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Subcommittee on Crime and Drugs
"Evaluating S. 1551: The Liability for Aiding and Abetting Securities Violations Act of 2009"

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Chairman Specter, Senator Graham, members of the Subcommittee, it is a privilege to testify on this important topic. The views that I'm expressing today are my own and do not reflect the views of my law firm or clients.

I've spent much of my professional career litigating securities class action cases. I've been involved in many significant cases. During 1995 and 1996, I served as Chief Counsel of the Senate Banking Committee. I spent many hours participating in the drafting of the Private Securities Litigation Reform Act of 1995 (the "PSLRA" or "Reform Act"). We worked very hard – Republicans and Democrats alike – to enact balanced legislation that would stop real abuses, but not prevent the bringing of meritorious securities cases.

I'm going to speak about several topics:

First, why I think Congress made the right decision in the 1995 Reform Act to permit only the SEC – and the Department of Justice in criminal cases – to bring so-called "aiding and abetting" securities claims against third parties – banks, accountants, vendors or lawyers – that have a business relationship with a public company alleged to have engaged in securities fraud. I believe that Congress acted wisely in entrusting the responsibility for deciding when to prosecute alleged aiders and abettors of securities fraud to the expert judgment of the SEC and the Department of Justice. Obviously, those agencies don't have the same incentives as the plaintiffs' bar to bring strike suits against deep-pocket defendants.

Second, I'd like to provide some perspective on how securities class actions are actually litigated and settled in the real world, and why I think Congress should not enact S. 1551. In my view, S. 1551 would hurt the competitiveness of U.S. capital markets and financial centers and vastly expand the potential liability and defense costs of innocent third parties that do business with public companies.

Third, I'd like to offer some practical suggestions for reforming securities class actions to address pressing issues that have arisen since the passage of the PSLRA.

The 1995 Reform Act

The 1995 Private Securities Litigation Reform Act was passed with broad bi-partisan support, including of Senators Bradley, Dodd, Feinstein, Kennedy, Kerry. Harkin, Mikulski, Murray, Reid, and Rockefeller. Senator Schumer supported the Reform Act when he was in the House. I worked very closely with Senator Dodd and his staff to pass the Reform Act.

It's important to remember why the Reform Act was enacted. This law addressed the serious problem of frivolous and abusive securities strike suits, while being careful not to impose significant burdens on meritorious fraud cases. Congressional hearings demonstrated that a small coterie of strike suit lawyers, some now in prison, were suing public companies whenever their stock price fell for any reason, claiming that securities fraud was responsible for the price decline.

To serve as their supposed "clients," these strike suit lawyers recruited professional – indeed, figurehead – plaintiffs who owned only a few shares of stock in dozens of companies for the sole purpose of bringing a securities class action the day after a company's stock price dropped. The lawyers would file a boilerplate complaint, with the same named "plaintiffs," in case after case. The selection of the lead plaintiff turned on the speed with which

a plaintiffs' lawyer could file a complaint, not on the care that they took to investigate the facts and to draft that complaint or the claimed financial losses of the named plaintiff.

These abusive practices permitted the strike suit lawyers to exact hefty attorneys' fees from companies that couldn't afford years of expensive litigation – inevitably paid by the shareholders of those companies. As a result, many cases settled for token payments for shareholders and large fees for plaintiffs' and defense lawyers. This system didn't benefit stockholders because stockholders had to bear the cost of these strike suits.

In the PSLRA, Congress enacted a balanced set of reforms. The Senate played a critical role in adding balance to the House bill. I worked closely with representatives of the SEC, including then-Chairman Arthur Levitt, in drafting legislation that would address the problem of strike suits and at the same time protect investors. In fact, the Senate introduced some revisions to the House bill that were suggested by representatives of the plaintiffs' bar.

To address lawyer-driven litigation and to slow the race to the courthouse, Congress barred suits by professional plaintiffs and created a rebuttable presumption that the lead plaintiff would be the plaintiff – typically an institutional investor such as a public pension fund – with the biggest loss. Today, large institutional investors are almost always the lead plaintiffs in big securities class actions.

To reduce the number of frivolous strike suits, Congress enacted a uniform pleading standard, based on the Second Circuit's pleading standard, requiring the plaintiff to state some facts (as opposed to mere allegations) supporting the existence of the claimed misstatement and the charge that the defendant acted with fraudulent intent. The Reform Act also requires that each defendant in a multi-defendant lawsuit usually pay only that portion of the

judgment for which the jury finds that defendant responsible, rather than the entire judgment, except where the defendant had actual knowledge that its statements were false.

And, to strengthen investor protections, the Reform Act confirmed the SEC's power to take action against third parties – such as a public company's bankers, accountants, customers and lawyers – who aid and abet securities fraud.

The PSLRA Worked and We Should Not Go Back

Back in 1995, when Congress was debating the Reform act, Bill Lerach, then probably the best known securities class action lawyer, came to see me in my Senate office. Bill knew that I had defended securities class actions. At the end of the meeting, Bill – frustrated because I didn't see the light – said: "You're going to put me out of business, and that won't be good for your law firm."

Now, Bill Lerach was eventually put out of business, but not by the PSLRA. Bill was put out of business and sent to jail, because he and his partner, Mel Weiss, were lying to investors and courts and paying kickbacks to plaintiffs and experts for many years.

Despite the fears of some, the PSLRA has not kept meritorious claims out of court. Post-PSLRA, the number of true strike suits is down, while the settlement value of claims is up substantially. More than 250 securities class actions were filed in 2008, and at least that many suits may be filed in 2009. Since 1995, there have been many settlements in the hundreds of millions of dollars, and some billion-dollar settlements in cases involving Worldcom and Enron.

But, as I'll discuss, significant changes in the real-world litigation environment since the PSLRA have permitted the return of some of the very same abuses that Congress sought to address in 1995. Rather than adding a new form of open-ended liability to a system

that is being abused in ways that hurt investors and our capital markets, Congress should enact legislation that stops the abuse.

Some Practical Aspects of Securities Class Actions

Securities class actions are almost always settled or dismissed. In the last ten years, only a handful of these cases actually have gone to trial. The PSLRA tried to address this issue by heightening pleading standards, but the massive growth in damages claims since 1995 has changed the game.

Back in 1995, plaintiffs in a "big" securities case sought hundreds of millions of dollars in damages. Today, plaintiffs seek *billions* of dollars in damages. According to one estimate, the claimed damages in the hundreds of putative securities class actions filed in 2008 exceeded an average of $1.6 billion.

As a result, now more than ever, settlement often is the only realistic option for a deep-pocket defendant. Very few defendants can afford the risk of a lengthy and complex trial where the price of losing can be hundreds of millions in damages, and no board of directors will let its executive roll the dice in even the most meritorious case.

When securities class actions are settled, a company's present shareholders effectively pay money to its past shareholders. Given the size of the claimed damages, it's rare for a company's executives to pay a meaningful part of the settlement out of their own pockets, and, if those executives have engaged in actual fraud, they rarely have enough money to make a serious contribution to a settlement. Most settlements are covered by D&O insurance and direct payments from companies – costs, ultimately, borne by their shareholders.

The defense of a securities class action (even a meritless claim) often can cost tens of millions of dollars. A huge part of the bill is the skyrocketing cost of e-discovery –

another important change since the enactment of the PSLRA. The cost of reviewing the millions of emails generated today by big public companies alone can cost many millions of dollars. In some of the larger cases, like Enron and Worldcom, the document discovery exceeded well in excess of 100 million pages documents and email.

In considering the reform of securities class actions, Congress should consider that companies and their executive make innocent mistakes. Bankers make innocent mistakes. Accountants make innocent mistakes. Vendors make innocent mistakes. And, yes, even lawyers make innocent mistakes.

It's easy to allege fraud by hindsight. Sometimes executives are too optimistic. In retrospect, sometimes disclosures arguably are not as full and complete as they might have been. It's easy to allege that an executive, banker, accountant, vendor or lawyer missed a red flag. Today, when executives, bankers, accountants, vendors and lawyers sometimes receive hundreds of emails a day, it's easy to find an email with loose language, to blow something out of proportion, and to allege that the services provided aided in the issuer's fraud.

Fraud is a very loose term, particularly when fraud is defined, as S. 1551 would do, to include "recklessness." When a murder occurs, we can all agree that a crime has been committed. Not so with securities fraud. The difference between an innocent mistake and fraud often turns on a jury's hindsight judgment about a defendant's state of mind years after the fact. This line-drawing will become an even more vexing issue if civil aider and abettor liability is revived.

The Case Against Deputizing the Plaintiffs' Bar To Bring "Aiding and Abetting" Claims Against Third Parties

If Congress permits "aiding and abetting" claims, plaintiffs' lawyers will be able once again to extract millions of dollar from innocent banks, accountants, vendors and lawyers whenever a company's stock price drops. The creation of aiding and abetting liability would generate lots of fees for lawyers. But, in long run, such liability would severely hurt U.S. capital markets and our broader economy.

1. S. 1551 would vastly expand the potential liability of innocent bankers, accountants, vendors, lawyers and other third parties. Under current law, liability under the securities laws is premised on a misstatement or misleading statement by the defendant to investors. Thus, if an accounting firm provides an audit opinion, the firm can be sued for making a false statement, assuming all the other elements of Section 10(b) liability are met. When accountants issue audit opinions, they recognize that this risk exists.

Here are some real-world examples of why S. 1551, however well-intentioned, almost certainly would have serious unintended consequences for innocent third parties.

Almost every public company faces business risks that even the most diligent banker, accountant or lawyer may not spot. Company executives routinely make decisions that turn out poorly in retrospect. Perhaps, the company lost money because a product didn't sell or the company's competitors made better products. Or, the economy suffered an unexpected downturn that caused the company to suffer significant losses. This happens every day in America.

As matters now stand, if the company's stock has fallen significantly, the plaintiffs' bar may sue the company and its executives charging that they were reckless in not disclosing the business risks that caused the company's stock to drop. If S. 1551 is enacted, the plaintiffs' bar almost certainly will name as defendants all of the third parties – particularly

bankers – who provided lending or financing to the company, claiming that those loans funded the "fraud."

Even if the case is weak, the third parties will have to spend hundreds of thousands of dollars moving to dismiss the complaint. If they fail to do so, then those third parties will have to spend millions in defense costs. As result, as before the PSLRA, the plaintiffs' bar will have the unjustified power to exact big settlements from innocent third parties.

Here's another real-world example. Let's suppose a company's executives lie to the company's bankers, accountants, vendors and lawyers. Assume that the executives are really good liars. Great con artists. I have deposed some pretty well-known con artists, and the best con artists could sell ice to eskimos.

Also assume that the company's bankers, accountants, vendors and lawyers reasonably believe the lies that they are told by the company's executives. The bankers agree to provide loans putting the bank's money at risk. The accountants provide audit opinions. The vendors engage in transactions with the company. And, the lawyers help the company draft SEC filings or provide opinion letters that are necessary for capital-raising or other corporate transactions to be completed.

At some point, the company's fraud is revealed. Maybe one of the company's bankers, accountants, vendors or lawyers figures out that something is wrong and blows the whistle to the Department of Justice or the SEC. The company's stock collapses. The executives plead guilty and go to jail.

A plaintiffs' lawyer doesn't need documentary proof to survive a motion to dismiss or even summary judgment. Sometimes, a criminal executive of a company will try to

cut a deal with the plaintiffs' lawyers: " Drop your case against me, and I'll testify against the deep-pocket banker." It's enough that one corrupt executive charges that a third party knew about the company's fraud, for example, the claim that a banker made a loan to prop up a company's fraud. There may be no other proof, but the mere allegation of an insider, even if a convicted felon, is enough to create an issue of fact for the jury.

Juries can be unpredictable. Some third parties, like Wall Street bankers, are not particularly popular with the typical juror. No deep-pocket third party wants to risk a catastrophic jury verdict or even the massive expense of defending a securities class action. So, fearful of a runaway jury, companies settle, with the settlement amount often turning on the size of the potential damages more than any notion of culpability. And, the cost of settling and defending securities class action is passed on to shareholders through higher D&O insurance premiums.

2. The SEC and DOJ Are Best Suited To Prosecute Aiders and Abettors.

In the PSLRA, Congress wisely decided that the SEC and Department of Justice (and not the plaintiffs' bar) should have the power to prosecute third parties – from banks to accountants to vendors – that aid and abet securities fraud. The SEC and Department of Justice should (and do) take action against real aiders and abettors of securities fraud. But, clearly, Congress did not want to give the plaintiffs' bar the enormous leverage of an open-ended theory of liability to extract huge settlements from the supposedly deep pockets of those who deal with public companies.

In 2002, in Sarbanes-Oxley, Congress gave the SEC the power to require wrongdoers (including aiders and abettors) to make payments into a "Fair Fund" to provide compensation to injured investors. Since 2002, the SEC has set up 115 Fair Funds and recovered

more than $8 billion from securities law violators. The SEC obviously doesn't have to pay as much as one-third of any recovery to lawyers, so that greater reliance on the SEC can result in larger recoveries for innocent investors.

In addition, the Department of Justice can pursue third parties that aid and abet securities fraud. If the threat of a long prison sentence doesn't deter aiding and abetting, it's highly doubtful that the risk of a class action lawsuit is going to stop such conduct.

3. S. 1551 Would Hurt the Competitiveness of U.S. Capital Markets. In considering S. 1551, Congress should consider the widely acknowledged concern that foreign private issuers are being driven from U.S. markets by fear that listing shares on the U.S. exchanges will expose them to worldwide securities class actions brought on behalf of shareholders who purchased their shares outside the United States.

In Europe and Asia, there are no U.S.-style securities class actions. Non-U.S. companies fear the U.S. legal system. They don't think it's fair, and they are utterly shocked by the enormous expense involved in U.S. discovery. As a result, many non-U.S. companies are delisting from our capital markets.

As a study commissioned by Senator Schumer and Mayor Bloomberg found: "the prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of doing business—and driven away potential investors." (McKinsey & Company, Report Commissioned by Mayor Michael R. Bloomberg and Senator Charles E. Schumer, *Sustaining New York's and the U.S.' Global Financial Leadership* ii (2007)).

Indeed, as Professor John Coffee has written: "while the press and others attribute the growing concern of foreign issuers with the U.S. market to the Sarbanes-Oxley Act, closer analysis and interview data suggest that fear of U.S. private antifraud litigation may be the

better explanation [for the flight of foreign private issuers from U.S. markets]." (John C. Coffee, Jr., Securities Policeman to the World? The Cost of Global Class Actions, N.Y.L.J., Sept. 18, 2008).

4. S. 1551 Would Hurt New York and Other U.S. Financial Centers. I live and work in New York City. There is no more important industry to New York than the financial services industry. Although it's fashionable now to attack banks and bankers, the financial services industry is critical to the economic health of our Nation. Enactment of S. 1551 would be good for the City of London, but it would be bad for New York, Chicago, Charlotte, Boston, Philadelphia, San Francisco and other U.S. financial centers.

Prior to the Supreme Court's decision in *Stoneridge*, financial institutions were the targets of so-called "scheme" liability claims. Thus, S. 1551 would expand the risk of liability for the very businesses that Congress has supported under the TARP program. As a result, instead of spending their capital making loans and thereby growing our economy, these financial institutions would be faced with having to foot an even bigger bill for expanded securities litigation, including tens of millions for both plaintiffs' and defense lawyers and potentially billions for settlements.

S. 1551's "Recklessness" Standard Is Too Vague and Amorphous

In the PSLRA, Congress did not expressly establish a substantive standard of fraudulent intent or scienter. As matters now stand, Federal Courts of Appeal have required proof of a high degree of recklessness to constitute fraudulent intent. For example, in the Second Circuit, a plaintiff must allege reckless conduct that "is highly unreasonable and . . . represents an extreme departure from the standards of ordinary care . . . to the extent that the danger was

either known to the defendant or so obvious that the defendant must have been aware of it." *Chill* v. *General Electric*, 101 F.3d 263, 269 (2d Cir. 1996).

S. 1551 would impose liability on any third party that "recklessly provides substantial assistance to another person" in violation of the Securities Exchange Act. By not at least adopting a strict definition of "recklessness," courts likely would view S. 1551 as watering down the current standard for alleging fraudulent intent to something approximating negligence or, at best, gross negligence. As a result, many cases that now do not survive motions to dismiss would pass this lower pleading threshold, and more companies would have no choice but to settle weak securities cases to avoid the risk of a large judgment. In addition, S. 1551 does not define "substantial assistance," leaving that term to be defined by courts and juries on an ad hoc basis, creating more uncertainty and pressure to settle cases.

The combination of an undefined "substantial assistance" – conduct that in itself may be perfectly legal – and a nebulous "recklessness" standard that does not require that the accused party have any actual knowledge that its conduct in some way assisted a fraud not only gives plaintiffs' lawyers a broad "hunting license," but creates such uncertainty about the legal standard that the pressure to settle cases (rather than risk a jury trial in which the damages could be billions of dollars) will be overwhelming. Indeed, even before the Supreme Court in *Central Bank* held that aiding and abetting claims are not authorized by the securities laws, many of the lower courts that permitted such claims had adopted strict limits on the circumstances in which such claims could be brought, including requiring proof that the accused party had knowledge of the fraud it allegedly was assisting.

Some Reforms of Securities Litigation That Congress Should Consider

The PSLRA improved securities class actions, but as I've explained the system is still far from perfect. While benefiting lawyers, the current system typically requires innocent shareholders to bear the cost of litigating and settling securities class actions – particularly when claims lack merit.

1. Eliminating Settlements Based on Legal Error. As I mentioned, unless dismissed on a motion, virtually all securities class actions settle. Many of these settlements are based on district court rulings denying motions to dismiss or for summary judgment, and granting motions for class certification. To avoid the risk that settlements are based on legal error by lower courts, Congress should permit parties to appeal immediately as of right lower court decisions on motions to dismiss, for summary judgment and for class certification. In their report, Senator Schumer and Mayor Bloomberg urged adoption of this needed reform.

Alternatively, Congress could provide parties with the right to petition appellate courts for interlocutory review of decisions on motions to dismiss and for summary judgment. These appellate rights could be limited to cases where plaintiffs seek damages of more than $50 million or do not specify an amount of alleged damages. Under the Federal Rules of Civil Procedure, parties presently can petition for interlocutory review of decisions on class certification.

2. Improving the Lead Plaintiff Selection Process. In the PSLRA, Congress adopted the presumption that the largest interested shareholder should, as lead plaintiff, control the conduct of securities class actions. This provision was intended to eliminate so-called captive plaintiffs in major securities class actions.

The recent revelations about "pay-to-play" relationships between plaintiffs' firms and the public officials who control public pension funds indicate that some lawyers may have

found a way to circumvent these provisions, returning to plaintiffs' lawyers the control that the PSLRA was designed to eliminate. Many prominent observers, including the late Judge Edward Becker and Professor Coffee, have criticized this practice. To eliminate any risk of "pay to play," Congress should require that plaintiffs' lawyers disclose to the court any political contributions made to elected officials who manage public pension funds when those funds seek to become lead plaintiffs in securities class actions.

Moreover, in order to eliminate the risk that lead plaintiffs will not effectively control securities class actions, Congress should bar plaintiffs' lawyers from aggregating unrelated plaintiffs as a single lead plaintiff group to seize control of a securities class action from the largest interested shareholder.

In some cases, plaintiffs (and their counsel) have unfairly secured the lead plaintiff role by submitting inflated calculations of their clients' alleged losses. To address this abuse, Congress could amend the PSLRA's lead plaintiff provision to require detailed submission of information about shareholder loss in connection with the lead plaintiff selection process.

3. Eliminating Coercive Settlements by Reforming the Calculation of Damages. Most securities class actions settle because defendants cannot afford the risk of a judgment based on a jury's acceptance of the grossly inflated theories of damages of plaintiffs. In some cases, district courts do not sufficiently scrutinize the damages theories of plaintiffs' experts.

At the pleading stage, Congress could require that plaintiffs plead loss causation with the particularity required for fraud claims. Courts presently are divided over whether such heightened pleading standards apply to loss causation.

To eliminate speculative theories of damages, Congress could expressly require that damages in securities class actions be based solely on losses caused by the fraud, and not from general market or industry factors, or from non-fraudulent company-specific factors, such as poor business performance.

In any securities class action, some members of the plaintiff class receive a "windfall," because they sold some shares at a fraudulently inflated profit before the disclosure of the fraud. Congress could require that, in the event of a judgment, any calculation of damages include a netting of any such gains from the calculation of individual class member's losses.

In an effort to inflate settlements, plaintiffs typically request that juries be permitted to award damages on an aggregate basis to a class of plaintiffs of largely unknown size. Congress could bar jury awards based on aggregate theories of damages. Instead, juries should award damages based on the damages per share, with the total amount of damages to be determined based on the number of shareholders who actually submit valid claims. In many cases, substantially less than 50% of affected shareholders even submit claims.

Under current law, the risk exists that a deep-pocket defendant might be liable for 100% of the damages caused by a securities fraud, even if that defendant bore only 1% of the responsibility for those damages. To avoid the coercive impact of this risk on settlements, Congress could eliminate joint and several liability in securities class actions.

4. Eliminating Speculative Theories of Reliance. In *Basic* v. *Levinson*, 485 U.S. 224 (1988), a divided Supreme Court effectively eliminated the requirement that plaintiffs in securities class actions plead a basic requirement of fraud – that the plaintiff relied on a misstatement of the defendant. Instead, the Supreme Court adopted a rebuttable presumption that all public statements about a company are reflected in the company's stock

price, including statements that not read by many shareholders, much less relied on, such as statements by third parties like stock analysts. One thing we've learned from the recent financial crisis is that markets are far from perfect. But the Supreme Court decision in *Basic* rests entirely on the notion that markets perfectly reflect all available information. Thus, Congress could limit application of the so-called "fraud on the market" theory to cases against issuers in which plaintiffs allege that the SEC filings of the issuer were false, as opposed to statements made by company officials reported in the press or that are not widely disseminated to the market.

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In sum, I urge the Committee to continue to rely on the SEC and DOJ to prosecute aiders and abettors of securities fraud. The benefits of allowing the plaintiffs' bar to assume this mantle are few and the costs are likely to be great. Congress should consider other reforms of securities class actions, but not revisit the balanced approach struck in the PSLRA to aiding and abetting liability.