TESTIMONY OF PROFESSOR DONALD C. LANGEVOORT, GEORGETOWN UNIVERSITY LAW CENTER, BEFORE THE COMMITTEE ON FINANCIAL SERVICES, UNITED STATES HOUSE OF REPRESENTATIVES, 107TH CONGRESS, 2D SESSION

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The last few months have brought public attention to bear on the seriousness of a problem of which we have known, or should have known, for years – that economic forces have increased the temptation for company executives to be dishonest with the investing public, and that this temptation has translated into an unacceptable level of corporate fraud, misrepresentation and concealment. The forces that have produced this are many, including weaknesses in the system of corporate governance, otherwise well-intentioned forms of stock-based executive compensation, compromises in the integrity of the accounting profession, the pace and profitability of financial innovation for both risk shifting and tax avoidance and, sadly, the sometimes too-easy willingness of investors to believe what they are told by both issuers and Wall Street when promises of riches are dangled in front of them. I commend members of this Committee, on both sides of the aisle, for your commitment to addressing many of these issues and establishing a higher level of accountability and transparency in our markets.

Without slighting many of these specific and important issues in the bills before you, my purpose today is to focus solely on private securities lawsuits and their role in this restoration of investor protection. As this Committee is well aware, the issue of private securities litigation is contentious and polarized. Securities fraud class actions are portrayed either as pure public-regarding mechanisms for championing investor rights or lawyer-driven sinkholes of opportunism and strike suit abuse. But the truth is neither of

these. Securities class actions do present an opportunity for abuse through the filing of low-merit complaints with the expectation of settlements that are profitable mainly for the lawyers, and there probably are too many weak claims. At the same time, however, there are – as recent events have amply demonstrated – many meritorious cases that dearly deserve redress. Especially given the under-funding of the SEC's oversight and enforcement capacity, private lawsuits play a necessary role in policing fraud in the markets. What is needed from the law, simply, is balance. I believe that portions of H.R. 3818 dealing with private rights of action are crucial to restore balance that has been lost in recent years in a number of key respects.

The Need for Legislation

Much has been said and written recently about private securities litigation and the efficacy of the Private Securities Litigation Reform Act of 1995. The most commonly publicized statistical evidence is that there has not been a sustained drop in the filing of lawsuits in the years following the legislation. From that, it is tempting to infer that neither the PSLRA nor the underlying case law has prejudiced plaintiffs unduly, and that therefore no reform is needed to restore any balance.

To be sure, cases can and do get brought: nothing in the law has been a death-knell for the fraud-on-the-market lawsuit. But the years prior to the legislation that serve as the baseline for these statistics do not provide a useful comparison. Both the economic risks of investing and the temptations and opportunities to engage in fraud have accelerated in recent years, such that it might fairly be said that there are many more

meritorious causes of action now than before. In fact, it is possible that precisely because of the deterrence lost as a result of both judicial pruning of the securities laws and legislative reforms, the incidence of fraud (and hence the number of good lawsuits) has risen.[1] In other words, current law could still be preventing too many good claims even if we observe no drop-off in the overall rate of litigation. These aggregate statistics don't tell us enough to make a judgment one way or the other.

I suggest that we not speak in generalities. Instead, in the aftermath of Enron, Global Crossing, Waste Management, Cendant, Sunbeam and so many less visible examples of real abuse – certainly circumstantial evidence, if nothing else, that the deterrence to fraud in inadequate – Congress should examine the *specific* roadblocks that might stand in the way of legitimate securities lawsuits, and decide whether current law is sensible, fair and balanced. If not, that rule should be changed. H.R. 3818 is an important, focused step in this direction.

Restoration of Aiding and Abetting Liability

In 1994, the Supreme Court surprised nearly everyone in the legal and business community by holding that private plaintiffs were no longer able to sue "aiders and abetters" of securities fraud for damages under Rule 10b-5.[2] Whatever the merits of its statutory construction methodology or policy musings, the Court's basic holding was

[1] It should be clear that the PSLRA was merely the culmination of a decade in which the courts created many roadblocks of their own to open-market securities fraud cases. The key provisions in many respects simply codified what most courts were already doing. If so, then a reduction in claims would not be likely except in geographic areas where certain courts had not as restrictive as others.

[2] Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

clear. If this kind of secondary liability is appropriate (as the Court conceded it may be), the job of creating it is for Congress, not the judiciary. I urge this Committee to accept the Court's invitation.

As I testified shortly after the *Central Bank* decision,[3] as a policy matter it is extraordinarily difficult to argue seriously that true aiders and abetters – that is, those who intentionally render substantial assistance to a securities fraud – should not be responsible to the victims for the harm they help cause. The common law has long imposed tort liability on aiders and abetters, reflecting the basic wisdom of this norm. And Congress has accepted the severe wrongfulness of aiding abetting, long ago making it a federal crime generally and more recently making clear the SEC's ability to bring enforcement actions based on it. If this kind of conduct is wrongful, why would we ever deny the victims, who often are unable to recover fully against the primary wrongdoers, their just compensation?[4]

There is no good reason at all, except for the supposed fear of litigation abuse. But even if (as I believe) that fear is well-founded to a limited degree, the right response is to control abuse through a carefully-tailored set of restraints on the cases that are brought rather than throwing out a good doctrine in its entirety. There are good ways of controlling unduly speculative claims against secondary actors, including certain of the steps taken in the PSLRA, which was enacted shortly after *Central Bank*. Once a healthy

[3] Statement of Donald C. Langevoort Before the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs, United State Senate, 103d Cong., 2d Sess., May 12, 1994.

[4] It bears noting that in suits where the issuer and its executives are the only defendants remaining, the *issuer* (directly or indirectly, though its D&O insurance carrier) funds on average more than 99% of any settlement. The practical effect, then, is that one group of innocent investors (existing company shareholders) pays damages to another (the class of traders).

balance has been achieved, courts should be authorized to impose liability when there truly was intentional and substantial assistance.

Even a brief survey of the kind of conduct that escapes responsibility under current law underscores the gap in investor protection that it creates. Imagine, for example, an investment bank that assists an issuer in financing an off-books entity used to fraudulently manipulate earnings. Or the accounting firm that helps structure it to avoid taxes that would otherwise be owed. Assuming that these firms knew of or recklessly shut their eyes to the issuer's fraud on investors, they bear responsibility to the victims. I would not want any legislation restoring aiding and abetting liability to be lax in defining substantial assistance. Mere proximity to a fraud is not enough. But when a person adds substantial value to a fraudulent course of conduct – in other words, contributes in a substantive way to its success – then liability is necessary and appropriate to achieve both deterrence and compensation. In cases such as the ones I have described, the professionals may well have provided not only technical assistance but aggressively advocated the desirability and efficacy of the strategies, reaping considerable consulting or banking fees in the process. If in so doing they intentionally furthered a fraud, they surely owe compensation to the victims.

Post-*Central Bank* developments in the law underscore the need for reform here. The Court's decision quickly generated confusion in the lower courts on the question of when a person or entity becomes "primarily" liable for a violation of the securities laws. There is one line of authority – perhaps now the most common approach – that absolves even those who participate directly in the formulation of deceptive publicity, financial

statements or SEC filings unless they are somehow *publicly identified* as responsible.[5] Read strictly, this test would mean that "behind the scenes" actors, no matter how central their role in the deception, avoid all responsibility to the victims under the securities laws, except where they are controlling persons. Whether we call such persons "primary participants" or aiders and abetters is unimportant: the important thing is that they be made liable if their involvement was both intentional and substantial in causing harm.

Statute of Limitations

When the Supreme Court resolved the question of the appropriate statute of limitations for Rule 10b-5, it had legislative guidance to work with, drawing from other provisions of the Securities Act and the Securities Exchange Act by analogy. And so the Court determined that the short statute of limitations found occasionally in the securities laws' express liability provisions – one year after discovery, and in no event more than three years after the fraud – was appropriate.[6]

Putting aside the correctness of this as a matter of statutory construction, the short statute of limitations is wholly ill-suited to the job of policing securities fraud in today's complex markets. When Congress wrote the other sections' statutes of limitation in 1934, it was addressing a world that pre-dates the modern class action. Rule 10b-5 didn't even exist. And certainly the size and breadth of today's investment marketplace could hardly be foreseen.

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[5] See Wright v. Ernst & Young LLP, 152 F.3d 169 (2d Cir. 1998)(statement must be "attributed to that actor at the time of dissemination").

[6] Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991).

Once again, Congress should use common sense as its guide. In a fraud-on-the-market case, one year is too little time to prepare an effective and well-grounded suit, especially if the clock begins running – as some courts insist – as soon as there is some basic notice of the likelihood of fraud.[7] As recent events have demonstrated, many large frauds unfold gradually: the first hints may be troubling, but do not clearly indicate either the nature or the extent of the wrongdoing. The realization that a lawsuit is necessary and appropriate does not come immediately. The one-year rule has much potential for mischief, including forcing unduly rushed pleadings when the need for a lawsuit is late in coming.

The three year "cap" is even more pernicious and archaic. With today's complex capital structures, delays in the discovery of fraud for more than three years are readily foreseeable. A firm that fraudulently hides liabilities off-books may sustain the illusion for some time. There is no reason to let a securities wrongdoer free simply because that short a period of time has elapsed.

For these reasons, I strongly endorse extending these periods to three and five years respectively, which corresponds more closely to the more modern statutes of limitation found today in analogous settings such as common law fraud and state blue-sky law.

[7] E.g., Whirlpool Fin. Corp. v. GN Holdings, 67 F.3d 605 (7th Cir. 1995). Fortunately, some other courts have been more forgiving.

Discovery Stays and Other Reforms

H.R. 3818 would reverse the rule established in the PSLRA that stays discovery pending a motion to dismiss for failure of adequate pleading under Section 21D(b) of the Securities Exchange Act, albeit only with respect to suits against auditors. As you know, this is a piece of a very big issue – the pleading standards generally in securities fraud actions. Without belaboring the broader issue here, I believe that the pleading standard requires revisions in two respects. First, Congress should make clear that the "strong inference" standard is to be construed with balance in mind. In many cases, investors lack the information necessary to present a strong case of intentional misconduct at the time they file their complaint. Although I am not uncomfortable with the approach taken by some courts that this standard can be met by showing such things as a sufficiently strong motive and opportunity, I think that the standard can be formulated better while still allowing courts to weed out speculative claims. I would set the bar simply at whether plaintiffs presented particularized facts giving rise to reasonable grounds to believe that a securities fraud violation has occurred. I would also give the trial court the discretion to allow a limited and supervised period of discovery, and allow dismissal thereafter if plaintiffs had not uncovered additional facts that give rise to a reasonable likelihood of success on the merits. I would not limit either reform to suits involving auditors.[8]

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[8] I believe that one additional change in the reforms created by the PSLRA would be desirable. The so-called "safe harbor" for forward-looking information today protects statements that are either accompanied

Conclusion

I make no claim that the beneficial reforms to private securities litigation proposed by H.R. 3818 will themselves restore integrity to the process of financial reporting and issuer disclosure. The threat of litigation, public or private, can only go so far in causing good behavior to occur instead of bad.

Presumably, the market will react to Enron and similar examples of corporate dishonesty by demanding better governance mechanisms and penalizing companies that do not offer high-quality disclosure. This will be a necessary and healthy discipline if it lasts past the next round of investor exuberance. But no one can argue seriously that marketplace discipline is enough to deter fraud. For one reason or another, corporate executives will find themselves tempted to lie if only to cover-up a streak of bad fortune and hold on to their jobs and perquisites long enough to try to gamble their way out of trouble – to me the single most common explanation for financial fraud. Indeed, there is reason to believe that increased marketplace demands are precisely the reason we are seeing more corporate frauds.

If recent financial frauds have taught us anything, in other words, it is that the temptation to be dishonest is strong, and existing corporate governance mechanisms that we would like to trust – e.g., independent directors and audit committees, "reputational intermediaries" like investment banks and accounting firms, marketplace demands for candor – operate with less force than we would like. The real work of reform (which I suspect should not rest heavily on increased threats of liability) must be in these areas,

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by meaningful cautionary language or made without actual knowledge of their falsity. I believe that when plaintiffs can create a strong inference of deliberate fraud (i.e., actual knowledge), the safe harbor based on cautionary language should disappear.

and will take time and cooperation between public and private forces. But that reform will take time and will never be perfect; inevitably corporate managers will find the means to cheat. Hence, it is essential that the law establish a clear baseline for tolerable behavior: those who intentionally participate in schemes to defraud the investing public should be liable for the harm they cause, and should be prevented from causing comparable harm again.

Rules of conduct mean nothing, however, unless someone is able to enforce them vigorously and effectively. Increased SEC funding is a must, so that the resources are there to make public enforcement operate as a much more powerful deterrent. Inevitably, private securities litigation will always have to assume a large part of the burden of both enforcement and the search for compensation. I urge this Committee to take the balanced, reasonable steps to restoring the effectiveness of private securities actions proposed by H.R. 3818.