FENWICK & WEST LLP

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The Private Securities Litigation Reform Act of 1995

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On December 22, 1995, the Senate overrode President Clinton's veto of the Private Securities Litigation Reform Act of 1995 (the "Reform Act"). Because the House previously overrode the veto, the Reform Act is now the law and will apply to all future federal securities litigation.

Abusive securities litigation has been an unfortunate fact of life in the Silicon Valley for years, and the high tech community lobbied long, hard and well for reform. As with all reform bills, various compromises were made, but on the whole the Reform Act provides substantial new protections against "strike suits". We outline below the important changes in the law made by the Reform Act.

1. Safe Harbor For Forward-Looking Statements

In the past, securities class action plaintiffs often sought to prove fraud by hindsight. Plaintiffs' counsel located optimistic statements made in various public statements and filings, pointed to adverse conditions existing at the time the complaint was filed, and then alleged that the company knew or should have known that its optimistic statements were not warranted by the facts. The existence of this type of claim posed serious dilemmas for companies whose shares are traded in the securities markets. The market virtually demands projections from public companies, but companies have been hesitant to issue projections for fear of a securities lawsuit if the projections are not realized. The new "safe harbor" for forward-looking statements was enacted to allow companies to make good faith projections without fear they will be second-guessed by plaintiffs' counsel.

The Reform Act provides in general that a person will not be liable for any forward-looking statement in a securities fraud action if:

1. The forward-looking statement is identified as such and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement; or
2. The statement is not material; or
3. The plaintiff fails to prove that the forward-looking statement (a) if made by a person, was made with actual knowledge by that person that the statement was false or misleading, or (b) if made by a business entity, was made by or with the

approval of an executive officer and was made or approved by such officer with actual knowledge that the statement was false or misleading.

This safe harbor provision does not apply to statements made in connection with initial public offerings, tender offers, or going private transactions, in financial statements prepared in accordance with GAAP, in investment company registration statements, and in connection with partnership offerings or relating to partnership operations. The law is silent as to whether secondary offerings are also excluded, but a plausible argument can be made that, because Congress did not specifically exclude secondary offerings, the safe harbor should apply to them.

The term "forward-looking statement" is defined broadly as a statement containing a projection of revenues, income, earnings, earnings per share, capital expenditures, dividends, capital structure or other financial items, a statement of the plans and objectives of management for future operations (including plans or objectives relating to products or services of the company), a statement of future economic performance (including any statement contained in a discussion and analysis of financial condition by the management or in the results of operations included pursuant to the rules and regulations of the SEC), any statement of the assumptions underlying or relating to the statements described above, any report issued by an outside reviewer retained by the company to the extent that the report assesses a forward-looking statement made by the issuer, or any statement containing a projection or estimate of such other items as might be required by rule or regulation of the SEC.

The protections of this safe harbor also apply to oral forward-looking statements. In order to come within the protection of the safe harbor, the oral statement must be accompanied by (1) a cautionary statement that the particular oral statement is a forward-looking statement and that the actual results could differ materially from those projected in the forward-looking statement, and (2) a statement that additional information concerning factors that could cause actual results to differ materially from those in the forward-looking statement is contained in a readily available document (such as a document filed with the SEC), in which case the oral statement must identify the document (or portion thereof) that contains that additional information, and the information contained in the written document must also include a cautionary statement to the effect that actual results could differ materially from those projected in the forward-looking statement.

At first blush, people may view this as a fairly cumbersome procedure, especially if employed during an analyst's call, but the appropriate language could be used as part of the prepared remarks at the start of each analyst call. Companies might consider invoking the safe harbor by stating, for example: "At this point, we would like to make some forward-looking statements about our view of the business for the coming year. Of course, the actual results we achieve could differ materially from the projections we are about to give, depending on a number of factors such as the timing of our new product introductions, the market acceptance of our new platform and our ability to increase our production capacity. Additional information concerning those and other risk factors that could cause actual results to differ materially from those in the following forward- looking statement is contained in the 'Risk Factors' section of our most recent report on Form 10-K that has been filed with the SEC."

If the appropriate cautionary statements are made, the speaker will not be liable in a 10b-5 action unless the plaintiff is able to prove that the speaker had actual knowledge that the statement was false or misleading or, if made by a company, the plaintiff is able to prove that it was made by or with the approval of an executive officer who had actual knowledge that the statement was false or misleading. Prior law would allow plaintiffs to establish liability by either proving the statement was known to be false or misleading, or was made with reckless disregard of its truth or falsity. It was the recklessness standard that allowed plaintiffs to employ their "fraud by hindsight" analysis, and this safe harbor provision will make it much tougher to establish liability for forward-looking statements.

On the other hand, we can expect that courts will have to wrestle with the question of whether the statement was accompanied by "meaningful cautionary statements" that identify "important factors". Plaintiffs may still second-guess cautionary statements by claiming they are mere boilerplate, and, with the benefit of hindsight, may be able to show the company omitted "important factors". The Conference Committee Report addresses this issue by advising that cautionary statements must not be "boilerplate warnings", but instead "must convey substantive information about factors that realistically could cause results to differ materially from those projected in the forward-looking statement, such as, for example, information about the issuers business". In other words, companies must tailor the cautionary language to the specific forward-looking information being supplied.

Significantly, that Report goes on to say that "Failure 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", and the requirement of listing "important factors" was created "to provide guidance to issuers and not to provide an opportunity for plaintiff counsel to conduct discovery on what factors were known to the issuer at the time the forward-looking statement was made." Nevertheless, a company should assume some amount of discovery will be conducted, either on the subject of the adequacy of the cautionary statement or on whether the company acted with "actual knowledge" that it was supplying "false or misleading" information. For that reason, a contemporaneous record that a company carefully considered the disclosure and the "important factors" affecting the forward-looking statement will be helpful to defeat a plaintiff's attempts to escape the safe harbor provisions.

2. Elimination of Certain Abusive Practices

Congress has also addressed the problems of "professional plaintiffs", inadequate disclosure of the terms of settlements, and excessive attorneys' fees. The Reform Act places curbs on these and other abusive practices in several ways.

First, the complaint must be accompanied by a sworn certification that the plaintiff has actually reviewed the complaint and authorized its filing. (In our experience, this is currently the exception, not the rule.) The plaintiff must also certify that he or she did not purchase the stock that is the subject of the complaint at the direction of counsel or in order to participate in any securities fraud action. The certification must also identify any other action filed during a three-year period in which the plaintiff has sought to serve or served as a class action representative. That certification must also state that the plaintiff will not accept any payment for serving as a representative party on behalf of the class beyond his or her pro rata share of any recovery.

The Reform Act also allows for another (more appropriate) plaintiff to step in and be appointed the representative of the class. The Reform Act accomplishes this by requiring the plaintiffs to publish, in a widely circulated national business-oriented publication or wire service, a notice advising members of the purported class of the pendency of the action, and that any member of the purported class may move the court to serve as the lead plaintiff. At a hearing scheduled within 90 days of the that notice, the court will appoint as lead plaintiff that person it determines to be the most capable of adequately representing the interest of class members. This reform (and the new, strict pleading requirements) should put an end to the tawdry "race to the courthouse" where competing firms filed their suits within days, sometimes even hours, of a dramatic stock price drop in the hopes of obtaining the advantage of being the first to file.

At the hearing, the court will presume that the most adequate plaintiff is the person (or persons) that has the largest financial interest in the relief sought by the class. Moreover, professional plaintiffs, those who have been a lead plaintiff in more than five securities class actions during any three-year period, are presumed to be unfit to serve as a lead plaintiff. The Conference Committee Report makes it clear that Congress intended to increase the likelihood that institutional investors will serve as lead plaintiffs, and that the lead plaintiff chosen by the court will in turn choose counsel, who may or may not be the lawyer who first filed the suit. (The Report puts it succinctly: As a result of these changes, "the Conference Committee expects that the plaintiff will choose counsel rather than, as is true today, counsel choosing the plaintiff.")

In the past, some settlements in securities class actions have carved out a special bonus payment to plaintiffs who have served as class representatives. The Reform Act prohibits any such bonus payments.

The Reform Act also requires comprehensive disclosure to the class of the provisions of any settlement. Among other things, the class will be notified of the amount of fees and costs that will be sought by plaintiffs' counsel.

Calculating damages in securities law lawsuits was often an esoteric exercise where experts argued over the "true value" of a stock over various periods of time. Typically, the experts for the plaintiffs would argue the "true value" was very close to the lowest stock price following the issuance of a press release containing adverse news. The Reform Act recognizes the inequity of that argument, and instead provides that an award of damages shall not exceed the difference between the purchase price paid or sale price received for the stock and the mean trading price of that stock during a 90-day period commencing on the date on which the press release "correcting the misstatement or omission that is the basis for the action" is disseminated to the market. In the typical case, then, a plaintiff might wish to wait 90 days following the issuance of the press release containing bad news to see if the stock price rebounds sufficiently to make a lawsuit no longer economically viable. (In the past, companies found some solace in not being sued within days of a bad earnings release. With this new 90-day damage window, companies may lose some of that comfort level.)

The Reform Act also provides that the total attorneys fees and expenses awarded to plaintiff's counsel "shall not exceed a reasonable percentage of the amount of any damages and prejudgment interest actually paid to the class." In the Ninth Circuit (federal courts for the Western United States), the courts typically award 25% to 33% of the total settlement amount to plaintiff's counsel for attorneys' fees, and the courts typically award a separate and additional amount for costs. Because plaintiffs' counsel often include such items as paralegals, clerks, investigators, and other outside experts in their cost claims, those claims can sometimes be several hundred thousand dollars. While we would expect the courts to continue to award a percentage of the recovery to plaintiffs' counsel, there is now more room to argue that these fees and costs are not reasonable.

3. Pleading Standards

In the past, plaintiffs' counsel often followed the practice of sue first, and discover the "fraud" later through extensive "fishing expedition" discovery. The Reform Act addresses this type of abusive litigation tactic by doing two things: (1) Setting forth pleading standards that require the plaintiff to identify each allegedly false or misleading statement and state why it is false or misleading; and (2) staying all discovery pending resolution of a motion to dismiss addressed to the adequacy of the complaint.

Prior to the Reform Act, the standards for pleading were fairly well defined by federal courts, although the degree of pleading specificity depended on which federal Circuit the case was brought in. The Reform Act sets forth a uniform nationwide standard, but leaves it to the lower courts to flesh out the new standard. While the standards may be the same, we anticipate they will still be applied differently by different judges.

In some jurisdictions, plaintiffs' counsel in securities cases had included in the complaint a claim under the Racketeer Influenced and the Corrupt Organization Act ("RICO"), which provides for treble damages and attorneys' fees. The Reform Act rules out most RICO actions based on alleged securities fraud by requiring a prior criminal conviction in connection with the securities fraud.

4. Mandatory Sanctions

The Reform Act requires the court to make specific findings at the conclusion of the litigation regarding compliance by each party and each attorney with the requirements of Rule 11 of the Federal Rules of Civil Procedure. That Rule prohibits a party and its attorney from (1) filing any pleading, motion or other paper that is presented for an improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation; (2) presenting claims, defenses or other legal contentions that are not warranted by existing law or by a non-frivolous argument for the extension, modification or reversal of the existing law; or (3) making allegations or denials of allegations that do not have evidentiary support or are not likely to have evidentiary support after a reasonable opportunity for further investigation or discovery.

Rule 11 has, of course, been in place for some time, and the courts have by and large been lenient in assessing sanctions. The Reform Act mandates a review by the court of the party's actions, and provides that, if the court finds any violation of Rule 11(b), it "shall impose sanctions" on such party or attorney. The court is to presume that an appropriate sanction is an award of the reasonable attorneys' fees and expenses incurred as a result of the violation.

It remains to be seen whether this "mandatory sanction" provision will be enforced by the courts. Plaintiffs' counsel vigorously objected to these provisions, and one prominent plaintiffs' lawyer was quoted as saying "It's just loser pays masquerading as mandatory sanctions. What plaintiff with a modest amount of money at stake would subject himself to such economic distress?".

5. Proportionate Liability

Prior to the Reform Act, liability under the securities laws was "joint and several": Each defendant was liable for the entire amount of damages regardless of fault. Under this system, a successful plaintiff could recover all of his or her damages against a single "deep pocket" defendant, even though the other defendants were also held liable and were more at fault than the defendant with deep pockets. Plaintiffs (and some courts) justified this result by stating that the risk of an insolvent defendant should be borne, not by the victimized plaintiff, but by the other defendants.

The Reform Act provides that joint and several liability can be imposed against a defendant only if the trier of fact specifically determines that the defendant knowingly committed a violation of the securities laws. If no such determination is made, the liability is limited to that portion of the judgment that corresponds to the percentage of responsibility of the defendant. The trier of fact must therefore make specific findings with respect to each defendant as to whether that person violated the securities laws and the percentage of responsibility of such person, measured as a percentage of the total fault of all persons who caused or contributed to the loss.

The Reform Act contains an important exception: If the court determines that all or part of the judgment is not collectible as against a particular defendant, all the defendants will be liable for the uncollectible share if the plaintiff establishes that he or she is an individual whose recoverable damages under the final judgment are equal to more than 10% of the net worth of the plaintiff and the net worth of the plaintiff is equal to or less than $200,000. If the plaintiff cannot meet this test, the other defendants will have to cover the uncollectible portion only to the extent of their relative fault.

6. New Requirements Regarding Auditor Disclosures

The Reform Act also formally requires a company's outside auditors to include procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts; procedures designed to identify related party transactions; and an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern.

If in the course of conducting an audit the auditor detects or otherwise becomes aware of information indicating an illegal act has or may have occurred, the auditor must inform the appropriate level of the management of the issuer and assure that the audit committee of the issuer, or the Board of Directors of the issuer, is adequately informed with the respect to such illegal acts. If the auditor, after disclosing the acts, concludes that the illegal act has a material effect on the financial statements and the senior management has not taken and the Board of Directors has not caused senior management to take timely and appropriate and remedial actions, the auditor must report its conclusions to the Board of Directors.

If an issuer receives such a report, it must inform the SEC by notice not later than one business day after the receipt of that report and send a copy to the auditor. If the auditor fails to receive a copy of that notice before the expiration of the required one-business-day period, the auditor must resign from the engagement and furnish to the SEC a copy of its report.

7. California Initiatives

The Reform Act applies only to actions brought under the federal securities laws, and there has been widespread speculation that the plaintiffs' bar will try to bring more cases in the state courts under local securities statutes and under the common law of fraud. In anticipation of such a move, the Alliance to Revitalize California has placed Proposition 201, the "Shareholder Litigation Reform Act", on the March, 1996 ballot. In general, this initiative would require the loser in a securities class action or a shareholder derivative action to pay to the prevailing party the reasonable fees and expenses incurred by that prevailing party in the prosecution or defense of the action, unless the loser is able to show substantial justification for the actions taken. The initiative also contains a provision requiring the plaintiffs or their attorneys to provide a bond for the estimated fees and expenses of the defendant, unless plaintiffs are able to show they own five percent or more of the total outstanding common shares of the organization or traded five percent or more of the total number of shares traded during the class period. The initiative also contains a provision staying all discovery until at least 30 days after the conditional or final certification of a class.

In reaction to Proposition 201, Bill Lerach of Milberg Weiss will be offering a counter-initiative for the November, 1996 ballot. That initiative is largely designed to make it easier to file securities lawsuits in the California state courts, and would, among other things, effectively reverse Proposition 201 (assuming it passes in March) and establish the "fraud-on-the-market" theory as the law of the land in California.

8. Conclusion

The Reform Act was designed to and should curb some of the abusive securities litigation we have experienced in the recent past. Because many of its provisions are new and untested, it remains to be seen how the federal courts will interpret the new provisions.

Some provisions are of immediate interest and help to our clients. The safe harbor for forward-looking statements should be of particular assistance to those of our clients who regularly communicate with analysts and who wish to supply them with forecasts and projections. Because the provisions contain several technical requirements, however, you should consult with counsel to establish a program by which the required disclosures are made each and every time a forward-looking statement is issued.

If you have any questions regarding the provisions on forward-looking statements or auditor disclosures, please call Gordon Davidson at 650-335-7237 or email him at gdavidson@fenwick.com. If you have questions regarding the litigation issues, please call Tim Roake at 650-335-7127 or e-mail him at troake@fenwick.com.