflated by the false and misleading information. This Supreme Court decision finds support in numerous empirical studies demonstrating that the stock price of a public company reflects *all* material information about it.

Because of the requirement of proof of individual reliance, it would be all but impossible under H.R. 1058 for groups of small investors to join together to bring a securities fraud class-action fraud created lawsuit in many cases.

S. 240 also fails sufficiently to provide for the availability of the fraud-on-the-market theory. It states that in a case in which plaintiffs rely on fraud-on-the-market (without codifying the availability of that principle), each individual plaintiff must still prove that the defendant's misstatement or omission actually *caused* the plaintiff's loss. This provision ignores the fact that the causation element of Section 10(b) actions may be presumed under the fraud-on-the-market theory just the same as the reliance element and for the same reasons: (1) because of our efficient markets, the fraud transmitted through the price of securities causes the loss of the purchasers or sellers; and (2) requiring each individual plaintiff to prove that his or her own loss was caused by the fraud would, in practical effect, preclude all class actions. The Supreme Court has recognized that both the reliance and causation elements of Section 10(b) are subsumed within the fraud-on-the-market theory.[23] By requiring individualized proof of causation, therefore, S. 240, like H.R. 10 and H.R. 1058, would essentially preclude class actions.

Imposition of Minimum Financial Requirements

Under S. 240, fraud victims must hold a certain minimum aggregate dollar amount ($10,000) or aggregate percentage of securities (1 percent) in a corporate malefactor before they can be named plaintiffs in a class action. This is a new and undesirable concept in American jurisprudence—that only shareholders with substantial holdings, and presumably substantial wealth, will have access to the court-

[22] 485 U.S. 224 (1988).

[23] *See Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988), at 241–42 ("The fraud-on-the-market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. . . . The *causal connection* between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations") , 243 ("Reliance provides the requisite *causal connection*"). Lower courts routinely apply the fraud-on-the-market theory of causation. *See e.g., Elkind* v. *Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980); *Zweig* v. *Hearst Corp.*, 594 F.2d 1261 (9th Cir. 1979).

house. It blatantly discriminates against small shareholders. As the Bar Association of the City of New York has stated in its report:

> In light of the power of the courts to deny class certification where the representative plaintiffs' damages are nominal, we question the need for the statute to define a minimum threshold for a class representative. In any event, the $10,000 threshold is far too high.[24]

The House deleted the provision imposing minimum financial thresholds before H.R. 1058 was passed. The Senate should also reject it.

Elimination of Another Weapon to Increase Recoveries by Fraud Victims

H.R. 10 as introduced and S. 240 eliminate fraud in securities sales as a predicate offense in RICO actions. The House-passed bill, H.R. 1058, goes even further by eliminating RICO liability in all cases "actionable" as securities fraud. This would include even wholly criminal enterprises in their securities dealings.

RICO is a potentially powerful weapon for fraud victims because of the possibility of treble damages and larger recoveries for defrauded investors. Unfortunately, the RICO statute has in large measure been eviscerated by the courts; to protect victims and increase recoveries for defrauded class members, Congress should strengthen the RICO statute and preserve its application to securities fraud.

The Association of the Bar of the City of New York opposes elimination of RICO in these cases. In its report, it comments, with respect to the provision S. 240 (which is also in H.R. 10 as introduced):

> We oppose this proposal, which arbitrarily singles out one type of action, or perhaps one industry, for an exemption from the civil RICO principles applicable to all other cases. If civil RICO is to be amended, changes should follow systematic study and be introduced systematically. The present proposal, in part because it rips securities actions from the context of other RICO actions, is both ambiguous and, we believe, unworkable.[25]

Adoption of Requirements That Will Slow the Litigation Process

H.R. 10 as introduced and S. 240 provide for a guardian *ad litem* or plaintiffs' steering committee for class actions "to direct counsel." H.R. 1058 provides for a steering committee, but no guardian *ad litem*. While the concept of a steering committee sounds like a pro-victim proposal, the practical problems associated with such committees (or a guardian) are manifold, and the proposal would ultimately *reduce* victim recoveries. NASCAT does not believe such a proposal should be included in any legislation.

Currently, under Rule 23 of the Federal Rules of Civil Procedure, the courts are required closely to supervise the efficient—and fair—prosecution of class actions. There has been no showing that the courts are not effectively doing their job. Yet these provisions would fundamentally change this rule by taking the responsibility from the court and transferring it to the guardian or steering committee. Such a change is contrary to the driving thrust of modern litigation reform, which had been to simplify, streamline, and reduce the expense of litigation. The procedures in these bills would frustrate these objectives and only increase the expense and time necessary to conclude litigation. Questions of appointment of the steering committees, relationship with class counsel, and delegation of decisionmaking will undoubtedly lead to more litigation, additional delays, and smaller recoveries.

Moreover, because the membership of the proposed steering committees has high cumulative minimum ownership requirements ($10 million or 5 percent of the subject stock), the committees will undoubtedly be comprised in the main of large institutional investors with ties to the defendant company. This may well disadvantage small investors.

The Association of the Bar of the City of New York, in its report, has opposed these provisions:

> By adding a new set of players, this proposal would further complicate already complex litigation and add to the costs. These new participants would be certain to bring to the action more questions, more disputes, more litigation, additional delays and increased attorneys' fees. The outcome of an enactment of this provision would thus be contrary to the thrust of modern litigation reform, that strongly favors simplicity.

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[24] *Report on Private Securities Reform Legislation, supra* note 14, at 43.
[25] *Id.* at 29.

The ultimate consequence of the proposal for the inclusion of a guardian *ad litem* or plaintiffs' steering committee may be to cause a significant disservice to the best interests of the class.[26]

A Sham "Disciplinary" Board for Accountants

S. 240 creates a "disciplinary" organization for auditors, in theory to ensure financial statement quality control and to provide greater investor confidence. Yet, rather than mandating that this new board be independent of the profession it is supposed to oversee, the bill permits the SEC to "designate an entity to serve as the Board" if it finds that such entity is "sponsored by an existing national organization of certified public accountants," is "most representative" of CPA's, and has "demonstrated its commitment to improving the quality of practice before the Commission." In other words, the bill allows the trade association for the accountants, the AICPA, to be the "disciplinary" board. Importantly, this sham board is given the power in many circumstances to *preempt* actions by state accountant licensing agencies. The proposal should be dropped.

Effective Date

We would note one final irony. As originally drafted, the securities litigation section of H.R. 10 was to be effective on the date of enactment and would apply to cases *"pending on* or commenced after such date of enactment." Thus, the draft bill would have applied its stringent procedural and substantive rules *retroactively* to pending cases, including, for example, the Orange County bondholders litigation.

Apparently because of Orange County, H.R. 10 as introduced was no longer retroactive. This change was carried through to H.R. 1058 as passed by the House. Although Orange County plaintiffs who file suit before the bill is enacted would now be spared facing the virtually insurmountable hurdles the bill imposes, future fraud victims in every other county and State will be left essentially without a remedy. Given the number of local jurisdictions that have experienced—and are likely to experience in the future-financial chicanery, this is patently unfair.[27]

NASCAT believes any legislation should be prospective only.

Areas Of General Agreement

With some technical drafting changes, NASCAT supports a number of proposals that are contained in slightly different form in all three bills, H.R. 10, H.R. 1058, and S. 240. NASCAT endorses these limited measures since they would not damage the overall securities litigation system or harm investors. These proposals involve: (1) elimination of bonus payments to named plaintiffs in class actions; (2) a prohibition against paying attorneys' fees from SEC disgorgement funds; (3) prevention of attorney conflicts of interest (with respect to stock ownership); and (4) a prohibition against referral fees paid to brokers for assisting attorneys in obtaining the representation of customers.

We would note that virtually no testimony has been received specifically on these issues and evidence that there are problems in any of these areas is entirely anecdotal. Nonetheless, to the extent problems do exist in the system, NASCAT agrees they should be addressed and the practices banned.

NASCAT also supports three other proposals that are in S. 240 and various other legislative proposals. First, we believe it is desirable to mandate a percentage approach to attorneys' fees based on the amount of the common fund and the value of other benefits made available to the class. The courts have moved in this direction in recent years and it is a simple and fair method of computation.

Second, NASCAT agrees with the state regulators and others that settlement notices provided to class members are often obtuse and confusing, and should be written in plain English. Much of the density of these documents is simply a result of lawyers' writing as they were taught in law school and using what worked in the last case. Class members have a right to insist on understandable documents that explain their options clearly, and NASCAT would be willing to work with Congress and the SEC to devise a workable formula to achieve this goal, with or without legislation.

Third, NASCAT believes that legislation like that introduced in the 103rd Congress by Senator Kerry and Congressman Wyden requiring, *inter alia*, that auditors

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[26] *Id.* at 15.

[27] While H.R. 10 as introduced and H.R. 1058 as passed by the House would not directly impact those who have already filed suit in Orange County, victims of the scandal who may seek to file a claim in the future will find the courthouse door closed if the bill has been enacted. Moreover, Orange County victims with State cases would also be adversely affected by these bills, since State courts and follow the lead of Federal law and victims in State actions would be barred from recovery as well.

report fraud is essential if we are to maintain the integrity of the financial markets. This language was added to H.R. 1058 on the House floor and a version is also included in S. 240. It should be enacted.

Notable Omissions

In the main, these "reform" bills—H.R. 10, H.R. 1058 and S. 240—make no pretense of a balanced approach. Not only do they gut the private enforcement scheme of the Federal securities laws, leaving fraud victims with no way to recover their losses, but they completely (in the case of H.R. 10 as introduced and H.R. 1058 as passed by the House) or mostly (in the case of S. 240) fail to address legislatively three matters that are absolutely critical to adequately protect investors' rights.

AIDING AND ABETTING

As the SEC and numerous other witnesses have testified, the Supreme Court's decision in *Central Bank*, eliminating aiding and abetting liability, should be overturned legislatively. Many Members of Congress who have been involved in the securities legislation issue have indicated their support for such efforts. NASCAT also believe the *Central Bank* decision should be overturned promptly.

None of the three "reform" bills has to date included a provision restoring aiding and abetting liability, although Senators Dodd and Domenici have indicated that they might be willing to include such a provision in S. 240. NASCAT strongly supports such an effort.

STATUTE OF LIMITATIONS

The Supreme Court's 1991 decision in the *Lampf* case established a uniform "one year after discovery/three years after the violation" statute of limitations for private actions filed under Section 10(b).

As the SEC and numerous experts have stated, this period is too short, given the fact that securities fraud is inherently complex. Defrauded investors should not be deprived of a remedy simply because the perpetrator of a fraud manages to conceal its existence for more than 3 years.

Neither H.R. 10 as introduced nor H.R. 1058 as passed attempts to remedy this problem. S. 240 extends the statute of limitations to the earlier of (1) 5 years after the violation or (2) 2 years after the violation was discovered "or should have been discovered through the exercise of reasonable diligence." This constructive notice (*i.e.*, "reasonable diligence") standard will, without question, lead to increased litigation as defendants seek to prove a victim's ability to discover fraud. The standard should be one of *actual knowledge.*

NASCAT recommends that the *Lampf* decision be legislatively overruled and that there be no outside limitation tied to the date of the violation, but only a 3-year limitation subsequent to the actual discovery of the fraud. This will also help diminish the need for quick filing.[28] If an outside limitation is included in legislation, at a minimum we would suggest that the language include a provision that tolls the statute of limitations for a continuing concealment of the fraud.

SECRECY ORDERS

H.R. 10 as introduced and H.R. 1058 as passed utterly fail to address the problem of secret settlements and sealed cases that shield evidence of wrongdoing from public scrutiny. S. 240 commendably requires that settlement agreements in securities class actions be a matter of public record. As many consumer groups have pointed out, however, that bill does *not* ban the almost universal secrecy orders that are required by defendants as a condition of producing documents during discovery. These secrecy orders remain in effect throughout the litigation, and generally require that, once the case is terminated, the produced documents be destroyed or returned to the defendants or other parties. Such secrecy orders keep significant wrongdoing from public scrutiny, and allow defendants, after settlement, to proclaim their innocence (and impugn the motives of those who sued them) without fear of contradiction.

[28] A 1 year limitation period after discovery provides an incentive to sue professionals at the outset, rather than wait for further information to become available. If a plaintiff sues the offending company and its officers, and after discovery seeks to add the accountants or attorneys, he may be met with the argument "too late." In this manner, a short limitation period tends to increase, rather than decrease, litigation and the number of parties sued.

REPORT ON TITLE II OF H.R. 10 (H.R. 1058) (REFORM OF PRIVATE SECURITIES LITIGATION) BY THE COMMITTEE ON SECURITIES REGULATION AND THE COMMITTEE ON FEDERAL COURTS

In December of 1994, The Association of the Bar of the City of New York (the "Association of the Bar"), through the above two committees, reported on private securities litigation reform legislation pending before a Senate committee. That report ("our earlier Report") was published soon thereafter. The Committee on Securities Regulation and The Committee on Federal Courts, "Report on Private Securities Litigation Reform Legislation (S. 1976, the Dodd-Domenici Bill)," *The Record of the Association of the Bar of the City of New York,* Vol. 50, No. 1, Jan./Feb. 1995. Since then, the House introduced and held hearings on H.R. 10, designated the "Common Sense Legal Reforms Act of 1995," of which Title II, entitled Reform of Private Securities Legislation (since renamed H.R. 1058), covers much of the same ground as the Dodd-Domenici bill, but with significant additions. The securities part of the bill (which we will continue to refer to herein as H.R. 10 because of the extensive literature already published on the bill), passed the House on March 8, 1995, and is now awaiting hearings by the Senate. We analyze these additions in detail below, but state them here in summary form, together with our conclusions.

Summary

Most important among the additions is a provision under which the loser of a private securities litigation, including a representative plaintiff in a securities class action, would pay the legal fees of the prevailing party. Thus an investor who has lost a $10,000 investment could, by suing for fraud, alone or as a class representative, risk an adverse judgment for hundreds of thousands, or even millions of dollars, to pay the legal fees of a prevailing corporate defendant. In the Commerce Committee, the provision for automatic fee-shifting was modified to one providing for fee-shifting if the losing party's position was not "substantially justified" and if the prevailing party persuades the Court that it would be just to shift fees to the losing party.

We conclude, however, that the *in terrorem* effect of such a change in the law, in either an absolute form or in the "substantially justified" form, will largely close the Federal courts to securities class actions, including clearly meritorious cases, as well as to much private securities litigation. We thus urge the Senate not to pass "loser pays" provisions of the type adopted by the Commerce Committee and passed by the House on March 8, and we urge that such provisions do not become law.

H.R. 10, in its original form, would also have eliminated the fraud on the market theory, which is essential for many securities fraud cases. This provision has been substantially modified by the House; the resulting compromise, however, raises numerous difficult and important issues, which militate against it. Thus we urge Congress not to enact this change to current law.

In addition, the original version of H.R. 10 would have eliminated recklessness as a basis for satisfying the scienter requirement in fraud cases. That provision also was modified in committee and again on the floor of the House. The resultant version, nevertheless, is ambiguous and internally inconsistent. We will suggest ways to improve it. In its present form, however, it should not be enacted.

There are several provisions in H.R. 10 that we agree with. Thus we agree that referral fees should not be paid to brokers, that bonus payments should not be paid to individual plaintiffs, that disclosure of settlement terms to class members should be improved, and that plaintiffs' counsel should not share in disgorgement funds created by the Securities & Exchange Commission, without their participation. All these reforms should be enacted.

New pleading and practice requirements in H.R. 10, as amended, differ from those in the Dodd-Domenici bill, but on balance are highly undesirable. They should not be enacted, for the reasons set forth below; instead, the matter should be referred to the Judicial Conference's Advisory Committee on Civil Rules, to be considered deliberately, with input from the Bench and Bar.

H.R. 10, are amended, also eliminates the guardian *ad litem* concept; we approve this change. On the other hand, the plaintiff steering committee remains; we believe this change to the law creates unacceptable burdens and conflicts of interest and should be deleted, for the reasons set forth at pp. 13–17 of our earlier Report. A committee of large institutional holders, who have chosen not to sue and who have assumed no fiduciary duties with respect to other shareholders, should not have the

right to override properly chosen class representatives and their counsel, who do have a fiduciary duty to the class.[1]

1. "Loser Pays"

The shifting of fees in class actions, under H.R. 10, would destroy the viability of almost all class actions, since reasonable persons, already injured by allegedly fraudulent activity, will not risk serving as representative plaintiffs when defeat could take away their homes and remaining savings. The result would be largely to deprive investors with limited resources of their sole practical means to pursue valid securities claims.

The point was eloquently made by the Chairman of the Securities and Exchange Commission, Arthur Levitt, in his speech on January 25, 1995 to the 22nd Annual Securities Litigation Institute in San Diego, California:

> Imagine you're a small investor whose nest egg of $10,000 loses its value overnight, due to the sudden disclosure that a company has withheld its true earnings. Two hours after the meter has started ticking at the law firm hired by the defendant, one senior partner alone has already racked up $1,000 in fees. Within a month, you're weighing the possibility of paying lawyers' fees that are dozens, if not hundreds of times larger than your whole investment; that strikes me as a powerful deterrent, no matter how legitimate your claim.
>
> This, too, is not just a question of investor interests—it is a question of the *market's* interests. Private securities litigation plays a prominent role in checking market excesses. To change that, we'd need to recalibrate our entire system of checks and balances.

Levitt, "Between Caveat Emptor and Caveat Venditor: The Middle Ground of Litigation Reform," p. 5.

"Loser pays," often known as the English Rule, closes the door to middle class litigants who cannot run those risks. Many of the English themselves oppose it; the respected and conservative Economist weekly magazine has recently called for its abolition, saying:

> The worst aspect of (the English] system is that it denies access to justice to huge numbers of people . . . as lawyers admit, only the very wealthy can afford the costs and risks of most litigation.
>
> . . . Losing a civil case means paying not only your own lawyer's hefty fees, but those of the other side's as well. For most people this means that they are risking financial ruin in all but the shortest, or most trivial, of cases.
>
> . . . Abandoning the "loser pays" rule in Britain and introducing contingency fees would make it possible for millions more people to use the courts, whatever their wealth. . . . Every citizen in the land would, at last, have an opportunity to have a case heard in the Nation's courts.

Economist, January 14, 1995, editorial (British edition).

As Chief Justice Earl Warren explained it in 1967:

> "Since litigation is at best uncertain one should not be penalized for merely defending or prosecuting a lawsuit, and . . . the poor might be unjustly discouraged from instituting actions to vindicate their rights if the penalty for losing included the fees of their opponents' counsel."[2]

The modifications by the Commerce Committee do nothing to eliminate the *in terrorem* effect of this provision. That a judge can relieve a loser of his or her obligation to pay the other side's costs if a case was "substantially justified" does not eliminate the risk of being wiped out. As we said in our earlier Report about a similar situation:

> Sanctions do not apply under the bill unless the [plaintiff] loses the case and a court determines that any claim or defense that lawyer asserts "was not substantially justified." . . . Such a test might prevent sanctions in some cases. We believe, however, that while the "substantially justified" requirement would reduce the scope of exposure . . . the uncertainty of litigation is such that the prospect of sanctions would remain as a substantial *in terrorem* effect.

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[1] The American Bar Association, acting through its House of Delegates, has adopted resolutions which are in substantial conformity with our conclusions here and in our earlier Report. *The New York Times* has also agreed, in broad outline, through editorials published on February 21, 1995 (on "loser pays") and February 22, 1995 (on the securities litigation reform legislation).

[2] Quoted in *The New York Times* editorial of February 21, 1995.

> In short, the bill creates a very potent coercive weapon . . . not significantly mitigated by the statutory requirement that the court find the party's position in litigation not to be "substantially justified."

See our earlier Report, pp. 19–20.

As The New York Times said in its second editorial on this subject, on February 22, 1995:

> The worst element [in H.R. 10] is a "loser pays" provision under which investors who sue companies for fraud and lose could be forced by judges—if no substantial justification for the suit was found—to reimburse defendants for their legal fees. Many plaintiffs will decide to swallow their losses in silence rather than risk bankruptcy pursuing a heartfelt, but uncertain, claim. . . .

While we recognize that the House moved away from an absolute "loser pays" position, the present bill still creates a risk that a reasonable investor will not undertake in order to pursue even a strong claim which, like all claims in complex litigation, cannot be a certainty.

Moreover, the use of such a standard is particularly onerous when combined with H.R. 10's requirement that a plaintiff provide security for costs. We agree with the SEC that such a bond by itself can deter meritorious lawsuits.

Unless this "loser pays" provision is stricken from the bill, the right of private parties to assert well founded claim of securities fraud may all but disappear, except for disputes between wealthy adversaries. The resulting loss in accountability, investor confidence, and the proper functioning of our capital markets would be wholly against the public interest. A major deterrent to corporate wrongdoing would be lost.[3] This cannot be the desire of a responsible Congress, and we urge the deletion of this provision.

2. Reliance and Fraud on the Market

A. Summary of Provisions in Revised H.R. 10

Section 204 of H.R. 10, as revised, provides for a new Section 10A of the Securities Exchange Act of 1934, titled "Requirements for Securities Fraud Actions." Subsection 10A(d) is titled "Reliance And Causation" and sets forth the requirements for establishing those elements in a plaintiff's Section 10(b) and Rule 10(b)(5) claim.

Section 10A(d)(1) states a general requirement that in all cases a plaintiff must prove (a) knowledge of and reliance on a statement that is either false or omits material information and (b) that such statement proximately caused, through both transaction causation and loss causation, any loss the plaintiff incurred.

Section 10A(d)(2) provides that for purposes of paragraph (1), reliance may be proven by establishing that "the market as a whole considered the fraudulent statement, that the price at which the security was purchased or sold reflected the market's estimation of that fraudulent information, and that the plaintiff relied on that market price."[4] Section 10A(d)(2) then sets forth the type of evidence that will be sufficient to prove that the "market as a whole" considered the fraudulent statement. Such evidence includes proof that the statement (A) was contained in "publicly available" research reports by analysts, (B) was the subject of news articles, (C) was delivered orally at public meetings by officers of the issuer or its agents, (D) was specifically considered by rating agencies in their published reports or (E) was otherwise made "publicly available" so that "other active participants" in the market for the security would "likely" have had it brought to their attention and consider it "credible." Such proof, under the Subsection, "may not consist of nonpublic information."

This Subsection codifies the fraud on the market presumption with respect to misstatements made by certain issuers of securities traded on a national securities exchange or NASDAQ. The presumption is stated as an exception to the general rule requiring proof of individualized reliance.

Subsection 10A(d)(3) provides that the defendant is entitled to rebut the presumption that the market price for the security reflected the fraudulent statement and that the plaintiff relied on that price. This may be done by evidence that (A) the "market as a whole considered other information that corrected the allegedly fraud-

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[3] The Association is now reviewing the general implications of "loser pays" provisions outside of the securities fraud context, but is not yet ready to report on those.

[4] The term "fraudulent statement" is defined as follows: [A] fraudulent statement is a statement that contains an untrue statement of a material fact, or omits a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading.

Sec. 10A(a)(2).

ulent statement" or (B) the plaintiff "possessed" corrective information prior to his or her transaction.

Finally, Subsection 10A(d)(4), titled "Reasonable Expectation Of Integrity Of Market Price," provides that a plaintiff is not permitted to establish reliance pursuant to paragraph (2) if it is "unreasonable" to rely on the market price as reflective of all current information. The Subsection then directs, in part, that certain factors, particularized in the Subsection, "shall be considered in determining whether it was reasonable for a party to expect the market price of the security to reflect substantially all publicly available information regarding the issuer of the security." The factors are: (A) weekly trading volume, (B) existence of security analyst reports, (C) eligibility of the issuer to incorporate by reference its periodic reports in a registration statement, and (D) "a history of immediate movement of the price of any class of securities of the issuer of the security caused by the public dissemination of information regarding unexpected corporate events or financial releases."

Subsection 10A(d)(4) then adds a provision that "[i]n no event shall it be considered reasonable for a party to expect the market price of the security to reflect substantially all publicly available information regarding the issuer of the security unless the issuer of the security has a class of securities," traded on a national securities exchange or quoted on an automatic quotation system.

B. Discussion

The reliance and causation provisions of revised H.R. 10, while a significant improvement over the provision in the initial bill, nevertheless would change current law so as to substantially limit plaintiffs in many circumstances where proof of individual reliance should not be required and, as noted by the Chairman of the Securities and Exchange Commission, would be inconsistent with public policy for protecting investors from securities fraud. Indeed, the individualized reliance requirement could destroy the class action itself because, as the United States Supreme Court has put it, "[r]equiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented [plaintiffs] from proceeding with a class action, since individual issues then would have overwhelmed the common ones." *Basic Inc.* v. *Levinson,* 485 U.S. 224, 242, 108 S. Ct. 978, 989 (1988).

A requirement to prove individual reliance, moreover, would reverse the Supreme Court's longstanding decision that such proof is not appropriate for a case based on failure to disclose. The Court held:

> "[In a case] involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact."

Affiliated Ute Citizens v. *United States,* 406 U.S. 128, 153–154, 92 S. Ct. 1456, 1472 (1972) (citations omitted).

The new requirement is particularly inappropriate where fraud is effected primarily by the omission of material facts and the misleading statement merely serves to camouflage that omission. A plaintiff would have the burden of making a speculative showing that he or she relied on the omission of the material facts and that such omission caused his or her purchase or sale.[5] Under present law, reliance and transaction causation are properly presumed when the omitted information is material and, therefore, there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Indust. Inc.* v. *Northway, Inc.,* 426 U.S. 438, 449 (1976). *See Affiliated Ute,* 406 U.S. at 153–154.

The new proposal does not eliminate the fraud on the market theory for all omissions cases, but almost fortuitously applies it for some, *i.e.,* those where fraud on the market is presumed because of trading volume, etc., but not for others, where such trading volume, etc. is lacking. Yet in all omissions cases the problem of proving reliance on an omission remains intractable, as does the problem of proving cau-

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[5] Further, in some instances, liability under Rule 10(b)(5) does not require the making of a misleading statement. In insider trading cases liability is triggered if the defendant traded the security and did not disclose material information. *SEC* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833 (2d Cir.), *cert. denied sub nom.,* 394 U.S. 976 (1969); *Dirks* v. *Securities & Exchange Commission,* 463 U.S. 646, 103 S. Ct. 3255 (1983). In cases involving stock recommendations by a fiduciary, such as a broker, liability may be premised on a material omission without having to prove a related statement that was rendered misleading by that omission. *Cf. Chasins* v. *Smith Barney & Co.,* 438 F.2d 1167, 1172 (2d Cir. 1970). Thus, in such cases, it is purely the omission as to which reliance and causation must be proved under the proposed legislation.

sation. The wisdom of the Supreme Court in *Affiliated Ute* and the experience from decades of securities litigation should not be brushed aside.

As Arthur Levitt, Chairman of the SEC, stated in a letter to the Chairman of the House Commerce Committee: "[t]he actual reliance requirement would . . . overturn existing law in cases based on an omission, as opposed to an affirmative misrepresentation." Chairman Levitt stated on behalf of the Commission that "[i]t would be preferable simply to codify existing law in this area."

The proposed legislation also appears to eliminate other well established presumptions that have been essential to achieve justice in this area. One is the presumption that pervasive fraud, in a market on whose integrity buyers rely, is sufficient to prove the reliance element. The Fifth Circuit, in *Shores* v. *Sklar,* 647 F.2d 462 (5th Cir. 1981), *cert. denied,* 459 U.S. 1102 (1983) and the Eleventh Circuit, in *Ross* v. *Bank South N.A.,* 885 F.2d 723 (11th Cir. 1989), *cert. denied,* 495 U.S. 905 (1990), have held that when "the fraud alleged is so pervasive that absent the fraud the [security] could not have been marketed, the reliance element is established by the buyer's reliance on the integrity of the market." *Ross,* 885 F.2d at 729. A District Court in the Ninth Circuit similarly held:

> If an enterprise is so laden with fraud that its entire public image is distorted, it is sensible to presume that reasonable investors relied on many material misrepresentations which, in aggregate, created a false image. In this situation, the offending misrepresentations are not merely presumed to compete successfully for the investor's attention amidst a mix of material, undistorted facts. Rather, the entire picture of the company's economic health and lawful character is skewed.

In re American Continental/Lincoln S&L Sec. Litig., 140 F.R.D. 425, 432 (D. Ariz. 1992).

Another closely related presumption has been set forth by the Ninth Circuit, which held that purchasers in an initial public offering rely on the integrity of the regulatory process:

> Just as the open market purchaser relies on the integrity of the market and the price of the security traded on the open market to reflect the true value of securities in which he invests, so the purchaser of an original issue security relies, at least indirectly, on the integrity of the regulatory process and the truth of any representation made to the appropriate agencies and the investors at the time of the original issue.

Arthur Young & Co. v. *United States Dist. Court,* 549 F.2d 686, 695 (9th Cir), *cert. denied,* 434 U.S. 829 (1977).

While it is possible that courts may continue to employ these necessary commonsense presumptions, there is a substantial danger that the proposed legislation may unnecessarily constrain a court in cases where reliance should be presumed. At the least, confusion would result, without any corresponding benefit.

Further, the legislation does not appear to provide any exemption from the actual reliance requirement for indirect reliance, as, e.g., for a person who relied not on the fraudulent statement but on what his broker or spouse told him about it. Indeed, Subsection 10A(d)(1)(A) requires that the *plaintiff* "had knowledge of, and relied" on the false or misleading statement, and Subsection 10(A)(d)(3) provides for the fraud on the market presumption only insofar as "the *plaintiff* relied on such market price." (Emphasis added.) Thus, the Subsection eliminates a cause of action on behalf of a substantial class of investors who, in the ordinary course, rely for their securities purchases on the recommendations of others who, in turn, will have relied on the misstatement or the market.

Chairman Levitt stated on this point:

> By requiring the plaintiff to establish actual knowledge of, and reliance on, a fraudulent statement, H.R. 10 would eliminate the possibility of recovery for investors in such securities who indirectly rely on the misstatements. Many investors who are injured by fraudulent statements would not be able to meet this test. An investor who did not read a fraudulent statement, for example, may have purchased a stock because he relied on a recommendation from a broker based on the fraudulent statement. The Commission recommends that the language be amended to clarify that both direct and indirect reliance would suffice.

We agree with the SEC that this large potential loophole in the law should be eliminated.

There are also serious problems in the proposed statute's choice of those securities markets for which fraud on the market may or may not be presumed. Chairman Levitt, on behalf of the SEC, expressed concern as to the effect of the provision read-

ing "in cases involving securities, such as municipal securities," that do not meet the qualifications for fraud on the market treatment. In light of the Orange County debacle, this exclusion is particularly inappropriate.

There are also problems with the rebuttal provisions. Defendants are provided the opportunity of rebutting the presumption by merely showing that "the market as a whole considered other information that corrected the allegedly fraudulent statement," Section 10A(d)(3)(A), without also having to prove that the market viewed such corrective information as credible.[6] However, under present law, as the Supreme Court has held, to defeat a fraud on the market claim it must be shown that news of the truth "credibly entered the market and dissipated the effects of the misstatements." *Basic, Inc.* v. *Levinson,* 485 U.S. at 248. *See also, Virginia Bankshares* v. *Sandberg,* 501 U.S. 1083, 1097 (1991) ("Not every mixture with the true will neutralize the deceptive.") There is no apparent reason to change this case law.

As the Ninth Circuit, citing *Basic,* explained:

> The investing public justifiably places heavy reliance on the statements and opinions of corporate insiders. In order to avoid Rule 10(b)(5) liability, any material information which insiders fail to disclose must be transmitted to the public with a degree of intensity and credibility sufficient to effectively counter-balance any misleading impressions created by the insiders' one-sided representations.

In re Ample Commuter Sec. Litig., 886 F.2d 1109, 116 (9th Cir. 1989), *cert. denied,* 496 U.S. 943 (1990). Under the proposed legislation, fraud claims would be dismissed without sufficient factual inquiry as to whether the market had in fact been alerted to the truth.

In addition, the criteria by which reliance on the market shall be considered unreasonable, under Subsection 10A(d)(4), will needlessly and inflexibly eliminate the presumption in many cases.

The general factors listed by H.R. 10 for proposed Subsection 10A(d)(4) that are to be considered in determining whether the securities of an issuer trade in an efficient market, i.e., one which is impacted by the fraud, are very close to those currently articulated by the courts. *See Cammer* v. *Bloom,* 711 F. Supp. 1264 (D.N.J. 1989). *See also* cases and commentaries that cite the analysis in *Cammer* with approval, *e.g. Hayes* v. *Gross,* 982 F.2d 104, n. 1 (3d Cir. 1992); *Greenberg* v. *Boettcher & Co.,* 755 F. Supp. 776, 782 (N.D.Ill. 1991); *Simpson* v. *Specialty Retail Concepts,* 823 F. Supp. 353, 354–5 (M.D.N.C. 1993); Russell Robinson, "Fraud-on-the-Market Theory and Thinly-Traded Securities Under Rule 10(b)(5): How Does a Court Decide if a Stock Market is Efficient?" 25 *Wake Forest L. Rev.* 223, 243–47 (1990). Nonetheless this portion of Subsection 10A(d)(4) should be brought further in line with current law by having it expressly state that it is not necessary that a security satisfy all of the listed factors in order to establish that the market in that security is efficient, *Cammer,* 711 F. Supp. at 1287, and that the listed factors "are by no means exhaustive." *Simpson,* 823 F. Supp. at 355.

Moreover, the part of the provision requiring that the securities of an issuer be traded on a national securities exchange or quoted on an automatic quotation system represents an unnecessary change in current law. The provision arbitrarily eliminates the fraud on the market presumption for all companies with small amounts of capital whose securities do not meet this strict test but may, nonetheless, based upon a sufficient number of other factors, trade in an efficient market. As the court in *Cammer* held, "[t]he central question under the fraud on the market theory is whether the stock price, at the time a plaintiff effected a trade, reflected the 'misinformation' alleged to have been disseminated." 711 F. Supp. at 1282. There is no empirical basis to conclude that the question can never be answered in the affirmative as to firms whose securities do not meet the rigid criteria set forth in Section 10A(d)(4).

Experience has indicated that the incidence of fraud is *higher* with respect to small capital companies, many of which are not traded on a national securities exchange or NASDAQ. Thus, to the extent the securities of those companies can be shown to trade in an efficient market, it is senseless to render it easier for them to escape liability. Quoting again from *Cammer,* "[i]t is not logical to draw bright line tests—*such as whether a company is listed on a national exchange* or is entitled to register securities on SEC Form 5–3—to assist fact finders in determining whether a stock trades in an 'open and efficient market.'" (Emphasis added.) 711 F. Supp. at 1287.

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[6] Plaintiffs, however, apparently must demonstrate that the market viewed the fraudulent statements as credible. Section 10A(d)(2)(E).

In sum, we agree with Chairman Levitt: Any codification of the fraud on the market theory should follow the present case law, which has been carefully carved out by the courts in recent decades. We doubt, however, that legislative codification of that case law is required or desirable. The present provision bears the signs of legislative compromise, which, however useful in helping to move the bill along, would promote public policy best if dropped in favor of the case law which already exists, and which should be permitted to develop as the cases require.

3. SCIENTER AND RECKLESSNESS

Section 204 of H.R. 10, as passed by the House, provides that:

> In any private action arising under this title based on a misstatement or omission of a material fact, liability may be established only on proof that—
>
> (A) the defendant directly or indirectly made a fraudulent statement;
>
> (B) the defendant possess the intention to deceive, manipulate, or defraud; and
>
> (C) the defendant made such fraudulent statement knowingly or recklessly.

Recklessly is defined as follows:

> For purposes of paragraph (1), a defendant makes a fraudulent statement recklessly if the defendant, in making such statement, is guilty of highly unreasonable conduct that (A) involves not merely simple or even gross negligence, but an extreme departure from standards of ordinary care, and (B) presents a danger of misleading buyers or sellers that was either known to the defendant or so obvious that the defendant must have been consciously aware of it. Deliberately refraining from taking steps to discover whether one's statements are false or misleading constitutes recklessness, but if the failure to investigate was not deliberate, such conduct shall not be considered to be reckless.

These scienter provisions improve the original version of H.R. 10, which would have eliminated recklessness as a basis for satisfying the scienter requirement of Section 10(b) of the Securities Exchange Act. As we said in our earlier Report:

> [The recklessness issue] may be the most significant issue that has not been definitively resolved by the Supreme Court under the Federal securities laws. . . . A Supreme Court holding [or a legislative provision providing] that only willful or intentional conduct violates Section 10(b) would have a potentially devastating effect on director, officer, and professional behavior; the soundness of both our disclosure system and securities markets would be gravely endangered. Directors, lawyers, accountants, and many others, would have powerful legal incentives to simply ignore red flags suggesting fraud or egregious disclosure failures. Only actual intent would make them vulnerable.

Report on S. 1976, p. 8.

Our earlier Report urged Congress to reaffirm what every lower Federal court to deal with the issue has held, "that recklessness is the culpability standard under Section 10(b)." We defined recklessness as "conduct which involves extreme departure from the standard of ordinary care." Report on S. 1976, p. 7 and n. 8. We again recommend that Congress adopt these formulations.

The Commerce Committee's recklessness formulation has the following extremely significant defects:

1. The introductory clause, covering "any private action arising under this title," requires a showing of scienter (*i.e.*, at least recklessness) under Section 14(a) (dealing with proxy solicitations) and other provisions of the Securities Exchange Act. But great jurists like Judge Henry J. Friendly of the Second Circuit, and the courts of the Second and Third Circuits, in carefully reasoned opinions, have held that unreasonable conduct—as opposed to recklessness—may violate Section 14(a). *See, e.g., Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973); *Gould* v. *American-Hawaiian Steamship Co.*, 535 F.2d 761 (3d Cir. 1976); *Herskowitz* v. *Nutri-System Inc.*, 857 F.2d 179 (3d Cir. 1988). The Commerce Committee offers not a word of explanation for overruling this case law and providing for a recklessness standard under the proxy provisions of Section 14(a). We join the SEC in strongly recommending that H.R. 10's scienter provisions be limited to those Sections of the Securities Exchange Act that "require a showing of scienter under current law." Letter from Chairman Arthur Levitt to The Honorable Thomas Bliley (February 23, 1995).

2. Clause (B) of H.R. 10's scienter provisions should be deleted. A defendant's violation of Section 10(b) may be shown by a "knowing or reckless" fraudulent statement (*i.e.*, Clause (C)). Clause (B) is, therefore, redundant and will only create un-

necessary litigation and potentially mischievous interpretative problems in the Federal courts. Similarly, the words "fraudulent statement" in Clauses (A) and (C) should be amended to read "fraudulent statement or omission," to make clear that these Clauses are not limited to affirmative misrepresentations.

3. The word "consciously" and the second sentence (beginning "Deliberately refraining") should be deleted from the bill's definition of recklessness. A defendant who reasonably or unreasonably refrains "from taking steps to discover" may not be reckless. But if in "an extreme departure from standards of ordinary care" a defendant participates in issuing a materially misleading statement, liability should follow.

There is obvious tension—and, perhaps, outright inconsistency—between the "extreme departure" standard in sentence one of the definition and the "deliberately refraining" requirement in sentence two. Requiring that a "failure to investigate" be "deliberate" encourages ignorance, reckless passivity, and may place a near impossible burden of proof on injured parties. Enormous confusion and costly litigation will undoubtedly ensue from the use of words like "deliberate" and "failure to investigate." In addition, from a defendant's standpoint, does this sentence create a broad affirmative duty for defendants to investigate the truth or falsity of statements in all instances? Instead of this imprecise, untested, and potentially mischievous terminology, the Congress should—consistently with the views of most Federal circuit courts—define recklessness by simply putting a period after the words "extreme departure from standards of ordinary care" and deleting the rest of the bill's definition.

The word "consciously" and the second sentence of the definition of recklessness must be deleted from the bill's scienter provisions in order to make them acceptable.

If the changes recommended above are made in the scienter provisions, we would strongly endorse their enactment.

4. Pleading and Practice Changes

For the reasons set forth herein, we oppose the enactment of amended Sections 10A(b) and (c) of H.R. 10, which: provide for heightened pleading requirements in securities fraud cases; mandate a stay of discovery except in rare instances, if there is a motion to dismiss; permit only a single amendment to a complaint; and place severe limits on discovery once a complaint has been found to be sufficiently pled.

A. Pleading and Proof of Scienter

H.R. 10's provision establishing more stringent pleading requirements for claims arising under Section 10(b) and Rule 10(b)(5) is inconsistent with the philosophy that has long and successfully guided amendments to the Federal Rules of Civil Procedure. Because the current bill calls for significant amendments to the Federal Rules of Civil Procedure, Congress should first seek the views of the Advisory Committee on Civil Rules, of the Judicial Conference of the United States, which receives input from both the Bench and Bar, before enacting such far-reaching changes in the Federal Rules. Moreover, as presently drafted, these changes to the Federal Rules of Civil Procedure required by H.R. 10 only apply to securities fraud cases and do not apply to other fraud actions in the Federal courts. Thus, another deleterious impact of these provisions of H.R. 10 would be the abandonment of a uniform set of Federal Rules of Civil Procedure.

Subsection (b) of Section 10A of H.R. 10 provides:

> (b) Requirement for Explicit Pleading and Proof of Scienter.—In any private action to which Subsection (a) applies, the complaint shall specify each statement or omission alleged to have been misleading, and the reasons the statement or omission is misleading. The complaint shall also make specific allegations which, if true, would be sufficient to establish scienter as to each defendant at the time the alleged violation occurred. It shall not be sufficient for this purpose to plead the mere presence of facts inconsistent with a statement or omission alleged to have been misleading. If an allegation is made on information and belief, the complaint shall set forth with specificity all information on which that belief is formed.

At present, Rule 9(b) of the Federal Rules of Civil Procedure requires a plaintiff to plead with particularity the circumstances constituting fraud or mistake. Thus, the first sentence in Subsection (b) of proposed Section 10A is consistent with that requirement and therefore is unnecessary. However, Rule 9(b) also specifically provides that "malice, intent, knowledge, and other condition of mind of a person may be averred generally." This latter provision recognizes that a plaintiff realistically cannot be expected to plead a defendant's state-of-mind with great specificity. *See Cohen* v. *Koenig*, 25 F.3d 1168, 1173 (2d Cir. 1994).

Yet the second sentence in Subsection (b) of Section 10A requires "specific" allegations to establish scienter and thus is contrary to the Rule 9(b) caveat that scienter may be pled generally. Rule 9(b) has been carefully scrutinized by several Circuit Courts in decisions reviewed by our earlier Report, pp. 23–25, and no Court, even the very strict Second Circuit, has required that a complaint make such particularized allegations before discovery has taken place. The reasons are apparent: the Courts' current standards have been effective to strike the balance of weeding out frivolous securities fraud claims without destroying meritorious cases. The proposed draft, by setting wholly impractical pleading requirements, would go too far, to the detriment of investors' legitimate claims.

The Ninth Circuit, in a recent *en banc* decision, *In re Glenfed, Inc. Sec. Litig.*, 42 F.3d 1541 (9th Cir. 1994), stressed the plain language of Rule 9(b) in rejecting the Second Circuit's view that plaintiffs in securities fraud cases must plead facts giving rise to a "strong inference of fraudulent intent." The Ninth Circuit found that standard to be contrary to the clear language of Rule 9(b). Indeed, the Second Circuit itself has stated that it would be "unworkable and unfair to require great specificity in pleading scienter, since 'a plaintiff realistically cannot be expected to plead a defendant's actual state-of-mind.'"[7] Both courts thus would stop well short of the line drawn by the proposed bill.

Moreover, empirical evidence suggests that the onerous and heightened pleading standard contained in H.R. 10 is not only unwise but unnecessary as well. There is widespread agreement that Rule 9(b) has been used with increasing frequency to weed out frivolous cases in recent years. According to the evidence developed by the Senate in its hearings last year on S. 1976 and analyzed in the Dodd Staff Report on private securities litigation:

> [T]here is evidence that in recent years courts have begun to use Rule 9(b), as well as motions for summary judgment and motions to dismiss, to screen out a greater number of securities cases. For example, the number of cases dismissed against major accounting firms increased from 23 in 1990 to 29 in 1991, to 79 in 1992. A broad empirical study of securities class actions resolved over the past 2 years showed the number of cases dismissed rising from 15 to 24. A wide variety of observers have agreed that courts are more aggressively dismissing securities cases on the pleadings.[8]
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> Professor Seligman, in *The Merits Do Matter*, 108 Harv. L. Rev. 438 (1994), notes that while only an average of 123.5 consolidated securities class-action suits were filed per year between 1989 and 1992—as compared to the more than 17,400 companies that file annually with the SEC and the more than three million business corporations that file Federal income tax returns in the United States—the number of such cases dismissed between 1990 and 1992 increased from 33 percent in 1990 to 40 percent in 1992, with courts granting 63 percent of all motions to dismiss in 1992. 108 Harv. L. Rev. at 444–446. As Professor Seligman notes, "(i]ndeed, an issue of current concern in Federal securities law is whether district courts are too frequently dismissing meritorious claims as well." 108 Harv. L. Rev. at 446.

We are also troubled by the language in the third sentence of Subsection (b) which provides that "it shall not be sufficient for this purpose to plead the mere presence of facts inconsistent with a statement or omission alleged to have been misleading." This language raises far more questions than it answers, particularly since it appears that even facts which are contemporaneous with a defendant's statement cannot be the basis for liability. Does this language mean that if plaintiffs have defendants "dead to rights" in a lie and plead those facts, it is still not sufficient because the plaintiffs have only pled "the mere presence of facts inconsistent with a statement or omission alleged to have been misleading?" Certainly, a literal reading of

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[7] *See Stern* v. *Leucadia Nat'l Corp.*, 844 F.2d 997, 1004 (2d Cir.), *cert. denied*, 488 U.S. 852 (1988) (quoting *Connecticut Nat'l Bank* v. *Fluor Corp.*, 808 F.2d 957, 962 (2d Cir. 1987)). *See also* 3 Leonard B. Sand et al., Modern Federal Jury Instructions ¶ 82.02, at 82–73 (1993) ("Direct proof of state-of-mind is almost never available, and is not required.").

[8] Staff of Subcomm. on Securities, Senate Comm. on Banking, Housing, and Urban Affairs, 103d Cong., 2d Sess., Report on Private Securities Litigation, at 41–42 (May 17, 1994). *See also* Richard B. Schmitt, "More Companies Succeed In Defending Charges That They Defrauded Investors," *The Wall Street Journal*, April 30, 1992, B–1 ("In a recent months, a number of other companies, from high-tech to banking have had unusual success in defending charges that they defrauded investors. . . ."); "More Class Action Suits Being Dismissed," *Pioneer Press*, December 27, 1993 ("Dismissals of such lawsuits are on the rise. Judges are finding major legal flaws in more of the cases and dismissing them outright. . . ."); Harvey L. Pitt & Karl A. Groskaufmanis, "Directors' Liability: No Fraud By Hindsight," *Corp. Board*, Jan./Feb. 1993, at 7, 8 ("[F]ederal courts have displayed a striking willingness to dismiss these suits.").

this language calls for that result. This is contrary to a Ninth Circuit holding, that even though it is not required under Rule 9(b) to allege facts from which scienter could be inferred, "[t]he contemporaneous existence of (inconsistent] statements may support an inference of scienter. . . ." *In re Glenfed, Inc. Sec. Litig*, 42 F.3d 1541, 1549 (9th Cir. 1994). *See also Shields* v. *Citytrust Bancorp*, 25 F.3d 1124, 1129 (2d Cir. 1994). This is yet another reason why any proposed changes to the Federal Rules of Civil Procedure should emanate from the Advisory Committee on Civil Rules.

Because the heightened pleading requirements of H.R. 10 will have the effect of mandating the dismissal of meritorious cases at the pleading stage, we oppose it. We agree with Professor Janet Cooper Alexander, a critic of securities class actions in other respects, who observed:

> [S]tringent pleading requirements . . . run the risk of eliminating good suits as well as bad ones. The essence of a securities violation is that it is hidden from the public. Plaintiffs can reasonably be required to make specific allegations about the nature of the misrepresentations they allege. But it is not reasonable to ask them to allege the facts of the concealment with particularity: plaintiffs need discovery to flesh out these facts. . . .

Hearings on Securities Reform before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, 103 Cong., 2d Sess. (August 10, 1994) (statement of Professor Janet Cooper Alexander, at 10). *See also* our earlier Report, at pp. 41–42.

There is also a requirement in Subsection (b) of Section 10A that "[i]f an allegation is made on information and belief, the complaint shall set forth with specificity *all* information on which that belief is formed." While it is the practice to set forth the basis for allegations pled on information and belief, this language, if read literally, would require a plaintiff to plead every piece of information that forms the basis of a belief and could raise serious questions about attorneys' work product. We find this requirement to be unnecessary and burdensome at the pleading stage. Moreover, it is contrary to Fed. R. Civ. P. 8(a) which requires "a short and plain statement of the claim showing that the pleader is entitled to relief." For these reasons, we oppose this provision.

B. Amended Pleadings, Discovery, Stays and Limitations, Summary Judgment

Equally troubling are the provisions of Subsection (c) of Section 10A which seek to legislate, among other things, limitations on discovery in securities fraud cases, the limitation to a single amendment of a securities fraud complaint and stay of discovery if there is a motion to dismiss. Subsection (c) provides:

> [d]uring the pendency of [a] motion to dismiss [for failure to satisfy the pleading requirements], all discovery and other proceedings shall be stayed unless the court finds . . . that particularized discovery is necessary to preserve evidence or to prevent undue prejudice. . . . If a complaint satisfies the [pleadings] requirements . . ., the plaintiff shall be entitled to conduct discovery limited to the facts concerning the allegedly misleading statement or omission. Upon completion of such discovery, the parties may move for summary judgment.

The entire thrust of the Federal Rules of Civil Procedure has been to provide for liberal discovery and permit pleadings to be amended by leave of the court which "shall be freely given when justice so requires." Fed. R. Civ. P. 15(a). *See also* Fed. R. Civ. P. 15(d) (Supplemental Pleadings). There is no apparent reason to create special rules to the contrary for securities fraud cases. Logic points the other way, for amended complaints are frequently more necessary for such complex cases than for simple ones. The proposed limitation, coupled with a requirement to stay discovery when requested by a defendant who files a motion to dismiss, will unfairly impose different rules in securities fraud cases and will prevent meritorious cases from being successfully prosecuted.[9]

Moreover, it is not uncommon for motions to dismiss to remain pending for many, many months, and some motions may be pending for as long as a year or more. Even the best-pled cases are routinely subject to motions to dismiss. Yet in the strong cases as well as the weak ones, H.R. 10 will mandate a stay of discovery. Such a stay will give defendants an unfair advantage, reduce the likelihood of settlement and will interfere with the ability to obtain necessary and timely testimony and documents from defendants and third parties. Moreover, witnesses may be elderly or infirm or may later be beyond the jurisdiction of the court. There should

[9] We take no position in this report on discovery limitations in other contexts or in general.

be a premium on locating documents when they are most accessible and taking testimony when memories are fresh, rather than the contrary. We believe it should be left to the courts to determine whether a stay of discovery is appropriate in a given case. Because these provisions of H.R. 10 can and will result in serious injustices, we are opposed to them.

Equally troubling are the provisions in Subsection (c) which state that, if the complaint satisfies the stringent pleading requirements of Subsection (b), discovery will be limited to the facts concerning the allegedly misleading statement or omission. Thus, in a securities fraud action, and presumably in no other type of fraud action in the Federal courts, plaintiffs will not be entitled to the usual discovery afforded under the Federal Rules. This language effectively would limit discovery to only those facts known by a plaintiff at the time the complaint was filed. There is no justification for such a blatant truncation of all securities law plaintiffs' rights in the Federal courts. Moreover, such a limitation on discovery flies in the face of the recent amendments to the Federal discovery rules, effective December 1993, which significantly revamped the discovery rules and provided for *mandatory* disclosure, among other things.

After severely limiting a securities plaintiff's rights to discovery, the legislation then provides that, upon completion of that limited discovery, the parties may move for summary judgment on a record that is less than complete. We oppose these provisions because we believe the cumulative effect of these proposals will work substantial injustices and will prevent the Federal Rules of Civil Procedure from being implemented in an even-handed manner for all types of cases before the Federal courts. In every other substantive area of the law, all parties will have equal access to discovery of all the facts relevant to all claims and defenses. It is unreasonable in the securities area to force litigants to have the validity of claims tested on a truncated record.

In sum, the proposed revisions to Rule 9(b) F.R.C.P. should not be enacted, nor should the other provisions discussed above. Pleading and practice proposals instead should be referred to the Judicial Conference.

Conclusion

We urge Congress to follow the recommendations of our earlier Report, and also to treat H.R. 10, as revised, in accordance with this Report.

The "loser pays" provision would destroy the securities class action and go far toward destroying much private securities litigation. It should not be enacted.

Proposed changes in the law on reliance and fraud on the market are counterproductive and should be withdrawn in favor of current case law in the area. The revised bill's provisions on scienter and recklessness, however, will be useful and should be enacted if modified as indicated above. Proposed changes in pleading and practice should be remitted to the Judicial Conference and its Advisory Committee on Civil Rules, for detailed and deliberate consideration by that body, the Bench and the Bar, in accordance with long established and successful procedures. Securities fraud cases should not be singled out and handicapped, but should be litigated under the Federal Rules of Civil Procedure.

Finally, we welcome the decision to abandon the pernicious *guardian ad litem* device, but point with equal concern to the proposed device of a plaintiff steering committee. That innovation seems well meaning on the surface, but on closer analysis can be seen to pose significant unjustified problems for investors with meritorious claims.

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*Abstains

Report on Private Securities Litigation Reform Legislation (S. 1976, the Dodd-Domenici Bill)

by THE COMMITTEE ON SECURITIES REGULATION *and* THE COMMITTEE ON FEDERAL COURTS

S. 1976 was introduced by Senators Dodd and Domenici in the last Congress and has been reintroduced in identical form in the new Congress as S. 240. That bill would dramatically change the rules for securities litigation in private securities actions. The Association, in analyzing the many sections of this bill, has taken a balanced, constructive approach which favors some changes in the law but urges Congress not to enact others. For example, the Association has urged Congress to restore liability for aiders and abettors of fraud and to make violators liable upon proof of either knowing or reckless assistance to a fraud. The Association, while disagreeing with the specific formulation proposed by the bill, nonetheless supports a proportionate fault concept provided that a victim of fraud is made whole when a wrongdoer cannot pay his or her share of any judgment. In addition, the Association has urged that recklessness be the culpability standard for all defendants when a proportionate liability concept is applied. The Association opposes the requirement in the bill to plead specific facts as to what was in each defendant's mind at the time of the transaction complained of, before plaintiff has taken any discovery, a task which the Report considers virtually impossible at that stage of a lawsuit. The Association also has opposed the proposals for a Guardian Ad Litem or Steering Committee in class actions because they will unnecessarily add a new set of players that will further complicate already complex litigation and create a new set of problems and issues. The Association is opposed to the alternative dispute resolution procedures as drafted because the bill provides for substantial sanctions in certain circumstances which can have a chilling effect on plaintiffs bringing meritorious suits.

Numerous other proposals are analyzed in depth with the Association approving some while urging modification or deletion of others.

INTRODUCTION

This Report addresses S. 1976, the Private Securities Litigation Reform Act of 1994, generally referred to as the Dodd-Domenici Bill, which would make dramatic changes in the rules governing federal private actions and class actions based on the federal securities laws. It also addresses the question of aiding and abetting liability under § 10(b) of the Securities Exchange Act, which was struck down by a 5 to 4 majority of the Supreme Court in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*[1]

Senator Dodd's staff has issued a report setting forth concerns that various persons have raised about securities lawsuits, particularly class actions, and has drafted language to curb what critics consider abuses. Others, including the SEC and such securities law experts as Professor Joel Seligman of Michigan Law School, co-author with Professor Louis Loss of the well-known treatise on securities law, have differed with much of that critique in detailed analyses that have been submitted to Congress.

In this Report we evaluate both the measures proposed by S. 1976 and the aiding and abetting question, based on the considerable experience which our members have had in this field. This Report was prepared by the Association's Committees on Securities Regulation and Federal Courts. These Committees are comprised of corporate lawyers, litigators, in-house counsel and faculty members with considerable experience in the securities field. They include many practitioners who represent primarily defendants in securities litigation, and others who represent primarily plaintiffs. The views that are set forth present the consensus of the Committees, and the Report is submitted on behalf of the Association of the Bar.

In this light, we conclude that aiding and abetting liability should be restored in a new provision added to the proposed legislation. In addition, while litigation reform is warranted in certain areas and various provisions would make useful corrections to current law, most of S. 1976's current provisions should be significantly modified or deleted. The provisions that we recommend be substantially modified or deleted would be cumbersome and costly; more significantly, they would, in general, threaten the viability of private litigation under the securities laws and, therefore, would threaten a basic protection for investors and for our capital markets. On the other hand, in the interest of litigation reform, we support S. 1976's proportionate liability concept; we believe, however, that the proposed provision (§ 203) should be revised to provide a more workable framework that better takes account of public policy concerns.

For the detailed reasons set forth below, we strongly recommend that Congress include an aiding and abetting provision in the proposed legisla-

[1] ___ U.S. ___, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994).

tion and that the proposed bill be modified as indicated. Absent the addition, and the kinds of modifications and deletions that we recommend, S. 1976 should not be enacted.

A. AIDING AND ABETTING LIABILITY SHOULD BE RESTORED

While the work on S. 1976 was underway, the Supreme Court handed down its decision in *Central Bank of Denver NA. v. First Interstate Bank of Denver*,[3] holding that § 10(b) and Rule 10b-5 may not be used to sue aiders and abettors for securities fraud. In a hearing held on May 12, 1994, Senator Dodd concluded:

> In my view, aiding and abetting liability has been critically important in deterring individuals from assisting possible fraudulent acts by others. Until the Supreme Court changed the landscape a few weeks ago, aiding and abetting liability was an important tool in ensuring honesty and high professional standards by individual professionals who facilitate access to the securities markets. . . . In my view, we need to respond to the Supreme Court's decision promptly and I emphasize promptly.[4]

Senator Domenici agreed that the Senate should "take a real look" at the impact of the *Central Bank of Denver* case in the context of a "comprehensive examination" of the issues raised in the Dodd-Domenici bill.[5]

This Association would welcome aiding and abetting legislation. In our amicus brief in the *Central Bank of Denver* case, we pointed to the need for such liability in order to hold professionals, including lawyers, accountable for their actions in securities transactions.

We urge that a new section be added to S. 1976 to change the result of the *Central Bank of Denver* case and make aiding and abetting claims available to both the SEC and private plaintiffs under § 10(b) and Rule 10b-5 of the Securities Exchange Act. As this Association's *amicus* brief in the *Central Bank of Denver* case concluded, the "preservation of the civil remedy for persons damaged by those who aid and abet a securities

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[3] *Supra*, at 1455.

[4] *Private Securities Litigation Reform Act: Hearing Before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs*, 103 Cong., 2d Sess. 1-3 (1994).

[5] *Id.* at 6.

fraud is essential to the effectiveness of the federal securities laws."[6] There is no hyperbole in this conclusion.

Prior to the Supreme Court's 5 to 4 decision in *Central Bank of Denver*, since 1939, in enforcement actions by the SEC, and at least since 1966, in private actions under § 10(b), aiding and abetting liability had been universally accepted by the lower federal courts. As Justice Stevens said in dissent in the *Central Bank of Denver* case:

> In *hundreds* of judicial and administrative proceedings in every circuit in the federal system, the courts and the SEC have concluded that aiders and abettors are subject to liability under § 10(b) and Rule 10b-5.[7]

The lower federal courts have understood that civil liability for aiding and abetting was required to impose an appropriate standard of diligence and care on professionals such as attorneys and accountants, without whose assistance many financial frauds could not be perpetrated. Investors in publicly traded securities often rely on professionals when evaluating investments. These professionals, whether attorneys, accountants, appraisers, engineers or geologists, act as "gatekeepers," who provide assurance to the public investor of the financial integrity of investments.

Without aiding and abetting civil liability, many of these gatekeepers, on whose credibility both buyers and sellers of securities depend, may be essentially immune from liability. More important, they may be free of the incremental spur to vigilance—the critical deterrent effect—that many need. In its *amicus* brief in the *Central Bank of Denver* case, this Association concluded:

> As an organization of attorneys, the Association of the Bar is, of course, sensitive to the issue of lawyers' exposure to large damage claims. But it is also concerned about creating proper incentives for professionals and other persons involved in securities markets and it is particularly concerned with maintaining the integrity of the Bar. A system that creates proper incentives for securities lawyers to exercise due care—and avoid recklessness or intentional misconduct—in securities transactions serves the interest of attorneys who are commit-

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[6] Brief *Amicus Curiae* of the Association of the Bar, at 20, Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 114 S.Ct. 1439 (1994) (No. 92-854).

[7] *Supra*, at 1456 (1994).

> ted to performing their responsibilities in a professional and ethical manner, as well as the interest of their clients and those who rely on their clients. The Association of the Bar believes that securities lawyers, like accountants and other professionals, are fundamentally important to the process of offering and trading securities in impersonal complex markets. Public confidence in such professionals is essential to a sound securities market system. Enforcement of the securities laws against transgressor professionals thus both serves the public and the best interests of the Bar.[7]

If the holding of the Supreme Court's majority in the *Central Bank of Denver* case is not legislatively overruled, we face either a most serious undermining of the integrity of our securities markets or years of confusion, unfairness, and unnecessary litigation while the word "indirectly" in § 10(b) is read broadly enough to fill much of the gap that the Supreme Court's unfortunate holding has created.

We recommend that Congress—as expeditiously as practicable—enact legislation explicitly making aiding and abetting claims available to both the SEC (whose use of aiding and abetting under § 10(b) is now in doubt) and private plaintiffs.[8] Aiding and abetting should be defined in traditional terms as involving i) a primary violation of the securities laws,[9] ii) knowledge of (or recklessness with respect to) the primary violation and iii) substantial assistance. Substantial assistance should be defined so as to preclude claims against professionals and other persons whose connection with the transaction is remote or insignificant.

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[7] Brief *Amicus Curiae* of the Association of the Bar, *supra*, at page 4.

[8] In the course of his dissent in the *Central Bank of Denver* case, Justice Stevens observed:

> [T]he majority's approach to aiding and abetting at the very least casts serious doubt, both for private and SEC actions, on other forms of secondary liability that, like the aiding and abetting theory, have long been recognized by the SEC and the courts but are not expressly spelled out in the securities statutes.

Id. at 1460.

Justice Stevens noted that the "Court's rationale would sweep away the decisions recognizing that a defendant may be found liable in a private action for *conspiring* to violate § 10(b) and Rule 10b-5." He also noted that secondary liability under the respondeat superior doctrine and "other common law agency principles" was now threatened. *Id.* at 1460 note 12. In a revised S. 1976, Congress should consider expressly making these secondary liability approaches available to both the SEC and private plaintiffs.

[9] The same rationale would apply to implied causes of action under other sections of the Securities Exchange Act (i.e., § 14).

The new section of S. 1976 should also reaffirm what every lower federal court to deal with the issue has held, that recklessness is the culpability standard under § 10(b).[10] This issue, left unresolved by the Supreme Court in *Ernst & Ernst v. Hochfelder*,[11] in 1976, may be the most significant issue that has not been definitively resolved by the Supreme Court under the federal securities laws. The issue was presented in the context of aiding and abetting in the *Central Bank of Denver* case, but was left unaddressed when the majority opinion held that there was no cause of action. A Supreme Court holding that only willful or intentional conduct violates § 10(b) would have a potentially devastating effect on director, officer, and professional behavior, the soundness of both our disclosure system and securities markets would be gravely endangered. Directors, lawyers, accountants and many others, would have powerful legal incentives simply to ignore red flags suggesting fraud or egregious disclosure failures. Only actual intent would make them vulnerable.[12]

B. THE CASE FOR S. 1976 AND A CRITIQUE

In a staff report dated May 17, 1994, directed by Senator Dodd, his staff has set forth the case made by proponents of reform for securities litigation, and primarily securities class actions. The Senate has received complaints from corporations, many of them in California's Silicon Valley, alleging that securities class actions follow willy nilly on the heels of unfavorable corporate earnings reports, thus creating strong incentives for defendants to settle. Complainants contend that settlements favor plaintiffs' lawyers but that the class does not benefit sufficiently. Furthermore, it is said that outside accountants, lawyers and directors are exposed to liability disproportionately to their involvement. Critics suggest that the alleged abuses undercut policies to promote capital formation.

Professor Seligman's letter to the Senate, dated April 22, 1994, during

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[10] "Recklessness means conduct which involves extreme departure from the standard of ordinary care. A person acts in reckless disregard if the risk is known to him, or it is obvious that an ordinary person under the circumstances would have realized the danger and taken care to avert the harm likely to follow. A person may be reckless within the meaning of the law even though he thought himself to be careful. But recklessness is more than mere negligence. Reckless conduct represents grossly unreasonable, rash or intemperate behavior." 3L. SAND, ET AL., MODERN FEDERAL JURY INSTRUCTIONS, 82-8, ¶ 82-8 (1993), *see also*, Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

[11] 425 U.S. 185 (1976).

[12] An actual intent standard would also be undesirable because it would invalidate insurance coverage in most cases.

the debate that preceded the staff's report, makes out the countervailing case.

On the question of whether alleged class action abuses undercut policies to promote capital formation, Professor Seligman cites SEC studies showing great increases in capital formation in recent years, rather than a decline. The SEC itself observed in January 1994:

> that the securities markets in the United States are the "fairest and most efficient in the world" and "by all measures our system is working well to raise capital and provide a wide range of investment opportunities for an even wider range of investors."

The Senate Staff report acknowledges the validity of this point:

> The American capital markets have maintained their preeminent position in the global economy due primarily to the view widely held by investors worldwide that American markets are generally very honest. Investor confidence in the fairness of American markets is bolstered by a system that permits private lawsuits for securities fraud. Despite the claim by critics that securities litigation is hampering capital formation, initial public offerings have proceeded at a record pace in recent years, and a long list of notorious cases have recovered billions of dollars for defrauded investors.

On the need for securities class actions, Professor Seligman further points to the significant and widely acknowledged role that private securities litigation has played in maintaining investor confidence. He quotes former SEC Chairman David Ruder to the effect that less than 10 percent of cases involving securities and commodities have been brought by the government and points to public statements by the head of the SEC's Enforcement Division that such private actions perform vital functions that government cannot handle by itself and cannot replace.

As to the complaints from Silicon Valley, Professor Seligman quotes statistics showing that class action suits have historically followed earnings drops in less than 5 percent of the occurrences, and that percentages have not been increasing. He also cites evidence that bad cases of such a nature have been regularly dismissed before trial.

Finally, Professor Seligman cites studies and evidence to the effect that settlements are not out of line and that attorneys fees have been running between 15 percent and 29 percent of settlements.

Summary of Conclusions on S. 1976

While we will not attempt to resolve the battle of statistical evidence provided by critics and defenders of the present system, our members believe, based on their own experience with countless securities class actions, that the proposed remedies for alleged abuses are excessive. They are not only cumbersome and costly, they threaten to destroy a procedure which no responsible person has seriously urged should be abolished. Most of them should be modified or deleted from the bill.

C. THE PROPOSALS OF S. 1976—IN GENERAL

1. The Main Provisions of S. 1976

The proposed bill in its present form contains two titles. Title I is labeled "Private Securities Litigation" and title II is labeled "Financial Disclosure." The first title deals with private securities actions, primarily class actions, and their alleged abuses, the second deals with such alternative regulatory procedures as a board to regulate accountants through peer review and a proposal to limit liability in proportion to relative fault. We will discuss these two titles separately, except to the extent that analysis of one has to deal with new provisions in the other.

2. Title I: Private Securities Litigation—Overview

This title contains five sections, designated §§ 101 through 105. Section 101 identifies alleged abusive practices and proposes corrections, the most significant of which appears in § 103, a proposal to create guardians *ad litem* for plaintiffs, or, alternatively, plaintiff steering committees. Section 102 would introduce alternative dispute resolution procedures into this area. Section 104 would create new pleading and proof requirements for plaintiffs, while § 105 would restrict the availability of securities law claims under the Racketeer Influenced and Corrupt Organizations Act ("RICO").

We will analyze each of these provisions in detail. Our conclusion is that while at first the reforms may appear desirable, closer analysis by experienced professionals shows that they are not only awkward but draconian, and are likely to destroy a valuable institution rather than improve it. Some parts of Title I, moreover, by-pass established procedures for revising federal practice, such as the Rules Enabling Act, with the result that they eliminate the careful, professional review by judges and lawyers which normally accompanies well considered amendments to federal practice. Others, such as the RICO reform proposal, are unworkable and

self-defeating, they should be considered only as part of a systematic Congressional review of that statute.

D. DETAILED ANALYSIS OF PROPOSALS IN TITLE I: MAJOR CHANGES TO CURRENT LAW

1. Guardian Ad Litem *and Steering Committee*

Section 101 details a series of alleged class action abuses, essentially by plaintiffs' attorneys, who the draftsmen suggest recover too much money for themselves and too little for the class. The bill proposes to eliminate such alleged abuses by several devices, the most important of which, set forth in § 103, would create guardians *ad litem* and plaintiffs' steering committees for class actions. We will address these proposals first.

As part of a new § 38 in the Securities Exchange Act, § 103 provides for the appointment of a guardian *ad litem* or plaintiffs' steering committee in class actions "to direct counsel." The guardian *ad litem* chosen to direct plaintiffs' counsel would be chosen from names provided by either side, plaintiff or defense. Thus a defendant could provide a name to direct its adversary. The bill provides that such guardian shall have the functions of a client, including the right to change plaintiffs' counsel, to reject settlement offers and to seek approval of settlement offers from a majority of the class without the need to solicit approval from the entire class.

Alternatively, the court can appoint a steering committee, on its own motion or on motion by a member of the class. That steering committee shall have similar powers, including the right to direct or change counsel, and the power over settlements. The steering committee would be comprised of at least five class members with specified minimum ownership interest in the defendant corporation.

The parties would pay for the costs of the guardian *ad litem*, as the court directs. There would be no interlocutory review of the court appointment of the guardian *ad litem* or the plaintiffs' steering committee.

Rule 23 of the Federal Rules of Civil Procedure, however, already charges the courts with the obligation to closely supervise the litigation to ensure the fair, efficient and effectual prosecution of class actions. In addition, counsel owes a fiduciary duty to the class, and if counsel fails to discharge that duty, the court is required to act on behalf of the class.

In his testimony before the House Subcommittee on Telecommunications and Finance, on August 10, 1994, Arthur R. Miller, Bruce Bromley Professor of Law at Harvard Law School, strongly criticized this proposed provision, stating "There are also many questions about the guardian *ad litem* concept. Isn't it predicated on the notion that the lawyers for the class, who are its guardians, are not doing their job? If so, where will the process of second-guessing end? Who will guard the guardians? Who will guard the guardians of guardians? What rationality is there to adding additional layers of lawyers to a case? Finally, we must remember that the court already has the power to appoint a guardian (or a special master) if necessary."[11]

By adding a new set of players, this proposal would further complicate already complex litigation and add to the costs. These new participants would be certain to bring to the action more questions, more disputes, more litigation, additional delays and increased attorneys' fees. The outcome of an enactment of this provision would thus be contrary to the thrust of modern litigation reform, that strongly favors simplicity.

The ultimate consequence of the proposal for the inclusion of a guardian *ad litem* or plaintiffs' steering committee may be to cause a significant disservice to the best interests of the class. Securities class action litigation is based upon sophisticated concepts. The prosecution of these actions requires specialized expertise and considerable resources. It is difficult to imagine how the system would be improved if we substitute the judgment of an inexperienced guardian *ad litem* or steering committee for that of experienced counsel and the court. Moreover, since, under the bill, the court has the right to appoint a guardian *ad litem* that is selected by the defendants, the litigation could be controlled by a person sympathetic to the defendant's case, when the judicial system mandates impartiality.

The bill appears particularly counterproductive and anomalous in view of the fact that the bill contemplates the guardian *ad litem* or steering committee would be immune from liability. Thus the guardian *ad litem* or the steering committee would control the litigation totally free from any accountability for their decisions. Further, the steering committee would be comprised of class members who neither initiate the litigation, contribute to its costs, nor have any economic accountability to the other class members. Yet, this group would end up in control of the absent class members' financial fate.

In addition, because the proposed steering committee's membership has cumulative minimum ownership requirements, it necessarily will be, at

[11] *Hearings on Securities Litigation Reform before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce*, 103d Cong., 2d Sess. (August 10, 1994) (Statement of Professor Arthur R. Miller at 29).

least in part, comprised of large position holders, who tend to be institutional investors with possible ties to the defendant company. The composition of the proposed steering committee thus created may skew the control of the litigation to the disadvantage of the small investor, more dependent on class actions than larger investors, who can sue for themselves. Inadequate attention has been given to the appropriateness of putting the fate of small investors in the hands of those whose interests might diverge from theirs.

Troublesome financial questions are also raised by this proposed section of the bill. Under the federal rules, the court has the power to appoint a magistrate judge to supervise the litigation without cost to the parties or the class. But the guardian *ad litem* would be paid by the parties, adding another layer of expense in addition to the considerable expense already involved in prosecuting class litigation. Further, issues of conflict of interest invariably arise. A guardian *ad litem* receiving substantial fees in the litigation might be less likely to recommend early settlement of the litigation if it consequently results in the termination of his or her fees.

The Senate Staff Report of May 17, 1994 recognizes some of these drawbacks of steering committees and recommends against mandated use of steering committees in all cases:

> Since it is unclear in how many cases class members would be willing to serve in such a role, and whether class members willing to serve would fairly represent the class, it would not be appropriate to require courts to follow this approach. However, it may be reasonable to authorize courts to follow such an approach in cases where the court finds that such a steering committee would work.[14]

In the final analysis, it is essential to realize, as stated by Professor Miller in his previously noted testimony, that "there is inherent power in the court under existing practice, on an ad hoc basis, to require that the class representatives be augmented, to call for the addition of lawyers to class counsel, or to appoint a master or guardian for special purposes." This power should afford whatever protections are needed, without the drawbacks and serious problems entailed by the proposals for a guardian *ad litem* and steering committee.

[14] Staff of Subcommittee on Securities, Senate Committee on Banking, Housing, and Urban Affairs, 103d Cong., 2d Sess., Report on Private Securities Litigation at 87 (May 17, 1994).

2. *Section 102: Alternative Dispute Resolution*

Section 102 would add a new § 36 to the Securities Exchange Act to provide an alternative dispute resolution procedure. The bill characterizes it as "voluntary [and] non-binding."[15]

The proposed procedure, however, is neither voluntary nor non-binding because the bill provides substantial sanctions for i) not participating in the alternative dispute resolution procedure or ii) not accepting its results.[16] The refusal to participate must be "unreasonable" for sanctions to result, while the refusal to accept the result triggers sanctions without such a reasonableness test. The bill sets no standard for determining when a refusal to participate is "unreasonable."[17]

The sanctions are an award of costs, including "reasonable attorneys fees." An award of such costs and fees is mandatory ("the court *shall* award") (emphasis added), not discretionary. The fees, however, are likely to become an obligation of the lawyer, for they may not be awarded against a plaintiff who has "never owned more than a million dollars of the securities which are the subject of the litigation."[18] There are no limits on the amount of costs and defendants' attorneys fees to be awarded against the plaintiff's lawyers other than that the fees awarded should be "reasonable."

The result is that the plaintiff's lawyer who declines alternative dispute resolution, or treats the result as non-binding, is subject to a sanction that requires him or her to pay the defendants' legal fees. Since the typical defendant in a securities class action is a large corporation represented by a large law firm, the amount of such fees could become large, hundreds of thousands of dollars or indeed millions, and a court may well view such sums as based on normal hourly billing rates and therefore reasonable. Similar risks would be found in many other private actions which are not class actions. Thus the bill creates an *in terrorem* weapon against plaintiffs' lawyers who are reluctant to participate in the alternative dispute resolution and to accept its results.

Sanctions do not apply under the bill unless the lawyer refusing to accept ADR or its result loses the case and a court determines that any claim or defense that lawyer asserts "was not substantially justified."[19] Such

[15] References below are to the new § 36.

[16] § 36(b)(1).

[17] The reference to "refus[al] to accept the result" presumably means that the alternative dispute resolution procedure contemplated is arbitration rather than mediation. While a mediator makes suggestions, mediation typically does not lead to a "result," while arbitration does.

[18] § 36(b)(3).

[19] § 36(b)(1)(C).

a test might prevent sanctions in some cases. We believe, however, that while the "substantially justified" requirement would reduce the scope of exposure for plaintiffs' lawyers who decline alternative dispute resolution, the uncertainty of litigation is such that the prospect of sanctions would remain as a substantial *in terrorem* effect, depriving plaintiffs' lawyers of the free choice on whether to accept alternative dispute resolution.

In short, the bill creates a very potent coercive weapon against plaintiffs' lawyers which would effectively compel them to participate in alternative dispute resolution and accept its results. Moreover, this coercive effect is not significantly mitigated by the statutory requirement that the court find the party's position in litigation not to be "substantially justified."

In a typical securities class action, moreover, and in most other private securities actions, alternative dispute resolution would be unsuitable unless discovery was provided. Typically the relevant evidence is all or mostly all in the possession of the defense. The proposed statute does not mandate discovery from the defendants, and since defendants' self-interest would be promoted by refusing discovery, defendants would presumably only propose an alternative dispute resolution procedure that does not provide for discovery.[20]

Plaintiffs would presumably have to counter-propose a procedure with discovery. The dispute would be settled by the court. While one would hope that judges would be fairminded and designate a procedure that protects the interest of both parties, there is nothing in the bill which specifies a standard for the court to follow, or grants the parties relief from a specification by the court which is arbitrary or unreasonable.

In addition, the pressure on plaintiffs to propose alternative dispute resolution that includes discovery tends to lock plaintiffs into binding alternative dispute resolution.

The bill also takes no account of the case management problems which self-regulatory organizations have had with efforts to bring securities class actions before arbitrators of the New York Stock Exchange or NASD, and have led to the exclusion of class actions from such arbitrations. For example, arbitration typically lacks procedures for certifying a class and for dealing with opt-outs. The large number of parties whose interests are involved might be hard to accommodate within the framework of arbitration. Most importantly, the risk to plaintiffs that plaintiffs would be cut off without discovery threatens major injustice.

[20] The bill permits the court to allow discovery for ten days after an offer for alternative dispute resolution has been received, § 36(a)(3), a period that can be extended for not more than ninety days, and provides for sanctions against a party delaying or obstructing such discovery, § 36(a)(5), but does not mandate any discovery. More significantly, it makes no provision to assure discovery for the arbitration.

Another important shortcoming is in the absence of guarantees for fair procedures to select a neutral arbitrator or arbitrators. The most critical part of a normal procedure for setting up an arbitration tribunal is choice of the authority to select the neutral arbitrator or arbitrators where party designated arbitrators cannot agree on who should serve. In some cases, parties have used the procedures of the American Arbitration Association; in others, parties have designated a public figure to designate a neutral arbitrator in the event of disagreement between the parties or their designated arbitrators. Examples of such appointing authorities are the President of The Association of the Bar of the City of New York, the president of the Comex, JAMS, Endispute, a designated judge, etc. The proposed bill, however, contains no requirement that an appropriately neutral appointing authority be named.

While we disapprove of § 102, we see no reason why courts cannot appoint settlement masters or settlement judges to help mediate such disputes. Current law so permits, and such a procedure has been successfully used, as in the *Agent Orange* case, where Judge Jack Weinstein appointed special masters to help settle that complex set of cases. Moreover, parties are free to reach voluntary agreements to arbitrate under current law, and nothing we say about § 102 of S. 1976 is intended to discourage such agreements.

We conclude nevertheless that § 102's proposals for alternative dispute resolution should be rejected in their entirety.[21]

3. *Section 104: Enhanced Pleading Requirements*

Section 104 contains provisions establishing more stringent pleading requirements for claims arising under § 10(b) and Rule 10b-5 than is consistent with the philosophy underlying the Federal Rules of Civil Procedure. It also imposes unreasonable pleading burdens which may eliminate many meritorious cases. These onerous pleading standards are both unnecessary and harmful, they should not be enacted.

The proposed legislation with respect to the pleading requirements also

[21] Some members of one of our Committees, while joining their colleagues in rejecting § 102, believe that the compulsion to accept ADR is a sufficient reason to reject that section. They do not believe that the rest of this report's analysis is necessary, they thus concur in the result. One member of the two Committees states that he wishes to encourage the spirit of alternative dispute resolution. Both Committees, however, are unanimous in urging the rejection of § 102.

raises a basic policy issue as to whether Congress should in the first instance seek the views of the Advisory Committee on Civil Rules of the Judicial Conference of the United States and thereby receive input from both the bench and bar before legislating changes to the Federal Rules of Civil Procedure. We favor such a procedure, which is embodied in present practice under the Rules Enabling Act.

The bill provides that a securities fraud complaint must "*allege specific facts demonstrating the state of mind of each defendant at the time the alleged violation occurred*."[22] This standard is directly contrary to Rule 9(b) of the Federal Rules of Civil Procedure which, while requiring that fraud must be pleaded with particularity, further provides that "[m]alice, intent, knowledge, and other condition of mind of a person may be averred generally."[23]

As a general matter, the bill's standards for pleading *scienter* in securities fraud cases are contrary to the longstanding philosophy of maintaining relatively uniform procedural rules for civil litigation in the federal courts.[24] Moreover, the proposal is contrary to common sense. In recent testimony before Congress, Professor Arthur R. Miller, author of the definitive treatise on federal practice and procedure, observed that the proposal

> seems to suggest that at the outset of the case, the plaintiff must have the clearest proof of each individual defendant's state of mind. But this is totally unrealistic. It is only in the rarest cases that this type of evidence exists. Under the best of circumstances, requiring plaintiffs to plead the defendants' states of mind generally calls for the drawing of subtle inferences from facts available prior to institution, a task that is highly treacherous. It would be impossible in the vast majority of cases in which those facts simply are unavailable prior to the lawsuit.[25]

[22] § 104(a) (emphasis added).

[23] This requirement of Rule 9(b) appeared in the first draft of the Federal Rules prepared by the Advisory Committee on Civil Rules in 1936 and continued, unchanged, through every successive draft of the proposed rules. It also has remained unchanged through every subsequent set of amendments to the Rules since 1938.

[24] *See Hearings on Securities Litigation Reform before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce*, 103d Cong., 2d Sess. (August 10, 1994) (Statement of Professor Arthur R. Miller, at 4, 27). It also is inconsistent with the liberal pleading philosophy underlying the Federal Rules and embodied in Rule 8. Rule 8(a)(2) calls for "a short and plain statement of the claim." Rule 8(e)(1) allows pleadings to be "simple, concise, and direct"; and Rule 8(f) provides that "[a]ll pleadings shall be so construed so as to do substantial justice."

[25] Hearings, *supra*, note 13, at 26-27.

Indeed, courts have recognized that it would be "unworkable and unfair to require great specificity in pleading *scienter*, since 'a plaintiff realistically cannot be expected to plead a defendant's actual state of mind.'"[26]

Moreover, empirical evidence suggests that the onerous and heightened pleading standard contained in S. 1976 is not only unwise but unnecessary as well. There is widespread agreement that Rule 9(b) has been used with increasing frequency to weed out frivolous cases in recent years. According to the evidence developed by the Senate in its hearings and analyzed in the Dodd Staff Report on private securities litigation:

> [T]here is evidence that in recent years courts have begun to use Rule 9(b), as well as motions for summary judgment and motions to dismiss, to screen out a greater number of securities cases. For example, the number of cases dismissed against major accounting firms increased from 23 in 1990 to 29 in 1991, to 79 in 1992. A broad empirical study of securities class actions resolved over the past two years showed the number of cases dismissed rising from 15 to 24. A wide variety of observers have agreed that courts are more aggressively dismissing securities cases on the pleadings.[27]

Even more important, however, is the danger that such an onerous pleading standard would eliminate meritorious claims. As Professor Janet Cooper Alexander, a critic of securities class actions in other respects, observed:

> [S]tringent pleading requirements . . . run the risk of eliminating good suits as well as bad ones. The essence of a securities

[26] *See* Stern v. Leucadia Nat'l Corp., 844 F.2d 997, 1004 (2d Cir.), *cert. denied*, 488 U.S. 852 (1988) (*quoting* Connecticut Nat'l Bank v. Fluor Corp., 808 F.2d 957, 962 (2d Cir. 1987)). *See also* 3 Edward B. Sander et al., Modern Federal Jury Instructions ¶ 82.02 at 82-7 (1994) ("Direct proof of state of mind is almost never available, and is not required.").

[27] Staff of Subcommittee on Securities, Senate Committee on Banking, Housing and Urban Affairs, 103d Cong., 2d Sess., Report on Private Securities Litigation, at 41-42 (May 17, 1994). *See also* Richard B. Schmitt, *More Companies Succeed In Defending Charges That They Defrauded Investors*, The Wall Street Journal, April 30, 1992, B-1 ("In recent months, a number of other companies, from high-tech to banking have had unusual success in defending charges that they defrauded investors . . ."); *More Class Action Suits Being Dismissed*, Pensions Press, December 27, 1993 ("Dismissals of such lawsuits are on the rise. Judges are finding major legal flaws in more of the cases and dismissing them outright . . ."); Harvey L. Pitt & Karl A. Groskaufmanis, *Directors' Liabilities Are Fraught With Hindsight*, Corp. Board, January/February 1993, at 7, 8 ("[F]ederal courts have displayed a striking willingness to dismiss these suits.").

> violation is that it is hidden from the public. Plaintiffs can reasonably be required to make specific allegations about the nature of the misrepresentations they allege. But it is not reasonable to ask them to allege the facts of the concealment with particularity: plaintiffs need discovery to flesh out these facts.[28]

Given the recent trend in the law in this area it is difficult to accept the Staff Report's conclusion that the detailed factual basis for a complaint's allegations of *scienter* contemplated by S. 1976 can be "established through information available from public sources."[29] Indeed, the types of factual allegations the Staff Report cites as presumptively sufficient to allege *scienter* — for example, allegations that fraudulent statements were made to increase the value of defendants' personal holdings of shares or options — have frequently been *rejected* as inadequate.

The Staff Report cites with approval the scienter allegations that were sustained by the District Court in *In re Ann Taylor Stores Sec. Litig.*[30] In *Ann Taylor*, the District Court, applying the Second Circuit's "particularity" requirement for pleading *scienter*,[31] held that plaintiffs had adequately alleged that defendants had a motive for making fraudulent statements because such statements would "continue and prolong the illusion of Ann Taylor's successful growth and management and inflate the price of Ann Taylor's securities" and, therefore, would enable the defendants to "(1) protect and enhance their executive positions and the substantial compensation, emoluments, perquisites and prestige they obtained thereby, and (2) enhance the value of their personal holdings of Ann Taylor common stock and options."[32] Recently, however, the Fifth Circuit found almost identical allegations of defendants' *scienter* inadequate to satisfy Rule 9(b).[33]

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[28] Hearings, *supra* note 13 (Statement of Professor Janet Cooper Alexander, at 10).

[29] Staff Report, *supra* note 14, at 41.

[30] 807 F. Supp. 990, 1001 (S.D.N.Y. 1992).

[31] The Second Circuit has held that the requisite "'strong inference' of fraud may be established either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness." Shields v. Citytrust Bancorp, 25 F.3d 1124, 1128. *See also In re* Time Warner Inc. Sec. Litig., 9 F.3d 259, 268-69 (2d Cir. 1993), *cert. denied*, 114 S. Ct. 1197 (1994).

The Ninth Circuit, in *In re* Glenfed, Inc., No. 92-55419, 1994 U.S. App. LEXIS 34334 at 11 (9th Cir. December 9, 1994) recently rejected the Second Circuit's view that plaintiffs in securities fraud cases must plead facts giving rise to a "strong inference of fraudulent intent" as contrary to the clear language of Rule 9(b).

[32] *Id.* at 1001.

[33] *See* Tuchman v. DSC Communications Corp., 14 F.3d 1061, 1068-69 (5th Cir. 1994).

If plaintiffs in securities fraud actions will be required to plead *scienter* with the particularity contemplated by S. 1976, they will need access to discovery in order to do so. However, the recently effective amendments to the Federal Rules providing for initial "mandatory disclosure"[34] have been strenuously opposed and blocked by local rule in numerous jurisdictions from taking effect. In such a regimen, many meritorious claims are therefore sure to perish at the pleading stage.

The proposed legislation requires plaintiff to specify why statements alleged to have been misleading are misleading, and, if such allegation is made on information and belief, plaintiff must "set forth *all information* on which that belief is formed."[35] It appears that S. 1976 is again creating a heightened pleading standard which is contrary to the requirements of Rules 8 and 9(b) of the Federal Rules of Civil Procedure. While it is generally the practice to set forth the basis for allegations pled on information and belief, this language, if read literally, requires plaintiff to plead every piece of information which forms the basis of a belief. This is unnecessary and burdensome at the pleading stage. We oppose this heightened pleading requirement.

4. Section 105: RICO Amendment

Section 105 of the proposed bill amends the Racketeer Influenced and Corrupt Organizations Act (RICO), in an apparent effort to eliminate civil RICO suits in cases involving allegations of securities fraud. We oppose this proposal, which arbitrarily singles out one type of action, or perhaps one industry, for an exemption from the civil RICO principles applicable to all other cases. If civil RICO is to be amended, changes should follow systematic study and be introduced systematically. The present proposal, in part because it rips securities actions from the context of other RICO actions, is both ambiguous and, we believe, unworkable.

Civil RICO is a deeply controversial subject. The plethora of proposals for revision of civil RICO demonstrate the concern felt by many that the remedy is excessive, or that its costs outweigh the benefits to legitimate victims. (Indeed, this Association opposed the enactment of the entire RICO statute.) But the failure of most of these proposals to be enacted testifies to the strength of the view of many in Congress that civil RICO provides a useful remedy to victims of financial crimes. Whatever the merits of this

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[34] FED. R. CIV. P. 26(a)(1).

[35] S. 1976, 103d Cong., 2d Sess. § 19(b) (1994).

dispute, there is no reason to adopt a bill that strikes a different balance for the securities industry, providing more protection for those accused of securities fraud and less for victims of securities crimes, than is struck for any other financial or commercial industry. While, as will be shown, the draftsmanship of § 105 is fatal to its objectives, the problem is not solely draftsmanship. The proposal is ill considered in both its objectives and its means, and should not be enacted.

The Structure of RICO

RICO is a complex statute that creates a variety of crimes and civil remedies applicable to cases in which "patterns" of repetitive violations of certain state and federal criminal laws affect or are accomplished through various kinds of "enterprises." The most significant new offense created by RICO makes it a federal crime for any person associated with an "enterprise" to "conduct . . . such enterprise's affairs through a pattern of racketeering activity."[36] A "pattern of racketeering activity" is defined in the statute simply as requiring at least two acts that constitute predicate crimes specified in the statute,[37] although judicial construction has made clear that to constitute a pattern, the series of predicate acts must be related to each other and present at least a threat of continuity over time. The long list of acts in violation of federal and state law that may constitute predicate "acts of racketeering" includes "any offense involving . . . fraud in the sale of securities."[38] Although § 1962(c) is by far the most important RICO crime, the statute also makes it a crime to use the proceeds of a pattern of racketeering to acquire an interest in an enterprise, or to acquire an interest in an enterprise by means of a pattern of racketeering.[39]

In addition to creating these crimes, RICO also provides that "[a]ny person injured in his business or property by reason of a violation of [RICO]" may bring a civil treble damages action.[40] Civil RICO actions have become quite common, because the treble damage remedy and the opportunity to obtain federal jurisdiction are quite attractive to potential plaintiffs, and the breadth of the RICO statute permits the recasting of many lawsuits that would otherwise be simple contract or common-law fraud claims under state law into federal RICO actions. Criticisms by federal judges and others of the breadth of the law and the number and complexity of the resulting lawsuits have resulted in numerous proposals for amending the statute to restrict its coverage, eliminate the civil remedy, or repeal RICO altogether.[41] None of these proposals, however, has become law.

[36] 18 U.S.C. § 1962(c).
[37] *See* 18 U.S.C. § 1961(5).
[38] 18 U.S.C. § 1961(1)(D).
[39] 18 U.S.C. § 1962(a), (b).
[40] 18 U.S.C. § 1964(c).

The Proposed RICO Changes

Section 105 of the proposed bill would amend 18 U.S.C. § 1964(c) by providing that no person may bring a civil RICO suit "if the racketeering activity, as defined in section 1961(1)(D), involves fraud in the sale of securities." The context of this proposal, within a bill dealing with reform of securities litigation, suggests that the purpose of this provision is to eliminate RICO as a weapon in litigation involving the issuance, purchase and sale of securities.

We believe that the proposal is ill conceived and ill supported. But before discussing the more profound objections to the proposal, it is worth pointing out that the current version of § 105 does not make clear its intended scope or effect. The imprecision of the language at a minimum guarantees considerable litigation over its meaning. Moreover, in our view, the likely judicial interpretation of the section as written will limit its effect to rules of pleading, rather than to the substantive reduction of RICO suits. Revision of the language to accomplish the apparently intended purpose, however, would only highlight the special-interest aspect of the proposal.

The ambiguities of § 105 can best be appreciated in the context of what the bill does *not* do. The bill does not undertake any of the broad reforms of civil RICO that have been pending for years before the relevant congressional committees. Regardless of one's views on the merits of these proposals, at least they stem from a consistent and broad-based analysis of the claimed benefits and burdens of civil RICO litigation, and attempt to craft broad solutions to the problems identified. But § 105 addresses only a single type of RICO litigation. Neither does § 105 undertake to consider the overall role of RICO in securities regulation. It pointedly does not eliminate securities fraud as a RICO predicate act under § 1961(1)(D), thus continuing to permit criminal RICO indictments predicated on fraud in the purchase and sale of securities.

Instead, § 105 simply attempts to eliminate one particular type of criminal conduct from the civil RICO remedy.

[41] *See* Lynch, *A Conceptual, Practical and Political Guide to RICO Reform*, 43 Vand. L. Rev. 769 (1990).

But the language chosen to accomplish this end is fatally ambiguous. The drafters apparently intend to exempt those who commit securities fraud from RICO liability, presumably because of a belief that the benefits of such liability are outweighed by the costs of frivolous invocations of the RICO remedy by plaintiffs with meritless claims. Yet the language used is ill chosen to accomplish that end.

Unlike traditional common law crimes, RICO does not define in legal language a concrete activity understood by lay persons as a type of criminal harm. Instead, the crime it creates is uniquely conceptual, consisting of a relation of one abstract notion—the "pattern of racketeering activity"—to another—the "enterprise." Accordingly, RICO is a complex statute which does not define its coverage in precise terms.

Securities fraud is covered by RICO because "offense[s] involving fraud in the sale of securities" are defined in § 1961(1)(D) as "racketeering activity" that can be part of the prohibited "pattern." For this reason, an allegation that a particular defendant has criminally violated the federal securities laws can be one allegation in a RICO criminal indictment or civil complaint, supporting the more general claim that the defendant has conducted the affairs of an enterprise through a pattern of such activity. The proposed legislation would apparently bar such allegations from civil RICO complaints.

The language of § 105 seems directly intended to accomplish this and only this result. A RICO civil action must be dismissed "if the racketeering activity, *as defined in section 1961(1)(D)*, involves fraud in the sale of securities." The specific reference to § 1961(1)(D), and the more general use of the technical term "racketeering activity," make it logical for a court to interpret the legislation as prohibiting the use of federal or state securities laws as the basis for allegations of racketeering activity.

But this by no means makes it impossible for plaintiffs who have been harmed by fraud in the sale of securities to bring a RICO action. So long as the mails or interstate wire communications have been used in connection with the relevant transaction—a certainty in almost any securities offering—virtually any claim of securities fraud can be recast as a violation of the mail and wire fraud statutes.[42] And acts indictable under these statutes separately form predicate acts under RICO, under § 1961(1)(B). Thus, the language of § 105 arguably addresses only the method of pleading a RICO violation in a securities matter, precluding the use of, for example, a violation of Rule 10b-5 as the technical basis for a RICO claim, but permitting the same facts to be alleged as violations of the mail fraud statute.

This result may preclude or make more difficult some classes of securities claims, which do not constitute mail or wire fraud, or which more naturally can be stated as securities violations. But this pattern of results would be entirely arbitrary. There is no basis for concluding that those securities claims that are best pleaded under the securities laws rather than as mail fraud are less important, or more likely to lack factual merit, than those that can be restated in some other terms.[43]

To cure this drafting defect, however, would not be a simple matter of change of language. Any effort to write the proposal more broadly would drop the technical disguise of the present language and reveal more clearly the special-interest quality of this legislation.

The RICO Amendment Protects Special Interests

As noted above, federal judges and others have been critical of the expansion of federal jurisdiction, and the extreme severity of the treble damages remedies, provided by RICO. Section 105—if redrafted as broadly as apparently intended—exempts one class of defendants, those involved in the securities industry, from these purported problems.

But there is no basis for a conclusion that the problems and costs of RICO are more severe or less justified in the context of the securities business than in any other area.

As the drafters of this legislation, above all others, are surely aware, securities litigation, with or without RICO, is broadly within the federal jurisdiction in any event. Eliminating civil RICO as a cause of action will eliminate one category of claim from securities complaints, but will not reduce the volume of federal litigation one iota. The most fervent complaints of judges and other commentators about civil RICO have been addressed to an entirely different area: to the use of RICO to obtain federal jurisdiction in "garden-variety" contract and common-law fraud claims that would otherwise not be federal cases at all.

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[42] 18 U.S.C. §§1341, 1343.

[43] One other ambiguity should be noted. Section 105 does not in terms prohibit the use of "fraud in the sale of securities" as a predicate act in a civil RICO suit, although the remainder of our discussion will treat it as doing so. Instead, it prohibits bringing such a suit where "the racketeering activity involves such fraud." Plaintiffs may argue that this language prohibits only actions in which no other type of racketeering activity is alleged to form part of the pattern, so that securities fraud may still be a part of a broader pattern.

Neither can this legislation be justified as a response to the arguable excessiveness of the RICO treble-damages remedy. Those who defraud others in the sale of securities are neither less nor more guilty, and those who are defrauded neither less nor more worthy of enhanced damages, than those who commit or are victims of similar frauds involving other forms of commercial activity. If it is deemed wise to subject bankers, insurance companies and vendors of merchandise to enhanced damages when they commit criminal acts—a point on which we express no opinion—it is difficult to see why those who sell securities to the general public should stand in a different position.

There is little or no reason, moreover, to conclude that frivolous RICO lawsuits are more common in the securities area than in any other type of litigation. The availability of treble damages under RICO may attract more frivolous suits than the less lucrative payouts provided for other causes of action—as it may attract more worthy claims that might not otherwise be brought. But the balance between the meritless and the meritorious, and the ability of the courts to distinguish the two, are unlikely to be different in the securities field from any other. Nor are the perceived deep pockets of some securities defendants a uniquely distinguishing feature. Not all securities defendants are wealthy, and banks and other commercial institutions subject to RICO claims are equally attractive to nuisance lawsuits.

Section 105 should not be enacted.

E. DETAILED ANALYSIS OF TITLE I—OTHER CHANGES

1. Section 101: Attorneys Fees

Section 101 of the bill, in part, would add a new subsection 21(1) to the Securities Exchange Act, to provide that attorneys fees for class counsel would be determined as a percentage of the amount of damages and prejudgment interest actually paid to the class, and limits such a percentage to a "reasonable percentage of the amount recovered."

We agree that attorneys fees should be awarded on a percentage basis, but the calculation should be based upon the total amount made available to the class by counsel. In addition, appropriate allowance should be made for value that may not translate into monetary damages, such as various forms of equitable relief.

We support the change to a statutorily mandated percentage approach for a number of reasons. First, the percentage calculation more clearly aligns

counsel's interests with the interests of the class, and creates an incentive for the attorneys to press for a larger recovery.[44] At the same time, percentage fee arrangements encourage early settlements. This approach acts as a disincentive for attorneys to bill hours as a means of increasing their fees, and avoids the principal-agent conflicts inherent in time-based formulae.[45]

The percentage approach also has significant benefits to the court, including simplicity and ease of administration.[46] The percentage approach is appealing because it relies on incentives in addition to judicial monitoring.[47] The courts would be relieved of the frustrating responsibility to determine whether lodestar hours were reasonable and beneficial to the class. As testament to its greater value, increasingly more courts are utilizing this method.[48]

We disagree, however, that the percentage should be applied to the amount actually paid to the class rather than the amount made available to the class by its counsel. Enactment of this proposed legislation would be antithetical to Supreme Court precedent and would be contrary to doctrines of fairness and equity. The United States Supreme Court has expressly held it is proper in a common fund case to award attorneys' fees from the *total* amount of a fund created for the benefit of a class even if some of the fund goes unclaimed, since each class member had a present *vested* interest in the class recovery and could collect his share of the fund upon request, therefore receiving a "benefit" within the meaning of the common fund

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[44] *See* Kirchoff v. Flynn, 786 F.2d 320, 324-25 (7th Cir. 1986); PRIVATE SECURITIES LITIGATION: STAFF REPORT PREPARED AT THE DIRECTION OF SENATOR CHRISTOPHER J. DODD ("STAFF REPORT") (May 17, 1994) at 82-83.

[45] *See, e.g., In re* Folding Carton Antitrust Litig., 84 F.R.D. 245, 262-63 (N.D. Ill. 1979); *see also*, STAFF REPORT at 83, *citing* Swedish Hospital Corp. v. Shalala, 1 F.3d 1261 (D.C. Cir. 1993).

[46] *See, e.g.*, STAFF REPORT at 82.

[47] *See Kirchhoff* at 324-25; STAFF REPORT at 83.

[48] *See, e.g.* Swedish Hospital Corporation v. Shalala, 1 F.3d 1261 (D.C. Cir. 1993); Camden I Condominium Association, Inc. v. Dunkle, 946 F.2d 768, 771-72 (11th Cir. 1991); *In re* Continental Illinois Sec. Litig., 962 F.2d 566 (7th Cir. 1992); Paul, Johnson, Alston & Hunt v. Graulty, 886 F.2d 268, 272 (9th Cir. 1989); Brown v. Phillips Petroleum Co., 838 F.2d 451, 454, 456 (10th Cir. 1988), *cert. denied*, 488 U.S. 822 (1988); Weinberger v. Great Northern Nekoosa Corp., 925 F.2d 518 (1st Cir. 1991); *In re* Crazy Eddie Sec. Litig., 824 F. Supp. 320, 325-36 (E.D.N.Y. 1993); *In re* Gulf Oil/Cities Service Tender Offer Litig., 142 F.R.D. 588, 596 (S.D.N.Y. 1992); *In re* Union Carbide Corp. Consumer Prod. Business Sec. Litig., 724 F. Supp. 160 (S.D.N.Y. 1989); *In re* First Fidelity Bancorporation Sec. Litig., 750 F. Supp. 160 (D.N.J. 1990). Further, a leading treatise on class actions also recommends the percentage method as appropriate in common fund cases. *See* H. NEWBERG AND A. CONTE, 3 NEWBERG ON CLASS ACTIONS, § 14 (3d ed. 1992); as does the Civil Justice Expense and Delay Reduction Plan, Section VI(A).

doctrine.[49] Creating such a guaranteed benefit for a class member who does not claim his share of the fund unjustly enriches that non-claiming class member, because each claiming class member is paying a share of the attorneys' fees for each non-claiming class member.

It would be unfair to the claiming class members to compel them to bear the expense of a benefit created by class counsel and conferred upon the non-claiming class members. The failure of all class members to claim against the fund does not diminish the court's power to act equitably and apportion the expenses ratably among all beneficiaries. Deducting attorneys fees only from the claimed portion of the fund increases the portion of every claiming class member's individual award that is allocated to attorneys' fees and thus leaves each claiming class member with a substantially reduced benefit.

We believe that to establish the size of the percentage, the court should look to a number of factors. These factors include the time and labor expended by plaintiffs' attorneys, the novelty and difficulty of the issues involved, the degree of skill required to properly perform the legal services, time constraints imposed by the litigation, the amount involved and the result obtained, the experience, reputation and ability of the attorney and the size of the award in similar cases. By utilizing these factors to calculate the appropriate percentage to apply, inappropriate windfalls to class counsel will be avoided, and class counsel will be awarded a fee that is commensurate with the job performed and fair to all parties involved.[50]

In adding a limitation that fees must be reasonable in relation to the amount recovered, the staff is apparently moved by a concern that attorneys' fees in securities class action litigation have continually mounted and have reached epic proportions. Yet, as Professor Seligman stated in his August 10, 1994 testimony on Litigation Under the Federal Securities Law before the Subcommittee on Telecommunications and Finance, House Committee on Energy and Commerce, the available data suggest that

> 1) As much as 40 percent of Rule 10b-5 claims in 1992 were dismissed by courts on a motion by defendants. This strongly suggests that nonmeritorious suits generally do not survive settlement.

[49] Boeing Co. v. Van Gemert, 444 U.S. 472, 479-481 (1980).

[50] *Camden I Condominium Association, Inc.*, 946 F.2d at 775; Johnson v. Georgia Highway Express, Inc., 488 F.2d 714, 717-19 (5th Cir. 1974).

> 2) Average recoveries in federal securities class settlements between July 1991 and June 1992 were $10.33 million, and between July 1992 and June 1993 were $7.36 million.
>
> 3) The average attorneys fees according to NERA were equal to 28 percent of 1991-1992 settlements and 29 percent of 1992-1993 settlements.[51]

These data are not consistent with arguments that the merits do not matter or that the federal securities class action is primarily a vehicle for enriching lawyers.

We note that the courts are already obligated to approve only those fees which they find to be reasonable. Too many factors go into the calculation of reasonableness in fees (i.e., reasonable in relation to the amount received) for the courts' discretion to be restricted by standards which in some cases may not prove to be just and workable.

2. *Section 101: Plaintiff's Holdings*

Section 101(o) of S. 1976 provides that

> In an implied private action arising under this title, in order for a plaintiff or plaintiffs to obtain certification as representatives of a class of investors pursuant to the Federal Rules of Civil Procedure, the plaintiff or plaintiffs must show that they owned, in the aggregate, during the time period in which violations of this title are alleged to have occurred, not less than the lesser of—
>
> (1) 1 percent of the securities which are the subject of the litigation, or
>
> (2) $10,000 (in market value) of such securities.

Although there is no specific reason given for this requirement in the Staff Report, it appears to have been designed to prevent a person with nominal holdings or losses from bringing an action on behalf of the class.

Assuming a threshold is necessary, the S. 1976 requirement is too high and is inconsistent with a fundamental purpose of Federal Rule of

[51] Hearings, *supra* note 13 (Testimony of Professor Joel Seligman at 16).

Civil Procedure 23, i.e., to permit the aggregation of small claims. As one court stated:

> In litigation involving securities fraud there is often a plethora of small investors who, but for the class action device, would be deterred from filing suit in light of prohibitively high litigation expenses, the difficulties of proof at trial, and the relatively small stakes at issue for any given plaintiff.[32]

In light of the power of the courts to deny class certification where the representative plaintiffs' damages are nominal,[33] we question the need for the statute to define a minimum threshold for a class representative.

In any event, the $10,000 threshold is far too high.

3. *Section 104: Burden of Proof*

Section 104 provides that plaintiff shall have the burden of proving that "the misstatement or omission caused any loss incurred by the plaintiff."[34] While loss causation is an element of 10b-5 cases, it is unclear whether the legislation requires that loss causation be established as to each statement or omission, as opposed to the total mix of statements and omissions. To the extent that the legislation is seeking to change the present law on loss causation, we oppose it.

4. *Section 103: Class Notice*

Section 103(m) of the bill provides for increased disclosure in notices published or otherwise disseminated to the class. Under this proposal, the class notice would include a statement of potential outcome of the case including an agreement on amount of damages and likelihood of prevailing or, if the parties cannot agree on a joint statement, a statement from each party concerning the issue or issues on which the parties disagree. The proposal would also require a statement of attorneys' fees or costs sought, including a brief explanation of the basis of the application and the identification of one or more representatives of counsel for the class who are available to answer questions from class members.

We support these provisions for increased disclosure of settlement terms and damages in class notices. We believe that increased disclosure to class members should result in their being better able to evaluate the terms of the settlement and decide whether to accept or reject the settlement.

5. *Section 104: Damages*

Section 104 proposes to limit a defrauded investor's damages to the *lesser* of

> (1) the difference between the price paid by the plaintiff for the security and *the market value of the security immediately after dissemination to the market of information which corrects the misstatement or omission; and (2) the difference between the price paid by the plaintiff for the security and the price at which the plaintiff sold the security after dissemination of information correcting the misstatement or omission.*[35]

Both of these measures differ significantly from the so-called out-of-pocket rule now applied in actions arising under § 10(b) and Rule 10b-5 and would undermine the principles of deterrence and investor protection underlying the antifraud provisions of the federal securities laws.

Under the currently used out-of-pocket measure of damages, a defrauded purchaser is entitled to recover the difference between the price paid for a security and its true value on the date of purchase if there had been no fraud.[36] As Judge Sneed observed in *Green v. Occidental Petroleum Corp.*:

> This difference is proximately caused by the misrepresentations of the defendant. It measures precisely the extent to which the purchaser has been required to invest a greater amount than otherwise would have been necessary.[37]

Unlike the out-of-pocket rule, the proposals contained in S. 1976 will not make investors whole. The first proposal seeks to measure damages by the amount of the drop in the price of security when a disclosure is made. This proposal will not accurately measure damages. The most accurate

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[32] Trief v. Dun & Bradstreet Corp., 144 F.R.D. 193, 200 (S.D.N.Y. 1992).

[33] *See, e.g.*, Shields v. Smith, 1992 Fed. Sec. L. Rep. (CCH) ¶ 97,001 (N.D. Cal. August 14, 1992) (where the court denied class certification to a plaintiff who purchased two shares but then permitted an intervenor with 1,300 shares to act as class representative).

[34] *Id.* § 39(c).

[35] S. 1976, 103d Cong., 2d Sess. § 104(d)(1) (1994) (emphasis added).

[36] *See, e.g.*, Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 155 (1972); Randall v. Loftsgaarden, 478 U.S. 647, 661-62 (1986); Harris Trust & Savings Bank v. Ellis, 810 F.2d 700, 806-07 (7th Cir. 1987); Sirota v. Solitron Devices, Inc., 673 F.2d 566, 578 (2d Cir.), *cert. denied*, 459 U.S. 908 (1982); *In re* LTV Sec. Litig., 88 F.R.D. 134, 148 (N.D. Tex. 1980).

[37] 541 F.2d 1335, 1344 (9th Cir. 1976) (Sneed, C.J., concurring).

measure of damages, which courts have consistently recognized, is the difference between the price paid and the true value of the security on the date of purchase absent any fraud. Moreover, this proposal does not take into account the situation where there has been no disclosure. Take for example a situation where the books have been "cooked" but that is never disclosed. Instead, the company cites some "benign" reason for disappointing earnings and the price of the stock drops. Clearly, the price of the security on the date of purchase was inflated as a result of the false financials which was not disclosed. Thus, the purchaser will have suffered recoverable damages under the "out-of pocket rule" even in the absence of corrective disclosures.[**]

The alternative measure of damages contained in S. 1976 would give the wrongdoers the benefit of an investor's second investment decision if the price of the security rose at some time in the future *for reasons unrelated to the fraud*.[**] Giving securities law violators such a windfall would undermine the deterrent purposes of the antifraud provisions of the federal securities laws and undermine our investor protection scheme. Indeed, current caselaw recognizes this fact and several courts have expressly held that defrauded purchasers could maintain an action under § 10(b) and Rule 10b-5 even if they sold their shares for a price greater than they paid for the stock.[**]

6. *Section 101: Conflicts of Interest*

Section 101(j) of the proposed bill provides that in securities litigation in which a class is certified, if an attorney representing a party owns securities that are the subject of the litigation, the court shall determine whether the attorney's securities ownership constitutes a conflict sufficient to warrant disqualification.

[**] See, *In re* Worlds of Wonder Sec. Litig., 35 F.3d 1407 (9th Cir. 1994); Wool v. Tandem Computers Inc., 818 F.2d 1433 (9th Cir. 1987).

[**] Under the out-of-pocket rule damages are fixed on the date the buyer purchases the securities in question. Any increase or decrease in the price of the stock after the full truth is disclosed does *not* affect the calculation of damages. *See, e.g., Simtu*, 673 F.2d at 578 ("[T]he issue is the amount by which each class member was defrauded on the date of his purchase. Any subsequent decline in the market had no effect on that fraudulent sale."); Bernstein v. Crazy Eddie, Inc., 702 F. Supp. 962, 980 (E.D.N.Y. 1988), *vacated in part on other grounds sub nom.*, 714 F. Supp. 1285 (E.D.N.Y. 1989) ("Plaintiffs' eventual realization of a profit or loss upon sale of the shares may result from supervening market forces (e.g., a general stock market rise or crash) that have nothing to do with the misrepresentations that induced the purchase and caused the inflated price."); Katz v. Comdisco, Inc., 117 F.R.D. 403, 408-09 (N.D. Ill. 1987).

[**] *See, e.g.*, Rand v. Monsanto Co., 926 F.2d 596, 597 (7th Cir. 1991).

Although we agree that the court and the parties should be able to inquire whether an attorney representing a party owns securities that are the subject of the litigation, we believe that mandatory court scrutiny of attorney stock ownership is unwarranted. The bill is also unclear as to how it would operate in practice.

Most fundamentally, we do not believe that mere ownership of the securities at issue should trigger court inquiry into a potential conflict of interest. We do not agree that mere ownership of securities should automatically suggest a disabling conflict. Because the protections built into Rule 23 of the Federal Rules of Civil Procedure and attorneys' professional and ethical duties operate to identify and address conflicts, we do not believe that court inquiry is necessary or appropriate unless the attorney's securities ownership reaches some very substantial level. Moreover, a rule mandating court review upon an attorney's ownership of as little as one share of the subject securities would be susceptible to abuse by adverse parties for strategic purposes.

The bill also provides the court with no guidance in conducting its inquiry into whether a disabling conflict exists. It is unclear whether the bill contemplates extensive hearings concerning attorney securities ownership, or whether a more streamlined process is envisioned. This lack of an ascertainable standard could lead to widely divergent results. Without reference to any established standard, one court might employ a fact-specific approach and disqualify the attorney only if a conflict actually arises, while another might adopt a *per se* rule of automatic disqualification based on avoiding even the appearance of impropriety.

The bill is also too broad in that it arguably would require attorneys representing parties in securities litigation to inquire periodically of every member and employee of their firm to determine whether they own the subject securities. It also would arguably require attorneys to know and disclose the securities held by any investment vehicle in which they invest, such as a mutual fund. Such a requirement would be onerous and unworkable.

Therefore, although we believe that parties should be able to learn upon request whether an attorney owns a specified threshold amount of securities that are the subject of the litigation to disclose their ownership interest, we do not believe that this is an appropriate subject for legislation.

7. *Section 101: Special Verdicts*

Section 101(n) of the proposed bill provides that in securities litigation in which *scienter* is an element of plaintiffs' claim, the court must, upon the request of "a defendant, submit to the jury a written interrogatory on the issue of each such defendant's state of mind at the time the alleged violation occurred." We read this proposal as enabling a defendant to have a jury determine *its* state of mind, but not the state of mind of another defendant that does not want a determination of its particular state of mind.

We believe that this proposal is an improper attempt to revise the Federal Rules of Civil Procedure with respect to written interrogatories. Federal Rule of Civil Procedure 49(b) authorizes the court to "submit to the jury, together with appropriate forms for a general verdict, written interrogatories upon one or more issues of fact the decision of which is necessary to a verdict." The purpose of this provision is to allow the court in its discretion to require the jury to focus on particular questions of fact as a means of ensuring that the jury's general verdict will reflect its consideration of the key factual elements of the case.[81]

The proposal would remove from the court's discretion the decision to submit written interrogatories on the *scienter* issue in securities fraud litigation. We believe this proposal is undesirable, as it would compromise the judge's ability to control the trial. If the proposal were accepted, it would permit the anomalous situation where the court could deny requests to submit written interrogatories on every issue except *scienter*. We do not believe that revisions to the federal securities laws are the proper vehicle for effecting a significant revision to the Federal Rules of Civil Procedure.

Moreover, because direct proof of state of mind is almost never available and is not required to establish liability, we believe that special provision for written interrogatories on *scienter* is inappropriate.

We also note that enabling a defendant to have a jury determine the particular state of mind of another defendant is not needed to facilitate an apportionment of liability under § 10(b) and Rule 10b-5. Co-defendants found liable for securities fraud may be jointly and severally liable to the plaintiff, entitling the plaintiff to recover all or a portion of the total judgment from one or more of the defendants who are found liable.[82] In *Musick,*

[81] *See* Industries, Investments & Agencies LTD. v. Panelfab Int'l Corp., 529 F.2d 1203 (5th Cir. 1976).

[82] *See* United States Indus., Inc. v. Touche Ross & Co., 854 F.2d 1223, 1261 (10th Cir. 1988).

Peeler & Garrett v. Employers Ins. of Wausau,[83] the United States Supreme Court announced last year that defendants in an action brought under § 10(b) and Rule 10b-5 have an implied right to seek contribution from joint tortfeasors.

Therefore, defendants who proceed to trial frequently will have asserted cross-claims for contribution against one another and will seek an apportionment of fault among the defendants from the jury. Indeed, the Tenth Circuit recently held that "[s]ecurities law requires a contribution claim before the court can order the jury to divide damages among the defendants."[84] Thus, as a practical matter, contribution claims already permit defendants in securities fraud litigation to have a jury allocate fault among the defendants. This counters any contention that the proposed § is needed to facilitate apportioning fault among defendants.[85]

For all of the foregoing reasons, we do not support legislation that will enable a defendant to have a jury determine its particular state of mind. We believe that the Federal Rules of Civil Procedure already provide the preferable mechanism on this issue, permitting a party to ask the court to submit written interrogatories to the jury, but granting the court discretion to accept or deny the request.

F. TITLE II—FINANCIAL DISCLOSURE OVERVIEW

Title II contains four new provisions, embellished with numerous details. Section 201 would have the SEC issue regulations providing a safe harbor to protect companies from being sued on the basis of forward-looking statements. Section 202 provides new audit requirements and limits liability for accountants who have complied with them. Section 203 provides a major change by creating proportionate liability for defendants. Section 204 creates a peer review board for accountants and limits accountants' liability.

1. *Section 201: Safe Harbor for Forward-Looking Statements*

Section 201(a) requires the SEC, in "consultation with investors and issuers of securities," to "consider adopting or amending its rules and regulations, or making legislative recommendations" concerning a "safe har-

[83] 113 S. Ct. 2085, 2091-92 (1993).

[84] TBG, Inc. v. Bendis, 36 F.3d 916, 928 (10th Cir. 1994).

[85] *See also* the discussion of § 203, *infra*.

bor" for forward-looking statements related to future economic performance. Section 201(a) requires the SEC to consider appropriate criteria for a "safe harbor" and to consider "procedures by which courts shall timely dismiss claims against such issuers" if forward-looking statements are in accordance with the SEC's criteria.

We support this provision, except that we see no reason i) to *require* consultation with investors and issuers and ii) we would delete a proposed limitation in § 201(a), which makes the section applicable only to "an issuer of securities registered under Section 12 of the Securities Exchange Act." The SEC, which would be required to accept public comments if it acts through a rulemaking process, should be afforded the usual flexibility to consult with interested parties in appropriate ways. Requiring the Commission to consult with investors and issuers by an ambiguous command (e.g., with respect to the scope and nature of the required consultation) could lead to mischievous claims. Indeed, rather than commanding the SEC to "consider adopting or amending its rules and regulations, or making legislative recommendations," it would be preferable simply to require the Commission to study the issues and then report to Congress. Section 10(b) has been interpreted to apply to non-public and close corporations[56] and, therefore, § 201(a)—in parallel fashion—should not be limited to public corporations as defined in § 12.

Subsections (b) and (c) of § 201 of the bill specify criteria and procedures to be used in § 10(b) actions related to forward-looking statements. These subsections should be deleted from the bill. Subsection (a) of § 201 sensibly asks the SEC to consider taking action in this area, and, in this context, it is unwise for Congress to jump precipitously to substantive and procedural conclusions. The SEC has already indicated that it is studying the issues that have been raised in § 201(a).[57] We see no basis for Congress to enact Subsections (b) and (c) of § 201 and thereby limit the Commission's flexibility. Congress should not make judgments now, when the SEC's study may later show such judgments to be questionable or unwarranted.

2. *Section 202: Proposed New Audit Requirements*

Section 202 would amend the Securities and Exchange Act by adding a new § 10A, which would require certain audit procedures by accountants and reports to corporate management. This is a constructive proposal, but there is one drafting problem. Section 10A(e) states that an accountant shall not "be liable in a private action for any finding, conclusion, or statement expressed in a report" made pursuant to the new provisions. The draft should make clear that such immunity only applies to an action predicated on a 10A report itself, but should have no effect upon any other liability of the accountant that may arise under any other provision of the Securities Exchange Act.

3. *Section 203: Proportionate Liability*

Section 203 proposes the establishment of a proportionate liability scheme in federal securities fraud actions. We support the proportionate liability concept, but believe § 203 must be revised to provide a more workable framework that better takes account of public policy concerns. In this regard, the "required significant modifications"[58] should be made and other significant suggestions contained herein (e.g., limiting the reduction of any judgment to a defendant's proportionate share of the damages) should also be made. Most importantly, § 203 as revised should provide that a victim of fraud is made whole when a wrongdoer is unable to pay his or her share of any judgment and, for the reasons stated in Section A, *supra*, should expressly provide that recklessness is the culpability standard for all defendants when the proportionate liability scheme is applied.

Section 203 as Presently Proposed

Plaintiffs in federal securities fraud actions typically sue multiple defendants. Under existing law, co-defendants found liable for securities fraud are jointly and severally liable to the plaintiff, entitling the plaintiff to recover all or a portion of the total judgment from any of the defendants who are found liable. In a distinction we would reject[59] § 203 continues joint and several liability only with respect to i) primary wrongdoers (as defined in the bill); ii) intentional wrongdoers, and iii) controlling persons of wrongdoers in the first two categories.

Section 203(d)(1) limits the liability of aiders and abettors to their proportionate share of the liability as determined by the finder of fact.[60]

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[56] *See* VIII Louis Loss & Joel Seligman, Securities Regulation 3677-80 (3d ed. 1991).

[57] *See* Safe Harbor for Forward-Looking Statements, Concept Release and Notice of Hearing, Release Nos. 33-7101, 34-34831, 35-26141, 39-2324, IC-20613 (October 13, 1994).

[58] Set forth at pages 62, *infra*.

[59] *See* pages 61-62, *infra*.

[60] Section 203(c) of the proposed bill requires the finder of fact to answer special interrogatories determining the relative fault of all defendants, including those that settled.

This proposed abolition of joint and several liability for aiders and abettors, however, is not absolute. Recognizing that complete compensation of victims of securities fraud is a paramount objective of the 1934 Act, § 203(d)(2) provides that where the insolvency of a primary wrongdoer renders "all or part" of the primary wrongdoer's obligation "uncollectible," the plaintiff may collect that unsatisfied obligation from any other defendant, including an aider and abettor.

Unfortunately, the proposed bill establishes a labyrinthine mechanism for determining the circumstances under which an undercompensated individual plaintiff may collect additional amounts from the remaining defendants. The provision is not available to corporate plaintiffs.

First, the plaintiff must apply to the court within six months after the entry of final judgment for an order determining that damages are uncollectible from a particular defendant. Upon obtaining such an order, the plaintiff must satisfy a needs test. The plaintiff must demonstrate that i) his or her recoverable damages are equal to or exceed 10 percent of the plaintiff's financial net worth, ii) the plaintiff's net financial worth is less than $200,000, and iii) the amount paid by each of the remaining defendants to other plaintiffs does not in the aggregate exceed the greater of a) that remaining defendant's percentage of fault for the uncollectible share, or b) five times the amount the defendant profited from its wrongdoing or, if no profit was made and the wrongdoing "consisted of the provision of deficient services to an entity involved in violation," five times the defendant's gross revenues received for the provision of all services involved in the violation during the calendar years in which deficient services were provided.

The deficiencies in this cumbersome framework are manifold. First, it is onerous to plaintiffs. By establishing a needs test for plaintiffs who have already established injury, it presents an overwhelming risk that plaintiffs will be undercompensated. It also may be inconsistent with the out-of-pocket measure of damages employed in Rule 10b-5 litigation. The limitations on the remaining defendants' contributions to an undercompensated plaintiff's damages appear arbitrary.

Moreover, enacting this framework would impose significant administrative burdens on the courts. Because the bill contemplates applying the scheme on a plaintiff-by-plaintiff basis, class actions involving a primary wrongdoer who is unable to pay his or her share of any judgment could engulf the court with post-trial inquiries into apportioning liability which will be far more complex than those that occurred before the bill.

Required Significant Modifications

Ensuring that the victim of fraud is made whole when a wrongdoer is unable to pay his or her share of any judgement must be the principal concern of any legislation addressing apportionment of liability under § 10(b) and Rule 10b-5. Thus, although we support implementing a proportionate liability regime, we believe it is critical that all defendants remain jointly and severally liable to the plaintiff when a wrongdoer is unable to pay his or her share of any judgment.[71]

Furthermore, we believe that distinctions drawn in the bill between "primary wrongdoers" and intentional wrongdoers, on the one hand, and other wrongdoers, on the other, is so complex and ill defined as to be basically unworkable. The confusion created by this distinction will be particularly acute when a jury acts as the trier of the fact.[72] It will be difficult enough for judges and juries to apportion liability without asking them to make distinctions of the type § 203 now contemplates. These distinctions, and associated definitions, should be deleted from § 203 and a simpler proportionate liability scheme applicable to all defendants should be inserted into the bill. Elimination of the distinctions and definitions will also negate any suggestion in the current bill that intent rather than recklessness should be the culpability standard under § 10(b). For the reasons set forth in Section A, *supra*, it is critically important that recklessness remain the

[71] Congress should also consider whether a fair and efficient mechanism can be created in the proposed legislation which would allow a settlement without a proportionate reduction with a wrongdoer who is unable to pay his or her share but is prepared to surrender all of his or her resources.

[72] Section 203(b)(2)(A) defines "primary wrongdoer" as follows:

> (i) any
> (I) issuer, registrant, purchaser, seller, or underwriter of securities,
> (II) marketmaker or specialist in securities, or
> (III) clearing agency, securities information processor, or government securities dealer if such a person breached a direct statutory or regulatory obligation or if such person otherwise had a principal role in the conduct that is the basis for the implied right of action, or
> (ii) any person who intentionally rendered substantial assistance to the fraudulent conduct of any person described in clause (i), with actual knowledge that such conduct was wrongful.

There is no definition provided for key terminology such as "direct statutory or regulatory obligation" or "principal role." Moreover, great confusion will be created where, for example, a jury concludes that a "primary wrongdoer" is less at fault than a defendant who is secondarily liable (e.g. where a corporation acted recklessly, but was both less reckless and less responsible for the harm caused than the corporation's counsel).

culpability standard § 10(b) and be used in any proportionate liability scheme. In addition, the proportionate liability scheme should have the following basic elements:

1. As previously indicated, the bill should ensure that a victim of fraud is made whole when a wrongdoer is unable to pay his or her share of any judgment.

2. The criteria for determining "responsibility" in § 203(a) should be broadened to take into account factors such as the role of a responsible party in the transaction, and the *ability* of a wrongdoer to have prevented the fraud that occurred.

3. Section 203 now assumes that all proportionate liability determinations will be made in a unitary trial. A unitary trial may, at times, work against defendants because, for example, they may want to contest liability without having to point their fingers at each other. A court, however, may order a bifurcated trial under Rule 42(b) of the Federal Rules of Civil Procedure. This flexibility, in the interest of justice, should be continued. In a bifurcated proceeding, following a determination of liability, a separate trial would be held to determine the responsibility of each person found liable.[73]

Approval of Section 203's Settlement Process

In *Musick, Peeler & Garrett v. Employers Ins. of Wausau*,[74] the Supreme Court held that defendants in an action brought under § 10(b) and Rule 10b-5 have an implied right to seek contribution from joint tortfeasors. *Musick*, however, left at least two recurring questions unresolved. First, what effect does a plaintiff's settlement with fewer than all defendants have on the non-settling defendants' right to contribution? Second, assuming that courts may properly enter "bar orders" extinguishing the contribution rights of non-settling defendants and substituting for the right to contribution, a set-off against any eventual judgment, what is the appropriate method for calculating the set-off? The proposed bill codifies *Musick's* recognition of the right to contribution, and satisfactorily resolves these two issues.

[73] The bifurcated trial approach should not, however, involve bifurcated discovery, which could delay and make more costly either or both stages of trial. It may also not eliminate the problem referred to, since the same jury is likely to hear both parts of the trial, but it may mitigate it.

[74] 113 S. Ct. 2085 (1993).

Settlements are favored by the courts and in most cases at least partial settlement is achieved. If fewer than all defendants settle a securities fraud case,[75] all parties understandably want assurance as to how the partial settlement will affect their rights and liabilities with respect to any judgment ultimately rendered against the non-settling defendants. Plaintiffs hope that their settlement will not prove to be inadequate after a verdict is returned against the non-settling defendants. Settling defendants want comfort that they have in fact "bought their peace," and will not be targeted later by non-settling defendants seeking contribution. Non-settling defendants want protection against having to pay damages in an amount disproportionate to their relative fault.

When fewer than all defendants settle with the plaintiff, the federal policy favoring settlement tends to collide with the right to contribution. Under traditional contribution principles, the settling defendant remains potentially liable to a non-settling defendant for the judgment amount exceeding the non-settling defendant's proportionate share of fault. The specter of this peril, in most cases, operates as a disincentive to partial settlements.

To counteract the inhibiting effect of contribution on settlement, § 203(f) of the proposed bill mandates the entry of a contribution bar order in conjunction with any settlement. The bar order discharges the settling defendant of any further obligation relating to the plaintiff's claims by precluding non-settling defendants from asserting claims for contribution against the settling defendant.

To mitigate the harshness of contribution bar orders to non-settling defendants, whose contribution rights are extinguished, the bill then adopts the practice prevailing in the courts of granting the non-settling defendant a credit against any judgment later returned against it.[76] Essentially, the bill substitutes a credit against any eventual judgment in place of the right to contribution.[77]

The proposed bill mandates a reduction of any judgment entered against

[75] *See* Nelson v. Bennett, 662 F. Supp. 1324, 1329 (E.D. Cal. 1987) ("as a practical matter a single, comprehensive settlement agreement is exceedingly difficult to orchestrate in complex actions").

[76] *See* § 203(f)(2).

[77] Although the use of contribution bar orders had been widely accepted, the courts had been unable to agree on the appropriate method for calculating the credit to which the non-settling defendant is entitled. The divergent approaches to judgment reduction previously employed by the courts have introduced confusion and uncertainty into an area of the law that demands uniformity. The proposed bill is a welcome change in this regard.

a non-settling defendant by the greater of the amount of the settlement or the amount of the settling defendant's proportionate share of the damages.[78] We would limit the reduction to the defendant's proportionate share. This method of judgment reduction is the only approach that ensures that non-settling defendants will be exposed to liability commensurately with their culpability.[79] "Because the credit determination is made after a determination of liability, the proportionate method is always consistent with fault."[80] However, if the jury ultimately determines that the proportionate share of the settling defendant is greater, and that of the non-settling defendant is smaller than the settlement amount reflects, plaintiff's total recovery is limited to an amount smaller than what might otherwise have been recovered.

For example, assume plaintiff sues two defendants, A and B. Before trial, A settles with plaintiff for $10 million and obtains a contribution bar order. At trial, B is found 10 percent at fault while A is found 90 percent at fault. If the jury awards $50 million in damages, B would pay only $5 million ($50 million x 10 percent fault), netting the plaintiffs $15 million. Hence, under the proportionate share method adopted in the bill, plaintiffs do not recover the $35 million shortfall.

By placing the risk of an inadequate settlement on the plaintiffs, the proportionate share method encourages plaintiffs to obtain settlements that accurately apportion fault[81] and eliminates the need for the fairness hearing necessitated by the *pro tanto* approach to judgment reduction previously used by some courts, under which non-settling defendants receive a credit in the dollar amount paid in settlement by settling defendants.[82] In some cases, the proportionate share method serves to spur global settlement by a culpable non-settler following a partial settlement.[83]

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[78] Earlier in 1994, in *McDermott, Inc. v. AmClyde*, 114 S. Ct. 1461 (1994), a unanimous Supreme Court adopted the proportionate share approach to determining "how a settlement with less than all of the defendants in an *admiralty* case should affect the liability of nonsettling defendants." *Id.* at 1464 (emphasis added).

[79] *In re* Masters Mates & Pilots Pension Plan, 957 F.2d 1020, 1029 (2d Cir. 1992). *See also*, Franklin v. Kaypro Corp., 884 F.2d 1222, 1231 (9th Cir. 1989), *cert. denied*, 498 U.S. 890 (1990); *In re* Jiffy Lube Sec. Litig., 927 F.2d 155, 160 n.3 (4th Cir. 1991).

[80] *In re* Masters Mates, 957 F.2d at 1029.

[81] *See Jiffy Lube*, 927 F.2d at 160 61 note 3; Federal Deposit Ins. Corp. v. Deloitte & Touche, 834 F. Supp. 1155, 1161 (E.D. Ark. 1993); Alvarado Partners, L.P. v. Mehta, 723 F. Supp. 540, 552 53 (D. Colo. 1989), *appeal dismissed*, 936 F.2d 582 (10th Cir. 1991).

[82] *See In re* VMS Ltd. Partnership Sec. Litig., 803 F. Supp. 179, 182, n.1 (N.D. Ill. 1992); United States v. Western Processing Co., Inc., 756 F. Supp. 1424, 1431 (W.D. Wash. 1990); MFS Mun. Income Trust v. American Medical Int'l, Inc., 751 F. Supp. 279, 284 85 (D. Mass. 1990).

[83] *See, e.g., Western Processing Co.*, 756 F. Supp. at 1431.

The most common criticism leveled against the proportionate share method is that, because plaintiffs generally bear the risk of a bad settlement, the method discourages settlement. Critics argue that the inability to know the real value of a partial settlement until a jury determines the defendants' relative fault chills plaintiffs' desire to settle in two ways.[84] First, plaintiffs will be wary of defense settlement offers because a low settlement with a more culpable defendant may result in plaintiffs recovering less than their total damages proved at trial.[85] Second, critics charge that postponing the final determination of the set-off amount makes it difficult to draft a notice to the members of the plaintiff class that fairly presents the merits and value of a proposed settlement.[86]

Opponents also claim that having a jury determine the relative fault of all defendants, including those that settled, nullifies the administrative advantages of partial settlements.[87] Moreover, some courts have asserted that the proportionate share method encourages non-settling defendants to adopt a "blame the empty chair" defense at trial to increase the fault ascribed to the missing defendant.[88] This practice may force plaintiffs to prosecute their case so as to furnish a surrogate defense for the absent defendants.[89]

These concerns, however, on balance, do not overcome the basic advantages of proportionate claim reduction—i.e., allowing the accurate apportionment of fault and affording a defendant the ability to go to trial without facing unwarranted exposure.[90]

The argument that the proportionate share method unfairly requires plaintiffs to estimate the relative culpability of each defendant at the time partial settlement is considered[91] misapprehends the nature of the settle-

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[84] *See* TBG Inc. v. Bendis, 811 F. Supp. 596, 604 (D. Kan. 1992); Federal Savings and Loan Ins. Corp. v. McGinnis, Juban, Bevan, Mullins & Patterson, P.C., 808 F. Supp. 1269, 1278 (M.D. La. 1992); South Carolina Nat. Bank v. Stone, 139 F.R.D. 335, 343 (D.S.C. 1991).

[85] *See TBG Inc.*, 811 F. Supp. at 604.

[86] *See In re* Atlantic Fin. Mgmt. Inc. Sec. Litig., 718 F. Supp. 1012, 1018 (D. Mass. 1988). *See also In re* Masters Mates & Pilots Pension Plan, 957 F.2d 1020, 1029 (2d Cir. 1992); *In re* Jiffy Lube Sec. Litig., 927 F.2d 155, 160 note 3, 161 (4th Cir. 1991); *South Carolina Nat. Bank*, 139 F.R.D. at 343.

[87] *See Masters Mates*, 957 F.2d at 1029 (*quoting In re* Atlantic Fin. Mgmt. Inc. Sec. Litig., 718 F. Supp. at 1018); Dalton v. Alston & Bird, 741 F. Supp. 157, 160 (S.D. Ill. 1990).

[88] *See e.g.*, McDermott, Inc. v. AmClyde, 114 S. Ct. 1461, 1470 (1994); TBG Inc., 811 F. Supp. at 604. *See also, Federal Sav. & Loan Ins. Corp.*, 808 F. Supp. at 1279 note 16; *In re* Jiffy Lube Sec. Litig., 772 F. Supp. 890, 894 (D. Md. 1991).

[89] *See TBG Inc.*, 811 F. Supp. at 604; United States v. Western Processing Co., Inc., 756 F. Supp. at 1424, 1431 (W.D. Wash. 1990).

[90] *See* McDermott, Inc. v. AmClyde, 114 S. Ct. 1461, 1469 note 22 (1994).

[91] *See South Carolina Nat. Bank*, 139 F.R.D. at 343.

ment process and its attendant risks. Litigants voluntarily accept the deals they strike with adversaries. The proportionate share method recognizes that plaintiffs are best situated to evaluate the strength of their case against each defendant and properly requires them to bear some risk when choosing to accept immediate payment over having to prove their case to a jury.[92]

When fewer than all defendants choose to settle with the plaintiff, the entry of a contribution bar order in conjunction with the proportionate share method of judgment reduction is the best approach to harmonize the competing interests of promoting settlements and ensuring that defendants are treated fairly, while still ensuring the deterrent force of the federal securities laws.

4. *Section 204: Public Auditing Self-Disciplinary Board*

Section 204 creates a so-called "disciplinary" board for auditors, which in theory is supposed to ensure financial statement quality control and to provide greater investor confidence. Yet, rather than mandating that this new board be independent of the profession it is supposed to oversee, and open to public scrutiny, the bill instead permits the SEC to "designate an entity to serve as the Board" if it finds that such entity is "sponsored by an existing national organization of certified public accountants" that is "most representative" of CPAs, and has "demonstrated its commitment to improving the quality of practice before the Commission."[93] In other words, the bill allows the trade association for the accountants, the AICPA, to be the "disciplinary" board. Moreover, the proposed legislation provides that the Board will be financed by the very entities it is supposed to oversee. Importantly, this board is given the power in many circumstances to *preempt* actions by state accountant licensing agencies.[94]

Even more disturbing, the bill provides that all of the Board's proceedings will be kept completely confidential and legislates the inadmissibility of such information in civil and administrative proceedings. Thus, the bill provides that: 1) "all reports, memoranda, and other information prepared, collected, or received by the Board, and the deliberations and other proceedings of the Board and its employees and agents in connection with an

[92] *See McDermott*, 114 S.Ct. at 1471-72 (when limitation on plaintiff's recovery arises "by its own agreement to settle . . . [t]here is no reason to allocate any shortfall to the other defendants, who were not parties to the settlement").

[93] S. 1976, 103d Cong., 2d Sess. § 204(b) (1994).

[94] *Id.* § 204(f)(6)(C).

investigation or disciplinary proceeding" *will not* be subject to discovery in any civil action in state or federal court or before any state or federal administrative agency; 2) "[s]ubmissions to the Board by or on behalf of a public accounting firm or person associated with such a firm or on behalf of any other participant in a Board proceeding, including documents generated by the Board itself, shall be *exempt from discovery*" if they were "prepared specifically for the purpose of the Board proceeding" and "address[] the merits of the issues under investigation by the Board," and 3) *all of the foregoing information will be inadmissible* in any civil proceeding in state or federal court or before any state or federal administrative agency.[95]

We are concerned that these provisions will be used to prevent otherwise admissible and critical evidence from seeing the light of day in a civil litigation against accountants. Thus, these proposals could have the effect of immunizing accountants from civil liability for violating the securities laws. Such a provision will erode investor confidence in the securities markets and the requirements for audited financial statements.

These confidentiality provisions benefit the wrongdoer at the expense of the victims of security fraud. If audit failures have caused investors to be defrauded, prompt dissemination of all information that relates to these issues is called for. Instead, the bill would permit accounting firms to provide relevant information to the Board but keep such information from their victims unless and until civil discovery can pry it from the "public watchdog's"[96] files. Such a result is not in the public's interest.

CONCLUSION

Congress should enact legislation to restore aiding and abetting liability to § 10(b) of the Securities Exchange Act, which should be based on a reckless disregard standard. Congress should also enact a modified statute to create proportionate liability for securities fraud cases, and we urge Congress to otherwise modify S. 1976 in accordance with the foregoing analysis and recommendations.

A separate Report will be issued shortly addressing the proposed changes in § 102 relating to the Statute of Limitations.

December 1994

[95] *Id.* § 204(f)(5). The bill also makes peer review materials confidential. *Id.* § 204(g)(3).

[96] United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984).

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PSA

March 21, 1995

The Honorable Phil Gramm
Senate Banking, Housing and Urban Affairs Committee
370 Russell Senate Office Building
Washington, DC 20510

Dear Senator Gramm:

I am writing to urge your support for securities litigation reform, which will be the subject of hearings before the Senate Banking Committee tomorrow. The Public Securities Association represents banks and securities firms interested in preserving the health and stability of the nation's capital markets, and therefore strongly advocates legislation that would discourage unwarranted securities lawsuits that raise the cost of borrowing for all securities issuers. Our Association is currently on record supporting H.R. 1058, the Securities Litigation Reform Act which was recently passed by the House of Representatives.

Each of the markets represented by PSA exists primarily to serve public policy goals. The municipal bond market provides financing for state and local investment in infrastructure and other productive assets. The government and federal agency securities markets provide capital and liquidity for securities issued by the U.S. Treasury and U.S. government agencies in order to service debt and pay for national needs at the lowest possible cost of borrowing for taxpayers. The mortgage-backed securities market helps provide financing for home ownership. By bringing together investors and public sector borrowers, these markets together provide hundreds of billions of dollars in financing each year for investment which is vital to the nation's continued economic strength. The liquidity and efficiency of these markets are their key characteristics. Excessive litigation costs from unsubstantiated securities lawsuits hamper issuers' abilities to access the capital markets, and ultimately may be shouldered by taxpayers and homeowners throughout the nation.

The securities litigation measure passed by the House would provide an added level of protection for all United States securities markets against the damaging effects of unsubstantiated lawsuits without impeding the ability of legitimately aggrieved parties to seek legal redress. We would be pleased to assist the Committee in any way during the debate on securities litigation reform, and trust you will contact me if you need further information.

Sincerely,

Micah S. Green
Executive Vice President

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

NASAA

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Hand Delivery

April 5, 1995

The Hon. Richard Bryan
U.S. Senate
364 Russell Senate Office Bldg.
Washington, DC 20510

RE: Support for S. 667, the "Private Securities Enforcement Improvements Act of 1995"

Dear Senator Bryan:

We are writing today on behalf of the North American Securities Administrators Association (NASAA) to express our strong support for S. 667, the "Private Securities Enforcement Improvements Act of 1995." In the U.S., NASAA is the national voice of the 50 state securities administrators responsible for investor protection and the efficient functioning of the capital markets at the grassroots level.

As you know, NASAA's consistent position has been that any securities litigation reform must achieve a balance between protecting the rights of defrauded investors and providing relief to honest companies and professionals who may find themselves the target of a frivolous lawsuit. NASAA believes that abusive practices should be deterred, and where appropriate, sternly sanctioned. At the same time, the Association believes that care must be taken to keep open the doorway to the American system of civil justice for those investors who believe they have been defrauded.

In evaluating the variety of litigation reform measures that have been put forward in the 104th Congress, NASAA has applied one simple test: Will the reforms further the interests of investor protection? Proposals that target frivolous lawsuits without doing damage to critical investor safeguards have been and will continue to be supported by NASAA. At the same time, the Association will continue to stand in opposition to changes we determine will have the practical effect of eviscerating investors' legitimate remedies against fraud.

In NASAA's view, the challenge is to identify ways to make the litigation system more fair and more efficient, while preserving the essential role that private actions play in supporting the integrity of our financial markets. We believe that S. 667 accomplishes this critical balancing and should serve as the basis for action in the Senate.

Indeed, S. 667 is the first measure to be considered by the U.S. Senate that meets the simple tests of balance and fairness. NASAA applauds you and Senator Shelby for your efforts to craft responsible and fair reform proposals that target frivolous lawsuits without undermining the entire system of private actions. Specifically, NASAA strongly supports the following provisions of S. 667:

* An early evaluation procedure designed to weed out clearly frivolous cases, with sanctions imposed in certain instances;

* A more rational system of determining liability based on proportionate liability for reckless violators and joint and several liability for knowing violators, with provision made for special circumstances in which knowing violators are unable to satisfy a judgment;

* Certification of complaints and improved case management procedures;

* Curbs on potentially abusive practices on the part of plaintiffs' attorneys;

* Improved disclosure of settlement terms to class members;

* A reasonable safe harbor for forward-looking statements;

* Restoration of aiding and abetting liability;

* Extension of the statute of limitations for securities fraud suits;

* Codification of the recklessness standard of liability as adopted by virtually every circuit court; and

* Rulemaking authority to the Securities and Exchange Commission with respect to "fraud-on-the-market" cases.

S. 667 meets the challenge of achieving balanced litigation reform, and as such, is enthusiastically supported by NASAA. We respectfully urge all Senators to

give serious consideration to this measure as the appropriate response to the need for constructive improvement in the federal securities litigation process.

NASAA also would like to take this opportunity to reiterate the Association's serious concerns about another pending litigation reform proposal, S. 240, the "Private Securities Litigation Reform Act," introduced by Senators Domenici and Dodd. As you know, this legislation is identical to a bill the Senators introduced in the last Congress.

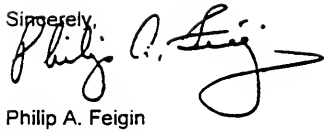
It might be suggested that S.240 now looks better than it did last year. After all, some argue, look how much more "moderate" it appears in relation to the securities litigation bill (H.R. 1058) approved by the House of Representatives. But surely it will be recognized in time that this kind of comparison is false and untenable. The legislation still would work to shield the most egregious wrongdoers among public companies, brokerage firms, accountants and insurance companies from legitimate suits brought by defrauded investors. NASAA believes that S. 240 remains an unacceptable alternative.

NASAA's concerns with S. 240 center around its following major provisions: (1) imposing unreasonable standards for fraud pleadings, burden of proof and damages; (2) requiring the appointment of a guardian ad litem or a steering committee to direct the course of the litigation; (3) introducing the concept of "means testing" for access to justice; (4) limiting joint and several liability in such a way so as to immunize from liability certain professional groups and to jeopardize recovery by defrauded investors; (5) replacing, in certain instances, the long-standing national policy in favor of access to justice whereby each side in a dispute pays its own fees and expenses with a "loser pays" standard; and (6) establishing a questionable system of self-regulation and discipline for accountants. In addition, the bill suffers from its failure to address the issue of aiding and abetting liability in the wake of the Supreme Court's *Central Bank* decision.

S. 667 is clear evidence that it is possible to craft litigation reform measures that target abusive practices without sacrificing the opportunity for redress and recovery for defrauded investors. Now, we have a common-sense vehicle for proceeding with a real debate in Congress about securities litigation reform. NASAA strongly supports S. 667 and calls upon every Member of the Senate to demonstrate his or her commitment to preserving the integrity of the marketplace by co-sponsoring this legislation. It is NASAA's view that this is one of the most important issues for small investors that will be considered by the 104th Congress.

If you have any questions or need more information about NASAA's position on S. 667 or S. 240, please contact Maureen Thompson, NASAA's legislative adviser, at 703/276-1116.

Sincerely,



Philip A. Feigin
President, NASAA
Securities Commissioner, Colorado Division of Securities

Mark Griffin
Chair, NASAA Action Group on Securities Litigation Reform
Director, Utah Division of Securities

(Substantially similar letter sent to Senator Richard Shelby)

cc: All Members, U.S. Senate

THE WALL STREET JOURNAL.

★ ★ ★ Eastern Edition FRIDAY, OCTOBER 28, 1994 White Oak, Maryland

Now It's SEC vs. the Lawyers

By J. Carter Beese Jr.

"Lawyers Acknowledge Litigation Crisis."

Improbable as that headline may sound, that's exactly what's happening in Washington these days. For far too long, gun-slinging plaintiffs' lawyers have forestalled meaningful discussion, much less meaningful reform, of the crisis affecting the securities litigation system in America.

But the numbers tell an undeniable story—there is a crisis and it's getting worse. In 1989, cash settlements for securities class-action suits totaled an estimated $329 million. In 1993, settlements jumped nearly threefold to $1.4 billion. Those payments come right off the bottom line or out of the R&D budget, thus hampering U.S. competitiveness.

Recently, the Securities and Exchange Commission decided to stand up and be heard on this issue. In a "concept release" that carries symbolic significance far beyond its simple terms, the SEC announced this month that it has decided to re-examine the liability standards for companies that issue earnings projections and other forward-looking information to investors. The commission also resolved to hold a roundtable hearing on Feb. 13 to bring all sides together. This concept release, the first step in the rule-making process, could be a big win for investors.

Under present law, the SEC encourages companies to provide forward-looking information—or, put another way, senior management's best estimate of where the company is heading. Unfortunately, one weak link exists in the chain of information between management and investors—"entrepreneurial" plaintiffs' lawyers. Never bashful about exploiting new opportunities, plaintiffs' attorneys have used class-action lawsuits as a means of making companies guarantors of any and all forward-looking statements. Pity the chief financial officer who estimates future earnings of "X" if, due to unforeseen events, the actual earnings come in at "X minus 1."

Symbolically, the action by the SEC could not have been clearer. It acknowledged that a problem does in fact exist, and that the SEC is committed to finding ways of solving it. In effect, the long-standing opponents of serious litigation reform have been intellectually isolated. Always quick to tarnish the motives of those in the business community who would interfere with their money machine, trial lawyers lack the ammunition to challenge the credibility of the SEC.

Job one at the SEC is the protection of investors. This is a duty at which the SEC has excelled for more than 60 years. Thanks in large part to the diligent efforts and professionalism of the SEC, a regulatory structure has evolved in the U.S. that has allowed the deepest and fairest markets in the world to develop.

Identifying the problem, however, is only half of the equation. Workable solutions must also be found. In my view, the model to follow in attempting to solve this litigation crisis already exists. The SEC should adopt a rule that provides a "safe harbor" patterned after the state corporate-law doctrine known as the "business judgment rule" to protect companies that provide good-faith projections to investors. Under this new rule, the SEC, and not private "get-rich-quick" litigation mills, would be responsible for policing companies that make material misstatements regarding forward-looking information.

The SEC knows that investors want full and fair disclosure, and has committed itself to making it safe for companies to provide such disclosure again. Under the business judgment rule, officers and directors would be protected from hindsight-based judicial review of shareholder antifraud claims, unless a plaintiff could establish a conflict, a lack of good faith, or a failure of honest and reasonable belief. The business judgment rule is based on the premise that it is the duty of the directors to run the corporation and that courts should not second-guess directors' good-faith business decisions.

As with many things in life, baseball offers a fitting example. For 20 years, Wrigley Field did not have lights for night games because a court applied the business judgment rule. A minority shareholder of the company that owns the Chicago Cubs sued the board of directors and Philip Wrigley, president and majority shareholder. In his suit, the minority shareholder argued that the Cubs could make more money if they put lights in Wrigley Field. But the board argued that doing so would cause the surrounding neighborhood to deteriorate and, in the long run, hurt attendance. Although the court acknowledged that the board may not have made the best business decision possible, it deferred to the board's good-faith judgment on the issue.

If the SEC wants corporations to provide projections voluntarily, corporate officers need and deserve this same leeway to exercise their judgment and make good-faith mistakes.

No one should make the mistake of interpreting the SEC's action as an invitation to commit fraud. The SEC has the authority to bring actions against companies making false or misleading forward-looking statements and will continue to do so. While some may argue that the SEC does not have the resources to pursue every conceivable case in this area, that's precisely the point. Perhaps not every conceivable case needs to be brought in order to protect our markets. We should have a minimum threshold of improper conduct, which excludes good-faith mistakes, before the legal papers start to fly. Investors will clearly be the winners in the long run as the flow of communication between senior management and investors is enhanced.

These first steps by the SEC reflect a moment of some historic importance—the point at which the government moved from merely debating whether a litigation crisis exists in this country to grappling with solutions to the crisis. In sports terms, the pre-game warm-ups are now over, and the real ballgame has begun.

Mr. Beese is a member of the Securities and Exchange Commission.

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Office of the Associate Dean

March 27, 1995

Hon. Phil Gramm
Subcommittee on Securities
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

RE: S. 240 and H.R. 1058

Dear Senator Gramm:

Mr. Sheldon Elsen, who appeared on behalf of the Association of the Bar of the City of New York before the Subcommittee on Securities last week in connection with the above referenced bills, informed me that a question has arisen about whether the courts are using Federal Rule of Civil Procedure 11 to impose sanctions on lawyers who bring frivolous securities and RICO/securities cases. Mr. Elsen asked me to provide you with some information about the use of Rule 11 in such cases.

I have been following Rule 11 since it was amended in 1983, and I have written a Treatise on the subject. See G. Vairo, Rule 11 Sanctions (2d ed. & 1994 Supp. Prentice Hall Law & Business). My research discloses that Rule 11 is used very actively in securities and RICO/securities cases. In fact, I devote a section of one chapter in my book to such cases because it is one of the "hot" areas of Rule 11 activity. I have enclosed for you a copy of the relevant pages, which discuss or cite approximately 50 Rule 11 cases in the securities and RICO/securities area. Almost all of these cases are reported in the West Federal Reporter. In addition to these cases, there are cases reported only on electronic data bases. I conducted a search today which reveals that Rule 11 has been so-cited in 343 cases. My review of a sample of these cases suggests that the search may be overbroad to the extent of between 5 to 10%. Accordingly, it would be safe to assume that there are over 300 reported Rule 11 cases in the securities and RICO/securities area. I have also attached a copy of my search terms and the list the search generated.

One problem in evaluating the use of Rule 11 is that reported cases are merely the tip of the iceberg. All commentators believe that there are many hundreds more unreported cases. Thus, it is impossible to know the exact number of cases in which Rule 11 sanctions have been imposed or threatened in securities and RICO/securities cases.

I would be happy to provide you with any other information, or with additional analysis.

Sincerely yours,

Georgene M. Vairo

Court of Appeals found that the Rule 11 motion and the appeal were part of a vendetta against the defendant, and imposed Rule 38 sanctions.

The 1993 Advisory Committee has attempted to deal with the problem of cross-motions by providing for prevailing party fee-shifting. Rule 11(c)(1) provides that the court may award to the prevailing party on a Rule 11 motion the reasonable costs, including attorney's fees, for making or opposing the Rule 11 motion.[470.1] This provision is important because fee-shifting as a Rule 11 sanction has been deemphasized.[470.2]

However, the 1993 Advisory Committee also makes clear that Rule 11 motions continue to be subject to Rule 11 as well:

> As under former [1983 version] Rule 11, the filing of a motion for sanctions is itself subject to the requirements of the rule and can lead to sanctions. However, service of a cross motion under Rule 11 should rarely be needed since under the revision the court may award to the person who prevails on the motion under Rule 11—whether the movant or the target of the motion—reasonable expenses, including attorney's fees, incurred in presenting or opposing the motion.

[e] Rule 11 and RICO and Securities Cases

Rule 11 is increasingly involved in RICO and securities fraud cases. The cases generally split into two types. In one, in which sanctions are frequently imposed, the plaintiff's attorney has made fanciful factual allegations to provide the basis for making RICO or federal securities claims that vest the federal courts with subject matter jurisdiction.[471] In the other

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470.1. The rule provides that: "If warranted, the court may award to the party prevailing on the motion the reasonable expenses and attorney's fees incurred in presenting or opposing the motion."

470.2. *See* §§ 2.04[e][1][C][v] & 9.01.

471. *See e.g.*, *Ryan v. Clemente*, 901 F.2d 177 (1st Cir. 1990). *See also Burnette v. Godshall*, 828 F. Supp. 1439, 1448 (N.D. Ca. 1993) (inadequate fact investigation; sanctions imposed); *Sable v. Southmark/Envicon Capital Corp.*, 819 F. Supp. 324, 343 (S.D.N.Y. 1993) (same).

line of cases, the essential problem with the claim is that the legal theory is shaky. In these cases, sanctions are less likely.

With respect to the first line of cases, involving the factual basis of claims, many courts are acting preemptively by requiring the plaintiff to file a "RICO case statement" as a way of ensuring compliance with Rule 11.[472] Many of the orders requiring such statements state that the case statement should include the facts relied upon to initiate the RICO claim "as a result of the 'reasonable inquiry' required by Rule 11."[473]

When a reasonable inquiry has been made, the courts will not sanction plaintiff's attorney.[474]

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472. *See, e.g., Chartrand v. Chrysler Corp.*, 785 F. Supp. 666, 668–69 (E.D. Mich. 1992) (imposing sanctions). *See generally* Report of Federal Procedure Committee, New York State Bar Association Commercial and Federal Litigation Section.

473. *See e.g., Kurz v. Mairone*, No. 86–5587 (E.D. Pa. Dec. 19, 1987) (available on LEXIS); *Sopis v. Tsaqaris*, [1987–88 Transfer Binder] RICO Bus. Disp. Guide (CCH) ¶ 6713 (S.D.N.Y. July 24, 1987); *R.M. Perez & Associates, Inc. v. Welch*, No. 85–3263 (E.D. La. May 14, 1987) (available on LEXIS); *Robinson v. Mount Vernon Realty, Inc.*, [1985–87 Transfer Binder] RICO Bus. Disp. Guide (CCH) ¶ 6484 (D.D.C. Dec. 17, 1986); *John L. Motley Associates, Inc. v. Rumbaugh*, 97 Bankr. 182, 186 (E.D. Pa. 1989), *reprinted in* 1990 RICO Business Dispute Guide (CCH) ¶ 7453. *See Schwechter v. Estate of Berger*, No. 88–C–2688 (N.D. Ill. Apr. 4, 1988) (available on LEXIS) (court directed plaintiff to submit RICO case statement, in part, to minimize prospect of Rule 11 motion by defendants).

474. *See, e.g., Ford Motor Co. v. Summit Motor Prod., Inc.*, 930 F.2d 277, 290 (3d Cir.), *cert. denied sub. nom. Altran v. Ford Motor Co.*, 112 S. Ct. 373 (1991) (no sanctions because "there was a reasonable, albeit tenuous" basis for RICO counterclaim); *Princeton Economics Group v. AT&T*, 768 F. Supp. 1101, 1116–17 (D.N.J. 1991) (sanctions not justified where allegations were based on first hand knowledge); *Morin v. Trupin*, 747 F. Supp. 1051 (S.D.N.Y. 1990) (In a civil RICO/securities case, the district court denied the defendant's motion for Rule 11 sanctions; "The record does not convincingly indicate that plaintiffs failed to make an objectively reasonable inquiry into the basis of their claims."); *Harrison v. Dean Witter Reynolds, Inc.*, 132 F.R.D. 184 (N.D. Ill. 1990) (After the district court granted summary judgment in favor of defendants, defendants moved for Rule 11 sanctions. The district court imposed sanctions in part and denied in part, finding that the plaintiffs (1) had conducted a reasonable prefiling inquiry as to the factual basis of their complaint, given that plaintiffs did

For example even though the court in *Smith v. Our Lady of the Lake Hospital, Inc.*,[475] suggested that attorneys should be especially diligent when determining whether to bring RICO actions, it reversed the Rule 11 award for the RICO claim and asserted:

> We view the attorney's duty under Rule 11 as particularly important in RICO cases:
>
> Given the resulting proliferation of civil RICO claims and the potential for frivolous suits in search of treble damages, greater responsibility will be placed on the bar to inquire into the factual and legal bases of potential claims or defenses prior to bringing such suit or risk sanctions for failing to do so. [citations omitted]. We in no way retreat from that position today.
>
> Nevertheless, given this circuit's requirements for RICO actions *at the time Smith filed his suit*, we must conclude that the district court abused its discretion in basing its decision to impose sanctions upon an erroneous view of the law as it applied to the facts of the case. Although we doubt the merits of Smith's suit, his RICO claim raised "good faith arguments based on existing law," [citations omitted] and the attorneys' investigation, while not perfect, was reasonable under the circumstances.[476]

As for cases involving purely the legal theory of the case, courts tend to be hesitant to sanction because the law on RICO remains unsettled and ever changing. For example, in *Rochester Midland Corp. v. Mesko*,[477] the court refused to impose sanctions on plaintiff's attorney because the law was unsettled. The court noted:

> The federal courts have struggled for more than five years over what constitutes a civil RICO claim. As of this date, the issue

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not possess certain critical information prior to discovery, but (2) had not done the same for the legal basis of their RICO and promissory note claims since they failed to recognize, even after notification, contrary controlling authority denying their claim), *appeal dism'd*, 974 F.2d 873 (7th Cir. 1992), *cert. denied*, 113 S. Ct. 2994 (1993). *Morin v. Trupin*, 711 F. Supp. 97, 114 (S.D.N.Y. 1989); *Thornock v. Kinderhill Corp.*, 712 F. Supp. 1123, 1132 (S.D.N.Y. 1989).

475. 960 F.2d 439, 444 (5th Cir. 1992).

476. *Id.* (emphasis supplied by court).

477. 696 F. Supp. 262, 268 (E.D. Mich. 1988).

remains unresolved. Rule 11 sanctions should not be imposed for the filing of an unsuccessful claim in an area of law as undecided as civil RICO unless the filing is patently without merit. Such is not the case at bar. Accordingly, the Court declines to impose sanctions for the filing of a RICO claim.[478]

In *Beverly Gravel, Inc. v. DiDomenico*,[479] the plaintiffs filed a RICO complaint. After successfully moving for summary judgment, defendants moved for Rule 11 sanctions. The district court declined to impose sanctions. The Seventh Circuit affirmed: "Plaintiffs filed their complaint soon after the United States Supreme Court decided *Sedima*, in the midst of attempts by the federal courts to construe the pattern requirement of RICO. Given the state of the law on the issue at the time plaintiffs' complaint was filed, their complaint evidences a reasonable inquiry into the law. Plaintiffs' factual assertions were sufficiently grounded in fact for purposes of Rule 11. Just because these facts are weakly characterized as evidence of fraudulent activity under RICO and plaintiffs lost on summary judgment does not in itself warrant sanctions."[480]

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478. *Id. See also Mendell v. Greenberg*, 927 F.2d 667 (2d Cir. 1990), *amended*, 938 F.2d 1528 (2d Cir. 1991) (Plaintiff brought an action under the federal securities laws, alleging that shareholder approval of the merger was obtained by means of a materially misleading proxy statement. The district court denied defendants' motion for Rule 11 sanctions. The district court found that although plaintiff's claims were subject to dismissal on summary judgment, they were not so lacking in a colorable basis to warrant sanctions. The Second Circuit affirmed); *Richardson Greenshields Securities Inc. v. Lau*, 809 F. Supp. 249 (S.D.N.Y. 1992) (declining to impose sanctions) *amended amd superseded on other gds.*, 819 F. Supp. 1246 (S.D.N.Y. 1993); *Guzzello v. Venteau*, 789 F. Supp. 112, 117–18 (E.D.N.Y. 1992) (Rule 11 sanctions should be sparingly applied); *Scholes v. Stone, McGuire and Benjamin*, 786 F. Supp. 1385, (N.D. Ill. 1992) (declining to impose sanctions in Rule 10b–5 action because law unsettled); *Miller v. Helmsley*, 745 F. Supp. 932, 940 (S.D.N.Y. 1990) (no sanctions imposed because Second Circuit decision clarifying law was handed down after briefs were filed). *First City National Bank and Trust Co. v. FDIC*, 730 F. Supp. 501, 516 (E.D.N.Y. 1990) (no sanctions because RICO law in flux); *West Mountain Sales, Inc. v. Logan Manufacturing Co.*, 718 F. Supp. 1084, 1087–88 (N.D.N.Y. 1989) (law had changed).

479. 908 F.2d 223 (7th Cir. 1990).

480. *Id.* at 230.

Attorneys filing RICO cases should beware of pushing this principle too far. As Judge Pratt wrote in *O'Malley v. New York City Transit Authority*,[481] in reversing the district court for refusing to impose sanctions,

> Mere lack of clarity in the general state of some areas of RICO law cannot shield every baseless RICO claim from Rule 11 sanctions, and affirmation of the district court's view would encourage bringing all sorts of groundless RICO claims, in direct contravention of both the language and purpose of Rule 11.[482]

Courts of Appeals will reverse district courts for refusing to sanction RICO plaintiffs if their claim is baseless. In *Pelletier v. Zweifel*,[483] the district court disposed of all the RICO and securities fraud claims by granting a motion to dismiss on some of the claims, and others on summary judgment. Defendant moved for Rule 11 sanctions. The district court refused.

In a lengthy opinion, the Eleventh Circuit reversed, holding that the suit was baseless and prosecuted in bad faith. The appellate court awarded sanctions imposed against the attorney and the client.[484]

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481. 896 F.2d 704 (2d Cir. 1990).

482. *Id.* at 709. *See also Harris Custom Builders, Inc. v. Hoffmeyer*, 834 F. Supp. 256, 263 (N.D. Ill. 1993) (defendant sanctioned for asserting RICO and antitrust counterclaims; no legal basis and improper purpose); *Aizuss v. Commonwealth Equity Trust*, 847 F. Supp. 1482 (E.D. Ca. 1993) (sanctions imposed; inadequate investigation into basis for RICO claims); *Schrag v. Dinges*, 153 F.R.D. 665 (D. Kan. 1993) (same); *Asbeka Industries v. Travelers Indemnity Co.*, 831 F. Supp. 74, 89-91 (E.D.N.Y. 1993) (not every business letter deposited in a postal box is mail fraud; imposing sanctions); *Greenfield v. U.S. Healthcare, Inc.* 146 F.R.D. 118, 126–27 (E.D. Pa. 1993) (inadequate investigation into whether named plaintiff could adequately represent the class warranted sanctions), *aff'd*, 22 F.3d 1274 (3d Cir. 1994); *Kushner v. DBG Property Investors, Inc.*, 793 F. Supp. 1161, 1181 (S.D.N.Y. 1992) (frivolous claims warranted sanctions); *Leogrande v. Leogrande*, 799 F. Supp. 1354, 1363–64 (E.D.N.Y. 1992) (sanctions against plaintiff's attorney warranted); *Project 74 Allentown, Inc. v. Frost*, 143 F.R.D. 77 (E.D. Pa. 1992) (over $200,000 in sanctions imposed), *aff'd*, 998 F.2d 1004 (3d Cir. 1993).

483. 921 F.2d 1465 (11th Cir.), *cert. denied*, 112 S. Ct. 167 (1991).

484. *See also Brubaker v. City of Richmond*, 943 F.2d 1363, 1376 (4th Cir. 1991) (reversing sanctions imposed for bringing RICO claim; *Sedima* did not

Applying the general rule that ignoring the precedent of the circuit in which the action is pending will result in sanctions[485] the Eighth Circuit in *Crookham v. Crookham*,[486] imposed sanctions against an attorney who was aware that there was a split in the circuits on the issue of whether there is a private right of action under § 17(a) of the Securities law, because he was unaware of the Eighth Circuit's negative holdings on the issue.

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shed light on issue posed); *Hartz v. Friedman*, 919 F.2d 469 (7th Cir. 1990) (Former clients brought a civil RICO action against attorneys who had represented them in a personal injury and medical malpractice action. The district court dismissed the RICO count and imposed sanctions against plaintiffs' counsel. The Seventh Circuit affirmed, holding that "while it does not appear that this complaint was filed for any improper purpose or in bad faith, it does appear that counsel neglected to make reasonable inquiry into the applicable law before filing." Also, plaintiff's counsel filed a motion to strike the defendant's motion to dismiss without citing any authority; the Ninth Circuit deemed this "obviously a frivolous gesture, which was also sanctionable."); *O'Malley v. New York City Transit Authority*, 896 F.2d 704, 709–10 (2d Cir. 1990) (The district court characterized the RICO complaint, in a case arising out of a worker's compensation dispute as "the most 'baseless' RICO claim ever encountered" but did not impose sanctions. The Second Circuit remanded: "[W]e do think that the district judge should consider whether imposition of sanctions against both the attorney and his client would be proper in the instant case. . . . The circumstances here differ from the norm in that the party who instigated the action is also a practicing attorney."); *Curtis v. Duffy*, 742 F. Supp. 34 (D. Mass. 1990) (In a civil RICO action, plaintiff alleged that the defendants' conduct was part of a general scheme by the insurance industry to subvert a statutory system for the insurance of automobile liability. After dismissing the complaint, the district judge, taking up the defendant's motion for Rule 11 sanctions, noted that the case "has enough of the indicia of a purely vindictive action to warrant an evidentiary hearing."). *But see E.F. Hutton Mortg. Corp. v. Equitable Bank, N.A.*, 678 F. Supp. 567, 588 (D. Md. 1988) (counsel for both sides pressed frivolous RICO claims. "Since each side is equally at fault, no sanctions will be imposed.").

485. *See supra* § 6.05 [a][1][A].

486. 914 F.2d 1027, 1029–30 (8th Cir. 1990).

[1] Copycat Complaints

The Third Circuit dealt with a problem confronting many defendants in RICO and securities fraud cases, the problem of so-called "copycat complaints." In a 2-1 decision, the court in *Garr v. U.S. Healthcare, Inc.*,[486.1] decided that attorneys filing copycat cases must engage in reasonable investigations of their own rather than rely on the investigation of counsel who file the first action.

Garr involved a typical scenario. Indeed, the following facts are a summary of the *Garr* facts. Plaintiff's securities lawyer A reads a newspaper article about a corporation with a headline that says insiders sold stock before a large decline in stock price. His firm maintains a list of corporate stockholders available to become plaintiffs. Before talking to any of the prospective clients, lawyer A does some further research: *i.e.*, reading other newspaper articles about the company, other background and public information about the company, including various SEC filings. Lawyer A "was seeking to generate a lawsuit.[486.2]

Lawyer A then contacts a stockholder from the list. He describes the article to the prospective client and determines that the person owns stock in the company. The stockholder agrees that if lawyer A believes there has been wrongdoing, a lawsuit could be filed on his behalf. "Within hours" lawyer A determines that a class of shareholders had securities claims based on the insider sales.[486.3]

Lawyer A files class action number 1, then after being contacted by a lawyer from another jurisdiction, files a virtually identical class action complaint with another named plaintiff. Lawyer A then contacts other lawyers to tell them about the lawsuit, and informs them of the products of his research. These lawyers, "lawyers B" ask lawyer A to fax them a copy of the complaints already filed. Lawyers B, who had a previous professional relationship with lawyer A and his firm, read the complaint, reread the newspaper article, and prepare and file "copycat complaints."

The twist in the story at this point is that within hours of the filing of these complaints, the defendants' attorneys filed motions for Rule 11 sanctions in all the actions.[486.4] The defendants' attorneys explained that

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486.1. 22 F.3d 1274 (3d Cir. 1994).
486.2. *Id.* at 1275.
486.3. *Id.*
486.4. *Id.* at 1276-77.

they anticipated that after the filing of the original complaint, there would be copycat actions filed that would be part of a drive to find allies in the lucrative pursuit of becoming the lead attorney in the expected nationwide class actions that might be filed.

In another twist, the plaintiff in the first case finally read the complaint, and realized that he did not want to sue the corporation because his son had substantial business dealings with the defendant corporation. He ordered lawyer A to withdraw the complaint. Defendants then supplement their Rule 11 motion to add that lawyer A had failed to make a reasonable inquiry into whether the stockholder could be an adequate class representative.

The district court orders the targeted attorneys to prepare a submission detailing their Rule 11 pre-filing inquiry. In *Garr*, the district court found:

1. Lawyer A did not violate Rule 11 with respect to the claims raised in the original complaint. He had engaged in an investigation that was reasonable under the circumstances;

2. Lawyer A violated Rule 11 by failing to sufficiently inquire into the stockholder's ability to serve as class representative;

3. Lawyers B violated Rule 11 by relying on the investigation of lawyer A, rather than engaging into their own investigation.

The majority of the Third Circuit panel affirmed, but a vigorous dissent was filed.

The majority agreed with the district court that Rule 11 imposes a nondelegable duty on attorneys to investigate the factual and legal basis for a position. However, this analysis is problematic in at least two respects. First, it ignores the case law that an attorney is generally entitled to place some reliance on the investigation of counsel with whom they have dealt with before and whom they have found to be responsible counsel.[486.5] As the dissent also notes, because the purpose of Rule 11 is to prevent the filing of baseless papers, it also should be relevant that the complaint in question stated colorable claims; indeed, the second complaint filed by lawyer A that had a good class representative, survived a motion to dismiss.[486.6]

The dissent argues that it is counterproductive to look into the

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486.5. *See* § 6.03[h].

486.6. *Id.* at 1282.

prefiling conduct of attorneys where a nonfrivolous pleading is presented to the court. Such an inquiry would waste court time for no real propose, and encourages the kind of Rule 11 motion brought in this case. Indeed, the dissent comes close to suggesting that the Rule 11 motions could also have been sanctionable on the same theory since the papers were clearly prepared before the defendants had seen the copycat complaints. What kind of reasonable investigation could the defendants' make in a couple of hours?

The dissent closes by noting that the majority seeks to prevent the indiscriminate filing of lawsuits, but argues that the majority's approach will not lead to a greater deterrent effect, but will lead to the filing of more Rule 11 motions. The dissent is correct.

[f] Rule 11 and Summary Judgment Motions

One interesting question that has arisen is whether Rule 11 sanctions can be imposed after a trial if summary judgment has been denied.

In some cases, courts will refuse to impose sanctions when summary judgment has been denied.[487] The argument against imposing sanctions is that if the case was good enough to survive summary judgment, it cannot be a sanctionable case.

The 1993 Advisory Committee supports this point. It provides:

> That summary judgment is rendered against a party does not necessarily mean, for purposes of [the factual] certification, that it had no evidentiary support for its position. On the other hand, if a party has evidence with respect to a contention that would suffice to defeat a motion for summary judgment based thereon,

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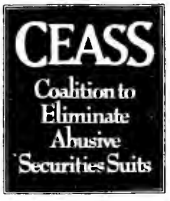
487. *Olsen v. United Parcel Service*, 892 F.2d 1290, 1298 (7th Cir. 1990); *Teamsters Local Union No. 430 v. Cement Express, Inc.*, 841 F.2d 66, 69 (3d Cir.), *cert. denied*, 488 U.S. 848 (1988) ("Rule 11 may not be invoked because an attorney, after time for discovery, is unable to withstand a motion for summary judgment."); *G. D. Searle & Co. v. Medicore Communications, Inc.*, 843 F. Supp. 895, 913 (S.D.N.Y. 1994) (no basis for sanctions where most of plaintiff's claims were sufficiently supported to survive cross-motion for summary judgment).



April 4, 1995

The Honorable Phil Gramm
United States Senate
370 SROB
Washington, DC 20510

Dear Senator Gramm,

The members of the Coalition to Eliminate Abusive Securities Suits (CEASS), an alliance of nearly 1,400 U.S companies, professional firms and organizations representing high-technology, financial services and basic manufacturing sectors, strongly believes that there is a pressing need to reform our nation's securities litigation system. Hundreds of abusive class action lawsuits are filed annually, many of which are totally unsubstantiated. A small group of lawyers file these suits knowing that they can coerce settlements from companies that understand it is cheaper to settle than win a protracted legal battle.

S. 240, the Private Securities Litigation Reform Act of 1995, introduced by Senators Domenici and Dodd and cosponsored by 37 Senators on both sides of the aisle, would solve this problem. The bill would create strong deterrents against filing speculative suits and transfer control of securities litigation from lawyers to investors. Equally important, S. 240 would encourage defendants to fight abusive claims and focus the resources of our legal system on truly meritorious ones.

We urge you to support this important legislation and help secure prompt consideration by the full Senate.

To illustrate the widespread support for action to curb securities litigation abuses, we are enclosing select editorials and articles from newspapers across the country underscoring the need for reform.

Sincerely,

1317 F Street, N.W.
Suite 600
Washington DC 20004
Telephone (202) 662-3750
Fax (202) 638-7045

CHICAGO TRIBUNE MAR 2 9 1995

Taming needless, costly lawsuits

For a long time, lawsuit abuse has been a problem much like the weather: Everyone talks about it, but no one does anything about it. That has changed dramatically since the Republican takeover of Congress, which signaled a sudden and welcome decline in the political influence of personal-injury lawyers and self-styled consumer advocates.

They had always aligned themselves with congressional Democrats, who in turn had foiled every attempt to tame the excesses afflicting our civil-justice system. The Republicans, by contrast, promised tort reform, and they are doing their best to deliver it.

The package of measures passed by the House shows that the pendulum that had swung so far to encourage destructive and costly litigation is now swinging back. The Senate is likely to tread more warily, but clearly some reforms are on the way.

The House attacked on a wide front. It established national standards for product liability, recognizing that nearly every commodity today trades in a national market. In all cases, it set reasonable limits on pain and suffering and punitive damages, which can magically transform a minor injury into a ticket to Easy Street. In securities actions, it tried to curtail groundless lawsuits by shareholders alleging fraud, which are often merely a way of extorting settlements from corporations whose stock prices have dropped.

The chief misstep by the House is a "loser pays" provision. It aims at discouraging frivolous lawsuits by requiring a litigant to pay the other side's legal costs if the other side offers a settlement that turns out to be larger than the eventual court award. The danger is that many legitimate victims will be afraid to sue, lest they be socked with a fat legal bill.

But mostly, the House effort tries to strike a wise balance between the need to deter misconduct by manufacturers and doctors and the need to avoid punishing them for injuries they didn't cause.

Opponents of tort reform would have you believe that the average person will suffer for being able to collect less in damages. But the average person pays dearly for the current liability system—in higher prices for products ranging from stepladders to drugs, in the loss of valuable products that are pulled off the market because some jury ignored scientific evidence and found them unsafe, in taxes to cover the legal costs of municipalities that have found that liability can sprout from every pothole and playground.

The average person grasps what the critics of tort reform do not: The legal system needs to be reined in to make sure it rewards only real victims and penalizes only genuine wrongdoers. The House made a good start in that direction. The Senate has the job of doing better still.

Wall Street Journal
March 30, 1995

Class-Action Clash

King of 'Strike Suits' Finds Style Cramped By Legal-Overhaul Bill

House Would Curb Litigation When Stock Prices Drop; Why Mr. Lerach Objects

CEO: 'I'd Punch Him Out'

By Jill Abramson and Amy Stevens
Staff Reporters of The Wall Street Journal

San Diego trial lawyer William Lerach is the king of the "strike suit," securities class-action lawsuits that hit when a company's stock drops. Executives from Wall Street to Silicon Valley routinely trade horror tales about being "Lerached."

Now Mr. Lerach's potent legal weapon is at risk of being "Newtered."

Part of the Republican legal-revision drive passed by the House this month under Speaker Newt Gingrich would put a big crimp in strike suits. So Mr. Lerach is leading the drive by trial lawyers to squelch the securities-litigation-overhaul bill in the U.S. Senate. No trial lawyer has been a more generous contributor to Democrats, whom opponents of the bill are counting on to block it or water it down. And none has more at stake in the outcome.

William Lerach

Mr. Lerach's law firm is involved in about one-quarter of all securities class actions; by his estimate, that is about 250 pending cases, alleging more than $10 billion in damages. In Silicon Valley, where more than half of the top computer and high-tech firms have been hit with strike suits, no lawyer is more feared or hated than Mr. Lerach.

"He is to this kind of lawsuit what IBM is to computers, but IBM has a smaller market share," says Brian Borders, president of the Association of Publicly Traded Companies, a group that includes companies that have been sued, sometimes more than once, by Mr. Lerach. GOP Rep. Christopher Cox, whose California corporate constituents have been on the receiving end of his lawsuits, calls Mr. Lerach's practice "an extortion racket" he says meritless strike suits are filed mainly to extract settlements from companies fearful of litigation costs and big fees for lawyers.

Corporate Campaign

Now they are striking back. Mr. Cox introduced the legislation to revise securities litigation that passed the House as part of the GOP "Contract With America." Mr. Borders is one of the lobbyists involved in a multimillion-dollar corporate campaign to get a somewhat-altered version of Mr. Cox's bill through the Senate this year. The bill they want would halt fishing-expedition lawsuits by forcing lawyers to specify factual charges in their initial complaints, and it would protect executives from liability when they make forecasts that don't pan out. The bill also has a losers-pay clause.

The 49-year-old Mr. Lerach, who views himself as a protector of defrauded shareholders, isn't conceding the battle. And if he is a symbol of the excesses of the current tort system, he is also emblematic of the immense political clout that the trial bar still enjoys in Washington, even as Democrats, the major beneficiaries of its largess, have lost control of Congress. Until the Republicans swept in in November, the donations of Mr. Lerach and like-minded trial lawyers meant that Democrats provided an insurance policy against almost all tort-revision bills, including securities-litigation overhaul. Mr. Lerach's total contributions to the Democratic Party and candidates at the federal and state level (including those from family members and law partners) exceed $1 million during the past five years.

'You Have to Give'

Mr. Lerach's sprawling Fairbanks Ranch estate has become a familiar site for Democratic fund-raising receptions. He says he doesn't link his contributions to his lobbying (indeed, that would be illegal). "There is no tie," he says, "but in this system you have to give."

And money, of course, does help win access, an edge Mr. Lerach is exploiting to the hilt. Mr. Lerach will soon be speaking with Christopher Dodd, the Connecticut Democrat who is a chief sponsor of the Senate's securities-litigation bill, in hopes of weakening some key provisions. Party officials were well aware that Mr. Lerach was unhappy over Mr. Dodd's appointment as co-chairman of the Democratic National Committee and worried that he might boycott party fund raising. Mr. Lerach says he hasn't closed his wallet and will soon host events for two Massachusetts Democrats, Sen. John Kerry and Rep. Joseph Kennedy.

According to one party official, Mr. Lerach attempted last year to enlist Democrats, including Sen. Bob Graham of Florida, who was deeply involved in party fund raising as chairman of the Democratic Senatorial Campaign Committee, to get Mr. Dodd to back off the overhaul bandwagon. Sen. Graham, according to a party official, refused. Mr. Lerach denies asking Sen. Graham to approach Sen. Dodd on his behalf, but confirms talking to him about securities-litigation change.

President Clinton and Vice President Al Gore have both been feted at lavish fund raising events held at Mr. Lerach's home. Mr. Lerach and his wife, in turn, were on the guest list at last fall's state dinner for Ukrainian President Leonid Kuchma. If Mr. Lerach fails to get satisfaction in the Senate, he will probably try to make securities-litigation overhaul presidential-veto bait. "I will fight to the death and use every potential device known to man to stop the legislation if it's like what came out of the House," he says.

Because the Senate bill is in flux, the White House doesn't yet have a position, although in a letter this month, it did express some reservations about the House bill. The administration's final position won't be affected by Mr. Lerach's contributions, according to White House counsel Abner Mikva.

Powerful Alliance

Besides making campaign contributions, Mr. Lerach endows and provides the energy behind a Washington lobby group, the National Association of Securities and Commercial Law Attorneys, that includes other attorneys who specialize in shareholder suits. The group has knitted together a formidable lobbying alliance that includes the American Association of Retired Persons, the AFL-CIO, the Consumer Federation of America and several of Ralph Nader's groups.

Mr. Lerach says his contributions and lobbying muscle amount to "spit in the ocean" when compared with the resources his foes have pumped into the fight. The accounting profession, for example, has backed up its lobbying efforts with some $4 million in contributions last year. An alliance of 1,400 companies, from the Big Six accounting firms to the securities industry to much smaller high-tech companies, are pouring millions of dollars into a lobbying campaign to pass a securities-litigation measure this year.

"I'm afraid if I got too close to him I'd punch him out," says Alan Shugart, chief executive of Seagate Technology Inc., whose Scotts Valley, Calif., disk-drive company has been sued by Mr. Lerach three times. Mr. Shugart, who is leading an effort to get a securities-litigation revision on the California ballot, says Seagate "paid ransom" to settle the first case and is still fighting the other two. "These cases are all frivolous, and all identical," he says. "They just copy them over, even the misspellings." Mr. Lerach denies the lawsuits are copied, saying they are prepared for each specific case. Mr. Shugart, he says, "is a sore loser."

While Mr. Lerach says he has never

been sanctioned for filing a frivolous lawsuit, a federal judge in Los Angeles fined him $2,400 in a 1992 case when Mr. Lerach tried to consolidate two securities cases and get himself appointed lead counsel. The judge also dismissed the suits. With characteristic bluster, Mr. Lerach blames the judge for being "an outspoken critic of class-action litigation."

Misplaced Toy

The speed at which Mr. Lerach's firm, Milberg, Weiss, Bershad, Hynes & Lerach, churns out complaints has also brought some embarrassing gaffes. For example, a 1993 complaint cited cigarette-maker Philip Morris Cos.' "success in the toy industry." He says his computerized spelling checker failed to pick up the error, and emphasizes that the New York tobacco and food company is identified correctly elsewhere in the document.

Apart from critics who complain that Mr. Lerach sometimes files lawsuits more for profit than for principle, the attorney has occasionally raised eyebrows over his legal maneuvers. In one case, he sued Pacific Enterprises, a Los Angeles utility holding company, on behalf of shareholders — and also sued former officers and directors on behalf of the company itself.

The Ninth U.S. Circuit Court of Appeals in Pasadena, Calif., said in February that it was "concerned about the potential conflicts" created by the dual representation, which netted Milberg Weiss $4 million in fees. Mr. Lerach says he acknowledges the court's concern, but says no conflict arose. He adds that having one law firm in both cases has tremendous advantages in helping to coordinate them.

Mr. Lerach prefers to highlight the millions of dollars he has recovered for defrauded investors and views himself as a civilian law enforcer. "We deter wrongdoing that's impossible to quantify," he says. "These companies are not afraid of the SEC; the worst they get in 90% of the cases is a consent decree. That's not the same as facing a multimillion-dollar lawsuit." He emphasizes that his firm refuses more cases than it files.

'Charming Rogue'

"I have enormous respect for him," says Tower Snow, a partner at the San Francisco law firm Brobeck, Phleger & Harrison, who has litigated against Mr. Lerach and describes him as a "charming rogue."

As the second-highest paid lawyer at Milberg Weiss, Mr. Lerach certainly makes millions of dollars a year. Last year alone, he and his partners were among the principal attorneys in cases that settled for a total of $295 million, according to Securities Class Action Alert. Since lawyers usually receive 25% to 35% of each settlement in contingency fees, the firm probably reaped the lion's share of $75 million last year — not including fees from its broad range of other legal work. (The firm refuses to disclose how much it shares with co-counsel.)

"If there's a criticism of us for making too much money," Mr. Lerach says, "it ought to be tempered by the knowledge that without well-capitalized, well-funded law firms willing to take these cases on a contingency basis, investors would never have obtained the recoveries they have."

Mounted on one wall of his San Diego law office, replete with its own bar, is a color poster depicting a rogues' gallery of 65 corporate executives named in lawsuits by his firm. "Look at these frauds from the past few years," it says. Among them: Michael Milken, David Paul and Charles Keating.

Ramona Jacobs, a plaintiff in Mr. Lerach's suit against Mr. Keating's Lincoln Savings & Loan, has come to Washington with him on several occasions and has testified against securities-litigation-overhaul legislation. She expects to recoup almost all of the $11,000 she and her daughter lost when they purchased Lincoln bonds in the late 1980s. "We would never have recouped anything without the lawyers that helped us," she says. On a recent Washington visit, Mr. Lerach had a group of angry Orange County investors in tow. "He parades around with his widows and orphans," grouses Rep. Billy Tauzin, a Louisiana Democrat and backer of securities-litigation revision.

Mr. Lerach himself was brought up by a widowed mother in Pittsburgh. Her government benefits helped send him to college. After graduating from the University of Pittsburgh Law School, Mr. Lerach joined the venerable local law firm Reed, Smith, Shaw & McClay. In 1976, the firm made him the youngest partner in its nearly 100-year history. At the time, he was handling a fraud lawsuit brought by investors in a San Diego financial institution. During the negotiations with fellow plaintiffs' attorneys, he met New York litigator Melvyn Weiss and soon joined his small law firm.

"He is extraordinarily articulate and resourceful," Mr. Weiss says. "He's always testing new theories and the parameters of people's rights."

Legal Merger

The firm has grown steadily to 90 attorneys, largely by adding young lawyers. Last fall, Mr. Lerach married one of them: Star Soltan, 32, whom he met several years ago when she was a Milberg Weiss associate in San Diego.

Mr. Lerach and his third wife are building a 10,000-square-foot villa plus a guest house and maid's quarters on 11 acres, complete with a tile-roofed doghouse matching the main structure. They need more space in part because Ms. Soltan is about to have their first child.

"We're going to have a little boy," Mr. Lerach says. "That ought to scare the corporate community."

SAINT PAUL PIONEER PRESS

13TH
JANUARY 1995
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BUSINESS
TWIN CITIES

DAVE BEAL

Stock plunges incite race to courthouse

STAFF COLUMNIST

You're the boss at a publicly held company, and suddenly orders plunge unexpectedly. Less than an hour after you convey the bad news to your shareholders, the price of your stock tanks. Less than 24 hours after that you find yourself in court, charged with securities fraud.

The lawsuit looks as phony as a three-dollar bill. Still, you decide to pay off the plaintiffs; at first there had been only one, but now there's a whole class of them. You settle for several million dollars without going to trial, which lets you avoid a huge legal bill and get on with running the company.

So goes the worst version of a nightmare top business leaders say they have experienced more and more over the last few years. In 1991, they fought back by firing up a national alliance to stop frivolous class action lawsuits. Allen Weltmann is national grass-roots coordinator for this movement, the Coalition to Eliminate Abusive Securities Suits, or CEASS.

Weltmann is also a partner with the Washington office of Coopers & Lybrand, a Big Six accounting firm that, like its peers, has seen its pocketbook thinned by securities liability litigation.

Two Minneapolis attorneys, Marc Whitehead and Scott Richter of the Popham Haik Schnobrich & Kaufman law firm, joined Weltmann here this week to talk about the growing controversy over class action securities litigation. Weltmann focused on legislative remedies proposed by Republican congressional leaders in the GOP's Contract With America. The two attorneys stressed ways to prevent legal crises before they occur.

There's disagreement over how much such litigation has risen, partly because so many suits get combined into single actions, but the list of Twin Cities companies named as defendants grew significantly last year. The merit of these cases is often difficult to judge since so few come to trial, but some filed here bear two characteristics that concern CEASS: filing promptly after a stock plunges, and boilerplate pleadings almost identical to those of other cases.

Weltmann says a handful of the nation's law firms monitor the stock market and insider trading reports. When they discover a sudden price decline at a deep-pockets company, plus stock sales by insiders, they look for a lead plaintiff and "race to the courthouse" with a claim that enables them eventually to land a big piece of the settlement.

High-tech companies have been juicy targets; their stocks are often volatile, and their managers take much of their pay in stock options and thus often sell their shares. California-based Seagate Technology, which employs more than 4,000 workers in the Twin Cities area, has been a frequent target. The coalition says that since 1985, 13 securities class action suits have been lodged against Seagate. Twelve were triggered by a price drop in its securities, the 13th by an earnings increase.

The House legislation seeks to raise the standards for bringing such lawsuits, protect companies from being sued just because their forecasts were off, and curb use of professional plaintiffs.

A shootout comes next week, when the bill gets a hearing in Washington. The CEASS concerns generally are shared by a long list of backers including the Wisconsin Investment Board, which manages $33 billion in public pension money.

But opponents are plentiful, powerful and persuasive, too. They include Ralph Nader, the Consumers Union and many attorneys. Both sides agree the courts are needed to protect investors from securities fraud, but Weltmann thinks the pendulum has swung too far in that direction.

"This is a process of intimidation," he declares. "The whole process is coercive. Fraud is not being deterred."

PHILADELPHIA INQUIRER APR 03 1995

Metropolitan Business Report

Suiting up for court

■ Proponents of legal reform just got more ammunition: Wyatt Co.'s annual survey on lawsuits filed against corporate directors and officers for alleged mismanagement showed that the cost of such suits hit a record high last year.

The survey tracks suits over a nine-year period, based on responses from 1,231 for-profit corporations in the United States.

In 1993, the average cost of settlements over the nine years was $3.3 million. A year later, it had jumped to $4.6 million. The average defense cost was $747,423 in the 1993 survey, last year, it jumped to $885,719.

While shareholders still account for the bulk of such suits, employees are growing more litigious, the survey showed.

Suing Corporate Directors

Here are the average costs of lawsuits against corporate directors for the nine-year period preceding each survey year.

Survey year	Settlements and awards	Defense costs
1994	$4,618,479	$885,719
1993	3,251,514	747,423
1992	3,257,441	676,769
1991	3,022,958	595,986
1990	1,938,501	490,822
1989	1,713,039	508,160
1988	2,012,173	329,833
1987	1,968,290	281,884

SOURCE: The Wyatt Co.

The Philadelphia Inquirer

National Law Journal
March 13, 1995

Pension Managers Speaking Up

Institutional investors ready for role in class action securities suits.

By Karen Donovan
National Law Journal Staff Reporter

INSTITUTIONAL INVESTORS that own huge blocks of stock traditionally have sat on the sidelines when companies in which they have a stake are sued in securities-fraud class actions. They have been content to let a small band of plaintiffs' lawyers file and settle the lawsuits.

But now, at least some of these institutions—pension funds—are investigating how their potentially powerful voices could be heard. Their involvement in these cases could alter the litigation's dynamics, regardless of what changes Congress makes to the class action system.

The Council of Institutional Investors in Washington, D.C., which represents 100 public, private and union pension funds that manage about $800 billion, has asked 10 law firms to submit proposals describing how council members could play a more active role in these suits. In a similar vein, a group of institutional investors that have been meeting since last year at Stanford Law School—all of whom happen to own stock in Intel Corp.—recently urged dismissal of class actions against Intel following disclosure of flaws in its Pentium chip.

The council's RFP, or request for proposal, which contemplates a tab for this legal work in the five-figure range, points out that large shareholders' failure to coordinate their involvement in class actions has created an "absentee" plaintiff class. "It seems naive to assume that shareholder interests are optimally represented when suits are more lawyer-driven than shareholder-driven," the council's RFP observes.

"The real blatant problem is that a small group of [plaintiffs'] lawyers are controlling everything," said Anne S. Hansen, the council's deputy director, who drafted the RFP. While her members are often among the plaintiffs in class actions who collect settlements, they also are particularly concerned about the cost of meritless litigation because they are long-term stockholders of the defendant companies, she said.

The council is eager to play a more forceful role in these suits. It is counting on lawyers to suggest the best ways of getting involved, and it foresees that the winning law firm will assist members in filing amicus briefs or monitoring litigation. The RFP itself, with a deadline of March 10 for responses, urges firms to be "creative" and states that the council would be open to a "pilot project" in a few test cases. "This is such an amorphous project right now," Ms. Hansen said. "We want a law firm with experience in these matters to advise us as to which cases are worth pursuing and which are not."

Peeved at Pentium Suit

A key council member behind the project is the California Public Employees Retirement System, known as Calpers, which last year provided the start-up money for an institutional investor forum at Stanford Law School. The forum is run by Prof. Joseph J. Grundfest, a vocal critic of the current class action system.

In February, Calpers and three other pension funds from the Stanford group decided to voice their complaints about what they saw as meritless class actions against Intel Corp. The cases alleged that Intel corporate directors committed securities fraud and violated fiduciary duties by their failure to disclose flaws in the Pentium chip. They sought damages on behalf of shareholders who bought at allegedly inflated prices during the class period, Jan. 1 to Dec. 9, 1994.

Calpers and the co-signers of the letter purchased Intel stock during this period and were potential members of the plaintiff classes. But they also continue to own several million shares of Intel stock. As their letter points out, the decline in Intel stock after its October announcement of the Pentium chip flaw was temporary, and once the company adopted a "no-questions-asked" policy regarding replacement, stock prices rose to levels higher than those just before disclosure of the flaw.

"Weak complaints can impose substantial and unnecessary costs on publicly traded firms that are forced to defend against such action," the letter observed in urging dismissal of the suits.

"We wanted to just basically step up to the plate and make our views known," said Calpers general counsel Richard H. Koppes. "When we looked at the facts as long-term holders [of stock], we said 'Hey wait a minute, as soon as Intel realized it had a public relations problem, it got corrected.'"

By the time the pension funds had drafted their Feb. 8 letter, the plaintiffs' lawyers had dropped their securities-fraud suit and, shortly after that, they agreed to dismiss the corporate derivative action. Still, Intel's defense lawyer, Robert A. Van Nest of San Francisco's Keker & Van Nest called the investors' letter "a very encouraging sign that investors are organizing themselves and taking a role to defeat shareholder litigation when there's no basis for it." Plaintiffs' lawyers said they had long decided to drop their suits, independent of the institutional investors' letter, owing to the rebound of Intel's stock. In fact, the lead plaintiffs' lawyer in the securities-fraud case, William S. Lerach of New York's Milberg Weiss Bershad Hynes & Lerach, called the investors' letter a "little sneak attack by some people trying to score a public relations coup." Mr. Lerach, the chief voice for the plaintiffs' bar in the debate over securities-litigation revision, said that institutional investors as a group, including the D.C.-based council, "have mutated to a point where they are aligning themselves more with management." That, he said, was also evident by the law firm names on the list selected by the council to receive its RFP. He said the firms mostly represent defendants in securities fraud cases.

Four of the firms due to submit bids are based in Washington, D.C. They are Covington & Burling, Crowell & Moring, Hogan & Hartson and Shaw, Pittman, Potts & Trowbridge. The other firms are Chicago's Mayer, Brown & Platt; San Francisco's Pillsbury, Madison & Sutro; Milwaukee's Foley & Lardner; Houston's Fulbright & Jaworski L.L.P.; and New York's Brown & Wood and Willkie Farr & Gallagher.

Washington Times
February 9, 1995

Out-of-control securities suits

By Theodore J. Boutrous Jr.

There is a real chance for major securities litigation reform during the 104th Congress.

Hearings are scheduled tomorrow on Title II of H.R. 10, a significant proposal to curb private securities-fraud suits introduced by over 100 Republican members of the House of Representatives as part of the Contract with America. Moderate House Democrats — like Rep. Billy Tauzin, who has introduced a similar bill — also should be receptive to H.R. 10. Securities litigation reform is likely to receive equally serious attention in the Senate, where Pete Domenici and Christopher Dodd are co-sponsoring another bill. And Securities and Exchange Commission Chairman Arthur Levitt recently called on Congress to fix the system, declaring that "investors and markets are being hurt by litigation excesses."

Most major securities lawsuits are filed as class actions. In turn, these actions invariably assert violations of Section 10(b) of the Securities Exchange Act of 1934, a general anti-fraud measure that Congress originally intended for use only by the SEC. Section 10(b) class actions, however, are not necessary to protect investors or ensure fair, honest and efficient capital markets. In fact, they are the source of the current system's worst problems.

Class actions are mainly intended to allow a case to be brought on behalf of a large group of similarly-situated individuals who have allegedly been injured by the defendant's conduct but probably would not themselves bring suit in their individual capacities because their respective losses are so small that it would not be worth it. In other words, the peculiar — and utterly perverse — idea behind class actions is to encourage individuals to pursue legal claims that the individuals do not themselves believe are worth pursuing. This extravagant approach toward allocating scarce judicial resources just doesn't work, at least in the federal securities context.

Indeed, numerous studies show that individual investors actually benefit very little from these sprawling lawsuits seeking millions of dollars on their behalf. They recover only a fraction (6 percent to 8 percent) of their alleged losses. A May 1994 report released by Mr. Dodd confirmed that class actions "tend to yield very low recoveries for investors."

The driving force behind the explosion of Section 10(b) class actions is not injured investors but rather trial attorneys who specialize in bringing such cases and almost always recover — in the form of contingency fees — a disproportionate share of the settlements and judgments when compared to the individual investors they ostensibly represent.

The examples are legion. Recently, a federal judge in New York threw out the Section 10(b) class actions that had been filed against cigarette manufacturer Philip Morris. Judge Richard Owen observed that the first lawsuit was filed, on behalf of a plaintiff who owned a mere 60 shares of stock, only five hours after the company announced that it was cutting the price of Marlboro cigarettes. Another nine suits were filed by the end of the next business day.

Judge Owen questioned how attorney-client relationships could have formed and produced full-blown lawsuits so quickly. He also pointedly noted that two of the lawsuits contained identical allegations, "apparently lodged in counsel's computer memory of fraud complaints, that the defendants . . . engaged in conduct to 'create and prolong the illusion of [Philip Morris] success in the toy industry."

In Frank vs. Cooper Industries, a Section 10(b) class action filed one day after the company's stock price fell, SEC General Counsel Simon Lorne took the extraordinary step of writing an opinion letter, which he invited the company to send to the court, expressing the view that the "vague and unenlightening" complaint was meritless. "Investors may suffer in several ways from the consequences of meritless securities litigation," Mr. Lorne's Nov. 8, 1994 letter said, "Such litigation can impose substantial unnecessary costs, including discovery expense, attorney fees, and time lost by corporate management. These costs are ultimately borne . . . by the public shareholders."

The April 1994 decision of the federal appeals court in Garr vs. U.S. Healthcare reads like a primer on the problems afflicting the system. This ill-fated case got started on Nov. 4, 1992, when an attorney from a Connecticut firm read a Wall Street Journal article about U.S. Healthcare's stock price decline. The law firm did not deny the "extraordinary allegation" that it "maintained a list of corporate stockholders available to become plaintiffs in securities litigation." Thus, as the court put it, "having a case but no client," the lawyer immediately called a person on the firm's handy stockholder list, described that morning's Journal article and later the same day filed a Section 10(b) class action on his behalf.

According to the court, however, once the "client" finally saw the complaint four days later, he realized that "he had made a mistake . . . because he knew of no basis for bringing [the action] and because his son had substantial business dealings in U.S. Healthcare." But a second class action — which replicated the allegations of the first one verbatim — had already been filed. While the district court ultimately dismissed both lawsuits and sanctioned the plaintiffs' attorneys for filing them, the two lawyers who filed the copycat suit appealed. By the time the appellate court rejected the appeal, these absurd suit had sucked up precious judicial resources for nearly 18 months.

H.R. 10 includes a number of provisions meant to address these problems, such as a rule requiring the loser in a lawsuit to pay the winner's attorney's fees. It would also establish new procedures restricting the ability of attorneys to manufacture class actions out of thin air. Moreover, the bill would impose stricter substantive requirements for private Section 10(b) claims, requiring, among other things, specific proof that the

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Theodore J. Boutrous Jr. is a lawyer in Washington who has written frequently about civil justice reform. He has defended firms against Section 10(b) suits

defendant intentionally (as opposed to recklessly or negligently) made misstatements that actually caused economic injury to the plaintiffs.

These reforms no doubt would improve the system. But in addition, Congress should at least consider an even simpler solution: eliminating altogether class actions based on alleged Section 10(b) violations. While at first this may sound like a radical alternative, it is not radical at all.

The fact is that class actions are not compensating injured investors. They are instead compensating contingency-fee lawyers and overloading the judicial system. Rep. Chris Cox, who drafted the securities provisions of H.R. 10, has called the current situation "an extortion racket" that amounts to a "national scandal of corruption." And the need for the class-action device was always dubious in securities cases. When government officials determine that society's best interests require it, numerous law enforcement agencies exist (e.g., the SEC, Justice Department and similar state government agencies) to prosecute wrongdoers whose actions inflict only minor injuries on individual investors.

The Section 10(b) private right of action also is a wholly unnecessary component of federal jurisprudence that Congress indisputably did not intend to create. It was instead invented by the courts in the 1940s and, ironically, it has eclipsed the many expressed rights that Congress did intend to afford private litigants.

Because of its sweeping, malleable standard (it bans "manipulative and deceptive" conduct), Section 10(b) provides an especially attractive vehicle for creative plaintiffs and their lawyers. Thus, as the Supreme Court has observed, "litigation under [Section 10(b)] presents a danger of vexatiousness different in kind and in degree from litigation in general."

Abolishing Section 10(b) class actions would, in one fell swoop, abolish many of the most egregious abuses of the system. Yet individuals would retain a comprehensive arsenal of remedies to redress their injuries, and the SEC would retain authority to enforce section 10(b), as Congress originally intended. Such a powerful reform should not be overlooked during the coming debate on the class action crisis in the 104th Congress

Why Class Action Attorneys Stalk High-Tech Companies

Rule of Law

By Mark Hoffman

My company, Sybase Inc., is among hundreds of high growth, high technology companies in California. Our story is not all that different from that of other successful high tech companies, but in one respect we stand out: We have not been hit with a securities class action lawsuit.

This is no small accomplishment. I read recently that more than a third of the top 100 companies in Silicon Valley have been subject to a securities class action lawsuit. Every CEO I know in the industry spends time worrying about facing one.

I founded Sybase in 1984 with my friend Bob Epstein in a back room of his Berkeley home. In the past 10 years our company has recorded tremendous growth, an average annual rate of more than 100% since 1987. Today, Sybase is the world's seventh-largest independent software company and a leading vendor of client/server software and services for building on-line, enterprise-wide information systems.

Our stock took a tumble this summer after we reported our second quarter financial results. While total revenues and earnings exceeded expectations, growth in one segment of our business did not. The stock has since recovered and our third quarter results appear to have removed previous concerns.

Nevertheless, when our stock fell I readied myself for a call from the lawyers. I knew that our board and management had done nothing wrong, but I also knew that our innocence really didn't matter in this particular legal game. As careful as we had been in our public statements, a stock drop and market confusion are precisely the "evidence" that class action lawyers pounce on to file suits.

High growth, high-tech companies are natural targets for class action securities suits because the inherent risks in rapidly changing, technology-driven industries lead to significant stock price volatility. The attorneys who specialize in class actions securities suits know that many courts will accept a sudden stock drop as prima facie evidence of malfeasance on the part of a company's directors.

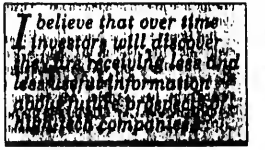
I have no problem with the basic right of shareholders to seek redress through the courts. Shareholder lawsuits are also necessary to bolster the enforcement efforts of the Securities and Exchange Commission. However, federal courts have greatly skewed the legal system in favor of plaintiffs in securities suits. Suits can be launched with very little "evidence." About all it takes is a turn of events that counters management's stated expectations, a precipitous stock drop, and officers trading stock.

Once these suits are filed, the class action attorneys inflate the discovery process, threaten huge judgments, and even subpoena your customers. They also enlarge their potential payoff by extending the suit to accountants, consultants and outside advisers.

Because securities suits are extremely complicated for jurors and expose corporations to the potential of multi-million dollar judgments, the class action attorneys enjoy extraordinary leverage in forcing early settlements. CEOs often decide to cut their losses and settle.

Given all this, it should be no surprise that the openness that once characterized the high-tech industry is being replaced by circumspection. News about business developments is carefully scrubbed. The once free-flowing dialogue between companies and investors is becoming more guarded. I believe that over time investors will discover they are receiving less and less useful information about the future prospects of high-tech companies. Ultimately, if something isn't done to reverse this trend, the stock prices for high-tech companies will no longer accurately reflect their values.

We need a fundamental rethinking of the laws and judicial procedures that regulate securities litigation. Shareholders must have easy and swift access to legal redress, but steps must also be taken to create a system that protects investors and punishes wrongdoers without feathering the nests of predatory attorneys. The key test of these reforms should be that they promote the disclosure of information that



investors need to make the best investment decisions.

The SEC is considering extending its "safe harbor" rule, under which companies cannot be held liable for forward-looking statements contained in their SEC filings, if made in good faith and with sufficient due diligence. The SEC is exploring ways of extending this protection to public statements in press releases, interviews and analysts meetings.

This change is long overdue. The information revolution has greatly reduced the average investor's reliance on 10Ks, annual reports, and proxy statements. Print and broadcast media and on-line services are saturated with news and advice for investors. Since the investment world demands that we communicate this way, doesn't it make sense that the SEC extend its safe harbor rule to these statements?

Something also needs to be done to change the "risk analysis" that class action attorneys now perform when deciding to launch a suit. It costs very little for a law firm to file an action because the pleading requirements are so low. A recent decision in the U.S. Ninth Circuit has made it even easier. The lawyers' potential payoffs are tremendous because of the way courts routinely calculate damages and attorney's fees. Consequently, class action attorneys see little downside and tremendous upside to harassing high-tech companies with securities suits.

Unquestionably the easiest way to correct this imbalance would be to enact the "loser pays" legislation proposed by Rep. Christopher Cox (R., Calif.), which is scheduled to be discussed tomorrow in the House subcomittee on telecommunications and finance. Doing so would raise the downside risk to the attorneys who abuse the current system. It would also encourage corporations to defend themselves rather that settling.

Sens. Christopher Dodd and Pete Domenici and Rep. Billy Tauzin have proposed other reforms that would also help balance the risks in securities litigation. Among them, tightening pleading requirements and pegging damage calculations to actual losses would certainly help, as would standardized fee schedules for class action attorneys, and proportional liability for secondary defendants.

All I'm hoping for is that class action attorneys have to think twice and perform their due diligence rather than race each other to the courthouse. If none of these reforms is adopted, class action attorneys will continue stalking the high-tech industry. The inevitable response will be a new code of silence in Silicon Valley. We will continue breaking new ground in technology. Unfortunately, the market will hear very little about it.

Mr. Hoffman is president, CEO and chairman of the board of Sybase, Inc., in Emeryville, Calif.

Wall Street Journal
March 10, 1995

Corporate Settlement Costs Hit a Record

By Wade Lanbert
Staff Reporter of The Wall Street Journal

A study says the cost of fending off lawsuits against corporate directors and officers hit a record last year, giving more ammunition to proponents of legislation that would curb frivolous shareholder litigation.

The cost of settlements in suits against directors and officers rose 39% to an average of $4.6 million for the nine-year period that ended in 1994, from an average of $3.3 million for the nine years ended in 1993, according to Wyatt Co., a Washington consulting firm. And settlements of shareholder suits – the most common and expensive claims – climbed 43% to $7.7 million on average, from $5.4 million a year earlier.

"The numbers are pretty staggering," said Phillip Norton, a Wyatt risk-management consultant who conducted the survey of 1,231 companies. "It is in fitting with the new Congress's mandate to do something about liability. . . . [Executives] feel it is a big tax on corporate America."

Mr. Norton said his survey's findings, which have shown a steady rise in costs, would quickly change if the bill passed this week by the House of Representatives becomes law. "If they do pass something with some teeth in it, it is going to create quite a difference in the Wyatt statistics," he said. The House bill would make it harder for disgruntled investors to sue public companies for fraud.

In addition to the actual settlement payments, companies also are forking over record amounts to outside law firms to fight the claims, the study found. For each claim – including those that companies won without paying a settlement – the average spending on outside counsel was $967,000, up 28% from $750,000 in the 1993 survey. Work on the cases ranged from a few months to several years before the claims were resolved. The figures don't include the cost of in-house attorneys also assigned to a case.

The Wyatt survey found that small companies, especially technology companies, have seen a sharper increase in lawsuits against directors and officers than larger corporations. Mr. Norton said less stable stock prices make smaller companies more vulnerable to suits alleging that the failure to disclose information affected the stock price.

"Currently a lot of the big [settlement] payouts have been coming from the high-tech sector," said Mr. Norton. Directors' and officers' insurance premiums for technology companies have increased as a result, while declining or remaining stable for other industries, he said.

The cost of lawsuits against directors and officers "is a hot issue in Silicon Valley," said Eric Keller, chief financial officer of Ventritex Inc., a Sunnyvale, Calif., company that makes implantable medical devices. Avoiding such suits is difficult, Mr. Keller said, "unless you can ensure that your stock [price] is always increasing." Mr. Keller said even in cases that a company expects to win, the cost of litigating puts pressure on the board to settle.

The study indicates some possible trends in new litigation. Although shareholder suits continue to account for the biggest portion of claims against directors and officers, their percentage has been declining, as other claims have increased at a faster pace. For instance, the number of employment lawsuits against directors and officers jumped by more than a third to 212 for the nine years that ended last year, from 157 for the nine years that ended in 1993. The average settlement cost of employment claims – including job-discrimination and harassment suits – was $247,000.

Though the majority of employment cases don't name directors and officers as defendants, claims are increasingly being made against top management, Mr. Norton said, especially in suits brought by other senior executives. More workplace-harassment suits also are being brought against directors and officers, Mr. Norton said, because of changing attitudes about corporate responsibility.

The Orange County Register
February 24, 1995

Security blanket

One provision of the Republican Contract with America's proposals for legal reform is little understood but could pay big dividends in productivity, encouraging innovation and speeding up the flow of information. The Securities Litigation Reform Act, crafted by Newport Beach Congressman Christopher Cox, seeks to make it more difficult for attorneys to file class-action lawsuits against companies while still maintaining protection for stockholders who really are victimized by fraudulent statements or misrepresentations.

What Rep. Cox seeks to curtail are what are called "strike suits." These often happen when the price of a company's stock goes down dramatically. Professional class-action plaintiff's attorneys then spring into action, alleging that the company must have been guilty of a "fraud on the market," based on increasingly liberal court interpretations of how culpable company officers are for falsely raising expectations of investors.

Whether fraud is eventually proven or not, these lawsuits are costly to defend. Even though 93 percent of such cases never go to trial, each lawsuit costs an average of $692,000 in legal fees. High-tech, biotechnology, and other growth companies are especially vulnerable since their stock prices tend to be especially volatile. But older, more established firms have been hit with strike suits also — one of eight companies on the New York Stock Exchange has received a strike suit. Lawyers in search of "deep pockets" also go after accounting firms, even though they usually have only a tangential relationship to securities transactions

Among the results of all this litigation are higher costs for products, layoffs, and people not hired. Such strikes also deter the free flow of information, since people who have

What Rep. Cox seeks to curtail are what are called 'strike suits.'

been chastened by a strike suit at their company or at a company they know about become increasingly cautious about just what they are willing to say. Choking off information hurts the kind of investors who do extensive research.

The Securities Litigation Reform Bill would deter lawyer-driven litigation by requiring court-appointed trustees for class-action plaintiffs rather than relying on a single lawyer. Full disclosure of proposed settlements will check settlements that benefit only lawyers. Professional plaintiffs who file repetitive lawsuits will be limited to five class-action lawsuits in three years. And losing litigants in securities cases (subject to some exceptions) will have to pay the winners' costs, including attorneys' fees.

The bill also would deter "fishing expeditions" by requiring lawsuits to allege specific facts that establish fraud. Lawsuits couldn't be brought simply because a stock price falls; litigants would have to show that they made investment decisions based on actual misrepresentations or omission of relevant information.

The purpose here is not to deny that companies sometimes make fraudulent statements when they offer stock or to eliminate court redress when an investor is actually victimized by fraud or misrepresentation. In fact, the hope is that with the courts less cluttered by frivolous or questionable cases brought in hope of an early settlement, actual victims of fraud will have a better chance of getting their cases heard.

This reform won't make markets perfectly efficient and honest by itself. But by reducing nuisance litigation, it should free up more capital for research, innovation, and job creation.

Fort Collins Coloradoan
January 16, 1995

Congress should set sights on tort terror in securities

Tony Snow

WASHINGTON — Washington has changed: Later this week, the House Commerce Committee will wage war on a breed of lawsuit that criminalizes the business cycle.

The beast is called a "10b-5" complaint, after a Securities and Exchange Commission rule that enables lawyers to accuse companies of securities fraud whenever bad news strikes. Barristers usually go on the offensive when they find a combination of depressed stock values, unexpected financial news and word that executives recently traded shares.

The 10b-5 rule lets attorneys open a company's books without first making a specific allegation. Borris Feldman, a partner at a San Francisco law firm that defends high-tech companies from such predations, explains: "Most of the time, these people don't know what they're looking for. The prevailing attitude is, 'Once we get in and look around, we may find a good case. If something turns up, we can proceed. If not, we can get them to settle.'"

The threat of ransacking a firm's records usually provokes a settlement; 93 percent of these suits never go to trial.

Some law firms actually put "victims" on retainer. The attorneys ask people what stocks they own and then attach the shareholder's names to suits against targeted companies.

The procedure was unmasked when attorneys placed a man's name on a complaint. The instaplaintiff asked a judge to remove his name because his son was one of the defendant's vendors.

Democrats have ignored this nonsense because some of their most cheerful contributors get rich from it. William Lerach, the dean of securities torts, is one of the party's major cash cows, which may have helped him get a good seat at a state dinner for the president of the Ukraine.

But Lerach's salad days may be numbered. Sen. Christopher Dodd, the new Democratic National Chairman, has co-sponsored a series of bills that would discourage 10b-5 suits. And Rep. Christopher Cox, R-Calif., a former securities lawyer, wants to take the fun out of business-bashing.

Cox's proposal which the Commerce Committee will review Thursday, recommends a liberal dose of common sense. Among other things, it would require plaintiffs to specify charges before filing a legal complaint. It also would let people sue only those actually involved in the action that harmed stockholders. (Today, lawyers can take aim at anyone remotely connected to the company, including such deep-pocket sources as accounting firms.)

The California Republican understands that the 10b-5 suits terrorize an American economy that has relied on inspiration and daring for two centuries. Any new company can expect a suit if its stock price is lower after two years of business. In a study of companies that began issuing stock in 1986, 62 percent reported having been sued by 1993.

American companies spend 15 times as much as their Japanese competitors and 20 times as much as European counterparts on defensive practices such as liability insurance.

Plaintiff's attorneys are fighting furiously against reform, even though 10b-5 cases occupy an itty-bitty niche in the tort business. They know that if Congress kills the securities scam, it won't be long before honorables also ring an end to the Golden Age of the Nuisance Suit.

Tony Snow writes for Gannett News Service. Address correspondence to The Coloradoan, Box 1577, Fort Collins, 80522, fax 224-7899.

Journal of Commerce

March 29, 1995

EDITORIAL/OPINION

Torts and the Securities Casino

By CAROL A. NOER

Republican control of Congress and growing concerns over professional plaintiffs offer legislators the best chance in years to reform the laws on securities litigation. The Securities Litigation Reform Act, now before Congress, achieves an equitable balance between an individual's right to redress grievances and the need to stop professional plaintiffs and their lawyers from enriching themselves at the expense of American business.

In the current judicial system, the scales are tipped in favor of the professional plaintiff. Filing suit can take as little as a matter of hours, and the rewards rival most lotteries: The average securities class action settlement was $7.4 million for cases between July 1993 and July 1994, up from $7.1 million the prior year, according to a study by National Economic Research Associates Inc.

Plaintiffs' law firms typically keep one-third of these settlements as fees; one such firm collected more than $4 billion in settlements and judgments in the last decade. The rest of the settlement fund is shared by all the class members. In 1993, plaintiffs received an average of only 6 to 14 cents on their original investment dollar.

For the lawyers, at least, this is a big business. A study by one plaintiffs' firm found that the number of suits filed against companies with large one-day drops in their stock price almost tripled to an average of about 300 each year between 1990 and 1992, up from an average of 100 a year from 1987 to 1989. One out of every 14 companies listed on the New York Stock Exchange has been sued for securities fraud.

The ultimate price of this litigation is enormous. Securities cases tie up the judicial system and distract management of the target corporation for years, and defense costs can reach into the millions. Consequently, most companies, even when confident of the merits of their case, elect to settle. As one executive observed, management cannot afford to bet the company's future on a jury verdict. A 1994 NERA study found that out of 177 shareholder lawsuits, 148, or 84%, were settled out of court, 22 were dismissed and only seven went to trial.

The millions spent in defending and settling these suits cost jobs and raise the price of goods, hurting the competitiveness of U.S. products. In addition, threats of these lawsuits can impede the flow of information from a company to the public. Executives are often hesitant to make any forward-looking statements, even when their research and understanding of their company and the marketplace should give them every reason to be confident. Seventy-one percent of companies surveyed by the National Venture Capital Associates were reluctant to discuss company performance with analysts.

Current securities laws and court rules make it easy for professional plaintiffs to generate securities fraud litigation:

- In many cases plaintiffs need not prove that they relied on a misstatement or omission.
- In most jurisdictions proof of actual intent to defraud is not necessary; plaintiffs need prove only that there was an extreme departure from the standards of ordinary care.
- Anyone who owns as little as one share of the security at issue may sue. This permits some firms to repeatedly use the same plaintiffs, who may own only a few shares in any given company.
- There is no limit on the number of suits a professional plaintiff may bring, and lead, or named, plaintiffs may receive bonus payments, also known as bounties.
- Since mail and wire fraud may be the basis for treble damages under the Racketeering Influenced and Corrupt Organizations Act, and since mail and phones are frequently used in securities transactions, plaintiffs can demand treble damages.

Thus, a plaintiff who knew nothing about company misstatements, who never relied on the misstatements in deciding to purchase shares and who owns as little as one share of stock can sue. He or she can expect a bonus payment and demand treble damages, and counsel can expect a fee of one third of an average settlement of $7.4 million.

There are many sections of H.R. 1058, which the House recently passed, that preserve an injured plaintiff's right to bring a bona fide case, but impede the professional plaintiff from filing frivolous litigation, including:

- Corporate estimates and projections are not actionable if the company clearly notes that they may not be realized.
- The losing party or its counsel can be liable for the prevailing party's attorneys' fees, at the court's discretion.
- Plaintiffs alleging fraudulent misstatements must prove that the defendant intended to deceive, defraud or manipulate, and that the defendant made the statement knowingly or recklessly. Recklessness is defined as an extreme departure from the standards of ordinary care, where the departure presents a danger to mislead and where such danger was either known to the defendant or was so obvious that the defendant must have been aware of it.
- RICO cannot be used in civil securities fraud cases.
- Plaintiffs' complaints must identify alleged misstatements or omissions, and the reasons the statement or omission was misleading.
- Plaintiff need not prove actual reliance on the misstatements or omissions unless the stock was thinly traded.
- A lead plaintiff cannot bring more than five class actions in any three-year period, and cannot receive bounty payments.

Any reform must strike a delicate balance. It must ensure that any remedy to the problem of frivolous litigation does not impinge on the right of the individual to pursue a bona fide claim. However, it also must recognize and protect the right of investors to appropriate corporate disclosure, and the right of companies involved in creating new jobs and products to be free from the fear that their industriousness will be their undoing.

If securities litigation isn't reformed, American business will be the loser. The only winners will be professional plaintiffs and their lawyers.

Carol A. Noer is vice president and underwriting counsel of Chubb & Son Inc.

SECURITIES SHENANIGANS
Scripps Howard News Service
Release date:01-17-95
Editorial
By Scripps Howard News Service / Akers

Smelling a racket, a federal judge in Manhattan has dismissed a class-action suit by stockholders against Philip Morris. The suit alleges that the company misled investors about its plans to drop the price of Marlboro cigarettes; when Philip Morris did just that, sending share value plunging, stockholders took it on the chin.

The judge was unamused that, in their race to the courthouse, the stockholders' lawyers had evidently forgotten to update their last computer-generated class-action suit. It still alleged fraud in ''the toy industry.'' Somebody forgot to delete ''toy'' and insert ''tobacco.''

But not all drummed-up shareholder suits self-destruct, and collectively they bleed American business. Young, high-tech companies, whose profits may wildly fluctuate, have become soft targets for a clique of lawyers who rush in when a stock price plummets. ''The list of companies that have been sued,'' says Sen. Pete Dominici, R-N.M., ''reads like a Who's Who of high-growth, high-technology and biotechnology companies.''

Most firms settle out of court because defending against a stockholder class-action suit easily can cost $5 million. Mounting a defense also drains executive time -- as much as one day per workweek -- and parks the defending company under an investment cloud. Suits, however flimsy, aren't often summarily tossed out because the Securities and Exchange Commission rule under which most are brought has been so fuzzed by a hodgepodge of judicial opinions. This maddening complexity drives up billable hours.

Executives who knowingly lead on investors, causing them losses, deserve to be held liable. Currently, however, the nogoodniks suffer at the same rate as the straight-shooters. Meanwhile, who profits? A coterie of lawyers with stock charts and fill-in-the-blanks fraud complaints. ''About nine firms'' bring more than half of all such suits filed, law professor John Coffee of Columbia tells The Wall Street Journal.

Responding to this predation -- which hurts investors and chills innovation -- Sens. Domenici and Christopher Dodd, D-Conn., plan to introduce legislation to tighten up the flabby SEC rule and to mandate arbitration in securities suits. Reform can't come too fast.

Investor's Business Daily
February 21, 1995

EDITORIAL

Beat The Lawyers

House Speaker Newt Gingrich warns the Common Sense Legal Reform Act will provoke one of the toughest fights for the GOP's "Contract With America." The fight makes so much sense, both as policy and as politics, that reformers should up the ante.

You couldn't pick a better enemy. Lawyers are perhaps the only group in America as unpopular as professional politicians. And the reform fits with the "downsizing government" theme, since plaintiffs' attorneys use the power of the state every time they drag their victims into court, and with every dollar they force us to spend in self-defense. Moreover, most of the proposed changes have significant bipartisan and liberal support.

The reform of greatest interest to *Investor's Business Daily* readers is almost certainly Title II, championed by Rep. Chris Cox, R-Calif. This aims to rein in "strike suits" — whereby companies are sued just because their stock drops.

These lawsuits do not benefit shareholders. Plaintiffs receive no more than 15% of the average award, according to a range of studies by The State of Wisconsin Investment Board, National Economic Research Associates and many others. Many of the suits are filed by professional litigants, who simply buy a few shares of many companies and wait for a price drop.

Meanwhile, honest investors suffer. Surveys of investor-relations personnel show that the threat of lawsuits limits voluntary disclosures of information. Corporate managers also cite fear of litigation as the biggest single obstacle to increased disclosure.

These suits chill innovation, as well as honesty. At least 19 of the 30 largest companies in Silicon Valley have been hit in the last six years for a total of $500 million, not including their own legal costs. A survey by the National Venture Capital Association found that 32% of entrepreneurial companies going public since 1986 had been sued by 1993.

The support for "strike suit" reform is strongly bipartisan — eight of 18 Democrats voted for it in the House Commerce Committee last week. Similar legislation has been authored by Sen. Christopher Dodd, D-Conn., the new head of the Democratic party, and backed by liberals like Sen. Barbara Mikulski, D-Md.

Another reform of interest to business would rein in product-liability lawsuits. These suits have closed down whole industries, from breast implants to IUDs.

Among other things, the provision limits punitive damage awards to $250,000, or three times compensatory damages, whichever is greater. It also offers protection against "joint and several liability," under which one company can be forced to pay "damages" even though it only did business with the real culprit.

Led by Rep. David McIntosh, R-Ind., House freshmen want these protections extended to suits against small businesses, local governments and nonprofits like the Little League.

They're absolutely right. Every American should share in relief from the "tort tax" that cost us $132.2 billion in 1991 and has grown 12% a year since 1980, according to Tillinghast, an insurance consulting unit of Towers Perrin.

Another section of the bill worth enlarging is Title I, which imposes the "loser pays" rule in some federal lawsuits. ("Loser pays" is also employed against strike suits.) Under this rule, also known as the "English rule," the loser in a personal-damage case has to cover the winners' court costs, up to reasonable limits.

The rule is employed by the rest of the world, including European welfare states such as Sweden. It's been endorsed by prominent liberals like Charles Peters of the Washington Monthly and James Fallows of Atlantic Monthly.

"Loser pays" doesn't make suing riskier or harder for the poor — it just takes away incentives for frivolous lawsuits. Law firms can still take cases on spec — but their speculation will be limited by the potential losses. They're no longer in a "no lose" situation.

Again, every American deserves protection against frivolous suits. Congress should take "loser pays" much further.

The opponents of common sense legal reform are *already* pulling out all the stops. Class-action lawsuits, which make up a disprortionate number of product-liability and strike-suit cases, earn $250 million a year for plaintiffs' attorneys. A good portion of that money will be spent lobbying against the reforms.

George Bushnell, the president of the 370,000-member American Bar Association, last week compared the Contract to "the invasion of our shores by foreign forces." And in describing the new leaders of Congress to the ABA convention, he used the adjective "reptilian" and another word that suggests they don't know who their fathers are.

Sounds like fightin' words to us, Newt. Why not hit back?

To: Members of the Senate Subcommittee on Securities

From: Wayne Abernathy and Courtney Ward

Date: April 7, 1995

Re: **Information on Frequency of Rule 11 Sanctions**

During the Subcommitte hearing on March 22, 1995, Chairman Gramm reported the findings of a search conducted at the Chairman's request by the Congressional Research Service (CRS), on the number of cases wherein Rule 11 sanctions had actually been imposed by judges in 10b-5 securities fraud cases. CRS had been able to find only three cases in the entire history of 10b-5 of the actual imposition of Rule 11 sanctions.

One of the witnesses, Mr. Sheldon Elsen, testifying on behalf of the Association of the Bar of the City of New York, said that his impression was that Rule 11 was used far more frequently than that. Chairman Gramm invited Mr. Elsen to provide to the Subcommittee information on additional examples of the imposition of Rule 11 sanctions in 10b-5 securities fraud cases.

Subsequently, at Mr. Elsen's request, Georgene M. Vairo, of the Fordham University School of Law, submitted to the Subcommittee the results of a computer search of court cases compiled by West Publishing Company. The Vairo search yielded 343 cases. It needs to be noted that the Vairo results were based upon a far broader search of cases than the narrow subject of 10b-5 securities cases, the focus of the legislation before the Subcommittee. The Vairo search included the mention of Rule 11 in cases that mentioned either "RICO" or "securities."

CRS was asked to conduct a review of the Vairo computer search, to determine which cases, if any, might involve the actual imposition of Rule 11 sanctions in 10b-5 cases. The result of the CRS review was that no additional examples of the imposition of penalties under Rule 11 for 10b-5 securities fraud cases were found.

CRS reaffirmed its earlier finding of only three cases in the history of 10b-5 in which Rule 11 sanctions were actually imposed.

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100. S arra v. Messina, 153 F.R.D. 22, RICO Bus.Disp.Guide 8515
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154. Charles Jacquin Et Cie, Inc. v. Marsalle Barands, Inc., 1991 WL 71101 (E.D.Pa., Apr 29, 1991) (NO. CIV. A. 89-5858)

155. Arntz v. National Educ. Center, 1991 WL 331347, RICO Bus.Disp.Guide 7939 (W.D.Mich., Mar 13, 1991) (NO. 190-CV-621)

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157. Marsam Const. Corp. v. Techno-Craft, Inc., 1991 WL 41768, RICO Bus.Disp.Guide 7723 (S.D.N.Y., Mar 11, 1991) (NO. 89 CIV. 0725 (CSH))

158. Merrill Lynch Pierce Fenner & Smith, Inc. v. Chipetine, 1991 WL 35493, Fed. Sec. L. Rep. P 96,561 (E.D.N.Y., Mar 05, 1991) (NO. CV-90-1998)

159. Aggregates (Carolina), Inc. v. Kruse, 134 F.R.D. 23 (D.P.R., Feb 26, 1991) (NO. CIV 90-1492 (JAF))

160. Durant v. Traditional Investments, Ltd., 135 F.R.D. 42 (S.D.N.Y., Feb 26, 1991) (NO. 88 CIV 9048 (PKL))

161. F.N. Wolf & Co., Inc. v. Estate of Neal, 1991 WL 34186, Fed. Sec. L. Rep. P 95,805, RICO Bus.Disp.Guide 7704 (S.D.N.Y., Feb 25, 1991) (NO. 89 CIV. 1223 (CSH))

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163. Smith v. Our Lady of the Lake Hosp., Inc., 135 F.R.D. 139, 20 Fed.R.Serv.3d 146 (M.D.La., Jan 22, 1991) (NO. CIV.A. 87-532-B)

164. Wegman v. Indal, Ltd., 1991 WL 10680 (N.D.Ill., Jan 18, 1991) (NO. 86 C 4744)

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311. Cuban v. Kapoor Bros., Inc., 653 F.Supp. 1025 (E.D.N.Y., Jan 30, 1986) (NO. CV-83-4954)

312. Medical Emergency Service Associates (MESA) S.C. v. Foulke, 633 F.Supp. 156, RICO Bus.Disp.Guide 6301 (N.D.Ill., Jan 06, 1986) (NO. 85 C 4604)

313. Pawlowske v. Chrysler Corp., 623 F.Supp. 569, 57 A.F.T.R.2d 86-892, 86-1 USTC P 9392 (N.D.Ill., Dec 13, 1985) (NO. 85 C 4209)

314. Beck v. Cantor, Fitzgerald & Co., Inc., 621 F.Supp. 1547, Fed. Sec. L. Rep. P 92,455, RICO Bus.Disp.Guide 6180 (N.D.Ill., Nov 19, 1985) (NO. 84 C 10557)

315. Martinez, Inc. v. H. Landau & Co., 107 F.R.D. 775, 54 USLW 2278 (N.D.Ind., Oct 23, 1985) (NO. CIV. F 85-10)

316. Northern Trust Co. v. Muller, 616 F.Supp. 788, 2 Fed.R.Serv.3d 1385 (N.D.Ill., Aug 28, 1985) (NO. 84 C 1073)

317. Centracchio v. Continental Ill. Nat'l Bank and Trust Co. of Chicago, 1985 WL 3630 (N.D.Ill., Aug 13, 1985) (NO. 83 C 9614)

318. Northern Trust Bank/O'Hare, N.A. v. Inryco, Inc., 615 F.Supp. 828, RICO Bus.Disp.Guide 6121 (N.D.Ill., Jul 29, 1985) (NO. 84 C 2077)

319. U.S. v. Persico, 620 F.Supp. 836 (S.D.N.Y., Jul 23, 1985) (NO. S 84 CR. 809 (JFK))

320. Rauenhorst v. U.S., 104 F.R.D. 588 (D.Minn., Feb 22, 1985) (NO. CIV. 4-79-241, CIV. 4-79-562, CIV. 4-84-864)

321. Davis v. U.S., 104 F.R.D. 509, 1 Fed.R.Serv.3d 839 (N.D.Ill., Feb 04, 1985) (NO. 84 C 5431)

322. In re Olympia Brewing Co. Securities Litigation, 613 F.Supp. 1286 (N.D.Ill., Jan 30, 1985) (NO. 77 C 1206)

323. WSB Elec. Co., Inc. v. Rank & File Committee to Stop 2-GATE System, 103 F.R.D. 417, 117 L.R.R.M. (BNA) 2994, 40 Fed.R.Serv.2d 568, 109 Lab.Cas. P 10,528 (N.D.Cal., Nov 09, 1984) (NO. C-84-2431-WWS)

324. Kostos v. Janney Montgomery Scott, Inc., 1984 WL 850 (Sep 10, 1984) (NO. 83 CIV. 6305-CSH)

325. S.E.C. v. Fraser, 1984 WL 2455, Fed. Sec. L. Rep. P 91,641 (D.D.C., Aug 30, 1984) (NO. 84-2652)

326. Goldman v. Belden, 580 F.Supp. 1373, Fed. Sec. L. Rep. P 91,447 (W.D.N.Y., Feb 24, 1984) (NO. CIV.-82-869T)

327. In re Longhorn Securities Litigation, 573 F.Supp. 274 (W.D.Okla., Sep 28, 1983) (NO. CIV. 82-2258-E, CIV. 82-2263-E, CIV. 82-2264-E, CIV. 82-2266-E, CIV. 82-2276-E, CIV. 82-2289-E, CIV. 83-1033-E)

328. In re Ramada Inns Securities Litigation, 550 F.Supp. 1127, Fed. Sec. L. Rep. P 99,011 (D.Del., Nov 04, 1982) (NO. 81-456)

329. Rodriguez v. Baldrich, 508 F.Supp. 614 (D.P.R., Jan 21, 1981) (NO. CIV. 79-1476)

330. Lenowitz v. Philadelphia Stock Exchange, Inc., 502 F.Supp. 428, Fed. Sec. L. Rep. P 97,801 (E.D.Pa., Dec 02, 1980) (NO. CIV. 79-4269)

331. Driscoll v. Oppenheimer & Co., Inc., 500 F.Supp. 174, Fed. Sec. L Rep. P 97,938 (N.D.Ill., Oct 28, 1980) (NO. 78 C 4970)

332. Nemeroff v. Abelson, 469 F.Supp. 630, Fed. Sec. L. Rep. P 96,849, 4 Media L. Rep. 2505 (S.D.N.Y., Apr 18, 1979) (NO. 77 CIV. 1472(RLC))

333. U. S. v. Marcano Garcia, 456 F.Supp. 1354 (D.P.R., Aug 29, 1978) (NO. CRIM 78-107)

334. Lucret Galarza v. Jimenez Oxio, 440 F.Supp. 47 (D.P.R., Nov 22, 1977) (NO. CIV 76-1366)

335. Ferrer Delgado v. Sylvia De Jesus, 440 F.Supp. 979 (D.P.R., Nov 05, 1976) (NO. CIV. 76-1030)

336. Browder v. U. S., 398 F.Supp. 1042 (D.Or., Aug 15, 1975) (NO. CIV. 73-987)

337. Cornaglia v. Ricciardi, 63 F.R.D. 416 (E.D.Pa., Apr 15, 1974) (NO. CIV 73-634)

338. Lewis v. Wells, 325 F.Supp. 382, Fed. Sec. L. Rep. P 92,980 (S.D.N.Y., Mar 27, 1971) (NO. 69 CIV. 4968)

339. Huber v. Bissel, 39 F.R.D. 346 (E.D.Pa., Dec 22, 1965) (NO. CIV. 36636)

340. Berkwich v. Mencher, 239 F.Supp. 792 (S.D.N.Y., Mar 17, 1965)

341. Molybdenum Corp. of America v. International Min. Corp., 32 F.R.D. 415 (S.D.N.Y., Apr 25, 1963)

342. In re Kouterick, 167 B.R. 353, 29 Fed.R.Serv.3d 356 (Bankr.D.N.J., May 24, 1994) (NO. 92-33447, 93-3079)

343. In re Langley, 86 B.R. 977 (Bankr.E.D.Wis., May 25, 1988) (NO. 86-05021

END OF CITATIONS LIST

II

104TH CONGRESS
1ST SESSION

S. 240

To amend the Securities Exchange Act of 1934 to establish a filing deadline and to provide certain safeguards to ensure that the interests of investors are well protected under the implied private action provisions of the Act.

IN THE SENATE OF THE UNITED STATES

JANUARY 18 (legislative day, JANUARY 10), 1995

Mr. DOMENICI (for himself, Mr. DODD, Mr. HATCH, Ms. MIKULSKI, Mr. BENNETT, Ms. MOSELEY-BRAUN, Mr. LOTT, Mrs. MURRAY, Mr. MACK, Mr. JOHNSTON, Mr. FAIRCLOTH, Mr. CONRAD, Mr. BURNS, Mr. CHAFEE, Mr. GORTON, Mr. HELMS, Mr. KYL, Mr. THOMAS, Mrs. HUTCHISON, Mr. SANTORUM, and Mr. PELL) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

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A BILL

To amend the Securities Exchange Act of 1934 to establish a filing deadline and to provide certain safeguards to ensure that the interests of investors are well protected under the implied private action provisions of the Act.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; TABLE OF CONTENTS.

(a) SHORT TITLE.—This Act may be cited as the "Private Securities Litigation Reform Act of 1995".

(b) TABLE OF CONTENTS.—The table of contents for this Act is as follows:

TITLE I—PRIVATE SECURITIES LITIGATION

SEC. 101. ELIMINATION OF CERTAIN ABUSIVE PRACTICES.

(a) RECEIPT FOR REFERRAL FEES.—Section 15(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(c)) is amended by adding at the end the following new paragraph:

"(7) RECEIPT OF REFERRAL FEES.—No broker or dealer, or person associated with a broker or dealer, may solicit or accept remuneration for assisting an attorney in obtaining the representation of any customer in any implied private action arising under this title.".

(b) PROHIBITION ON ATTORNEYS' FEES PAID FROM COMMISSION DISGORGEMENT FUNDS.—Section 21(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78u(d))

is amended by adding at the end the following new paragraph:

"(4) PROHIBITION ON ATTORNEYS' FEES PAID FROM COMMISSION DISGORGEMENT FUNDS.—Except as otherwise ordered by the court, funds disgorged as the result of an action brought by the Commission in Federal court, or of any Commission administrative action, shall not be distributed as payment for attorneys' fees or expenses incurred by private parties seeking distribution of the disgorged funds.".

(c) ADDITIONAL PROVISIONS APPLICABLE TO CLASS ACTIONS.—Section 21 of the Securities Exchange Act of 1934 (15 U.S.C. 78u) is amended by adding at the end the following new subsections:

"(i) RECOVERY BY NAMED PLAINTIFFS IN CLASS ACTIONS.—In an implied private action arising under this title that is certified as a class action pursuant to the Federal Rules of Civil Procedure, the share of any final judgment or of any settlement that is awarded to class plaintiffs serving as the representative parties shall be calculated in the same manner as the shares of the final judgment or settlement awarded to all other members of the class. Nothing in this subsection shall be construed to limit the award to any representative parties of reasonable

compensation, costs, and expenses (including lost wages) relating to the representation of the class.

"(j) CONFLICTS OF INTEREST.—In an implied private action arising under this title that is certified as a class action pursuant to the Federal Rules of Civil Procedure, if a party is represented by an attorney who directly owns or otherwise has a beneficial interest in the securities that are the subject of the litigation, the court shall make a determination of whether such interest constitutes a conflict of interest sufficient to disqualify the attorney from representing the party.

"(k) RESTRICTIONS ON SETTLEMENTS UNDER SEAL.—In an implied private action arising under this title that is certified as a class action pursuant to the Federal Rules of Civil Procedure, the terms and provisions of any settlement agreement between any of the parties shall not be filed under seal, except that on motion of any of the parties to the settlement, the court may order filing under seal for those portions of a settlement agreement as to which good cause is shown for such filing under seal. Good cause shall only exist if publication of a term or provision of a settlement agreement would cause direct and substantial harm to any person.

"(l) RESTRICTIONS ON PAYMENT OF ATTORNEYS' FEES FROM SETTLEMENT FUNDS.—In an implied private

action arising under this title that is certified as a class action pursuant to the Federal Rules of Civil Procedure, attorneys' fees awarded by the court to counsel for the class shall be determined as a percentage of the amount of damages and prejudgment interest actually paid to the class as a result of the attorneys' efforts. In no event shall the amount awarded to counsel for the class exceed a reasonable percentage of the amount recovered by the class plus reasonable expenses.

"(m) DISCLOSURE OF SETTLEMENT TERMS TO CLASS MEMBERS.—In an implied private action arising under this title that is certified as a class action pursuant to the Federal Rules of Civil Procedure, a proposed settlement agreement that is published or otherwise disseminated to the class shall include the following statements, which shall not be admissible for purposes of any Federal or State judicial or administrative proceeding:

"(1) STATEMENT OF POTENTIAL OUTCOME OF CASE.—

"(A) AGREEMENT ON AMOUNT OF DAMAGES AND LIKELIHOOD OF PREVAILING.—If the settling parties agree on the amount of damages per share that would be recoverable if the plaintiff prevailed on each claim alleged under

this title and the likelihood that the plaintiff would prevail—

"(i) a statement concerning the amount of such potential damages; and

"(ii) a statement concerning the probability that the plaintiff would prevail on the claims alleged under this title and a brief explanation of the reasons for that conclusion.

"(B) DISAGREEMENT ON AMOUNT OF DAMAGES OR LIKELIHOOD OF PREVAILING.—If the parties do not agree on the amount of damages per share that would be recoverable if the plaintiff prevailed on each claim alleged under this title or on the likelihood that the plaintiff would prevail on those claims, or both, a statement from each settling party concerning the issue or issues on which the parties disagree.

"(C) INADMISSIBILITY FOR CERTAIN PURPOSES.—Statements made in accordance with subparagraphs (A) and (B) shall not be admissible for purposes of any Federal or State judicial or administrative proceeding.

"(2) STATEMENT OF ATTORNEYS' FEES OR COSTS SOUGHT.—If any of the settling parties or

their counsel intend to apply to the court for an award of attorneys' fees or costs from any fund established as part of the settlement, a statement indicating which parties or counsel intend to make such an application, the amount of fees and costs that will be sought, and a brief explanation of the basis for the application.

"(3) IDENTIFICATION OF REPRESENTATIVES.—The name, telephone number, and address of one or more representatives of counsel for the plaintiff class who will be reasonably available to answer questions from class members concerning any matter contained in any notice of settlement published or otherwise disseminated to class members.

"(4) OTHER INFORMATION.—Such other information as may be required by the court, or by any guardian ad litem or plaintiff steering committee appointed by the court pursuant to section 38.

"(n) SPECIAL VERDICTS.—In an implied private action arising under this title in which the plaintiff may recover money damages only on proof that a defendant acted with a particular state of mind, the court shall, when requested by a defendant, submit to the jury a written interrogatory on the issue of each such defendant's state of mind at the time the alleged violation occurred.

"(o) NAMED PLAINTIFF THRESHOLD.—In an implied private action arising under this title, in order for a plaintiff or plaintiffs to obtain certification as representatives of a class of investors pursuant to the Federal Rules of Civil Procedure, the plaintiff or plaintiffs must show that they owned, in the aggregate, during the time period in which violations of this title are alleged to have occurred, not less than the lesser of—

"(1) 1 percent of the securities which are the subject of the litigation; or

"(2) $10,000 (in market value) of such securities.".

SEC. 102. ALTERNATIVE DISPUTE RESOLUTION PROCEDURE; TIME LIMITATION ON PRIVATE RIGHTS OF ACTION.

(a) RECOVERY OF COSTS AND ATTORNEYS' FEES.—The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by adding at the end the following new section:

"SEC. 36. ALTERNATIVE DISPUTE RESOLUTION PROCEDURE.

"(a) IN GENERAL.—

"(1) OFFER TO PROCEED.—Except as provided in paragraph (2), in an implied private action arising under this title, any party may, before the expiration of the period permitted for answering the complaint, deliver to all other parties an offer to proceed pursuant to any voluntary, nonbinding alternative dispute resolution procedure established or recognized under the rules of the court in which the action is maintained.

"(2) PLAINTIFF CLASS ACTIONS.—In an implied private action under this title which is brought as a plaintiff class action, an offer under paragraph (1) shall be made not later than 30 days after a guardian ad litem or plaintiff steering committee is appointed by the court in accordance with section 38.

"(3) RESPONSE.—The recipient of an offer under paragraph (1) or (2) shall file a written notice of acceptance or rejection of the offer with the court not later than 10 days after receipt of the offer. The court may, upon motion by any party made prior to the expiration of such period, extend the period for not more than 90 additional days, during which time discovery may be permitted by the court.

"(4) SELECTION OF TYPE OF ALTERNATIVE DISPUTE RESOLUTION.—For purposes of paragraphs (1) and (2), if the rules of the court establish or recognize more than 1 type of alternative dispute reso-

lution, the parties may stipulate as to the type of alternative dispute resolution to be applied. If the parties are unable to so stipulate, the court shall issue an order not later than 20 days after the date on which the parties agree to the use of alternative dispute resolution, specifying the type of alternative dispute resolution to be applied.

"(5) SANCTIONS FOR DILATORY OR OBSTRUCTIVE CONDUCT.—If the court finds that a party has engaged in dilatory or obstructive conduct in taking or opposing any discovery allowed during the response period described in paragraph (3), the court may—

"(A) extend the period to permit further discovery from that party for a suitable period; and

"(B) deny that party the opportunity to conduct further discovery prior to the expiration of the period.

"(b) PENALTY FOR UNREASONABLE LITIGATION POSITION.—

"(1) AWARD OF COSTS.—In an implied private action arising under this title, upon motion of the prevailing party made prior to final judgment, the court shall award costs, including reasonable attor-

neys' fees, against a party or parties or their attorneys, if—

"(A) the party unreasonably refuses to proceed pursuant to an alternative dispute resolution procedure, or refuses to accept the result of an alternative dispute resolution procedure;

"(B) final judgment is entered against the party; and

"(C) the party asserted a claim or defense in the action which was not substantially justified.

"(2) DETERMINATION OF JUSTIFICATION.—For purposes of paragraph (1)(C), whether a position is 'substantially justified' shall be determined in the same manner as under section 2412(d)(1)(B) of title 28, United States Code.

"(3) LIMITED USE.—Fees and costs awarded under this paragraph shall not be applied to any named plaintiff in any action certified as a class action under the Federal Rules of Civil Procedure if such plaintiff has never owned more than $1,000,000 of the securities which are the subject of the litigation.".

(b) LIMITATIONS PERIOD FOR IMPLIED PRIVATE RIGHTS OF ACTION.—The Securities Exchange Act of

1934 (15 U.S.C. 78a et seq.) is amended by adding at the end the following new section:

"SEC. 37. LIMITATIONS PERIOD FOR IMPLIED PRIVATE RIGHTS OF ACTION.

"(a) IN GENERAL.—Except as otherwise provided in this title, an implied private right of action arising under this title shall be brought not later than the earlier of—

"(1) 5 years after the date on which the alleged violation occurred; or

"(2) 2 years after the date on which the alleged violation was discovered or should have been discovered through the exercise of reasonable diligence.

"(b) EFFECTIVE DATE.—The limitations period provided by this section shall apply to all proceedings pending on or commenced after the date of enactment of this section.".

SEC. 103. PLAINTIFF STEERING COMMITTEES.

The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by adding at the end the following new section:

"SEC. 38. GUARDIAN AD LITEM AND CLASS ACTION STEERING COMMITTEES.

"(a) GUARDIAN AD LITEM.—Except as provided in subsection (b), not later than 10 days after certifying a plaintiff class in an implied private action brought under

this title, the court shall appoint a guardian ad litem for the plaintiff class from a list or lists provided by the parties or their counsel. The guardian ad litem shall direct counsel for the class and perform such other functions as the court may specify. The court shall apportion the reasonable fees and expenses of the guardian ad litem among the parties. Court appointment of a guardian ad litem shall not be subject to interlocutory review.

"(b) CLASS ACTION STEERING COMMITTEE.—Subsection (a) shall not apply if, not later than 10 days after certifying a plaintiff class, on its own motion or on motion of a member of the class, the court appoints a committee of class members to direct counsel for the class (hereafter in this section referred to as the 'plaintiff steering committee') and to perform such other functions as the court may specify. Court appointment of a plaintiff steering committee shall not be subject to interlocutory review.

"(c) MEMBERSHIP OF PLAINTIFF STEERING COMMITTEE.—

"(1) QUALIFICATIONS.—

"(A) NUMBER.—A plaintiff steering committee shall consist of not less than 5 class members, willing to serve, who the court believes will fairly represent the class.

"(B) OWNERSHIP INTERESTS.—Members of the plaintiff steering committee shall have cumulatively held during the class period not less than—

"(i) the lesser of 5 percent of the securities which are the subject matter of the litigation or securities which are the subject matter of the litigation with a market value of $10,000,000; or

"(ii) such smaller percentage or dollar amount as the court finds appropriate under the circumstances.

"(2) NAMED PLAINTIFFS.—Class members who are named plaintiffs in the litigation may serve on the plaintiff steering committee, but shall not comprise a majority of the committee.

"(3) NONCOMPENSATION OF MEMBERS.—Members of the plaintiff steering committee shall serve without compensation, except that any member may apply to the court for reimbursement of reasonable out-of-pocket expenses from any common fund established for the class.

"(4) MEETINGS.—The plaintiff steering committee shall conduct its business at one or more previously scheduled meetings of the committee at

which a majority of its members are present in person or by electronic communication. The plaintiff steering committee shall decide all matters within its authority by a majority vote of all members, except that the committee may determine that decisions other than to accept or reject a settlement offer or to employ or dismiss counsel for the class may be delegated to one or more members of the committee, or may be voted upon by committee members seriatim, without a meeting.

"(5) RIGHT OF NONMEMBERS TO BE HEARD.—A class member who is not a member of the plaintiff steering committee may appear and be heard by the court on any issue in the action, to the same extent as any other party.

"(d) FUNCTIONS OF GUARDIAN AD LITEM AND PLAINTIFF STEERING COMMITTEE.—

"(1) DIRECT COUNSEL.—The authority of the guardian ad litem or the plaintiff steering committee to direct counsel for the class shall include all powers normally permitted to an attorney's client in litigation, including the authority to retain or dismiss counsel and to reject offers of settlement, and the preliminary authority to accept an offer of settlement, subject to the restrictions specified in para-

graph (2). Dismissal of counsel other than for cause shall not limit the ability of counsel to enforce any contractual fee agreement or to apply to the court for a fee award from any common fund established for the class.

"(2) SETTLEMENT OFFERS.—If a guardian ad litem or a plaintiff steering committee gives preliminary approval to an offer of settlement, the guardian ad litem or the plaintiff steering committee may seek approval of the offer by a majority of class members if the committee determines that the benefit of seeking such approval outweighs the cost of soliciting the approval of class members.

"(e) IMMUNITY FROM LIABILITY; REMOVAL.—Any person serving as a guardian ad litem or as a member of a plaintiff steering committee shall be immune from any liability arising from such service. The court may remove a guardian ad litem or a member of a plaintiff steering committee for good cause shown.

"(f) EFFECT ON OTHER LAW.—This section does not affect any other provision of law concerning class actions or the authority of the court to give final approval to any offer of settlement.".

SEC. 104. REQUIREMENTS FOR SECURITIES FRAUD ACTIONS.

The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by adding at the end the following new section:

"SEC. 39. REQUIREMENTS FOR SECURITIES FRAUD ACTIONS.

"(a) INTENT.—In an implied private action arising under this title in which the plaintiff may recover money damages from a defendant only on proof that the defendant acted with some level of intent, the plaintiff's complaint shall allege specific facts demonstrating the state of mind of each defendant at the time the alleged violation occurred.

"(b) MISLEADING STATEMENTS AND OMISSIONS.—In an implied action arising under this title in which the plaintiff alleges that the defendant—

"(1) made an untrue statement of a material fact; or

"(2) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading;

the plaintiff shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the state-

ment or omission is made on information and belief, the plaintiff shall set forth all information on which that belief is formed.

"(c) BURDEN OF PROOF.—In an implied private action arising under this title based on a material misstatement or omission concerning a security, and in which the plaintiff claims to have bought or sold the security based on a reasonable belief that the market value of the security reflected all publicly available information, the plaintiff shall have the burden of proving that the misstatement or omission caused any loss incurred by the plaintiff.

"(d) DAMAGES.—In an implied private action arising under this title based on a material misstatement or omission concerning a security, and in which the plaintiff claims to have bought or sold the security based on a reasonable belief that the market value of the security reflected all publicly available information, the plaintiff's damages shall not exceed the lesser of—

"(1) the difference between the price paid by the plaintiff for the security and the market value of the security immediately after dissemination to the market of information which corrects the misstatement or omission; and

"(2) the difference between the price paid by the plaintiff for the security and the price at which the plaintiff sold the security after dissemination of information correcting the misstatement or omission.".

SEC. 105. AMENDMENT TO RACKETEER INFLUENCED AND CORRUPT ORGANIZATIONS ACT.

Section 1964(c) of title 18, United States Code, is amended by inserting ", except that no person may bring an action under this provision if the racketeering activity, as defined in section 1961(1)(D), involves fraud in the sale of securities" before the period.

TITLE II—FINANCIAL DISCLOSURE

SEC. 201. SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS.

(a) CONSIDERATION OF REGULATORY OR LEGISLATIVE CHANGES.—In consultation with investors and issuers of securities, the Securities and Exchange Commission shall consider adopting or amending its rules and regulations, or making legislative recommendations, concerning—

(1) criteria that the Commission finds appropriate for the protection of investors by which forward-looking statements concerning the future eco-

nomic performance of an issuer of securities registered under section 12 of the Securities Exchange Act of 1934 will be deemed not to be in violation of section 10(b) of that Act; and

(2) procedures by which courts shall timely dismiss claims against such issuers of securities based on such forward-looking statements if such statements are in accordance with any criteria under paragraph (1).

(b) COMMISSION CONSIDERATIONS.—In developing rules or legislative recommendations in accordance with subsection (a), the Commission shall consider—

(1) appropriate limits to liability for forward-looking statements;

(2) procedures for making a summary determination of the applicability of any Commission rule for forward-looking statements early in a judicial proceeding to limit protracted litigation and expansive discovery;

(3) incorporating and reflecting the scienter requirements applicable to implied private actions under section 10(b); and

(4) providing clear guidance to issuers of securities and the judiciary.

(c) SECURITIES ACT AMENDMENT.—The Securities and Exchange Act of 1934 (15 U.S.C. 78a et seq.), is amended by adding at the end the following new section:

"SEC. 40. APPLICATION OF SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS.

"(a) IN GENERAL.—In any implied private action arising under this title that alleges that a forward-looking statement concerning the future economic performance of an issuer registered under section 12 was materially false or misleading, if a party making a motion in accordance with subsection (b) requests a stay of discovery concerning the claims or defenses of that party, the court shall grant such a stay until it has ruled on any such motion.

"(b) SUMMARY JUDGMENT MOTIONS.—Subsection (a) shall apply to any motion for summary judgment made by a defendant asserting that the forward-looking statement was within the coverage of any rule which the Commission may have adopted concerning such predictive statements, if such motion is made not less than 60 days after the plaintiff commences discovery in the action.

"(c) DILATORY CONDUCT; DUPLICATIVE DISCOVERY.—Notwithstanding subsection (a) or (b), the time permitted for a plaintiff to conduct discovery under subsection (b) may be extended, or a stay of the proceedings may be denied, if the court finds that—

"(1) the defendant making a motion described in subsection (b) engaged in dilatory or obstructive conduct in taking or opposing any discovery; or

"(2) a stay of discovery pending a ruling on a motion under subsection (b) would be substantially unfair to the plaintiff or other parties to the action.".

SEC. 202. FRAUD DETECTION AND DISCLOSURE.

(a) IN GENERAL.—The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by inserting immediately after section 10 the following new section:

"SEC. 10A. AUDIT REQUIREMENTS.

"(a) IN GENERAL.—Each audit required pursuant to this title of an issuer's financial statements by an independent public accountant shall include, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission—

"(1) procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts;

"(2) procedures designed to identify related party transactions which are material to the finan-

cial statements or otherwise require disclosure therein; and

"(3) an evaluation of whether there is substantial doubt about the issuer's ability to continue as a going concern during the ensuing fiscal year.

"(b) REQUIRED RESPONSE TO AUDIT DISCOVERIES.—

"(1) INVESTIGATION AND REPORT TO MANAGEMENT.—If, in the course of conducting an audit pursuant to this title to which subsection (a) applies, the independent public accountant detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the issuer's financial statements) has or may have occurred, the accountant shall, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission—

"(A)(i) determine whether it is likely that an illegal act has occurred; and

"(ii) if so, determine and consider the possible effect of the illegal act on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties, and damages; and

"(B) as soon as practicable, inform the appropriate level of the issuer's management and assure that the issuer's audit committee, or the issuer's board of directors in the absence of such a committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of such accountant in the course of the audit, unless the illegal act is clearly inconsequential.

"(2) RESPONSE TO FAILURE TO TAKE REMEDIAL ACTION.—If, having first assured itself that the audit committee of the board of directors of the issuer or the board (in the absence of an audit committee) is adequately informed with respect to illegal acts that have been detected or have otherwise come to the accountant's attention in the course of such accountant's audit, the independent public accountant concludes that—

"(A) the illegal act has a material effect on the financial statements of the issuer;

"(B) the senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to the illegal act; and

"(C) the failure to take remedial action is reasonably expected to warrant departure from a standard auditor's report, when made, or warrant resignation from the audit engagement;

the independent public accountant shall, as soon as practicable, directly report its conclusions to the board of directors.

"(3) NOTICE TO COMMISSION; RESPONSE TO FAILURE TO NOTIFY.—An issuer whose board of directors receives a report under paragraph (2) shall inform the Commission by notice not later than 1 business day after the receipt of such report and shall furnish the independent public accountant making such report with a copy of the notice furnished to the Commission. If the independent public accountant fails to receive a copy of the notice before the expiration of the required 1-business-day period, the independent public accountant shall—

"(A) resign from the engagement; or

"(B) furnish to the Commission a copy of its report (or the documentation of any oral report given) not later than 1 business day following such failure to receive notice.

"(4) REPORT AFTER RESIGNATION.—If an independent public accountant resigns from an en-

gagement under paragraph (3)(A), the accountant shall, not later than 1 business day following the failure by the issuer to notify the Commission under paragraph (3), furnish to the Commission a copy of the accountant's report (or the documentation of any oral report given).

"(c) AUDITOR LIABILITY LIMITATION.—No independent public accountant shall be liable in a private action for any finding, conclusion, or statement expressed in a report made pursuant to paragraph (3) or (4) of subsection (b), including any rules promulgated pursuant thereto.

"(d) CIVIL PENALTIES IN CEASE-AND-DESIST PROCEEDINGS.—If the Commission finds, after notice and opportunity for hearing in a proceeding instituted pursuant to section 21C, that an independent public accountant has willfully violated paragraph (3) or (4) of subsection (b), the Commission may, in addition to entering an order under section 21C, impose a civil penalty against the independent public accountant and any other person that the Commission finds was a cause of such violation. The determination to impose a civil penalty and the amount of the penalty shall be governed by the standards set forth in section 21B.

"(e) PRESERVATION OF EXISTING AUTHORITY.—Except as provided in subsection (d), nothing in this section shall be held to limit or otherwise affect the authority of the Commission under this title.

"(f) DEFINITION.—As used in this section, the term 'illegal act' means an act or omission that violates any law, or any rule or regulation having the force of law.".

(b) EFFECTIVE DATES.—With respect to any registrant that is required to file selected quarterly financial data pursuant to item 302(a) of Regulation S–K of the Securities and Exchange Commission (17 CFR 229.302(a)), the amendments made by subsection (a) shall apply to any annual report for any period beginning on or after January 1, 1994. With respect to any other registrant, the amendment shall apply for any period beginning on or after January 1, 1995.

SEC. 203. PROPORTIONATE LIABILITY AND JOINT AND SEVERAL LIABILITY.

(a) SECURITIES ACT AMENDMENT.—The Securities and Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by adding at the end the following new section:

"SEC. 41. PROPORTIONATE LIABILITY AND JOINT AND SEVERAL LIABILITY IN IMPLIED ACTIONS.

"(a) APPLICABILITY.—This section shall apply only to the allocation of damages among persons who are, or

who may become, liable for damages in an implied private action arising under this title. Nothing in this section shall affect the standards for liability associated with an implied private action arising under this title.

"(b) APPLICATION OF JOINT AND SEVERAL LIABILITY.—

"(1) IN GENERAL.—A person against whom a judgment is entered in an implied private action arising under this title shall be liable jointly and severally for any recoverable damages on such judgment if the person is found to have—

"(A) been a primary wrongdoer;

"(B) committed knowing securities fraud; or

"(C) controlled any primary wrongdoer or person who committed knowing securities fraud.

"(2) PRIMARY WRONGDOER.—As used in this subsection—

"(A) the term 'primary wrongdoer' means—

"(i) any—

"(I) issuer, registrant, purchaser, seller, or underwriter of securities;

"(II) marketmaker or specialist in securities; or

"(III) clearing agency, securities information processor, or government securities dealer;

if such person breached a direct statutory or regulatory obligation or if such person otherwise had a principal role in the conduct that is the basis for the implied right of action; or

"(ii) any person who intentionally rendered substantial assistance to the fraudulent conduct of any person described in clause (i), with actual knowledge of such person's fraudulent conduct or fraudulent purpose, and with knowledge that such conduct was wrongful; and

"(B) a defendant engages in 'knowing securities fraud' if such defendant—

"(i) makes a material representation with actual knowledge that the representation is false, or omits to make a statement with actual knowledge that, as a result of the omission, one of the defendant's material representations is false and knows that other persons are likely to rely on that misrepresentation or omission, except that

reckless conduct by the defendant shall not be construed to constitute 'knowing securities fraud'; or

"(ii) intentionally rendered substantial assistance to the fraudulent conduct of any person described in clause (i), with actual knowledge of such person's fraudulent conduct or fraudulent purpose, and with knowledge that such conduct was wrongful.

"(c) DETERMINATION OF RESPONSIBILITY.—In an implied private action in which more than 1 person contributed to a violation of this title, the court shall instruct the jury to answer special interrogatories, or if there is no jury, shall make findings, concerning the degree of responsibility of each person alleged to have caused or contributed to the violation of this title, including persons who have entered into settlements with the plaintiff. The interrogatories or findings shall specify the amount of damages the plaintiff is entitled to recover and the degree of responsibility, measured as a percentage of the total fault of all persons involved in the violation, of each person found to have caused or contributed to the damages incurred by the plaintiff or plaintiffs. In determining the degree of responsibility, the trier of fact shall consider—

"(1) the nature of the conduct of each person; and

"(2) the nature and extent of the causal relationship between that conduct and the damage claimed by the plaintiff.

"(d) APPLICATION OF PROPORTIONATE LIABILITY.—Except as provided in subsection (b), the amount of liability of a person who is, or may through right of contribution become, liable for damages based on an implied private action arising under this title shall be determined as follows:

"(1) DEGREE OF RESPONSIBILITY.—Except as provided in paragraph (2), each liable party shall only be liable for the portion of the judgment that corresponds to that party's degree of responsibility, as determined under subsection (c).

"(2) UNCOLLECTIBLE SHARES.—If, upon motion made not later than 6 months after a final judgment is entered, the court determines that all or part of a defendant's share of the obligation is uncollectible—

"(A) the remaining defendants shall be jointly and severally liable for the uncollectible share if the plaintiff establishes that—

"(i) the plaintiff is an individual whose recoverable damages under a final judgment are equal to more than 10 percent of the plaintiff's net financial worth; and

"(ii) the plaintiff's net financial worth is less than $200,000; and

"(B) the amount paid by each of the remaining defendants to all other plaintiffs shall be, in total, not more than the greater of—

"(i) that remaining defendant's percentage of fault for the uncollectible share; or

"(ii) 5 times—

"(I) the amount which the defendant gained from the conduct that gave rise to its liability; or

"(II) if a defendant did not obtain a direct financial gain from the conduct that gave rise to the liability and the conduct consisted of the provision of deficient services to an entity involved in the violation, the defendant's gross revenues received for the provision of all services to the other

entity involved in the violation during the calendar years in which deficient services were provided.

"(3) OVERALL LIMIT.—In no event shall the total payments required pursuant to paragraph (2) exceed the amount of the uncollectible share.

"(4) DEFENDANTS SUBJECT TO CONTRIBUTION.—A defendant whose liability is reallocated pursuant to paragraph (2) shall be subject to contribution and to any continuing liability to the plaintiff on the judgment.

"(5) RIGHT OF CONTRIBUTION.—To the extent that a defendant is required to make an additional payment pursuant to paragraph (2), that defendant may recover contribution—

"(A) from the defendant originally liable to make the payment;

"(B) from any defendant liable jointly and severally pursuant to subsection (b)(1);

"(C) from any defendant held proportionately liable pursuant to this subsection who is liable to make the same payment and has paid less than his or her proportionate share of that payment; or

"(D) from any other person responsible for the conduct giving rise to the payment who would have been liable to make the same payment.

"(e) NONDISCLOSURE TO JURY.—The standard for allocation of damages under subsections (b)(1) and (c) and the procedure for reallocation of uncollectible shares under subsection (d)(2) shall not be disclosed to members of the jury.

"(f) SETTLEMENT DISCHARGE.—

"(1) IN GENERAL.—A defendant who settles an implied private action brought under this title at any time before verdict or judgment shall be discharged from all claims for contribution brought by other persons. Upon entry of the settlement by the court, the court shall enter a bar order constituting the final discharge of all obligations to the plaintiff of the settling defendant arising out of the action. The order shall bar all future claims for contribution or indemnity arising out of the action—

"(A) by nonsettling persons against the settling defendant; and

"(B) by the settling defendant against any nonsettling defendants.

"(2) REDUCTION.—If a person enters into a settlement with the plaintiff prior to verdict or judgment, the verdict or judgment shall be reduced by the greater of—

"(A) an amount that corresponds to the degree of responsibility of that person; or

"(B) the amount paid to the plaintiff by that person.

"(g) CONTRIBUTION.—A person who becomes liable for damages in an implied private action arising under this title may recover contribution from any other person who, if joined in the original suit, would have been liable for the same damages. A claim for contribution shall be determined based on the degree of responsibility of the claimant and of each person against whom a claim for contribution is made.

"(h) STATUTE OF LIMITATIONS FOR CONTRIBUTION.—Once judgment has been entered in an implied private action arising under this title determining liability, an action for contribution must be brought not later than 6 months after the entry of a final, nonappealable judgment in the action, except that an action for contribution brought by a defendant who was required to make an additional payment pursuant to subsection (d)(2) may be

brought not later than 6 months after the date on which such payment was made.".

(b) EFFECTIVE DATE.—Section 41 of the Securities Exchange Act of 1934, as added by subsection (a), shall only apply to implied private actions commenced after the date of enactment of this Act.

SEC. 204. PUBLIC AUDITING SELF-DISCIPLINARY BOARD.

The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by inserting immediately after section 13 the following new section:

"SEC. 13A. PUBLIC AUDITING SELF-DISCIPLINARY BOARD.

"(a) DEFINITIONS.—For purposes of this section, the following definitions shall apply:

"(1) PUBLIC ACCOUNTING FIRM.—The term 'public accounting firm' means a sole proprietorship, unincorporated association, partnership, corporation, or other legal entity that is engaged in the practice of public accounting.

"(2) BOARD.—The term 'Board' means the Public Auditing Self-Disciplinary Board designated by the Commission pursuant to subsection (b).

"(3) ACCOUNTANT'S REPORT.—The term 'accountant's report' means a document in which a public accounting firm identifies a financial statement, report, or other document and sets forth the

firm's opinion regarding such financial statement, report, or other document, or an assertion that an opinion cannot be expressed.

"(4) PERSON ASSOCIATED WITH A PUBLIC ACCOUNTING FIRM.—The term 'person associated with a public accounting firm' means a natural person who—

"(A) is a partner, shareholder, employee, or individual proprietor of a public accounting firm, or who shares in the profits of a public accounting firm; and

"(B) engages in any conduct or practice in connection with the preparation of an accountant's report on any financial statement, report, or other document required to be filed with the Commission under any securities law.

"(5) PROFESSIONAL STANDARDS.—The term 'professional standards' means generally accepted auditing standards, generally accepted accounting principles, generally accepted standards for attestation engagements, and any other standards related to the preparation of financial statements or accountant's reports promulgated by the Commission or a standard-setting body recognized by the Board.

"(b) ESTABLISHMENT OF BOARD.—

"(1) IN GENERAL.—Not later than 90 days after the date of enactment of this section, the Commission shall establish a Public Auditing Self-Disciplinary Board to perform the duties set forth in this section. The Commission shall designate an entity to serve as the Board if the Commission finds that—

"(A) such entity is sponsored by an existing national organization of certified public accountants that—

"(i) is most representative of certified public accountants covered by this title; and

"(ii) has demonstrated its commitment to improving the quality of practice before the Commission; and

"(B) control over such entity is vested in the members of the Board selected pursuant to subsection (c).

"(2) ALTERNATIVE ELECTION OF MEMBERS.—If the Commission designates an entity to serve as the Board pursuant to paragraph (1), the entity shall conduct the election of initial Board members in accordance with subsection (c)(1)(B)(i).

"(c) MEMBERSHIP OF BOARD.—

"(1) IN GENERAL.—The Board shall be composed of 3 appointed members and 4 elected members, as follows:

"(A) APPOINTED MEMBERS.—Three members of the Board shall be appointed in accordance with the following:

"(i) INITIAL APPOINTMENTS.—The Chairman of the Commission shall make the initial appointments, in consultation with the other members of the Commission, not later than 90 days after the date of enactment of this section.

"(ii) SUBSEQUENT APPOINTMENTS.—After the initial appointments under clause (i), members of the Board appointed to fill vacancies of appointed members of the Board shall be appointed in accordance with the rules adopted pursuant to paragraph (5). Such rules shall provide that such members shall be appointed by the Board, subject to the approval of the Commission.

"(B) ELECTED MEMBERS.—Four members, including the member who shall serve as

the chairperson of the Board, shall be elected in accordance with the following:

"(i) INITIAL ELECTION.—Not later than 120 days after the date on which the Chairman of the Commission makes appointments under subparagraph (A)(i), an entity designated by the Commission pursuant to subsection (b) shall conduct an election of 4 initial elected members pursuant to interim election rules proposed by the entity and approved by the 3 interim members of the Board and the Commission. If the Commission is unable to designate an entity meeting the criteria set forth in subsection (b)(1), the members of the Board appointed under subparagraph (A)(i) shall adopt interim rules, subject to approval by the Commission, providing for the election of the 4 initial elected members. Such rules shall provide that such members of the Board shall be elected—

"(I) not later than 120 days after the date on which members are initially appointed under subparagraph (A)(i);

"(II) by persons who are associated with public accounting firms and who are certified public accountants under the laws of any State; and

"(III) subject to the approval of the Commission.

"(ii) SUBSEQUENT ELECTIONS.—After the initial elections under clause (i), members of the Board elected to fill vacancies of elected members of the Board shall be elected in accordance with the rules adopted pursuant to paragraph (5). Such rules shall provide that such members of the Board shall be elected—

"(I) by persons who are associated with public accounting firms and who are certified public accountants under the laws of any State; and

"(II) subject to the approval of the Commission.

"(2) QUALIFICATION.—Four members of the Board, including the chairperson of the Board, shall be persons who have not been associated with a public accounting firm during the 10-year period preceding appointment or election to the Board under

paragraph (1). Three members of the Board who are elected shall be persons associated with a public accounting firm registered with the Board.

"(3) FULL-TIME BASIS.—The chairperson of the Board shall serve on a full-time basis, severing all business ties with his or her former firms or employers prior to beginning service on the Board.

"(4) TERMS.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), each member of the Board shall hold office for a term of 4 years or until a successor is appointed, whichever is later, except that any member appointed to fill a vacancy occurring prior to the expiration of the term for which such member's predecessor was appointed shall be appointed for the remainder of such term.

"(B) INITIAL BOARD MEMBERS.—Beginning on the date on which all members of the Board have been selected in accordance with this subsection, the terms of office of the initial Board members shall expire, as determined by the Board, by lottery—

"(i) for 1 member, 1 year after such date;

"(ii) for 2 members, 2 years after such date;

"(iii) for 2 members, 3 years after such date; and

"(iv) for 2 members, 4 years after such date.

"(5) RULES.—Following selection of the 7 initial members of the Board in accordance with subparagraphs (A)(i) and (B)(i) of paragraph (1), the Board shall propose and adopt rules, which shall provide for—

"(A) the operation and administration of the Board, including—

"(i) the appointment of members in accordance with paragraph (1)(A)(ii);

"(ii) the election of members in accordance with paragraph (1)(B)(ii); and

"(iii) the compensation of the members of the Board;

"(B) the appointment and compensation of such employees, attorneys, and consultants as may be necessary or appropriate to carry out the Board's functions under this title;

"(C) the registration of public accounting firms with the Board pursuant to subsections (d) and (e); and

"(D) the matters described in subsections (f) and (g).

"(d) REGISTRATION AND ANNUAL FEES.—After the date on which all initial members of the Board have been selected in accordance with subsection (c), the Board shall assess and collect a registration fee and annual dues from each public accounting firm registered with the Board. Such fees and dues shall be assessed at a level sufficient to recover the costs and expenses of the Board and to permit the Board to operate on a self-financing basis. The amount of fees and dues for each public accounting firm shall be based upon—

"(1) the annual revenues of such firm from accounting and auditing services;

"(2) the number of persons associated with the public accounting firm;

"(3) the number of clients for which such firm furnishes accountant's reports on financial statements, reports, or other documents filed with the Commission; and

"(4) such other criteria as the Board may establish.

"(e) REGISTRATION WITH BOARD.—

"(1) REGISTRATION REQUIRED.—Beginning 1 year after the date on which all initial members of the Board have been selected in accordance with subsection (c), it shall be unlawful for a public accounting firm to furnish an accountant's report on any financial statement, report, or other document required to be filed with the Commission under any Federal securities law, unless such firm is registered with the Board.

"(2) APPLICATION FOR REGISTRATION.—A public accounting firm may be registered under this subsection by filing with the Board an application for registration in such form and containing such information as the Board, by rule, may prescribe. Each application shall include—

"(A) the names of all clients of the public accounting firm for which the firm furnishes accountant's reports on financial statements, reports, or other documents filed with the Commission;

"(B) financial information of the public accounting firm for its most recent fiscal year, including its annual revenues from accounting

and auditing services, its assets and its liabilities;

"(C) a statement of the public accounting firm's policies and procedures with respect to quality control of its accounting and auditing practice;

"(D) information relating to criminal, civil, or administrative actions or formal disciplinary proceedings pending against such firm, or any person associated with such firm, in connection with an accountant's report furnished by such firm;

"(E) a list of persons associated with the public accounting firm who are certified public accountants, including any State professional license or certification number for each such person; and

"(F) such other information that is reasonably related to the Board's responsibilities as the Board considers necessary or appropriate.

"(3) PERIODIC REPORTS.- Once in each year, or more frequently as the Board, by rule, may prescribe, each public accounting firm registered with the Board shall submit reports to the Board updating the information contained in its application for

registration and containing such additional information that is reasonably related to the Board's responsibilities as the Board, by rule, may prescribe.

"(4) EXEMPTIONS.—The Commission, by rule or order, upon its own motion or upon application, may conditionally or unconditionally exempt any public accounting firm or any accountant's report, or any class of public accounting firms or any class of accountant's reports, from any provisions of this section or the rules or regulations issued hereunder, if the Commission finds that such exemption is consistent with the public interest, the protection of investors, and the purposes of this section.

"(5) CONFIDENTIALITY.—The Board may, by rule, designate portions of the filings required pursuant to paragraphs (2) and (3) as privileged and confidential.

"(f) DUTIES OF BOARD.—After the date on which all initial members of the Board have been selected in accordance with subsection (c), the Board shall have the following duties and powers:

"(1) INVESTIGATIONS AND DISCIPLINARY PROCEEDINGS.—The Board shall establish fair procedures for investigating and disciplining public accounting firms registered with the Board, and per-

sons associated with such firms, for violations of the Federal securities laws, the rules or regulations issued thereunder, the rules adopted by the Board, or professional standards in connection with the preparation of an accountant's report on a financial statement, report, or other document filed with the Commission.

"(2) INVESTIGATION PROCEDURES.—

"(A) IN GENERAL.—The Board may conduct an investigation of any act, practice, or omission by a public accounting firm registered with the Board, or by any person associated with such firm, in connection with the preparation of an accountant's report on a financial statement, report, or other document filed with the Commission that may violate any applicable provision of the Federal securities laws, the rules and regulations issued thereunder, the rules adopted by the Board, or professional standards, whether such act, practice, or omission is the subject of a criminal, civil, or administrative action, or a disciplinary proceeding, or otherwise is brought to the attention of the Board.

"(B) POWERS OF BOARD.—For purposes of an investigation under this paragraph, the Board may, in addition to such other actions as the Board determines to be necessary or appropriate—

"(i) require the testimony of any person associated with a public accounting firm registered with the Board, with respect to any matter which the Board considers relevant or material to the investigation;

"(ii) require the production of audit workpapers and any other document or information in the possession of a public accounting firm registered with the Board, or any person associated with such firm, wherever domiciled, that the Board considers relevant or material to the investigation, and may examine the books and records of such firm to verify the accuracy of any documents or information so supplied; and

"(iii) request the testimony of any person and the production of any document in the possession of any person, in-

cluding a client of a public accounting firm registered with the Board, that the Board considers relevant or material to the investigation.

"(C) SUSPENSION OR REVOCATION OF REGISTRATION FOR NONCOMPLIANCE.—The refusal of any person associated with a public accounting firm registered with the Board to testify, or the refusal of any such person to produce documents or otherwise cooperate with the Board, in connection with an investigation under this section, shall be cause for suspending or barring such person from associating with a public accounting firm registered with the Board, or such other appropriate sanction as the Board shall determine. The refusal of any public accounting firm registered with the Board to produce documents or otherwise cooperate with the Board, in connection with an investigation under this section, shall be cause for the suspension or revocation of the registration of such firm, or such other appropriate sanction as the Board shall determine.

"(D) REFERRAL TO COMMISSION.—

"(i) IN GENERAL.—If the Board is unable to conduct or complete an investigation under this section because of the refusal of any client of a public accounting firm registered with the Board, or any other person, to testify, produce documents, or otherwise cooperate with the Board in connection with such investigation, the Board shall report such refusal to the Commission.

"(ii) INVESTIGATION.—The Commission may designate the Board or one or more officers of the Board who shall be empowered, in accordance with such procedures as the Commission may adopt, to subpoena witnesses, compel their attendance, and require the production of any books, papers, correspondence, memoranda, or other records relevant to any investigation by the Board. Attendance of witnesses and the production of any records may be required from any place in the United States or any State at any designated place of hearing. Enforcement of a subpoena issued by the Board, or an offi-

cer of the Board, pursuant to this subparagraph shall occur in the manner provided for in section 21(c). Examination of witnesses subpoenaed pursuant to this subparagraph shall be conducted before an officer authorized to administer oaths by the laws of the United States or of the place where the examination is held.

"(iii) REFERRALS TO COMMISSION.—The Board may refer any investigation to the Commission, as the Board deems appropriate.

"(E) IMMUNITY FROM CIVIL LIABILITY.—An employee of the Board engaged in carrying out an investigation or disciplinary proceeding under this section shall be immune from any civil liability arising out of such investigation or disciplinary proceeding in the same manner and to the same extent as an employee of the Federal Government in similar circumstances.

"(3) DISCIPLINARY PROCEDURES.—

"(A) DECISION TO DISCIPLINE.—In a proceeding by the Board to determine whether a public accounting firm, or a person associated with such firm, should be disciplined, the Board

shall bring specific charges, notify such firm or person of the charges, give such firm or person an opportunity to defend against such charges, and keep a record of such actions.

"(B) SANCTIONS.—If the Board finds that a public accounting firm, or a person associated with such firm, has engaged in any act, practice, or omission in violation of the Federal securities laws, the rules or regulations issued thereunder, the rules adopted by the Board, or professional standards, the Board may impose such disciplinary sanctions as it deems appropriate, including—

"(i) revocation or suspension of registration under this section;

"(ii) limitation of activities, functions, and operations;

"(iii) fine;

"(iv) censure;

"(v) in the case of a person associated with a public accounting firm, suspension or bar from being associated with a public accounting firm registered with the Board; and

"(vi) any other disciplinary sanction that the Board determines to be appropriate.

"(C) STATEMENT REQUIRED.—A determination by the Board to impose a disciplinary sanction shall be supported by a written statement by the Board setting forth—

"(i) any act or practice in which the public accounting firm or person associated with such firm has been found to have engaged, or which such firm or person has been found to have omitted;

"(ii) the specific provision of the Federal securities laws, the rules or regulations issued thereunder, the rules adopted by the Board, or professional standards which any such act, practice, or omission is deemed to violate; and

"(iii) the sanction imposed and the reasons therefor.

"(D) PROHIBITION ON ASSOCIATION.—It shall be unlawful—

"(i) for any person as to whom a suspension or bar is in effect willfully to be or to become associated with a public ac-

counting firm registered with the Board, in connection with the preparation of an accountant's report on any financial statement, report, or other document filed with the Commission, without the consent of the Board or the Commission; and

"(ii) for any public accounting firm registered with the Board to permit such a person to become, or remain, associated with such firm without the consent of the Board or the Commission, if such firm knew or, in the exercise of reasonable care should have known, of such suspension or bar.

"(4) REPORTING OF SANCTIONS.—If the Board imposes a disciplinary sanction against a public accounting firm, or a person associated with such firm, the Board shall report such sanction to the Commission, to the appropriate State or foreign licensing board or boards with which such firm or such person is licensed or certified to practice public accounting, and to the public. The information reported shall include—

"(A) the name of the public accounting firm, or person associated with such firm, against whom the sanction is imposed;

"(B) a description of the acts, practices, or omissions upon which the sanction is based;

"(C) the nature of the sanction; and

"(D) such other information respecting the circumstances of the disciplinary action (including the name of any client of such firm affected by such acts, practices, or omissions) as the Board deems appropriate.

"(5) DISCOVERY AND ADMISSIBILITY OF BOARD MATERIAL.—

"(A) DISCOVERABILITY.—

"(i) IN GENERAL.—Except as provided in subparagraph (C), all reports, memoranda, and other information prepared, collected, or received by the Board, and the deliberations and other proceedings of the Board and its employees and agents in connection with an investigation or disciplinary proceeding under this section shall not be subject to any form of civil discovery, including demands for production of documents and for testimony of

individuals, in connection with any proceeding in any State or Federal court, or before any State or Federal administrative agency. This subparagraph shall not apply to any information provided to the Board that would have been subject to discovery from the person or entity that provided it to the Board, but is no longer available from that person or entity.

"(ii) EXEMPTION.—Submissions to the Board by or on behalf of a public accounting firm or person associated with such a firm or on behalf of any other participant in a Board proceeding, including documents generated by the Board itself, shall be exempt from discovery to the same extent as the material described in clause (i), whether in the possession of the Board or any other person, if such submission—

"(I) is prepared specifically for the purpose of the Board proceeding; and

"(II) addresses the merits of the issues under investigation by the Board.

"(iii) CONSTRUCTION.—Nothing in this subparagraph shall limit the authority of the Board to provide appropriate public access to disciplinary hearings of the Board, or to reports or memoranda received by the Board in connection with such proceedings.

"(B) ADMISSIBILITY.—

"(i) IN GENERAL.—Except as provided in subparagraph (C), all reports, memoranda, and other information prepared, collected, or received by the Board, the deliberations and other proceedings of the Board and its employees and agents in connection with an investigation or disciplinary proceeding under this section, the fact that an investigation or disciplinary proceeding has been commenced, and the Board's determination with respect to any investigation or disciplinary proceeding shall be inadmissible in any proceeding in any State or Federal court or before any State or Federal administrative agency.

"(ii) TREATMENT OF CERTAIN DOCUMENTS.—Submissions to the Board by or

on behalf of a public accounting firm or person associated with such a firm or on behalf of any other participant in a Board proceeding, including documents generated by the Board itself, shall be inadmissible to the same extent as the material described in clause (i), if such submission—

"(I) is prepared specifically for the purpose of the Board proceedings; and

"(II) addresses the merits of the issues under investigation by the Board.

"(C) AVAILABILITY AND ADMISSIBILITY OF INFORMATION.—

"(i) IN GENERAL.—All information referred to in subparagraphs (A) and (B) shall be—

"(I) available to the Commission and to any other Federal department or agency in connection with the exercise of its regulatory authority to the extent that such information would be available to such agency from the

Commission as a result of a Commission enforcement investigation;

"(II) available to Federal and State authorities in connection with any criminal investigation or proceeding;

"(III) admissible in any action brought by the Commission or any other Federal department or agency pursuant to its regulatory authority, to the extent that such information would be available to such agency from the Commission as a result of a Commission enforcement investigation and in any criminal action; and

"(IV) available to State licensing boards to the extent authorized in paragraph (6).

"(ii) OTHER LIMITATIONS.—Any documents or other information provided to the Commission or other authorities pursuant to clause (i) shall be subject to the limitations on discovery and admissibility set forth in subparagraphs (A) and (B).

"(D) TITLE 5 TREATMENT.—This subsection shall be considered to be a statute described in section 552(b)(3)(B) of title 5, United States Code, for purposes of that section 552.

"(6) PARTICIPATION BY STATE LICENSING BOARDS.—

"(A) NOTICE.—When the Board institutes an investigation pursuant to paragraph (2)(A), it shall notify the State licensing boards in the States in which the public accounting firm or person associated with such firm engaged in the act or failure to act alleged to have violated professional standards, of the pendancy of the investigation, and shall invite the State licensing boards to participate in the investigation.

"(B) ACCEPTANCE BY STATE BOARD.—

"(i) PARTICIPATION.—If a State licensing board elects to join in the investigation, its representatives shall participate, pursuant to rules established by the Board, in investigating the matter and in presenting the evidence justifying the charges in any hearing pursuant to paragraph (3)(A).

"(ii) REVIEW.—In the event that the State licensing board disagrees with the Board's determination with respect to the matter under investigation, it may seek review of that determination by the Commission pursuant to procedures that the Commission shall specify by regulation.

"(C) PROHIBITION ON CONCURRENT INVESTIGATIONS.—A State licensing board shall not institute its own proceeding with respect to a matter referred to in subparagraph (A) until after the Board's determination has become final, including completion of all review by the Commission and the courts.

"(D) STATE SANCTIONS PERMITTED.—If the Board or the Commission imposes a sanction upon a public accounting firm or person associated with such a firm, and that determination either is not subjected to judicial review or is upheld on judicial review, a State licensing board may impose a sanction on the basis of the Board's report pursuant to paragraph (4). Any sanction imposed by the State licensing board under this clause shall be inadmissible in any proceeding in any State or Fed-

eral court or before any State or Federal administrative agency, except to the extent provided in paragraph (5)(D).

"(E) SANCTIONS NOT PERMITTED.—If a sanction is not imposed on a public accounting firm or person associated with such a firm, and—

"(i) a State licensing board elected to participate in an investigation referred to in subparagraph (A), the State licensing board may not impose a sanction with respect to the matter; and

"(ii) a State licensing board elected not to participate in an investigation referred to in subparagraph (A), subparagraphs (A) and (B) of paragraph (5) shall apply with respect to any investigation or proceeding subsequently instituted by the State licensing board and, in particular, the State licensing board shall not have access to the record of the proceeding before the Board and that record shall be inadmissible in any proceeding before the State licensing board.

"(g) ADDITIONAL DUTIES REGARDING QUALITY CONTROL.—After the date on which all initial members of the Board have been selected in accordance with subsection (e), the Board shall have the following duties and powers in addition to those set forth in subsection (f):

"(1) IN GENERAL.—The Board shall seek to promote a high level of professional conduct among public accounting firms registered with the Board, to improve the quality of audit services provided by such firms, and, in general, to protect investors and promote the public interest.

"(2) PROFESSIONAL PEER REVIEW ORGANIZATIONS.—

"(A) MEMBERSHIP REQUIREMENT.—The Board shall require each public accounting firm subject to the disciplinary authority of the Board to be a member of a professional peer review organization certified by the Board pursuant to subparagraph (B).

"(B) CRITERIA FOR CERTIFICATION.—The Board shall, by rule, establish general criteria for the certification of peer review organizations and shall certify organizations that satisfy those criteria, or such amended criteria as the Board

may adopt. To be certified, a peer review organization shall, at a minimum—

"(i) require a member public accounting firm to undergo peer review not less than once every 3 years and publish the results of the peer review; and

"(ii) adopt standards that are acceptable to the Board relating to audit service quality control.

"(C) PENALTIES.—Violation by a public accounting firm or a person associated with such a firm of a rule of the peer review organization to which the firm belongs shall constitute grounds for—

"(i) the imposition of disciplinary sanctions by the Board pursuant to subsection (f); and

"(ii) denial to the public accounting firm or person associated with such firm of the privilege of appearing or practicing before the Commission.

"(3) CONFIDENTIALITY.—Except as otherwise provided by this section, all reports, memoranda, and other information provided to the Board solely for purposes of paragraph (2), or to a peer review

organization certified by the Board, shall be confidential and privileged, unless such confidentiality and privilege are expressly waived by the person or entity that created or provided the information.

"(h) COMMISSION OVERSIGHT OF THE BOARD.—

"(1) PROPOSED RULE CHANGES.—

"(A) IN GENERAL.—The Board shall file with the Commission, in accordance with such rules as the Commission may prescribe, copies of any proposed rule or any proposed change in, addition to, or deletion from the rules of the Board (hereafter in this subsection collectively referred to as a 'proposed rule change') accompanied by a concise general statement of the basis and purpose of such proposed rule change. The Commission shall, upon the filing of any proposed rule change, publish notice thereof together with the terms of substance of the proposed rule change or a description of the subjects and issues involved. The Commission shall give interested persons an opportunity to submit written data, views, and arguments concerning the proposed rule change. No proposed rule change shall take effect unless approved by

the Commission or otherwise permitted in accordance with this subsection.

"(B) APPROVAL OR DISAPPROVAL.—

"(i) IN GENERAL.—Not later than 35 days after the date on which notice of the filing of a proposed rule change is published in accordance with subparagraph (A), or such longer period as the Commission may designate (not to exceed 90 days after such date, if it finds such longer period to be appropriate and publishes its reasons for such finding or as to which the Board consents) the Commission shall—

"(I) by order approve such proposed rule change; or

"(II) institute proceedings to determine whether the proposed rule change should be disapproved.

"(ii) DISAPPROVAL PROCEEDINGS.—Proceedings for disapproval shall include notice of the grounds for disapproval under consideration and opportunity for hearing and shall be concluded not later than 180 days after the date of publication of notice of the filing of the proposed rule change.

At the conclusion of the proceedings for disapproval, the Commission, by order, shall approve or disapprove such proposed rule change. The Commission may extend the time for conclusion of such proceedings for—

"(I) not more than 60 days, if the Commission finds good cause for such extension and publishes its reasons for such finding; or

"(II) such longer period to which the Board consents.

"(iii) APPROVAL.—The Commission shall approve a proposed rule change if it finds that such proposed rule change is consistent with the requirements of the Federal securities laws, and the rules and regulations issued thereunder, applicable to the Board. The Commission shall disapprove a proposed rule change if it does not make such finding. The Commission shall not approve any proposed rule change prior to the expiration of the 30-day period beginning on the date on which notice of the filing of a proposed rule change is pub-

lished in accordance with this subparagraph, unless the Commission finds good cause to do so and publishes its reasons for such finding.

"(C) EFFECT OF PROPOSED RULE CHANGE.—

"(i) EFFECTIVE DATE.—Notwithstanding subparagraph (B), a proposed rule change may take effect upon filing with the Commission if designated by the Board as—

"(I) constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the Board;

"(II) establishing or changing a due, fee, or other charge imposed by the Board; or

"(III) concerned solely with the administration of the Board or other matters which the Commission, by rule, consistent with the public interest and the purposes of this subsection, may specify.

"(ii) SUMMARY EFFECT.—Notwithstanding any other provision of this subsection, a proposed rule change may be put into effect summarily if it appears to the Commission that such action is necessary for the protection of investors. Any proposed rule change put into effect summarily shall be filed promptly thereafter in accordance with this paragraph.

"(iii) ENFORCEMENT.—Any proposed rule change which has taken effect pursuant to clause (i) or (ii) may be enforced by the Board to the extent that it is not inconsistent with the Federal securities laws, the rules and regulations issued thereunder, and applicable Federal and State law. During the 60-day period beginning on the date on which notice of the filing of a proposed rule change if filed in accordance with this paragraph, the Commission may summarily abrogate the change in the rules of the Board made thereby and require that the proposed rule change be refiled in accordance with subparagraph (A) and reviewed in accordance with sub-

paragraph (B) if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Federal securities laws. Commission action pursuant to the preceding sentence shall not affect the validity or force of the rule change during the period it was in effect and shall not be reviewable under section 25 of this Act nor deemed to be 'final agency action' for purposes of section 704 of title 5, United States Code.

"(2) AMENDMENT BY COMMISSION OF RULES OF THE BOARD.—The Commission, by rule, may abrogate, add to, and delete from (hereafter in this subsection collectively referred to as 'amend') the rules of the Board as the Commission deems necessary or appropriate to ensure the fair administration of the Board, to conform its rules to requirements of the Federal securities laws, and the rules and regulations issued thereunder applicable to the Board, or otherwise in furtherance of the purposes of the Federal securities laws, in the following manner:

"(A) PUBLICATION OF NOTICE.—The Commission shall notify the Board and publish notice of the proposed rulemaking in the Federal Register. The notice shall include the text of the proposed amendment to the rules of the Board and a statement of the Commission's reasons, including any pertinent facts, for commencing such proposed rulemaking.

"(B) COMMENTS.—The Commission shall give interested persons an opportunity for the oral presentation of data, views, and arguments, in addition to an opportunity to make written submissions. A transcript shall be kept of any oral presentation.

"(C) INCORPORATION.—A rule adopted pursuant to this subsection shall incorporate the text of the amendment to the rules of the Board and a statement of the Commission's basis for and purpose in so amending such rules. Such statement shall include an identification of any facts on which the Commission considers its determination to so amend the rules of the Board to be based, including the reasons for the Commission's conclusions as to

any of the facts that were disputed in the rulemaking.

"(D) REGULATIONS.—

"(i) TITLE 5 APPLICABILITY.—Except as otherwise provided in this paragraph, rulemaking under this paragraph shall be in accordance with the procedures specified in section 553 of title 5, United States Code, for rulemaking not on the record.

"(ii) CONSTRUCTION.—Nothing in this subsection shall be construed to impair or limit the Commission's power to make, modify, or alter the procedures the Commission may follow in making rules and regulations pursuant to any other authority under the Federal securities laws.

"(iii) INCORPORATION OF AMENDMENTS.—Any amendment to the rules of the Board made by the Commission pursuant to this subsection shall be considered for purposes of the Federal securities laws to be part of the rules of the Board and shall not be considered to be a rule of the Commission.

"(3) NOTICE OF DISCIPLINARY ACTION TAKEN BY THE BOARD; REVIEW OF ACTION BY THE COMMISSION.—

"(A) NOTICE REQUIRED.—If the Board imposes a final disciplinary sanction on a public accounting firm registered with the Board or on any person associated with such a firm, the Board shall promptly file notice thereof with the Commission The notice shall be in such form and contain such information as the Commission, by rule, may prescribe as necessary or appropriate in furtherance of the purposes of the Federal securities laws.

"(B) REVIEW.—An action with respect to which the Board is required by subparagraph (A) to file notice shall be subject to review by the Commission, on its own motion, or upon application by any person aggrieved thereby, filed not later than 30 days after the date on which such notice is filed with the Commission and received by such aggrieved person, or within such longer period as the Commission may determine. Application to the Commission for review, or the institution of review by the Commission on its own motion, shall not operate as a stay

of such action unless the Commission otherwise orders, summarily or after notice and opportunity for hearing on the question of a stay (which hearing may consist solely of the submission of affidavits or presentation of oral arguments). The Commission shall establish for appropriate cases an expedited procedure for consideration and determination of the question of a stay.

"(4) DISPOSITION OF REVIEW; CANCELLATION, REDUCTION, OR REMISSION OF SANCTION.—

"(A) IN GENERAL.—In any proceeding to review a final disciplinary sanction imposed by the Board on a public accounting firm registered with the Board or a person associated with such a firm, after notice and opportunity for hearing (which hearing may consist solely of consideration of the record before the Board and opportunity for the presentation of supporting reasons to affirm, modify, or set aside the sanction)—

"(i) if the Commission finds that—

"(I) such firm or person associated with such a firm has engaged in such acts or practices, or has omitted

such acts, as the Board has found them to have engaged in or omitted;

"(II) such acts, practices, or omissions, are in violation of such provisions of the Federal securities laws, the rules or regulations issued thereunder, the rules adopted by the Board, or professional standards as have been specified in the determination of the Board; and

"(III) such provisions were applied in a manner consistent with the purposes of the Federal securities laws;

the Commission, by order, shall so declare and, as appropriate, affirm the sanction imposed by the Board, modify the sanction in accordance with paragraph (2), or remand to the Board for further proceedings; or

"(ii) if the Commission does not make the findings under clause (i), it shall, by order, set aside the sanction imposed by the Board and, if appropriate, remand to the Board for further proceedings.

"(B) CANCELLATION, REDUCTION, OR REMISSION OF SANCTION.—If the Commission, having due regard for the public interest and the protection of investors, finds after a proceeding in accordance with subparagraph (A) that a sanction imposed by the Board upon a firm or person associated with a firm imposes any burden on competition not necessary or appropriate in furtherance of the purposes of the Federal securities laws or is excessive or oppressive, the Commission may cancel, reduce, or require the remission of such sanction.

"(5) COMPLIANCE WITH RULES AND REGULATIONS.—

"(A) DUTIES OF BOARD.—The Board shall—

"(i) comply with the Federal securities laws, the rules and regulations issued thereunder, and its own rules; and

"(ii) subject to subparagraph (B) and the rules thereunder, absent reasonable justification or excuse, enforce compliance with such provisions and with professional standards by public accounting firms reg-

istered with the Board and persons associated with such firms.

"(B) RELIEF BY COMMISSION.—The Commission, by rule, consistent with the public interest, the protection of investors, and the other purposes of the Federal securities laws, may relieve the Board of any responsibility under this section to enforce compliance with any specified provision of the Federal securities laws, the rules or regulations issued thereunder, or professional standards by any public accounting firm registered with the Board or person associated with such a firm, or any class of such firms or persons associated with such a firm.

"(6) CENSURE; OTHER SANCTIONS.—

"(A) IN GENERAL.—The Commission is authorized, by order, if in its opinion such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Federal securities laws, to censure or impose limitations upon the activities, functions, and operations of the Board, if the Commission finds, on the record after notice and opportunity for hearing, that the Board has—

"(i) violated or is unable to comply with any provision of the Federal securities laws, the rules or regulations issued thereunder, or its own rules; or

"(ii) without reasonable justification or excuse, has failed to enforce compliance with any such provision or any professional standard by a public accounting firm registered with the Board or a person associated with such a firm.

"(B) REMOVAL FROM OFFICE.—The Commission is authorized, by order, if in its opinion such action is necessary or appropriate, in the public interest for the protection of investors, or otherwise in furtherance of the purposes of the Federal securities laws, to remove from office or censure any member of the Board, if the Commission finds, on the record after notice and opportunity for hearing, that such member has—

"(i) willfully violated any provision of the Federal securities laws, the rules or regulations issued thereunder, or the rules of the Board;

"(ii) willfully abused such member's authority; or

"(iii) without reasonable justification or excuse, failed to enforce compliance with any such provision or any professional standard by any public accounting firm registered with the Board or any person associated with such a firm.

"(i) FOREIGN ACCOUNTING FIRMS.—A foreign public accounting firm that furnishes accountant's reports on any financial statement, report, or other document required to be filed with the Commission under any Federal securities law shall, with respect to those reports, be subject to the provisions of this section in the same manner and to the same extent as a domestic public accounting firm. The Commission may, by rule, regulation, or order and as it deems consistent with the public interest and the protection of investors, either unconditionally or upon specified terms and conditions, exempt from one or more provisions of this section any foreign public accounting firm. Registration pursuant to this subsection shall not, by itself, provide a basis for subjecting foreign accounting firms to the jurisdiction of the Federal or State courts.

"(j) RELATIONSHIP WITH ANTITRUST LAWS.—

"(1) TREATMENT UNDER ANTITRUST LAWS.—In no case shall the Board, any member thereof, any public accounting firm registered with the Board, or

any person associated with such a firm be subject to liability under any antitrust law for any act of the Board or any failure to act by the Board.

"(2) DEFINITION.—For purposes of this subsection, the term 'antitrust law' means the Federal Trade Commission Act and each statute defined by section 4 thereof as 'Antitrust Acts' and all amendments to such Act and such statutes and any other Federal Acts or State laws in pari materia.

"(k) APPLICABILITY OF AUDITING PRINCIPLES.—Each audit required pursuant to this title of an issuer's financial statements by an independent public accountant shall be conducted in accordance with generally accepted auditing standards, as may be modified or supplemented from time-to-time by the Commission. The Commission may defer to professional standards promulgated by private organizations that are generally accepted by the accounting or auditing profession.

"(l) COMMISSION AUTHORITY NOT IMPAIRED.—Nothing in this section shall be construed to impair or limit the Commission's authority—

"(1) over the accounting profession, accounting firms, or any persons associated with such firms;

"(2) to set standards for accounting practices, derived from other provisions of the Federal securi-

ties laws or the rules or regulations issued thereunder; or

"(3) to take, on its own initiative, legal, administrative, or disciplinary action against any public accounting firm registered with the Board or any person associated with such a firm.".

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II

104TH CONGRESS
1ST SESSION

S. 667

To amend the Securities Exchange Act of 1934 in order to reform the conduct of private securities litigation, to provide for financial fraud detection and disclosure, and for other purposes.

IN THE SENATE OF THE UNITED STATES

APRIL 4 (legislative day, MARCH 27), 1995

Mr. BRYAN (for himself and Mr. SHELBY) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

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A BILL

To amend the Securities Exchange Act of 1934 in order to reform the conduct of private securities litigation, to provide for financial fraud detection and disclosure, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; TABLE OF CONTENTS.

(a) SHORT TITLE.—This Act may be cited as the "Private Securities Enforcement Improvements Act of 1995".

(b) TABLE OF CONTENTS.—The table of contents for this Act is as follows:

TITLE I—PRIVATE SECURITIES LITIGATION

SEC. 101. ELIMINATION OF CERTAIN ABUSIVE PRACTICES AND PROCEDURAL REFORMS.

(a) RECEIPT FOR REFERRAL FEES.—Section 15(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78*o*(c)) is amended by adding at the end the following new paragraph:

"(8) RECEIPT OF REFERRAL FEES.—No broker or dealer, or person associated with a broker or dealer, may solicit or accept remuneration for assisting an attorney in obtaining the representation of any customer in any implied private action arising under this title.".

(b) PROHIBITION ON ATTORNEYS' FEES PAID FROM COMMISSION DISGORGEMENT FUNDS.—Section 21(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78u(d))

is amended by adding at the end the following new paragraph:

"(4) PROHIBITION ON ATTORNEYS' FEES PAID FROM COMMISSION DISGORGEMENT FUNDS.—Except as otherwise ordered by the court, funds disgorged solely as the result of an action brought by the Commission, or of any Commission proceeding, shall not be distributed as payment for attorneys' fees or expenses incurred by private parties seeking distribution of the disgorged funds.".

(c) ADDITIONAL PROVISIONS APPLICABLE TO CLASS ACTIONS.—Section 21 of the Securities Exchange Act of 1934 (15 U.S.C. 78u) is amended by adding at the end the following new subsections:

"(i) RECOVERY BY NAMED PLAINTIFFS IN CLASS ACTIONS.—In an implied private action arising under this title that is certified as a class action pursuant to the Federal Rules of Civil Procedure, the share of any final judgment or of any settlement that is awarded to class plaintiffs serving as the representative parties shall be calculated in the same manner as the shares of the final judgment or settlement awarded to all other members of the class. Nothing in this subsection shall be construed to limit the award to any representative parties of reasonable

compensation, costs, and expenses (including lost wages) relating to the representation of the class.

"(j) CONFLICTS OF INTEREST.—In an implied private action arising under this title that is certified as a class action pursuant to the Federal Rules of Civil Procedure, if a party is represented by an attorney who directly owns or otherwise has a beneficial interest in the securities that are the subject of the litigation, the court shall, upon motion by any party, make a determination of whether such interest constitutes a conflict of interest sufficient to disqualify the attorney from representing the party.

"(k) RESTRICTIONS ON SECRECY.—

"(1) RESTRICTIONS ON SETTLEMENTS UNDER SEAL.—In an implied private action arising under this title, the terms and provisions of any settlement agreement between any of the parties shall not be filed under seal, except that on motion of any of the parties to the settlement, the court may order filing under seal for those portions of a settlement agreement as to which good cause is shown for such filing under seal. Good cause shall only exist if publication of a term or provision of a settlement agreement would cause direct and substantial harm to any person.

"(2) RESTRICTIONS ON PROTECTIVE ORDERS AND SEALING OF CASES.—In an implied private action arising under this title, a court may enter an order restricting the disclosure of information obtained through discovery, or an order restricting access after entry of final judgment to court records, only after making particularized findings of fact that such disclosure or access would cause direct and substantial harm to the competitive or privacy interests of a person.

"(l) PAYMENT OF ATTORNEYS' FEES FROM SETTLEMENT FUNDS.—In an implied private action arising under this title that is certified as a class action pursuant to the Federal Rules of Civil Procedure, attorneys' fees awarded by the court from a common fund for the class to counsel for the class shall—

"(1) be determined based on—

"(A) a reasonable percentage of the amount made available to class members from the common fund; and

"(B) a reasonable percentage of the value of any other benefits made available to the class; and

"(2) include reasonable expenses incurred in the prosecution of the action.

"(m) DISCLOSURE OF SETTLEMENT TERMS TO CLASS MEMBERS.—In an implied private action arising under this title that is certified as a class action pursuant to the Federal Rules of Civil Procedure, a proposed or final settlement agreement that is published or otherwise disseminated to the class shall include the following statements, which shall not be admissible for purposes of any Federal or State judicial action or administrative proceeding, other than an action or proceeding arising out of such statements:

"(1) STATEMENT OF THE BENEFITS OF SETTLEMENT.—A statement of the total amount of the settlement, fully describing all proposed payments and non-monetary benefits to the class, and a schedule setting forth the reasonably anticipated payments to class members.

"(2) STATEMENT OF POTENTIAL OUTCOME OF CASE.—

"(A) AGREEMENT ON AMOUNT OF DAMAGES AND LIKELIHOOD OF PREVAILING.—If the settling parties agree on the amount of damages that would be recoverable if the plaintiff prevailed on each claim alleged under this title and the likelihood that the plaintiff would prevail—

"(i) a statement concerning the amount of such potential damages; and

"(ii) a statement concerning the likelihood that the plaintiff would prevail on the claims alleged under this title and a brief explanation of the reasons for that conclusion.

"(B) DISAGREEMENT ON AMOUNT OF DAMAGES OR LIKELIHOOD OF PREVAILING.—If the settling parties do not agree on the amount of damages that would be recoverable if the plaintiff prevailed on each claim alleged under this title or on the likelihood that the plaintiff would prevail on those claims, or both, a statement concerning the issue or issues on which the parties disagree.

"(3) STATEMENT OF ATTORNEYS' FEES OR COSTS SOUGHT.—If any of the settling parties or their counsel intend to apply to the court for an award of attorneys' fees or costs from any fund established as part of the settlement, a statement indicating which parties or counsel intend to make such an application, the amount of fees and costs that will be sought, and a brief explanation of the basis for the application.

"(4) IDENTIFICATION OF REPRESENTATIVES.—The name, telephone number, and address of one or more representatives of counsel for the class who will be reasonably available to answer questions from class members concerning any matter contained in any notice of settlement published or otherwise disseminated to the class.

"(5) OTHER INFORMATION.—Such other information as may be required by the court.".

SEC. 102. SPECIAL REQUIREMENTS FOR CLASS ACTION COMPLAINTS; MULTIPLE SECURITIES CLASS ACTIONS; PROCEDURE FOR SELECTING LEAD COUNSEL IN CLASS ACTIONS; EARLY EVALUATION PROCEDURE.

The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by inserting after section 27A the following new section:

"SEC. 27B. SPECIAL PROVISIONS FOR CLASS ACTIONS.

"(a) CERTIFICATION OF COMPLAINTS.—

"(1) IN GENERAL.—In an implied private action arising under this title that is filed as a class action pursuant to the Federal Rules of Civil Procedure, each plaintiff seeking to serve as a class representative shall provide a certification personally

signed by the plaintiff to be filed with the complaint that—

"(A) states that the plaintiff has reviewed the complaint and authorized its filing;

"(B) states that the plaintiff did not purchase the security that is the subject of the complaint at the direction of plaintiff's counsel;

"(C) states that the plaintiff is willing to serve as a class representative, including providing testimony at deposition and trial, if necessary;

"(D) sets forth all of the plaintiffs' transactions in the security that is the subject of the complaint during the class period specified in the complaint;

"(E) identifies all suits under this title which the plaintiff has filed as a class action in the prior 12 months; and

"(F) states that the plaintiff will not accept any payment for serving as class representative beyond the plaintiff's pro rata share of any recovery, except as ordered by the court.

"(2) NON-WAIVER OF ATTORNEY-CLIENT PRIVILEGE.—The certification filed pursuant to para-

graph (1) shall not be construed to be a waiver of the attorney-client privilege.

"(b) MULTIPLE SECURITIES CLASS ACTIONS.—

"(1) IN GENERAL.—If more than one implied private action arising under this title out of substantially the same transaction or occurrence is filed in one or more Federal courts, and any person or entity is named as a defendant in more than one such action, each such action shall be deemed a multiple securities class action, and the actions shall be deemed a group of multiple securities class actions.

"(2) CONSOLIDATION.—The parties shall promptly call to the attention of each court in which multiple securities class actions are filed the other actions in the group of multiple securities class actions. All the actions in the group of multiple securities class actions shall be transferred or consolidated (or both) in the most convenient forum before one judge as promptly as possible. The Judicial Panel on Multi-District Litigation shall give expedited treatment to proceedings involving multiple securities class actions to facilitate their transfer to one district as promptly as possible.

"(3) SELECTION OF LEAD COUNSEL.—When multiple securities class actions are filed, plaintiffs'

counsel shall promptly organize themselves and select lead counsel to direct the prosecution of the actions, subject to the approval of the court. If plaintiffs' counsel do not organize themselves, the court shall promptly designate lead counsel, in no event later than 45 days after the filing of the first multiple securities class action. In selecting or designating lead counsel, plaintiffs' counsel and the court shall not give undue weight to the order of filing the multiple securities class actions.

"(4) LATER-FILED CASES.—Any multiple securities class action filed after the case organization period shall be subject to the decisions taken during the case organization period.

"(c) EARLY EVALUATION PROCEDURE.—

"(1) IN GENERAL.—In an implied private action arising under this title that is filed as a class action pursuant to the Federal Rules of Civil Procedure, if the class representatives and each of the other parties to the action agree and any party so requests, or if the court upon motion of any party so decides, not later than 60 days after the filing of the class action, the court shall order an early evaluation procedure. The period of the early evaluation procedure shall not extend beyond 150 days after

the filing of the first complaint subject to the procedure.

"(2) REQUIREMENTS.—During the early evaluation procedure described under paragraph (1)—

"(A) defendants shall not be required to answer or otherwise respond to any complaint;

"(B) plaintiffs may file a consolidated or amended complaint at any time and may dismiss the action or actions at any time without sanction;

"(C) unless otherwise ordered by the court, no formal discovery shall occur, except that parties may propound discovery requests to third parties to preserve evidence;

"(D) the parties shall evaluate the merits of the action under the supervision of a person (hereafter in this section referred to as the 'mediator') agreed upon by them or designated by the court in the absence of agreement, which person may be another district court judge, any magistrate-judge or a special master, each side having one peremptory challenge of a mediator designated by the court by filing a written notice of challenge not later than 5 days after receipt of an order designating the mediator;

"(E) the parties shall promptly provide access to or exchange all nonprivileged documents relating to the allegations in the complaint or complaints, and any documents withheld on the grounds of privilege shall be sufficiently identified so as to permit the mediator to determine if they are, in fact, privileged; and

"(F) the parties shall exchange damage studies and such other expert reports as may be helpful to an evaluation of the action on the merits, which materials shall be treated as prepared and used in the context of settlement negotiations.

"(3) FAILURE TO PRODUCE DOCUMENTS.—Any party that fails to produce documents relevant to the allegations of the complaint or complaints during the early evaluation procedure described in paragraph (1) may be sanctioned by the court pursuant to the Federal Rules of Civil Procedure. Notwithstanding paragraph (2), subject to review by the court, the mediator may order the production of evidence by any party and, to the extent necessary properly to evaluate the case, may permit discovery of nonparties and depositions of parties for good cause shown.

"(4) EVALUATION BY THE MEDIATOR.—

"(A) IN GENERAL.—If, at the end of the early evaluation procedure described in paragraph (1), the action has not been voluntarily dismissed or settled, the mediator shall evaluate the action as being—

"(i) clearly frivolous, such that it can only be further maintained in bad faith; or

"(ii) clearly meritorious, such that it can only be further defended in bad faith; or

"(iii) described by neither clause (i) nor clause (ii).

"(B) WRITTEN EVALUATION.—An evaluation required by subparagraph (A) with respect to the claims against and defenses of each defendant shall be issued in writing not later than 10 days after the end of the early evaluation procedure and provided to the parties. The evaluation shall not be admissible in the action, and shall not be provided to the court until a motion for sanctions under paragraph (5) is timely filed.

"(5) MANDATORY SANCTIONS.—

"(A) CLEARLY FRIVOLOUS ACTIONS.—In an action that is evaluated under paragraph (4)(A)(i) in which final judgment is entered against the plaintiff, the plaintiff or plaintiff's counsel shall be liable to the defendant for sanctions as awarded by the court, which may include an order to pay reasonable attorneys' fees and other expenses, if the court agrees, based on the entire record, that the action was clearly frivolous when filed and was maintained in bad faith.

"(B) CLEARLY MERITORIOUS ACTIONS.—In an action that is evaluated under paragraph (4)(A)(ii) in which final judgment is entered against the defendant, the defendant or defendant's counsel shall be liable to the plaintiff for sanctions as awarded by the court, which may include an order to pay reasonable attorneys' fees and other expenses, if the court agrees, based on the entire record, that the action was clearly meritorious and was defended in bad faith.

"(6) EXTENSION OF EARLY EVALUATION PERIOD.—The period of the early evaluation procedure described in paragraph (1) may be extended by stip-

ulation of all parties. At the conclusion of the period, the action shall proceed in accordance with Federal Rules of Civil Procedure.

"(7) FEES.—In an implied private action described in paragraph (1), each side shall bear equally the reasonable fees and expenses of the mediator agreed upon or designated under paragraph (2)(D), if the mediator is not a judicial officer.".

SEC. 103. REQUIREMENTS FOR SECURITIES FRAUD ACTIONS.

The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by inserting after section 10 the following new section:

"SEC. 10A. REQUIREMENTS FOR SECURITIES FRAUD ACTIONS.

"(a) IN GENERAL.—In any private action arising under section 10(b) that is based on a fraudulent statement or fraudulent omission, liability for that statement or omission may be established only upon proof that—

"(1) the defendant directly or indirectly made that fraudulent statement or omission; and

"(2) the defendant made that fraudulent statement or fraudulent omission knowingly or recklessly.

"(b) APPLICATION.—Subsection (a) does not affect any liability under section 10(b), other than as provided

in subsection (a), based on the employment of any device, scheme, or artifice to defraud or on the engagement in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

"(c) FRAUDULENT STATEMENT.—For purposes of this section, a fraudulent statement is a statement that contains an untrue statement of a material fact, or omits to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading.

"(d) KNOWINGLY.—For purposes of subsection (a), a person makes a fraudulent statement knowingly if the person knew that the statement of a material fact was untrue at the time it was made, or knew that an omitted fact was necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading.

"(e) RECKLESSLY.—For purposes of subsection (a), a person makes a fraudulent statement recklessly if the person, in making the statement is guilty of highly unreasonable conduct that—

"(1) involves not merely simple or even inexcusable negligence, but an extreme departure from standards of ordinary care; and

"(2) presents a danger of misleading securities purchasers or sellers that was either known to the defendant or so obvious that the defendant must have been aware of it.

"(f) PLEADING REQUIREMENT.—In any private action described in subsection (a), in which the plaintiff may recover money damages only if it proves that the defendant acted as described in subsection (a)(2), the plaintiff shall allege in its complaint facts suggesting that the defendant made a fraudulent statement or fraudulent omission knowingly or recklessly.

"(g) FRAUD ON THE MARKET.—The Commission shall, by rule, define the circumstances in which it is and is not appropriate for reliance to be presumed under the fraud on the market theory in any action to which subsection (a) applies. In promulgating such rules, the Commission shall consider—

"(1) whether the issuer and its securities are regularly reviewed by 2 or more analysts;

"(2) the weekly trading volume of any class of securities of the issuer of the security;

"(3) the existence of public reports by securities analysts concerning any class of securities of the issuer of the security;

"(4) the eligibility of the issuer of the security, under the rules and regulations of the Commission, to incorporate by reference its reports made pursuant to section 13 in a registration statement filed under the Securities Act of 1933 in connection with the sale of equity securities;

"(5) a history of immediate movement of the price of any class of securities of the issuer of the security caused by the public dissemination of information regarding unexpected corporate events or financial releases; and

"(6) any other factors determined by the Commission to be appropriate.".

SEC. 104. PROPORTIONATE LIABILITY AND CONTRIBUTION.

The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by inserting after section 10A (as added by section 103 of this Act) the following new section:

"SEC. 10B. PROPORTIONATE LIABILITY AND CONTRIBUTION.

"(a) PROPORTIONATE LIABILITY.—

"(1) SPECIAL FINDINGS.—In all implied private actions arising under this title involving the fault of more than one defendant, including third-party defendants, the court, unless otherwise agreed by all

parties, shall instruct the jury to answer special interrogatories or, if there is no jury, shall make findings, indicating whether such defendant—

"(A) acted with a degree of scienter greater than recklessness; or

"(B) at the time of the violation of this title for which liability is claimed, directly or indirectly controlled a defendant who acted with a degree of scienter greater than recklessness.

"(2) ALLOCATION OF LIABILITY.—

"(A) IN GENERAL.—

"(i) RULES OF JOINT AND SEVERAL LIABILITY.—In all private actions arising under this title to which paragraph (1) applies, each liable defendant, including third-party defendants, as to whom an affirmative finding under paragraph (1) has been made shall be subject to the rules of joint and several liability.

"(ii) PROPORTIONATE LIABILITY.—Subject to subparagraph (C), each liable defendant to which clause (i) does not apply, including third-party defendants, shall be proportionately liable for his or her equitable share of the obligation, as de-

termined in accordance with subsection (c)(4).

"(B) UNCOLLECTIBLE SHARES.—If, upon motion made under subsection (c)(5), the court determines that all or part of the equitable share of a defendant of the obligation is uncollectible from that defendant, the court shall reallocate any uncollectible amount among those defendants who are jointly and severally liable under subparagraph (A)(i) according to their respective percentages of fault, as determined in accordance with subsection (c)(1).

"(C) REALLOCATION.—If there are no defendants who are jointly and severally liable (other than defendants whose equitable shares are uncollectible) or if, upon motion made not later than 6 months after reallocation of an uncollectible amount under subparagraph (B), the court shall determine that all or part of such uncollectible amount is uncollectible from defendants who are jointly and severally liable, the court shall reallocate any uncollectible amount among the defendants who are proportionately liable under subparagraph (A)(ii), according to their respective percentages of fault

as determined in accordance with subsection (c)(1).

"(D) CONTRIBUTION AND CONTINUING LIABILITY.—A defendant whose liability is reallocated pursuant to subparagraph (B) and (C) shall be subject to contribution under subsection (b) and to any continuing liability to the plaintiff on the judgment.

"(b) RIGHT TO CONTRIBUTION.—Subject to subsection (f), in an implied private action arising under this title, a right of contribution—

"(1) shall exist between or among 2 or more persons who are liable upon the same indivisible claim for the same damages, whether or not judgment has been recovered against all or any of such persons;

"(2) may be enforced either in the original action or by a separate action brought for that purpose; and

"(3) shall be based upon the equitable share of each person of the obligation, as determined in accordance with subsection (c)(4), except that a defendant who is jointly and severally liable under subsection (a)(2)(A)(i) shall not be entitled to contribution for the payment of any amount reallocated

under subsection (a)(2)(B) from any party who is proportionately liable under subsection (a)(2)(A)(ii), other than the party whose liability was reallocated.

"(c) SPECIAL FINDINGS.—

"(1) FAULT OF MULTIPLE PARTIES.—In all implied private actions arising under this title involving the fault of more than 1 defendant, including third-party defendants and persons who have been released under subsection (e), the court, unless otherwise agreed by all parties, shall instruct the jury to answer special interrogatories or, if there is no jury, shall make findings indicating—

"(A) the amount of damages the plaintiff is entitled to recover; and

"(B) the percentage of the total fault that is allocated to each defendant, each third-party defendant, and each person who has been released from liability under subsection (e).

"(2) SINGLE PARTY DETERMINATIONS.—For purposes of paragraph (1), the court may determine that 2 or more persons are to be treated as a single party.

"(3) COURT CONSIDERATIONS.—In determining the percentages of fault for purposes of this subsection, the trier of fact shall consider both the na-

ture of the conduct of each party at fault and the extent of the causal relation between the conduct and the damages claimed.

"(4) DETERMINATION AND ALLOCATION OF DAMAGES.—The court shall determine the award of damages to the plaintiff in accordance with its findings, subject to any reduction under subsection (e), and shall enter judgment against each liable defendant and third-party defendant on the basis of the rules of joint and several liability or, if applicable, as set forth in subsection (a). For purposes of allocation of liability under subsection (a)(2), and contribution under subsections (b) and (d), the court shall also determine and state in the judgment the equitable share of each party of the obligation in accordance with the respective percentages of fault assigned to each party.

"(5) DETERMINATION OF COLLECTIBILITY.—Upon motion made not later than 6 months after judgment is entered in an action arising under this title, the court shall determine whether all or part of the equitable share of a party of the obligation is uncollectible from that party and, except as otherwise provided in subsection (a)(2), shall reallocate any uncollectible amount among the other parties

according to their respective percentages of fault. A party whose liability is reallocated shall be subject to contribution and to any continuing liability to the plaintiff on the judgment.

"(d) ENFORCEMENT OF CONTRIBUTION.—

"(1) IN GENERAL.—In an implied private action arising under this title, if the proportionate fault of the parties to a claim for contribution—

"(A) has been established previously by the court, as provided by subsection (c), a party paying more than its equitable share of the obligation, upon motion, may recover judgment for contribution; or

"(B) has not been established by the court, contribution may be enforced in a separate action, whether or not a judgment has been rendered against either the person seeking contribution or the person from whom contribution is being sought.

"(2) TIMING.—In an implied private action arising under this title—

"(A) if a judgment has been rendered, an action for contribution shall be commenced not later than 1 year after the date on which the judgment becomes final; or

"(B) if no judgment has been rendered, a person bringing an action for contribution shall—

"(i) discharge by payment the common liability within the period of the statute of limitations applicable to the plaintiff's right of action and commence the action for contribution not later than 1 year after the date on which such payment is made; or

"(ii) agree while the action is pending, to discharge the common liability and, not later than 1 year after the date of the agreement, pay the liability and commence an action for contribution.

"(e) EFFECT OF RELEASE.—A release, covenant not to sue, or similar agreement entered into by a plaintiff and a person liable, shall discharge that person from all liabilities for contribution, but shall not discharge any other persons liable upon the same claim unless the agreement so provides. Upon such release, covenant not to sue, or similar agreement, the claim of the releasing person against other persons shall be reduced by the amount paid to the releasing person in consideration of such release, covenant not to sue, or similar agreement.

"(f) ENCOURAGEMENT OF FINALITY IN SETTLEMENT DISCHARGE.—

"(1) DISCHARGE.—A defendant who, in good faith, settles any private action brought under this title at any time before verdict or judgment is rendered shall be discharged from all claims for contribution brought by other persons. Upon entry of the settlement by the court, the court shall enter a bar order constituting the final discharge of all obligations to the plaintiff of the settling defendant arising out of the action. The order shall bar all future claims for contribution or indemnity arising out of the action—

"(A) by nonsettling persons against the settling defendant; and

"(B) by the settling defendant against any nonsettling defendants.

"(2) REDUCTION.—If a person enters into a settlement with the plaintiff prior to verdict or judgment rendered in any private action brought under this title, the verdict or judgment shall be reduced by the amount paid to the plaintiff by that person.".

SEC. 105. RESTORATION OF AIDING AND ABETTING LIABILITY.

(a) SECURITIES ACT OF 1933.—Section 20 of the Securities Act of 1933 (15 U.S.C. 77t) is amended by adding at the end the following new subsection:

"(f) PROSECUTION OF PERSONS WHO AID OR ABET VIOLATIONS.—For purposes of subsections (b) and (d), any person who knowingly or recklessly provides substantial assistance to another person in the violation of a provision of this title, or of any rule or regulation promulgated under this title, shall be deemed to violate such provision to the same extent as the person to whom such assistance is provided. No person shall be liable under this subsection based on an omission or failure to act unless such omission or failure constituted a breach of a duty owed by such person.".

(b) SECURITIES EXCHANGE ACT OF 1934.—Section 20 of the Securities Exchange Act of 1934 (15 U.S.C. 78t) is amended—

(1) by adding at the end the following new subsection:

"(e) PROSECUTION OF PERSONS WHO AID OR ABET VIOLATIONS.—For purposes of subsections (d)(1) and (d)(3) of section 21, or an action by a self-regulatory organization, or an express or implied private right of action arising under this title, any person who knowingly or reck-

lessly provides substantial assistance to another person in the violation of a provision of this title, or of any rule or regulation promulgated under this title, shall be deemed to violate such provision and shall be liable to the same extent as the person to whom such assistance is provided. No person shall be liable under this subsection based on an omission or failure to act unless such omission or failure constituted a breach of a duty owed by such person."; and

(2) by striking the heading of such section and inserting the following:

"SEC. 20. LIABILITY OF CONTROLLING PERSONS AND PERSONS WHO AID OR ABET VIOLATIONS.".

(c) INVESTMENT COMPANY ACT OF 1940.—Section 42 of the Investment Company Act of 1940 (15 U.S.C. 80a–41) is amended by adding at the end the following new subsection:

"(f) PROSECUTION OF PERSONS WHO AID OR ABET VIOLATIONS.—For purposes of subsections (d) and (e), any person who knowingly or recklessly provides substantial assistance to another person in the violation of a provision of this title, or of any rule, regulation, or order promulgated under this title, shall be deemed to violate such provision to the same extent as the person to whom such assistance is provided. No person shall be liable under this

subsection based on an omission or failure to act unless such omission or failure constituted a breach of a duty owed by such person.".

(d) INVESTMENT ADVISERS ACT OF 1940.—Section 209(d) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–9) is amended—

(1) in subsection (d)—

(A) by striking "or that any person has aided, abetted, counseled, commanded, induced, or procured, is aiding, abetting, counseling, commanding, inducing, or procuring, or is about to aid, abet, counsel, command, induce, or procure such a violation,"; and

(B) by striking "or in aiding, abetting, counseling, commanding, inducing, or procuring any such act or practice"; and

(2) by adding at the end the following new subsection:

"(f) PROSECUTION OF PERSONS WHO AID OR ABET VIOLATIONS.—For purposes of subsections (d) and (e), any person who knowingly or recklessly provides substantial assistance to another person in the violation of a provision of this title, or of any rule, regulation, or order promulgated under this title, shall be deemed to violate such provision to the same extent as the person to whom such

assistance is provided. No person shall be liable under this subsection based on an omission or failure to act unless such omission or failure constituted a breach of duty owed by such person.".

SEC. 106. LIMITATIONS PERIOD FOR IMPLIED PRIVATE RIGHTS OF ACTION.

The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by adding at the end the following new section:

"SEC. 36. LIMITATIONS PERIOD FOR IMPLIED PRIVATE RIGHTS OF ACTION.

"(a) IN GENERAL.—Except as otherwise provided in this title, an implied private right of action arising under this title shall be brought not later than the earlier of—

"(1) 5 years after the date on which the alleged violation occurred; or

"(2) 2 years after the date on which the alleged violation was discovered.

"(b) EFFECTIVE DATE.—The limitations period provided by this section shall apply to all proceedings commenced after the date of enactment of this section.".

SEC. 107. SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS.

(a) RULEMAKING.—Not later than 12 months after the date of enactment of this Act, the Commission shall

adopt rules or regulations (or amend the rules or regulations in effect on the date of enactment of this Act), to provide one or more safe harbors for such forward-looking information, as that term is defined by the Commission, as the Commission may designate, having due regard for the public interest and the protection of investors.

(b) CRITERIA.—Rules or regulations adopted (or amended) pursuant to subsection (a) shall specify with respect to a safe harbor—

(1) the forward-looking information or classes of forward-looking information to be covered by the safe harbor;

(2) the securities or classes of securities to be covered by the safe harbor;

(3) the issuers of or classes of issuers of securities or other persons to whom the safe harbor shall apply, as appropriate;

(4) the criteria the Commission determines to be necessary and appropriate in the public interest and for the protection of investors by which such forward-looking information may be included in the safe harbor; and

(5) the provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 to which the safe harbor shall apply.

(c) REPORT.—

(1) SUBMISSION.—Not later than 30 days after the date of adoption of the rules described in subsection (a), the Commission shall submit a report to the Committee on Commerce of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate describing such rules.

(2) CONTENTS.—The report required by paragraph (1) shall include a description of—

(A) the procedures to be followed by the court for making a summary determination early in a judicial proceeding of the applicability of any rule of the Commission to forward-looking statements in order—

(i) to limit litigation and discovery; and

(ii) to promote timely dismissal of claims against issuers of securities based on such forward-looking statements if such statements are in accordance with the rules and regulations of the Commission;

(B) the steps that the Commission is undertaking to provide clear guidance to issuers of

securities and the judiciary regarding the rules prescribed pursuant to subsection (a); and

(C) any legislative recommendations relating to forward-looking statements that the Commission determines to be appropriate.

(d) SECURITIES EXCHANGE ACT AMENDMENT.—The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by adding at the end the following new section:

"SEC. 37. APPLICATION OF SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS.

"(a) IN GENERAL.—In any implied private action arising under this title that alleges that a forward-looking statement concerning the future economic performance of an issuer registered under section 12 was materially false or misleading, if a party making a motion in accordance with subsection (b) requests a stay of discovery concerning the claims or defenses related to such statement of that party, the court shall grant such a stay until it has ruled on any such motion.

"(b) SUMMARY JUDGMENT MOTIONS.—Subsection (a) shall apply to any motion for summary judgment made by a defendant asserting that the forward-looking statement was within the coverage of any rule which the Commission may have adopted concerning such predictive

statements, if such motion is made not later than 60 days after the plaintiff commences discovery in the action.

"(c) DILATORY CONDUCT; DUPLICATIVE DISCOVERY.—Notwithstanding subsection (a) or (b), the time permitted for a plaintiff to conduct discovery under subsection (b) may be extended, or a stay of the proceedings may be denied, if the court finds that—

"(1) the defendant making a motion described in subsection (b) engaged in dilatory or obstructive conduct in taking or opposing any discovery; or

"(2) a stay of discovery pending a ruling on a motion under subsection (b) would be substantially unfair to the plaintiff or other parties to the action.".

TITLE II—FINANCIAL FRAUD DETECTION AND DISCLOSURE

SEC. 201. FINANCIAL FRAUD DETECTION AND DISCLOSURE.

(a) AMENDMENTS TO THE SECURITIES EXCHANGE ACT OF 1934.—The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by inserting after section 13 the following new section:

"SEC. 13A. FRAUD DETECTION AND DISCLOSURE.

"(a) AUDIT REQUIREMENTS.—Each audit required pursuant to this title of an issuer's financial statements by an independent public accountant shall include, in ac-

cordance with generally accepted auditing standards, as may be modified or supplemented by the Commission—

"(1) procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts;

"(2) procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein; and

"(3) an evaluation of whether there is substantial doubt about the issuer's ability to continue as a going concern during the ensuing fiscal year.

"(b) REQUIRED RESPONSE TO AUDIT DISCOVERIES.—

"(1) INVESTIGATION AND REPORT TO MANAGEMENT.—If, in the course of conducting any audit pursuant to this title to which subsection (a) applies, the independent public accountant detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the issuer's financial statements) has or may have occurred, the accountant shall, in accordance with generally accepted auditing stand-

1 ards, as may be modified or supplemented by the
2 Commission—
3 "(A) determine whether it is likely that an
4 illegal act has occurred, and if so, determine
5 and consider the possible effect of the illegal act
6 on the financial statements of the issuer, in-
7 cluding any contingent monetary effects, such
8 as fines, penalties, and damages; and
9 "(B) as soon as practicable, inform the ap-
10 propriate level of the issuer's management and
11 assure that the issuer's audit committee, or the
12 issuer's board of directors in the absence of
13 such a committee, is adequately informed with
14 respect to illegal acts that have been detected or
15 have otherwise come to the attention of such
16 accountant in the course of the audit, unless
17 the illegal act is clearly inconsequential.
18 "(2) RESPONSE TO FAILURE TO TAKE REME-
19 DIAL ACTION.—If, having first assured itself that
20 the audit committee of the board of directors of the
21 issuer or the board of directors (in the absence of
22 an audit committee) is adequately informed with re-
23 spect to illegal acts that have been detected or have
24 otherwise come to the attention of the independent
25 public accountant in the course of such accountant's

audit, the independent public accountant concludes that—

"(A) any such illegal act has a material effect on the financial statements of the issuer;

"(B) senior management of the issuer have not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to such illegal act; and

"(C) the failure to take remedial action is reasonably expected to warrant departure from a standard auditor's report, when made, or warrant resignation from the audit engagement,

the independent public accountant shall, as soon as practicable, directly report its conclusions to the board of directors of the issuer.

"(3) NOTICE TO COMMISSION; RESPONSE TO FAILURE TO NOTIFY.—An issuer whose board of directors has received a report pursuant to paragraph (2) shall inform the Commission by notice not later than 1 business day after receipt of such report, and shall furnish the independent public accountant making such report with a copy of the notice furnished to the Commission. If the independent public accountant making such report does not receive a

copy of such notice within the required one-business-day period, the independent public accountant shall—

"(A) resign from the engagement; or

"(B) furnish to the Commission a copy of its report (or the documentation of any oral report given) not later than 1 business day after such failure to receive notice.

"(4) REPORT AFTER RESIGNATION.—An independent public accountant electing resignation under paragraph (3)(A) shall, not later than 1 business day after a failure by an issuer to notify the Commission under paragraph (3), furnish to the Commission a copy of the accountant's report (or the documentation of any oral report given).

"(c) AUDITOR LIABILITY LIMITATION.—No independent public accountant shall be liable in a private action for any finding, conclusion, or statement expressed in a report made pursuant to paragraph (3) or (4) of subsection (b), including any rules promulgated pursuant to those provisions.

"(d) CIVIL PENALTIES IN CEASE-AND-DESIST PROCEEDINGS.—If the Commission finds, after notice and opportunity for hearing in a proceeding instituted pursuant to section 21C, that an independent public accountant has

willfully violated paragraph (3) or (4) of subsection (b), the Commission may, in addition to entering an order under section 21C, impose a civil penalty against the independent public accountant and any other person that the Commission finds was a cause of such violation. The determination whether to impose a civil penalty, and the amount of any such penalty, shall be governed by the standards set forth in section 21B.

"(e) PRESERVATION OF EXISTING AUTHORITY.—Except as provided in subsection (d), nothing in this section limits or otherwise affects the authority of the Commission under this title.

"(f) DEFINITION.—As used in this section, the term 'illegal act' means any action or omission that violates any law, or any rule or regulation having the force of law.".

(b) EFFECTIVE DATES.—Section 13A of the Securities Exchange Act of 1934, as added by subsection (a) of this section, shall apply to any person registered under that Act that is required to file selected quarterly financial data pursuant to the rules of the Commission for all such reports for any period beginning on or after January 1, 1996. Such section shall apply to such reports filed by any other person registered under that Act for any period beginning on or after January 1, 1997.

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II

104TH CONGRESS
1ST SESSION

H. R. 1058

IN THE SENATE OF THE UNITED STATES

MARCH 10 (legislative day, MARCH 6), 1995

Received; read twice and referred to the Committee on Banking, Housing, and Urban Affairs

AN ACT

To reform Federal securities litigation, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; TABLE OF CONTENTS.

(a) SHORT TITLE.—This Act may be cited as the "Securities Litigation Reform Act".

(b) TABLE OF CONTENTS.—The table of contents for this Act is as follows:

SEC. 2. PREVENTION OF LAWYER-DRIVEN LITIGATION.

(a) PLAINTIFF STEERING COMMITTEES TO ENSURE CLIENT CONTROL OF LAWSUITS.—The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by adding at the end the following new section:

"SEC. 36. CLASS ACTION STEERING COMMITTEES.

"(a) CLASS ACTION STEERING COMMITTEE.—In any private action arising under this title seeking to recover damages on behalf of a class, the court shall, at the earliest practicable time, appoint a committee of class members to direct counsel for the class (hereafter in this section referred to as the 'plaintiff steering committee') and to perform such other functions as the court may specify. Court appointment of a plaintiff steering committee shall not be subject to interlocutory review.

"(b) MEMBERSHIP OF PLAINTIFF STEERING COMMITTEE.—

"(1) QUALIFICATIONS.—

"(A) NUMBER.—A plaintiff steering committee shall consist of not fewer than 5 class members, willing to serve, who the court believes will fairly represent the class.

"(B) OWNERSHIP INTERESTS.—Members of the plaintiff steering committee shall have cumulatively held during the class period not less than—

"(i) the lesser of 5 percent of the securities which are the subject matter of the litigation or $10,000,000 in market value of the securities which are the subject matter of the litigation; or

"(ii) such smaller percentage or dollar amount as the court finds appropriate under the circumstances.

"(2) NAMED PLAINTIFFS.—Class plaintiffs serving as the representative parties in the litigation may serve on the plaintiff steering committee, but shall not comprise a majority of the committee.

"(3) NONCOMPENSATION OF MEMBERS.—Members of the plaintiff steering committee shall serve without compensation, except that any member may apply to the court for reimbursement of reasonable out-of-pocket expenses from any common fund established for the class.

"(4) MEETINGS.—The plaintiff steering committee shall conduct its business at one or more previously scheduled meetings of the committee, of which prior notice shall have been given and at which a majority of its members are present in person or by electronic communication. The plaintiff steering committee shall decide all matters within its

authority by a majority vote of all members, except that the committee may determine that decisions other than to accept or reject a settlement offer or to employ or dismiss counsel for the class may be delegated to one or more members of the committee, or may be voted upon by committee members seriatim, without a meeting.

"(5) RIGHT OF NONMEMBERS TO BE HEARD.—A class member who is not a member of the plaintiff steering committee may appear and be heard by the court on any issue relating to the organization or actions of the plaintiff steering committee.

"(c) FUNCTIONS OF PLAINTIFF STEERING COMMITTEE.—The authority of the plaintiff steering committee to direct counsel for the class shall include all powers normally permitted to an attorney's client in litigation, including the authority to retain or dismiss counsel and to reject offers of settlement, and the authority to accept an offer of settlement subject to final approval by the court. Dismissal of counsel other than for cause shall not limit the ability of counsel to enforce any contractual fee agreement or to apply to the court for a fee award from any common fund established for the class.

"(d) IMMUNITY FROM CIVIL LIABILITY; REMOVAL.—Any person serving as a member of a plaintiff steering

committee shall be immune from any civil liability for any negligence in performing such service, but shall not be immune from liability for intentional misconduct or from the assessment of costs pursuant to section 20B(c). The court may remove a member of a plaintiff steering committee for good cause shown.

"(e) EFFECT ON OTHER LAW.—This section does not affect any other provision of law concerning class actions or the authority of the court to give final approval to any offer of settlement.".

(b) PROHIBITION ON ATTORNEYS' FEES PAID FROM COMMISSION DISGORGEMENT FUNDS.—Section 21(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78u(d)) is amended by adding at the end the following new paragraph:

"(4) PROHIBITION ON ATTORNEYS' FEES PAID FROM COMMISSION DISGORGEMENT FUNDS.—Except as otherwise ordered by the court, funds disgorged as the result of an action brought by the Commission, or of any Commission proceeding, shall not be distributed as payment for attorneys' fees or expenses incurred by private parties seeking distribution of the disgorged funds.".

SEC. 3. PREVENTION OF ABUSIVE PRACTICES THAT FOMENT LITIGATION.

(a) ADDITIONAL PROVISIONS APPLICABLE TO PRIVATE ACTIONS.—The Securities Exchange Act of 1934 is amended by inserting after section 20A (15 U.S.C. 78t–1) the following new section:

"PROCEDURES APPLICABLE TO PRIVATE ACTIONS

"SEC. 20B. (a) ELIMINATION OF BONUS PAYMENTS TO NAMED PLAINTIFFS IN CLASS ACTIONS.—In any private action under this title that is certified as a class action pursuant to the Federal Rules of Civil Procedure, the portion of any final judgment or of any settlement that is awarded to class plaintiffs serving as the representative parties shall be equal, on a per share basis, to the portion of the final judgment or settlement awarded to all other members of the class. Nothing in this subsection shall be construed to limit the award to any representative parties of actual expenses (including lost wages) relating to the representation of the class.

"(b) RESTRICTIONS ON PROFESSIONAL PLAINTIFFS.—Except as the court may otherwise permit for good cause, a person may be a named plaintiff, or an officer, director, or fiduciary of a named plaintiff, in no more than 5 class actions filed during any 3-year period.

"(c) AWARDS OF FEES AND EXPENSES.—

"(1) AUTHORITY TO AWARD FEES AND EXPENSES.—If the court in any private action arising under this title enters a final judgment against a party litigant on the basis of a motion to dismiss, motion for summary judgment, or a trial on the merits, the court shall, upon motion by the prevailing party, determine whether (A) the position of the losing party was not substantially justified, (B) imposing fees and expenses on the losing party or the losing party's attorney would be just, and (C) the cost of such fees and expenses to the prevailing party is substantially burdensome or unjust. If the court makes the determinations described in clauses (A), (B), and (C), the court shall award the prevailing party reasonable fees and other expenses incurred by that party. The determination of whether the position of the losing party was substantially justified shall be made on the basis of the record in the action for which fees and other expenses are sought, but the burden of persuasion shall be on the prevailing party.

"(2) SECURITY FOR PAYMENT OF COSTS IN CLASS ACTIONS.—In any private action arising under this title that is certified as a class action pursuant to the Federal Rules of Civil Procedure, the

court shall require an undertaking from the attorneys for the plaintiff class, the plaintiff class, or both, in such proportions and at such times as the court determines are just and equitable, for the payment of the fees and expenses that may be awarded under paragraph (1).

"(3) APPLICATION FOR FEES.—A party seeking an award of fees and other expenses shall, within 30 days of a final, nonappealable judgment in the action, submit to the court an application for fees and other expenses that certifies that the party is entitled to such an award under paragraph (1) and the amount sought, including an itemized statement from any attorney or expert witness representing or appearing on behalf of the party stating the actual time expended and the rate at which fees and other expenses are computed.

"(4) ALLOCATION AND SIZE OF AWARD.—The court, in its discretion, may—

"(A) determine whether the amount to be awarded pursuant to this section shall be awarded against the losing party, its attorney, or both; and

"(B) reduce the amount to be awarded pursuant to this section, or deny an award, to

the extent that the prevailing party during the course of the proceedings engaged in conduct that unduly and unreasonably protracted the final resolution of the action.

"(5) AWARDS IN DISCOVERY PROCEEDINGS.—In adjudicating any motion for an order compelling discovery or any motion for a protective order made in any private action arising under this title, the court shall award the prevailing party reasonable fees and other expenses incurred by the party in bringing or defending against the motion, including reasonable attorneys' fees, unless the court finds that special circumstances make an award unjust.

"(6) RULE OF CONSTRUCTION.—Nothing in this subsection shall be construed to limit or impair the discretion of the court to award costs pursuant to other provisions of law.

"(7) PROTECTION AGAINST ABUSE OF PROCESS.—In any action to which this subsection applies, a court shall not permit a plaintiff to withdraw from or voluntarily dismiss such action if the court determines that such withdrawal or dismissal is taken for purposes of evasion of the requirements of this subsection.

"(8) DEFINITIONS.—For purposes of this subsection—

"(A) The term 'fees and other expenses' includes the reasonable expenses of expert witnesses, the reasonable cost of any study, analysis, report, test, or project which is found by the court to be necessary for the preparation of the party's case, and reasonable attorneys' fees and expenses. The amount of fees awarded under this section shall be based upon prevailing market rates for the kind and quality of services furnished.

"(B) The term 'substantially justified' shall have the same meaning as in section 2412(d)(1) of title 28, United States Code.

"(d) PREVENTION OF ABUSIVE CONFLICTS OF INTEREST.—In any private action under this title pursuant to a complaint seeking damages on behalf of a class, if the class is represented by an attorney who directly owns or otherwise has a beneficial interest in the securities that are the subject of the litigation, the court shall, on motion by any party, make a determination of whether such interest constitutes a conflict of interest sufficient to disqualify the attorney from representing the class.

"(e) DISCLOSURE OF SETTLEMENT TERMS TO CLASS MEMBERS.—In any private action under this title that is certified as a class action pursuant to the Federal Rules of Civil Procedure, any proposed or final settlement agreement that is published or otherwise disseminated to the class shall include the following statements:

"(1) STATEMENT OF POTENTIAL OUTCOME OF CASE.—

"(A) AGREEMENT ON AMOUNT OF DAMAGES AND LIKELIHOOD OF PREVAILING.—If the settling parties agree on the amount of damages per share that would be recoverable if the plaintiff prevailed on each claim alleged under this title and the likelihood that the plaintiff would prevail—

"(i) a statement concerning the amount of such potential damages per share; and

"(ii) a statement concerning the likelihood that the plaintiff would prevail on the claims alleged under this title and a brief explanation of the reasons for that conclusion.

"(B) DISAGREEMENT ON AMOUNT OF DAMAGES OR LIKELIHOOD OF PREVAILING.—If

the parties do not agree on the amount of damages per share that would be recoverable if the plaintiff prevailed on each claim alleged under this title or on the likelihood that the plaintiff would prevail on those claims, or both, a statement from each settling party concerning the issue or issues on which the parties disagree.

"(C) INADMISSIBILITY FOR CERTAIN PURPOSES.—Statements made in accordance with subparagraphs (A) and (B) concerning the amount of damages and the likelihood of prevailing shall not be admissible for purposes of any Federal or State judicial action or administrative proceeding.

"(2) STATEMENT OF ATTORNEYS' FEES OR COSTS SOUGHT.—If any of the settling parties or their counsel intend to apply to the court for an award of attorneys' fees or costs from any fund established as part of the settlement, a statement indicating which parties or counsel intend to make such an application, the amount of fees and costs that will be sought (including the amount of such fees and costs determined on a per-share basis, together with the amount of the settlement proposed to be distributed to the parties to suit, determined on a

per-share basis), and a brief explanation of the basis for the application. Such information shall be clearly summarized on the cover page of any notice to a party of any proposed or final settlement agreement.

"(3) IDENTIFICATION OF LAWYERS' REPRESENTATIVES.—The name and address of one or more representatives of counsel for the class who will be reasonably available to answer written questions from class members concerning any matter contained in any notice of settlement published or otherwise disseminated to the class.

"(4) OTHER INFORMATION.—Such other information as may be required by the court, or by any plaintiff steering committee appointed by the court pursuant to section 36.

"(f) ENCOURAGEMENT OF FINALITY IN SETTLEMENT DISCHARGES.—

"(1) DISCHARGE.—A defendant who settles any private action arising under this title at any time before verdict or judgment shall be discharged from all claims for contribution brought by other persons with respect to the matters that are the subject of such action. Upon entry of the settlement by the court, the court shall enter a bar order constituting the final discharge of all obligations to the plaintiff

of the settling defendant arising out of the action. The order shall bar all future claims for contribution arising out of the action—

"(A) by any person against the settling defendant; and

"(B) by the settling defendant against any person other than a person whose liability has been extinguished by the settling defendant's settlement.

"(2) REDUCTION.—If a person enters into a settlement with the plaintiff prior to verdict or judgment, the verdict or judgment shall be reduced by the greater of—

"(A) an amount that corresponds to the percentage of responsibility of that person; or

"(B) the amount paid to the plaintiff by that person.

"(g) CONTRIBUTION FROM NON-PARTIES IN INTERESTS OF FAIRNESS.—

"(1) RIGHT OF CONTRIBUTION.—A person who becomes liable for damages in any private action under this title (other than an action under section 9(e) or 18(a)) may recover contribution from any other person who, if joined in the original suit, would have been liable for the same damages.

"(2) STATUTE OF LIMITATIONS FOR CONTRIBUTION.—Once judgment has been entered in any such private action determining liability, an action for contribution must be brought not later than 6 months after the entry of a final, nonappealable judgment in the action.

"(h) DEFENDANT'S RIGHT TO WRITTEN INTERROGATORIES ESTABLISHING SCIENTER.—In any private action under this title in which the plaintiff may recover money damages, the court shall, when requested by a defendant, submit to the jury a written interrogatory on the issue of each such defendant's state of mind at the time the alleged violation occurred.".

(b) PROHIBITION OF REFERRAL FEES THAT FOMENT LITIGATION.—Section 15(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78*o*(c)) is amended by adding at the end the following new paragraph:

"(8) RECEIPT OF REFERRAL FEES.—No broker or dealer, or person associated with a broker or dealer, may solicit or accept remuneration for assisting an attorney in obtaining the representation of any customer in any private action under this title.".

SEC. 4. PREVENTION OF "FISHING EXPEDITION" LAWSUITS.

The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by inserting after section 10 the following new section:

"SEC. 10A. REQUIREMENTS FOR SECURITIES FRAUD ACTIONS.

"(a) SCIENTER.—

"(1) IN GENERAL.—In any private action arising under section 10(b) of this title based on a fraudulent statement, liability may be established only on proof that—

"(A) the defendant directly or indirectly made a fraudulent statement;

"(B) the defendant possessed the intention to deceive, manipulate, or defraud; and

"(C) the defendant made such fraudulent statement knowingly or recklessly.

"(2) FRAUDULENT STATEMENT.—For purposes of this section, a fraudulent statement is a statement that contains an untrue statement of a material fact, or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading.

"(3) KNOWINGLY.—For purposes of paragraph (1), a defendant makes a fraudulent statement

knowingly if the defendant knew that the statement of a material fact was untrue at the time it was made, or knew that an omitted fact was necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading.

"(4) RECKLESSNESS.—For purposes of paragraph (1), a defendant makes a fraudulent statement recklessly if the defendant, in making such statement, is guilty of highly unreasonable conduct that (A) involves not merely simple or even gross negligence, but an extreme departure from standards of ordinary care, and (B) presents a danger of misleading buyers, sellers, or security holders that was either known to the defendant or so obvious that the defendant must have been aware of it. Deliberately refraining from taking steps to discover whether one's statements are false or misleading constitutes recklessness, but if the failure to investigate was not deliberate, such conduct shall not be considered to be reckless.

"(b) REQUIREMENT FOR EXPLICIT PLEADING OF SCIENTER.—In any private action to which subsection (a) applies, the complaint shall specify each statement or omission alleged to have been misleading, and the reasons

the statement or omission was misleading. The complaint shall also make specific allegations which, if true, would be sufficient to establish scienter as to each defendant at the time the alleged violation occurred. It shall not be sufficient for this purpose to plead the mere presence of facts inconsistent with a statement or omission alleged to have been misleading. If an allegation is made on information and belief, the complaint shall set forth with specificity all information on which that belief is formed.

"(c) DISMISSAL FOR FAILURE TO MEET PLEADING REQUIREMENTS; STAY OF DISCOVERY; SUMMARY JUDGMENT.—In any private action to which subsection (a) applies, the court shall, on the motion of any defendant, dismiss the complaint if the requirements of subsection (b) are not met, except that the court may, in its discretion, permit a single amended complaint to be filed. During the pendency of any such motion to dismiss, all discovery and other proceedings shall be stayed unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party. If a complaint satisfies the requirements of subsection (b), the plaintiff shall be entitled to conduct discovery limited to the facts concerning the allegedly misleading statement or omission. Upon completion

of such discovery, the parties may move for summary judgment.

"(d) RELIANCE AND CAUSATION.—

"(1) IN GENERAL.—In any private action to which subsection (a) applies, the plaintiff shall prove that—

"(A) he or she had knowledge of, and relied (in connection with the purchase or sale of a security) on, the statement that contained the misstatement or omission described in subsection (a)(1); and

"(B) that the statement containing such misstatement or omission proximately caused (through both transaction causation and loss causation) any loss incurred by the plaintiff.

"(2) FRAUD ON THE MARKET.—For purposes of paragraph (1), knowledge and reliance may be proven by establishing that the market as a whole considered the fraudulent statement, that the price at which the security was purchased or sold reflected the market's estimation of the fraudulent statement, and that the plaintiff relied on that market price. Proof that the market as a whole considered the fraudulent statement may consist of evidence that the statement—

"(A) was published in publicly available research reports by analysts of such security;

"(B) was the subject of news articles;

"(C) was delivered orally at public meetings by officers of the issuer, or its agents;

"(D) was specifically considered by rating agencies in their published reports; or

"(E) was otherwise made publicly available to the market in a manner that was likely to bring it to the attention of, and to be considered as credible by, other active participants in the market for such security.

Nonpublic information may not be used as proof that the market as a whole considered the fraudulent statement.

"(3) PRESUMPTION OF RELIANCE.—Upon proof that the market as a whole considered the fraudulent statement pursuant to paragraph (2), the plaintiff is entitled to a rebuttable presumption that the price at which the security was purchased or sold reflected the market's estimation of the fraudulent statement and that the plaintiff relied on such market price. This presumption may be rebutted by evidence that—

"(A) the market as a whole considered other information that corrected the allegedly fraudulent statement; or

"(B) the plaintiff possessed such corrective information prior to the purchase or sale of the security.

"(4) REASONABLE EXPECTATION OF INTEGRITY OF MARKET PRICE.—A plaintiff who buys or sells a security for which it is unreasonable to rely on market price to reflect all current information may not establish reliance pursuant to paragraph (2). For purposes of paragraph (2), the following factors shall be considered in determining whether it was reasonable for a party to expect the market price of the security to reflect substantially all publicly available information regarding the issuer of the security:

"(A) The weekly trading volume of any class of securities of the issuer of the security.

"(B) The existence of public reports by securities analysts concerning any class of securities of the issuer of the security.

"(C) The eligibility of the issuer of the security, under the rules and regulations of the Commission, to incorporate by reference its reports made pursuant to section 13 of this title

in a registration statement filed under the Securities Act of 1933 in connection with the sale of equity securities.

"(D) A history of immediate movement of the price of any class of securities of the issuer of the security caused by the public dissemination of information regarding unexpected corporate events or financial releases.

In no event shall it be considered reasonable for a party to expect the market price of the security to reflect substantially all publicly available information regarding the issuer of the security unless the issuer of the security has a class of securities listed and registered on a national securities exchange or quoted on the automated quotation system of a national securities association.

"(e) ALLOCATION OF LIABILITY.—

"(1) JOINT AND SEVERAL LIABILITY FOR KNOWING FRAUD.—A defendant who is found liable for damages in a private action to which subsection (a) applies may be liable jointly and severally only if the trier of fact specifically determines that the defendant acted knowingly (as defined in subsection (a)(3)).

"(2) PROPORTIONATE LIABILITY FOR RECKLESSNESS.—If the trier of fact does not make the findings required by paragraph (1) for joint and several liability, a defendant's liability in a private action to which subsection (a) applies shall be determined under paragraph (3) of this subsection only if the trier of fact specifically determines that the defendant acted recklessly (as defined in subsection (a)(4)).

"(3) DETERMINATION OF PROPORTIONATE LIABILITY.—If the trier of fact makes the findings required by paragraph (2), the defendant's liability shall be determined as follows:

"(A) The trier of fact shall determine the percentage of responsibility of the plaintiff, of each of the defendants, and of each of the other persons or entities alleged by the parties to have caused or contributed to the harm alleged by the plaintiff. In determining the percentages of responsibility, the trier of fact shall consider both the nature of the conduct of each person and the nature and extent of the causal relationship between that conduct and the damage claimed by the plaintiff.

"(B) For each defendant, the trier of fact shall then multiply the defendant's percentage of responsibility by the total amount of damage suffered by the plaintiff that was caused in whole or in part by that defendant and the court shall enter a verdict or judgment against the defendant in that amount. No defendant whose liability is determined under this subsection shall be jointly liable on any judgment entered against any other party to the action.

"(C) Except where contractual relationship permits, no defendant whose liability is determined under this paragraph shall have a right to recover any portion of the judgment entered against such defendant from another defendant.

"(4) EFFECT OF PROVISION.—This subsection relates only to the allocation of damages among defendants. Nothing in this subsection shall affect the standards for liability under any private action arising under this title.

"(f) DAMAGES.—In any private action to which subsection (a) applies, and in which the plaintiff claims to have bought or sold the security based on a reasonable belief that the market value of the security reflected all

publicly available information, the plaintiff's damages shall not exceed the lesser of—

"(1) the difference between the price paid by the plaintiff for the security and the market value of the security immediately after dissemination to the market of information which corrects the fraudulent statement; and

"(2) the difference between the price paid by the plaintiff for the security and the price at which the plaintiff sold the security after dissemination of information correcting the fraudulent statement.".

SEC. 5. ESTABLISHMENT OF "SAFE HARBOR" FOR PREDICTIVE STATEMENTS.

The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by adding at the end the following new section:

"SEC. 37. APPLICATION OF SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS.

"(a) SAFE HARBOR IN GENERAL.—In any private action arising under this title based on a fraudulent statement (as defined in section 10A), a person shall not be liable with respect to any forward-looking statement if and to the extent that the statement—

"(1) contains a projection, estimate, or description of future events; and

"(2) refers clearly (or is understood by the recipient to refer) to—

"(A) such projections, estimates, or descriptions as forward-looking statements; and

"(B) the risk that such projections, estimates, or descriptions may not be realized.

The safe harbor for forward-looking statements established under this subsection shall be in addition to any safe harbor the Commission may establish by rule or regulation.

"(b) DEFINITION OF FORWARD-LOOKING STATEMENT.—For the purpose of this section, the term 'forward-looking statement' shall include (but not be limited to) projections, estimates, and descriptions of future events, whether made orally or in writing, voluntarily or otherwise.

"(c) NO DUTY TO MAKE CONTINUING PROJECTIONS.—In any private action arising under this title, no person shall be deemed to have any obligation to update a forward-looking statement made by such person unless such person has expressly and substantially contemporaneously undertaken to update such statement.

"(d) AUTOMATIC PROCEDURE FOR STAYING DISCOVERY; EXPEDITED PROCEDURE FOR CONSIDERATION OF MOTION ON APPLICABILITY OF SAFE HARBOR.—

"(1) STAY PENDING DECISION ON MOTION.—Upon motion by a defendant to dismiss on the ground that the statement or omission upon which the complaint is based is a forward-looking statement within the meaning of this section and that the safe harbor provisions of this section preclude a claim for relief, the court shall stay discovery until such motion is decided.

"(2) PROTECTIVE ORDERS.—If the court denies a motion to dismiss to which paragraph (1) is applicable, or if no such motion is made and a party makes a motion for a protective order, at any time beginning after the filing of the complaint and ending 10 days after the filing of such party's answer to the complaint, asserting that the safe harbor provisions of this section apply to the action, a protective order shall issue forthwith to stay all discovery as to any party to whom the safe harbor provisions of this section may apply, except that which is directed to the specific issue of the applicability of the safe harbor. A hearing on the applicability of the safe harbor shall be conducted within 45 days of the issuance of the protective order. At the conclusion of the hearing, the court shall either dismiss the portion of the action based upon the use of the forward-

looking information or determine that the safe harbor is unavailable in the circumstances.

"(e) REGULATORY AUTHORITY.—The Commission shall exercise its authority to describe conduct with respect to the making of forward-looking statements that will be deemed not to provide a basis for liability in private actions under this title. Such rules and regulations shall—

"(1) include clear and objective guidance that the Commission finds sufficient for the protection of investors;

"(2) prescribe such guidance with sufficient particularity that compliance shall be readily ascertainable by issuers prior to issuance of securities; and

"(3) provide that forward-looking statements that are in compliance with such guidance and that concern the future economic performance of an issuer of securities registered under section 12 of this title will be deemed not to be in violation of this title.

Nothing in this section shall be deemed to limit, either expressly or by implication, the authority of the Commission to exercise similar authority or to adopt similar rules and regulations with respect to forward-looking state-

ments under other statutes under which the Commission exercises rulemaking authority.".

SEC. 6. AMENDMENT TO RACKETEER INFLUENCED AND CORRUPT ORGANIZATIONS ACT.

Section 1964(c) of title 18, United States Code, is amended by inserting ", except that no person may bring an action under this provision if the racketeering activity, as defined in section 1961(1)(D), involves conduct actionable as fraud in the purchase or sale of securities" before the period.

SEC. 7. FINANCIAL FRAUD DETECTION AND DISCLOSURE.

(a) AMENDMENTS TO THE SECURITIES EXCHANGE ACT OF 1934.—The Securities Exchange Act of 1934 is amended by inserting after section 13 (15 U.S.C. 78m) the following new section:

"SEC. 13A. FRAUD DETECTION AND DISCLOSURE.

"(a) AUDIT REQUIREMENTS.—Each audit required pursuant to this title of an issuer's financial statements by an independent public accountant shall include, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission, the following:

"(1) procedures designed to provide reasonable assurance of detecting illegal acts that would have a

direct and material effect on the determination of financial statement amounts;

"(2) procedures designed to identify related party transactions which are material to the financial statements or otherwise require disclosure therein; and

"(3) an evaluation of whether there is substantial doubt about the issuer's ability to continue as a going concern over the ensuing fiscal year.

"(b) REQUIRED RESPONSE TO AUDIT DISCOVERIES.—

"(1) INVESTIGATION AND REPORT TO MANAGEMENT.—If, in the course of conducting any audit pursuant to this title to which subsection (a) applies, the independent public accountant detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the issuer's financial statements) has or may have occurred, the accountant shall, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission—

"(A)(i) determine whether it is likely that an illegal act has occurred, and (ii) if so, determine and consider the possible effect of the ille-

gal act on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties, and damages; and

"(B) as soon as practicable inform the appropriate level of the issuer's management and assure that the issuer's audit committee, or the issuer's board of directors in the absence of such a committee, is adequately informed with respect to illegal acts that have been detected or otherwise come to the attention of such accountant in the course of the audit, unless the illegal act is clearly inconsequential.

"(2) RESPONSE TO FAILURE TO TAKE REMEDIAL ACTION.—If, having first assured itself that the audit committee of the board of directors of the issuer or the board (in the absence of an audit committee) is adequately informed with respect to illegal acts that have been detected or otherwise come to the accountant's attention in the course of such accountant's audit, the independent public accountant concludes that—

"(A) any such illegal act has a material effect on the financial statements of the issuer,

"(B) senior management has not taken, and the board of directors has not caused sen-

ior management to take, timely and appropriate remedial actions with respect to such illegal act, and

"(C) the failure to take remedial action is reasonably expected to warrant departure from a standard auditor's report, when made, or warrant resignation from the audit engagement,

the independent public accountant shall, as soon as practicable, directly report its conclusions to the board of directors.

"(3) NOTICE TO COMMISSION; RESPONSE TO FAILURE TO NOTIFY.—An issuer whose board of directors has received a report pursuant to paragraph (2) shall inform the Commission by notice within one business day of receipt of such report and shall furnish the independent public accountant making such report with a copy of the notice furnished the Commission. If the independent public accountant making such report shall fail to receive a copy of such notice within the required one-business-day period, the independent public accountant shall—

"(A) resign from the engagement; or

"(B) furnish to the Commission a copy of its report (or the documentation of any oral re-

port given) within the next business day following such failure to receive notice.

"(4) REPORT AFTER RESIGNATION.—An independent public accountant electing resignation shall, within the one business day following a failure by an issuer to notify the Commission under paragraph (3), furnish to the Commission a copy of the accountant's report (or the documentation of any oral report given).

"(c) AUDITOR LIABILITY LIMITATION.—No independent public accountant shall be liable in a private action for any finding, conclusion, or statement expressed in a report made pursuant to paragraph (3) or (4) of subsection (b), including any rules promulgated pursuant thereto.

"(d) CIVIL PENALTIES IN CEASE-AND-DESIST PROCEEDINGS.—If the Commission finds, after notice and opportunity for hearing in a proceeding instituted pursuant to section 21C of this title, that an independent public accountant has willfully violated paragraph (3) or (4) of subsection (b) of this section, then the Commission may, in addition to entering an order under section 21C, impose a civil penalty against the independent public accountant and any other person that the Commission finds was a cause of such violation. The determination whether to im-

pose a civil penalty, and the amount of any such penalty, shall be governed by the standards set forth in section 21B of this title.

"(e) PRESERVATION OF EXISTING AUTHORITY.—Except for subsection (d), nothing in this section limits or otherwise affects the authority of the Commission under this title.

"(f) DEFINITIONS.—As used in this section, the term 'illegal act' means any action or omission to act that violates any law, or any rule or regulation having the force of law.".

(b) EFFECTIVE DATES.—As to any registrant that is required to file selected quarterly financial data pursuant to item 302(a) of Regulation S–K (17 CFR 229.302(a)) of the Securities and Exchange Commission, the amendments made by subsection (a) of this section shall apply to any annual report for any period beginning on or after January 1, 1996. As to any other registrant, such amendment shall apply for any period beginning on or after January 1, 1997.

SEC. 8. RULE OF CONSTRUCTION.

Nothing in the amendments made by this Act shall be deemed to create or ratify any implied private right of action, or to prevent the Commission by rule from re-

strieting or otherwise regulating private actions under the Securities Exchange Act of 1934.

SEC. 9. EFFECTIVE DATE.

This Act and the amendments made by this Act are effective on the date of enactment of this Act and shall apply to cases commenced after such date of enactment.

Passed the House of Representatives March 8, 1995.

Attest: ROBIN H. CARLE,
Clerk.

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ISBN 0-16-047651-8