

Originally Processed With FOIA(s):
2021-0094-F

FOIA Number:
2021-0094-F

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Collection/Office of Origin: Deputy Chief of Staff's Office
Series: Porter, Richard W., Files
Subseries: Subject Files

OA/ID Number: 21804
Folder ID Number: 21804-026

Folder Title:
Civil Justice Reform, Securities Lawsuits

Stack:	Row:	Section:	Shelf:	Position:
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MEMORANDUM FOR MR. RICHARD PORTER

FROM: KATHLEEN SHANAHAN
GAIL HARRISON 

DATE: APRIL 9, 1992

SUBJECT: COALITION TO ELIMINATE ABUSIVE SECURITIES SUITS

Thank you again for your call. We greatly appreciate your interest and support.

Since we last communicated with you, the Coalition to Eliminate Abusive Securities Suits has continued to work toward enactment of 10b-5 litigation reforms. As you can see from the enclosed membership list, we now have over 100 members who share the common goal of putting an end to meritless securities fraud suits. The Coalition is currently engaged in efforts to collect data from a variety of industries regarding the costs of abusive securities suits to U.S. businesses. We have also organized extensive grassroots activities in 17 key states. And, we are continuing our efforts to marshal support among members of Congress for these much-needed reforms.

Senate committee staff has indicated that the Subcommittee on Securities of the Senate Banking Committee is likely to hold hearings on this issue in May. We expect our reform proposals to be introduced in both the House and Senate soon, with Democratic support.

We hope that we can count on the Administration to continue to support the 10b-5 litigation reforms proposed by the Coalition, which we believe will protect the rights of legitimate claimants while minimizing the potential for unnecessary or abusive litigation. We would be happy to meet with you to discuss the objectives and strategies of the Coalition in greater detail.

COALITION TO ELIMINATE ABUSIVE SECURITIES SUITS

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4/08/92

Membership List

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A.G. Edwards & Sons, Inc.	Dionex Corporation
AST Research Inc.	EMC Corporation
Allied-Signal Inc.	Electromagnetic Sciences, Inc.
AmBase Corporation	Ernst & Young
Amdahl Corporation	Everex Systems, Inc.
American Business Conference	FHP, Inc.
American Institute of Certified Public Accountants	FUQUA Industries, Inc.
American International Group, Inc.	The Fairchild Corporation
Apple Computer, Inc.	Federal Express
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BancTec, Inc.	Intel Corporation
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Coopers & Lybrand	National Association of Corporate Directors
Craftmatic\Contour Industries, Inc.	National Association of Manufacturers
Cryomedical Sciences, Inc.	National Education Corporation
Cytocare, Inc.	National Tech Team Inc.
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Data General Corporation	Nationwide Insurance Companies
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Occidental International Corporation
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Piper, Jaffray & Hopwood Incorporated
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Prudential Securities
Public Securities Association
Pyramid Technology Corp.
RJR Nabisco, Inc.
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Richardson Electronics, Ltd.
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Science Dynamics Corporation
Seagate Technology
Sears, Roebuck and Co.
Securities Industry Association
Sprint
Storage Technology Corporation
Sun Microsystems, Inc.
Symbol Technologies, Inc.
SysteMed, Inc.
Telematics International, Inc.
Textron Inc.
Timex Corporation
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Union Carbide Corporation
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VALHI, Inc.
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Zapata Corporation

Measures To Combat Unwarranted 10b-5 Litigation

There is clear evidence that the implied right of action for violations of SEC Rule 10b-5 is not functioning as an effective remedy for securities fraud. The system of litigation spawned by this provision (which was established piecemeal by the courts and has never been examined on a comprehensive basis by Congress) neither channels benefits to investors actually injured by securities fraud nor focuses the burdens of litigation and liability for damages upon those who engage in fraudulent activities. Recent empirical studies of 10b-5 class actions have shown that virtually all claims -- meritorious and frivolous -- are treated alike. These actions are almost always settled -- in contrast to a settlement rate of approximately 60% for civil actions generally -- and in amounts bearing no relation to the merits of the underlying claim but linked only to the amount of damages sought in the complaint or the extent of the defendants' insurance coverage. See Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497 (1991); O'Brien, *The Class-Action Shakedown Racket*, Wall St. J., Sept. 10, 1991. Thus, plaintiffs who have suffered genuine injury are not getting the compensation they deserve while plaintiffs who have brought unjustified lawsuits are receiving a windfall. And defendants who have not engaged in any wrongdoing are in effect forced to bear costs that should be paid by true fraud-doers.

The basic problem with the current system is that it imposes coercive pressure on defendants to enter into settlements in every case, even those in which the defendants have a strong defense on the merits. The system fails to distinguish efficiently between meritorious and unjustified claims at an early stage of the litigation, thereby forcing defendants to shoulder enormous costs in terms of attorneys' fees and disruption of business if they wish to defend the lawsuit. Even if the defendant ultimately prevails, he must absorb these costs. For these reasons, plaintiffs (and the plaintiffs' lawyers who actually control much of this litigation) have no incentive to focus their efforts on meritorious claims: they are assured of essentially the same recovery regardless of the actual strength of their position.

Reform of the 10b-5 system should focus on the foregoing considerations. Plaintiffs and their lawyers must be provided with incentives to concentrate their efforts on meritorious claims; defendants must be given incentives to fight unjustified claims and settle only meritorious ones; and the litigation system must be restructured to make possible, at least in some cases, early termination of unwarranted claims. The following reform measures will accomplish these goals.

Proportionate Liability

Under the current 10b-5 system, a defendant may be forced to compensate the plaintiff for all of the damage that the plaintiff suffered, even where other parties bear the lion's share of the responsibility for the injury. A proportionate liability standard would require each defendant to compensate the plaintiff based on his own responsibility for the plaintiff's injury. That result is justified by basic fairness: a defendant would be liable for his share of the injury and no more. Especially in securities fraud actions, where some of the parties most frequently named as defendants -- such as accountants, independent outside directors, and underwriters -- typically are alleged to be liable not because they committed the basic fraud but only because they failed to uncover wrongdoing by others, it is grossly unfair to require comparatively nonculpable parties to shoulder the burden of the entire liability.

A proportionate liability rule would be a large step toward righting the skewed incentives of the current litigation system -- a system that is geared to the "deep pockets" of defendants rather than to their fault and a system that pressures guilt-free defendants to settle. For example, plaintiffs now have a tremendous incentive to include outside directors, accountants, attorneys, and underwriters as defendants, even if there is no indication that they engaged in any wrongdoing, because those defendants have significant financial resources that would be available to pay the entire judgment. Indeed, two leading plaintiffs' attorneys have suggested that such parties should be joined as defendants only if necessary to provide additional deep pockets. See Bershad & Lerach, *Securities Class Actions and Derivative Litigation Involving Public Companies: A Plaintiff's Perspective*, in *Securities Litigation 1986* at 135-137 (PLI). Under a proportionate liability rule, by contrast, the decision whether to sue a party would turn on the merits of the claim, not on the need for additional sources of financing. Because each defendant's liability would be limited to the portion of the damages for which it is responsible, plaintiffs would no longer have an incentive to ignore the merits in deciding whether to institute claims against "deep pockets" defendants. That will deter frivolous claims by requiring plaintiffs to focus on the merits of the claim rather than the resources of the defendant.

Moreover, the current system of joint liability enables plaintiffs to sustain unwarranted lawsuits by forcing defendants to enter into settlements. A defendant now cannot decide whether or not to litigate a claim based solely on the strength of the claim against it. The defendant also must consider that the stakes of the litigation may double or triple because it may be required to shoulder the liability of other, more culpable parties who either settle for a disproportionately low amount or are insolvent.

In the typical action in which a number of defendants are named in the complaint, there is thus considerable incentive to settle quickly because a

January 23, 1992.

defendant that does not settle may find himself faced with the possibility that -- if he loses at trial -- he will have to bear much more than his share of the damages. This possibility is exploited by plaintiffs' lawyers who play the defendants off against each other in an effort to obtain quick settlements. That is why virtually all 10b-5 class actions are settled (compared to a dramatically lower settlement rate for civil actions generally) and why scholars have repeatedly found the settlement amounts wholly unrelated to the strength of the underlying claims. Under proportionate liability, however, the plaintiff could recover from a defendant only that share of the liability that it establishes as that defendant's responsibility. Because the risk to the defendant of litigating a claim will thus be limited, the defendant will be more willing to fight frivolous claims instead of settling them. That, in turn will discourage frivolous claims, funnel more money to deserving plaintiffs, and significantly reduce windfalls to plaintiffs who bring unjustified lawsuits.

This provision retains joint and several liability for the most culpable 10b-5 action defendants: those who are proven to have engaged in intentional and deliberate fraud and who stood to gain a pecuniary benefit from the fraud. It establishes a rule of proportionate liability for 10b-5 defendants found otherwise liable; for example, on a recklessness theory. Thus, the persons who are the primary wrongdoers in these cases -- the Ivan Boeskys and Michael Milken who set up fraudulent schemes for the purpose of bilking innocent investors -- would remain jointly and severally liable. Such persons always act deliberately for their own personal gain. Those whose 10b-5 liability is premised on other grounds -- typically outside directors, lawyers, accountants, and other professionals held liable because they failed to detect an illegal scheme instigated by others -- would be subject to proportionate liability. They would be liable for the portion of the damages for which they are found responsible but would not be required to compensate the plaintiff for damages attributable to the actions of other parties.

Shifting Of Attorneys' Fees

Another significant problem with the current system is that the initiation of a lawsuit is essentially cost free to the plaintiffs and their attorneys. The most significant burden in 10b-5 actions -- responding to discovery demands -- falls almost exclusively on defendants because facts within the knowledge of the particular plaintiff usually bear little relevance to the issues in the litigation. (The courts have essentially eliminated the requirement that plaintiffs prove that they actually relied on the alleged misrepresentation or omission.) Because he must bear these tremendous costs, the defendant has an interest in settling the case regardless of the underlying merits. This, in turn, eliminates any incentive for plaintiffs' attorneys to carefully screen the cases that they file.

Providing that the party who loses the case must pay the winner's attorneys' fees will give plaintiffs' attorneys an incentive to file only those cases in which the claim appears to have merit. (To ensure that the parties could recover any fees eventually awarded, the court could require the posting of a bond (as in Section 11(e) of the Securities Act, 15 U.S.C. § 77k) or award fees against both the party and its attorneys.) Plaintiffs who institute meritorious claims will obtain a greater recovery (because they will be awarded attorneys' fees as well), thereby providing an additional incentive for such cases to be brought. And defendants will have an incentive to fight unjustified claims because they will be able to recover their attorneys' fees. (The burden of the fee shifting in the situation in which a defendant prevails in an action brought by a plaintiff class should be on the attorney, not the class, unless class members had actual notice of the risk before joining the class.)

Curbs On Litigation Abuses

A number of practices unique to 10b-5 litigation are so clearly abusive that correction is plainly warranted. First, the current system of paying "bounties" to individuals who serve as "representative plaintiffs" in class actions should be abolished. Such payments provide a perverse incentive for individuals to become professional plaintiffs by buying a few shares of stock in many companies and joining forces with class action attorneys whenever the stock of one of those companies falls by enough to make a lawsuit economically worthwhile to the attorneys. Some individuals have served as plaintiffs in nearly one hundred lawsuits. See Coffee, *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 Colum. L. Rev. 669, 682 & n.38 (1986). Frivolous litigation will be discouraged by prohibiting representative plaintiffs from receiving more than their pro rata share of settlements. At the same time, this reform would make more of the settlement pool or final judgment available for all investors.

Second, Congress should reaffirm that attorneys may not act as counsel in cases in which they have a financial interest. Some law firms reportedly invest their own profit-sharing plans broadly in the stock of numerous companies in order to have an in-house plaintiff on hand in the event they wish to file a 10b-5 action against these companies. See Coffee, *supra*, 86 Colum. L. Rev. at 682. These attorney-class representatives have a built-in conflict of interest because they have much more to gain from a settlement (which comes with a guaranteed attorneys' fee) than from taking the case to trial. This conflict situation should be prohibited.

Third, class action attorneys should not be permitted to pay stockbrokers "forwarding fees" for referring their customers to attorneys bringing class action suits. This practice already is forbidden as a matter of professional ethics, but it apparently continues nonetheless. See Coffee, *supra*, 86 Colum. at 682-683. Prohibiting this practice by statute (and providing for substantial penalties -- such

as disqualification as class counsel -- for violations) should help reduce the amount of collusive, meritless litigation.

Fourth, the SEC has authority to obtain disgorgement relief in the context of administrative actions for violations of Rule 10b-5. See 15 U.S.C. §§ 78u-2(e) & 78u-3(e). These disgorgement funds are then made available to investors injured by the violations. A controversy apparently has arisen in connection with two aspects of the disgorgement process: whether private attorneys may be paid with the disgorgement funds and whether payments from the disgorgement funds must be credited against any possible recovery by the same individual in private litigation under Rule 10b-5 and other provisions of the securities laws. Congress should preserve such recoveries for investors and affirm that private lawyers are not entitled to any of these funds -- which were recovered solely through the efforts of the SEC. Congress also should protect defendants against potential double liability by making clear that any payments to plaintiffs from these funds will offset future awards in 10b-5 actions growing out of the same alleged misconduct.

Clear Proof Of Violation

The area covered by 10b-5 actions -- identifying and trying to ensure the accuracy of information disclosed about a company -- is peculiarly vulnerable to second-guessing. Evaluating and describing the economic prospects and condition of a company is an extremely difficult task. With the benefit of hindsight, plaintiffs usually are able to find some statement that did not turn out to be correct or some statement that should have been made to provide full disclosure. Rule 10b-5 is supposed to be an anti-fraud rule, however, and proof of scienter -- that the defendant acted with fraudulent intent -- is the key factor that distinguishes between investors who are victims of fraud and investors who are merely disgruntled because their investment did not turn out as expected.

Because of the inherent danger of unjustified second-guessing in this type of litigation, it is imperative that juries be certain that defendants in fact engaged in fraud before imposing liability. At common law, courts required proof of fraud by "clear and convincing evidence." Adopting that standard for 10b-5 actions, rather than the present "preponderance of the evidence" test, will lead to more reliable jury verdicts.

Pleading Reform

Rule 9(b) of the Federal Rules of Civil Procedure states that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally." Several courts have recognized that, due to the special dangers of unjustified 10b-5 actions, this standard must be enforced vigorously. Those courts hold that "[a]lthough states of mind may be

pleaded generally, the 'circumstances' must be pleaded in detail"; the plaintiff must "point to some facts suggesting that" the defendant acted with the requisite state of mind (which the courts have held to be knowledge of the falsity of the allegedly deceptive statement or extreme recklessness with respect to the statement's truth or falsity). See, e.g., *Robin v. Arthur Young & Co.*, 915 F.2d 1120, 1127 (7th Cir. 1990); *DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir. 1990); *Stern v. Leucadia National Corp.*, 844 F.2d 997, 1004 (2d Cir.), cert. denied, 109 S. Ct. 137 (1988).

This pleading requirement should be codified for 10b-5 actions. It would prevent plaintiffs from simply pointing to a downturn in a company's fortunes and contending that the difference between the earlier, favorable performance and the more recent, less favorable condition is attributable to fraud. "Because only a fraction of financial deteriorations reflects fraud, plaintiffs may not proffer the different financial statements and rest. Investors must point to some facts suggesting that the difference is attributable to fraud." *DiLeo*, 910 F.2d at 627. Such a requirement would discourage unwarranted lawsuits and, in addition, provide defendants with a means for cutting off such lawsuits at an early stage in the litigation process.

Clarify Principles For Aiding And Abetting Liability

Some courts have concluded that defendants may be held liable under Rule 10b-5 for "aiding and abetting" another defendant's violation of the provision. The typical scenario involves a claim against an attorney, accountant, underwriter or other professional for failure to "blow the whistle" on a misrepresentation made by another party. The parameters of this form of liability are at best murky; indeed, the Supreme Court has never even considered whether aiding and abetting liability is permissible. Plaintiffs' attorneys frequently try to use this theory to avoid the requirements that apply to 10b-5 actions generally. The confusion about the existence and scope of aiding and abetting liability leads to both unnecessary litigation and settlements by defendants fearful of unjustified liability.

Congress should affirm that even if a plaintiff proceeds on an aiding and abetting theory, he must prove that the defendant acted with scienter -- that he knew of the misrepresentation by the third party and intended to assist the third party in deceiving the plaintiff. Rule 10b-5 is a fraud remedy, and proof of fraud should therefore be required in all circumstances.

BACKGROUND BRIEF

I. Background

Federal law provides a remedy for buyers and sellers of securities who are injured by fraud (a knowing or reckless misstatement or omission of a material fact) in connection with a securities transaction. (These claims are called "10b-5 actions" because the prohibition against fraud in securities transactions is set forth in Securities and Exchange Commission Rule 10b-5.) Individuals claiming to have been injured by fraud may sue for money damages and, where large numbers of securities buyers and sellers allegedly were affected by the fraud, one or two individuals may file a class action seeking damages for all of the supposedly injured parties.

In June 1991, the U.S. Supreme Court decided -- in the case of *Lampf Pleva, Lipkind, Prupis & Petigrow v. Gilbertson* -- that a claim for damages for a violation of Rule 10b-5 must be brought within one year of the time the plaintiff knew or should have known of the facts constituting alleged fraud, but in any event no later than three years from the time of events allegedly constituting fraud. This statute of limitations is the same one that applies to remedies expressly set forth in the federal securities laws. Under a different case decided on the same day as *Lampf* (*James B. Beam Distilling Co. v. Georgia*), the one year/three year rule adopted in *Lampf* applied retroactively to all cases pending at the time of the decision.

Soon after *Lampf* was decided, lawyers who represent plaintiffs in securities cases began to try to get Congress to overturn the decision. Bills were introduced in the Senate (by Senator Richard Bryan of Nevada) and House of Representatives (by Representative Edward Markey of Massachusetts) providing for a longer statute of limitations and, in addition, applying that longer limitations period retroactively to all cases pending at the time *Lampf* was decided.

A coalition of entrepreneurial companies, corporate directors, insurers, accounting firms, and securities firms opposed these measures on the ground that a longer statute of limitations would exacerbate the problem of meritless claims now rampant in securities litigation. The coalition advanced a number of proposals for litigation reforms to weed out such claims. Senator Pete Domenici (New Mexico) and Senator Mitch McConnell (Kentucky) subsequently announced their intention to offer amendments containing a number of measures designed to reduce unwarranted securities litigation.

In a compromise reached at the end of the 1991 session of Congress, a provision was passed by both houses and signed by the President that eliminated the retroactive effect of the *Lampf* decision -- those cases filed before *Lampf* was decided by the Supreme Court are to be governed by the statute of limitations applicable prior to the Supreme Court's decision in *Lampf*. The Senate Banking

Committee agreed to hold hearings in early 1992 on (1) whether to change the statute of limitations governing 10b-5 claims in the future, and (2) whether to enact measures to combat meritless 10b-5 claims. The House Energy and Commerce Committee currently plans to hold hearings on the statute of limitations question during the same time period (these hearings may be expanded to encompass the other issues as well).

This memorandum provides background information regarding the arguments in favor of reform of the securities laws to prevent unjustified lawsuits. It also discusses the justifications for the one year/three year statute of limitations endorsed by the Supreme Court in the *Lampf* decision.

II. The 10b-5 Litigation System Is Out Of Control

There is broad agreement that the 10b-5 remedy is not working and hurts rather than helps both investors and businesses. It should be noted that this is a remedy that was established by the courts, not by Congress. And there never has been any comprehensive examination of its effectiveness. The following is some of the evidence we have gathered establishing that the current system actually encourages the filing of such unwarranted litigation, rather than screening out meritless claims.

- There is objective evidence that the system does not distinguish between meritorious and meritless claims. Several independent studies of securities fraud litigation have found that the system is seriously out of whack. The conclusions of all of these studies are remarkably similar. First, 95% or more of 10b-5 class actions are settled, compared to a normal settlement rate for civil cases that is much lower. Second, the settlement amounts do not vary on the basis of the strength of the plaintiff's claim; they depend entirely on the amount of damages claimed or the amount of the defendants' insurance coverage. Third, the settlements provide relatively little for plaintiffs -- between five and fifteen cents for each dollar sought in the complaint -- but the plaintiffs' lawyers average \$1 million in fees for each case, typically 30% of the entire settlement. (Summaries of these studies are attached as Appendices A and B.)

These findings reveal a fundamentally flawed remedy. Innocent defendants are settling meritless cases rather than fighting them. And plaintiffs who are actual victims of fraud are getting no more than those asserting meritless claims. A system that focused on real fraud should allow real victims to recover at least 60%-70% of their loss and give nothing to speculators. As Professor Janet Cooper Alexander, the author of one of the studies, observed, "[i]f private enforcement does not sort out claims according to whether violations actually

occurred, but instead merely exacts a sort of tax from companies that suffer large market losses, then we are paying for an elaborate, expensive enforcement system without receiving the benefits of that system."

- Why is this happening? A recent article in Forbes Magazine entitled "Shakedown" discusses the large volume of securities lawsuits instituted against high-technology companies. (The article is attached as Appendix C.) It describes the problem perfectly: "Earnings less than anticipated? The company is served with a class suit for failing to tell shareholders the bad news. Earnings better than expected? A company may be sued for withholding the good news that would have prevented impatient shareholders from unloading." Alan Shugart, the CEO of a high-tech company that has been sued by 13 different plaintiffs, calls the present system "legalized extortion." "They know how expensive it is for us to take our case to court. We're supposed to give them a few million dollars so they'll go away." Stanford Law Professor Joseph Grundfest, a former SEC Commissioner, says that "in many cases, perfectly honest people are being forced to pay outrageous sums simply because they didn't have perfect foresight" about the prospects of their company.

As the Forbes author concludes, "you can make a case that the losers are the American people, since these suits and settlements become a kind of tax on American businesses trying to survive in a tough industry and a tough world."

- It is quite easy to commence a 10b-5 lawsuit. Indeed, plaintiffs' law firms use form complaints readily available on word processing systems. The plaintiff basically must allege only that he bought the security at a price that was inflated because of a misstatement or omission, that the price of the security declined when the true facts came to light, and that the misstatement or omission was made with fraudulent intent. (Analogous allegations can be made by one who sold a security at a price that allegedly was artificially depressed.) Thus, the sole objective fact is a decline in the price of the security; the other allegations -- a misstatement or omission with fraudulent intent -- are inherently unverifiable at the initial stage of the lawsuit. In many cases the plaintiff's bare assertion of these "facts" is held sufficient to trigger the costly discovery process. And the discovery burden falls disproportionately on the defendant because it is the one that possesses the bulk of the relevant information.
- Once a suit is filed, the defendant has enormous incentives to settle even if it is innocent. Because defendants typically can't cut off the suit prior to trial, they will have to pay large bills from their lawyers even if they ultimately win. The defendant also must face the fact that

suit prior to trial, they will have to pay large bills from their lawyers even if they ultimately win. The defendant also must face the fact that the stakes of the litigation could double or triple because it could be required to pay for the losses of other parties that settle for a disproportionately low amount or are insolvent. The defendant therefore has no choice other than settling, even if the claim is completely meritless. Harvey Pitt, a distinguished attorney and former SEC general counsel testified before a subcommittee of the Senate Banking Committee that companies that have done nothing wrong are forced to settle -- and that he advises them to settle -- because that is the only rational choice under the current system.

For that reason, plaintiffs and their lawyers have absolutely no incentive to distinguish between real fraud and situations in which the plaintiff just made a bad investment. In either case, the plaintiff and the lawyer will profit from filing suit. And the plaintiffs' lawyer has no incentive to focus attention on cases of actual fraud. He will maximize his profits and minimize his costs by bringing many cases (some with merit, most without), spending little time investigating the merits of the claims, and settling them all for roughly the same amount, including a sizeable fee.

- Right now, the 10b-5 litigation system is run by the lawyers for the benefit of the lawyers. Forbes estimates that plaintiffs' suits against businesses are a \$10 billion industry. The lawyers look for cases in which there has been a significant change in the price of a company's stock so they will be able to assert a large damages claim. Then they go looking for a client. As one academic commentator has aptly observed, "As a practical matter, the lawyer has hired the client rather than the client hiring the lawyer." And no one bothers to ask the critical question -- was this a case of fraud or just a bad investment -- because the merits don't make any difference. Any lawsuit will net a profit for the lawyer. *Investors Business Daily* recently described how the process works:

"When an attorney's computer alerts him to a company whose stock price is falling sharply because of an earnings surprise, he needs to quickly find a shareholder who can serve as a plaintiff in a lawsuit.

The lawyer, however, can't dally. Chances are, dozens of other attorneys are also aware of the stock-price change and are racing their complaints to the courthouse.

The incentive to the lawyers for being first is simple: usually the judge who ultimately presides over the case will name the lawyers who got their cases filed first to be lead counsel. That means they control the case and get a larger cut of the fees.

To gain an edge, firms that specialize in such lawsuits maintain lists of 'professional plaintiffs.' Their portfolios are structured to be as diverse as possible. After all, you never know who you're going to have to sue."

Harry Lewis, a retired lawyer, reportedly has been the lead plaintiff in an estimated 300-400 lawsuits. William Weinberger, a retired accountant, has been a plaintiff in over 90 suits. Some law firms advertise for plaintiffs. One recent add reads "Losses in the financial or stock markets? You may have a legal remedy" and lists the name and telephone number of the law firm. (A copy of this advertisement is attached as Appendix D.) One of the principal plaintiff's law firms for securities law cases -- Milberg Weiss Bershad Specthrie & Lerach - also is one of the moving forces behind the Milli Vanilli class action litigation, which was recently the subject of a critical investigative report in the Wall Street Journal (see Appendix E).

- The chairman of the SEC has endorsed these conclusions, publicly stating a number of times that the "problem of meritless securities litigation . . . is a serious one" and that legislative reforms to deter such meritless claims "would be highly beneficial." Chairman Breeden recognizes that "litigation in all too many cases may be seen as the route for trying to recover what may have been market losses. In effect, some investors may seek a system of 'Heads I win, tails I sue.'"

He has recited the findings of the academic studies discussed above, agreeing that "because of the risks and costs of litigation, companies settle weak or even meritless claims on essentially the same terms as they settle meritorious claims." He has further stated that "[a] litigation system that fails to separate strong claims from meritless claims serves no one. It does not serve investors who have clear, solid claims and yet receive only a modest settlement, even more modest after payment of substantial attorneys' fees. It does not serve companies who have valid, strong defenses, and yet pay millions to settle claims to avoid the costs and risks of litigation."

III. Meritless 10b-5 Litigation Is Hurting Our Economy

The present system is not only unfair both to plaintiffs and defendants. What is even more troubling is that the onslaught of meritless 10b-5 actions is hurting the American economy. It diverts resources that otherwise would be devoted to technical innovation and job creation -- what is needed to get our economy growing and improve the competitiveness of U.S. firms. Indeed, the principal impact is on the new and emerging companies that are the source of most of the new jobs in this country.

- The impact on new companies is particularly acute because these companies frequently have the large unanticipated swings in earnings that plaintiffs and their lawyers seize upon as the basis for a lawsuit. Seagate Technology, a California disk drive manufacturer provides a good example. Since 1985 it has been subjected to 13 securities class actions, twelve of which were triggered by a drop in the price of its stocks and bonds. The thirteenth was triggered by an increase in earnings. The claim in that case is that the company failed to disclose that it expected to do better than it had in the previous quarter. Seagate has spent nearly \$3 million defending these cases, not counting the time that its executives have had to spend on litigation rather than expanding their business.

Seagate is not unique. Many other companies have been sued in precisely the same circumstances. One of the greatest American success stories -- Apple Computer -- just went through a lengthy case in which a jury awarded \$100 million against two executives for securities fraud. The judge later threw out the verdict against the executives on the ground that there was "no substantial evidence" of a violation.

- Companies in Japan and Europe do not face this burden. Why do we insist on forcing American business to bear these unjustified burdens? Why do we divert their attention from managing the business to managing litigation? An official of Seagate Technologies says "When I spend mind share on these suits, it cheats my company. These suits are not just nonproductive. They are counterproductive." Another Silicon Valley official states: "There is an unreasonable amount of time spent avoiding litigation instead of paying attention to growing a business." As Paul Wythes, a partner in a Palo Alto venture capital firm specializing in high-tech offerings has said, "These high-tech companies are trying to compete in a world market. They ought to be out trying to do a better job designing products. You don't see these [suits] happening in Japan." Another executive observes: "In Japan, executives spend their time doing business. They don't have to deal with such nonproductive efforts as litigation. We are going to get our clocks cleaned this way." Attached as Appendix F is the testimony of another corporate executive regarding the devastating impact of these lawsuits.

- The securities laws are supposed to help investors by ensuring a flow of accurate information about public companies. The present system actually reduces the amount of available information, thereby making it more difficult to raise capital for new ventures. One company -- Oracle Systems Corp., which was the target of 19 class actions last year -- has adopted a policy of refusing to speak to analysts about its

-expected revenues and earnings. Other companies have taken the same approach.

Moreover, the threat of litigation has deprived American business of services available in other countries. For example, the traditional audit is only a retrospective look at a company's financial condition: it describes the company's position as of a certain date. Accounting firms could in addition attest to the reasonableness of a company's projections of future earnings trends. Because that service would provide investors with an independent check on the company's view of its future financial condition, it would be extremely useful to those considering investing in or lending to the venture. That is especially true of new businesses with innovative products that lack track records. That service isn't available here because of the accountants' fear that they will be sued anytime the projection turns out to be wrong, as will often be the case because, after all, projections are merely educated guesses.

This service is available in other countries with more rational liability systems. And an investor choosing between an innovative United States company with unverified projections and a foreign venture with audited projections of an equal, or even slightly lower, return on investment might be more inclined to put his money in the foreign venture. As capital markets become more global in nature -- and competition for capital increases -- American industry will be at a significant disadvantage in raising the funds needed to innovate and expand.

- Also, the effect of this type of litigation is simply to redistribute money from one class of a company's shareholders (the current owners who must absorb the cost of the settlement even though they did not gain a penny from the alleged fraud) to another class of securities holders (those who are plaintiffs in the lawsuit). Investors are the losers in this shell game.
- The present system makes it more costly to raise capital in the United States. As SEC Chairman Breeden has stated "[e]xcessive class action settlements may deter companies from raising capital through the public markets and operating as public companies." Companies now pay a "litigation tax" in the form of higher fees to the professionals whose services are needed to raise capital -- underwriters, accountants, and lawyers -- because these parties frequently are included as defendants in 10b-5 actions and must cover the costs of litigating and settling those cases. That "tax" drains from the economy funds that would be used for productive purpose -- to develop new products and expand plants. Companies raising capital in other countries don't have those costs. That gives them a competitive advantage over U.S. companies. Chairman Breeden

recently stated that "[b]ecause baseless securities litigation amounts to a 'tax on capital' which undermines economic competitiveness, there is a strong public interest in eliminating meritless suits."

- The present system also discourages foreign companies from selling their securities in the United States. That not only deprives American investors of an opportunity to invest in these companies but it threatens America's role as the world's leading financial market.
- The system also is hurting the accounting profession. Between 1981 and 1990, the six largest accounting firms have seen a fourfold increase in the number of claims filed against them; most of these cases included 10b-5 claims. One accounting firm -- the seventh largest in the country -- filed for bankruptcy in 1990 due in large part to the burden of securities fraud claims.
- The independent outside directors who perform the critical role of watching over corporate managers are another casualty of these lawsuits. These independent directors are always sued when their company is sued. As a result, there is a dwindling pool of qualified persons willing to serve on corporate boards. No one wants to put their life savings and reputation at risk defending against allegations of fraud, no matter how far-fetched. As the CEO of one company stated in testimony before the Senate Banking Committee, "[a]s the pressures mount and the risks increase, directors are limiting the number of boards they will serve on, or are deciding not to serve at all. A recent study done by [the National Association of Corporate Directors] and Arthur Young reports that 17% of the CEO's of the Fortune 1000 companies no longer serve as independent directors" on the boards of companies other than their own. The chairman of one Silicon Valley company sits only on his own company's board: "I'm not a member of any other board. I do that because securities class actions are a distraction. Most executives are avoiding boards. Who could blame them?" Another says "We can't attract good directors. Why should they put their whole net worth on the line?"

Some companies try to protect their outside directors through insurance, but the cost of coverage has skyrocketed in recent years so that even that option may not be available. For example, Armada Corporation, a Detroit-based manufacturer of alloys and exhaust systems, was faced seven years ago with a premium increase from \$47,000 to \$720,000 for \$10 million in coverage; the deductible also increased from \$125,000 to \$750,000. In response, Armada eliminated its insurance coverage, and eight of its ten directors resigned. The company's president stated that it had "decided we could only afford to have low-net-worth individuals to replace the directors who left. . . . So we found well-qualified individuals who are a little younger,

whose net worth is low enough so we don't have a problem."

The withdrawal of qualified individuals from the pool of potential outside directors hurts young companies, who can use the guidance of experienced managers and who are asked by investors and lenders "Who is on your board?" in order to gauge the quality of the business. If inexperienced persons are the only ones willing to take the risk, the quality of decisionmaking and the company's ability to obtain financing will necessarily suffer. And shareholders who need these watchdogs to make sure management acts in their interest are also harmed. As one Silicon Valley executive stated, "Shareholders get hurt by these suits over the long term because companies lose the quality of their boards."

IV. Solutions To The Problem Of Meritless 10b-5 Litigation

There are a number of measures that will help curb unwarranted litigation. They are discussed in the document entitled "Measures To Combat Unwarranted 10b-5 Litigation" included in this book. The focus of our efforts are a proportionate liability rule and shifting of attorneys' fees. The Bush Administration has endorsed these reforms.

V. The Statute Of Limitations Issue

There are two different proposals before Congress for altering the one year from discovery but in no event more than three years limitations period recognized by the Supreme Court in *Lampf*. The Senate bill would substitute a two year/five year rule, with the two years beginning to run only when the plaintiff actually discovers the fraud (not when the plaintiff discovers or should have discovered the fraud in the exercise of reasonable diligence, as under current law). The Markey bill introduced in the House provides for a three year/five year rule but does include the reasonable diligence requirement. There are strong arguments against any tinkering with current law.

The Supreme Court did not simply make up the one year/three year rule. That was the limitations period that Congress specified in 1934 (when it enacted the securities law) for express causes of action for damages. The question is, therefore, why should a different rule be specified now?

The One-Year Limit

To begin with, there is no reason to alter the requirement that a plaintiff bring suit within one year from the date that he discovers a fraud or should have discovered it through the exercise of reasonable diligence. Any lawyer worth his

suit can bring suit within a year of becoming aware of the cause of action. Indeed, some securities law firms have become so proficient at filing shareholders' class actions that they are able to file their complaints within days of the announcement that a company has suffered a drop in earnings. For example, Compaq Corp. was sued one day after announcing a drop in earnings; Apple Computer, Inc. was sued six days after a similar announcement. And, more recently, over a dozen suits were filed against Salomon Brothers within days of the revelation that it had violated federal regulations governing Treasury securities purchases. Dozens of other examples abound.

With two or three years to work with, plaintiffs and their lawyers will be able to wait until a company suffers a decline in earnings or other reversal to bring an action based on events that occurred years earlier. Congress recognized way back in 1934 that this kind of speculation is affirmatively harmful and should not be encouraged. For example, Senator Kean explained during the debate on the 1934 statute:

"[I]f a man buys something today and discovers tomorrow that some mistake has been made and perhaps he has a ground for a suit because of fraud, under the terms of the bill he must bring his suit within one year. But suppose he thinks, 'Perhaps the bonds I have bought will go up. I will not bring suit until I find out about that. If the bonds go down then I will have the option of suing these people and trying to recover. If the bonds go up, then I will not sue because I can get a profit on them.'" 78 Cong. Rec. 8199 (1934).

The Senate bill also encourages speculation by allowing plaintiffs to bring suit two years after discovering the alleged fraud, whether or not they could have discovered it sooner through the exercise of reasonable diligence. In the absence of an obligation to exercise reasonable diligence, plaintiffs will have every incentive to await a loss before investigating to determine whether there have been any representations upon which they might pin a 10b-5 action. Statutes and court decisions that permit the tolling of a statute of limitations until the discovery of the harm virtually always encompass a diligence requirement. The Senate bill's abandonment of such a requirement is a drastic departure from generally applicable principles.

The Three-Year Limit

Similarly, there is no reason to expand the outside limit for filing suit from three years to five years. The five-year outside limit has been expressly rejected by the Supreme Court and three federal courts of appeals. Like the lengthy state statutes of limitations that some federal courts had borrowed prior to *Lampf*, the five-year period will give investors much longer to determine whether they have made a bad decision and to seek to pin the consequences of that decision on

someone else. Today, there is even less reason to invite speculation than in 1934. Because shareholders' suits are so lucrative for the plaintiffs' bar, there is so much monitoring going on that true fraud will be detected within the three year limitations period announced in *Lampf*. As two members of the largest securities class action firm in the country have written:

"A thorough investigation does not necessarily mean an undertaking of great expense or even of long duration. We live in an information society. [T]here are a wealth of public sources of information about corporations and other business entities available to the diligent lawyer. Many services exist whereby government filings, studies and other information can be located and transmitted to a lawyer overnight. Virtually every industry has one or more trade journals which contain very current and sophisticated information about the industries. The large "full text" data bases now available bring the resources of the largest libraries instantly to even the small law office."

RECENT STUDY SHOWS THAT SECURITIES FRAUD CLASS ACTIONS ARE FILED
AND ROUTINELY SETTLED WITHOUT REGARD TO THE MERITS:
A "PARTIAL PUT" FOR SPECULATORS

- Stanford Law School Professor Janet Cooper Alexander has reached some alarming conclusions about securities class actions. In a study published in the February 1991 issue of the Stanford Law Review (Alexander, Do the Merits Matter?: A Study of Settlements in Securities Class Actions, 43 Stan. L. Rev. 497 (1991)), Professor Alexander explains how a variety of factors combine to encourage "the filing of more and weaker suits," which routinely settle for millions of dollars, providing class action attorneys with huge fee awards, "while undercompensating actual victims of securities violations."

- Professor Alexander studied the seventeen computer or computer-related initial public offerings of at least \$3 million that took place during the first six months of 1983. She found that every company whose stock declined in value by \$20 million or more (9 of the 17) was subjected to a securities fraud class action. No company with a loss of less than \$20 million was sued. Several such companies suffered greater losses as a percentage of value than those that were sued. Professor Alexander concluded from this that securities class action firms do not deem it profitable to sue companies where the potential recovery is less than \$20 million, regardless of the merits of the claims against such companies.

- In reviewing the complaints in the nine law suits, Professor Alexander noted a remarkable similarity. "The complaints contain virtually identical factual allegations and legal theories" and indeed evidenced a "formulaic quality." What may account for this is that one law firm -- Milberg, Weiss, Bershad, Specthrie & Lerach -- represented plaintiffs in every one of the nine cases, serving as lead counsel or co-lead counsel in eight.

- Of the nine companies that were sued, eight settled before trial and the ninth case is likely to settle before trial. In looking at the settlements in these cases, Professor Alexander concluded that "the settlement amounts could be approximated without knowing any information other than the number of shares sold in the offering and the stock price at the beginning and end of the class period." The cases "settled at an apparent 'going rate' of approximately one quarter of the potential damages," regardless of the strength of the claims. According to Professor Alexander, "a strong case in this group appears to have been worth no more than a weak one."

- Professor Alexander posits that this "striking" outcome is the result of several factors. First, the applicable procedural and substantive law makes it virtually impossible to obtain early dismissal of even frivolous claims. Second, the threat of crimp-

pling liability constitutes a tremendous disincentive to go to trial even if a defendant believes that it has a strong case on the merits. Third, the "asymmetric costs of litigation" (defendants must incur far greater costs in responding to discovery requests than plaintiffs do in propounding them) increase the hydraulic pressure on defendants to settle early. Finally, the availability of insurance to fund settlements, but not necessarily judgments, gives both plaintiffs and defendants a distorted incentive to settle rather than litigate, no matter what the strength of the claim.

- The ramifications of Professor Alexander's study are disturbing. The system has evolved so that "we have what amounts to a grotesquely inefficient form of insurance against large stock market losses by giving investors, in effect, a legally mandated 'partial put' that entitles them to recover a portion of such losses from issuers." To make matters worse, "[s]uch insurance is available only where total market losses are large enough to support million-dollar attorneys' fees. It favors investors in especially risky stocks, where the likelihood of such losses is greatest."

- The effect on businesses is devastating: the present non-merits-based system "may deter valuable risk-taking, cause qualified persons to be unwilling to serve as directors because of the risks of liability or the unavailability of insurance, affect companies' choice of financing methods * * *." Because the merits don't matter, "issuers cannot avoid [the sizeable direct and indirect costs of securities litigation] through compliance programs or careful scrutiny of offering materials." As a result, one might expect fewer new companies to be formed * * *.

- And, what is particularly startling, these substantial harms are not offset by benefits to victims of securities fraud. Although this system of non-merits-based results may give investors a "partial put," that put is relatively small -- the plaintiff class typically obtains only about 60% of the settlement (attorneys' fees and litigation expenses eat up the rest), which in turn is usually 25% of the amount at stake. Moreover, because plaintiffs' attorneys only pursue cases involving large offerings, the lion's share of the stock at issue tends to be held by institutional investors. Small investors often account for only an insignificant percentage of the shares at issue. As a result of this factor and the fact that cases tend to settle for the same amount regardless of merit, "[p]laintiffs who were the victims of actual securities violations * * * are likely worse off under the present system." Put another way, "[a] non-merits-based system for resolving litigation effectively transfers wealth from plaintiffs with strong cases to those with weak cases."

The Class-Action Shakedown Racket

By VINCENT E. O'BRIEN

The class-action securities-fraud suit has become a feature of doing business for just about every size and type of company in the U.S. Since 1988, the number of these suits filed in federal courts has almost tripled. In the past three years, at least one out of every 14 companies on the Big Board has experienced a securities-fraud suit, most of them alleging concealment or failure to disclose information, and claiming significant monetary damages.

Proponents of securities class actions say that the suits prevent fraud and help maintain the integrity of financial markets. The large number of cases and the settlements are, to them, evidence of the need for securities class actions.

Are the proponents right? To shed some light on the issue, I collected data on more than 330 federal class-action securities-fraud cases involving common stock, all of them within the past three years. In every case, the plaintiffs alleged material misrepresentations and omissions by management regarding the true health and potential of the defendant company.

I found, as have most other studies of the subject, that virtually all securities-fraud class-action cases are resolved through settlement. In my 330-case sample, only three cases were decided by a jury; an additional five were dismissed or withdrawn. All in all, 99% of securities class-action cases in my sample were settled out of court. The norm for most other civil cases is 60% to 70%.

It is not the small investor who benefits from this litigation. Individual stock

buyers get little direct benefit from the class-action suits brought on their behalf. Most of the shareholder losses are suffered by large institutional investors, and it is they who receive the bulk of the settlements. In the most extreme case, five claimants out of 302—the T. Rowe Price Horizons Fund, the Fidelity Magellan Fund, the IDS Managed Retirement Fund, the Kemper Total Return Fund and Chase Manhattan Bank—received 30% of the settlements. In another case, with 4,963 approved claimants, 82% of the settlement went to 1% of the claimants; not one of that 1% was an individual. In a third, just one out of 1,631 claimants got more than 30% of the claim.

After, of course, deducting for attorneys' fees: the average attorney's award in the 330 cases was about \$1 million in fees and \$250,000 in expenses, or a little more than 21% of the average settlement amount. In 1990, settlements were announced for 83 cases, earning the plaintiffs' attorneys more than \$100 million in fees and expenses. A big part of these fees goes to a small handful of plaintiffs' firms: While more than 120 firms were identified as plaintiffs' counsel, one or more of just seven of these firms were involved in 40% of the cases.

None of these facts would be especially objectionable if the lawsuits were in fact punishing and deterring wrongdoers. But despite the high settlement rate, the data don't support such a sunny conclusion. Instead, regardless of size, profitability, industry type or location, any company whose stock price declines is open to a class-action suit.

Conventional wisdom says companies likely to be the target of shareholders' wrath are small, new and probably high-tech. But in fact, securities-fraud class-action suits are not confined to any one type of company. While one-quarter of the defendants in the sample of 330 cases were banking and investment companies and one-fifth were computer or software companies, more than half of the cases represented a wide range of industries: heavy equipment, entertainment, retail, pharmaceuticals and health care.

Nor did size make any difference. Companies with less than \$10 million in revenues were sued as frequently as their \$30 billion brethren. While more than half of the companies sued had less than \$500 million in sales, fully 13% had annual revenues exceeding \$2.5 billion.

Being long established did not protect a company from litigation either. Nine percent of the companies sued had been incorporated for five years or less, but 75% had existed as corporations for more than 10 years. Fewer than a quarter of the suits related to new securities offerings, and fewer yet involved initial public offerings of stock.

One thing that virtually all the defendants did have in common was a steep drop in the price of their common stock—40%, on average. In a handful of cases, the defendant company was sued because the stock price went up. In these cases the plaintiff class consisted of investors who sold stock before disclosures, typically of mergers or takeovers, boosted the share price.

Curiously, there is little variation in settlement amounts, both in real terms and as a percentage of investor losses. This suggests that settlement payments are not determined on the merits of the cases but by other factors, perhaps insurance coverage. While the types of companies sued and the circumstances vary widely, settlement outcomes do not. One hundred and seventy-nine cases have reportedly settled since April 1988. Two-thirds of the cases studied settled for less than \$5 million; almost 85% for less than \$10 million.

The settlement amount as a percentage of stockholder losses was consistently low. In a random sample of 20 cases, I estimated actual trading patterns and calculated the total trading losses to stock buyers in the alleged damage period. I found that cash settlement amounts averaged about 6% of total trading losses for purchasers of common stock during the relevant period. Once again, the outcomes were highly concentrated in the lower end of the range; 12 of the 20 cases settled for less than 5% of the trading losses.

Cash settlements in our sample provided less than a nickel in actual compensation for every dollar lost by investors, since attorneys' fees and administrative fees consumed, on average, 21% or more of the settlement fund.

In sum, virtually every company in every industry faces a significant probability of being sued, most likely by one of seven law firms. If past experience holds true, the litigation will undoubtedly be settled and the amount of the settlement will probably be less than \$5 million. Investors will receive only a tiny fraction of their losses, with most of this being paid to sophisticated, professional investors. Plaintiffs' attorneys will divvy up more than \$1 million in fees. It is not likely that undergoing such a suit will improve a company's way of doing business, nor is it likely to deter fraud. Most important, the securities class-action suit will seldom offer any benefit to the party it is supposed to champion: the stockholder.

Mr. O'Brien is a principal of the Law and Economics Consulting Group, in Berkeley, Calif.

Technology firms have volatile earnings. Lawyers have figured out how to get fat off this fact of life.

Shakedown?

By William Tucker

WHEN A Silicon Valley company issues an unexpected change in earnings, the race is on to the San Jose or San Francisco Federal Court House.

Earnings less than anticipated? The company is served with a class suit for failing to tell shareholders the bad news. Earnings better than expected? A company may be sued for withholding the good news that would have prevented impatient shareholders from unloading.

More than 98% of the suits are settled without trial, according to Newman. The officers and directors agree to pay money to the class of disaffected shareholders the attorneys represent. The lawyers typically get 30% of the settlement. The insurance company pays, but the cost of insurance is just one more burden on the sometimes struggling businesses. If a firm has gone bankrupt, the plaintiffs are still eligible to collect from the



Melvin Weiss, dean of the plaintiff's bar
"We're doing what the SEC doesn't have time to do."

"Shareholders' suits have become a sport in Silicon Valley," says Melvin Goldman, a San Francisco attorney who represents corporate defendants. "They take every unexpected movement of a stock and try to call it fraud. High-tech companies are volatile, so they're easy game."

At any one moment, there are about 500 to 700 shareholder suits outstanding across the country, according to James Newman, editor of *Securities Class Action Alert* in Cresskill, N.J. Milberg Weiss Bershad Specthrie & Lerach, of New York and San Diego, is the most active firm in this bustling industry. Milberg Weiss has over 150 active suits all by itself.

insurance company, and they also pursue claims against the accountants, lawyers and underwriters who worked with the defendant.

Typical case: Lawyers sue Verbatim Corp., a floppy disk manufacturer, when its stock drops more than \$2 a share at the end of 1983. Six years later, after the defendants have spent almost \$2 million on legal fees, the case is settled: a \$4.3 million recovery for investors who bought the stock between June 1983 and January 1984 of which plaintiff lawyers pocket \$1.5 million in fees and costs.

"It's legalized extortion," complains Alan Shugart, chief executive of Seagate Technology, a disk drive firm

that has been sued by 13 different plaintiffs. "They know how expensive it is for us to take our case to court. We're supposed to give them a few million dollars so they'll go away."

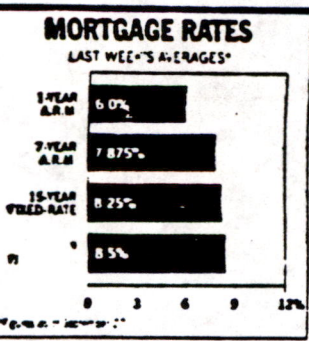
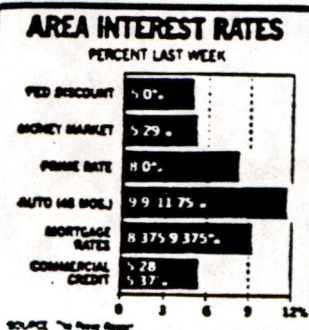
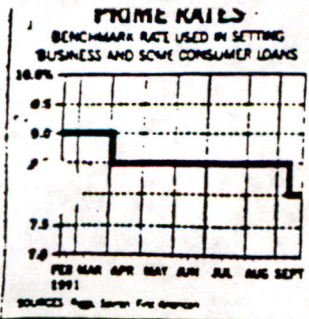
In 1988, after a jury ruled for defendants in a case against Nucorp Energy Inc., Silicon Valley executives were beginning to think they might not have to make such payoffs in the future. But on May 30 a San Jose Federal jury returned a \$100 million verdict against A.C. (Mike) Markkula, a cofounder and vice chairman of Apple, and John Vennard, a former vice president. Markkula and Vennard had been responsible for optimistic statements in the fall of 1982 about Apple's Twiggy disk drive at a time when corporate records showed Twiggy mechanisms to be failing. When Apple finally abandoned Twiggy in September 1983, its stock opened down \$8 a share the next day. The jury attributed \$2.90 of this loss to misrepresentation on the part of the officers.

Melvin I. Weiss, founding partner of Milberg Weiss, argues that his firm and others like it are helping keep business honest: "We're doing the job that the SEC doesn't have the time or the resources to do."

Weiss says his firm has recovered \$2.5 billion for aggrieved shareholders. But Joseph Grundfest, former Securities & Exchange Commissioner and now a Stanford Law School professor, takes issue with the notion that these victories amount to a great public service. Grundfest says: "There is no question that there are instances of outright fraud and that directors and officers should be made to pay compensation in some cases. But in many cases, perfectly honest people are being forced to pay outrageous sums, simply because they didn't have perfect foresight."

"These cases fail to make clear that, while some buyers and sellers lost money through market movements, the winners are other buyers and sellers, not necessarily the corporation or its current shareholders."

Actually, you can make a case that the losers are the American people, since these suits and settlements become a kind of tax on American businesses trying to survive in a tough industry and a tough world.



ECONOMIC INDEX APPENDIX D

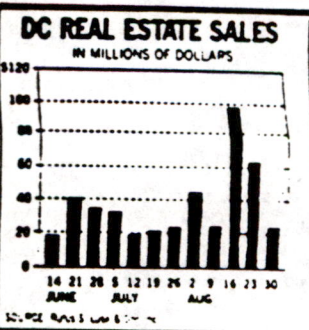
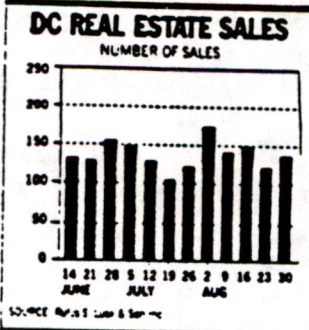
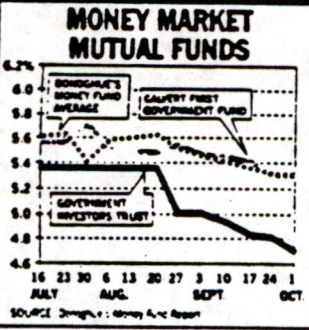
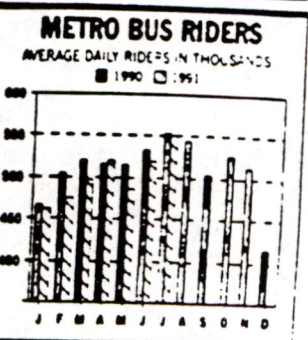
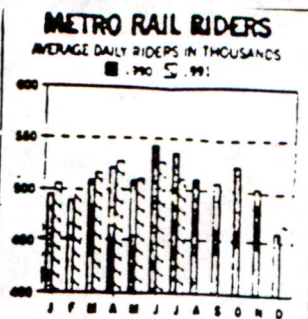
Monthly Figures

Recent Month	Previous Month	Year Ago
Aug 28	Aug 28	Aug 28
Oct 5	Oct 5	Oct 5

Quarterly Figures

Recent Month	Previous Month	Year Ago
Jul	Jul	Jul
Aug	Aug	Aug
Oct	Oct	Oct

Footnotes: 1 1970-71 = 100 index revised 2 1982 B4 = 100 3 2 Months Ago 4 SWSA Standard Metropolitan Statistical Area includes D.C. the cities of Alexandria, Fairfax, Falls Church, Manassas and Manassas Park, and Fairfax Arlington, Prince William, Loudoun, Stafford, Montgomery, Prince Georges, Charles, Frederick and Calvert Counties



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Class-Action Lawyers Brawl Over Big Fees In Milli Vanilli Fraud

**They Line Up Teen 'Victims'
Of the Lip-Synching Duo;
Judge Notes 'Strong Odor'**

Rob and Fab or Fab and Tide?

By AMY STEVENS
Staff Reporter of THE WALL STREET JOURNAL

When Milli Vanilli was exposed as a lip-synching fraud, it was bad news for the pop-singing duo from Germany. But for America's class-action lawyers, it was a major business opportunity.

They found clients in their own law offices and contacted their friends with teenage children. Their clients included 16-year-old Jay Freedman, who exclaimed "Gee!" after his father suggested the lawsuit, and Jessica Pinks, a high-school cheerleader who didn't know she was a plaintiff until she read it in the newspaper. "You couldn't imagine the ridicule I got at school," she says.

Before long, at least 26 suits were filed, all seeking court approval to become class actions, in at least seven states. They sought damages from Arista Records, the Bertelsmann AG unit that distributed Milli Vanilli's "Girl You Know It's True" album. Mr. Freedman, Miss Pinks and thousands of other young fans will get, at best, a few dollars each from all the suits. It's doubtful that any of the plaintiffs spent more than \$30 or so on Milli Vanilli merchandise—and virtually all of them had stopped listening to their record long before the lip-synching was revealed.

But the lawyers involved stand to make hundreds of thousands of dollars. And that has led to an ugly confrontation among them, prompting one judge to declare that he senses a "strong odor" from the conduct of some of the attorneys. "The whole legal pretense is that these cases arose from spontaneous consumer grievances," says Walter K. Olson, a senior fellow at the Manhattan Institute who has written a book on the proliferation of lawsuits. But in fact, he says, "the lawyers are doing what they accuse the record company of doing: Getting people to lip-synch for them."

William C. MacLeod, a former director of the Federal Trade Commission's Bureau of Consumer Protection, agrees. "It's hard to imagine there's a crying consumer need for redress of injuries here," he says. "While all the Milli Vanillis are crowding the court dockets, cases involving very serious injuries or people driven near bankruptcy are sitting and waiting."

RICO Violations?

Milli Vanilli was the stage name for two young performers, Robert "Rob" Pilatus and Fabrice "Fab" Morvan, who had come out of nowhere, released their hit album and won the 1990 Grammy Award for best new artist. Last year, when they were revealed to be lip-synching front men for a clever record producer, the revelation was greeted more with derision than outrage. The men were stripped of their Grammy. U.S. record sales weren't affected because the album had long since been off the charts anyway.

But the lawsuits flew, most alleging violations of a variety of state consumer statutes and contract laws and some charging that Rob and Fab were part of an enterprise that violated the federal Racketeer Influenced and Corrupt Organizations (RICO) act.

The country's top class-action lawyers and law firms got involved, such as William S. Lerach of Milberg, Weiss,



Milli Vanilli: Fab Morvan and Rob Pilatus

Specthrie, Bershad & Lerach of San Diego. Mr. Lerach's firm filed a Milli Vanilli suit in state court in San Diego, listing as co-counsel the nation's other leading class-action law firm, Greenfield & Chimicles of Hanover, Pa. That firm also filed a virtually identical suit in federal court in Los Angeles, later adding Mr. Lerach's firm and others. Both Milberg Weiss and Greenfield & Chimicles are probably best known for filing shareholder suits against companies involved in leveraged buy-outs and other deals.

David Stalder of Oakland, Calif., who's now 15, remembers being "pretty angry" when he heard about the lip-synching, since his mother had given him a Milli Vanilli cassette a year earlier. That night at dinner, his mother and her attorney boyfriend "suggested a lawsuit," David says in an interview. The following evening, two

other lawyers—family friends—came over and drafted court papers that were filed in state court in Alameda County, Calif., by three Bay Area-based law firms.

Albert Meyerhoff, the attorney boyfriend, says: "I remember telling David he had legal rights and could exercise them."

In the San Diego state court case, which has since been transferred to Los Angeles, all three of the original named plaintiffs have ties to the Lerach firm: Danielle Jeffrey is the 10-year-old daughter of a lawyer at the firm, Linda J. Starr is a former word-processing supervisor there, and Carla J. Freudenburg is a former law school classmate of another attorney there. The Starr and Freudenburg names also appear on the federal case, along with Leo Senay Jr., now the husband of one of the law firm's copy clerks, and Lisa Kelton, a former law school classmate of a Greenfield & Chimicles attorney.

Meanwhile, in Philadelphia, attorneys at another class-action law firm, Cohen, Shapiro, Polisher, Shiekman and Cohen, called two friends with teen-agers and asked them during the conversations if they had bought any Milli Vanilli recordings. "I said my son had the tape. Just one thing led to another where we ought to do something about it, see what we can do," Dennis Freedman, of Erdenheim, Pa., told Arista lawyers in a deposition. They asked whether Mr. Freedman talked to his son about the possibility of bringing the suit after his conversation with the lawyer.

"Yes," Mr. Freedman said.

"What did your son say?" Arista's attorneys asked.

"Really? Gee!" Mr. Freedman answered, adding that his son was "in agreement" when told that Milli Vanilli might be sued.

In most states, the rules governing attorneys bar direct solicitation of clients for particular suits unless the person solicited is a relative or an existing client. These rules apply to class actions as well as to individual suits, although once the class action is approved, additional potential plaintiffs must be notified of the existence of the class.

A lawyer at Cohen Shapiro says there was nothing wrong because the case came up innocently in the course of informal conversations among friends; in one case, the lawyer says, the youth, after being told about the case, asked if he could get involved.

Of the 49 named plaintiffs in the Milli Vanilli cases, at least 41 appear to have had pre-existing relationships to lawyers, most of whom worked at firms specializing in class-action cases. And many of the plaintiffs say they agreed to file suit at the suggestion of a lawyer.

The case of Miss Pinks, a 16-year-old from Port Clinton, Ohio, is one example. At a Christmas party in 1989, Miss Pinks won a gift certificate that she redeemed for a "Girl You Know It's True" cassette. Miss Pinks wasn't a big Milli Vanilli fan and the tape wasn't her favorite. "I didn't keep up with them," she says.

So how did her name wind up on a lawsuit? "It wasn't my idea at all," Miss Pinks says. She was out of town when a lawyer friend got in touch with her father and the two men agreed to file papers. Returning a few days later, Miss Pinks says she was shocked to see her name in the Port Clinton News-Herald. "It was awful," Miss Pinks says. "I'd walk into a classroom and they'd have the cassette playing, and they'd laugh at me."

Her lawyer, John A. Pietrykowski of Toledo, says the attorney-client privilege prevents him from discussing the origins of the lawsuit.

Denial of Recruitment

Mr. Lerach of Milberg Weiss says that in the days after the Milli Vanilli fuss arose, "the phone rang off the hook with people wanting to sue." He denies that his firm stirred up litigation or recruited anyone. When asked why the original named plaintiffs in the case brought by his firm had some pre-existing association with it, he replies: "We could add another hundred names easily. But for what purpose? So that Arista could take their depositions? Because they paid \$12 for a bogus CD? Please, excuse me!"

All of the Milli Vanilli cases were brought as class actions on a contingency-fee basis, which means that the named plaintiffs pay nothing up front to their lawyers, who then petition the court for their fees. If a judge approves a class action, all buyers of Milli Vanilli records and merchandise would be entitled to be included as plaintiffs. In recent years, judges in consumer fraud class-action cases have allowed attorneys to recover as much as a third of an award.

There's one big problem for law firms involved in nationwide class-action cases. Say one suit is filed in California state court and another in Ohio. If the judge in Ohio certifies that case as a class-action first, then defendants can argue that the Ohio judgment binds everyone. Such a ruling would preclude recovery in the California case—and could mean the California lawyers make no money.

That's why plaintiffs' lawyers often cooperate with each other in class actions against large companies. When the decision is finally made, all of the lawyers may get a piece of the pie.

But four Chicago law firms involved in the Milli Vanilli case upset the usual arrangement. They negotiated separately with Arista for a proposed nationwide settlement, drafting terms that would provide partial rebates to consumers—and nothing to other attorneys.

Under the agreement, Milli Vanilli fans would be eligible for rebates of \$3 for each

compact disk, \$2 for each cassette and \$1 for each single. Concert-goers and buyers of Milli Vanilli merchandise could ask Arista to donate 5% of the purchase price to one of three charities in their names.

Arista estimates that if everyone participates, the settlement could cost it \$20 million. That's about 10% of what some plaintiffs' attorneys estimate the group generated in total revenue. The four plaintiffs' attorneys would split \$675,000.

The 'Cynic' Judge

In July, Cook County Circuit Court Judge Thomas J. O'Brien held a hearing on the tentative settlement. Lawyers who would be shut out of fees if the agreement was approved showed up to protest. Nineteen attorneys jammed into the Chicago courtroom—so many that they couldn't all stand in front of the bench. Judge O'Brien asked some to sit in the gallery.

The lawyers who weren't party to the settlement asked that the deal be set aside in part because it didn't offer full refunds. Judge O'Brien, however, sensed other motives. "I'm a cynic with some justification," he said at the hearing, during which he declined to let the Lerach group and the other challengers intervene. "And in my opinion, what's involved here, undisguised or disguised, is a strong odor of concern to control the case and insure attorneys' fees."

The excluded attorneys are angry. "The level of compensation [for the record buyers] is just inadequate to address the problem," says Mark Rifkin, an attorney at Greenfield & Chimicles. "Some clients that I represent have said that they're embarrassed now to play the music. It was not a victimless prank."

Mr. Lerach vows he'll "fight forever" against the proposed settlement. He argues that Arista should be made to disgorge all Milli Vanilli proceeds, "even if they can't be distributed" to his clients. (If, as Mr. Lerach figures, Milli Vanilli made as much as \$200 million, the lawyers' share could be many millions.)

That's the only way to deter future wrongdoers, he says. "At this point, I'm not motivated at all by fees, not at all," Mr. Lerach says. "I'm motivated by the fact that I think consumers have been run roughshod over. To have it turn out that this wildly successful group was just a sham, just impostors, and have nothing done about it countenances deceit and the worst kind of business ethics."

Seven Million Sold

Mr. Lerach accuses Arista of "cherry-picking" to "find the weakest, hungriest, plaintiffs' lawyers, and present them with an opportunity to make a huge legal fee in return for entering into a nationwide settlement."

But Larry D. Drury, a Chicago lawyer who participated in the settlement talks, says, "If they were the ones with the exact same settlement approved, they'd be telling you how great it was. I don't think it's any great secret that they'd like to get

compensated. But you don't get compensated if you don't win."

The Lerach group plans to object to the settlement in January, when it's scheduled to go back before Judge O'Brien for final approval.

Arista says the proposed settlement is fair. "When you consider that seven million copies of the album were sold in the U.S., you have to wonder how upset people really were," says Trish Heimers, a spokeswoman for Bertelsmann Music Group, Arista's New York-based parent, adding that the record company received "fewer than 100" letters of complaint.

Moreover, the record company says, Milli Vanilli fans got what they paid for, and, in most cases, didn't really care about the identity of the singers when they made the purchases. "These people didn't know Rob and Fab from Fab and Tide," says Irving Scher, a New York attorney for Arista.

Some of the plaintiffs, however, say they were genuinely upset when they heard about the lip-synching. "I felt they deceived me and my children, and others all over the world," says Carol Gaines, a cashier at a Wal-Mart store in Baton Rouge, La. "I didn't appreciate being lied to. We paid our money and thought they were performing." Mrs. Gaines says she was so angry that, a few days later, she picked a lawyer's number out of the phone book—she reached Syed A. Salat of Baton Rouge—to ask what she could do.

The record company's Miss Heimers won't say how much all the litigation has cost the firm, but estimates that 25 lawyers have spent 10,000 hours on the cases so far, an expenditure that legal experts say could already be close to \$2 million.

Suit Over Beer

Marc Galanter, a professor at the University of Wisconsin at Madison School of Law, calls cases such as the Milli Vanilli suit "indicative of the degradation of the very good idea that was the class action." Some consumer class actions help combat fraud and effectively reimburse people who suffered genuine harm. But Prof. Galanter and others cite different kinds of cases, such as a suit filed—and later dismissed—in federal court last year by purchasers of Coors beer who claimed they were damaged because Adolf Coors & Co. had touted "Rocky Mountain spring water," when, they allege, the company was really using "ordinary water."

Mr. Lerach defends the merits of his Milli Vanilli cases by citing statutes that provide for punitive damages against companies that intentionally mislabel products, especially one of the most consumer-friendly laws, California's Consumers Legal Remedies Act. "The California legislature gave people the right to get their money back," says Mr. Lerach. "I didn't make that law."

But the man who did write the law, while serving as chief counsel to the state assembly's Judiciary Committee in 1971, has a different view. "I will say categorically that we didn't have this kind of case in mind," says James S. Reed. "We had in

mind a lot more egregious kind of advertising, such as real misrepresentation of the quality and value of a product."

Adds Mr. Reed: "My kids played Milli Vanilli a few times. They think this whole thing's a joke."

Rob Pilatus and Fab Morvan them-

selves, meantime, have abandoned the Milli Vanilli name and are working in London on their next album, for which they plan to do their own singing. "These lawsuits hurt us very much. It took us a long time to get back up on our own feet," says Mr. Pilatus. Through a spokesman.

STATEMENT OF ROGER COLEMAN

PRESIDENT

RYKOFF-SEXTON, INC.

PREPARED FOR DELIVERY AT HEARINGS ON

H.R. 3185

(POSTPONED: NOVEMBER 14, 1991)

(ENTERED FOR THE RECORD: NOVEMBER 21, 1991)

For additional information CONTACT:

**Mary Lou McDonald
American Business Conference
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My name is Roger Coleman. I am the President and Chief Executive Officer of Rykoff-Sexton, Incorporated.

Rykoff-Sexton is a public company with annual sales of \$1,460,000,000. Based in Los Angeles, our company manufactures and distributes foods and related products. You can find our products wherever food is prepared and consumed away from home. Our customers include restaurants, industrial cafeterias, hospitals, schools, hotels, and airlines. In addition we offer restaurant design and engineering services and, until last year, we published a consumer mail order catalog featuring specialty food items. In all, we produce or distribute more than 42,000 products.

We employ over 5,400 women and men in manufacturing and distribution centers around the country. Whether as plant workers, truck drivers, designers, or sales personnel, all of them have collectively contributed to our company's strong performance and growth.

As chief executive officer, I am the steward of their jobs. I hold ultimate responsibility for key decisions regarding the future of Rykoff-Sexton. One such decision, regarding the settlement of a class-action securities litigation, brings me here today.

I have come to Washington to ask that you amend H.R. 3185. Specifically, I ask that you consider adding to the bill provisions to address the problem of frivolous and harassing securities suits.

The problem of frivolous securities suits has been well-documented in the popular press and in law journals. Casual observers associate these suits with high-tech firms along Boston's Route 128 and in the Silicon Valley in California. As serious as the problem is for such companies, other firms are not immune. I should know.

Rykoff-Sexton had record earnings in 1989. I made a statement to my corporate community that 1990 performance should be even better. Due to declining economic conditions in some geographic regions of the country and other business conditions, we did not achieve that level of performance. As a result, I was sued in a shareholder class-action litigation, along with the Company, some of my fellow officers and the directors of Rykoff-Sexton.

At our first meeting with plaintiffs' counsel I learned a lesson that was confirmed again and again throughout the entire process. This suit was not about whether we were right or wrong. Plaintiffs' counsel focused at that meeting on only two concerns: Rykoff-Sexton's solvency and the nature of our insurance policies for directors and officers. And the merits of the case? Not one word. The issue was the depth of our pockets.

After that meeting I had little doubt who was driving this suit: the lawyers. Class-action plaintiffs, I found, often had no real interest in righting any wrong. Their passive participation simply gives lawyers a license to hunt. This creates a situation in which the plaintiff's lawyer is acting more for his own interest rather than for either the interests of his supposed client or for the shareholder group at large.

My own lawyers advised me not to expect the courts to rule quickly on the merits of the case. To be sure, I was told, there are rules designed to deter the filing of frivolous suits. But there is such a huge grey area as to what constitutes frivolous and malicious cases that forcing counsel for plaintiffs to demonstrate proof of merit usually is postponed until the very end of a long and expensive process.

Then there is the matter of discovery. Once it was determined this case could proceed as a class action, which required no showing of any strength to the case or even any basis for it, we became mired in an expensive and invasive discovery process. Discovery in federal court suits, I learned, is extremely broad and virtually limitless. We were required to turn over company files, to submit our officers and directors for days and days of deposition testimony, all without any requirement that the plaintiff at any time prove any merit to his case.

For a company like ours, which has a relatively lean management structure, time lost in the deposition process can be devastating. We simply could not afford the diversion of managerial attention away from company affairs. Many commentators bewail the supposedly short-term outlook of American management. I can tell you that nothing in my experience so shortens the time horizons of management more than becoming entangled in one of these suits. It brings everything to a stop.

Morale at the company was taking a beating, sometimes in unexpected ways. For example, because he was named in the complaint and therefore was

potentially liable, a Rykoff-Sexton vice president was unable to obtain a home mortgage. More broadly, so long as the suit was pending, our prospects, our reputation, our ability to bring our stockholders full value for their investment were all in jeopardy.

I faced a difficult dilemma. The company could continue to endure a crippling and expensive discovery process, in the hope of eventually convincing a judge to give us summary judgment. But achieving summary judgment was by no means certain. If we failed, we would then face the expense of trial preparation, followed by the uncertainties of a protracted jury trial. During that time, the case would continue to hang over our heads. Moreover, I was hearing from our insurers that they preferred a settlement instead of going to trial and risking greater liability.

Ultimately, I swallowed hard and decided to settle. Plaintiffs' attorneys readily agreed provided that we did not contest their fee application. In all, I calculate that this legal nightmare cost Rykoff-Sexton and its insurance company in settlement in excess of \$8.7 million, of which at least 25% will go into the pockets of plaintiffs' lawyers. That's over \$8.7 million that was diverted from new investments in jobs and facilities.

And what countervailing benefits were realized? None that I can see. Anyone who believes that the Securities and Exchange Commission determines what I and other CEO's can and cannot tell the investing public about our companies is mistaken. It's the trial lawyers and their professional plaintiffs who increasingly govern corporate disclosure policies, and that means less rather

than more information to the public. Perhaps that is why SEC Chairman Breen supports legislation to curtail frivolous suits.

I think this subcommittee has before it a real opportunity to achieve substantive reform. By adopting provisions to minimize frivolous suits, you can better direct the legal system toward assisting legitimate victims of fraud.

How could this system be improved so as to not sap the strength of the American business system at the whim of a plaintiff's lawyer? We must act to take the weapons of expense and delay from these extortionists. In my view, the changes that are needed are relatively straightforward.

- o Plaintiffs should be required to show some merit and some basis for the claims they make before they can start in motion the discovery process.
- o There should be reasonable time and cost limits on pretrial discovery so that discovery becomes a method for pursuing facts rather than a bludgeon for pursuing a quick settlement.
- o Attorneys should be prohibited from paying "finders' fees" or "bounties" to induce potential plaintiffs to sue.
- o Plaintiffs attorneys or the plaintiffs themselves should face some risk if they lose. If the loser were required to pay attorneys' fees, we would see fewer frivolous suits.

I note that in a recent Sunday New York Times, an aide to this subcommittee said that the aim of H.R. 3185 is fairness toward those who have been defrauded in the securities markets. My recommendations are wholly consistent with that purpose. It seems to me that the only people who could

oppose these or similar ideas are the people currently profiting from the legal system's inordinate complexities.

We all read stories every day about the financial excesses of the past decade, stories associated with the S&L crisis and certain Wall Street frauds. What I have tried to talk about today is my direct experience with another form of wasteful, fraudulent behavior. It is the shakedown of corporations through the abuse of class-action litigation. While legal, it is no less cynical and no less destructive than some of the more notorious examples of financial corruption.

So I say, let's kill two birds with one stone. Use H.R. 3185 as the vehicle to help victims of fraud make the con artists accountable. But let's also use it to end another kind of scam: the class-action shakedown. The goals are complimentary: indeed, they are intertwined.

I strongly urge that in the name of protecting business, serious consideration be given to limitations of the type I have suggested. To level the playing field will allow American business to go on with its objectives of creating jobs and making profits without distractions from baseless litigation.

CHALLENGES TO THE CONSTITUTIONALITY OF STATUTE ELIMINATING RETROACTIVE EFFECT OF *LAMPF* DECISION

The one year/three year statute of limitations adopted by the Supreme Court in its *Lampf* decision applied prospectively -- to all cases filed after the Court announced its decision on July 19, 1991 -- and retroactively to all 10b-5 cases pending on that date. The retroactive application of *Lampf* led to dismissal of a number of pending lawsuits on the grounds that they had not been brought within the one year/three year period.

Section 27A, passed last year as part of banking bill, eliminated the retroactive effect of the *Lampf* decision. The provision permits reinstatement of 10b-5 claims that were timely under the limitations period that courts applied before *Lampf* and filed before June 19. As a result, plaintiffs' lawyers in these cases have filed legal motions asking to have their dismissed suits reinstated.

In response to the plaintiffs' motions, some defendants' lawyers -- including those representing some of the Big Six accounting firms, as well as several other members of the coalition -- have filed briefs arguing that Section 27A is unconstitutional. If it is, there is no basis for reinstating plaintiffs' claims.

The constitutional challenge rests on the separation of powers doctrine. Based on an 1872 Supreme Court decision, the lawyers are arguing that Congress stepped out of the legislative sphere and into the judicial arena by enacting a statute that directs a particular outcome for a particular class of cases. In some cases, defense counsel also contend that Section 27A violates the vested rights doctrine by depriving defendants of rights that have been vested by the final judgment of a court.

To date, the constitutional argument has been rejected by several courts, and no court has agreed with the contention that Section 27A is unconstitutional.

* Additional material as of this date.