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REGULATION AND LEGISLATION

# It's time to rethink securities litigation laws

## More lawsuits being filed, but recovering losses is harder than ever

By **Norman Berman**
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The historic meltdown in the U.S. financial markets has produced an outpouring of securities litigation with pension funds taking the lead. Union and government pension funds figured as lead plaintiffs in half of all securities class actions filed last year. But while these pension funds are leading class actions, they are also finding it more difficult to recoup their fraud-related losses.

In recent years, new laws coming out of Congress and rulings by the U.S. Supreme Court have given advantage after advantage to corporate defendants, who now can choose an array of legal strategies to shield themselves from legitimate lawsuits. Investors today have a tougher road to success due to new legal barriers in the nation's courts.

For the same reason the focus in Washington is on regulatory reform to prevent future financial disasters, Congress and President Barack Obama should revise federal securities laws.

The issue is currently pressing on investors who have suffered unprecedented losses from fraud-driven subprime credit activities on Wall Street. Last year, 210 securities fraud class actions were filed in federal court — 48% of them led by public and union pension funds, according to a report by PricewaterhouseCoopers.

Subprime-related cases drove the surge. The report said the majority of lawsuits targeted lenders, investment banks and other financial companies — 2008 was the first year in which financial industry filings exceeded filings against other industry. The pace of activity is rising again this year.

There haven't been this many shareholder suits since early in the decade, when the spectacular frauds at Enron Corp., WorldCom, and other corporations dominated the headlines. While those marquee cases resulted in the largest settlements ever for securities class actions — $7.2 billion for Enron and $6.2 billion for WorldCom — there has been a major change in the intervening years.

The threat of big settlements can be a powerful deterrent to fraud. But changes in securities laws make it easier to commit fraud now and evade punishment later in the courts.

The stepped-up engagement by public pension funds in class-action litigation — a positive change benefiting all investors — is rooted in the Private Securities Litigation Reform Act of 1995. By directing judges to appoint the investor with the largest loss as the lead plaintiff, the PSLRA paved the way for sophisticated institutional investors to supplant individuals, who sometimes had little at stake in the litigation they filed. Academic studies show that these institutional investors exact larger settlements for the entire class of investors.

But if Congress gets credit for passing the PSLRA and opening courtroom doors to pension funds, it must also bear blame for other "reforms" contained in the PSLRA that stripped investors of long-held legal rights.

**1995 reform's catch-22**

The PSLRA has created a catch-22 for plaintiffs and their attorneys: The law raised the standards for evidence required to support the allegations in the initial complaints while strictly limiting investors' power to gather that evidence.

One provision of the PSLRA limiting investors' rights is the automatic stay on evidence-gathering or discovery. The stay means plaintiffs' counsel cannot gather documents and interview key witnesses until the court rules the complaint is strong enough to survive defendants' motion to dismiss. Lawyers are required to provide strong proof in complex securities litigation, yet they have fewer tools at their disposal to do so.

Securities cases are the only legal cases to which this automatic discovery stay applies. Congress should eliminate the stay and put investors on the same footing as plaintiffs in every other type of litigation and to give them a fair chance of success when bringing claims of fraud against corporations and their executives.

The U.S. Supreme Court also has tilted the advantage in favor of corporate defendants in several high-profile decisions interpreting securities laws. One notable example: Last year, in Stoneridge Investment Partners LLC vs. Scientific-Atlanta Inc. the high court shielded parties such as suppliers, attorneys, and auditors that aid corporations in their illegal acts.

In a class action involving the 2005 collapse of the international brokerage firm Refco Inc., a New York judge recently criticized as "dismaying" the impact Stoneridge had on his Refco ruling. Last year, Refco's former chief executive pleaded guilty and is serving a 16-year prison sentence.

In an unusual footnote, the judge pointed to an obvious avenue for overriding Supreme Court decisions like Stoneridge. Securities laws, he wrote, "may be ripe for legislative re-

examination." This judge clearly understands the dilemma facing pension funds that take legal action against fraud.

With their major stake in securities litigation, funds should support revisions to the law.

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