

## OPINION

# Restoring investor confidence in the securities markets

By Blair A. Nicholas

Worldcom and Enron may be "The Perfect Storms" that capsized billions of dollars in investor equity and thousands of jobs overnight, but one need only look to Cendant, Waste Management, 3Com, Sunbeam, McKesson, Adelphia, Dynege or any other large recent corporate scandal 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.

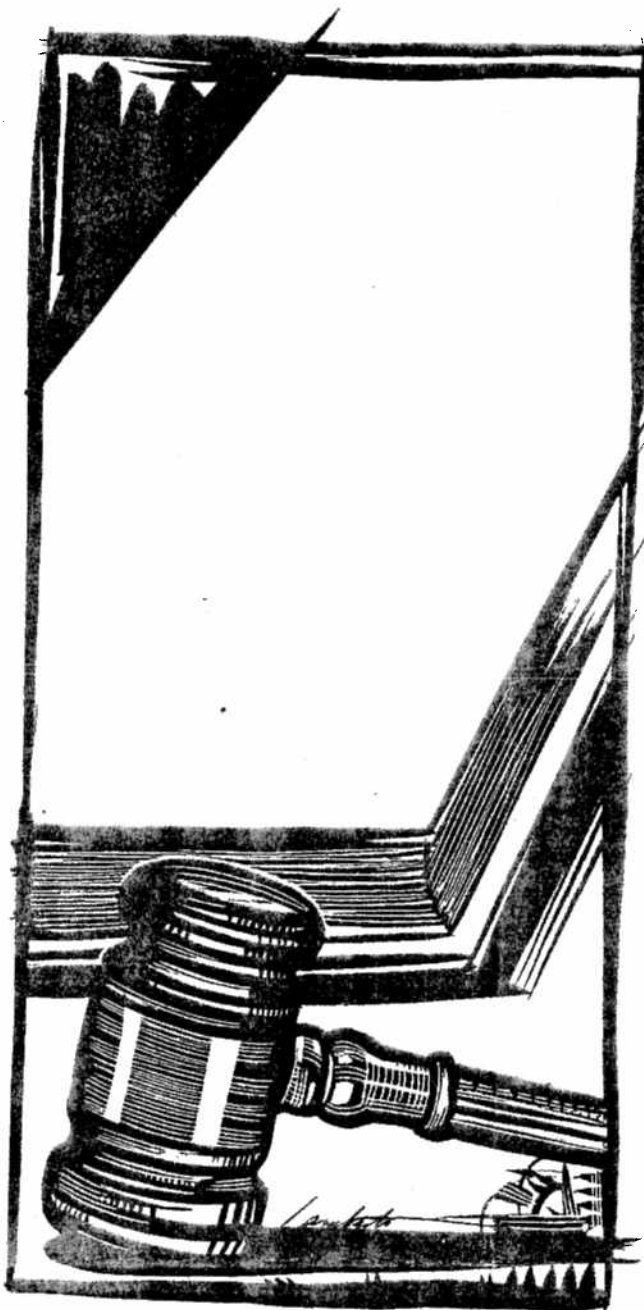
Seven years after Congress enacted the Private Securities Litigation Reform Act of 1995 as part of Newt Gingrich's "Contract with America," revelations of ponderous accounting manipulations, off-balance-sheet debts, and shrouded partnerships that accompanied the high-tech boom seem to surface as often as dot-com bankruptcies. What reforms should be enacted?

*Erect a reasonable statute of limitations.* For over 40 years, federal courts held that the time to assert a securities fraud claim was the statute of limitations determined by state law, usually six years. In 1991, however, this all changed, when the Supreme Court ended this long-standing practice by deciding that securities fraud litigation "must be commenced within one year after the discovery of the facts constituting the violation and within three years after such violation."

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. 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.

*Hold aiders and abettors accountable.* In 1994, Central Bank of Denver vs. First Interstate Bank of Denver 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. However, 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.

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*The reform act: the creation of excessive obstacles for investors seeking to hold corporate 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 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.

The reform act also eliminated "joint and several liability" for reckless conduct by securities violators. 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 damages solely from the accounting firm under the doctrine of "joint and several liability." The reform act, however, abolished this for reckless participants and instituted a level of liability "proportionate" to each participant's wrongdoing.

This was a tremendous victory for the large accounting firms, such as Arthur Anderson, as they no longer face the viable threat of being held fully accountable for their audit failures.

Prior to the passage of the reform act, the Securities and Exchange Commission prohibited companies from issuing predictions or "forward looking statements" that 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: pre-emption of state court remedies.* The ink had barely dried on the reform act when, in 1998, Congress passed The Securities Litigation Uniform Standards Act to retaliate against shareholders who were utilizing investor-friendly state law remedies to pursue their securities fraud claims against corporate wrongdoers. SLUSA effectively pre-empts 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.

The Supreme Court's 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 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.