

# Promises Made, Promises Kept: The Practical Implications of the Private Securities Litigation Reform Act of 1995

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## I. INTRODUCTION

The legislative history of the Private Securities Litigation Reform Act of 1995<sup>1</sup> (Reform Act) reads like Armageddon. To its opponents, the

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1. Private Securities Litigation Reform Act of 1995 (Reform Act), Pub. L. No. 104-67, 109 Stat. 737, 744 (1995)(codified as amended in scattered sections of 15 U.S.C.A.) (West Supp. 1996) (amending the Securities Act of 1933 (Securities Act), 15 U.S.C. §§ 77a-bbbb (1994 & West Supp. 1996) and the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. §§ 78a-ll (1994 & West Supp. 1996)).

Reform Act “was conceived in sin.”<sup>2</sup> Proponents countered that it was a necessary check on “lawyer’s greed.”<sup>3</sup> Notwithstanding the venom of the debate, the Reform Act cleared the House and the Senate with substantial bipartisan support.<sup>4</sup> President Clinton responded—literally in the eleventh hour—with a veto and his first substantive comment on the legislation.<sup>5</sup> Within days, both houses of Congress responded with more than enough votes to record the first override of this President’s veto.<sup>6</sup>

This Article looks beyond the political hyperbole to consider the practical implications of the Reform Act. While the primary purpose of the Reform Act is to revamp the process by which private claims are asserted under the federal securities laws, the implications of the legislation extend far beyond the litigation battlefields. There is little in the Reform Act’s legislative history to guide practitioners or their clients on how they should adapt to the legislation.

This paucity of guidance exists even with those aspects of the legislation that were bitterly contested throughout the legislative process. There was, for example, intense debate about the merits and form of a “safe harbor” for predictive statements.<sup>7</sup> Scant practical guidance emerged from this debate to direct companies on what form their disclosure should take to secure the protection of the safe harbor. Other important issues garnered even less attention in the congressional debates. For example, by imposing a statutory “whistle-blowing” obligation on public company auditors, the Reform Act has altered the relationship between companies and their accountants. There exists no concrete guidance on the day-to-day response to obligations that now are imposed by statute. Similarly, the congressional record reflects considerable concern about the litigation risks confronted by public company directors. Individual directors, however, cannot look to the statute or its legislative history for a blueprint on how their boards should respond to the legislation. Finally, the legislation mirrors a premise that shareholder class litigation would operate more effectively

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2. 141 CONG. REC. H14033 (daily ed. Dec. 6, 1995) (statement of Rep. John Dingell).

3. See *id.* at H14038 (statement of Rep. Christopher Cox).

4. The House of Representatives passed the legislation by a 320-102 vote. See *id.* at H14055. In the Senate, the margin was 65-30. See 141 CONG. REC. S17997 (daily ed. Dec. 5, 1995).

5. See Michael K. Frisby & Jeffrey Taylor, *Clinton Vetoes Bill Limiting Securities Suits*, WALL ST. J., Dec. 20, 1995, at A3.

6. Jeffrey Taylor, *House Votes to Override Veto of Securities-Suit Bill*, WALL ST. J., Dec. 21, 1995, at A3; Jeffrey Taylor, *Congress Sends Business a Christmas Gift*, WALL ST. J., Dec. 26, 1995, at A2.

7. See 141 CONG. REC. S1075-91 (daily ed. Jan. 18, 1995).

if it was supervised by institutional investors. Significant shareholders now must consider whether (and when) they elect to assume that cudgel.

Since the Reform Act targets shortcomings in the administration of private actions under the federal securities law, there is a temptation to focus singularly on the statute's effect on securities *litigation*. At any given moment, however, only a small subset of public companies are enmeshed in securities litigation. By contrast, the general counselling questions outlined above are relevant to all companies. This Article suggests approaches that can be taken in addressing these pragmatic concerns.

## II. THE REFORMS

The Reform Act's passage was driven by a familiar image. It began with an adverse announcement by a public company which produced a quick drop in the company's stock price. Within days—sometimes within hours—shareholder class action complaints were filed alleging that earlier statements of optimism by the company or its executives constituted securities fraud. Confronted with costly litigation and potentially crippling liability, the vast majority of defendants settled. Investors recouped a small percentage of their alleged damages and, directly or indirectly, paid both plaintiffs' counsel and the lawyers defending the company.<sup>8</sup>

While this litigation often was initiated with limited time for reflection, the suits were not inconsequential. The Supreme Court recently noted that litigation under the federal securities laws "presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."<sup>9</sup> In crafting legislative relief

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8. See *Securities Litigation Reform Proposals: Hearings on S.240 and S.667 Before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs*, 104th Cong., 1st Sess. 118 (1995) (statement of Senator Pete V. Domenici) (expressing his skepticism that attorneys could perform the necessary due diligence and research into the merits of such cases in 48 hours). See also Milt Policzer, *They've Cornered the Market; A Few Firms Dominate the Derivative-Suit Arena*, NAT'L L.J., Apr. 27, 1992, at 1 (study of 46 securities class actions reveals that one-quarter were filed within one day of an adverse announcement and another 30 were filed within one week).

9. *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 189 (1994) (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975)).

from abuses associated with litigation, the Reform Act introduces a panoply of reforms. Four are particularly noteworthy.

First, the legislation attempts to interpose a real "client" into securities class action litigation. One of the enduring criticisms of securities class action litigation was that figurehead plaintiffs routinely exercised no meaningful control over the litigation—or even the decision to file suit.<sup>10</sup> The legislative history reflects congressional acceptance of the commentary suggesting that this litigation would function more effectively if it was supervised by institutional shareholders.<sup>11</sup> As a result, in class action claims asserted under the Securities Act of 1933 (Securities Act)<sup>12</sup> or the Securities Exchange Act of 1934 (Exchange Act),<sup>13</sup> the court is now required to appoint as lead plaintiff "the member . . . of the purported plaintiff class that the court determines to be most capable of adequately representing the interests of class members . . .".<sup>14</sup> The legislation explicitly creates a rebuttable presumption that the most adequate representative will be the party that has "the largest financial interest in the relief sought by the class . . .".<sup>15</sup> The legislative history reflects the expectation that, under this system, "the plaintiff will choose counsel rather than, as is true today, counsel choosing the plaintiff," and having done so, the lead plaintiff would "exercise supervision and control of the lawyers for the class."<sup>16</sup>

Second, the legislation imposes "speed bumps" along what used to be a race to the courthouse to file securities class actions. Some of these changes introduced in the Reform Act are ministerial (such as the requirement that the lead plaintiff certify that he or she has reviewed the complaint and did not purchase the securities for the purpose of participating in private litigation).<sup>17</sup> Others, however, are substantive. For example, complaints alleging violations of the federal securities laws now are subject to demanding pleading standards. A plaintiff making

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10. For example, a William Weinberger has appeared in over 90 shareholder suits. Two years after Weinberger's death in 1991, Cipher Data Corporation was still battling the notorious plaintiff, Jack Sweeney, *Busy Plaintiffs Keep Silicon Valley on Edge*, COMPUTER RESELLER NEWS, Nov. 28, 1994, at 1.

11. H.R. CONF. REP. NO. 369, 104th Cong., 1st Sess. 34 (1995) [hereinafter CONFERENCE REPORT] (citing Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053 (1995)).

12. 15 U.S.C. § 77aa-bbbb (1994 & West Supp. 1996).

13. 15 U.S.C. § 78a-ll (1994 & West Supp. 1996).

14. 15 U.S.C.A. § 78-u (West Supp. 1996) (adding new § 21D(a)(3)(B)(i) to the Exchange Act).

15. *Id.* (adding new § 21D(a)(3)(b)(iii) to the Exchange Act).

16. CONFERENCE REPORT, *supra* note 11, at 32, 35.

17. 15 U.S.C.A. § 78u-4 (West Supp. 1996) (adding new § 21D(a)(2)(A)(ii) to the Exchange Act).

allegations of fraudulent disclosure violations must specify (1) each statement alleged to be misleading, (2) the reasons the statement is misleading, and (3) to the extent that an allegation is made on "information and belief," the complaint must detail with particularity all the facts on which that belief is formed.<sup>18</sup> Moreover, the Reform Act also requires a plaintiff to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."<sup>19</sup>

Third, the legislation seeks to shelter the disclosure of "soft" or forward-looking information. Predictive statements are the grist of much securities litigation. This threat of securities litigation chilled the flow of information.<sup>20</sup> With the Reform Act, Congress has tried to mitigate the litigation risk and foster the disclosure of forward-looking information.

Safe harbors incorporated into new section 27A of the Securities Act and section 21E of the Exchange Act provide a measure of protection for predictive statements. A forward-looking statement is defined in the safe harbor provisions to include projections (for example, of revenues, earnings, or losses), "plans and objectives of management for future operations," and statements of future economic performance (including analyses mandated by SEC filing requirements).<sup>21</sup> Typically, these statements are isolated in shareholder litigation if any prove to be less than perfectly prescient. Material forward-looking statements will be shielded by the safe harbor provided that (1) they are identified as such, and (2) they are "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."<sup>22</sup> Even in the absence of cautionary language, a plaintiff bears the burden of proving that the statement was made with "actual knowledge" that it was false or misleading.<sup>23</sup>

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18. *Id.* (adding new § 21D(b)(1) to the Exchange Act).

19. *Id.* (adding new § 21D(b)(2) to the Exchange Act).

20. During the hearings on the Reform Act, James F. Morgan of the National Venture Capital Association testified that over two-thirds of venture capital firms were reluctant to discuss their performance with analysts or the public because of the threat of litigation. S. REP. NO. 98, 104th Cong., 1st Sess. 16 (1995).

21. 15 U.S.C.A. § 78u-5 (West Supp. 1996) (adding new § 21E(i)(1)(A)-(C) to the Exchange Act).

22. *Id.* (adding new § 21E(c)(1)(A)(i) to the Exchange Act).

23. *Id.* (adding new § 21E(c)(1)(B) to the Exchange Act).

While the safe harbor is a welcome change in the law, it is pock-marked with exceptions. For example, it does not extend to forward-looking statements made in connection with initial public offerings, tender offers, section 13(d) disclosures, going private transactions, roll-up transactions, or financial statements. Similarly, issuers excluded from the safe harbor's protection include partnerships, limited liability companies, investment companies, issuers of penny stock, or companies that, in the prior three years, were the subject of judicial or administrative decrees prohibiting further violations of the antifraud provisions, whether entered after litigation, or upon consent.<sup>24</sup>

Finally, the Reform Act limits the exposure of so-called "deep pocket" defendants. The Reform Act's legislative history identified as "[o]ne of the most manifestly unfair aspects of the current system of [private] securities litigation," the application of joint and several liability principles under which "a single defendant who has been found to be 1% liable may be forced to pay 100% of the damages in the case."<sup>25</sup> The Reform Act generally limits joint and several liability for violations of the Exchange Act to defendants who participated "knowingly" in the misconduct.<sup>26</sup> The exposure of most other defendants is limited to their proportionate fault.<sup>27</sup>

This relief was achieved through an important tradeoff. The Reform Act imposes upon independent outside auditors, under new section 10A of the Exchange Act, the obligation to employ audit procedures designed to detect illegal conduct by their clients. Auditors must inform management of any illegal act—defined broadly to include "an act or omission that violates any law, or any rule having the force of law"—unless the act is "clearly inconsequential."<sup>28</sup> If management fails to respond "appropriate[ly]," if the illegal conduct will have a material impact on the company's financial statements, and if failure to take corrective action will lead to a non-standard audit report or the auditor's resignation, then the auditors must submit a report to the board.<sup>29</sup> The board, in turn, is obligated to turn the report over to the

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24. *Id.* (adding new § 21E(b) to the Exchange Act).

25. CONFERENCE REPORT, *supra* note 11, at 37.

26. 15 U.S.C.A. § 78u-4 (West Supp. 1996) (adding new § 21D(g)(2)(A) to the Exchange Act).

27. The Reform Act preserves joint and several liability for damages owed to a plaintiff with a net worth below \$200,000 when that plaintiff's damages exceed 10% of the plaintiff's net worth. Solvent defendants assume proportionate responsibility for the "uncollectible share" up to 50% of their proportionate damages. *Id.* (adding new § 21D(g)(4) to the Exchange Act).

28. *Id.* § 78j-1 (adding new § 10A(f) to the Exchange Act).

29. *Id.* (adding new § 10A(b)(2)(A)-(C) to the Exchange Act).

Securities Exchange Commission (SEC or Commission) and, failing that, the auditor must make disclosure to the SEC and resign the engagement.<sup>30</sup>

### III. DISCLOSURE PRACTICES AFTER THE REFORM ACT

The statutory safe harbor formulated by Congress in the Reform Act has added to the importance of the process by which a company's disclosure documents are crafted. If counsel has crafted disclosure that highlights the important risk factors that relate to predictive statements, such disclosure can facilitate the prompt dismissal of actions based on these statements. The utility of the safe harbor will be enhanced if federal courts implement the legislative intent to limit significantly any discovery while a motion to dismiss is pending.<sup>31</sup> Accordingly, companies should consider four principles when preparing their post-Reform Act disclosure.

#### *A. Disclosure of Forward-Looking Information Should Be Tailored to Meet the Requirements of the Statutory Safe Harbor for Such Statements*

There exists no clear delineation of what constitutes a "meaningful cautionary statement."<sup>32</sup> For purposes of the safe harbor, the legislative history notes that companies relying on the safe harbor must "identify important factors that could cause results to differ materially—but not

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30. *Id.* (adding new § 10A(b)(3) to the Exchange Act).

31. As one of the modifications introduced by the Reform Act, § 21D(b)(3)(B) of the Exchange Act now requires that in any private action, "all discovery and other proceedings shall be stayed during the pending of any motion to dismiss, unless the court finds . . . that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party." *Id.* § 78u-4 (adding new § 21D(b)(3)(B) to the Exchange Act). The first reported decision addressing this provision applied the limitation strictly. The court held that a plaintiff in an injunctive action alleging violations of section 13(d) of the Exchange Act failed to meet the statutory threshold of undue prejudice when the defendant's motion to dismiss was deemed to preclude the expedited discovery sought by the plaintiff. *See Medical Imaging Ctrs. of America, Inc. v. Lichenstein*, 917 F. Supp. 717, 721-22 (S.D. Cal. 1996).

32. *See, e.g.*, Margaret A. Jacobs & Edward Felsenthal, *Securities Bill May Prompt New Litigation*, WALL ST. J., Dec. 13, 1995, at B2 (while "there is no term more ambiguous than a 'meaningful relationship,'". . . "the phrase 'meaningful cautionary statement' is a close second.") (quoting the statement of Professor John C. Coffee of Columbia Law School).

all factors.”<sup>33</sup> Specifically, the “[f]ailure to include the particular factor that ultimately causes the forward-looking statement not to come true will not mean that the statement is not protected by the safe harbor.”<sup>34</sup> While the legislative history is clear on this point, it provides little direction to counsel who must identify important factors that could cause actual results to differ.

The best guidance may exist not in the legislative history but in a growing body of case law applying the “bespeaks caution” doctrine. This judicially-created doctrine articulates the common sense proposition that forward-looking statements are not fraudulent when they are accompanied by appropriate cautionary language. From its germination in a footnote to a 1977 Eighth Circuit case,<sup>35</sup> the doctrine has been adopted, in one form or another, by the First, Second, Third, Fifth, Sixth, Ninth, and Eleventh circuits.<sup>36</sup> The Reform Act’s legislative history notes that the safe harbor “is based on aspects of SEC Rule 175 and the judicial[ly] created ‘bespeaks caution’ doctrine.”<sup>37</sup>

In each case, the bespeaks caution analysis turns on a fact-intensive analysis. Nonetheless, these cases and the Reform Act’s legislative history suggest several guidelines for crafting meaningful cautionary statements in the wake of the Reform Act.

### *1. The Cautionary Language Must Be Tailored to the Forward-Looking Information*

The Reform Act’s legislative history cautions that “boilerplate warnings will not suffice as meaningful cautionary statements.”<sup>38</sup> Bespeaks caution cases have emphasized that warnings must be “substantive and tailored to the specific future projections, estimates or

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33. CONFERENCE REPORT, *supra* note 11, at 44.

34. *Id.*

35. Polin v. Conductron Corp., 552 F.2d 797, 806 n.28 (8th Cir. 1977) (“The terms thus employed bespeak caution in outlook and fall far short of the assurances required for a finding of falsity and fraud.”). See also Moorhead v. Merrill Lynch, 949 F.2d 243 (8th Cir. 1991).

36. See, e.g., Romani v. Shearson Lehman Hutton, 929 F.2d 875 (1st Cir. 1991); I. Meyer Pincus & Assoc. v. Oppenheimer & Co., 936 F.2d 759 (2d Cir. 1991); *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357 (3d Cir. 1993), cert. denied, 114 S. Ct. 1219 (1994); Rubinstein v. Collins, 20 F.3d 160 (5th Cir. 1994); Sinay v. Lamson & Sessions Co., 948 F.2d 1037 (6th Cir. 1991); *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407 (9th Cir. 1994), cert. denied, 116 S. Ct. 277 (1995); Saltzberg v. TM Sterling/Austin Assoc., Ltd., 45 F.3d 399 (11th Cir. 1995).

37. CONFERENCE REPORT, *supra* note 11, at 43.

38. *Id.*

opinions" that are coming under scrutiny.<sup>39</sup> These cases suggest, for example, that a company touting a new product should disclose information about the competitive forces that would impact the product's success.<sup>40</sup> Similarly, it is prudent to temper predictions of earnings growth with a cautionary note about the adverse impact that would inure from the loss of a significant customer.<sup>41</sup> In the same vein, companies have benefited from warnings of pending legislative action that, should it materialize, would limit the company's capacity to operate at management's expectations.<sup>42</sup>

## 2. *Risk Disclosure Should Convey the Magnitude of the Risk—Not Just That It Exists*

When defendants are unsuccessful in their efforts to invoke the bespeaks caution doctrine, courts often emphasize that the disclosure did not present a complete picture of the risk involved. A cautionary note that results would hinge on the successful integration of an acquired company may be insufficient if it fails to outline what integration problems are confronted.<sup>43</sup> Similarly, a pharmaceutical company predicting success for a new product should do more than simply note that governmental approval is beyond its control. Instead, the disclosure should, to the extent possible, enable investors to assess any potential impediments to approval.<sup>44</sup> If the consummation of a proposed

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39. *Trump*, 7 F.3d at 371-72. See also *Saltzberg*, 45 F.3d at 400 ("The cautionary language used in the private placement memorandum in this case was . . . explicit, repetitive and linked to the projections about which plaintiffs complain.").

40. See, e.g., *In re Quarterdeck Office Sys., Inc. Sec. Litig.*, 854 F. Supp. 1466, 1471 (C.D. Cal. 1994) (failure to disclose possible competitive impact of Microsoft Inc. products rendered immaterial by warnings about the competitive forces that the company's products were and would be facing).

41. See, e.g., *Schwartz v. Novo Industri A/S*, 658 F. Supp. 795, 798 (S.D.N.Y. 1987) (disclosure included warning that primary customer may not be purchaser from the issuer to the extent of its prior purchases).

42. See, e.g., *Pache v. Wallace*, [1994-95 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,643, at 91,968 (E.D. Pa. Mar. 20, 1995).

43. See, e.g., *Burstein v. Applied Extrusion Technologies, Inc.*, 150 F.R.D. 433, 443 (D. Mass. 1993).

44. *Marion Merrell Dow, Inc. Sec. Litig.*, [1993-94 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,776, at 97,763 (W.D. Mo. Oct. 4, 1993) (issuer did not disclose reports of deaths and cardiovascular incidents linked to product awaiting governmental approval).

transaction is linked closely to a particular type of financing, this aspect of the transaction should be disclosed.<sup>45</sup>

### 3. *The Warnings Should Be Prominent*

As a drafting principle, counsel should ensure that the language that bespeaks caution is easy to find and easy to understand. Courts are skeptical of claims that the cautionary language was mired in fine print when, in reality, it was set forth prominently in a "risk factors" section.<sup>46</sup> That is not to say that the statements must be placed side-by-side. In one case, cautionary language separated by twenty pages from optimistic statements was deemed sufficient because the warnings were cross-referenced.<sup>47</sup>

### 4. *If the Forward-Looking Statement is Based on Certain Assumptions, Those Assumptions Should Be Disclosed*

The safe harbor's definition of a forward-looking statement includes "any statement of the assumptions underlying a projection or outline of management's plans."<sup>48</sup> The bespeaks caution case law suggests that companies should outline the basis on which they are making predictions. For example, if an earnings prediction contemplates an improving economy or increased tourism, such assumptions should be disclosed.<sup>49</sup> Similarly, if projections are based on assumptions specific to the company, those assumptions should be discussed whenever possible.<sup>50</sup> Some issuers have addressed this issue not only by discussing the

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45. *Peregrine Options Inc. v. Farley*, [1994-95 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,313, at 90,181 (N.D. Ill. Mar. 29, 1994) (noting the importance of high-yield debt financing).

46. *In re Worlds of Wonder Sec. Litig.*, 814 F. Supp. 850, 860 (N.D. Cal. 1993) (risk factors section "is not buried beneath other, more optimistic language. On the contrary, it appears as the first major subsection of the document"), *aff'd in relevant part*, 35 F.3d 1407 (9th Cir. 1994).

47. *I. Meyer Pincus & Assoc., P.C. v. Oppenheimer & Co., Inc.*, 936 F.2d 759, 763 (2d Cir. 1991).

48. 15 U.S.C.A. § 77z-2 (West Supp. 1996) (adding new § 27A(i)(1)(D) to the Securities Act).

49. See, e.g., *Furman v. Sherwood*, 833 F. Supp. 408, 415 (S.D.N.Y. 1993) (optimistic statements about defendant's ferry business were "clearly predicated" on an economic upturn in Britain and increased demand due to EuroDisney and other attractions).

50. See, e.g., *Schwartz v. Michaels*, [1992-93 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,920, at 93,840-41 (S.D.N.Y. July 22, 1992) (prospectus warned that financial projections were based on hypothetical assumptions with no guarantee that they would materialize).

assumptions but also by conceding that they may not be the most plausible assumptions.<sup>51</sup>

Each company must develop a methodology to ensure that the realities of the marketplace are being reflected in its disclosure documents. One litmus test would be to ensure that at least one nonlawyer who is familiar with the company's business environment reviews the risk disclosure to ensure that it addresses the risks that he or she thinks about on a regular basis.

### *B. Companies Also Should "Bespeak Caution" in Their Oral Communications*

An important contribution of the Reform Act is that it extends the protection of the safe harbor to oral forward-looking statements. The safe harbor extends to forward-looking oral statements if they are identified as such and if there is a cautionary statement that actual results might differ. The safe harbor does not require the speaker to identify important factors that could undermine predictions; it affords the speaker the opportunity to refer to a "readily available written document" that outlines the risks in greater detail.<sup>52</sup>

This innovation is important because some companies address forward-looking information in analyst conference calls and other presentations.<sup>53</sup> This information often is communicated throughout the marketplace and becomes part of the mix of information relating to the issuer. Although the safe harbor reflects emerging trends in the case law,<sup>54</sup> senior managers are well advised to address the most pertinent risk factors in any public discussion of projections or other forward-looking information. Recent cases from the Fourth and Sixth Circuits have extended the bespeaks caution doctrine to oral communications when appropriate safeguards were taken.<sup>55</sup> Although the law now

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51. See *Kushner v. DBG Property Investors, Inc.*, 793. F. Supp. 1161, 1175 (S.D.N.Y. 1992) (The prospectus warned that projections "are an illustration of financial results based on assumptions which are not necessarily the most likely.").

52. See 15 U.S.C.A. § 77z-2 (West Supp. 1996) (adding new § 27A(c)(2)(B)(i) to the Securities Act).

53. See, e.g., Randall Smith, *Conference Calls to Big Investors Often Leave Little Guys Hung Up*, WALL ST. J., June 21, 1995, at C1.

54. Brown v. E.F. Hutton Group, 991 F.2d 1020 (2d Cir. 1993).

55. See, e.g., Sinay v. Lamson & Sessions Co., 948 F.2d 1037, 1039-40 (6th Cir. 1991) (statement by defendant company's chairman that he "does not quarrel" with

allows the spokesperson to refer an audience to the risk factors section in a prospectus, companies should consider a practice of addressing important risk considerations any time that forward-looking information is discussed, to the extent that it is practical.

### *C. Counsel Should Create a Record Reflecting the Resolution of Difficult Disclosure Issues*

At some point, every company faces the difficult question of whether a particular disclosure should be made and, if so, in what way. There is an advantage to companies that ensure that the record reflects a reasoned deliberation prior to the disclosure.

This advice is particularly applicable to forward-looking statements. The second prong of the statutory safe harbor requires plaintiffs to demonstrate that statements were made with “actual knowledge” that they were “false or misleading.”<sup>56</sup> The safe harbor suggests that, notwithstanding the discovery stay imposed upon motions to dismiss, “discovery that is specifically directed to the applicability of the exemption” may be allowed. While the legislative history is clear that discovery should be limited,<sup>57</sup> courts will be reluctant to dismiss, without some inquiry, claims that companies and their executives lied to their investors. A contemporaneous record that the disclosure was reached after a reasoned consideration will make it more difficult to sustain such allegations. This drill will pay dividends beyond the realm of forward-looking statements because when they make allegations of

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analyst earnings estimates was tempered by statements that the market was experiencing a slowdown and there might be lower demand due to higher interest rates); *Herman v. Legent Corp.*, [1994-95 Transfer Binder] Fed. Sec. L. Rep. ¶ 98,650, at 92,007 (4th Cir. 1995) (holding that a CEO’s comments in an analyst conference call are not actionable when accompanied with an acknowledgment that the company had difficulty in forecasting earnings).

56. 15 U.S.C.A. § 78u-5 (West Supp. 1996) (adding new § 21E(c)(1)(B) to the Exchange Act). The provision provides that if the statement is made by a natural person, plaintiffs must establish that the statement was made “with actual knowledge that the statement was false or misleading . . . .” *Id.* (adding new § 21E(c)(1)(B)(i) to the Exchange Act). If the statement is made by a business entity, plaintiffs must allege that the statement was approved by an “executive officer . . . with actual knowledge by that officer that the statement was false or misleading.” *Id.* (adding new § 21E(c)(1)(B)(ii)(I)-(II) to the Exchange Act).

57. See, e.g., CONFERENCE REPORT, *supra* note 11, at 44 (“The Conference Committee specifies that the cautionary statements identify ‘important’ factors to provide guidance to issuers and not to provide an opportunity for plaintiff[s’] counsel to conduct discovery on what factors were known to the issuer at the time the forward-looking statement was made.”).

securities fraud, both private litigants and the SEC must demonstrate that the defendant acted with *scienter*.<sup>58</sup>

*D. It May Be Prudent to Consider Updating Disclosures—Even in the Absence of an Affirmative Obligation to Do So*

The legislation's drafters took some pains to underscore that "nothing" in the safe harbor "shall impose upon any person a duty to update a forward-looking statement."<sup>59</sup> In doing so, Congress sidestepped an issue which has befuddled federal courts for years. To date, several circuits have offered uniquely ambiguous statements that certain, precise forward-looking statements may require further disclosure when they are rendered untrue by subsequent events.<sup>60</sup> The Seventh Circuit recently rejected this approach, noting that "the securities laws typically do not act as a Monday Morning Quarterback."<sup>61</sup>

Regardless of what requirements are imposed as a matter of law, it often will be prudent to consider updating forward-looking statements. This will be particularly important if issuers take advantage of the safe harbor to add more of their own prognostications to the mix of information. Several practical considerations will make updates appropriate in some circumstances. The first is the need to maintain credibility in the marketplace. An investor relations program will suffer if stale forward-looking statements are allowed to persist in the marketplace. Second, the longer that incorrect statements remain unchanged, the more likely the stock will sustain a substantial price correction and, as such, create the potential for shareholder litigation. Finally, it takes only a deft keyboard stroke to allege that a duty to update was in fact a duty to *correct*. Courts are less ambivalent about the duty to correct statements which turn out to have been false when made.<sup>62</sup>

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58. See *Aaron v. SEC*, 446 U.S. 680, 691 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1975).

59. See 15 U.S.C.A. § 78u-5 (West Supp. 1996) (adding new § 21E(d) to the Exchange Act). The legislative history included merely a single sentence reiterating the statutory standard. CONFERENCE REPORT,*supra* note 11, at 46.

60. See, e.g., *In re Time Warner Sec. Litig.*, 9 F.3d 259, 267 (2d Cir. 1993).

61. *Stransky v. Cummins Engine Co., Inc.*, 51 F.3d 1329, 1332 (7th Cir. 1995).

62. See, e.g., *Backman v. Polaroid Corp.*, 910 F.2d 10, 16-17 (1st Cir. 1990) (en banc) ("Obviously, if a disclosure is in fact misleading when made, and the speaker thereafter learns of this, there is a duty to correct it.").

## IV. THE REFORM ACT AND THE AUDIT PROCESS

### A. Background: Statutory Audit Requirements

Accounting firms were the Reform Act's earliest and strongest advocates reflecting years of harsh experience as "deep-pocket" defendants in private securities litigation. Liventhol & Horwath, once the nation's seventh largest accounting firm, declared bankruptcy in 1990, due to its litigation exposure.<sup>63</sup> While fears expressed by the American Institute of Certified Public Accountants' (AICPA) Public Oversight Board that other large accounting firms might follow suit did not materialize,<sup>64</sup> the "Big Six" firms spent over fourteen percent of their domestic accounting and audit revenues in 1992 on legal matters.<sup>65</sup> The need to curtail this litigation explosion was palpable.

By curbing litigation abuses (and, in particular, by replacing joint and several liability with proportionate liability when accounting firms typically are sued), the Reform Act should substantially reduce the profession's litigation costs. The "price" of this reform, however, is high: New Exchange Act section 10A requires accountants to employ audit procedures designed to detect illegal acts by their clients and to report to corporate boards and, in some cases, directly to the SEC, if a client fails to take "appropriate" remedial action to address auditor concerns.<sup>66</sup>

New section 10A codifies existing auditing standards by requiring auditors to design and employ audit procedures to permit the detection of illegal acts by their clients.<sup>67</sup> But, it also fundamentally alters the

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63. See Alison L. Cowan, *Bankruptcy Filing by Liventhol*, N.Y. TIMES, Nov. 22, 1990, at D1.

64. See *Private Litigation Under the Federal Securities Laws: Hearings Before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs*, 103d Cong. 302 (1993) (statement of A.A. Sommer, Jr.).

65. See *Private Securities Litigation Reform Act of 1995*, S. REP. NO. 98, 104th Cong., 1st Sess. 21 (1995).

66. 15 U.S.C.A. § 78j-1 (West Supp. 1996) (adding new § 10A(b)(3) to the Exchange Act). Similar legislation attempting to impose new duties and responsibilities upon auditors had been introduced in Congress on numerous occasions since the mid-1980s by then-Rep. (now Sen.) Ron Wyden (D-OR). See, e.g., The Financial Fraud Detection and Disclosure Act, H.R. 4313, 102d Cong., 2d Sess. (1992); The Financial Institutions Safety and Consumer Choice Act of 1991, H.R. 6, 102d Cong., 1st Sess. (1991); The Financial Fraud Detection and Disclosure Act, H.R. 5439, 99th Cong., 2d Sess. (1986).

67. New § 10A(a) requires that each audit of a public company by an independent public accountant shall include:

(1) procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of

relationship between public companies and their auditors by requiring auditors to take specific steps, if they learn during the course of an audit that a client *may* have committed an "illegal act," a term defined broadly to include "an act or omission that violates *any* law, or *any* rule or regulation having the force of law."<sup>68</sup> In such circumstances, *and regardless of the perceived impact of the illegal act on the client's financial statements*, the auditor must (1) determine whether it is likely that an illegal act has occurred, (2) if so, determine the possible effect on the client's financial statements, including "*any* contingent monetary effects, such as fines, penalties, and damages", and (3) as soon as practicable, inform management of the illegal acts and assure that the client's audit committee is also adequately informed with respect to such acts, unless the illegal act is "clearly inconsequential."<sup>69</sup>

Moreover, the Reform Act imposes reporting obligations *not currently required or contemplated under GAAS*, if management fails to respond "*appropriate[ly]*" upon learning of significant illegal activities. Auditors must report to the board of directors if they believe that (1) an illegal act will have a material effect on an issuer's financial statements, (2) senior management has not taken "*timely and appropriate remedial actions*" with respect to the illegal act, and (3) failure to take remedial action will result in the issuance of a non-standard audit report or the auditor's

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financial statement amounts;

- (2) procedures designed to identify related-party transactions that are material to the financial statements or otherwise require disclosure therein; and
- (3) an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year.

15 U.S.C.A. § 78j-1 (West Supp. 1996) (adding new § 10A(a)(1)-(3) to the Exchange Act).

Auditors of public companies are already required to perform such procedures under generally accepted auditing standards (GAAS). See CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards, AU §§ 316 (The Auditors Responsibility to Detect and Report Errors and Parties), 317 (Illegal Acts by Clients), 334 (Related Parties), and 341 (The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern) (Am. Inst. of Certified Pub. Accountants 1991). Section 10A, however, provides that these procedures "*may be modified or supplemented from time to time by the Commission.*" 15 U.S.C.A. § 78j-1 (West Supp. 1996) (adding new § 10A(f) to the Exchange Act)(emphasis added).

68. *Id.* § 78j-1 (adding new § 10A(a) to the Exchange Act)(emphasis added).

69. *Id.* (adding new § 10A(b)(1) to the Exchange Act). New section 10A directs auditors to discharge these responsibilities in accordance with GAAS, but again states that these standards may be "*modified or supplemented from time to time by the Commission.*" *Id.* (emphasis added).

resignation from the audit engagement.<sup>70</sup> Once auditors report to the board that appropriate remedial actions have not been taken, an issuer must inform the SEC of the auditor's conclusions within *one business day* of receiving the accountants' report. If the issuer fails to do so, the reporting duty passes to the auditor, who must notify the SEC *the following day*. To encourage and enforce these reporting obligations, section 10A(c) precludes *private* auditor liability based on any finding, conclusion, or statement expressed in a report to a company's board or the SEC,<sup>71</sup> while section 10A(d) authorizes the SEC to impose civil penalties in cease-and-desist proceedings against auditors who "willfully"<sup>72</sup> violate these reporting obligations.<sup>73</sup> The significance of this aspect of legislation cannot be ignored.

#### *B. Implications for Auditor-Client Relationships*

Since these new accounting requirements will first apply to audits undertaken in early 1997,<sup>74</sup> companies and their auditors have an opportunity to review section 10A and plan ahead. There are certain

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70. *Id.* (adding new § 10A(b)(2) to the Exchange Act).

71. The legislative history of an earlier version of the Reform Act states that this provision is intended to ensure that accountants are not exposed to private litigation "based on the content of their direct reports to the Commission." See Financial Fraud Detection and Disclosure Act, H.R. REP. NO. 890, 102d Cong., 2d Sess. 15 (1992). Although the legislative history to the 1992 version of the Wyden bill states that this provision "is not intended to circumscribe in any way the existing rights of private individuals to sue accountants with respect to other matters, including with respect to any failure by the auditor to file such reports or any failure by the auditor to comply with GAAS," *id.* at 25, the statutory language is sufficiently broad to allow auditors to maintain that they are not liable in *any* private action in which the allegations pertain to matters disclosed or discussed in the auditor's report.

72. 15 U.S.C.A. § 78j-1 (West Supp. 1996) (adding new § 10A(d) to the Exchange Act). The SEC has construed the term "willful" under the Exchange Act to mean voluntary conduct, not knowledge that the voluntary conduct constitutes a violation of the law. *See, e.g.*, *In re The Whitehall Corp.*, 38 S.E.C. 259 (1958). Recent cases cast doubt on the validity of the Commission's interpretation, however, and instead suggest the need to apply a criminal intent standard. *See, e.g.*, *Cheek v. United States*, 498 U.S. 192, 201 (1991) (holding, in a criminal prosecution for failure to file a tax return, that "the standard for the statutory willfulness requirement is the 'voluntary, intentional violation of a known legal duty.'").

73. The amount of the civil penalty in any such proceeding would be governed by the standards set forth in §21B of the Exchange Act. 15 U.S.C. § 78u-2(b)(2) (1994). Under § 21B(b)(2) the maximum penalty for each violation that involves deliberate or reckless disregard of a regulatory requirement is \$50,000 for a natural person or \$250,000 for any other person.

74. The Reform Act's requirements apply to each annual report for any period beginning on or after January 1, 1996 with respect to any registrant required to file quarterly financial data with the SEC, and for any period beginning on or after January 1, 1997 with respect to any other registrant. *See* 15 U.S.C.A. § 78j-1 (West Supp. 1996) (adding new § 10A(b) to the Exchange Act).

steps public companies and their auditors could consider to satisfy the Reform Act's new requirements.

### *1. Management Should Review, Enhance, and Regularize Its Lines of Communication With Company Auditors*

Public companies already need continuous and appropriate interaction with outside auditors, including periodic meetings, communications in connection with ongoing litigation or other significant accounting-related issues, discussions preparatory to the annual audit, and a thorough review of the annual audit. The Reform Act increases exponentially the need for effective lines of communication; no company would want to be the subject of a section 10A report, which could leave a company vulnerable to significant stock price fluctuations, serious adverse publicity, and potentially ruinous attention from various governmental quarters. Companies and their auditors should make every effort to ensure that concerns are raised with the audit committee, and that appropriate remedial steps are being taken before such concerns are reported to the SEC.<sup>75</sup>

Beyond these efforts, there are a number of additional steps that public company managements may want to consider.

(a) Senior management should develop a regimen of working closely with auditors to learn of, investigate, and respond to, any auditor concerns about, or suspicions of, illegal conduct. In essence, management must be proactive in dealing with the outside auditors. By the time issues are brought to management's attention by the auditors, it already may be too late to effect a meaningful response and obviate any need for a section 10A report.

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75. Currently, a Form 8-K disclosing a change in a company's auditors generally results in a review by the SEC's Division of Corporation Finance. See Amendments to Regulation S-K Regarding Changes in Accountants, Financial Reporting Release No. 34, 7 Fed. Sec. L. Rep. (CCH) ¶ 72,434, at 62,128 n.5 (Mar. 8, 1989) (noting that all Forms 8-K disclosing a change in auditors are reviewed by the Division of Corporation Finance and that "[t]his review *may* result in a referral to the Commission's Division of Enforcement, examination of the [Registrant's] current or next financial statements on a high priority basis, or disposition according to the routine comment process") (emphasis added). A section 10A report disclosing an auditor's conclusion that management has failed to take appropriate remedial actions after being apprised of illegal acts, however, almost certainly *will* trigger an immediate inquiry by the Enforcement Division.

(b) At least one member of senior management should be designated as the contact person to whom auditors may immediately report any suspected illegal acts. Centralizing the function of interaction with the outside auditors in one or two senior managers is likely to ensure that any and all reports of possible illegal acts are actually communicated from the auditors to management, and then appropriately evaluated by management. Obvious candidates for these roles are the Chief Financial Officer and the Chief Legal Officer.

(c) Any and all indications of possible illegal conduct should be dealt with carefully and effectively, whether brought to management's attention by the outside auditors or otherwise. It probably does not bear too much emphasis to note that indications of illegality from any source should be treated with equal dignity. Nothing could be worse than an indication that problems identified by the auditor had been raised previously, but that management had been inattentive to those concerns. To the extent management can document its responsiveness to indications of potential illegality, this record will go a long way toward meeting the statutory judgment thrust upon auditors to be satisfied that management responds appropriately to indications of illegal acts. Particularly with respect to information brought to management's attention by outside auditors, indications of auditor concern should be logged, and a discussion should ensue with corporate counsel, to ascertain whether any action by the management team may be necessary in light of the information reported by the auditors.

(d) Management's determinations on how to respond (or a determination not to respond) to indications of illegal acts should be passed by the auditors, and the auditors' acquiescence in that resolution should be recorded in some permanent form. To the extent decisions are made either to take action, or not to take action, these should be documented in writing. Particularly where possible illegal acts have been identified by the auditors, management should be able to demonstrate at a later point in time that it alerted the auditors to the precise response management contemplated, and the auditors expressed no discomfort with that approach. Where management rejects suggestions by the auditors, the reasons for the rejection should be recorded, supported, and made known to the auditors. A close working relationship between management and a company's auditors is critical to allay any concerns on the part of the auditors that management is prepared to, and will, respond appropriately and promptly to any concerns that may be brought to management's attention.

**2. Audit Committees Should Review and Revise Their Charters and Procedures to Ensure Their Ability to Respond Effectively to Significant Issues Brought to Their Attention by Management or the Company's Outside Auditors**

As noted, the Reform Act imposes a heavy burden on audit committees to ensure that senior management has taken "timely and appropriate remedial actions" upon being advised of illegal acts that could have a material effect on an issuer's financial statements.<sup>76</sup> Audit committees thus should consider a number of steps to make their involvement in the process as effective as possible.

(a) Audit committees should review their charters to ensure their ability to learn of, investigate and redress suspected illegal acts. Most audit committees have formal, written charters defining their responsibilities.<sup>77</sup> In light of the obligations placed on them under the Reform Act, audit committees should review their charters to ensure that appropriate mechanisms exist for the reporting of illegal acts to the committee by both management *and* the outside auditors. In order to ensure that appropriate remedial steps are taken when illegal acts are detected, the charter also should empower the committee to conduct investigations and to retain outside counsel and other experts, if necessary, to assist in such investigations.<sup>78</sup> Naturally, where improper conduct is believed to have occurred, the audit committee will need ample authority to redress any violations of law.

(b) Audit committees should establish an ongoing dialogue with their outside auditors, without the presence of management, and at the

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76. 15 U.S.C.A. § 78j-1 (West Supp. 1996) (adding new § 10A(b)(2)(B) to the Exchange Act).

77. The National Commission on Fraudulent Financial Reporting (the "Treadway Commission") recommended in 1987 that all public corporations develop a written charter setting forth the duties and responsibilities of the audit committee. See JAMES C. TREADWAY, JR., ET. AL., REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING 42 (1987). The Treadway Commission further advised that the audit committee charter should be reviewed periodically and amended as necessary. *Id.*

78. A company's full board of directors may also wish to consider whether to authorize the audit committee to *compel* senior management to take remedial measures, at least when it appears that management has failed to respond on a timely basis to concerns raised by the auditors.

initiative of both the committee and the auditors. An important byproduct of the Reform Act is to require audit committees to become more involved in the audit process itself. Among other things, the committee should make clear to the outside auditors that they are available for consultation with respect to any concerns that arise during an audit (or at other times), especially when illegal acts are suspected to have occurred. Even in the absence of a request for such consultations, the audit committee should initiate periodic meetings with the auditors to satisfy itself that the auditors are not aware of any conduct that raises questions under the Reform Act.

(c) Audit committees should insist upon an ongoing, periodic dialogue with senior management to ascertain whether there have been indications of potential illegal acts, and to satisfy themselves as to the efficacy of management's responses to such indications. Because of the dramatic consequences that can arise under the Reform Act in response to indications of potential illegal conduct, the audit committee (or any other committee of the board of directors that the board seeks to vest with this responsibility) should undertake a regular and periodic review of what problems have arisen and how management has dealt with those problems. Among other things, breaches of corporate codes of conduct, and the punishments meted out to redress those breaches, are matters the audit committee should review on a regular basis.

### *3. Companies Should Review Their Codes of Conduct to Enhance Their Ability to Satisfy Their Obligations Under the Reform Act*

Most public companies have adopted a written code of conduct.<sup>79</sup> Codes of conduct should indicate that violations by employees will result in significant penalties. By establishing a possible range of penalties, and reviewing the code of conduct with the auditors in advance, companies may find it easier, should a problem later arise, to satisfy their accountants that they have taken "appropriate remedial actions."<sup>80</sup>

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79. See Harvey L. Pitt & Karl A. Groskaufmanis, *Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct*, 78 GEO. L.J. 1559, 1601-02 (1990) (concluding, based on survey results, that "corporate codes have become standard corporate fare.").

80. While current auditing standards imply that auditors should consider whether management has taken appropriate remedial measures upon learning that illegal acts may have occurred, they provide limited guidance as to what types of measures are appropriate in different circumstances. See CODIFICATION OF ACCOUNTING STANDARDS, Statement on Auditing Standards No. 54, § 17 (Am. Inst. of Certified Pub. Accountants 1996) [hereinafter *Auditing Standards*] (noting that possible remedial actions include "disciplinary action against involved personnel, seeking restitution, adoption of

Codes of conduct should be reviewed periodically to ensure they reflect both case law developments and the latest experiences of the company in dealing with untoward conduct. Efforts also should be made to monitor the sanctions imposed under the code of conduct, in order to confirm that the sanctions provide an effective deterrent and are consistently applied.

*4. Companies Should Provide Employees With an Anonymous Internal Mechanism to Disclose Potential Illegal or Questionable Conduct Without Fear of Recrimination or Retribution*

The best source for indications of potentially wrongful conduct generally is the corporation itself. Employees tend to become aware when those above them, below them, or simply around them are breaking corporate policies or engaging in illegal conduct. Some companies shy away from providing a mechanism for employees to report illegal acts within the company. The reasons for this reluctance typically include concerns about privilege, the fear that employees will be encouraged to dredge up instances of potential wrongdoing they might otherwise be inclined to ignore, and the imposition on the company of the obligation to respond to each and every indication of potential illegality. While it cannot be gainsaid that such disadvantages, and perhaps others,<sup>81</sup> may flow from creating an anonymous reporting mechanism, the benefits seem to us to far outweigh the negatives, and the passage of the Reform Act seems to make this the most prudent course for companies to follow.

In the absence of an internal reporting mechanism, employees will have no confidence that they can bring their concerns about the conduct of others (and especially superiors) to anyone's attention. Experience teaches that when employees have no internal mechanism to report their concerns, these concerns will be reported outside the corporation when

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preventive or corrective company policies, and modifications of specific control procedures.").

81. If a mechanism exists for employees to report improper or questionable conduct on an anonymous basis, auditors may ask to review the records pertaining to this mechanism as part of their fulfillment of the duties imposed on them by the Reform Act. In addition, the existence of such a mechanism may attract attention from the government, private litigants, and other persons with axes to grind against a company's interests.

they cause discomfort. It is difficult to imagine any benign recipient of this type of information who may reside outside a corporation. Likely candidates include reporters, the government, corporate competitors, short sellers, and lawyers who specialize in defending so-called "whistle blowers." Try as we might, we cannot come up with any positive benefits associated with restricting the ability of employees to divulge questionable corporate conduct solely to these categories of recipients! Of course, if an internal mechanism is established, a company must ensure that there is appropriate follow-up to redress the issues reported. Again, it is important for the company not only to respond properly to such concerns, but also to be able to refer to a contemporaneous record of the actions taken by the company when potentially illegal or questionable conduct is brought to its attention.

*5. In Advance of an Annual Audit, Auditors and Audit Committees Should Consider and Agree Upon Appropriate Methodologies and Definitions for the Application of the Reform Act*

While the Reform Act is quite significant, it is not self-contained. Questions will arise concerning its interpretation and application. For a variety of reasons, *and in the absence of any SEC rulemaking to implement the Reform Act*, we believe that it is better to try to establish ground rules for some of the interpretive issues that are sure to arise, before those issues actually surface, when their resolution is not tainted by concerns about the specific conduct involved. Several possibilities for consideration exist.

(a) Audit committees and auditors should decide which issues are "clearly inconsequential." The Reform Act provides that an auditor need not communicate "clearly inconsequential" illegal acts to the audit committee,<sup>82</sup> but no definition of this critical term is supplied. Since no obvious consensus may exist as to what acts fall within this category, audit committees should establish a clear understanding with the auditors as to the types of acts that will not be brought to the audit committee's attention, in order to avoid later recriminations.

(b) Audit committees and auditors should attempt to reach agreement regarding the audit procedures to be employed to assist the auditors in fulfilling their obligation to seek indications of illegal conduct. While the conduct of an audit, in the final analysis, must be left to the auditors, public companies and their auditors both will benefit from a discussion

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82. 15 U.S.C.A. § 78j-1 (West Supp. 1996) (adding new § 10A(b)(1)(B) to the Exchange Act).

of any special audit procedures the auditors intend to employ to satisfy the Reform Act's requirements. In particular, companies that have internal reporting mechanisms or maintain adequate records of customer and employee complaints may find that their outside auditors seek access to these materials. Similarly, auditors may seek access to inside and outside counsel to assess just how significant indications of illegality actually are, and whether they have been dealt with effectively. A company's failure to provide access to these materials and sources may compel an auditor to deem itself incapable of concluding that management has handled indications of illegality appropriately and expeditiously. On the other hand, affording access to some of these materials or sources may constitute a waiver of the attorney-client and attorney work product protections. While there are no easy answers to these dilemmas, the best solution is for the audit committee and the auditors to discuss these problems candidly before an audit commences, not when a problem arises.

*6. Auditors Should Rethink Their Engagement Letters in  
Light of the Reform Act and Determine Whether They  
Have the Resources and Support of the Company Needed to  
Satisfy the Reform Act's Obligations*

The Reform Act imposes a number of significant obligations on outside auditors, including duties to structure the audit process in a way designed to detect illegal acts by clients, to determine whether it is likely that an illegal act took place, to assess the potential financial consequences of any illegal acts that are uncovered, and to evaluate whether management has responded appropriately to any such acts.<sup>83</sup> Given these requirements, auditors may wish to ensure that their retainer letters adequately take into account the various issues implicated by the Reform Act. In particular, the subjects that could be addressed include the following.

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83. Traditionally, the audit literature has disclaimed the ability of accountants to make such legal determinations. See *Auditing Standards*, *supra* note 80, at §§ 3 (stating that “[w]hether an act is, in fact, illegal is a determination that is normally beyond the auditor's professional competence.”) and 7 (providing that an audit conducted in accordance with GAAS “provides no assurance that illegal acts will be detected or that any contingent liabilities that may result will be disclosed.”).

(a) A delineation of any audit procedures specifically designed to assist the outside auditors in detecting whether client fraud has occurred. From a practical perspective, auditors should consider whether additional procedures are required, or whether procedures previously employed will suffice in the performance of their new statutory obligations. Whichever determination is made, it may be useful to indicate whether (and if so, what) additional procedures will be employed, and to obtain management's concurrence with the decisions made, as well as management's assurance that it is not aware of any specific circumstances that might warrant additional audit procedures, or any specific audit procedures that might be warranted in light of circumstances known to management.

(b) A contractual undertaking from management and the audit committee to provide whatever assistance and information may be appropriate to enable the auditors to fulfill their statutory obligations. This is an area where specificity may benefit companies and their management, and generalization may benefit the auditors. To the extent that management has prepared reports regarding illegal acts or sanctioned individuals for illegal acts, however, the auditors presumably will want to have some information about the types of illegal or improper acts that have been found by management or the audit committee during the preceding fiscal year. Customer complaints, governmental inquiries, anonymous reports, litigations instituted and threatened, and any internal analyses of industry-specific problems (whether or not they have materialized at the particular client company) are all subjects into which auditors may deem it appropriate to delve. At the present time, management is not required to identify all government inquiries, customer complaints or anonymous reports. Nor is it clear that auditors will be required to ascertain all of these items in order to satisfy their obligations under the Reform Act. But it will behoove both the auditors and management to consider whether any of this information is appropriate to provide to the auditors and, if so, in what format.

(c) Depending upon the circumstances, authority for the outside auditors to retain their own counsel and/or obtain access to inside corporate counsel.

In order to satisfy their statutory obligations, auditors may not only require outside counsel of their own, but also may seek access to damage calculations and liability assessments prepared by company lawyers. Any such request, of course, would raise significant issues as to the waiver of the corporate attorney-client privilege or attorney work product protections. Auditors and their clients should also determine which party will bear these expenses and may wish to document their decision in retainer or engagement letters.

(d) An agreed-upon resolution of how auditors should handle illegal acts detected outside an audit engagement. As noted, section 10A's reporting requirements are triggered only when an auditor becomes aware, "in the course of conducting an audit," that illegal acts may have occurred.<sup>84</sup> Accountants may learn of possible illegal acts, however, in contexts *outside* the annual audit (for example, when performing a quarterly review of a company's financial statements, or while providing consulting or other non-attest services). The SEC may take the position that an auditor's obligations upon learning of potential illegal acts outside an annual audit are similar to those that exist under new section 10A when such acts come to the auditor's attention during an audit engagement. In assessing their obligations outside the scope of an annual audit, however, auditors will be required to balance the SEC's likely position with the fact that, depending upon the circumstances, the safe harbor protections afforded under section 10A(c) may be unavailable if the auditor's report was *not* the result of information learned during an annual audit.<sup>85</sup> Public companies and their auditors should discuss whether such information will be handled in the same manner as suspicious facts learned *during* the annual audit, and may wish to note their understandings in the retainer letter.

(e) An express undertaking by management to advise the auditors when the SEC is notified of a section 10A report. Once the auditors issue a section 10A report, the company to whom that report is issued is obligated to notify the SEC of its receipt. In the event the company does not fulfill its obligation to report to the SEC, that duty falls upon the outside auditor. In order to justify the auditor's filing with the SEC, retainer agreements should make clear that the company has an obligation to notify the auditor immediately upon the filing of a section 10A report with the SEC, and that the failure to receive such notification within the next business day will constitute implicit authorization for the auditors to notify the Commission directly on their own.

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84. 15 U.S.C.A. § 78j-1 (West Supp. 1996) (adding new § 10A(b)(1) to the Exchange Act).

85. At least with respect to information learned during a review of quarterly financial information, auditors can argue that the safe harbor provisions limiting their liability should apply. See MARTIN A. MILLER & LARRY P. BAILEY, MILLER'S COMPREHENSIVE GAAS GUIDE § 13.13 (noting that "[i]n most instances, the review of interim financial information likely would be an extension of the audit engagement.").

### C. Implications for the Relationship Between the SEC and the Accounting Profession

The Reform Act also will have several effects upon the relationship between the SEC and the accounting profession.

#### 1. The SEC May Play a More Active Role in Defining GAAS, or Assume a More Active Role in Interpreting an Auditor's Fulfillment of the Responsibility to Investigate Illegal Acts

Section 10A requires auditors to perform designated audit procedures and assess the consequences of suspected illegal acts "in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the [SEC]."<sup>86</sup> The legislative history makes clear that Congress intended that "the SEC . . . continue its longstanding practice of looking to the private sector to set and to improve auditing standards."<sup>87</sup> Nevertheless, section 10A's clear authorization to the SEC to establish GAAS may render the Commission unable, or unwilling, to resist the temptation to issue new audit requirements.<sup>88</sup> Even if the SEC does not expressly exercise its authority under section 10A to *define* GAAS, the Reform Act provides the SEC with a new vehicle to articulate its *interpretations* of existing GAAS. In the past, the Commission has only rarely disciplined accountants based on their alleged failure under GAAS to detect and report illegal acts by clients.<sup>89</sup> In the future, however, the SEC may assert that noncompliance with such standards violates not only professional requirements, but also section 10A.

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86. 15 U.S.C.A. § 78j-1 (West Supp. 1996) (adding new § 10A(a) to the Exchange Act) (emphasis added).

87. See CONFERENCE REPORT, *supra* note 11, at 47-48. Indeed, since the Reform Act's enactment, the American Institute of Certified Public Accountants has proposed revisions to its current standards governing illegal acts by clients designed to enhance an auditor's responsibilities to detect such activities. See Lee Berton, *Auditors Face Stiffer Rules for Finding, Reporting Fraud at Client Companies*, WALL ST. J., Feb. 5, 1996, at A2.

88. See CONFERENCE REPORT, *supra* note 11, at 48 (noting that "[t]he SEC should act promptly [to modify or supplement GAAS] if required by the public interest or for the protection of investors.").

89. See, e.g., *In re Scott L. Jenson, C.P.A., Accounting and Auditing Enforcement Release*, No. 534, 56 SEC Docket 0474 (Mar. 22, 1994). In this Rule 2(e) proceeding, the SEC alleged that an auditor failed to comply with SAS No. 54 because he failed to determine whether a client's weaknesses in internal controls rose to such a level as to violate the accounting and internal controls provisions of the Foreign Corrupt Practices Act. The Commission stressed that Jenson neither consulted with counsel nor reported his concerns directly to the issuer's board of directors.

**2. *New Section 10A Requires Auditors to Make Managerial Judgments on Behalf of Their Clients and, as a Result, Should Require the SEC to Modify Some of Its Longstanding Positions on Auditor Independence***

The SEC often takes the position that an auditor cannot be independent with respect to a client if the auditor assumes functions similar to those customarily performed by management.<sup>90</sup> New section 10A, however, not only allows, but *requires* an auditor to determine whether a company has taken "timely and appropriate remedial actions" when illegal acts come to light.<sup>91</sup> The Reform Act thus imposes quasi-managerial responsibilities on auditors to assess the adequacy of a company's response, and implicitly recognizes that auditors can play an important role in developing and implementing remedial measures. Accordingly, section 10A should cause the Commission to revisit some of its historical biases against the rendering of certain non-attest services by accounting firms for their clients.

Audits determine whether a company's financial statements are presented fairly, in accordance with GAAP, not whether fraud *per se* occurred. This was true before the Reform Act, and it remains true today. The Reform Act, however, embraces and strengthens the need for auditors to employ specific procedures designed to uncover illegal acts that *could* have a material impact on client financial statements. Over time, the interplay between GAAS and new section 10A will be clarified. In the interim, companies and auditors should coordinate their efforts closely to ensure that illegal acts are promptly brought to the attention of management and the audit committee, and that appropriate remedial measures are identified and implemented.

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90. See, e.g., CODIFICATION OF FINANCIAL REPORTING POLICIES, § 602.02.d, 17 C.F.R. pt. 210 (Feb. 25, 1983).

91. 15 U.S.C.A. § 78j-1 (West Supp. 1996) (adding new § 10A(b)(2)(B) to the Exchange Act).

## V. THE CORPORATE BOARD

### A. Introduction

Litigation risk is an occupational hazard of service as a director on a corporate board. This is true in securities litigation even though "independent" corporate directors typically are not enmeshed in the mechanics of preparing the company's disclosure. The introduction of the Reform Act makes this an apt time for a corporate board to reassess the company's disclosure practices and the operation of its compliance program. This assessment does not occur in a vacuum. The Reform Act has become law at a time when directors are under increased scrutiny for their response to allegations of management misconduct. These pressures serve as an important backdrop to a discussion of how corporate boards should respond to the Reform Act.

### B. Director Accountability

The Reform Act's passage will not alter the fact that civil litigation is a constant risk for corporate directors. A recent survey of 300 directors of Fortune 500 companies found that nearly half had been sued in their capacity as outside directors.<sup>92</sup> The risk of litigation, however, is not the sole means of heightening directors' accountability. Regulators have taken additional steps to remind directors of their obligations. Thus, although independent directors rarely prepare disclosure statements, the SEC repeatedly has reinforced their shared responsibility for the final product.<sup>93</sup> And, in the SEC's first use of its enforcement powers to

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92. See Brian Cox, *Small-Firm Directors Have Biggest D & O Concern*, NAT'L UNDERWRITER PROP. & CASUALTY-RISK BENEFITS, Oct. 2, 1995, at 34 (discussing a Louis Harris & Associates Poll, *Outside Directors and the Risks They Face*).

Directors long have been acutely aware of the significant risks posed by private securities litigation to corporate boards and the companies they serve. Indeed, a recent survey found an increase in claims asserted against corporate directors involved allegations of improper disclosure under the federal securities laws. See Edward Felsenthal & Junda Yoo, *As Suits Against Officers Level Off, Disclosure Cases Rise*, WALL ST. J., Feb 17, 1993, at B10 (Wyatt Co. survey of 1342 companies found that 10% of claims in the previous nine years against directors and officers involved financial disclosure, an increase from 6% in the nine-year period ending 1990).

93. When the disclosure requirements for executive compensation were overhauled in 1992, the Commission's rules were framed to require that the report of the board's compensation committee appear under the *names* of the individual directors on the committee. See 17 C.F.R. § 229.402(k)(3)(1995). This requirement was crafted with deliberation; the proposal to require a report by the Board Compensation Committee

reinforce its longstanding efforts to foster more meaningful disclosure in the Management Discussion and Analysis section of public filings, the Commission's *Caterpillar* release noted that public companies have an obligation to make disclosure of material or highly significant information that has been underscored for the board.<sup>94</sup>

In this retributive decade of the 1990s,<sup>95</sup> when corporations can find longstanding senior managers suddenly suspected of egregious criminal wrongdoing by a very aggressive governmental cadre of prosecutors, the Commission has stressed that inaction can be a director's cardinal sin. In its December 1994 *Cooper Companies* release,<sup>96</sup> the Commission took the opportunity to send a message to other corporate boards in the form of a report under section 21(a) of the Exchange Act. The Commission emphasized that "directors have a significant responsibility and play a critical role in safeguarding the integrity of the company's public statements and the interests of investors when evidence of fraudulent conduct by corporate management comes to their attention."<sup>97</sup> The Commission's release noted that Cooper co-chairman Gary Singer and his brother, Steven Singer (Cooper's chief administrative officer), responded to government inquiries by invoking their Fifth Amendment privilege and declined to be interviewed by Cooper's counsel.<sup>98</sup> Nonetheless, their latitude in managing the company was not restricted by the Cooper board in any meaningful way. This, the Commission alleged, allowed Steven Singer to issue a press release in May 1992 indicating that Cooper was "unaware of any wrongdoing on

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"provoked the strongest comment of any of the proposals concerning executive compensation." Executive Compensation Disclosure Rule Amendments, Securities Act Release No. 6962, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,056, at 83,414, 83,431 (Oct. 16, 1992). See also Harvey L. Pitt et. al., *Proxy Reform: A New Era of SEC Activism*, INSIGHTS, Nov. 1992.

94. *In re Caterpillar, Inc.*, Securities Exchange Act of 1934 Release No. 30532, 51 SEC Docket 0197 (Apr. 14, 1992). For a detailed analysis of that release, see Harvey L. Pitt et al., *The SEC's New Preference for Prophecy*, *LEGAL TIMES*, July 6, 1992, at 28.

95. See, e.g., Harvey L. Pitt & Karl A. Groskaufmanis, *Mischief Afoot: The Need for Incentives to Control Corporate Criminal Conduct*, 71 B.U. L. REV. 447, 448-49 (1991).

96. See *In re Cooper Companies, Inc.*, [1994-95 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,472, at 86,061 (Dec. 12, 1994).

97. *Id.* at 86,062.

98. *Id.* at 86,063.

the part of its officers or its employees.”<sup>99</sup> The Commission found that statement misleading; by May 1992, the Company was aware that Gary Singer had engaged in a series of transactions between Cooper and Singer family accounts, which were concealed from the company and were under investigation, during which they had asserted their rights under the Fifth Amendment’s protection against self-incrimination.<sup>100</sup>

The SEC found that the Cooper board did too little, too late, in the face of this situation. “By failing to take immediate and decisive corrective action on these matters, the Cooper Board appeared to prefer management’s interest in keeping the facts secret over the investors’ interest in full, fair and accurate disclosure under the federal securities laws.”<sup>101</sup> Specifically, the Commission emphasized that the board made half-hearted efforts to restrict Singer’s activities once he was designated the target of a criminal inquiry. Throughout the months of the investigation, Singer maintained discretion over Cooper’s substantial portfolio of securities.<sup>102</sup> Even after being placed on administrative leave, Singer appeared at Cooper’s headquarters several times each week, met with officers regarding company business, and was able to place calls to brokers handling Cooper’s securities accounts.<sup>103</sup> The Commission stressed that the fiduciary obligations of the Cooper board were “particularly acute where potential violations of the federal securities laws involving self-dealing and fraud by management are called to the attention of the board of directors.”<sup>104</sup>

The SEC’s Enforcement Division is not the sole prod being felt by corporate boards. Last fall, Archer-Daniels-Midland Co. (ADM) was pelted with letters from public institutional investors lambasting the directors for their perceived inadequate response to federal inquiries about internal misconduct at the company involving alleged price collusion and off-the-books compensation for several executives. The California Public Employees Retirement System (CalPERS), for example, complained the ADM board was dominated by insiders.<sup>105</sup> Responding to such criticisms, ADM announced early this year that the

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99. *Id.* at 86,064.

100. *Id.*

101. *Id.* at 86,065.

102. *Id.* at 86,064 n.10.

103. *Id.* at 86,065.

104. *Id.* at 86,065.

105. Joann S. Lublin, *Archer-Daniels-Midland Is Drawing Fire From Some Institutional Holders*, WALL ST. J., Oct. 11, 1995, at B12. Similarly, New York City comptroller Alan G. Hevesi sent ADM Chairman and Chief Executive Officer Wayne Andreas a letter requesting that Mr. Andreas describe what board actions were being taken to ensure the board’s independence and to safeguard against unethical and illegal conduct. *Id.*

board unanimously had approved a series of recommendations made by a corporate governance committee to place outside directors in majority control of the board.<sup>106</sup> The committee, formed in the wake of the negative publicity, recommended that the board's size be reduced from seventeen members to between nine and fifteen members, with most of those members constituting outside directors. The reforms served to mute some—but not all—of the criticism directed at ADM's board.<sup>107</sup>

ADM's experience is not atypical of companies confronting allegations of misconduct by their personnel.<sup>108</sup> Indeed, the reform of the SEC's proxy rules has enhanced the capacity of institutional investors to amplify the influence afforded by their substantial equity positions.<sup>109</sup> New information technologies are accelerating the rate at which such liaisons among institutional investors can occur. For example, one shareholder-rights group has tapped into the Internet by staking out a site on the World Wide Web to distribute research on corporate governance, among other activities, and to facilitate "director lobbying" by forwarding messages to corporate directors from the public.<sup>110</sup> In this environment, once a company faces serious legal questions, both management and the board will be required to respond quickly.

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106. See Kurt Eichenwald, *Big Board Room Shift Will Bring in Outsiders*, N.Y. TIMES, Jan. 16, 1996, at D1; *Archer Daniels Midland Shuffles Board*, WASH. POST, Jan. 16, 1996, at D3.

107. While CalPERS General Counsel Richard Koppes reportedly called the committee's report "a quantum leap forward," the United Brotherhood of Carpenters noted that ADM's board was "catching up . . . These guys [at ADM] have gone from the Dark Ages to the Middle Ages." The union has indicated it intends to bring proposals before the shareholders at the next annual meeting suggesting that all board committees be composed of independent directors and that directors be held personally liable in instances of gross negligence. Scott Kilman & Joann S. Lublin, *ADM Panel Recommends Sweeping Changes in Board*, WALL ST. J., Jan. 16, 1996, at A3; Scott Kilman, *ADM Directors Raise Issue of Andreas Successor*, WALL ST. J., Jan. 17, 1996, at A5. See also Eichenwald, *supra* note 106, at D1.

108. For example, the Teamsters union urged the Gannett Co. board to retain an independent auditor to investigate the company's response to insider trading charges against a Gannett executive when the executive continued to manage one of the company's largest investments. Mark Fitzgerald, *Teamsters Continue to Pressure Gannett Board*, EDITOR & PUBLISHER MAG., Sept. 30, 1995, at 10.

109. See Karl A. Groskaufmanis, *Proxy Reform and the Brave New World of Investor Relations: Ten Rules of Thumb for the 1990s*, INSIGHTS, Dec. 1993, at 18.

110. Geoffrey Smith, *Raider on the Net*, BUS. WK., Oct. 23, 1995, at 35.

### *C. Considerations for the Board*

Given these pressures, corporate directors have a vested interest in a company's disclosure practices. In light of these rules, there are four questions that directors should ask of the company's senior managers.

#### *1. Does the Company Have a Disclosure Regimen, and If So, What Is It?*

Before considering alterations to existing practices, it is prudent to assess how the present system operates in practice (and where modifications should be made). While public companies are subject to standardized reporting requirements, their approaches to these disclosure requirements vary widely. Nonetheless, several elements should be common to all disclosure regimens.

(a) Every company needs a disclosure regimen that is tailored to the particular activities and culture of the company. This is important for two reasons. First, in crafting disclosures for periodic filings, there must be a mechanism in place that ensures that any significant information will be considered and reviewed for possible inclusion in a public filing. Second, the board is under much more of an affirmative obligation to know precisely what, of a material nature, is going on within the company. This is the byproduct of the accounting reforms in the Reform Act, but it is also a byproduct of various governmental pronouncements seeking to impose heavier obligations upon outside directors.

(b) Every public company should designate one or two spokespersons who are authorized to make comments to the marketplace or respond to inquiries.

The disclosure regimen will operate most effectively when the company can impose some real controls on what is being said and by whom. Consistency is critical in this regard, and limiting the number of corporate spokespersons is helpful in ensuring that whatever comments are made can be addressed quickly. Prompt debriefings of corporate spokespersons after they have communicated with institutional investors, analysts or reporters, is an essential facet of any disclosure regimen.

(c) There should be some methodology to review the narrative of public filings both before and after they are disseminated to the public. While the managers actively involved in running the business need not be involved in preparing historical data, they should review the Management, Discussion and Analysis section of public filings to ensure that it is an accurate reflection of the business. In addition, there should

be some mechanism for senior managers to check with department and division heads to find out what items of significance are percolating through the company, whether or not these matters have yet reached a critical stage or have yet been reported to the board.

(d) Corporate directors should seek face-to-face meetings with senior management around the time of public filings to ensure that information of a material or significant nature has been brought to the board's attention and is properly disclosed. In connection with certain disclosure obligations, such as the filing of an annual report on SEC Form 10-K, directors (or at least a majority of them) are required to certify they have reviewed the disclosures and believe them to be accurate. At periodic filing time (as well as the filing of current statements on SEC Form 8-K), it makes sense for management and the directors to sit down and discuss the key items of disclosure, understand the matters that were considered for disclosure but rejected, and make certain that no loose ends have been left untied.

(e) Companies should maintain an up-to-date set of disclosure binders that collect, on a real time basis, all public filings, press releases, analyst reports, and press accounts. This compilation allows the company to assess the impression of the issuer that is being formed in the marketplace and how its disclosure practices should be adapted.<sup>111</sup>

(f) Companies should review their disclosure regimens periodically (but not less than annually), to ascertain whether there is any need for modification in the procedures being employed to craft public disclosures. As with so many things, disclosure reports are an art form that constantly changes. The boards of public companies would do well to have senior management analyze for them, on at least an annual basis, what the current disclosure regimen is, how it has worked, how it differs from the regimens employed by comparably situated companies, and whether any new developments in the law, or lore, might affect the methodology being employed.

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111. For a more detailed discussion of these principles, see Harvey L. Pitt & Karl A. Groskaufmanis, *Shareholder Suits Suggest Some Lessons*, NAT'L L.J., Aug. 10, 1992, at 24, 26-27.

## *2. How Are the Company's Competitors Responding to the Reform Act?*

No company should ever adopt by rote the disclosure methodology of another issuer. Each company must tailor its compliance and disclosure practices to its unique circumstances. Nevertheless, there is merit in examining how other, similarly situated companies are responding to the requirements and opportunities afforded under the legislation. The response of competitors is important because it will shape expectations in the marketplace. If, for example, all other companies in an industry segment adopt a practice of making public statements about expected future earnings or the impact of certain regulatory initiatives, there will be considerable pressure upon the company which is not doing so to take the same approach. This is one factor that both management and the board can consider in deciding whether to alter existing practices with respect to disclosure of forward-looking information.

## *3. What Are the Company's Relations With Its Institutional Investors?*

In a marketplace increasingly dominated by institutions,<sup>112</sup> public companies already have a strong incentive to foster good relations with significant shareholders. The existence of a lead plaintiff requirement will add to those incentives. Many institutional investors may have little interest in the time and expense of supervising litigation. If, on the other hand, institutional investors feel slighted by management and are stung by a sudden drop in the stock price, they may be more willing to serve in that capacity. As a practical matter, the same cause of action will have considerably more credibility with the court and with other investors when the litigation is led by a substantial investor than would be the case if the same cause of action was advanced by a nominal investor with a dozen shares. Given this added risk, corporate directors should be skeptical of managers who recommend an aloof response to overtures from institutional shareholders.<sup>113</sup>

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112. See, e.g., John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 848 (1994) (citing Columbia Institutional Investor Project Research indicating that institutional ownership of U.S. equity securities increased from 23% in 1955 to 53.3% in 1990).

113. See, e.g., Judith H. Dobrynzki, *Small Companies, Big Problems*, N.Y. TIMES, Feb. 6, 1996, at D1 (noting the recalcitrance of small and mid-sized companies targeted for review by CalPERS).

**4. *What Steps Should a Company and Its Board Take  
When They Learn That Employees Have (or Might)  
Become the Subject of a Government Investigation and  
Have Asserted (or Might Be Advised to Assert)  
Their Fifth Amendment Rights?***

By intoning three times the simple words—"I wish to assert my Fifth Amendment privilege"<sup>114</sup>—former Los Angeles Police Department Detective Mark Fuhrman electrified the trial of O.J. Simpson and prompted broader soul-searching about the use of the Fifth Amendment.<sup>115</sup> The disclosure requirements imposed upon auditors only compound the difficulties confronted by corporate directors when a member of senior management is under investigation, or may come under investigation, and has been (or may be) advised to assert the Fifth Amendment privilege.

The *Cooper Companies* release provides just the latest reminder that an employee's invocation of the Fifth Amendment has implications for the company as well. The Commission took pains to note that an officer's invocation of his Fifth Amendment privilege did not negate the company's disclosure obligations and, "[i]ndeed, it is under these circumstances that the need for the Board to safeguard investor interests may be most compelling."<sup>116</sup> Moreover, the assertion of the Fifth Amendment privilege over the course of an SEC inquiry will heighten the suspicions of the Commission's staff and heighten the probability that an informal investigation will be subject to a formal order of investigation.<sup>117</sup> In a civil action initiated by the SEC, some courts

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114. See David Margolick, *Simpson Detective, Back in Court, Refuses to Reply on Role in Case*, N.Y. TIMES, Sept. 7, 1995, at A1.

115. See Edward Felsenthal, *As Fifth Amendment is Invoked More, Would Framers Rue What They Have Created?*, WALL ST. J., Sept. 12, 1995, at B1.

116. *In re Cooper Companies, Inc.*, [1994-95 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,472, at 86,064 n.9 (Dec. 12, 1994).

117. See, e.g., William R. McLucas et. al., *SEC Enforcement: A Look at the Current Program and Some Thoughts About the 1990s*, 46 BUS. LAW. 797, 843 (1991) ("Invoking the [F]ifth [A]mendment and resisting requests for documents and other information may also persuade the staff that the conduct is more likely to merit investigation. The lack of cooperation, particularly at early stages of an investigation, may lead to a rapid end to the informal stage of an inquiry.").

have recognized that the trier of fact can draw an adverse inference from the assertion of the Fifth Amendment privilege.<sup>118</sup>

Directors face a wrenching decision when they learn that an officer whose integrity they trust is under investigation by the government and has been advised to assert his or her Fifth Amendment privilege. In that situation, many directors would take affront at an unyielding rule that the existence of a government investigation should seal an individual's career at the company. Yet, at the same time, the existence of the investigation places the board on notice of at least allegations relating to what may be serious misconduct. The Reform Act and the *Cooper Companies* release reinforce the obligations of boards to assert their stewardship aggressively at such times. There are several ways in which boards can balance these concerns.

(a) The board has an obligation to be informed, and informed promptly, of any governmental inquiry involving corporate employees of the company and to take steps to satisfy itself regarding the situation. Merely because a governmental inquiry commences, or proceeds, does not mean that any wrongdoing occurred or that the employee involved must forfeit his or her corporate career. But that could be a possible meaning of such information. The only way for the board to know is to ensure that it receives an independent assessment of the situation. The board's responses will be subject to less second-guessing if the board and its independent advisors have reviewed the relevant facts and determined whether there is evidence of a violation of law.

(b) Corporate employees should not be allowed to remain in place, without any restrictions, unless the board is satisfied that the employee has been forthcoming about the events in question and is not likely to be found to have violated the law. One of the first questions that must be addressed when a corporate employee is suspected of wrongful conduct is whether there are protections in place to prevent a recurrence of the alleged wrongful conduct. Leaving a corporate officer in place, without providing such assurances, means that the company, its other officers, and its directors all expose themselves to potential responsibility for any further misdeeds that may occur.<sup>119</sup> The *Cooper Companies*

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118. See, e.g., SEC v. Tome, 638 F. Supp. 629, 631-32 (S.D.N.Y. 1986), *aff'd*, 833 F.2d 1086 (2d Cir. 1987), *cert. denied*, 486 U.S. 1014 (1988). But see SEC v. Conserv Corp., 908 F.2d 1407, 1410, 1410 n.3 (8th Cir. 1990) (noting district court's rejection of SEC argument that assertion of Fifth Amendment privilege should preclude recovery of fees under the Equal Access to Justice Act).

119. See *In re Gutfreund*, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,067, at 83,597, 83,607 (Dec. 3, 1992) ("Had limits been placed on his activities after the one unauthorized bid was disclosed, these violations might have been prevented. . . . The supervisors were required to take action reasonably designed to prevent a repetition of

release stressed that the board's inaction in that case allowed a corporate officer implicated in the wrongdoing to issue a misleading release to the marketplace.<sup>120</sup> There are many ways to ensure that no repetition of alleged wrongful conduct occurs, but some mechanism must be selected, and a basis must exist, for the board's assumption that that mechanism will prevent any recurrence of the conduct in issue.

(c) Corporations should revisit their policies of indemnification and advancement of expenses to employees accused or suspected of significant wrongdoing. As a result of the takeover boom of the 1980s, many corporations have taken advantage of Delaware law (or similar laws in other jurisdictions) that permit companies to make advancement of expenses and indemnification a matter of corporate contract.<sup>121</sup> Unfortunately, these provisions have a decidedly negative effect on companies whose employees are subject to governmental inquiries.

We believe that corporations should be circumspect about advancing the costs of defense to an employee who refuses to cooperate with either the company or the government, or both, while nonetheless asserting his or her innocence. There is no doubt that employees have the right to assert their Fifth Amendment rights, but it cannot be gainsaid that the corporation may be disadvantaged by the advancement of legal fees to someone who is refusing to cooperate with regulatory and governmental authorities, not to mention the company as well. Particularly in regulated industries, such as the defense industry, or the broker-dealer industry, criminal proceedings can lead to a loss of employment and a loss of privileges for the corporation.<sup>122</sup>

As a general proposition, employees who seek advancement of expenses should be told that their expenses will be advanced provided they agree to (1) cooperate fully with all relevant governmental and corporate inquiries, (2) acknowledge for the corporation that they are not aware of any unlawful acts they have committed, and (3) reimburse the

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the misconduct that had been disclosed to them."). Mr. Pitt was counsel to Salomon's then-General Counsel, Donald M. Feuerstein, in connection with this proceeding.

120. *In re Cooper Companies, Inc.*, [1994-95 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85, 472, at 86,065 (Dec. 12, 1994).

121. See, e.g., General Corporation Law, DEL. CODE ANN. tit. 8, § 145 (Supp. 1994).

122. See generally John T. Boese, *Suspension and Debarment: A Primer for the 1990s*, ACQUISITION ISSUES, June 1994, at 1.

company for any moneys advanced in the event they are convicted (or plead guilty to) a criminal act.

## VI. THE INSTITUTIONAL INVESTOR

### A. Background

Typically, institutional investors and their money managers have avoided active participation in shareholder suits, for a variety of reasons. The Reform Act, however, changes the rules of the game, providing institutional shareholders and securities counsel with both new challenges and opportunities. Given the contours of the Reform Act, it is not clear that institutional investors will always be able—or should want—to sit passively on the sidelines in battles between corporate issuers and shareholders. By the same token, corporate issuers can no longer afford to assume that their large institutional holders will—or will be able to—stay out of the fray of shareholder litigation.

Prior to the Reform Act's adoption, institutional investors routinely avoided assuming a leadership role in securities litigation. This was relatively easy to do, because the old system made taking an active role in class-action litigation procedurally difficult, economically impracticable, and “politically” unwise for institutional investors.<sup>123</sup> Taking a passive role in litigation against portfolio companies allowed institutions to obtain some redress for their constituent shareholders, while remaining on good terms with the issuer.<sup>124</sup> This passivity often resulted in institutions, on average, recovering less than fifteen percent of their total court-certified losses in class actions, while bearing most of the costs associated with that litigation, at the same time that the plaintiffs' lawyers in these actions received twenty-five to thirty-five percent off the top of each recovery.<sup>125</sup>

### B. Litigation Reform

Part of Congress' intent in adopting the Reform Act was to eliminate figurehead plaintiffs who exercised no meaningful supervision of the

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123. See, e.g., Keith Johnson, Assistant General Counsel, SWIB, *Securities Class Action Reform: A Real Client's Perspective*, 1995 ABA Annual Meeting Section of Business Law (copy on file with authors).

124. See generally Richard H. Kopps & Maureen L. Reilly, *An Ounce of Prevention: Meeting the Fiduciary Duty to Monitor an Index Fund Through Relationship Investing*, 20 IOWA J. CORP. L. 414 (1995).

125. See Johnson, *supra* note 123, at 1; see also CONFERENCE REPORT, *supra* note 11, at 3.

litigation—or even the decision to file suit—by attempting to *encourage*, but not *require*, institutional shareholders to supervise this litigation, and to select their own counsel whom these institutions would monitor and supervise.<sup>126</sup> There are three principal facets to the reform Congress effected.

First, when a class action is filed, the named plaintiff must give notice to all members of the class, and any member of the class can seek leave to serve as the lead plaintiff, with the court required to indulge a rebuttable presumption that the shareholder with the largest economic stake in the issues raised also is likely to be the “most adequate plaintiff” class representative.

Second, once a lead plaintiff is selected, control over the hiring of counsel falls to the lead plaintiff, subject to court approval. This will enable the lead plaintiff to monitor counsel, to control the pace or direction of litigation, and to be involved in the negotiation of any settlement.

Finally, any proposed settlement agreement that is disseminated to the class must set forth the amount that will be distributed to the class, in both aggregate and average-per-share terms, and must allow the class to compare that amount with the potential amount of damages both parties believe each claim could have produced, along with a statement of attorneys' fees and costs to be sought from the fund (if any) that will be established.

### C. *A Fiduciary Duty to Litigate?*

Although some commentators have suggested that institutional managers may have a fiduciary duty to cause their institutions to assume the role of lead plaintiff in certain cases, or at least to make a considered decision as to why they should not assume that role,<sup>127</sup> neither the language of the Reform Act nor its legislative history imposes such a

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126. CONFERENCE REPORT, *supra* note 11, at 34.

127. See Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2112 (1995) (“Consideration of their fiduciary obligations also may lead many institutional investors to decide that they should seek to serve as lead plaintiff whenever they are eligible to do so.”).

duty. In fact, Congress actually disclaimed such an intent.<sup>128</sup> Nonetheless, given that Congress stated that its specific intent was to “encourage institutional investors to take a more active role in securities class action lawsuits,”<sup>129</sup> some might seek to imply a duty to litigate from the existing fiduciary rules applicable to trustees and corporate managers and, in some cases, the laws applicable to pension fund managers and investment advisers.

The law of trusts, for example, imposes a duty on a trustee—akin to the fund manager of an institution—not only to act prudently in the investment and management of trust funds, but to “monitor[] and review[] investments” and to “keep[] informed of rights and opportunities associated with those investments.”<sup>130</sup> Further, a fiduciary to a trust must “take reasonable steps to realize on claims” when the “probable benefit to the trust will exceed the costs the trust reasonably can expect to incur.”<sup>131</sup> If, under the circumstances, the only reasonable step “would be to bring suit to enforce the claims, [the trustee] has a duty to bring such suit.”<sup>132</sup>

General corporate law contains similar (although somewhat less strenuous) fiduciary rules, requiring corporate managers to take steps similar to those required of a trustee to protect corporate assets.<sup>133</sup> With respect to pension funds, the Employee Retirement Income Security Act (ERISA) imposes rigorous fiduciary duties on fund managers in connection with managing plan assets.<sup>134</sup> The Department of Labor has stated that these duties extend to actively monitoring situations where “such activities of the plan alone, or together with other shareholders, are likely to enhance the value of the plan's investment, after taking into account the costs involved.”<sup>135</sup> Courts have held that

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128. The legislative history states that the Reform Act should not confer any new fiduciary duty on institutional investors, and urges courts not to impose such a duty. CONFERENCE REPORT, *supra* note 11, at 34.

129. *Id.*

130. Weiss & Beckerman, *supra* note 127, at 2113 (quoting the RESTATEMENT (THIRD) OF TRUSTS § 227 (1992)).

131. *Id.* (quoting the RESTATEMENT (SECOND) OF TRUSTS, § 177 (1959)). Courts have found trustees negligent for failure to monitor their internally-managed investments. See, e.g., Katsaros v. Cody, 744 F.2d 270, 276 (2d Cir. 1984), *cert. denied*, 469 U.S. 1072 (1984).

132. RESTATEMENT (SECOND) OF TRUSTS § 192 cmt. a. (1959); Weiss & Beckerman, *supra* note 127, at 2113.

133. See Weiss & Beckerman, *supra* note 127, at 2113-14; see also General Rubber Co. v. Benedict, 109 N.E. 96 (N.Y. 1915).

134. See Employee Retirement Income Security Act of 1974 § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B) (1988 & Supp. II 1990).

135. See Interpretive Bulletins Relating to ERISA, 59 Fed. Reg. 38,860, 38,862 (1994).

fiduciaries of employee stock ownership plans have a duty to pursue minority shareholder claims, and have imposed liability on plan fiduciaries for failing to do so.<sup>136</sup> In addition, the Investment Advisers Act of 1940 has been interpreted to impose a duty on investment advisers to act as fiduciaries with respect to their customers.<sup>137</sup>

We do not believe the Reform Act imposes any obligation either to conjure up litigation, or to partake in any particular case. Managers ultimately may decide that a given action is meritless or exposes their clients to too much risk or too little benefit. But, upon notification of the existence of a claim, institutional money managers should consider, deliberately and without self-interest, whether to undertake a more active role in connection with such litigation.

#### *D. Practice Points*

In this new environment, institutional investors and their money managers may wish to consider the following possibilities to avoid having their passivity criticized as a decision to forego an opportunity to enhance investor returns.

##### *I. Litigation Monitoring Committees*

Institutional money managers should consider establishing litigation monitoring committees—either by themselves or in coordination with other comparably situated money managers—to monitor class actions filed against companies whose securities are held in the portfolios they manage. While the composition of such a committee should reflect the culture of the particular money manager and the institutional investor involved, as a general rule, the committee should include someone knowledgeable about securities litigation, who is well-versed in the legal duties under which the money manager operates, and someone capable of analyzing whether filed litigation has merit.

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136. See, e.g., *Martin v. Feilen*, 965 F.2d 660, 667-68 (8th Cir. 1992), cert. denied, 506 U.S. 1054 (1993).

137. See *Investment Advisers Act of 1940* § 206, 15 U.S.C. § 80b-6(1994); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963); *In re Arlene W. Hughes*, 27 S.E.C. 34-4048 (1948).

## *2. Monitoring Existing and Future Litigation Opportunities*

Litigation monitoring committees should review news and reports of SEC and other governmental action affecting portfolio companies to determine whether a cause of action may exist on behalf of the institution's beneficiaries. They also should ensure that major publications are scanned regularly to pick up notices of new class action lawsuits. Ongoing litigation involving portfolio companies also should be monitored, because even cases not governed by the Reform Act can be influenced by the changes the Reform Act has wrought in securities litigation.

## *3. Choosing Counsel in Advance*

Many defense law firms previously took the position that they represented only business clients, and usually only as defendants; these firms would not represent a plaintiff class in an action against a business. However, some of those firms have represented institutional investors and money managers for decades and have begun seeking assignments as counsel of choice in the event their clients (or someone else's) should pursue appointment as lead plaintiff.<sup>138</sup> Given the relatively short time frame within which a decision must be made to seek appointment as a lead plaintiff, having knowledge of the lawyers or law firms a manager would retain can avoid distractions during a period when institutional managers will want to pay more attention to the merits of the litigation.

## *4. Recording the Committee's Deliberations and Activities*

As a general proposition, we believe that it is important not only to do the right thing, but also to be able to prove that the right thing was done! To this end, institutional investors should keep a log of the suits that they monitor and record, in summary fashion, the basis for their decisions whether to become involved in litigation.

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138. See Karen Donovan, *Securities Defense Bar Soaks up Rays, Across Bay Bill Lerach Chases Silicon Graphics*, NAT'L L.J., Feb. 12, 1996, at A1; Karen Donovan, *Pension Managers Speaking Up: Institutional Investors Ready for Role in Class Action Securities Suits*, NAT'L L.J., Mar. 13, 1995, at A6 (reporting that Council of Institutional Investors asked law firms to submit proposals describing how they could play a more active role in class actions).

### 5. *Minimizing the Committee's Burdens*

Institutional managers understandably may be reluctant to expend a great deal of time or resources on tracking all the class action litigation filed that relates to companies whose securities they hold in their institutional portfolios. It may make sense to ask counsel for the putative plaintiff and the portfolio company to share with the institutional manager their basis for the claims and defenses they intend to assert, and to indicate how the case will be established or defended, and what factual proof exists. In this fashion, institutional managers can (1) conserve their resources by relying on the good faith efforts of those directly involved in the litigation, (2) maintain good relationships with the management of the portfolio company by evidencing a willingness to listen to management's side of things and to assess management's defenses, and (3) justify a decision not to become involved in a particular action, based either on management's defenses, plaintiffs' counsel's evidence, or both.

### 6. *Coordinating With Other Institutional Investors*

Even before the Reform Act, institutional investors had begun to combine their efforts to influence class action lawsuits involving federal securities claims. For example, in the spring of 1995, the Council of Institutional Investors retained legal counsel to assist its members in reviewing class actions and seeking greater involvement, after submitting requests for proposals to many law firms known for their work defending class action lawsuits. As a result of the Council's monitoring efforts, the Colorado Public Employees Retirement Association filed a motion to intervene in a lawsuit against California Micro Devices.<sup>139</sup> Participants in the Stanford Forum, a group of institutional investors that meets yearly to discuss issues in which they have common interest, went one step further, coordinating on a letter urging plaintiffs' counsel in a class action lawsuit against Intel Corporation to reconsider whether the

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139. See Diana B. Henriques, *Market Place: A Class Action is Seen as a Dress Rehearsal for New Securities Laws*, N.Y. TIMES, Feb. 23, 1996, at D6; James M. Finberg, *Big Shareholders Back Micro Devices Settlement*, NAT'L L.J., Dec. 4, 1995, at A18.

claims had merit.<sup>140</sup> If going it alone is too burdensome, a group of similarly situated parties can provide the vehicle for addressing fiduciary responsibilities at minimal cost while minimizing the likelihood of attacks on individual institutions.

### *7. Using Leverage Early*

An institutional investor who might be a credible candidate for lead plaintiff (and who might choose its own counsel rather than counsel of record) can negotiate the circumstances under which it would be willing to forego that opportunity. Lower attorneys' fees, regular meetings of plaintiffs monitoring the litigation, requiring the use of a plaintiffs' steering committee to direct counsel during the litigation, and approval of settlement agreements before they are presented to defendants—all of these and more possibilities can be addressed by agreement among the parties at the outset of the litigation.

### *8. Participating in Settlement Discussions*

If a lawsuit is filed, it behooves large investors to become “players,” at least when any settlement discussions begin. In crafting settlements, for example, there is often a disparity between the interests of former shareholders and ongoing shareholders of a corporation. To the extent institutional managers retain an investment in the target of litigation, it is to their benefit to make their presence felt in settlement discussions, in order to ensure that the terms of a settlement, and the proposed fees, do not unfairly prejudice the interests of continuing shareholders. Similarly, the active involvement of a major institutional investor can assist corporate management in assessing the nature of class action litigation and its likely impact on shareholders.

### *9. Opting Out*

Where proposed settlements are inadequate or otherwise are unfair, consideration could be given to opting out of the litigation completely. With the heightened notice requirements imposed by the Reform Act, opting out has become a more realistic option. Institutional money managers should be certain that opting out is consistent with their fiduciary responsibilities, a conclusion more easily reached if a simultaneous decision is made to pursue a different resolution with the company.

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140. Donovan, *Pension Managers Speaking Up*, *supra* note 138, at A6.

## 10. Disclosure Risks

Those petitioning to be lead plaintiff must disclose, in a certificate attached to their complaint, their holdings and trading patterns in the subject securities from prior years.<sup>141</sup> This may discourage institutional investors from serving as the initial named plaintiff on a class action complaint. While movants seeking lead plaintiff status also must make other various disclosures, Congress attempted to limit the burden on institutional investors in this regard, permitting members of the purported class to seek discovery on the adequacy of representation by the presumptively most adequate plaintiff only if "the plaintiff first demonstrates a reasonable basis for a finding that the presumptively most adequate plaintiff is incapable of adequately representing the class."<sup>142</sup> Of course, the court may allow discovery of additional information relevant to whether a member of the class is the most adequate plaintiff once a "reasonable basis" is established, which may include the petitioner's voting record, involvement with management, resources for litigation costs, and the like.<sup>143</sup> Institutional investors and their managers may prefer not to provide such information, to protect client privacy interests or their own business confidentiality, and therefore may conclude that the risks of service as lead plaintiff outweigh the potential

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141. See 15 U.S.C.A. § 77z-1 (West Supp. 1996) (adding new § 27(a)(2)(A)(iv) to the Securities Act); *id.* § 78u-4 (adding new § 21D(a)(2)(A)(iv) to the Exchange Act). ("Each plaintiff seeking to serve as a representative party on behalf of a class shall provide a sworn certification . . . set[ting] forth all of the transactions of the plaintiff in the security that is the subject of the complaint during the class period specified in the complaint.").

142. See *id.* § 77z-1 (adding new § 27(a)(3)(B)(iv) to the Securities Act); *id.* § 78u-4 (adding new § 21D(a)(3)(B)(iv) to the Exchange Act). To be eligible for the "most adequate plaintiff" presumption, a plaintiff must "otherwise satisfy] the requirements of Rule 23 of the Federal Rules of Civil Procedure." *Id.* § 77z-1 (adding new § 27(a)(3)(B)(iii) to the Securities Act); *id.* § 78u-4 (adding new § 21D(a)(3)(B)(iii) to the Exchange Act). In addition to requiring "adequacy of representation," Rule 23 requires that the claims or defenses of the representative party be "typical" of the claims or defenses of the class. See, e.g., *Garonzik v. Shearson Hayden Stone, Inc.*, 574 F.2d 1220, 1221 (5th Cir. 1978) (stating that an admission that the plaintiff was a "sophisticated investor raises a defense as to plaintiff's own claim which deprives him of the typicality of the class required for class representation").

143. Cf. *ML-Lee Acquisition Fund II, L.P. Securities Litig.*, 149 F.R.D. 506 (D. Del. 1993) (ordering the production of documents relating to the plaintiff's investment history at the class certification stage).

benefits. In this regard, joining forces with other institutional investors may increase opportunities to influence litigation while reducing the profile of particular institutions, thereby limiting the potential for discovery exposure.

### 11. Additional Costs

The Reform Act ratchets up the potential for parties to be required to pay their opponents' attorneys' fees by requiring the court to make a specific finding, at the conclusion of a class action, as to the compliance of each party with the requirements of Rule 11(b) of the Federal Rules of Civil Procedure,<sup>144</sup> and then presuming that the appropriate sanction for violating Rule 11 is an award of attorneys' fees to the other party.<sup>145</sup> Meanwhile, courts are showing less enthusiasm for affirming settlements where the most significant percentage of the payout goes to lawyers, rather than to the claimants. In this environment, serving as plaintiffs' counsel may not hold the financial lure it once did.

## VII. CONCLUSION

The passage of the Reform Act was a product of a unique alignment of political forces. Securities litigation has been an enduring concern on Capitol Hill for years. The issue assumed greater prominence when it became part of the Republican "Contract with America" which shaped the 104th Congress. This energized support for an issue that already had attracted broad bipartisan interest. The issue came to the fore during the tenure of an SEC Chairman who, while he did not lend unqualified support for the entire bill,<sup>146</sup> was unique in his willingness to address

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144. 15 U.S.C.A. § 77z-1 (West Supp. 1996) (adding new § 27(c)(1) to the Securities Act); *id.* § 78u-4 (adding new § 21D(c)(1) to the Exchange Act).

145. See *id.* § 77z-1 (adding new § 27(c) to the Securities Act); *id.* § 78u-4 (adding new § 21D(c) to the Exchange Act); CONFERENCE REPORT, *supra* note 11, at 39. The Act requires courts to adopt a presumption that an award of attorneys' fees is the appropriate sanction for "failure of any responsive pleading or dispositive motion to comply" and for "substantial failure of any complaint to comply" with Rule 11. 15 U.S.C.A. § 77z-1 (West Supp. 1996) (adding new § 27(c)(3)(A) to the Securities Act); *id.* § 78u-4 (adding new § 21D(c)(3)(A) to the Exchange Act)(emphasis added). A complaint that violates Rule 11 will result in an award of attorneys' fees "incurred in the action," whereas violation of Rule 11 on a responsive pleading or dispositive motion will only result in an award of attorneys' fees incurred as a "direct result of the violation." *Id.*

146. While Chairman Arthur Levitt stated, in a November 15, 1995 letter to Senate Banking Committee Chairman Alfonse D'Amato that the safe harbor represents a "workable balance," he emphasized, in a subsequent letter to the *Los Angeles Times*, that an article was "wrong in reporting that I now support the litigation reform bill." See 141 CONG. REC. S17935, S17994 (daily ed. Dec. 5, 1995).

shortcomings in our present system of securities litigation.<sup>147</sup> In the end, President Clinton's veto came too late. At the critical juncture, the push to override the veto in the Senate was led by Senator Christopher Dodd, the Chairman of the Democratic National Committee, and a co-sponsor of the Reform Act.<sup>148</sup>

For corporate counsel, the Reform Act generates the pragmatic questions of implementation. Yet, for all the charges introduced by the Reform Act, it is clear that shareholder litigation has not been eviscerated by the legislation.<sup>149</sup> To the extent that the federal forum becomes less friendly, plaintiffs' counsel will be tempted to test the waters in state courts and to retry this issue in state legislatures. Whatever the forum, good corporate practices will be as important as ever in the wake of the Reform Act.

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147. See *Remarks of SEC Chairman Arthur Levitt to the 22nd Annual Securities Regulation Institute in San Diego, California, [1994-95 Transfer Binder]* Fed. Sec. L. Rep. (CCH) ¶ 85,600, at 86,244 (Jan. 25, 1995).

148. See, e.g., Michael K. Frisby & Jeffrey Taylor, *Senate Poised to Override Securities Veto*, WALL ST. J., Dec. 22, 1995, at A3.

149. See, e.g., Mike France, *Bye, Fraud Suits. Hello, Fraud Suits*, BUS. WK., June 24, 1996, at 127 (noting that at least 35 companies have been sued in 1996 in securities class action suits). The pace at which suits are being initiated has slowed. One survey found that 20 companies were named in securities class action in the first quarter of 1996 compared with 45 in the first quarter of 1995 and 55 in the first quarter of 1994. (Survey results on file at the *University of San Diego Law Review*).