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2008 Securities Litigation Reform Forecast: Cloudy, Chance of Rain

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The past two years have seen an increased focus on the question of whether the U.S. capital markets are impaired by over regulation and whether certain reforms adopted as part of the Sarbanes-Oxley Act (SOX) are adversely affecting the competitiveness of public companies. For the first time since SOX was enacted in 2001, there seems to be mounting concern that the pendulum has swung too far in the wake of the collapse of Enron, Worldcom, Adelphia, and other companies and that the net effect has been adverse to economic growth in America.

As discussed below, a number of significant reform proposals are now being advanced by various market participants in the U.S. capital markets, with one common theme—the U.S. needs to take bold steps to avoid the "flight" of capital to foreign markets and a corresponding loss of competitiveness.

These proposals may have difficulty gaining momentum, however, until after the November elections. If, as some expect, the White House changes hands, the prognosis for some of the reform proposals may be poor. And given the current crisis in the credit markets, one can expect that Congressional focus will be on solving the current issues surrounding sub-prime lending. As a result, reform legislation directed to securities litigation and SEC enforcement may be relegated to the proverbial back burner.

Following is an overview of some of the key reform proposals currently being considered in three different areas: 1) reforms of securities class action litigation generally; 2) reforms related to public companies and

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their directors and officers: and 3) reforms related to the audit profession.

Reform Proposals Related to Securities Class Action Litigation Generally

***SEC Roundtable*—**On September 24, 2007, Securities & Exchange Commission Chairman Christopher Cox announced that the SEC would hold roundtable discussions during the spring of 2008 to discuss the effects of shareholder litigation on U.S. capital markets, shareholder value, and investor protection.

The roundtable was announced in response to an August 2, 2007, letter from a group of law professors headed by Donald Langevoort of Georgetown University to Chairman Cox urging him to convene a series of roundtables on the issue of how well investors fare in private securities litigation.[1] The professors asserted that the roundtables were necessary to address the "world-wide perception in some quarters" that U.S. securities litigation costs investors more than it benefits them.

Without endorsing a particular position, the professors raised three concerns. First, because securities litigation is directed primarily at corporate defendants, and because securities settlements typically are funded by the companies or their D&O insurers, settlements result in unnecessary "pocket shifting" and likely overcompensate large, well-diversified investors over time. Second, because of attorneys' fees and related expenses, the costs of identifying and compensating aggrieved shareholders are relatively high compared to the benefits. Third, the current system does a poor job of deterring fraud, because managers that execute fraud rarely fund settlements.

Although Langevoort's August 2, 2007, letter was the impetus for the upcoming roundtable, the issues raised in the letter have been bandied about in the academic community for some time.[2] In addition to Langevoort, John C. Coffee of Columbia University is a leading academic critic of the current securities class action scheme and has written a number of articles consistent with the concerns raised in Langevoort's letter.[3]

In addition, The Committee on Capital Markets Regulation, led by Harvard law professor Hal Scott, Glenn Hubbard, the dean of Columbia's business school, and John L. Thornton, a former president of Goldman Sachs and current chairman of the Brookings Institution, issued an interim report on capital markets regulation on November 30, 2006, that echoed some of the concerns raised by Langevoort, Coffee, and others. The committee—colloquially referred to as the "Paulson Committee" because it was created with the blessing of U.S. Treasury Secretary Henry Paulson—concluded that the competitiveness of U.S. capital markets was declining, a development the committee attributed in part to the comparatively high costs of U.S. regulatory compliance and litigation risk. Among other things, the committee recommended that 1) the SEC provide additional guidance concerning certain elements of 10b-5 liability, such as materiality, scienter, and reliance; 2) private damage awards be offset by any amount that the SEC has collected from defendants and distributed to shareholders; 3) criminal prosecutions of corporate entities be reserved for extreme cases; and 4) Congress explore options for protecting auditors from catastrophic liability.[4]

To date, the participants in the roundtable have not been announced, and no date has been set for the roundtable. Pressure appears to be mounting, however, as at least two members of Congress have publicly expressed interest in the upcoming roundtable. On December 19, 2007, Reps. Vito Fossella (R-N.Y.) and Gregory Meeks (D-N.Y.) sent a letter to Chairman Cox urging him to schedule the roundtable.

The effect of the upcoming presidential election on the roundtable is uncertain. SEC commissioners are appointed for five years, and no more than three of the five commissioners may belong to the same political party. Three of the current commissioners, including Chairman Cox, who joined the SEC in 2005, are Republicans. Although SEC commissioners are independent and can only be removed from office for cause,[5] the practice for more than 50 years has been for the chairperson of the SEC to step down following the transition from one presidential administration to the next so that the new president may appoint his or her

own chairperson. Thus, Chairman Cox most likely will step down as Chairman in the event a Democrat is elected and may well be replaced by a new chairperson with less enthusiasm for curbing shareholder litigation.

Financial Services Roundtable, "Blueprint for U.S. Financial Competitiveness"

In late 2007, the Financial Services Roundtable's Blue Ribbon Commission on Enhancing Competitiveness issued its "Blueprint" report, in which several key reforms in the area of securities litigation were proposed. Among the recommendations for reforming securities litigation were:

- Require pre-screening of cases by the SEC prior to filing of private class actions under Section 10(b) of the Securities Exchange Act;
- Require loss causation to be pleaded with particularity;
- Limit joint and several liability in securities cases;
- Expand the federal courts' removal jurisdiction and amend the Class Action Fairness Act;
- Permit interlocutory appeals of motions to dismiss;
- Coordinate SEC "fair funds" recoveries and private litigation settlement funds;
- Amend the Securities Litigation Uniform Standards Act of 1998 (SLUSA) to permit appellate review of remand decisions.

Reform Proposals Directed to Protection of Public Companies, Their Directors & Officers

The "Paulson Committee" Report—On November 30, 2006, the Committee on Capital Markets Regulation (a.k.a. "the Paulson Committee") issued its "Interim Report of the Committee on Capital Markets Regulation," covering various aspects of the regulation of the capital markets and proposing various regulatory and market reforms. Several of the reforms pertain to securities litigation and auditor liability. (The latter subject is addressed in the next section below.) As to securities litigation more generally, the Paulson Committee report notes that although the total number of class action suits has dropped in the last two years, the settlement values have sky-rocketed. The Report notes the threat that, as average settlement values climb, "so too do the incentives for companies to try to evade private litigation under the U.S. securities laws by simply choosing to sell their shares elsewhere." The Report recommends various reforms aimed at making the U.S. trading markets more attractive to companies, including:

- Resolving existing uncertainties in Rule 10b-5 liability, including issues of materiality, scienter, and reliance.
- Preventing overlap between private suits and the SEC's "Fair Funds" compensation system for injured investors.
- Prohibiting so-called "pay to play" practices by class representatives and discouraging the practice of the "lawyers hiring the client."
- Eliminating enhanced criminal penalties against corporations who choose not to waive their attorney-client privilege or decide to advance defense costs for officers and employees accused of criminal wrongdoing.
- Instituting greater protections for outside directors, including strengthening the ability of such directors to rely upon audited financial statements, and expanding the ability of outside directors to be indemnified against liability under Section 11 of the 1933 Act.

Following release of the Paulson Report, Secretary Paulson appointed a Treasury Advisory Committee to further study these and other issues. In January 2008, the Advisory Committee met, and a Draft Decision Memo was released. Several of the proposals in the Draft Decision Memo center on financial reporting and liability issues for public companies arising out of financial reporting. One area of focus, for example, is the use of corporate websites for financial disclosure, and liabil-

ity issues for information presented in summary form, or for hyperlinked information. Similarly, the Draft Decision Memo addresses whether "key performance indicators" should be required, and if so, what liability might attach. These and other proposals of the Advisory Committee are likely to receive greater attention in 2008.

The Commission on Regulation of U.S. Capital Markets in the 21st Century**—**A March 2007 report from the Commission on the Regulation of U.S. Capital Markets in the 21st Century recommended several broad litigation reforms and specifically calls upon the SEC to undertake a thorough review of how the Private Securities Litigation Reform Act of 1995 (PSLRA) has addressed the problem of frivolous shareholder litigation since its passage by Congress. Among the Commission's other recommendations:

- Eliminate public company quarterly earnings guidance; instead, companies would provide investors with "meaningful information on their long-term business strategies." Alternatively, companies could provide no more than annual guidance, expressed as a range of earnings, rather than earnings projections "to the penny."

- Prohibit the Department of Justice seeking privilege waivers from business organizations under threat of indictment or other enforcement action. As well, the DOJ should not be permitted to base charging decisions on whether a corporation advances counsel fees to its executives.

- Permit public companies to selectively waive their privileges, enabling them to produce documents to the SEC but still maintain a privilege as against private litigants.

- Restrict the scope of "scheme" liability under Section 10(b) (along the lines of the *Stoneridge* case recently decided by the U.S. Supreme Court).

- Allow a damages offset in private civil litigation for amounts paid by a company in settlement of an SEC action in the form of "Fair Funds."

The Bloomberg-Schumer Report**—**Also in early 2007, Mayor Michael R. Bloomberg of New York City and Senator Charles E. Schumer (D-N.Y.) issued a comprehensive report entitled "Sustaining New York's and the US' Global Financial Services Leadership." The Bloomberg-Schumer Report made a number of recommendations to increase the competitiveness of the U.S. capital markets, a few of which are pertinent here. One key recommendation is to "implement securities litigation reform that has a significant short-term impact," which would include the following:

- Encourage SEC rulemaking to limit the liability of foreign companies with U.S. listings to securities-related damages proportional to their degree of exposure to the U.S. markets;

- Give smaller public companies the ability to "opt out" of some portions of Sarbanes-Oxley;

- Promote arbitration as a means of resolving securities-related disputes, using a charter amendment approved by shareholders;

- Legislatively limit punitive damages in securities cases; and

- Allow parties in federal securities class actions to appeal interlocutory judgments immediately to the courts of appeal.

The "Shadow Financial Regulatory Committee"**—**On February 12, 2007, the "Shadow Financial Regulatory Committee" issued a short statement on the competitiveness of the U.S. securities markets, echoing many of the themes of the Paulson Committee report and the Bloomberg-Schumer report. The Shadow Financial Regulatory Committee is an organization comprised of a number of academicians sponsored by the American Enterprise Institute. In its report, the Committee expressed concern that "excessive regulation and large and arbitrary litigation risks appear to be hindering this country's ability to compete." Of all the risks facing the U.S. capital markets, the Committee chose to focus on only one—the litigation risk faced by U.S. public companies, and in particular the regressive economic profile of most securities class action litigation—where "one

group of innocent shareholders is often required to pay another group of shareholders" for injuries that are "the responsibility of company managements." The Committee expressed the view that the deterrent value of class actions is small, and that the SEC's enforcement system "could do a better job of punishing wrongdoers and deterring financial manipulation and fraud at much less cost." The Committee recommends therefore that Congress adopt legislation that limits private securities class actions to those cases where insider trading had occurred, but otherwise require that violations of Rule 10b-5 be enforced against companies *only* by the SEC.

Reform Proposals Directed to Protection of the Accounting Profession

***The "Paulson Committee" Report*—**The Paulson Committee Report includes several proposed reforms directed to the issue of auditor liability. The Report discussed the increasing liability risks posed to the remaining "Big Four" accounting firms and the possible impairment of consumer choice if one of those firms were to fail. The Report noted in particular that there are more than three dozen cases involving tens of billions of dollars of potential exposure to accounting firms and expressed the concern that even a relatively small share of proportional liability in these cases may lead to the financial failure of one of the remaining firms. "For the profession itself, there is consensus both inside and out that the demise of one of the remaining Big Four could have adverse consequences for audited companies and their shareholders."[6]

In light of these concerns, the Report suggested several possible reforms:

- Create a safe harbor for certain defined auditing practices;
- Set a cap on auditor liability in certain circumstances;
- Grant regulators specific powers to appoint "monitors" to oversee operations of audit firms found to have engaged in systemic failures in process, management, or personnel;
- Clarify and limit an auditor's duties under Section 10A; and
- Restrict criminal indictments against firms, as opposed to individual audit partners.

In light of the Committee recommendations, on May 17, 2007, the U.S. Treasury Department announced that it was appointed a "Treasury Advisory Committee on the Auditing Profession," headed up by former SEC Chairman Arthur Levitt and former SEC Chief Accountant Donald Nicolaisen, to consider possible reforms relating to the accounting profession. In January 2008, the Advisory Committee met and released a Draft Decision Memo. With respect to auditor liability, the Draft Decision Memo outlined the concept of a "framework for professional judgment in accounting," pursuant to which auditors' work could be evaluated against the guidelines, and noted that a limited "safe harbor" would be available to auditors whose exercise of professional judgment is the outcome of a process in which each involved person has the "appropriate level of knowledge, experience, and objectivity" to form an opinion on the subject. To that extent, the "framework" sounds somewhat like the Delaware "business judgment rule" that serves to protect directors against personal liability in the exercise of business judgment.

***The Bloomberg-Schumer Report*—**The 2007 Bloomberg-Schumer Report makes one recommendation directed at the protection of audit firms, echoing the Paulson Committee report. Specifically, the Bloomberg-Schumer report proposes imposition of a "cap" on auditor damages that would maintain the deterrent effect of large financial penalties, while also reducing the likelihood of the highly concentrated U.S. auditing industry losing another major player.

***Commission on Regulation of the U.S. Capital Markets in the 21st Century*—**This Commission recommends that domestic and international policy makers "seriously consider proposals … to address the significant risks faced by the public audit profession from catastrophic litigation."

The Commission includes representatives from stakeholders from the mutual fund and pension fund industries, as well as financial services firms, the insurance industry, and other important industry representatives. Among other findings, the report states that "sustaining a strong, economically viable, public company audit profession is vital to domestic and global capital markets" and that this condition is threatened by the current climate of civil litigation and regulatory proceedings against accounting firms.[7] Specific recommendations of the Commission include:

- Focus any criminal indictments on culpable individuals within audit firms, not the firms themselves;
- Create a national charter, similar to the national bank charter, that would confer positive benefits for audit firms by replacing the multiplicity of conflicting state regulations now facing audit firms;
- Include international audit firm liability issues as a topic to be addressed by the Group of Eight (G-8) countries;
- Expand the overall capacity of the audit profession through expansion of the next tier of audit firms below the Big Four; and
- Strengthen the ability of audit firms to use arbitration or other Alternative Dispute Resolution (ADR) solutions instead of litigation in the court system.

European Commission Proposals—The concept of liability "caps" also is being considered by the European Commission as a means of avoiding the failure of any of the major audit firms practicing in the EU. Among the ideas being considered by the European Commission are:

- Fixed monetary caps at the European level;
- Caps based on market capitalization of the audited company;
- Caps based upon a multiple of audit fees; and
- Proportionate liability based upon degree of responsibility.

Last year, Charles McGreevy, an EU Internal Market commissioner, voiced support for these ideas: "there is a real danger of one of the Big Four being faced with a claim that could threaten its existence," he said.[8] The European Commission has established an "Auditors Liability Forum" to consider the issues, comprised of representatives from the Big Four firms, as well as other constituencies. In January 2007, the European Commissions issued a Staff Working Paper on "Auditors Liability and Its Impact on the European Capital Markets," in which it noted an array of potentially adverse consequences if another Big Four audit firm were to fail and also the challenges to attracting new audit firms to step forward. The Commission's Working Paper was largely based upon an independent study by London Economics.[9]

Very shortly, the EU Commission is expected to offer guidelines for possible liability caps. It appears, however, that the EU Commission does not intend to promulgate a legislative fix that would apply uniformly to all EU countries generally, but rather intends to leave it to individual countries to determine what reforms to adopt. In a January 2008 talk, McGreevy was quoted as saying that "I do not intend to impose the means by which liability is limited."[10]

Conclusion

Despite the wealth of constructive proposals that have been generated on how to reform securities litigation in the United States and to restore balance to the regulatory environment, the forecast for these reforms is cloudy at best. Some fear that the coming election cycle may, if anything, reverse the direction of these reform efforts. Because of the critical issues facing the U.S. economy as a result of the sub-prime crisis, it is doubtful that meaningful progress will be made on any of these reform proposals by the time America will go to the polls and elect a new president. But the importance of solving these issues remains, and whatever the outcome of the elections, the dialogue over these reforms must continue.

NOTES

1. *See* August 2, 2007 Letter from Donald C. Langevoort to The Honorable Christopher Cox.
2. *See, e.g.*, Donald C. Langevoort, "On Leaving Executives 'Naked, Homeless and Without Wheels': Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability," 42 Wake Forest L. Rev. 627 (2007).
3. *See* John C. Coffee, "Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation, 106 Colum. L. Rev. 1534 (2006); John C. Coffee, "Memo to Congress: Reform and Its Perils," N.Y.L.J., Nov. 15, 2007; John C. Coffee, "The Cost of Scandals: Realism About Enforcement," N.Y.L.J., May 17, 2007; John C. Coffee, "Fear of the U.S. Market," The Nat'l L.J., Dec. 11, 2006.
4. Interim Report of the Committee on Capital Markets Regulation, Nov. 30, 2006.
5. *See* 15 U.S.C.A. § 78d.
6. Interim Report of the Committee on Capital Markets Regulation, p. 87.
7. Commission of the Regulation of U.S. Capital Markets in the 21st Century: Report and Recommendations (March 2007), available on the Commission website at www.CapitalMarketsCommission.com.
8. "EU Calls for Input on Auditor Liability Caps," Compliance Week (Feb. 6, 2007).
9. "EU Call for Opinions on Auditor Liability Caps," Compliance Week (April 2007).
10. "EU Commission to Offer Recommendations on Countries' Liability Caps for Audit Firms," Corporate Accountability (BNA Jan. 4, 2008).