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CONGRATULATIONS TO ARTHUR ANDERSEN:

Why Self-Regulation of the Accounting Industry Doesn't Work

By Lisa Buckser-Schulz

The list is long. Too long. Some of its most recent entries are Waste Management, Sunbeam, Microstrategy, Baptist Foundation of Arizona and, of course, Enron — the latest and greatest in a long line of audit failures. Collectively, those audit failures allowed hundreds of millions of dollars in phony revenues and assets to be reported and, when those companies were forced to restate, billions of dollars in market capitalization were erased. For those of you that are keeping score, each of those companies had the same auditor — Arthur Andersen. With all of the public outcry over Enron and Andersen's involvement in what is undoubtedly one of the biggest accounting frauds of all time, one might think that the regulators that oversee the accounting industry would be all over Andersen, subjecting them to disciplinary measures, requiring them to change their ways. Well, not exactly...

At the same time that the Enron scandal broke with the Company announcing a restatement which obliterated $586 million in revenue over a five year period and subsequently filing the largest bankruptcy petition in history, Andersen was undergoing its required triennial "peer review" by fellow "Big Five" auditor Deloitte and Touche. With full knowledge of the Enron situation in hand, as well as the fact that just a few months earlier Andersen paid an unprecedented $7 million to the SEC to settle a civil fraud complaint arising out of its audits of Waste Management (where Andersen apparently discovered and then acquiesced in Waste Management's fraudulent accounting), Deloitte

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The SEC has not "been a kinder and gentler place for accountants....I speak for the entire Commission when I say that we want to have a... partnership with the accounting profession, and we will do everything in our power to evidence a new era of respect and cooperation."

Speech by SEC Chairman Harvey Pitt to the AICPA Governing Council on October 22, 2001

LOOK BEFORE YOU LEAP

What Enron Can Teach Potential Lead Plaintiffs

By Andrew M. Gshwind

Like a volcano whose stubborn, angry eruptions continue for months, Enron's Shakespearean demise continues to burn brightly, as fresh revelations and new plot twists bubble forth daily. All the elements of tragedy (except thwarted love) are present: greed; hubris; destruction of innocents; double-crossing; willful blindness; humiliation; suicide.

To be sure, there are many lessons to be learned from Enron, and it is encouraging that politicians and businessmen appear anxious to learn them. There is serious talk about reforming the accounting industry and its rules. Wall Street analysts are being pressed to become more independent. Congress has

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WHY SELF-REGULATION DOESN'T WORK

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gave Andersen a glowing review, noting in a December 21, 2001 letter to the firm:

> In our opinion, the system of quality control for the accounting and auditing practice of Arthur Andersen LLP for the year ended August 31, 2001, has been designed to meet the requirements of the quality control standards for an accounting and auditing practice established by the AICPA [American Institute of Certified Public Accountants], and was complied with during the year then ended to provide the firm with reasonable assurance of complying with professional standards.

One week later, with news of Enron's sham accounting practices splashed on the front pages of newspapers across the country, the Chair of the SEC Practice Section ("SECPS") of the AICPA sent the following letter to Joseph Berardino, CEO of Andersen:

> It is my pleasure to notify you that on December 28, 2001, the SECPS Peer Review Committee accepted the report on the most recent peer review of your firm. . . .
>
> As you know, the reviewers opinion was unmodified. *The Committee asked me to convey its congratulations to the firm.* (Emphasis added).

How could the AICPA have sent a letter to Andersen congratulating the firm under the circumstances? Why did similar letters issue to the accounting firms responsible for the now discredited audits of Cendant, Centennial Technologies, and Livent? Why did Ernst & Young rubber stamp PricewaterhouseCoopers' controls for monitoring the independence of its auditors during its 1997 peer review of the firm when an SEC review of Coopers during the same period found immeasurable independence violations and Coopers itself subsequently admitted that almost half of the firm's 2,698 partners had direct investments in the securities of the firm's clients? The answer is that the present system of regulating the accounting profession does not work. This is hardly surprising. The AICPA, the body currently responsible for monitoring and disciplining accountants, is a private trade association for CPAs. Accountants call it "self-regulation" but what it really means is no regulation at all. The only people charged with keeping accountants honest are accountants themselves and, left to their own devices, they have not been getting the job done.

There are currently two components to the accounting profession's self regulatory system: peer reviews and discipline. While publicly touted as a quality control check on accounting firms, peer reviews are, in actuality, little more than accounting firms patting each other on the back for a job well done. Indeed, in 25 years of self-regulation, there has *never* been a negative review of any large accounting firm. How this can be the case in light of the steady deterioration over the last few years in the quality of audited financial results and the dramatic rise in the number of restatements (464 restatements

Inside Look

The Enron and Arthur Andersen revelations have consumed the American public's attention and rattled the very foundation of our economic system. The word "Enron" undoubtedly conjures up so many thoughts that it has come to take on a meaning that far transcends the name of this Texas energy company itself. We've all been "Enronized." Enron is "The Perfect Storm."

As a result of the Enron debacle, the field of securities law and regulation of public companies and accountants has taken center stage. Among some of the more recent battle cries is a fervent movement to revisit the onerous provisions of the Private Securities Litigation Reform Act which, together with the federal preemption statute (SLUSA) and two Supreme Court cases, has severely limited the civil liability of many potential securities law violators. It is against this backdrop that Andrew Gschwind, in *Look Before You Leap—What Enron Can Teach Potential Lead Plaintiffs,* discusses the many lessons that can be gleaned from Enron for institutional investors seeking to recover losses caused by corporate fraud. In particular, in a situation like Enron, where there exists only limited assets from which to recover, institutions need to carefully consider what type of action (if any) to bring and in what forum — state or federal court — to file any such claims. It is these types of critical decisions that can oftentimes determine the success and amount of any recovery for an institution.

In *Congratulations To Arthur Andersen: Why Self-Regulation Of The Accounting Industry Doesn't Work,* Lisa Buckser-Schulz analyzes the bizarre system of self-regulation, i.e., "you wash my back and I'll wash yours," of public accountants. Under this system, Arthur Andersen was given a congratulatory clean bill of health by the AICPA on December 28, 2001 — after Enron was very much in the public consciousness.

Also, in *Eye On The Issues,* Beata Gocyk-Farber makes her debut and provides some of the many interesting and cutting-edge securities and legislative developments including, of course, some of the more fascinating highlights from the Enron blowup.

As always, we strive to make the *Advocate* worthwhile reading and we welcome all of your thoughts and input.

Max W. Berger

between 1998 and 2000, which was higher than the previous 10 years combined), can only be attributed to the fact that the system is rigged in favor of protecting the auditor at the expense of the investors who have come to rely on audited financial statements in making their investment decisions.

Peer reviews are simply not designed to take a *critical* look at whether an accounting firm's audit procedures are adequate. For one thing, there is no peer review of audits that are already the subject of litigation or investigation by a governmental authority. That means that audits that have already been identified by others as being problems are shielded from scrutiny. That is how Andersen was able to keep Deloitte from reviewing the Enron audit. In addition, according to Lynn Turner, former Chief Accountant of the SEC, audit partners are told which of their audits are going to be reviewed *before the audit begins.* What auditors aren't going to be on their best behavior knowing that someone is looking over their shoulder?

The only people charged with keeping accountants honest are accountants themselves and, left to their own devices, they have not been getting the job done.

Further, peer reviewers are told up front that the peer review program "depends on mutual trust and cooperation" and that "disciplinary actions . . . will be taken only for a failure to cooperate or for deficiencies that are so serious that remedial or corrective actions are not suitable." Accordingly, when a reviewer does find a problem with an audit, it is not brought to the attention of the AICPA. Instead, *the firm under review* is asked to undertake an investigation into its own conduct! If the firm decides to take no action and the reviewer disagrees, the reviewer is cautioned to recognize that it has not audited the financial statements in question. In other words, the benefit of the doubt goes to the firm being reviewed. It should come as no surprise, then, that an SEC investigation into the regulation of the accounting industry conducted under former commissioner Arthur Levitt found that, in performing peer reviews of each other, the Big Five accounting firms repeatedly discovered major flaws in the way audits were conducted, but nevertheless gave each other clean bills of health in public reports of the reviews.

Incredibly, no major accounting firm has ever been disciplined by the AICPA.

The disciplinary function of the AICPA is also ineffective. Incredibly, no major accounting firm has ever been disciplined by the AICPA. Indeed, less than one out of every five accountants that have been sanctioned by the SEC for unprofessional conduct have been subjected to discipline by the AICPA. Further, even in situations where the AICPA concluded that those members sanctioned by the SEC had actually committed violations, it refused to take public disciplinary action in five out of six cases, choosing instead to close the matter after issuing confidential letters instructing the offenders to take remedial steps such as additional training.

There is no doubt that self-regulation of the accounting profession has been a complete and utter failure. As Sarah Teslik, Executive Director of the Council for Institutional Investors recently wrote on the subject:

> [S]elf regulation does not work. Criminals and other law violators do not self regulate. The fact that we have law enforcement officials, school principals, IRS auditors—even basic corporate audits—show that no one is so naive as to rely on self regulation to police society's most critical functions.

One positive legacy from the Enron debacle may be that self-regulation of the accounting industry may finally be put to rest. Investors and lawmakers alike are clamoring for stronger accountability for the people who have been championed as the gate keepers of honest financial reporting. Even SEC chairman Harvey Pitt, who took office saying that he wanted to usher in a "new era of respect and cooperation" between the SEC and the accounting profession (Pitt represented the AICPA and all of the Big Five accounting firms when he was in private practice), has conceded that more oversight over the accounting profession is needed. Hopefully, the end result will be that a truly independent body with broader disciplinary powers over accountants will be put into place. Until then, investors should not take the attitude that "what you see is what you get" when it comes to audited financial statements.

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Eye On The Issues

LEGISLATIVE/REGULATORY UPDATES
AND RECENT DECISIONS OF INTEREST

By Beata Gocyk-Farber

Better Late Than Never: SEC Announces That It Will Review The Annual Report Of Every Fortune 500 Company. In the wake of the financial collapse of Enron Corp., the SEC announced that in 2002 its staff will begin to scrutinize the annual reports of all Fortune 500 companies. The SEC currently reviews corporate financial reports on a selective basis only. According to the SEC's report, in 2001, the staff reviewed filings from 3,595 companies — about 30% of the companies that filed financial information with the Commission. Although the SEC refuses to disclose what criteria it uses in the selection process, it is evident from the SEC's report that the financial statements of established Fortune 500 companies like Enron were less likely to be reviewed. Out of approximately 10,000 reports filed with the SEC by established companies in 2001, only about 2400 were reviewed by the Commission, or less than 25%. The SEC had not reviewed Enron's financial statements since 1997, and its formal investigation into Enron's dubious accounting practices had been launched only after Enron had announced that it was making a gigantic correction to its balance sheet. It remains to be seen, however, whether the SEC has the resources to deliver on its promise and perform rigorous reviews of financial statements of every Fortune 500 company. Former SEC officials, including former SEC Chairman Arthur Levitt Jr., have stated on many occasions that the Commission is significantly understaffed. One of the SEC's reviewers stated that "there are more filings...than can physically be reviewed....It's not a question of the [staff] dropping the ball; it's a question of how many balls they already have in the air." *The Los Angeles Times, February 3, 2002.*

Musical Chairs At the SEC. Harvey Goldschmid, a Columbia University law school professor and a former general counsel to the SEC, is slotted to fill the seat of Isaac Hunt as one of the five commissioners of the SEC. Goldschmid's nomination will add a second Democrat to SEC's top ranks. As it now stands, the Republican Commissioners will be: Harvey Pitt, Chairman, Cynthia A. Glassman, principal of Ernst & Young, and Paul Atkins, a partner at PricewaterhouseCoopers. The Democratic Commissioners will be: Goldschmid and Roel C. Campos, attorney and part owner of El Dorado Communications. Goldschmid, Campos and Atkins still face Senate confirmations. *Council Research Service, February, 2002.*

Shareholders' Voices After Enron Are Loud And Clear — Limit Accountants to Accounting. The collapse of Enron has prompted a new breed of shareholders proposals. A number of institutional investors are calling for companies to adopt no-conflict-of-interest policies that would prevent their accounting firms from providing any services beyond auditing services. Shareholders of about 30 large companies proposed the no-conflict-of-interest initiatives, including shareholders of Apple Computer Corp., Johnson & Johnson, Motorola Inc., PG&E and Walt Disney Co. Most of the companies are opposing the initiative and have asked the SEC to rule against the inclusion of these proposals in their proxies. At the heart of the shareholders' proposals is an obvious concern that accounting firms have a financial incentive to bless overly aggressive accounting policies of the audited companies who also happen to be one of the auditors' most lucrative consulting clients. The shareholders proposals are not original. Two years ago, former SEC Chairman Arthur Levitt Jr. sought to limit the accountants' dual role as auditors and consultants but was forced to back down in the face of fierce resistance from the accounting profession and Congress. Although it is unlikely that the proposals will pass and become policies at individual companies, these types of initiatives coupled with pressures from regulators have already succeeded in persuading the Big Five accounting firms to revamp their internal policies. Over the past few weeks, all of the Big Five accounting firms announced plans to significantly change their practices to avoid potential conflicts of interest from selling both audit services and lucrative consulting services to the same clients. *Wall Street Journal, January 25, 2002 and New York Times, February 6, 2002.*

Enron Losses In Perspective. USA Today reported Enron losses to investors at $92 to $93 billion dollars. Here are some comparisons to put that number in perspective: it amounts to approximately six times the losses suffered from Hurricane Andrew; twice the amount of funding Congress recently approved for the losses from September 11; and approximately the amount of the economic stimulus package President Bush has requested for the entire country. *National SEC Reporting Conference, SEC Institute, December 18, 2001.*

Lynn Turner Calls for Reform of Accounting Profession. In a dramatic speech at the National SEC Reporting Conference, Lynn E. Turner, former chief accountant for the SEC, called for drastic reforms in the accounting profession. Turner bluntly recognized that accountants can and need to do more to timely detect fraud in financial statements. To restore the public's confidence in the accounting profession, Turner called for accountants to recall that their mission is to serve the public and that cross-selling of auditing and consulting services often yields opposite results. Turner also called for tougher standards with respect to the audit process itself, finding the current practice of not examining companies' non-standard journal entries unacceptable. Finally Turner called for more effective oversight of the accounting profession and expansion of the SEC enforcement resources and powers. *National SEC Reporting Conference, SEC Institute, December 18, 2001.*

Pension Funds Unite In a Call for "Real" Reform of Financial Markets. In an effort to prevent future Enron debacles, a coalition of more than 250 pension funds, which control over $2 trillion in pension assets, urged regulators and Congress to radically revamp the auditing profession, financial reporting and the role of outside directors. Led by the Council of Institutional Investors, the coalition made several recommendations to improve auditor independence, including a ban on consulting work for a client that accountant is also auditing, creation of a new public entity to regulate auditors, criminal prosecution of firms that audited companies guilty of accounting fraud, and requirements for companies to disclose in proxy materials any non-audit relationships with outside auditors. The coalition also recognized that the reform has to run deeper than overhaul of audit rules and reach corporate governance. Keith Johnson, chief legal counsel to the State of Wisconsin Investment Board said that "the first line of defense for preventing future Enrons [is] not the auditors.... It is the board of directors." In that regard, the coalition proposed that the companies be required to disclose all financial links with directors, and that outside directors should by rule of law constitute the majority of the corporations' boards and audit committees. The coalition's recommendations also extend to the SEC. The group proposed that candidates for SEC commissioners disclose their clients prior to a confirmation hearing and that at least two of the five SEC commissioners had experience in representing investors. In addition, the coalition joined in public criticism of the quality of the financial statements. It did not, however, issue specific recommendations on how to make the financial statements more comprehensible to the public. The group is also currently deliberating whether to endorse a recommendation for government-conducted audits. *The Deal, February 6, 2002.*

Huge Victory For Shareholders In Waste Management Litigation. Waste Management, Inc. has agreed to pay $457 million in cash and adopt certain corporate governance reforms pursuant to the settlement of the consolidated securities class action lawsuit led by the Connecticut Retirement Plans and Trust Funds. The lawsuit alleged that Waste Management failed to properly disclose material problems related to the 1998 merger of U.S.A. Waste Services and the old Waste Management, and that certain employees of the company engaged in insider trading. The cash payout in connection with the settlement is the third largest securities fraud action settlement in history. In addition, Waste Management agreed to recommend to the shareholders a vote for the proposal to repeal the classified board, and toughen qualification requirements for the audit committee. According to Connecticut Treasurer Denise L. Nappier, "the reforms offer shareholders a stronger voice, greater independence and more accountability all in the long-term financial best interest of the company and its shareholders." *Council Research Service, November, 2001.*

Wall Street Gurus Offer Insight Into Successful Audits. Is an adversarial relationship between the auditor and the company essential for a successful audit? Byron R. Wien, a senior economist at Morgan Stanley Dean Witter, recalls that a few decades ago the audited financial statements were treated like "gospel" because there was a truly adversarial relationship between the auditor and the corporation. Wien blames the expansion of auditors' consulting business for the erosion of the adversarial relationship between the auditors and the corporation, and for creating a new, collegial and cooperative relationship that puts auditors in a very difficult position. *New York Times, January 2, 2002.*

Is the Future of the Private Securities Litigation Reform Act Short-Lived? It should not come as a surprise that in the wake of the Enron collapse Congress is revisiting the provisions of the Private Securities Litigation Reform Act, which substantially curbed securities fraud lawsuits. On February 6, the Senate Judiciary Committee heard testimony on how PSLRA's provisions could block Enron employees and shareholders from suing the accountants, lawyers and bankers who helped create the complicated partnerships scheme that contributed to the giant energy trader's demise. More specifically, the Committee will probe into the PSLRA's demanding pleading rules and limitations on discovery and liability. The PSLRA's proportionate liability rules, which limit the recovery from accountants or other corporate advisors, are particularly harmful for plaintiffs in cases like Enron where the defendant company is in bankruptcy. *Wall Street Journal, February 6, 2002.*

State of Wisconsin Investment Board Calls For Improvement Of Class Action Notices. Keith L. Johnson, chief legal counsel of the State of Wisconsin Investment Board (SWIB), told the Federal Judicial Center that class action notices should be improved to provide clearer and more useful information to class members. SWIB proposed that class notices should contain more information relating to certain aspects of litigation and settlement, including details on the risks of not settling, any substantive court rulings on the case, the company's ability to pay, settlement payments from individuals, and corporate governance reforms. SWIB also proposed that class notices be expanded to include more information on legal fees. At the heart of SWIB's proposals is the concern that on too many occasions the interests of class members are compromised because of the interests of counsel and federal judges who naturally favor settlement. *Council Research Service, November, 2001.*

WHAT ENRON CAN TEACH POTENTIAL LEAD PLAINTIFFS

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pledged to beef up the Securities and Exchange Commission ("SEC") and reform the nation's 401(k) laws. Companies are coming under increasing scrutiny regarding their accounting practices. There is even talk on Capitol Hill of re-examining the 1995 pro-business Private Securities Litigation Reform Act ("PSLRA"), enacted as part of the Contract with America. Yet these important issues are beyond the scope of this article.

Let me pose a more modest inquiry. What can Enron teach public institutional investors that are considering whether or not to come forward as lead plaintiffs in a securities fraud action?

Enron's fraud counsels institutions to think twice before assuming that their most important (or only) decision is whether to seek lead plaintiff status in a federal securities fraud class action or just remain a passive member of that class. In fact, public institutional investors should first decide whether to pursue their claims, individually or as part of a group, in state court.

Most of the time, institutions seeking to maximize their recovery from losses caused by securities fraud should consider moving for lead plaintiff in a federal court securities fraud class action. The nation's securities laws (the Securities Act of 1933 and the Securities Exchange Act of 1934) provide good remedies for defrauded investors and an orderly framework for pursuing these remedies. When companies that are alleged to have committed securities fraud are solvent and capable of paying significant recoveries, suing in federal court typically makes the most sense. Yet, as discussed below, Enron should remind us that there are instances when it may make more sense to bring suit in state court pursuant to state law causes of action.

> *[While] suing in federal court typically makes the most sense… Enron should remind us that there are instances when it may make more sense to bring suit in state court.*

To begin with, the vast majority of investors *cannot* bring suit in state court to redress a fraud involving a nationally-traded security. In 1998, Congress passed the Securities Litigation Uniform Standards Act ("SLUSA") to limit private securities class actions brought under state law. Under this preemption statute, most investors are effectively barred from bringing securities fraud class actions in state court. However, this statute contains an important exemption for public pension funds, allowing them to bring an action individually or as part of a larger group in state court. As we will see, this exception provides public institutions tremendous benefits, unavailable to others, in seeking to recover for investing losses caused by fraud.

Under the PSLRA and Supreme Court precedent, there are several, quite significant limitations on securities fraud class actions brought in federal court. First, lead plaintiffs and federal class members give up their right to bring any claim other than a federal securities fraud claim. In the case of Enron, this limitation is significant. As a result of the Supreme Court's 1994 decision in *Central Bank,* plaintiffs asserting a federal securities fraud claim cannot sue a party that aided or abetted another company in committing the fraud. In state court, a plaintiff can assert both a common law fraud claim and also a claim for "aiding and abetting fraud," i.e., assisting another person's fraud.

In Enron's case, it appears that viable "aiding and abetting" claims could be asserted against several lucrative parties that cannot be sued in federal court. According to news reports, Enron's outside counsel not only set up many of the infamous limited partnerships and

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Special Purpose Entities ("SPEs") "LJM," "Raptor," "Chewco," "JEDI," "Southampton Place," and "Osprey Trust," it also represented them and issued opinion letters vouchsafing for the propriety of their transactions with Enron. Yet the law firm undoubtedly knew that most of these entities were managed by Enron's then CFO, Andrew Fastow, in a clear conflict of interest. Indeed, as Enron employee Sherron Watkins noted in her warning letter to Enron C.E.O. and Chairman Ken Lay, the law firm's dual representation of these SPEs and Enron also involved a clear conflict of interest. The law firm should have known that Enron was using these entities to inflate profits and hide debt. In state court, a public institutional investor could assert a viable aiding and abetting claim against the law firm; in federal court they have no claim.

Similarly, investors may have viable aiding and abetting claims against several of Enron's well-known and highly solvent investment and merchant bankers. It has now come to light that many investors in these SPEs were investment banks that performed substantial work for Enron and earned substantial fees. Some of these banks apparently earned outrageous 60 – 100% annual returns from these partnerships, enabling Enron to keep debt off its balance sheet and manipulate earnings, at the same time that they underwrote bond offerings for Enron and strongly recommended its stock. Indeed, it has been reported that Enron promised these banks underwriting business in return for investing in its SPEs, enticing them to help carry out its fraudulent scheme. Perhaps because they earned millions in banking fees from Enron, they went along. In state court, pension funds may have viable claims against these investment banks; in federal court they have none.

Also, while it now appears that investors have a good securities fraud claim against Arthur Andersen due to Enron's false financial statements and Andersen's knowledge of, and accounting for, these SPEs (not to mention its destruction of documents), there is no question that public investors would have a very strong aiding and abetting claim against Andersen in state court.

A public institutional investor that brings suit in state court can assert a wide variety of additional claims. In addition to bringing fraud and aiding and abetting claims, a plaintiff can assert a claim for breach of fiduciary duty. Also, public institutions may bring claims for negligence or negligent or intentional misrepresentation in some circumstances. For example, clients of Alliance Capital Management may have viable negligence or other claims against the company for its purchase of millions of Enron shares in late October, 2001, after details concerning losses from the Fastow partnerships emerged and the company was under SEC investigation. Alliance's former Chairman, Frank Savage, sat on Enron's Board of Directors, and there has been some speculation that Ken Lay may have asked Mr. Savage to support Enron's stock during its nosedive around this time. (At a minimum, it is unusual for a money manager to sit on the Board of a company his or her firm invests in.) It is also conceivable that unique state law claims could be asserted against other defendants, such as credit rating agencies.

Given Enron's bankruptcy, investors in federal court are fighting over a very limited pot of money: Enron's directors and officers insurance policy and Andersen's ability to pay. In state court, the potential pot of money, and hence potential for recovery, is far greater due to the additional defendants. Also, a successful state court plaintiff can potentially recover punitive or triple damages for fraud. In federal court, a successful securities fraud plaintiff cannot recover more than its actual damages. This can make a huge difference in recovery.

Yet the advantages of state court extend beyond the ability to assert additional causes of action and receive greater damages. Under the PSLRA, there is an automatic discovery stay that is not lifted unless a lead plaintiff can survive a motion to dismiss. This means that a lead plaintiff in federal court generally does not receive any discovery until almost two years after suit is brought assuming it defeats the inevitable motion to dismiss. The PSLRA also created heightened pleading and, arguably, "scienter" (consciousness of wrongdoing) requirements. Lead plaintiffs must now allege with great particularity each false statement made by a defendant and why the defendant knew, or was severely reckless in not knowing, that the statement was false. As Columbia Law School professor Jack Coffee notes, the PSLRA puts investors in a Catch-22: they must allege fraud in great detail but they typically cannot learn such detail without discovery.

In state court, the pleading requirements for asserting a fraud claim are not nearly as strict as those under the PSLRA, and investors are typically entitled to discovery immediately upon filing their complaint. Thus, they have a much greater chance

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of having their complaint sustained. They can also apply more pressure on a defendant by demanding important discovery while federal court plaintiffs remain idle.

Also, under the PSLRA, a defendant is only liable for his or her proportional share of damages caused by the fraud unless a lead plaintiff can prove that the defendant had actual knowledge it was violating the securities laws. This means that if Enron is found to be 90 percent responsible for defrauding investors and Andersen 10 percent responsible, Andersen is only responsible for paying 10 percent of plaintiffs' total damages. However, in state court any defendant found liable for fraud is "jointly and severally liable," *i.e.,* liable up to the full amount of damages suffered by plaintiffs. Under the same scenario, this means that even though Andersen is only 10 percent at fault, it is liable for 100 percent of all damages since Enron is bankrupt. In most instances where one or more defendants is insolvent, the difference between these two forms of liability is dramatic. (Because total damages in Enron are so enormous, even 10 percent of this amount is probably more than Andersen can pay.)

In addition, pursuant to the Supreme Court decision in *Lampf*, a lead plaintiff in federal court can only sue for securities fraud dating back no more than three years. Enron, however, restated four and a half years of financial results. This means that class members in the federal class action cannot recover damages for losses caused by Enron's false financial results in all of 1997 and half of 1998. Public pension funds in state court can recover damages for losses during the entire period.

Of course, bringing suit in state court involves risks. A federal court securities fraud class action will encompass the vast majority of investors and occupy center stage. Some judges might stay a state court securities fraud case in deference to the larger federal case. State court judges might seek to coordinate discovery with the federal proceeding. Yet it is also possible that a state court case would go to trial (or be scheduled for trial) well before the federal case, allowing state court plaintiffs first access to limited funds.

A successful state court plaintiff can potentially recover punitive or triple damages for fraud. In federal court, a successful securities fraud plaintiff cannot recover more than the actual damages.

There is also a highly-developed body of federal securities fraud case law that promotes consistency and allows parties to assess the relative strengths and weaknesses of their case at an early stage. Yet the comparatively chaotic world of state court can be to a plaintiff's advantage, as defendants may feel less comfortable there. In addition, it is possible that pension funds bringing suit in their home state may enjoy something of a "home field advantage."

In conclusion, Enron counsels public institutional investors to think twice before reflexively assuming that their only option is to move for lead plaintiff in a federal securities fraud class action or do nothing and become a regular class member. It isn't. You may have a much greater likelihood of recouping your losses by suing in state court. Consider your options carefully.

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