BLB&G

Bernstein Litowitz Berger & Grossmann LLP

Volume 4
Second Quarter 2002

INSTITUTIONAL INVESTOR

Advocate

A SECURITIES FRAUD AND CORPORATE GOVERNANCE QUARTERLY

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A Defense Counsel's Perspective
AFTER SIX YEARS THE JURY IS STILL OUT ON THE PSLRA

By Jonathan J. Lerner

Jonathan J. Lerner

Jonathan J. Lerner is a member of the law firm of Skadden, Arps, Slate, Meagher & Flom, LLP, where he heads the New York Litigation practice and devotes a substantial portion of his practice to defending securities class actions. Any views expressed herein are those of the author, do not reflect those of any other member of his law firm or any other organization, and are offered solely for the purpose of stimulating academic debate.

I must confess to having had at least a modicum of trepidation before accepting the honor of venturing a few personal observations on the success of the Private Securities Litigation Reform Act (the "PSLRA") to a group comprised primarily of active institutions to whom the PSLRA handed the responsibility to bring securities class actions against my clients. But like Daniel and the proverbial lion's den, I could not resist the opportunity. After all, a dialogue is really a monologue if the views expressed lack diversity and civil discourse on almost any subject can be constructive. And, given the Enron debacle, the time for reflecting on the PSLRA seems especially propitious.

One area of common ground that we can all agree on is that after an initial lull in filings, the PSLRA has certainly failed to reduce the number of securities class actions. But, the stated purpose of the PSLRA was to reduce the unmeritorious cases—not to throw the baby out with the bath water. And, although it took awhile, institutional shareholders have certainly arrived on the scene—some with such great gusto that they have attempted to exceed the statutory limitation on serving as lead plaintiff in more than five cases in a three-year period.

Is The PSLRA Responsible For Any Increase In Settlement Values?

Some would argue that institutional involvement in securities class actions—a direct result of the PSLRA—has led to great success, pointing to the historic size of the *Cendant* settlement

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REFORMING THE REFORM ACT AND SAVING OUR SECURITIES MARKETS IN THE POST-ENRON ERA

By Blair A. Nicholas

Enron may be "The Perfect Storm" that capsized billions of dollars in investor equity and thousands of jobs overnight, but one need only look to Cendant, Waste Management, 3Com, Sunbeam, Global Crossing, MicroStrategy, Rite Aid, McKesson, Adelphia, Dynegy or any other large recent corporate fraud to realize that Enron is different only in its unprecedented magnitude and by no measure represents a unique or isolated event in our securities markets. Seven years after Congress enacted the Securities Reform Act as part of Newt Gingrich's Contract with America, revelations of ponderous accounting manipulations, off-balance-sheet debts, and shrouded partnerships that accompanied the high-tech boom seem to surface as often as dot-com bankruptcies.

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REFORMING THE REFORM ACT

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Prior to the passage of the Reform Act, numerous national public interest groups, including pension funds, senior citizen advocates, labor unions, consumer groups, as well as federal, state and local government regulators, forewarned Congress that the Reform Act was so overly-expansive and effective in insulating perpetrators of securities fraud from liability that it would lead to an erosion in the integrity of the financial markets. Unfortunately for shareholders, their prognosis has become a reality, as New York Stock Exchange companies fall like houses of cards.

Blair A. Nicholas is an associate at BLB&G and has prosecuted many significant federal and state securities class actions. He practices out of the firm's California office and can be reached at blairn@blbglaw.com.

Inside Look

Not since the Great Depression has the distrust in the integrity of our nation's securities markets been as widespread as it is today. Not a day passes without reading about a scandal involving a company's bogus accounting, a public accounting firm that had blatantly failed in its gatekeeper function, an executive receiving an exorbitant payoff for leaving a company he ran aground, or an investment bank receiving "kickbacks" for allocating shares on IPOs or issuing false research reports in order to garner lucrative business for its underwriting operations. These issues have undermined investor confidence; indeed, they have rocked the very core of our financial markets.

It is this horrid state of affairs that has fueled the call by investors to reform our nation's securities laws. In *Reforming the Reform Act And Saving Our Securities Markets In The Post-Enron Era*, Blair Nicholas, one of the firm's senior associates, examines the laws and precedents that have contributed to the erosion in protections afforded to investors. Blair highlights some of the specific areas that need to be amended in order to restore investor trust and confidence in the markets.

In *A Defense Counsel's Perspective — After Six Years The Jury Is Still Out On The PSLRA*, Jonathan Lerner, a prominent defense lawyer and the head of Skadden Arps' New York litigation practice, provides an insightful defense attorney's perspective on the 1995 Reform Act, and how it has affected the securities litigation landscape. We are fortunate to have a contribution from such a respected member of the defense bar, who has appeared as an adversary in some of the nation's largest securities fraud actions, including Cendant and McKesson. Also, in *Eye On The Issues*, Beata Gocyk-Farber discusses some of the recent regulatory and legal developments in the securities arena. Even a quick perusal of the stories in the *Eye* show the many reforms being proposed and investigations being conducted as a result of the Enron debacle and the other all too common accounting and Wall Street scandals.

We welcome, as always, all of your thoughts and input.

Max W. Berger

Yet, financial scandals can be powerful catalysts for reform. Though the SEC, Department of Justice and various state attorney generals are scrambling to initiate countless new securities fraud investigations, and criminal and civil prosecutions are sure to follow, investors cannot afford for regulators and Congress to sit on their hands. The reasons are clear: the current safeguards that are supposed to provide protection against securities frauds have failed. As Congress and regulators begin to address ways to prevent the next Enron, it is critical that investors stand up and be heard so that the next wave of legislation creates meaningful reforms to the Reform Act and provides more adequate protections against the forces of greed that have overtaken corporate America.

What reforms should be enacted? A review of two landmark decisions by the United States Supreme Court, *Lampf* (1991) and *Central Bank* (1994), as well as the Reform Act and the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), provides a starting point for understanding where and how our safeguards have broken down.

Lampf: Erecting An Unreasonably Short Statute Of Limitations

For over forty years, federal courts held that the statute of limitations for private rights of action under Section 10(b) of the Exchange Act of 1934, was the statute of limitations determined by applicable state law, usually six years. In 1991, however, this all changed, when the Supreme Court ended this long-standing practice by deciding in the *Lampf* case that litigation instituted pursuant to Section 10(b) of the 1934 Exchange Act *"must be commenced within one year after the discovery of the facts constituting the violation and within three years after such violation."*

Accordingly, if shareholders fail to discover corporate wrongdoing within three years of the wrongdoing, they are foreclosed from asserting any private

cause of action against the wrongdoers to recover their investment losses. As illustrated by Enron, sophisticated corporate frauds do not happen overnight, they take years to assemble and even more time for shareholders to actually discover. The accounting improprieties in Enron date back to as early as 1997. Because of *Lampf*, Enron investors are likely to be unjustly foreclosed from recovering the full scope of their investment losses resulting from defendants' violations which spanned over five years, only because Enron was successful in concealing the wrongdoing from its shareholders for such a protracted period of time.

Despite requests by commentators, the SEC and President Clinton to extend the one year/three year statute of limitations for securities fraud set forth in *Lampf*, Congress declined to do so when it passed the Reform Act in 1995. It should do so now.

BLB&G Institutional Investor Forum Proves A Great Success

On April 18 & 19, 2002, BLB&G held its 8th *Institutional Investor Forum*, an educational conference attended by plan sponsor representatives from all over the nation. The *Forum* featured an interactive panel discussion regarding the future of securities litigation in the wake of recent high-profile accounting frauds such as Enron. The panel included Columbia University Law Professor and former SEC General Counsel Harvey Goldschmid, Ann Yerger, the Director of the Council of Institutional Investors' Research Service, Linda Scott, the Director of Investor Affairs for the New York State Common Retirement Fund and Robert Klausner, General Counsel of a number of public pension funds. Also, Harvey Goldschmid spoke on the activities of the SEC under Arthur Levitt and Jonathan Lerner, head of Skadden Arps' New York Litigation practice, gave us the defense perspective in securities litigation.

If you are interested in attending a future *Forum*, please contact firm partner Douglas McKeige at (800) 380-8496 or doug@blbglaw.com.

Central Bank: Elimination Of Aiding And Abetting Liability

In 1994, three years after the *Lampf* decision, *Central Bank* was decided by the Supreme Court. *Central Bank* effectively eliminated a private plaintiff's right to sue secondary actors such as investment bankers, accountants, lawyers or other co-conspirators for "aiding and abetting" the primary wrongdoers' perpetration of securities fraud.

In Enron, the shareholders have sued law firms and investment banks for violations of the federal securities laws claiming that they participated in an elaborate scheme to cover-up the fraudulent practices at Enron and help structure and fund hidden partnerships in order to facilitate the falsification of Enron's financial statements. In predictable fashion, these defendants moved to dismiss plaintiffs' allegations as a matter of law by claiming that they are totally insulated from liability under the Supreme Court's *Central Bank* decision. In essence, they argue that the claims boil down to nothing more than untenable aiding and abetting claims and that *Central Bank* forecloses "plaintiffs' attempts to bring these defendants within the scope of the securities laws by alleging that it helped others to commit fraud."

This standard is clearly unfair and unreasonable for shareholders. Common sense tells us that the person who drives the getaway car should be as legally responsible as the one who robs the bank. By the same token, there is no legitimate reason for shielding accountants, attorneys, investment bankers and other co-conspirators who aid the primary wrongdoer to escape accountability to investors. Too often, the corporate blueprint has been to conceal the company's true financial condition through sophisticated accounting schemes, lawyering through loopholes, and other practices facilitated by professionals who fully recognize that they are shielded from liability under the federal securities laws.

The Reform Act: The Creation of Excessive Obstacles For Investors Seeking To Hold Corporate Wrongdoers Accountable

While Congress' platform for passing the Reform Act was to eliminate frivolous securities class action lawsuits filed by enterprising lawyers on behalf of nominal investors, the effect has been to minimize the liability of corporate wrongdoers to their shareholders— who are left holding the bag. As a result, at the very least Congress should immediately repeal the following provisions of the Reform Act that only serve to frustrate defrauded investors' ability to hold wrongdoers accountable.

The Reform Act established a "heightened" pleading standard which requires shareholders to plead "with particularity all facts giving rise to a strong inference that the defendant acted with the required state of mind" while at the same time denying shareholders the right to any discovery until all defendants' motions to dismiss the shareholders' complaint have been denied.

As Columbia Law School professor Jack Coffee observed, the two rules are a Catch-22: "You can't get discovery unless you have strong evidence of fraud, and you can't get strong evidence of fraud without discovery." As a result, while defrauded shareholders are denied access to critical internal corporate documents necessary for them to satisfy the heightened pleading standards of the Reform Act, courts are forced to dismiss otherwise meritorious securities fraud actions, which leaves corporate wrongdoers unpunished and investors without any source of recovery.

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Eye On The Issues

LEGISLATIVE/REGULATORY UPDATES
AND RECENT DECISIONS OF INTEREST

By Beata Gocyk-Farber

"Clean Audit Opinions"— How Clean Are They? According to a Bloomberg study, in 54 percent of the 673 largest bankruptcies of public corporations since 1996, the auditors furnished clean audit opinions to companies that only months later filed for bankruptcy protection. Under auditing standards, if auditors conclude that a company may fail in the next year, they must issue a "going-concern" opinion. A clean opinion tells investors that a corporation's auditors raised no questions about that company's financial statements. Five of the seven largest bankruptcies ever—including Enron, Global Crossing, and Kmart—followed the issuance of annual reports in which clean audit opinions were provided by auditors in the very months or even weeks prior to these companies filing for bankruptcy. Bloomberg reports that shareholders lost $119.8 billion in the 10 largest bankruptcies following clean audit opinions. *Bloomberg Markets, May, 2002.*

Institutional Investors Push For Reforms. TIAA-CREF, a $270 billion teachers pension fund, expects to take its latest corporate governance campaign to the top brass at the SEC. At issue is the fund's shareholder proposal that calls for a shareholder vote on highly dilutive executive stock option plans. TIAA-CREF submitted this proposal to 123 companies this year, but some of the companies sought, and received, an SEC staff blessing to exclude the proposals. Now, TIAA-CREF is appealing the SEC's decision to the SEC's Commissioners themselves. TIAA-CREF also announced that it will be pressing companies on auditor independence issues. Peter Clapman, Senior Vice President for the fund, said that TIAA-CREF approached more than a dozen companies and asked for a special report to shareholders concerning auditors' independence. The fund is asking the boards of these companies to report whether the boards considered a policy of rotating auditors, to what extent their auditors are providing non-audit services, and if there are any restrictions on non-audit work. TIAA-CREF is also continuing to press companies on directors' independence. As a result of the fund's effort, at least two companies have already pledged to add independent directors to their boards and make other policy changes. *Dow Jones Newswire, March 25 and April 2, 2002.*

Are Institutional Investors Leaving Money On The Table? Professor Randall Thomas of Vanderbilt University and James D. Cox of Duke University are conducting a study to see if institutional investors are "leaving money on the table" by failing to file claims in securities fraud class action settlements. So far, the news has been staggering. The study examined the claims settled in 53 lawsuits, and their tentative findings so far are that only 25 to 33 percent of the institutions had filed claims. To shed light on the reasons, and perhaps raise consciousness about the money that's being lost by not filing claims, the institutional investors were asked to help the study by answering a questionnaire about responsibilities and procedures at their funds for filing claims. The questionnaire is available at http://law.vanderbilt.edu/faculty/thomas. *Council of Institutional Investors, Research Services, Vol. 7, No. 15, May 3, 2002.*

Burned by Stock Market Losses? The Wall Street Journal Says To Consider Litigation. In an incredible post-Enron change of heart, the *Wall Street Journal* recently noted that "participating in [securities] cases [is] increasingly worth considering." As reported by the *Journal*, this year alone, U.S. companies have already paid out more than $1 billion to settle such suits. While, on average, investors recover only about 15 percent of their loss, there are cases where recovery reaches 40 or 50 percent. According to the *Journal*, more aggressive pursuit of deep-pocketed co-defendants like accounting firms, and the increasing involvement of financially savvy institutional investors as plaintiffs drive the payments to investors higher and the attorneys fees lower. *Wall Street Journal, April 24, 2002.*

SEC Proposes New Rules To Improve Financial Disclosure By Public Companies. In December 2001, the SEC advised public companies to prepare their 2001 annual reports with "clear, concise descriptions of accounting policies and an explanation how such policies affect revenue and earnings." Unfortunately, the SEC recently reported that this voluntary approach was largely a failure. Alan Beller, a director of the SEC division of corporate finance, observed that "far too many companies did nothing more" than repeat information that was disclosed elsewhere in footnotes. Frustrated by this failure, the SEC is pressing ahead with new rules that would order public companies to do a better job of explaining their true condition in annual reports. *Wall Street Journal, April 12 and April 30, 2002.*

SEC Investigations Into Financial Reporting Reach Unprecedented Highs. In the first two months of the year, the SEC opened 49 new financial-reporting cases compared to 18 such cases in the first two months of 2001, an all time high then as well. Charles Niemeier, head of accounting in the SEC's enforcement division, observes, however, that the rise in the number of investigations is not the "big story..., the bigger story is the size of the companies being investigated. We are investigating more Fortune 500 companies than we ever

have." The type of financial fraud has also evolved. While the SEC's number one problem has always been revenue recognition, today, the SEC faces more and more of so-called "round-tripping," the SEC's shorthand for arrangements in which two companies swap assets in a transaction that amounts to mere corporate back scratching. For example, the SEC is currently investigating the capacity swaps between Global Crossing Ltd. and Qwest Communications International Inc., which allowed both companies to record revenue as a result of an exchange of fiber-optics capacity but not to record the costs of such exchanges as capital expense. *Wall Street Journal, April 3, 2002.*

Congress Reacts To Enron Debacle But Does The Proposed Legislation Go Far Enough? Enron-related reform legislation is starting to move through Congress, and as expected, not everybody is happy with the proposed changes. On April 25, 2002, the House passed the "Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002" (HR 3763), which would create a new Public Regulatory Organization (PRO) to oversee the accounting profession and make other changes that sponsors hope will help restore investor confidence in the wake of the recent corporate accounting scandals. The bill, which was supported by the accounting industry, provides that any accountant that certifies financial statements of public companies must pass muster with a PRO. SEC is given the authority to establish the PRO. PRO's boards would be comprised of two accountants with recent experience in auditing public companies, two members who could be accountants if they hadn't worked as such for two years, and one who's never been an accountant. The bill is heavily criticized; it has been called a "cosmetic change," a "joke" and "a gift to the accounting industry." A stronger reform may come from the Democratic-controlled Senate, where several committees are working on bills. The Senate Judiciary Committee, for example, has unanimously approved a "Corporate and Criminal Fraud and Accountability Act" (S 2010), which would create new criminal felony charges for persons who alter or destroy evidence in certain federal investigations or defraud investors of publicly traded securities, improve protections for corporate whistle blowers, and extend the time limit for bringing civil lawsuits against corporations accused of wrongdoing. *Council Of Institutional Investors, Research Service, Vol. 7, No. 15, May 3, 2002.*

Good Deal For Merrill, But How About Investors? Merrill Lynch has agreed to pay $100 million to settle charges that its analysts misled investors by promoting shares in companies in order for Merrill to attract investment banking business. The settlement averted the possibility that Eliot L. Spitzer, the Attorney General of the State of New York, would file charges against Merrill or any of its analysts or managers. Merrill was quick to observe that the settlement with Mr. Spitzer "represents neither evidence nor admission of wrongdoing or liability," but the firm apologized to its clients "for the inappropriate communications brought to light" by the investigation. In addition to the $100 million penalty and a public apology, Merrill also agreed to separate analyst compensation from investment banking fees reaped from stock and bond offerings, and create a new committee to oversee research recommendations. Still, the deal holds much allure for Merrill. First, a $100 million penalty is hardly onerous: According to Merrill's most recent annual financial report, $100 million is *less* than one-third of what the firm paid for office supplies and postage last year. And as to the pledges of making the research culture more transparent, a former Merrill analyst made the following observation: "I wish I could say that management is sincere about changing research cultures. External regulatory forces are making Wall Street change. But to develop a true professional research culture where investors' interests come first, the firms themselves have to want to change." *The New York Times, May 22, 2002.*

SEC Adopts New Rules Governing Wall Street's Research Analysts. On May 8, 2002, the SEC voted unanimously to adopt rules that would prohibit a firm's investment banking operation from having a supervisory role over research analysts, and that would require analysts and their firms to reveal their financial interests in companies they cover. Firms would also be required to disclose if they own one percent or more of a company's shares or if they expect to receive or intend to seek compensation for investment banking services from a company during the next three months. *The Deal, May 10, 2002.*

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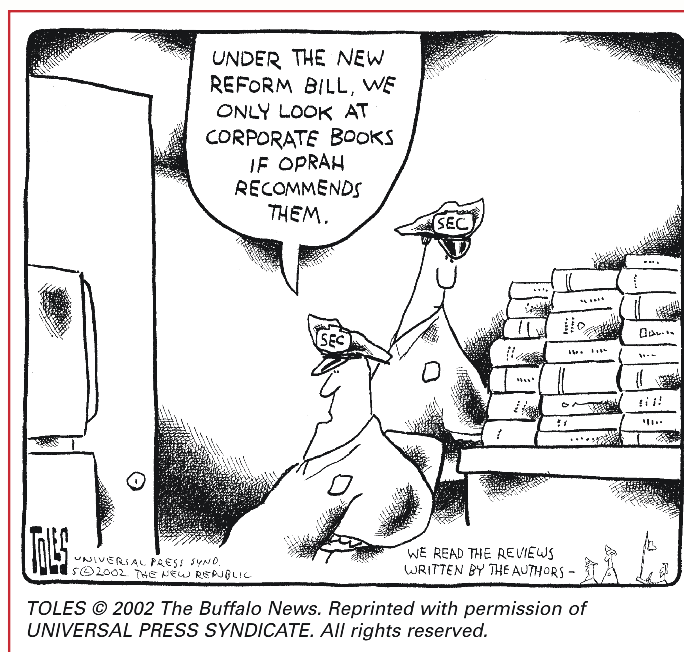

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A DEFENSE COUNSEL'S PERSPECTIVE ON THE PSLRA

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and other large settlements as proof. To be sure, the class counsel in *Cendant* lawyered the case superbly, obtained more than $3 billion cash and achieved this result in a relatively short time. On the other hand, it strains credulity to suggest that these same lawyers would have done anything different or less if the PSLRA did not exist. Of course, it is possible that under the pre-PSLRA regime, the lead plaintiff would not have been a large institution with the good sense to select strong counsel. Before the PSLRA, it is possible that the lead plaintiff could have been the typical 100-share holder accompanied by far less qualified and formidable law firms. Given the size of the *Cendant* case, the large number of lawsuits (more than 80) and the visibility of the situation, however, it is unrealistic to believe that the case could have been hijacked by a small fringe player and that an unreasonable outcome would not have drawn a torrent of objections.

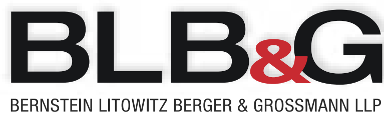
In this same vein, it is not entirely clear that any statistical increase in the value of settlements since the PSLRA became effective is attributable to institutional involvement or the PSLRA. As we know, since 1995 the number of financial restatements—especially large ones—also has risen dramatically. At the same time, the bull market pushed stock prices to all time highs. As a result, larger price drops and larger potential damage claims along with more financial restatements may have more to do with higher settlement values than the PSLRA.

The PSLRA Selection Process Has Produced Incongruous Battles Between Institutions

One area where the PSLRA plainly has made a difference is in the selection of the lead plaintiff. In general, it has imposed a degree of order and orderliness on the process where the chaos associated with a race to the courthouse once reigned. From the defendants' vantage point, the current selection process, which includes the automatic discovery stay, is a quantum leap forward. It provides a hiatus for defense counsel to get a handle on the case while plaintiffs organize themselves and has generally eliminated much of the vexatious motion practice directed at defendants by a few grandstanding would-be lead plaintiffs who would attempt to substitute misplaced zeal for other attributes in their quest to garner a lead position. To be sure, we still encounter the occasional filing of random cases in odd venues by fringe plaintiffs hoping to exert leverage at some point in the process. But, these "outrider" cases appear to have achieved few, if any, benefits and the number has declined significantly. Although some added delay has been built into the process by the introduction of an initial sixty-day notification period, which has the effect of extending the automatic discovery stay, the additional delay is relatively modest.

Some delay is inevitable, especially if the court does not decide the lead plaintiff motion with dispatch, but the longer delays are caused by the briefing of the dismissal motions and the time it takes for the court of dispose of them.

At the same time, however, the PSLRA process for selecting a lead plaintiff has frequently precipitated incongruous, and often nasty, battles between institutions vying to become lead plaintiff. From the defendant's perspective, it is hard to understand the reasons for these contests. After all, the Congressional objective of the PSLRA was to eliminate lawyer-driven litigation and to replace "phantom" placeholder plaintiffs with adult supervision by real institutional "clients". This goal is achieved whenever a large institutional shareholder with substantial losses seeks to be appointed as lead plaintiff. Once that occurs, one would think that other institutions would be only too happy to avoid the time, effort, expense and distraction associated with overseeing a complex securities class action by deferring. But that has hardly been the case. On the contrary,



Bernstein Litowitz Berger & Grossmann LLP prosecutes class and private actions, nationwide, on behalf of institutions and individuals. Founded in 1983, the firm's practice concentrates in the litigation of securities fraud; corporate governance; antitrust; employment discrimination; and consumer fraud actions. The firm also handles, on behalf of major institutional clients and lenders, more general complex commercial litigation. The firm's client base in securities fraud and corporate governance litigation includes large public pension funds and other institutional investors.

BLB&G: INSTITUTIONAL INVESTOR ADVOCATE is published quarterly by Bernstein Litowitz Berger & Grossmann LLP, 1285 Avenue of the Americas, New York, NY 10019, 212-554-1400 or 800-380-8496. The materials in this newsletter have been prepared for information purposes only and are not intended to be, and should not be taken as, legal advice.

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titanic battles have raged over which institution will control the case—often leading one institutional plaintiff to denigrate the substantive claims of the other and vice versa—while we sit back and take notes.

Two-Tier System

Not all cases attract institutional activism, especially smaller cap stocks, and the PSLRA has led to unevenness in the manner in which the selection of lead plaintiff is conducted. In reality, a "two-tier" system of cases has developed. There exists a whole category of less visible cases — comprised largely of the non-restatement cases traditionally (if not pejoratively) known as "fraud by hindsight" cases. In this genre, bad news is announced, the stock drops and suits are filed claiming the bad news should have been disclosed earlier. In most of these cases, especially where the issuer's capitalization—and thus the potential damages—are relatively small, the PSLRA regime appears to have left the "old rules" undisturbed. In these cases, the competing lead plaintiffs organize themselves into a "committee" to share the responsibility and usually submit a stipulation carving up the case which judges routinely sign without opposition — or question.

Quarterly Quote

"[A]fter watching many Andersen partners sabotage Mr. Volcker's rescue effort, and seeing Andersen's Big Four Competitors circle their wagons to block reform, we wonder if these fellows can be trusted with the grocery money, much less with restoring public confidence in shareholder capitalism."

From "Volcker's Andersen Triumph", *The Wall Street Journal, Review & Outlook*, April 23, 2002

The "Rigorous" Pleading Requirements

The "rigorous" new uniform pleading requirements were a central feature of the PSLRA. At a minimum, these "fraud by hindsight" complaints are the cases that the more "rigorous" pleading requirements of the PSLRA combined with the mandatory sanctions provisions were designed to deter or eliminate. The heightened pleading requirements generated a good deal of Congressional debate. Indeed, President Clinton's short-lived veto was predicated largely on his stated view that the pleading requirements being imposed would be too stringent. Unfortunately, the disparate interpretation of the specificity requirements among the various circuits—and even within circuits—has led to a welter of inconsistent and confusing interpretations. As a result, even the most "generic" allegations of "scienter" have managed to survive in some cases. In this important area, the PSLRA has not performed as it was intended—even before Enron. Not surprisingly, the drumbeat—fueled no doubt by special interest groups—has already begun to roll back the pleading requirements in the name of preventing future Enrons.

Attorneys' Fees

With the increased supervision of class counsel by the lead plaintiff called for under the PSLRA, the courts were supposed to have enlisted an ally in determining the amount of attorneys fees to be paid to class counsel. The Court of Appeals for the Third Circuit has now firmly placed the responsibility, at least in the first instance, on the shoulders of lead plaintiff. The increased importance of an ex ante fee agreement was explicitly reinforced in the Third Circuit's approval of the Cendant settlement in which the Court of Appeals also rejected the right of a district court to select counsel through an auction (except in rare circumstances).

Are Class Actions Really Efficient for Institutional Plaintiffs Where The Losses Are Larger?

The ultimate question is whether institutions could more efficiently recover their own damages by foregoing the "class" aspects of a securities litigation and simply hire a lawyer and go it alone without the extra complexity, judicial oversight and other difficulties associated with a class action. Indeed, those institutional plaintiffs which proceed in a class wide basis may find themselves faced with other institutions "opting out", an increasing phenomena. Indeed, the purpose of the class action device is to allow the aggregation of claims by shareholders with claims too small to allow them to proceed individually. Where an institution finds itself with large damages and a strong claim, it may conclude that it is far better off to proceed on its own outside the class framework.

Conclusion

In the final analysis, it is still too early to measure the impact of the PSLRA—the jury is still out.

REFORMING THE REFORM ACT

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The Reform Act also eliminated "joint and several liability" for reckless conduct by securities violators. Prior to the passage of the Reform Act, each reckless participant in a securities fraud was fully accountable for the damages caused to shareholders under the doctrine of "joint and several liability." For example, if there were two reckless participants in a securities fraud, such as a corporation and an accounting firm, and the corporation was declared insolvent, the shareholders could collect their full damages solely from the accounting firm under the doctrine of "joint and several liability." The theory behind this rule was simply that the innocent victim should not be the one to have to allocate fault—let the wrongdoers fight it out amongst themselves.

The Reform Act, however, abolished "joint and several liability" for reckless participants and instituted a level of liability "proportionate" to each of the participants' wrongdoing. This was considered a tremendous victory for the large accounting firms, among others, as they no longer face the viable threat of being held fully accountable for their audit failures allowing them to cast blame for their failures on others in order to decrease or eliminate their own liability.

Prior to the passage of the Reform Act, the SEC prohibited companies from issuing predictions or "forward looking statements" which had no reasonable basis in fact. Under the Reform Act, however, corporate executives are now unrestrained in issuing *knowingly false* predictions, such as earnings projections, without the fear of shareholder liability provided that such knowingly false predictions are accompanied by "meaningful cautionary statements"— often just a menu of boilerplate risk disclosures.

As the dot-com bubble illustrated, unrealistic and inaccurate predictions, regardless of the breadth of the surrounding legal disclaimers and jargon, only serve to artificially inflate stock prices to the detriment of shareholders who are now left without a remedy.

SLUSA: Preemption Of State Court Remedies

The ink had barely dried on the Reform Act when, in 1998, Congress passed SLUSA to retaliate against shareholders who were utilizing investor-friendly state law remedies to pursue their securities fraud claims against corporate wrongdoers. SLUSA effectively preempts all state court based securities class actions, thereby forcing investors to litigate under the punitive pleading and liability requirements of the Reform Act. Thus, shareholders are denied the right to pursue any claims or remedies under state law, which are important tools in holding corporate wrongdoers accountable.

Conclusion

The *Lampf* and *Central Bank* decisions, coupled with the Reform Act and SLUSA, have created an environment where defrauded shareholders are unreasonably constrained in their ability to police the marketplace, recover their losses, and hold corporate wrongdoers accountable. The end result has been that massive securities frauds have, and will continue to, multiply and flourish. The consequence, of course, is not only to the investors who will be denied a recovery but, also, the further erosion of confidence throughout the world in our extraordinarily vital capital markets.

Despite all the publicity surrounding the Enron meltdown, it remains to be seen whether members of Congress possess the courage to enact meaningful reforms — including repealing the above provisions of the Reform Act and SLUSA and restoring aiding-and-abetting and joint and several liability — to ensure that investors in the next Enron have adequate remedies. Those with the most at stake, such as public pension funds, investment funds, labor unions, and consumer interest groups, should utilize this window of public outrage to become pro-active in publicly supporting meaningful reforms to the securities laws in order to ensure that private securities class actions remain an effective weapon in the enforcement of the securities laws.

Contact Us

We at BLB&G welcome input from our readers. If you would like to comment on any of the articles in this newsletter, or have any suggestions for articles that may be of interest to you, please contact Editor David R. Stickney, at 858-793-0070 or by E-mail at davids@blbglaw.com. Questions for our INFORMED SOURCES question and answer column may also be submitted to David R. Stickney. If you would like more information about our firm, please visit our website at

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