Statement of Hon. Christopher Cox
Regarding Securities Litigation Reform

Subcommittee on Telecommunications and Finance
January 19, 1995

MR. CHAIRMAN, it's frequently said that lawyers have turned America into a nation of victims. Thanks to the trial bar, which makes its living fanning these flames, not only real injuries but every imaginable harm is now compensable in court--except one. The only injury that America's trial layers are determined not to redress is the injury that comes from their own misconduct--the ruinous economic losses, the delays, and the sheer misery caused by lawyers' misconduct. Private securities litigation may be the most egregious instance of this curse today--a legal torture chamber for plaintiff and defendants alike, more suitable to the pages of Charles Dickens' Bleak House than a nation dedicated to equal justice under law.[1]

The current system of private securities litigation is an outrage and a disgrace. It cheats both the victims of fraud and innocent defendants. By lavishly encouraging meritless cases, it has destroyed thousands of jobs, undercut economic growth and American competitiveness, and raised the prices that every American consumer pays for goods and services. Yet it mocks the many victims of real, knowing fraud, who receive pennies on the dollar for their original investments. The only beneficiaries are the lawyers, who walk away with millions while their clients get a pittance for their claims.

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[1] "This is the Court of Chancery...which so exhausts finances, patience, courage, hope; so overthrows the brain and breaks the heart; that there is not an honorable man among its practitioners who would not give--who does not often give--the warning, 'Suffer any wrong that can be done you, rather than come here!'" Charles Dickens, Bleak House, p. 7 (1853).

Who are the victims of strike-suit cases? First and foremost, real victims of fraud. The current system herds them into powerless "classes" of plaintiffs, who are completely under the thumb of strike- suit lawyers. The "lead plaintiffs" who supposedly represent the victims' interest are not the average investors Mr. Lerach brings to his news conferences. As often as not, the so-called "lead plaintiffs" are virtually employees of their own counsel. Professor Coffee of Columbia has stated that "as a practical matter, the lawyer has hired the client rather than the client hiring the lawyer." As our witness Mr. Lerach once put it, "I have the greatest practice of law in the world. I have no clients."

And the same stable of tame lead plaintiffs appears in case after case. Harry Lewis has appeared as lead plaintiff in an estimated 300-400 lawsuits. Rodney Shields has been in over 80 cases. William Weinberger had appeared in 90 cases as of 1990. One court recently called one veteran strike-suit plaintiff "the unluckiest investor in the world."

With the lawyers in charge of the litigation, it's little wonder that they manage the case to <u>their</u> benefit--not their clients'. Recent studies have shown that the current system encourages strike-suit lawyers to ignore overwhelming cases of fraud--flagrant cases that should lead to a 100% recovery--in their rush to settle. That's because strike-suit lawyers clear more profit on volume than they do by pursuing individual claims. Instead of pursuing strong cases and turning away weak ones, they indiscriminately bring good, bad and indifferent claims--and then simply settle them all for their nuisance value (whatever amount is just under the defendants' cost of litigating the case).

A good example of that took place recently in my home State of California. After the owners of energy partnerships lost half the value of their investments, and despite clear evidence of misconduct in the sale of the securities, the investors' lawyers sought to settle the suit for less than a third of the case's value. Securities regulators objected that the settlement was far less than the actual value of the claims. The settlement was ultimately <u>tripled</u> as a result of the regulators' efforts. State and federal securities regulators stated that the lawyers had "made little, if any, real contribution to the substantial increase in the settlement," and demanded "a strong signal to the class action bar that, if they are to earn their fees, it is critical that the only interest they serve during a class action litigation is their clients' interest."

Even when the victims get a full recovery, the current system still ensures that they will never really be adequately compensated. Their attorneys' fees and costs come right off the top of any settlement they receive. And because the plaintiffs' lawyers, not the victims, control the litigation, they make sure that they get top dollar for their "services," no matter how meager their clients' recovery.

And the current system ensures that there will be more victims in the future--if not of fraud, at least of avoidable losses. By indiscriminately punishing even good faith, reasonable predictions about future events, strike suits compel companies to release the bare minimum legally required to be disclosed. Investors, and the market as a whole, are starved of companies' best estimates of their future prospects--the most relevant information for any investor. The Securities and Exchange Commission, Democratic National Committee Chairman Chris Dodd, and a host of others have all decried the status quo's chilling effect on efficient markets.

Strike suits claim a second set of less visible victims--ordinary workers and consumers. Both are victims of the heavy "litigation tax" levied by strike-suit lawyers. The tens of millions of dollars siphoned off each year by strike suits represents thousands of workers not hired; new products delayed or canceled outright; vital research that will never be done; and price increases imposed on consumers. And this tax falls most heavily on high-tech, biotechnology, and other growth companies--the very industries most critical to American competitiveness. One out of every four strike-suit targets is a high-tech company. High-tech and biotechnology companies have paid 40% of the cost of strike suit settlements, handing out some $440 million over the last two years alone.

The victims of fraud are visible; the employees, potential employees, and consumers victimized by strike suits all too often are not. I can't hold a press conference with blue-collar workers who were never hired, or show you the products that have never come to market, thanks to meritless strike suits. But the sheer volume of the losses tells its own story. One fast-growing high-tech company was stopped in its tracks by an extorted strike-suit settlement that, combined with litigation expenses, cost them almost $5 million. As a direct result, the company shelved aggressive plans for expansion. The company's leadership calculates that the losses caused by the suit amount to almost fifty engineer jobs, or almost 170 blue-collar jobs.

We can make the rough calculation in other ways, as well. Biomedical companies spend an average of about $33 million a year to bring a new drug to market. Since the average cost of a strike suit is over a fourth of that--$8.6 million--it seems fair to say that the average strike suit against a biomedical company translates into three months' delay in getting new drugs to the people who need them. Sins of omission may be less visible than sins of commission; but the cost is every bit as great.

Strike suits claim a third category of victims, as well--the tens of millions of Americans who've invested in securities through their labor union pension fund, ESOP, or individual mutual fund. These investors suffer twice--from whatever price fluctuation triggers the suit, and again through the costs of litigating and settling the strike suits that follow. That's why the trustees of ten public and private employee pension funds last year stated categorically, "the current system is not protecting investors and needs reform."[3]

To the extent that these investors are members of the plaintiff class, the whole lawsuit represents little more than a transfer of their assets from one pocket, marked "investor," to another, marked "plaintiff"--except that a huge percentage of the assets involved get diverted along the way.

<u>The Only Winners: The Lawyers</u>

That brings us, Mr. Chairman, to the lawyers, the only winners in this rigged casino. We are fortunate to have with us today Bill Lerach of California, one of the most distinguished representatives of the plaintiffs' bar. In the course of his career, Mr. Lerach has created a neologism: "lerachateering." He has sued Milli Vanilli under the RICO statute for "fraudulent" lip-synching--and not only lost but was sanctioned; he has sued California's biggest public employees' credit union, the Golden One--a non-profit, employee-owned service organization--for charging $5 late fees on credit card payments; he lost that one, too.

But mostly Mr. Lerach files securities class-action cases--over 400 of them, by his count two years ago. And mostly he doesn't lose, in part because mostly he doesn't go to trial. Current law creates coercive pressure to settle for the nuisance value of the suit, which turns out to be a lot of money: the average settlement totals some $8.6 million. Of that, investors get, on average, fourteen cents on the dollar. (Some studies found average recoveries to be as low as six cents on the dollar.) And lawyers get on average some $2 million. In one recent year, plaintiff's securities

[3] They went on to write: "Under the current system, defrauded investors are receiving too little compensation, while plaintiffs' lawyers take the lion's share of any settlement. Moreover, meritless litigation costs companies millions of dollars--money that could be generating greater profit for the company <u>and higher returns for investors</u>. Finally, the fear of such meritless litigation has caused many companies to minimize the amount of information that they disclose--the opposite of what we need to do our job effectively." Letter of Ten Public and Private Pension Fund Managers to Senators Dodd and Domenici (July 19, 1994) (emphasis added).

lawyers cleared a quarter of a billion dollars. No wonder Mr. Lerach said a while back, and I quote: "People try to pretend the law is not a business. Baloney! It's a big business."

What does society get for this investment? The answer is suggested by a decision two weeks ago from the Southern District of New York, our most knowledgeable and distinguished court when it comes to securities law. Let me read part of Judge Owens' opinion concerning the aftermath of Philip Morris' decision in April 1993 to lower the price of its flagship brand:

> Less than five hours later, the first of these class action lawsuits was filed....Four more lawsuits were filed that same day, and on the very next business day...five additional lawsuits were commenced....I note that in the few hours counsel devoted to getting the initial complaints to the courthouse, overlooked was the fact that two of them contained identical allegations, apparently lodged in counsel's computer memory of 'fraud' form complaints, that the defendants here engaged in conduct 'to create and prolong the illusion of [Philip Morris'] success in the toy industry. (Emphasis supplied)

Judge Owen went on to quote an earlier district court decision addressing similar facts:

> Most of the complaints are virtually identical (including typographical errors). At the hearing the court inquired about the swiftness of the plaintiffs' response to the [defendant company's] announcement...: "How did you get to be so smart and to acquire all this knowledge about fraud from Friday to Tuesday?... [O]n Friday afternoon did your client suddenly appear at your doorstep and say 'My God, I just read in the Wall Street Journal about [the defendant company]. They defrauded me,' and you agreed with them and you determined that there was fraud and therefore you had a god lawsuit, so you filed it Tuesday morning, is that what happened?

The court noted, "Counsel for the plaintiffs was not responsive to this line of inquiry."

The Contract With America

When we drafted the Contract With America strike suit bill, I had both these problems in mind. We were determined to write a bill that did better than the current system both for fraud victims and for innocent defendants.

To protect fraud victims, we borrowed provisions from the Senate's bipartisan

Dodd-Domenici bill that ensure plaintiffs, not their lawyers, will control the litigation. Our plaintiff steering committee and disclosure requirements will empower fraud victims to determine what actions are in their best interest--from settlement decisions to the size of attorney's fees. You can bet that informed plaintiffs will not willingly accept six cents on the dollar in cases of real fraud. In addition, we deploy a battery of weapons against abusive "professional plaintiffs": barring bonus payments; requiring lead plaintiffs (and only lead plaintiffs) to have collectively owned a grand total of 1% or $10,000 worth of the securities at issue; and adopting a "five-strikes" rule that allows litigants to serve as lead plaintiffs in no more than five cases every three years.

To ensure that fraud victims and innocent defendants alike are completely compensated for their losses, federal securities law would reflect the rule that prevails throughout most of the world: prevailing investors will recover their legal fees in addition to their damages, rather than having to pay their lawyers out of their own recovery. So will defendants who have been exonerated. But plaintiffs who fear this consequence can avoid it simply by filing suit in state rather than federal court.

In addition to strengthening the rights of genuine victims, our bill would also end the fleecing of innocent defendants. We would end the costly "fishing expedition" lawsuits that create coercive pressure for even innocent parties to settle. We codify the California Supreme Court's recent holding that litigants must actually rely on misrepresentations and omissions. We restore the traditional definition of fraud, ending the oxymoron of "unknowing fraud" and creating a clear standard of conduct. And we direct the SEC to issue rules creating a safe harbor for responsible predictive information, promoting market efficiency and ensuring investor access to the best available investment information.

Orange County

Mr. Chairman, opponents of the Contract With America have spent much time and energy arguing that my bill will hurt my own constituents, the taxpayers and bondholders of Orange County. I believe that a number of them have come all the way to Washington and are in the audience here today in opposition to the Contract reform bill.

I sincerely hope that I don't have to prove my credentials to speak to this issue. Since the crisis developed, I've taken the lead in fashioning federal relief legislation that will relieve the burden on Orange County without fiscal irresponsibility. And long before the crisis erupted in Orange County erupted, I did everything in my power to oppose Bob Citron's irresponsible investment plan--the plan that caused my constituents' losses. Although since then everyone from Senator Boxer to my distinguished colleague from Massachusetts have jumped on to denounce Bob Citron, at the time it was lonely work. One of the few other people who did at the time was Citron's opponent for County Treasurer, John Moorlach, who predicted the County investment Pool's collapse with uncanny accuracy.[3] If there is any hero in the Orange County debacle, it's John Moorlach.

I'd like to insert in the hearing record what John wrote about our Contract With America bill to Chairman Fields and my distinguished colleague from Massachusetts. I'll also take this opportunity to quote briefly from it:

> I find it ironic that the Contract bill to limit frivolous securities suits has been a particular target for criticism. The taxpayers of Orange County will suffer severe financial repercussions resulting from [Citron's] strategy. Now lawyers may victimize our taxpayers a second time, by extorting multi-million dollar settlements under rigged rules that stack the deck against the County. This game has already started in Orange County. Whatever the rights or wrongs of these cases, the only certainty is that under the current system only the lawyers will get rich. Justice will not be done--not for the plaintiffs, who will receive a percentage on the dollar as their lawyers benefit from the handsome fees; and not for Orange County's taxpayers, who may have to take another multimillion dollar hit that will be as unnecessary and destructive as Citron's investment strategy itself.
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> The Contract With America bill will stop this "legalized embezzlement" farce. It will strengthen the rights of real victims of fraud, while preventing frivolous cases from victimizing responsible people. It will be good for the country and good for Orange County.

I would also like to add to the record a letter I sent yesterday to Ed, setting out in greater detail why I believe the Contract With America will help Orange County investors and taxpayers, and why his bill will hurt them both.

I would like to close by commenting on how unfortunate it is that such concerted efforts at fearmongering have been made with respect to my bill. I was vividly reminded of the human cost of this political gamesmanship last weekend, when

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[3] In May 1994, Citron issued a detailed, heavily documented critique of Citron's strategy, warning the County that "I would strongly recommend that you prepare for a worst-case scenario." I chaired John's campaign for Treasurer.

I got a call in the office from an elderly constituent who was almost sick with fear because of lying propaganda she had been given about the effect of the Contract With America on her Social Security. After we had spoken for a while and I had allayed her concerns somewhat, she very plaintively asked me why people would tell her those things? Didn't they know how much anguish they were causing her and people like her? I didn't really have the heart to tell her that I was quite certain that they did; that they not only knew it but banked on it.

And I have every reason to ask the same question about the same big-lie scare tactics that are being used against H.R. 10. It is extraordinary, to use no stronger word, that responsible figures would seek to exploit the tragedy in my home County, and create baseless fears in the general public, for the sake of political advantage.

I would also like to say that I find it extraordinary that a member of this Subcommittee would preside at a press conference of my constituents, summoned for the purpose of accusing me of abandoning their interest, without having the courtesy even to speak to me about it prior to the event. I am sincerely sorry that this appears to be the standard of collegiality the minority wishes to adopt; but if it is, I would only observe that my distinguished colleague from Massachusetts represents, or at any event has in his district, Route 128, one of the most important high-technology centers in America--and one of the places, like Silicon Valley, most victimized by strike suits. I challenge any impartial observer to look at my bill and his, and tell me which of us is doing a better job of representing his constituents.

Conclusion

Mr. Chairman, we can and must reform a system that mocks fraud victims with a pittance, while it simultaneously defrauds and victimizes innocent workers, investors, and consumers through extorted settlements. Today, everyone who enters federal court in a securities case loses--except the lawyers. We can and must create a system that swiftly finds and punishes real fraud, and allows the victims of fraud to be fully compensated for their losses. We can and must create a system that swiftly exonerates innocent parties, and stops the hemorrhaging of jobs and savings.

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