

*Reforming the Reform Act and Restoring  
Investor Confidence in the Securities Markets*

by

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**A. Preventing the Next WorldCom or Enron -  
Time to Focus on Meaningful Reforms to the  
Securities Laws**

While WorldCom and Enron may be the perfect storms that capsized billions of dollars in investor equity and thousands of jobs overnight, one need only to look to Cendant, Waste Management, Sunbeam, Global Crossing, MicroStrategy, Rite Aid, McKesson, Finova, Legato and other large recent corporate scandals to conclude that Enron and WorldCom are only different in their unprecedented magnitude and do not represent unique or isolated events. Seven years after Congress enacted the Private Securities Litigation Reform Act of 1995 (the "Reform Act") as part of Newt Gingrich's Contract with America, revelations of ponderous accounting manipulations, prodigious off-balance-sheet debts, and shrouded partnerships that accompanied the high-tech boom seem to surface as often as dotcom bankruptcies.

Prior to the passage of the Reform Act, over forty 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 be the harbinger to a rapid erosion in the integrity of the financial markets as well as corporate management and their independent auditors. Unfortunately for shareholders, their prognosis has materialized as the

public possesses a profound suspicion and distrust in a financial market where a top ten company in the Fortune 500 collapses instantaneously like a house of cards.

Yet, financial scandals and catastrophes are powerful catalysts for reforms—real and meaningful reforms—not just superficial reforms. Though the SEC and Department of Justice 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 back and learn lessons as they slowly develop. The lesson is already clear: the current safeguards and weapons that enable investors to police the marketplace and ensure that securities frauds do not permeate, influence or discredit the integrity of the market has failed. Congress and regulators must immediately address why these colossal occurrences of securities frauds have become so prevalent and enact meaningful reforms to deter corporate wrongdoing as well as provide an effective means for shareholders to police the corporate marketplace and seek recovery of their investment losses.

So what reforms should be enacted to ensure against the next Enron or WorldCom watersheds and the cascade of adverse events that have followed in their wake? While one could point to various shortcomings in both federal common law and statutory law that has facilitated corporate malfeasance to go unchecked, the culmination in just the last decade of two landmark decisions by United States Supreme Court, *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gibertson* (US Sup. Ct. 1991) ("*Lampf*") and *Central Bank of Denver v. First Interstate Bank* (US Sup. Ct. 1994)

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(“*Central Bank*”), coupled with the passage of two legislative acts by Congress, the Reform Act and the Securities Litigation Uniform Standards Act of 1998 (“SLUSA”), has exposed an environment where securities frauds are flourishing, the structural protections and safeguards designed to protect investors are rapidly eroding and the federal securities laws are failing to provide an effective weapon in deterring securities fraud.

## 1. *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 Securities Exchange Act of 1934 (“Section 10(b)”) and Rule 10b-5 promulgated thereunder, was the statute of limitations determined by applicable state law, usually six years. In 1991, however, the Supreme Court ended this longstanding practice by announcing in the *Lampf* decision that litigation instituted pursuant to Section 10(b) and Rule 10b-5 “*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, shareholders are foreclosed from asserting any private cause of action against the wrongdoers to recover their investment losses. Put another way, if a corporation can successfully conceal wrongdoing from shareholders for more than three years, the wrongdoers will effectively be insulated from shareholder liability under Section 10(b) and Rule 10b-5—an absurd and unjust consequence of the truncated statute of limitations espoused in *Lampf*.

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. If the defendants are successful in asserting a statute of limitation defense, Enron investors will 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 implementing and concealing the wrongdoing from its shareholder 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. If anything, the recent corporate scandals have taught us that investors need more time to discover and investigate sophisticated and elaborate fraudulent corporate schemes and investors should not be precluded from pursuing the full scope of their remedies and investment losses simply because the Supreme Court unilaterally decided erect an unreasonably short statute of limitations in securities fraud cases.

## 2. *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 accountants, lawyers or other co-conspirators for “aiding and abetting” securities fraud. Under *Central Bank*, if an accountant or attorney provides assistance to the primary wrongdoer in committing a securities violation—such as preparing false financial statements, SEC filings or other documents disseminated to shareholders—shareholders are essentially left with no recourse against these co-conspirators to recover their investment losses.

In Enron, the shareholders have sued two law firms for violations of the federal securities laws claiming that the firms participated in an elaborate scheme to cover-up the fraudulent practices at Enron and help structure hidden partnerships in order to facilitate the falsification of Enron’s financial statements. In predictable fashion, the law firms 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, the law firms claim that the Enron suits boil down to nothing more than untenable aiding and abetting claims and that *Central Bank* “forecloses plaintiffs’ attempt to bring [the law firm] within the scope of the

securities laws by alleging that it helped others to commit fraud.” Touting the *Central Bank* decision, the law firms argue that the shareholders’ claims against the law firms are “so clearly foreclosed.”

To counteract the *Central Bank* decision, shareholders are now forced to characterize secondary actors as “primary violators” and must satisfy all elements of primary liability under the federal securities laws. However, there is a large divide that now exists in the federal appeals courts over the standard of establishing a “primary violator.” The Ninth Circuit has held that an accounting or law firm can be held liable for securities fraud if there is a “reasonable inference that [the firm] knew or recklessly disregarded” false information, while substantially participating in the drafting of financial statements.” See *In re Software Toolworks*, 50 F.3d 615 (1994). By contrast, the Tenth Circuit and most other federal appeal courts have concluded that “the critical element separating primary from aiding and abetting violations is the existence of a representation, either by statement or omission, made by the defendant, that is relied upon by the plaintiff. Reliance only on representations by others cannot itself form the basis of liability.” *Anixter v. Home-Stake Production Co.*, 77 F.3d 1215 (1996).

While the federal appellate courts remain divided, investors cannot afford to wait for the Supreme Court to break the tie. It is basic fundamental law that the person who drives the getaway car is just as legally responsible as the one who robs the bank. By the same token, there is no legitimate reason for shielding accountants, attorneys and other co-conspirators who aid the primary wrongdoer in a violation of the federal securities laws to escape accountability to corporate shareholders. 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 they are shielded from liability under the federal securities laws.

While Congress declined the SEC’s recommendation in 1995 to restore aiding and abetting liability as part of the Reform Act, Congress should immediately revisit this decision as accountants, attorneys, and other co-conspirators have been

increasingly successful in escaping liability for their participation in securities frauds. By restoring aiding and abetting liability it will not only serve as a meaningful deterrent, but will empower shareholders’ ability to better police the financial markets and recover their investment losses from all active participants involved in the fraud.

### **3. The Reform Act: The Creation of Excessive Obstacles For Investors Seeking To Hold Corporate Wrongoers Accountable**

While Congress’ platform for passing the Reform Act was too eliminate frivolous securities class action lawsuits filed by enterprising lawyers on behalf of nominal investors, the effect has been to effectively insulate corporate wrongdoers from accountability to their shareholders. 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:

#### ***a. The Catch-22 Pleading Requirement***

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 during the pendency of the defendants’ motion to dismiss.

As Columbia University law 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 in order to satisfy the required heightened pleading standards of the Reform Act, courts are forced to dismiss otherwise meritorious securities fraud actions, which has left corporate wrongdoers unpunished and investors without any source of recovery.

#### ***b. The “Safe Harbor” Protection for False Forward Looking Statements***

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 to issue *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.

As the dotcom bubble illustrated, unrealistic and inaccurate predictions, regardless of the breath of the surrounding legal disclaimers and jargon, only served to artificially inflate stock prices to the detriment of shareholders who are now left without a remedy to hold corporate executives accountable.

### *c. The Elimination of “Joint and Several Liability” For Reckless Participants In Securities Frauds*

Prior to the passage of the Reform Act, each reckless participant 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 Reform Act, however, abolished “joint and several liability” for reckless participants and instituted a level of liability “proportionate” to each of the participants’ wrongdoing. The elimination of “joint and several liability” was considered a tremendous victory for the large accounting firms as they no longer face the viable threat of being held fully accountable for their audit failures and allows them to cast blame for their failures at other parties in order to decrease or eliminate their own liability.

By contrast, the elimination of “joint and several liability” was a major setback for shareholders as corporations involved in securities fraud often collapse and declare insolvency, as Enron and WorldCom illustrate in grand style, and the shareholders are left with the troubling and often burdensome task of recovering only a small proportionate of their losses from the auditors. In

short, while the federal securities laws once imposed a severe penalty and deterrent for accountants and co-conspirators who actively participate in securities frauds, the Reform Act’s elimination of “joint and several liability” has relegated this risk to a small cost of conducting business.

### **4. SLUSA: Preemption of State Court Remedies**

The ink had barely dried on the Reform Act, when in 1998 Congress passed the Securities Litigation Uniform Standards Act of 1998 (“SLUSA”) to retaliate against small shareholders who were joining forces and utilizing strong and investor-friendly state law remedies to pursue their securities fraud claims against corporate wrongdoers. SLUSA effectively removes all shareholder class actions out of state court and into federal court where investors are forced to litigate under the punitive pleading and liability requirements of the Reform Act.

Further, and perhaps even more draconian, SLUSA denies shareholders in securities class actions the right to pursue any claims or remedies under state law, which are important tools in holding corporate wrongdoers accountable. For example, state securities laws often provide a lower standard for pleading and proving investors’ claims, the right to recover punitive damages, aiding and abetting liability, a longer statute of limitations, and other favorable shareholder remedies that are not available under the federal securities laws. By forcing shareholders into federal court and denying them the favorable remedies under the laws of their own states, SLUSA has only added to the erosion of the deterrence against corporate wrongdoing and has made it even more problematic for defrauded investors to recover their losses.

### **B. The Window of Opportunity To Enact Meaningful Reforms Is Now**

The culmination in the last decade of the *Lampf* and *Central Bank* decisions coupled with the passage of the Reform Act and SLUSA, has created an environment where defrauded shareholders are unreasonably constrained in their ability to police the marketplace, recover their losses, and hold corporate wrongdoers accountable for their losses. The end result has been that securities frauds have,

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and will continue to, multiply and flourish until the risk of liability far outweighs the financial gain of engaging in a securities fraud.

Despite all the publicity surrounding the WorldCom and Enron meltdowns, it remains to be seen whether members of Congress possess the courage to enact meaningful reforms—including repealing the Reform Act and SLUSA and restoring aiding-and-abetting liability and joint and several liability— to ensure that the next Enron or

WorldCom do not fly under the radar. Yet, those with the most at stake, such as public pension funds, investment funds, labor unions, and consumer interest groups, can utilize this window of public outrage to become a proactive and unified force in publicly supporting meaningful reforms to the securities laws in order to bring light out of the darkness of the Enron and WorldCom debacles and ensure that private securities class actions remain an effective weapon in the enforcement of the securities laws.

