Testimony of

Mr. Stephen Schatz

February 6, 2002

Chairman Leahy, Senator Hatch, and Members of the Senate Judiciary Committee:

It is an honor to appear before you today and offer my thoughts on possible responses to the Enron debacle. As a former federal prosecutor, I urge you to bring swift and severe punishment to the wrong-doers who have apparently harmed so many innocent people. As an advisor to numerous honest companies that depend on the capital markets, however, I urge you to be sensitive to the indirect consequences your actions may have on those whom are frequently targets of frivolous litigation.

I. Introduction

For four and a half years, I served as Assistant United States Attorney for the Southern District of New York in the Criminal Division. That experience has given me particular insight into the types of frauds that rapacious companies and rapacious individuals can and do perpetrate, and has impressed upon me the importance of harshly punishing those who would exploit their positions for personal gain at the expense of others. I applaud your efforts today to ensure that wrong-doers face appropriately severe consequences.

Today, I am a senior member of the law firm of Wilson Sonsini Goodrich & Rosati, P.C., located in Silicon Valley and numbering over 700 lawyers. We are proud to represent some of the most innovative, successful companies in the United States. Our clients include leaders in computers (Hewlett-Packard, Sun), semiconductors (Cypress, LSI Logic, Micron, VIA), disk drives (Seagate), electronics manufacturing (Solectron), software (Autodesk, Sybase), networking (3Com, Juniper, Broadcom), aviation (America West), and biotechnology (Genentech). We currently represent approximately 300 public companies. We also represent hundreds of start-ups that are working to become leaders of their industry sectors. Frankly, our clients depend on the availability of capital and the integrity of the financial markets, both of which the Enron scandal has jeopardized. I am heartened to know that you are considering measures to ameliorate these harms and protected against future abuses.

As a litigator, I have devoted a significant portion of the last seventeen years of my life to defending securities class action, representing clients such as Hewlett-Packard, Informix, Convergent Technologies, InfoSpace, Unisys, Cirrus Logic, Critical Path, Splash, Ventana Medical Systems, Robertson Stephens & Co., Santa Cruz Operations, MicroAge, Pyramid Technology, STAC Electronics, Ventritex, Laserscope and Continental Savings. In defending more than sixty securities class actions over the past two decades, I have personally witnessed the explosive growth of frivolous litigation, the measures Congress has taken to curb abusive litigation tactics, and the salutary effects those measures have had.

Others have detailed, and will detail, the specific conduct that allegedly gave rise to fraud at Enron, and I yield to their expertise. I think we all agree that the Enron fraud - and the fact that it

continued undetected for so long and harmed so many people - demands us to take a hard look at certain reforms. Simply put, we must prevent such a situation from ever recurring. In crafting an adequate and well-reasoned response, however, we must not allow our anger at Enron's egregious conduct to have unintended, negative consequences. Specifically, I am concerned that recent, and perhaps well-meaning, proposals to revise provisions of the Private Securities Litigation Reform Act may inadvertently and unfairly punish the many honest companies and employees that make our economy flourish.

II. The Private Securities Litigation Reform Act

As you are no doubt aware, Congress passed the Reform Act in 1995 to curb what it accurately perceived as substantial litigation abuses by the private plaintiffs securities class action bar. Congress took this action in response to "significant evidence of abuse in private securities lawsuits," including, among other things, "the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action." These meritless cases diverted companies' attention from their core businesses and forced them either to spend millions in defense costs or millions on unwarranted settlements. Simply put, abusive litigation cost public companies - and hence the investing public - tremendous amounts of money each year.

Recognizing this serious problem, Congress adopted the Reform Act with broad bipartisan support. The Act contains numerous provisions, but three are particularly crucial to protecting companies and their employees from frivolous and abusive litigation. Those three are: the Safe Harbor for forward-looking statements, the discovery stay, and the heightened pleading standard. None of these provisions facilitated Enron's accounting scandal, and none will shield Enron from the consequences of its fraudulent conduct. Let me very briefly consider each in turn.

A. Safe Harbor

The Reform Act's Safe Harbor encourages companies to publicly disclose their predictions of future performance by insulating them from liability in the event those predictions do not come true. Specifically, the Safe Harbor provides that "[A defendant] shall not be liable with respect to any forward-looking statement, whether written or oral, if and to the extent that . . . the forward looking statement is . . . identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." The Safe Harbor also protects forecasts and projections of future results that are not accompanied by "meaningful cautionary statements" by requiring plaintiffs to demonstrate that they were made with actual knowledge of falsity.

This protection, in conjunction with Regulation FD, has allowed investors to benefit from increased information flow and to make more informed financial decisions, by making companies less nervous about disclosing their necessarily uncertain hopes for the future. The Safe Harbor often serves as an effective tool for companies unfairly accused of fraud-by-hindsight. It does not, however, provide any protection for perpetrators of accounting frauds such as Enron's. Indeed, the Safe Harbor expressly does not apply to audited financial statements. In short, the Enron scandal and the Safe Harbor have nothing to do with each other.

B. Discovery Stay

Congress enacted another core provision of the Reform Act, the discovery stay, in response to evidence that "the abuse of the discovery process ... impose[d] costs so burdensome that it is often economical for the victimized party to settle" private securities class actions, regardless of guilt. In order to limit potentially unnecessary and burdensome fishing-expeditions, discovery in such cases is stayed until plaintiffs survive a motion to dismiss; that is, until they establish that their complaint is not facially inadequate. At the same time, the Reform Act compels companies to preserve all relevant evidence while the case is pending, and allows discovery when evidence is at risk .

The Reform Act's express command not to destroy evidence strongly protects plaintiffs. More importantly, in cases such as Enron's, in which the fraud seems clear and the likelihood of surviving a motion to dismiss seems almost certain, the Reform Act ultimately does nothing to prevent plaintiffs from getting the evidence they need.

C. Heightened Pleading Standard

Finally, the Reform Act provides a heightened pleading standard designed to weed out cases where plaintiffs lack a substantial basis for their fraud accusations. Specifically, it requires that every securities class action complaint "shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." It further requires plaintiffs to "state with particularity facts giving rise to a strong inference"of scienter. Given the extent of its fraud, Enron can hardly expect to benefit from this provision; undoubtedly there will be no issue with respect to the pleading standard in that case.

The key Reform Act provisions did not cause the Enron scandal and will not allow Enron to escape punishment. They do, however, protect companies from frivolous lawsuits, onerous discovery and exposure to extortionary settlements. The concerns which motivated Congress to enact the Reform Act in 1995 and the Securities Litigation Uniform Standards Act in 1998 are equally valid today, as demonstrated by the fact that the number of private securities class actions filed each year continues to rise. The Reform Act remains of vital importance in defending honest companies against these often meritless suits.

III. Reform Proposals

In evaluating proposals to modify the Reform Act, I urge you to be sensitive to potential spillover effects on frivolous cases. Reform is vital, but it is also imperative not to undermine key aspects of the Reform Act. In our zeal to respond to the Enron disaster, we must be careful to avoid creating new vehicles for frivolous litigation.

For example, one proposed bill would allow plaintiffs to add RICO claims to their securities class action complaints, and thereby seek treble damages. At first blush, it may seem appealing to increase penalties for wrong-doers. In actual fact, however, cases such as Enron's already involve damages beyond any defendant's ability to pay, even absent the addition of RICO penalties. Thus, this proposal would do little to inflict additional pain on those who commit fraud.

Rather, this provision would allow plaintiffs' counsel to reflexively include a RICO claim in every garden-variety securities class action complaint, providing additional - and typically unwarranted - leverage in settlement negotiations. By adopting this provision, Congress would simply increase the frequency with which "innocent parties are often forced to pay exorbitant 'settlements'" -- precisely the sort of abuse this body sought to deter in 1995. Indeed, no less than then-SEC Chairman Arthur Levitt testified in favor of the RICO exclusion, recognizing that "[b]ecause the securities laws generally provide adequate remedies for those injured by securities fraud, it is ... unfair to expose defendants in securities cases to the threat of treble damages and other extraordinary remedies provided by RICO."

Similar proposals involve efforts to impose aider and abettor liability and/or joint and several liability for securities violations. In weighing these proposals, it bears mentioning that the Reform Act (in a section titled "Reduction of Coercive Settlements") already imposes joint and several liability - without exception - for knowingly violating the securities laws; in addition, the Act already specifies that if a defendant cannot pay its share of the damages due to insolvency, each of the other defendants must make an additional payment - up to 50% of their own liability - to make up the shortfall in plaintiff's recovery. The Reform Act provides for even broader contributions to make whole certain small investors. Also, in evaluating aiding and abetting liability proposals, it should be recognized that courts have taken a broad view of direct liability. Undue expansion of these doctrines could become a tool allowing plaintiffs to expose tangential defendants to enormous risk even in frivolous cases.

Effectively, expanding the scope of liability would give plaintiffs an undeserved bargaining chip with which to compel settlement of meritless cases. Congress recognized this risk in the enactment of the Reform Act, criticizing plaintiffs' "targeting of deep pocket defendants ... without regard to their actual culpability." These concerns remain equally pressing today, and should be fully considered in any reforms. In addition, keep in mind that the SEC is authorized to investigate and pursue civilly and/or administratively anyone who violates the federal securities laws, whether directly or as an aider and abettor, and, where appropriate, can refer the matter for criminal prosecution.

Another proposal would allow immediate discovery in cases where a company's accountant is named as a defendant. No doubt this was drafted to prevent Arthur Anderson-type document destruction abuses. Unfortunately, it would also allow plaintiffs to gut the Reform Act's discovery stay simply by naming company auditors in every lawsuit. (Moreover, as I explained before, the Reform Act itself prohibits the destruction of documents and provides severe penalties for violations.) Congress must carefully consider whether it wishes to punish every honest company with onerous and costly discovery obligations in response to Enron's extreme misconduct, particularly when early discovery will serve little purpose.

IV. Conclusions

In addition to the proposals that have already been suggested, Congress has many other options. For example, Congress may wish to consider approaches that would require auditors to make affirmative and descriptive assertions about companies in their financial statements. In a recent speech, a former SEC Commissioner raised the possibility that auditors be required to supplement their audited financial statements with "an opinion and report describing significant

accounting treatments and judgments that comply with GAAP but that, if disclosed, would have a material effect on the valuation" of the company. This sort of response suggests one possible remedy that should be explored and may be part of an overall approach to deter Enron-like abuses. Naturally, the various proposals offered in response to the Enron debacle will need to be carefully studied, and their advantages and disadvantages carefully weighed, before any decisions regarding the appropriate prophylactic actions and reforms are made.

Enron has hurt our financial markets, our economy, and millions of innocent investors. Reform is vital; we must act to prevent this from ever happening again. At the same time, we must make sure that our response does not do more harm than good, and thus must be sensitive to the collateral consequences that reforms may have for frivolous class actions. We should not let the extreme circumstances of the Enron matter cause us to forget the very real and tangible reasons for enacting the Reform Act.