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BEFORE THE
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UNITED STATES SENATE

EVALUATING S. 1551: THE LIABILITY FOR AIDING AND ABETTING SECURITIES VIOLATIONS ACT OF 2009

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Mr. Chairman and members of the Committee, thank you for inviting me to this hearing. Securities class actions are the principal focus of my academic research and I welcome the opportunity to share my views with the Committee as it considers this legislation, which would extend securities fraud liability in private class actions to secondary actors.

Stoneridge* and *Central Bank

S. 1551 would reverse two Supreme Court decisions interpreting Section 10(b) and Rule 10b-5 of the Exchange Act. In *Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc.*,[1] the Court rejected "scheme" liability in private causes of action. *Stoneridge* followed an earlier decision by the Court, *Central Bank of Denver v. First Interstate Bank of Denver*,[2] in which the Court rejected "aiding and abetting" liability. In both cases, the Court rejected attempts by the plaintiffs' bar to bring in third parties as defendants in securities class actions.

The Court's principal concern in these cases was the specter of unlimited liability. As Justice Kennedy wrote for the Court in *Stoneridge*, "[w]ere [the plaintiffs'] concept of reliance to be adopted, the implied cause of action would reach the whole marketplace in which the issuing company does business." If accepted, the plaintiff's theory in *Stoneridge* threatened to inject the § 10(b) cause of action into "the realm of ordinary business operations."

S. 1551 would tear down the safeguards that the Court adopted in *Stoneridge* and *Central Bank*, creating the potential for the securities laws to be injected into a wide range of ordinary commercial transactions. As Justice Kennedy recognized in *Stoneridge*, expanding liability to secondary actors would undermine the United State's international competitiveness and raise the cost of capital because companies would be reluctant to do business with American issuers. Issuers might list their shares elsewhere to avoid these burdens, thereby further fueling the flight from America's securities markets.

Commercial counterparties of the sort named as defendants in *Stoneridge* and *Central Bank* are just a sideshow to S. 1551l's real purpose. The goal of the bill is to rope in more "deep pocket" defendants to feed the plaintiffs' bar's lucrative class action machine. That class action machine generates enormous fees that support the "pay to play" political contributions that plaintiffs' lawyers use to persuade state pension funds to bring the lawsuits that help keep the machine rolling.

By offering up additional targets to the class action bar, S. 1551 promises to worsen the fundamental problems that make America's securities class action regime so dysfunctional and destructive of shareholder wealth. Securities class actions are already an enormous drain on America's capital markets. S. 1551 would make a bad situation worse.

The Economics of Securities Fraud Class Actions

No other nation has adopted the open-ended private liability for misrepresentations affecting the secondary market price of corporate securities that we have in the United States, and for good reason. Our current regime is not the product of congressional action, but rather, judicial happenstance. In *Basic, Inc.* v. *Levinson*[3] the Supreme Court – in a 4-2 decision – unleashed an avalanche of securities fraud class actions under Rule 10b-5. The Court did this by creating a presumption of reliance for lawsuits involving securities traded in the secondary public markets – the fraud on the market theory (FOTM). The FOTM presumption greatly expands the size of the class, and

[1] 128 S. Ct. 761 (2008).
[2] 511 U.S. 164 (1994).
[3] 485 U.S. 224 (1988).

thus, the potential amount of damages. Every investor who purchased stock during the time that a misrepresentation was affecting the company's stock price—and did not sell it before the truth was revealed—has a cause of action under Rule 10b-5. In the overwhelming majority of securities fraud class actions, plaintiffs' attorneys sue the corporation for misrepresenting the company's operations, financial performance, or future prospects that inflate the price of the company's stock in secondary trading markets. Although these misrepresentations may have a material effect on a company's stock price, in the aggregate there is no net wealth transfer away from investors. For every shareholder who *bought* at a fraudulently inflated price, another shareholder has *sold*: The buyer's individual loss is offset by the seller's gain, investors can expect to win as often as lose from fraudulently distorted prices. With no expected loss from fraud on the market, shareholders do not need to take precautions against the fraud; they can protect themselves against fraud much more cheaply through diversification. Losses from the few fraudulent bad apples will be offset by the gains from the honest companies.

Despite the ability of shareholders to protect themselves against secondary market fraud cheaply through diversification, the FOTM presumption puts the corporation on the hook to compensate investors who come out on the losing end of a trade at a price distorted by misrepresentation. Corporations are held responsible for the entire loss of all of the shareholders who paid too much for their shares as a result of fraudulent misrepresentations. Critically, there is no offset for the windfall gain on the other side of the trade. The investors lucky enough to have been selling during the period of the fraud do not have to disgorge their profits. Given the trading volume in secondary markets, the potential recoverable damages in securities class actions can be a substantial percentage of the corporation's total capitalization, easily reaching hundreds of millions of dollars, and sometimes billions.

The size of the damages becomes a cause for concern when we factor in the inevitably scattershot nature of securities fraud class actions. Distinguishing fraud from mere business reversals is difficult. As a result, a substantial drop in stock price following news that contradicts a previous optimistic statement may well produce a lawsuit. Courts face the difficult task of sorting the meritorious cases from those with weak evidence of fraud (so-called "strike suits"). If plaintiffs can withstand a motion to dismiss, defendants generally will find settlement more attractive than litigating to a jury verdict, even if the defendants believe that a jury would share their view of the facts. From the company's perspective, the enormous potential damages make the merits of the suit a secondary consideration in deciding whether or not to settle. The math is straightforward: A ten percent chance of a \$2 billion judgment means that a settlement for \$199.9 million makes sense. For many companies facing a securities fraud class action, the choice is settle or risk the very real possibility of a bankruptcy-inducing jury verdict.

If the threat of bankruptcy-inducing damages were not enough, any case plausible enough to get past a motion to dismiss may be worth settling just to avoid the costs of discovery and attorneys' fees, which can be enormous in these cases. The recent experience of JDS Uniphase is illustrative.[4] After five years of litigation, the company was eventually exonerated by a jury after a trial—one of only four securities class actions to go to verdict out of 2,105 suits filed since 1995. The company knew that it was risking bankruptcy if it lost, but it gambled and won—after paying a reported \$50 million in legal fees. Even if JDS had been *certain* that it would prevail at trial, it would have been economically rational to settle the case for \$49 million when it was filed. Combine this calculus with one other data point—NERA reports that median settlement in securities fraud class actions was \$6.4 million from 2002 to

[4] Ashby Jones, JDS Wins Investor Lawsuit, Bucking a Trend, Wall Street Journal, June 2, 2008, at B4.

2007.[5] Given JDS's experience, it is difficult to argue that any suit likely to be filed that gets past a motion to dismiss can be defended for less than $6.4 million. This means that *at least* half of the suits that produce a settlement are settling for essentially nuisance value.

The deterrent value of securities class actions is further diluted by the fact that the measure of damages currently used encourages plaintiffs' lawyers to pursue the wrong party—the corporation. The current regime for secondary-market class actions largely produces an exercise in "pocket shifting." Traditionally, class action settlements have not included a contribution from corporate officers individually. Plaintiffs' lawyers forgo that source of recovery because they can reach a settlement much more quickly if they do not insist on a contribution from the individual defendants. The big money for plaintiffs' attorneys is in pursuing the corporation and its insurers, and the officers and directors are happy to buy peace for themselves with the corporation's money. The dirty secret of securities class actions is that companies and their insurers pay the costs of settlement, which effectively means that shareholders are paying the costs of settlements to shareholders.

In sum, the combination of the potential for enormous judgments and the cost of litigating securities class actions means that even weak cases may produce a settlement if they are not dismissed at the complaint stage. Paying a settlement is a perfectly rational response in the face of the threat of bankrupting liability. If the question is "Your money or your life?," the answer is always the money, unless you are Jack Benny. The deterrent effect of class actions is diluted by this settlement imperative because both wrongful and innocent conduct is punished. Settlement is all the more attractive because the individual defendants can use the shareholders' money to make the suit go away. Consequently, securities class actions punish the wrong party; it is the innocent shareholders who pay, with the wrongdoers generally walking away unscathed. Rule 10b-5 actions sometimes target fraud, but more frequently they are simply legalized extortion at shareholders' expense.

The Effect of S. 1551

Giving the plaintiffs' bar aiding-and-abetting authority would offer class action lawyers one more weapon with which to shake down settlements.[6] Here the obvious targets would be available deep pockets with some contractual connection to the corporation, such as accountants, lawyers, and banks. The demise of Arthur Andersen suggests that increasing the liability burden of these third party professionals is fraught with risks for the capital markets. Aside from the threat of bankruptcy, shifting liability from the corporation to these third parties only puts an additional link in the chain of the pocket shifting problem. Professionals providing services to public corporations will demand compensation for bearing the risks of liability. Moreover, these advisors will begin more aggressively monitoring statements in order to protect themselves from litigation risk. The additional time spent on monitoring will not only duplicate the corporation's efforts to ensure accuracy; it will also be redundant across the multiple advisors working on a common document. Shareholders will bear those costs; securities class actions are not a free lunch.

The burden imposed by extortionate settlements drove Congress's previous response to the question of aiding and abetting liability. In the wake of *Central Bank*, a bill was introduced to extend aiding-and-abetting authority to private litigants. The argument was that expanded liability would encourage accountants and lawyers to be more vigorous "gatekeepers," denying defrauders access to

[5] NERA Economic Consulting, Recent Trends in Shareholder Class Action Litigation: Filings Stay Low and Average Settlements Stay High–But Are These Trends Reversing? (September 2007).

[6] Secondary defendants might be afforded some protection by proportionate liability, 15 U.S.C. § 21D(f), but the effect of that provision is reduced substantially by the exceptions for intentional fraud and the insolvency of other defendants.

the financial markets. Congress rejected those arguments in 1995 when it adopted the Private Securities Litigation Reform Act ("PSLRA"), instead giving aiding-and-abetting authority only to the SEC.[7]

The balance struck by the PSRLA is a sensible compromise. The SEC has the authority to pursue secondary defendants with knowledge of the fraud, and unlike plaintiffs' lawyers, the agency is not driven by its financial incentives in using its aiding-and-abetting authority. Facing the knowledge standard, the SEC is forced to pursue secondary defendants only when there is clear evidence of wrongdoing. By vesting authority to pursue aiders-and-abettors in the SEC, Congress recognized that securities class actions are not the primary vehicle for deterring fraud. Civil sanctions imposed by the SEC, criminal prosecution by the Justice Department, and both civil and criminal cases brought by state attorneys general are the primary deterrent of fraud in the securities markets. Private class actions move a lot of money around, but add little to deterrence at the margin.

Moreover, even in private actions, secondary defendants do not enjoy immunity from liability under current law. If they make misrepresentations upon which investors rely (such as certifying false financial statements or hyping a security with inflated prospects), secondary defendants can and will be held liable. *Central Bank* and *Stoneridge* only exclude liability when secondary defendants have made no false statement themselves. That is hardly a startling principle. The basic purpose of securities law is to protect investors who reasonably rely on information. If the accountant, investment banker, or lawyer has made no statement, then investors have not relied on that person in making their investment decisions. On the other hand, current law already provides that if the secondary defendants have induced reliance by investors, they will be on the hook.

The purported benefits of expanded liability – a nebulous increase in marginal deterrence beyond that afford by SEC enforcement and criminal punishment – are unlikely to be worth the costs – a sharp spike in securities class actions, with a corresponding increase in strike suit settlements. In the hands of plaintiffs' lawyers, aiding-and-abetting liability transforms the law of fraud from a sanction for misleading people into a sanction for failing to uncover fraud committed by others.

Such a regime might make sense if we thought it would be proper to transform professionals into quasi-fraud police. But there are good reasons why audits of public companies are not full-scale investigations for fraud. A forensic audit to uncover fraud requires an enormous investment of time and resources and therefore costs a multiple of the typical charge for an annual audit. A forensic audit is a huge waste for the overwhelming majority of public companies that are not engaged in fraud. And it is not as if public accountants are lacking in leverage over their clients; the Sarbanes-Oxley Act has already given accountants the whip hand in that relationship. A chief financial officer disagrees with his independent auditor's interpretation of the sometimes open-ended provisions of GAAP at his peril. Terminating your auditor because of an accounting disagreement assures a steep drop in the stock price. Internal controls? Public accountants love 'em; they come at the company's expense. The Sarbanes-Oxley Act has sent audit fees skyrocketing; introducing aiding-and-abetting liability would send them higher still.

Perhaps more expensive would be the cost of training lawyers to uncover fraud. As an educator of future lawyers, I know first-hand that the average corporate lawyer is doing well to understand the transactions that he is asked to document, much less look behind them for nefarious purposes. Uncovering fraud requires specialized expertise that can only be developed through extensive and expensive training. Law schools do not provide it, nor could they on any cost-effective basis.

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[7] PSLRA § 104, 109 Stat. 757 (codified at 15 U.S.C. § 78t(e)).

Imposing liability on the banks raises different concerns. Already a big target for the class action bar before the financial crisis, financial institutions were named as defendants in half of the securities class actions filed last year. In the post-bailout world, suing the large banks that dominate the financial services industry effectively means suing the U.S. Treasury. Almost 80% of the TARP funds have gone to financial institutions that have been named as defendants in recent securities class actions. The pocket-shifting problem of shareholders paying themselves in securities class actions takes on a whole new dimension when we start taking the money out of the pocket of the U.S. taxpayer. S. 1551 would increase the windfall that the plaintiffs' bar has received from the TARP program.

Perhaps the worst consequence of introducing aiding-and-abetting liability, however, would be to further diminish the incentive of plaintiffs' lawyers to pursue the corporate executives who are responsible for the fraud. Under the current scheme, plaintiffs' lawyers extract settlements from the corporation because it is the easiest target and companies fear bankruptcy if they gamble on a trial and lose. The third-party defendants that would be targeted under aiding-and-abetting liability face a similar calculus: even a weak lawsuit poses *some* chance of bankrupting liability. Better to pay up than to become extinct. The costs can always be passed along to the shareholders of the client firms

A Better Solution

Basic economics teaches that deterrence is maximized by sanctioning the person who is most at fault for the fraud. Congress can encourage plaintiffs' lawyers to go after the real wrongdoers in every fraud case by altering the damages remedy for Rule 10b-5 fraud on the market cases. The current rule holds corporations responsible for the entire loss of all of the shareholders who paid too much for their shares as a result of fraudulent misrepresentations. But that measure exaggerates the social harm caused by fraud on the market because it fails to account for the gains of equally innocent shareholders who sold at the inflated price. In most cases, the losses and gains will be a wash for shareholders in the aggregate: some individual shareholders will have suffered losses, others will have reaped windfall gains.

A better damages rule would focus on deterrence rather than compensation.[8] Instead of making defendants liable for all losses resulting from misstatements, we should instead force defendants to disgorge their gains (or expected gains, for those who fail in their scheme) from the fraud. So if a corporation were issuing securities at the time it was distorting the market price of its stock, it would be required to disgorge the amount by which it inflated the price of the securities that it sold to the investors who bought them. In most fraud on the market cases, however, the corporation has not benefited from the misrepresentation that is the basis of the class action. Indeed, the corporation is usually the *victim* of the fraud. The corporation is victimized when an executive is awarded a bonus that is undeserved because he creates the appearance of having met the target stock price. The corporation is also victimized when a chief executive officer keeps his job for a bit longer because he creates the appearance of adequate performance. The proper remedy in such cases is for the executive to return the bonus or salary earned from the fraud to the corporation. If the executive benefits from the fraud by cashing out stock options at an inflated price, those profits can be paid over to the corporation. The Sarbanes-Oxley Act makes a beginning toward making executives pay for their fraud by requiring them to reimburse the corporation for any incentive compensation (as well as profits from any stock sales) if the corporation is required to restate its financial results.[9] The big money for plaintiffs' attorneys, however, remains in pursuing the corporation and its insurers. If we took away the corporation's

[8] I develop these ideas further in a recent article, Stoneridge Investment Partners v. Scientific Atlanta, 2007-2008 Cato Sup. Ct. Rev. 217.

[9] 15 U.S.C. § 78t-1(b)(1).

exposure when it did not benefit from the fraud, we would substantially increase the attorneys' incentive to pursue the executives responsible for the fraud.

If Congress were to adopt a disgorgement measure of damages for Rule 10b-5 class actions, plaintiffs' lawyers would have to extract settlements from executives' bonuses and stock options instead of relying on the corporation's coffers for their payday or targeting deep-pocketed secondary defendants. Deterrence is maximized by sanctioning the person who is most at fault for the fraud, so turning the sights of the class action bar on the culpable individuals would give us substantially more deterrent bang for our class action buck. And reducing the potential dollar figures involved would eliminate the ability of plaintiffs' lawyers to extract nuisance settlements in weak cases. If defendants believe they can prevail at trial, a small probability of losing an enormous judgment will no longer tip the balance in favor of settlement. Fraud should should not pay, but neither should strike suits.

How would the principle apply to aiding-and-abetting liability? Accountants, lawyers, and investment bankers who are complicit in the corporation's fraud should be forced to give up their fees (or some multiple thereof) earned during the fraud period. Canada uses a version of this remedy in its recently adopted securities class action legislation. Under that legislation, the liability cap for experts is $1 million or the revenue that the expert and its affiliates have earned from the issuer and its affiliates during the 12-month period immediately preceding the day on which the misrepresentation or the failure to make timely disclosure occurred.[10] Those limits are inapplicable if the fraud is done knowingly.

The desire to enlist secondary parties in rooting out fraud does not require us to expose them to extortionate settlements in securities class actions. The objective here should be to ensure that fraud does not pay, not to enrich the class action bar. Until Congress reforms the damages measure for Rule 10b-5 class actions, private aiding-and-abetting liability will only serve to fuel the plaintiffs' lawyers' class action machine.

Summing Up

Securities class actions are a big stick to wield against corporate fraud. Unfortunately, they are also all too prone to abuse. Under the damages measure currently used in such actions, corporations are coerced into paying settlements even in weak cases. Expanding liability to "aiders-and-abettors" of securities fraud would expand the potential range of victims for this extortion. Moreover, bringing accountants, attorneys, and banks into the crosshairs further distracts the plaintiffs' bar from going after the real culprits, the corporate executives who commit fraud. If Congress wants to make securities fraud class actions a more effective deterrent, it needs to fix the Rule 10b-5 damages formula first.

[10] Ontario Securities Act, s. 138.1. Liability can be proportionately allocated in respect of each defendant's responsibility for the damages assessed. Ontario Securities Act s. 138.6. Janis Sarra and I discuss the Canadian securities class action regime at greater length in *Securities Class Actions Move North: A Doctrinal and Empirical Analysis of Securities Class Actions in Canada*, which is forthcoming in the Alberta Law Review.