SECURITIES REFORM: ITS EFFECT ON LITIGATION AND CAPITAL FORMATION

By Martin D. Chitwood and Christi C. Mobley

Published in Calendar Call, Vol II, Winter 1996, No. 4

On December 22, 1995, the Private Securities Litigation Reform Act of 1995 (the "Act") became law. According to those who lobbied most strenuously for the Act's passage, this legislation was designed to allow officials of public companies to publish statements about their companies' prospects without fear of shareholder lawsuits. The proponents of the Act, purporting to champion the American capital markets, argued that without the safeguards provided by the Act, companies would not be able to furnish the public with the information needed to make meaningful investment decisions. Therefore, they argued, passage of the Act would aid capital formation.

Opponents of the Act argued that those who lobbied for the legislation were motivated only by their desire to protect themselves from meritorious lawsuits and that the effect of the legislation could be the opposite of its articulated purpose. In reality, the legislation could go "far beyond curbing meritless lawsuits to all but legalizing securities fraud." The Act could allow companies to induce investment

with unsubstantiated statements, which could ultimately erode investors' faith in the information they receive and harm capital formation.

A History of Securities Legislation

Prior to the passage of the Act, American capital markets operated under the provisions of the Securities Act of 1933 (the "33 Act") and the Securities Exchange Act of 1934 (the "34 Act"). The purpose of those bills was

> . . . to protect the investing public and honest business; . . . . to prevent further exploitation of the public; . . . to place adequate and true information before the investor; to protect honest enterprise; . . . [and] to restore the confidence of the investor . . .

U.S. capital markets have thrived under the protection of these acts. Indeed,

[d]espite more than an occasional scandal or two, the highly liquid and reliable U.S. securities markets remain the envy of the world. Nearly a third of all American families continually demonstrate their faith in the market's basic fairness by investing their savings in stocks, bonds and mutual funds.

In particular, Section 10-b of the 33 Act and its Rule 10b-5 deterred fraudulent conduct by insuring that companies were punished when they misrepresented or exaggerated information to affect the price of their stock.

Because the Securities Exchange Commission ("S.E.C.") does not collect investment losses for defrauded investors, private causes of action under the 33 Act and the 34 Act have played an important role in supplementing the enforcement powers of the S.E.C. As one court observed:

The most effective control and deterrent to over-reaching and wrongful conduct in the capital raising area is the presence of private lawyers who are willing to devote their time, their energy, and their own personal resources to vindicate the rights of individual investors who have been importuned, misled, or who somehow have been fraudulently deprived of their money.

Despite the substantial securities and investment frauds taking place today, pre-Reform Act legal safeguards have convinced millions of Americans to invest in U.S. markets. Consequently, companies have been able to raise money from an enormous pool of capital. With acquisitions, stock prices, stock offerings and trading volume at or near record levels, investors clearly did not believe that American capital markets needed radical reform.

Where Did the Act Originate?

The Act was championed by a self-serving coalition called the Committee to Eliminate Abusive Securities Suits ("CEASS"). CEASS is led by Silicon Valley-based public companies and Big Six accounting firms, which wield unmatched money and influence in the arena of lobbying. Since 1992, accounting firms and their lobbyists contributed over $3.3 million to legislators' campaigns, a 50% increase from pre-1992 contributions.

The motives of these members of CEASS were transparent. Silicon Valley, California is the home of numerous start-up companies on the cutting edge of technology. Such companies can be riskier investments than established companies, and they have tended to be more aggressive in their statements to potential investors. If the directors of these companies induced investment through fraudulent statements, Rule 10b-5 could require them to repay investors' losses. Hence, the directors lobbied Congress for the Act, which could substantially prevent such recoveries.

The Big Six firms joined the fight because they were frustrated by their inclusion in lawsuits alleging financial reporting fraud. The public considers an audit by a respected accounting firm to constitute a "stamp of approval," which goes far in convincing potential investors that the company's financial statements are reliable. Nonetheless, the accounting firms protested being subjected to joint and several responsibility for misleading financial statements even though they gave the financial statements their stamp of approval. Consistent with their ethical standards, it would seem that public accountants would seek laws with more severe penalties for inaccurate accounting by corporations and tighten their own audit standards. Instead, the accountants joined forces with the companies they audit -- not to adopt policies to eliminate fraud, but to restrict the ability of defrauded shareholders to sue.

How did CEASS Promote Passage of the Act?

With a well-funded agenda, CEASS members instituted a massive Madison Avenue propaganda campaign, attempting to convince the public (1) that all securities lawsuits are frivolous; (2) that lawyers are the only beneficiaries of such lawsuits; and (3) that companies that are sued are forced to settle because they cannot afford to litigate.

1. CEASS' first point -- that all securities lawsuits are frivolous -- is demonstrably untrue. Frivolous lawsuits do not survive dispositive motions such as motions to dismiss or motions for summary judgment. In fact, securities fraud lawsuits are <u>more</u> likely to be defeated by motion than other actions because the information necessary to plead the company's fraud with particularity has usually either been destroyed or is solely within the hands of the defendants.

Furthermore, lawyers have no incentive to bring frivolous lawsuits. Securities fraud cases are often brought as class actions, in which attorneys must work for a contingent fee because an investors' individual losses would not warrant paying hourly legal fees. If such a lawsuit is dismissed, the attorneys do not get paid.

In further support of its argument that all securities suits are meritless, CEASS alleged that any dip in the value of a company's stock would bring a class action lawsuit. This is also false. A securities action, like any other lawsuit, has two components: liability and damages. A drop in stock price may establish damages, but without liability, no lawsuit would survive. Securities lawsuits have typically followed a drastic decline in stock price accompanied by at least <u>four</u> things, which establish liability: (1) a public misstatement about the company (e.g., for simplicity, that it had sales of $100 million when its sales were only $50 million); (2) a rise in stock price because of the false information; (3) insider selling at the inflated stock price; and (4) public correction of the misinformation that results in the decline in the stock price. Without the first three of these elements (or another basis for liability), stock price decline does not provide the basis for a lawsuit.

Securities class actions are few -- only about 300 are filed per year. Of the approximately 14,000 public companies that report to the SEC, only about 120 (or 0.1%) are sued in securities fraud class actions each year. While the number of securities class actions filed annually has remained static over the past 20 years (representing approximately .13% of the new federal court filings each year), public offerings have increased 9,000% in the last 20 years. Indeed, more capital was raised in initial public offerings by emerging high-tech firms in 1995 than ever before -- $8.4 billion. Additionally, there has been a 1,200% increase in the number of common stock offerings in the last 20 years, and the proceeds raised from those offerings have increased 4,200%.

2. As its second point, CEASS argued that lawyers were the only beneficiaries of securities class action lawsuits. Throughout its propaganda campaign, CEASS intentionally obscured the benefits of the class mechanism by which so many investors recoup their losses. For instance, CEASS and other pro-reform groups ran advertisements in which they compared the recovery a single female investor received to the total attorney's fees in a class action (e.g., "I got only a few thousand dollars, and my attorneys received hundreds of thousands.") The advertisements did not disclose the recovery the class received, which, in the example, was likely millions of dollars. This type of misleading advertisement led the public to believe that lawyers were the only substantial beneficiaries of securities class action suits and obscured the fact that it is the public itself and capital markets that are the primary beneficiaries of these actions.

3. The third falsehood that CEASS used to lobby Congress and miseducate the public is that companies are compelled to settle all shareholder lawsuits because they cannot afford to defend them. This argument is ludicrous on its face. Securities lawyers work on a contingent basis and advance expenses. Consequently, class attorneys do not earn fees unless the shareholders prevail in the action. Conversely, most public corporations have litigation budgets and liability insurance. Moreover, public corporations, like many other defendants, generally defend any questionable lawsuit either with the hope of a successful result or for the deterrent value.

The Substantive Changes Effected by the Act May Allow Company Management to Defraud its Shareholders

The Act goes well beyond reform to stifle an individual's chances of recouping an investment loss. The Act, although fraught with many potentially damaging provisions to plaintiffs, contains three significant departures from traditional securities law. Each of these provisions will negatively impact an investor's ability to recover his lost investment.

The Statutory Safe Harbor

The Act contains a "safe harbor" provision that allows a company or its principals to release statements predicting the company's future economic performance and describing the assumptions underlying such statements. The safe harbor provision has two prongs that operate in the disjunctive:

* Under the "actual knowledge" prong, the issuer is protected with respect to the forward-looking statement if the plaintiff fails to prove that the statement was made with actual knowledge that the statement was false or misleading.

* Under the "bespeaks caution" prong, the person making the forward-looking statement is protected if the 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 "actual knowledge" prong raises several obstacles to recouping investor losses. The first obstacle is encountered in the pleading stage. The Act includes several heightened pleading standards for private actions, including codification of a state of mind requirement that is based on the Second Circuit's requirement, which is generally regarded as the most stringent standard that has been applied. Pursuant to the Act, the plaintiff must state with particularity facts giving rise to a "strong inference" that the defendant acted with the required state of mind.

The Act elevates the plaintiff's burden by providing that discovery in the case is stayed when the defendant files a motion to dismiss. The effect of the combination of heightened pleading standards and the stay of discovery is that a plaintiff must plead facts that are uniquely within the defendant's possession, but is precluded from exploring company records that would demonstrate the defendant's knowledge of the falsity. The Act requires that, before any discovery can be transacted, a plaintiff must carry the often insuperable burden of pleading, with exacting specificity, facts sufficient to show "actual knowledge."

The Act also limits a plaintiff's ability to seek relief from the court. The Act undermines the trial court's discretion to guide discovery by limiting discovery during the pendency of a motion to dismiss to exceptional circumstances where particularized discovery is necessary to preserve evidence or prevent undue prejudice to a party.

The "bespeaks caution" prong of the safe harbor provision is also problematic. Read literally, it will protect forward-looking statements that were known to be false and misleading when made, so long as they were accompanied by meaningful cautionary statements. The Statement of Managers accompanying the Reform Act confirms this reading by providing that "courts . . . examine only the cautionary statement accompanying the forward-looking statement. Courts should not examine the state of mind of the person making the statement."

Additionally, the cautionary language that accompanies the forward-looking statement need only identify some important factors that could cause the company's actual performance to differ materially. "Failure to include the particular factor that ultimately causes the forward-looking statement not to come true will not mean that the statement is not protected by the safe harbor." Consequently, a company can release false or incomplete information and still fall within the Reform Act's safe harbor provision, avoiding any liability.

These relaxed standards may serve as a license to commit fraud. As Senator Paul Sarbannes (D - Maryland) noted, "[a] lot of very fast games by some very fast artists are going to be played on the investing public" in the wake of the Reform Act.

The Proportionate Liability Provision of the Act May Prevent Shareholders from Recovering Their Losses

The Act limits the application of joint and several liability to defendants who knowingly commit a violation of the securities laws. All other defendants are proportionately liable based upon their percentage of responsibility for the damages.

Knowledge, for purposes of proportionate liability, exists when the defendant (1) makes an untrue statement of a material fact with knowledge of its falsity, (2) omits to state a fact necessary to make a material statement true, with actual knowledge that without the omitted fact, the representation is false and people are likely to rely on that false representation, or (3) in cases not involving false representations, engages in conduct with actual knowledge of the facts and circumstances that make such conduct a violation of the securities laws. As discussed above, proof of actual knowledge, particularly at the pleading stage, presents tremendous problems for plaintiffs.

The Act's departure from joint and several liability demonstrates the extreme nature of this legislation. Joint and several liability is a well-established rule of law grounded in equitable principles that operate to protect innocent investors. Under the Act, defrauded investors may not be made whole if a defendant is insolvent. As between defrauded investors and multiple defendants who are found to have committed the fraud, the risk of loss should fall on the latter.

Mandatory Sanctions

The Act establishes a rebuttable presumption that the appropriate sanction for filing a complaint that violates Rule 11(b) is an award of all attorney's fees and costs incurred in the action. The Act also provides that other filings for which Rule 11 requirements are not satisfied will justify an award of attorney's fees incurred by the prevailing party for handling that particular filing. Nowhere does the Act provide for sanctions for defendants who defend meritorious actions in bad faith.

The presumption that the losing party should pay the fees of the prevailing party will effectively eliminate the private right of action for small investors. In class action lawsuits, an individual plaintiff's potential liability for the opposing party's fees would be disproportionate to his possible recovery, greatly decreasing his incentive to bring suit. This result is directly at odds with the important role that the private cause of action has historically played in policing securities fraud.

The "loser pays" provision is also at odds with American jurisprudence. In general, American courts do not favor provisions that require the losing party to pay the prevailing party's attorneys' fees. Hence, the distinction between the American Rule and the English Rule.

Moreover, the mandatory sanctions provisions will trigger continuous satellite litigation as defense attorneys move, upon the filing of every new complaint, for sanctions. On the effect of fee-shifting provisions, Professor Arthur Miller has noted:

In the course of deliberations within the Judicial Conference during the revision of Rule 11, the Federal Judicial Center performed a survey of Federal judges, which showed that the vast majority of them did not believe that frivolous lawsuits were a major problem. The survey also demonstrated that Federal judges believed that the most expedient way of dealing with frivolous lawsuits was not through the imposition of sanctions under Rule 11, but through prompt and decisive judicial action on motions to dismiss under Federal Rule 12(b)(6) and for summary judgment under Rule 56. A decade of practical experience under Rule 11 also demonstrated that post-1983 expanded "fee shifting" itself spawned satellite litigation about sanctions and created unnecessary adversariness between counsel, which in turn impeded cooperation and settlement.

President Clinton's Veto

At the eleventh hour, President Clinton vetoed the bill that became the Act. In his veto message, he observed that the bill, in its present form, would "have the effect of closing the courthouse door on investors who have legitimate claims." He made three specific objections to the bill. First, he objected to the heightened pleading requirements pertaining to the defendant's state of mind. Second, he supported the statutory language for the safe harbor for forward-looking statements, but opposed the language of the Statement of Managers that diluted the nature of the cautionary language required to accompany forward-looking statements. Finally, President Clinton objected to the disparate treatment of plaintiffs and defendants under the bill's provision for mandatory sanctions for violations of Rule 11, finding that it came "too close to a 'loser pays' standard that I oppose."

Nonetheless, both houses of Congress deferred to the money and influence wielded by CEASS and quickly overrode the President's veto, the Senate voting to do so with only one member present.

CONCLUSION

Although the Act must still stand the test of judicial interpretation, it appears that it may be a substantial deterrent to many legitimate class action securities lawsuits, just as its proponents -- securities issuers and their auditors -- intended when they lobbied for its passage. Securities class action lawsuits have been an efficient method by which defrauded investors have asserted their claims in the federal courts. Such access to our court system by defrauded investors has promoted capital formation by assuring potential investors that in the event of corporate fraud at their expense, they will have meaningful recourse without regard to the cost of prosecution of small claims.

Because of the Act, we are entering into a period of caveat emptor for the investor, which may stifle capital formation, although it may take more than a year after passage of the Act for its effect to be felt. Further, big business interests like CEASS have announced that their next targets are state securities and consumer and tort laws, including products liability laws. Their apparent hope is to insulate themselves from any meaningful lawsuits by investors or consumers, class action or otherwise. The primary hope for investors, for the integrity of the American capital market, and for successful capital formation, is for an enlightened judiciary to rise to this occasion, as it has on so many others, and to apply the seemingly draconian rules of the Act in a manner that continues protection for investors.