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INTRODUCTION

For close to fifty years Rule 10b-5[1] (the "Rule") has provided a remedy for private investors injured as a result of securities fraud. Over this period, the courts have painstakingly defined, honed, and developed the Rule, thereby establishing it as a proven weapon to counter securities fraud violations.

Recently, however, Rule 10b-5 has come under attack. Politicians and business leaders assert that extant principles of Rule 10b-5 litigation encourage meritless suits that have spawned an excess of securities litigation. These groups argue that this superfluous litigation hinders America's global competitiveness and threatens the viability of major financial institutions.[2] In response to these concerns, legislative efforts have commenced in earnest to restrict litigation under Rule 10b-5.

In August 1992, bills targeting Rule 10b-5 litigation (the "bills") were introduced in both houses of Congress as part of a bipartisan effort to reform Rule 10b-5.[3] Although Congress did not act upon the bills before the Congressional session ended, the original sponsors of the House bill

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1. 17 C.F.R. § 240.10b-5 (1992). Rule 10b-5 was promulgated by the Securities Exchange Commission ("SEC"). The rule provides as follows:

> § 240.10b-5 Employment of manipulative and deceptive devices.
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> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

Id.

2. *See* 138 Cong. Rec. S12,599 (daily ed. Aug. 12, 1992) (statements of Sen. Domenici); 138 Cong. Rec. E2463 (daily ed. Aug. 12, 1992) (statements of Rep. Tauzin).

3. *See* H.R. 5828, 102d Cong., 2d Sess. (1992). Representatives Tauzin, Lent, Hall, and Ritter introduced the House bill. The legislation is described as a bill "[t]o amend the Securities Exchange Act of 1934 in order to reform private enforcement of the Federal securities laws, and for other purposes." *Id.* The bill is entitled the Securities Private Enforcement Reform Act. *See id.*; S. 3181, 102d Cong., 2d Sess. (1992). Senators Domenici and Sanford introduced the Senate bill. The Senate bill was titled the Securities Private Enforcement Act of 1992. *See id.* The bill died at the end of the 102d Congress. As of the writing of this Note, the Senators have not reintroduced their bill. For an up-to-date listing of bill H.R. 417's co-sponsors, see *Securities Private Enforcement Reform Act*, Bill Tracking Report, *available in* LEXIS, Legis Library, BLTRK File (presenting the list of sponsors and cosponsors of the house bill and their respective political parties).

reintroduced it to the new Congressional session in early 1993.[4] The legislative proposals put forth in the House bill embody sweeping changes to the procedural provisions of the Rule, and will produce far-reaching consequences for participants in the securities industry—investment bankers, insurance companies, accounting firms, and investors.[5] Among the proposals under consideration are provisions for fee shifting, proportional liability in place of joint and several liability, a heightened burden of proof—from a preponderance of the evidence standard to a clear and convincing evidence standard, and an extended statute of limitations period.[6]

The proposed reforms are controversial. Controversy over these proposals may be heightened by the fact that one of the premises underlying the reforms—that Rule 10b-5 encourages frivolous litigation—is dubious at best. Even assuming that underlying premise is true, the reforms suggested embody risks that may outweigh the intended benefits. In other words, the cure may be worse than the disease. The fear is that the proposed reforms will chill private enforcement of the securities law to such an extent that Rule 10b-5 will no longer be an effective deterrent against securities fraud.

This Note explores the recent efforts to restrict litigation under Rule 10b-5 and argues that the present Rule 10b-5 reform measures are merely cosmetic remedies that conceal more troubling issues. Specifically, this Note asserts that the putative evils attributed to Rule 10b-5 abuse can be more readily traced to problems identified with class action litigation in general, the dual role of the public accountant, and the development of alternative, overlapping securities fraud remedies.

In addition, this Note argues that along with difficulties relating to the substance of the proposed reforms, development and expansion of alter-

4. *See* H.R. 417, 103d Cong., 1st Sess. (1993).

5. The House bill and the Senate bill contained substantially similar provisions. *Compare* H.R. 5828, 102d Cong., 2d Sess. (1992) *and* H.R. 417, 103d Cong., 1st Sess. (1993) (containing a provision for a new statute of limitations for Rule 10b-5 actions, proportionate liability in place of joint and several liability and fee shifting where the losing party's claim was not substantially justified) *with* S. 3181, 102d Cong., 2d Sess. (1992) (same). One difference between the two bills concerns the specifics of their fee shifting provisions. Fee shifting under the House bill is nearly automatic because the House bill directs the court to award attorney fees and costs to the successful litigant "unless the the court determines that the position of the losing party was substantially justified." H.R. 417, 103d Cong., 1st Sess. § 3(a)(b) (1993). The Senate bill's fee shifting provision, by contrast, contains certain pre-conditions to fee shifting. First, the Senate bill permits fee shifting only if the court entered a prelimary ruling stating that fee shifting might be appropriate in the case. *See* S. 3181, 102d Cong., 2d Sess. § 3(c)(1) (1992). Second, after a final judgment in the action, to recover fees and expenses, the prevailing party must make a motion for fees and expenses. *See id.* § 3(b)(1). Both bills exempt substantially justified claims from fee shifting. See id. § 3(b)(2); H.R. 417, 103d Cong., 1st Sess. § 3(b)(1) (1993).

6. *See* H.R. 5828, §§ 3-5; *see also infra* part II (discussing three reform proposals at length). The proposals also include provisions for limiting attorney fees in class action litigation. *See* H.R. 417, 103d Cong., 1st Sess. (1993).

native securities fraud remedies threaten to vitiate the intended remedial effects of the proposed reforms. In particular, while the legislative spotlight shines on Rule 10b-5, plaintiffs continue to turn to the Racketeer Influenced and Corrupt Organization Act[7] ("RICO") to provide an alternative security fraud remedy.

Part I of this Note discusses the background, motivations, and presumptions giving rise to the movement towards reform. Part II examines specific reform proposals and explores some of the difficulties they engender. Part III argues that Congress should abandon Rule 10b-5 reform. This Note concludes that Congress should instead redirect its efforts towards the reform of overlapping securities fraud remedies, starting with civil RICO.

I. PRIVATE ENFORCEMENT OF § 10(b): ESSENTIAL FOR EFFICIENT MARKETS

Congress enacted section 10(b) of the Securities Exchange Act of 1934[8] (the " '34 Act") to address securities fraud. More precisely, Congress enacted section 10(b) to prevent "knowing and intentional misconduct designed to deceive or defraud investors."[9] Towards this end, section 10(b) authorizes the Securities Exchange Commission (the "SEC") to promulgate rules to effectuate section 10(b)'s purpose.[10] Accordingly, the SEC promulgated Rule 10b-5 to implement section 10(b) of the '34 Act.[11] Neither section 10(b) nor Rule 10b-5 expressly provide for a private right of action to enforce their provisions. Since 1946, however, the courts have implied such a right.[12] Courts and commentators

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7. 18 U.S.C. §§ 1961-1968 (1988 & Supp. II 1990).

8. 15 U.S.C. §§ 78a-78ll (1988 & Supp. II 1990). Section 10(b) provides in relevant part as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1988).

9. Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 Stan. L. Rev. 385, 387 (1990) (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)); *see* Aaron v. SEC, 446 U.S. 680, 689-90 (1980); Chiarella v. United States, 445 U.S. 222, 226 (1980); Santa Fe Indus. v. Green, 430 U.S. 462, 471-72 (1977).

10. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78ll (1988 & Supp. II 1990).

11. *See* Kardon v. National Gypsum Co., 69 F. Supp. 512, 513 (E.D. Pa. 1946).

12. *See id.*; Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 111 S. Ct. 2773, 2779-80 (1991) (acknowledging that private actions under § 10(b) of the '34 Act and Rule 10b-5 have been implied by courts for close to 50 years); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 n.16 (1976) (citing *Kardon* as support); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971).

have since recognized that private actions under Rule 10b-5 are essential to the effective functioning of the securities laws because the government lacks the resources to police Rule 10b-5 violations alone.[13] Private actions supplement government enforcement efforts and ensure the integrity and efficiency of the markets by deputizing investors to enforce the law as "private attorneys general."[14]

Reforms that increase the burdens upon investors seeking to enforce Rule 10b-5 through private litigation entail a risk that they will diminish the effectiveness of the private attorney general patrol. Such reforms may also undermine confidence in the securities markets because the threat of civil liability is a crucial deterrent to securities fraud.[15]

II. FACTORS UNDERLYING THE CURRENT REFORM MOVEMENT: A CASE OF MISTAKEN IDENTITY

Proponents of reform allege that abuses of Rule 10b-5 have caused far reaching deleterious consequences. For example, supporters of reform assert that Rule 10b-5 is used by investors to hedge against investment loss.[16] Such abuse occurs when investors faced with a loss resulting from a movement in the price of a stock simply sue under Rule 10b-5 to recover their losses.[17] In addition, Rule 10b-5 allegedly is used by specula-

13. *See* Richard C. Breeden, Remarks at Corporate Counsel Institute 5, (Oct. 16, 1991) (transcript on file with *Fordham Law Review*) ("Private securities litigation has long been recognized as an important tool for helping to achieve the enforcement of the federal securities laws.... Private actions have a very important role to play in redressing the effects of deliberate fraud on investors, and in supplementing the enforcement efforts of the SEC."); Berner v. Lazzaro, 730 F.2d 1319, 1322-23 (9th Cir. 1984) ("The resources of the [SEC] are adequate to prosecute only the most flagrant abuses. To this end, private actions brought by investors have long been viewed as a necessary supplement to SEC enforcement actions.") (citations omitted); *see also* J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) (noting that private actions supplement SEC enforcement efforts).

14. 5A Arnold S. Jacobs, Litigation and Practice Under Rule 10b-5, § 8.01, at 1-228 (2d ed. 1992). Governmental action, while important, is incapable of enforcing the securities laws alone. Private actions are the primary enforcement mechanism of the securities laws. Private actions are "the most effective way to police 10b-5 breaches and provide[ ] the deterrent element so essential in securities transactions." *Id.* § 8.01, at 1-228 to 1-229 (citations omitted). Judge Jerome Frank first used the term "private attorney general" in an opinion in 1943 to refer to private individuals who are authorized to bring actions to "vindicate the public interest." Associated Indus. v. Ickes, 134 F.2d 694, 704 (2d Cir.), *vacated*, 320 U.S. 707 (1943). For a brief review of the development of private enforcement, see John C. Coffee, Jr., *Understanding The Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 Colum. L. Rev. 669, 669-70 n.1 (1986).

15. *See Berner*, 730 F.2d at 1323.

16. *See* 138 Cong. Rec. S12,599 (daily ed. Aug. 12, 1992) (statements of Sen. Domenici); 138 Cong. Rec. E2463 (daily ed. Aug. 12, 1992) (statements of Rep. Tauzin). Both Senator Domenici and Representative Tauzin alleged that speculators were instituting suits under Rule 10b-5 to recover investment losses. Senator Domenici further stated that a lawsuit investment hedge is employed regardless of whether the stock price moves up or down, because any move in the price of a stock produces losses. *See* 138 Cong. Rec. S12,599, S12,599.

17. *See* 138 Cong. Rec. S12,599, S12,599; *see also* Kennedy v. Josephthal & Co., 635

tors to coerce large settlements from defendants.[18] Further abuses include the use of pro forma complaints alleging Rule 10b-5 violations, filed by certain law firms merely upon the news of stock price swings.[19]

According to reformers, these abuses of Rule 10b-5 have adversely effected the national economy. For example, they argue that the increased incidence of securities fraud litigation has discouraged experienced directors and officers from sitting on the boards of directors of publicly held corporations.[20] In addition, they allege that excessive securities fraud litigation has devastated the accounting industry to the extent that many accounting firms now avoid auditing companies with highly volatile stocks.[21]

Proponents of reform argue that these developments threaten America's global competitiveness. They base their argument on the premise that incipient companies often experience stock volatility and that such companies often introduce innovative products.[22] If accountants refuse to audit these companies' financial statements, such companies will have difficulty raising cash in the capital markets.[23] Lack of capital will hinder these companies from introducing their innovative products.[24] Consequently, excessive securities litigation is said to hinder America's global competitiveness.[25]

Although Rule 10b-5 abuses do exist,[26] there are underlying issues which, arguably, are themselves responsible for the adverse effects attributed to Rule 10b-5 litigation. These underlying issues, discussed below, include the perception of excess litigation in our society, the abuse of class action litigation and the attempt by repeat defendants to limit their liability.

F. Supp. 399, 405 (D. Mass. 1985) (admonishing the plaintiff that Rule 10b-5 was not designed to provide recovery for an ordinary investment loss), *aff'd*, 814 F.2d 798, 806 (1st Cir. 1987).

18. *See* 138 Cong. Rec. S12,599 (daily ed. Aug. 12, 1992) (statement of Sen. Domenici).

19. *See id.* at S12,599-600.

20. *See id.* at S12,601.

21. *See id.* at S12,599; Arthur Andersen & Co. et al., The Liability Crisis in the United States: Impact on the Accounting Profession 5 (1992). The industries that pose a heightened liability risk to auditors include "financial institutions, insurance companies, [ ] real estate investment firms[,] . . . high technology and mid-size companies, and private companies making initial public offerings (IPOs)." *Id.* While the larger firms are screening their clients more carefully, some of the mid-size and smaller accounting firms have abandoned their audit business entirely. *See id.*

22. *See* 138 Cong. Rec. S12,599 (daily ed. Aug. 12, 1992) (statements of Sen. Domenici); 138 Cong. Rec. E2463 (daily ed. Aug. 12, 1992) (statements of Rep. Tauzin).

23. *See* 138 Cong. Rec. S12,599, S12,599 (daily ed. Aug. 12, 1992) (statements of Sen. Domenici).

24. *See id.*

25. *See id.*; Arthur Andersen & Co. et al., *supra* note 21, at 5.

26. *See, e.g.*, Kennedy v. Josephthal & Co., 635 F. Supp. 399, 405 (D. Mass. 1985) (admonishing plaintiff that Rule 10b-5 was not designed to provide recovery for an ordinary investment loss), *aff'd*, 814 F.2d 798, 806 (1st Cir. 1987).

A. *Societal Perception of a Litigation Explosion*

Over the past decade, the perception of litigation as a national pastime has been debated forcefully.[27] Politicians[28] and academics[29] have argued that America suffers from excessive litigation and Congress or the judiciary should somehow restrict access to the courts. Consistent with this trend, litigation reform efforts have recently focused on restricting suits under Rule 10b-5.[30]

In many respects, the debate over securities litigation reform parallels the larger debate concerning general litigation reform in our society. Arguably, the current Rule 10b-5 reform movement is simply an outgrowth of the larger movement towards litigation reform; it incorporates many of the same disputed assumptions and arguments. A brief discussion of the general litigation reform debate is therefore relevant in exploring the impetus for securities litigation reform.

1. General Litigation Explosion

On one side of the debate over general litigation reform are those who assert that the courts are flooded with frivolous lawsuits that cost society upwards of $300 billion a year.[31] These groups argue that "America[ ]'s

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27. *Compare* Walter K. Olson, The Litigation Explosion (1991) (arguing that America is experiencing a litigation explosion) *and* Peter W. Huber, Liability (1988) (arguing that the development of tort law and expansion of liability over the past three decades primarily has benefitted lawyers while resulting in a "tort tax" levied upon society) *and* Warren E. Burger, *Too Many Lawyers, Too Many Suits*, N.Y. Times (Book Rev.), May 12, 1991, at 12 (review of Olson's book, *supra*) *with* Marc Galanter, *Reading the Landscape of Disputes: What We Know and Don't Know (And Think We Know) About Our Allegedly Contentious and Litigious Society*, 31 UCLA L. Rev. 4 (1983) (analyzing data on the way society currently processes disputes and arguing that claims that America is an overlitigatious society draw upon weak scholarship and flawed policy analysis) *and* Jack B. Weinstein, *After Fifty Years of the Federal Rules of Civil Procedure: Are the Barriers to Justice Being Raised?*, 137 U. Pa. L. Rev. 1901, 1909 (1989) (doubting the existence of a litigation explosion and noting that federal judges have approximately the same number of cases now as they had in 1960) *and* Richard L. Marcus, *The Revival of Fact Pleading Under the Federal Rules of Civil Procedure*, 86 Colum. L. Rev. 433, 440, 442 n.54 (1986) (noting that "dramatic increases in litigation are hardly unprecedented" and "empirical investigation suggests that the current preoccupation with the litigation 'boom' may be an overreaction").

28. *See, e.g.*, Nancy E. Roman, *Angry at Bush and Quayle, Lawyers Pour Funds to Clinton*, Wash. Times, Oct. 5, 1992, at A5 (reporting that Vice President Dan Quayle has argued repeatedly that there are "too many lawyers and too much litigation and that frivolous lawsuits increase medical costs, consumer costs, and insurance premiums"); Joe Queenan, *Birth of a Notion*, Wash. Post, Sept. 20, 1992, at C1, C2 (reporting that Vice President Dan Quayle argued that litigation costs Americans $80 billion dollars per annum).

29. *See* sources cited *supra* note 27.

30. *See* H.R. 417, 103d Cong., 1st Sess. (1993); S. 3181, 102d Cong., 2d Sess. (1992); H.R. 5828, 102d Cong., 2d Sess. (1992).

31. *See* American Bar Assoc., *Comparisons of Various Studies of the U.S. Civil Justice System with the Remarks of President Bush and Vice President Bush and Vice President Quayle* 4 (developed by Talbot D'Alemberte) (on file with the *Fordham Law Review*). " 'Every year in America, individuals and businesses spend more than [$]80 billion on

love affair with the lawsuit"[32] causes far reaching consequences. For example, excessive litigation allegedly hinders national competitiveness[33] by discouraging the development of new products,[34] increasing unemployment,[35] and flooding the courts with frivolous cases that expend judicial time and effort more appropriately reserved for meritorious suits.[36]

These assertions, however, are strongly contested.[37] On the other side of the debate, critics argue that the $300 billion estimated cost of litigation is not based upon sound evidence but is instead the product of flawed assumptions and calculations.[38] Indeed, critics argue that calculations regarding the costs of a liability system are far from precise.[39] Moreover, the $300 billion statistic erroneously considers the costs of litigation while ignoring the intangible benefits of litigation.[40] Critics argue that by reducing the analysis of litigation to a financial costs/benefits calculus one ignores many of the important incalculable benefits that the law performs, such as creating incentives for product enhancement and product safety.[41]

2. Notion of Litigation Explosion Underlying Securities Reform

Legislative efforts to reform securities litigation coincide with the general litigation reform debate and incorporate some of the same arguments. For example, proposed securities reform legislation explicitly embraces the notion of a general litigation explosion.[42] Senator Domenici, sponsor of the now-defunct Senate bill, stated that "[society

direct litigation costs and higher insurance premiums. When you include the indirect costs, it may add up to more than [$]300 billion.'" *Id.* (quoting Vice President Dan Quayle's remarks at the Annual ABA meeting in Atlanta Georgia, Aug. 13, 1991).

32. *Id.* at 2 (quoting President George Bush in an address to the National Grocers Association on Feb. 4, 1992).

33. *See id.* at 3.

34. *See* 138 Cong. Rec. S12,599-60 (daily ed. Aug. 12, 1992) (statements of Sen. Domenici).

35. *See id.*

36. *See* Marc Galanter, *Pick A Number, Any Number*, Am. Law., Apr. 1992, at 82.

37. *See id.*

38. *See id.*; *Presumed Guilty*, Economist, Sept. 12, 1992, at 30. The claim that litigation costs $300 billion a year is "bogus." *Id.* The $300 billion dollar estimated cost of litigation to society was a product of conjecture and dubious scholarship—the figure started out as $80 billion which was a number forwarded in the course of a "round-table discussion of insurance costs by a group of executives in 1986 . . . . [That figure was multiplied] by 3.5 to create an estimate for the indirect costs of litigation: some $300 billion." Milo Geyelin, *Tort Bar's Scourge*, Wall St. J., Oct. 16, 1992, at A1, A1.

39. *See Presumed Guilty*, *supra* note 38, at 30; Geyelin, *supra* note 38, at A1.

40. *See* Galanter, *supra* note 36, at 85. By emphasizing the financial costs of litigation, one fails to take into account some of the incalculable benefits of litigation. Litigation provides "vindication [of legal rights], induce[s] investment in safety, and deter[s] undesirable behavior." *Id*; *see also Presumed Guilty*, *supra* note 38, at 30 (estimated cost of litigation to society does not "take [into] account [ ] the indirect benefits [of litigation], such as product safety").

41. *See Presumed Guilty*, *supra* note 38, at 30.

42. *See* 138 Cong. Rec. S12,599 (daily ed. Aug. 12, 1992) (statements of Sen. Domenici).

is] suffering from hyperlexia, a serious disease caused by an excessive reliance on law and lawyers. It is pervasive throughout our society but has reached epidemic dimensions in the court-created private actions brought under section 10(b) of the ['34 Act]."[43] He also describes the adverse effects meritless securities litigation has on society which, not surprisingly, mirror the predicted effects of a general litigation explosion.[44]

Similar to the debate over whether the country is experiencing a litigation explosion, whether there has been an "explosion" in Rule 10b-5 litigation is also heatedly contested. Opponents of reform argue that the number of Rule 10b-5 cases brought in federal courts has actually declined in recent years.[45] In addition, the recent success of the capital markets in raising funds for new issues counters the arguments of those asserting that a Rule 10b-5 explosion is hindering capital formation.[46]

B. *The Class Action Controversy: Problems of Class*

Supporters of Rule 10b-5 reform assert that under current principles of securities litigation, the settlement values of meritless suits are identical to meritorious ones.[47] Such conditions encourage frivolous litigation because the incentive for a plaintiff to bring a meritless securities fraud suit

43. *Id.* For a discussion of the derivation of the word "hyperlexia," see Galanter, *supra* note 27, at 4 n.4.

44. Excessive securities litigation hinders competition and chills innovation. *See* 138 Cong. Rec. S12,599 (daily ed. Aug. 12, 1992) (statements of Sen. Domenici). "Everyone says they care about competitiveness, yet if we don't stop this destructive trend, the only manufacturing preeminence the United States may enjoy is the world renowned ability to manufacture lawsuits." *Id.* at S12,601 (statements of Sen. Domenici).

45. *See* William Lerach, *The Claims Made By Senator Domenici On The Senate Floor Are False* 1 (1992) (on file with the *Fordham Law Review*). Lerach argues that since the Supreme Court's decision in Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987), the number of suits in federal courts predicated on violations of Rule 10b-5 have declined. In *McMahon*, the Supreme Court held that an arbitration agreement between a broker and customer was enforceable even where the arbitrable controversy involved allegations of violations of § 10(b) of the '34 Act. *See id.* at 238. The customer had argued that the agreement was unenforceable because it violated § 29(a) of the '34 Act which voids any agreement that waives compliance with a provision of the Act. *See id.* at 228. The customer argued that since § 27 of the '34 Act gave the district courts exclusive jurisdiction over violations of § 10(b), § 10(b) claims could not be arbitrated rendering the arbitration agreement void. *See id.* The Court rejected this claim looking to the Federal Arbitration Act's, 9 U.S.C. §§ 1307 (1988 & Supp. I 1991), strong policy of encouraging arbitration of disputes. *See* McMahon, 482 U.S. at 225-26. Courts should uphold arbitration agreements in disputes involving violations of § 10(b) because "the SEC has sufficient statutory authority to ensure that arbitration is adequate to vindicate Exchange Act rights." *Id.* at 238.

46. *See* William Lerach, *The Claims Made By Senator Domenici on The Senate Floor Are False* 4 (1992). Lerach argues that the record number of initial public offerings over the past few years debunks claims that excessive Rule 10b-5 suits are hindering capital formation. In 1992, initial public stock offerings raised a record $39.4 billion. Many observers believe that this record setting trend will continue. *See* Sara Calian, *IPO's Raise A Record $39.4 Billion For '92*, Wall St. J., Jan. 4, 1993 at C1.

47. *See* 138 Cong. Rec. S12,599 (daily ed. Aug. 12, 1992).

is the same as the incentive to bring a meritorious one.[48] To bolster these assertions, supporters of reform refer to a recent study published in the *Stanford Law Review*.[49] This article argues that securities suits that take the form of a class action have a predisposition toward abusive litigation because the merits of such cases are irrelevant.[50] The study does not, however, single out litigation under Rule 10b-5, nor does it support sweeping reform of Rule 10b-5. The abuses and deleterious consequences associated with class action litigation nonetheless have been inappropriately cited as support for Rule 10b-5 reform.[51] A discussion of the abuses long associated with securities class action litigation is necessary in order to identify the origins of some of the arguments made in support of Rule 10b-5 reform.

1. Benefits of a Class Action

A class action allows an individual whose damages are insufficient to justify the costs of a solitary suit to join his or her claim with other victims of the same fraud.[52] Only one suit is then instituted on behalf of the joined claims. Legal fees are paid out of the award of damages if the class is successful.[53] By spreading the costs of the litigation across a group of plaintiffs, the class action promotes the prosecution of claims that would otherwise go unprosecuted.[54] Consequently, the threat of a class action lawsuit heightens the vigilance of would be defendants.[55]

These features of a class action make it a particularly appropriate form of litigation under the securities laws. As noted above, the securities laws rely upon the enforcement efforts of individual plaintiffs. By facilitating such efforts, the class action promotes the enforcement of the securities laws. Similarly, by heightening the vigilance of would be defendants, the class action furthers the goals of the securities laws by encouraging those involved in securities transactions to maintain a higher standard of conduct. The importance of the class action to securities fraud litigation has been described as "essential to the integrity of our financial markets."[56]

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48. *See id.*

49. *See infra* note 64 and accompanying text.

50. *See infra* note 64 and accompanying text.

51. *See* 138 Cong. Rec. S12,599 (daily ed. Aug. 12, 1992) (statements of Sen. Domenici); 138 Cong. Rec. E2,463 (daily ed. Aug. 12, 1992) (statements of Rep. Tauzin).

52. *See* Jack H. Friedenthal et al., Civil Procedure § 16.1, at 722 (1985).

53. *See id.*

54. *See id.*

55. *See* William Lerach, *Counterpoint: Class Action Suits Help Keep Predators Away*, San Jose Bus. J., May 25, 1992, at 7. William Lerach is a prominent class action plaintiff's attorney. He has argued forcefully the importance of class action litigation. By highlighting the recent well publicized scandals on Wall Street, including "[t]he scandals involving Drexel Burnham Lambert, Michael Milken, Ivan Boesky, Charles Keating, BCCI and the Treasury markets, and a disturbing number of the nation's savings and loans," he has asserted that now is an inappropriate time to seek reforms that would curtail private enforcement of the securities laws. *Id.*

56. *Id.*

2. Problems Associated With Class Action Litigation

Notwithstanding the benefits of a class action, courts and commentators have criticized this form of litigation as embodying a danger of extortion.[57] Because the individual damages of members in a class are aggregated, the damages sought in a class action can be exorbitant. A defendant who faces the hazard of class action damages must choose between settlement for a fixed amount or face the caprice of a jury verdict.

The Supreme Court acknowledged this danger[58] in *Blue Chip Stamps v. Manor Drug Stores*,[59] a class action Rule 10b-5 securities fraud suit. There, the Court stated that, "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general. . . . The very pendency of the lawsuit may frustrate or delay normal business activity of the defendant which is totally unrelated to the lawsuit."[60] By this statement, the Court accepted the theory that "nuisance actions give plaintiff's attorneys extortionate leverage over defendants."[61]

The issue of whether class action litigation consists disproportionately of frivolous suits has been a "theme long debated in the legal literature."[62] Anecdotal evidence suggesting that settlement values in class action litigation do not reflect the merits of a case has existed for some time.[63] Only recently, however, has a statistical study appeared to support that assertion.

In 1991, the *Stanford Law Review* released a seminal article by Professor Janet Cooper Alexander, wherein she analyzed the seventeen computer-related companies that made initial public offerings ("IPO's") in 1983.[64] Twelve of these companies subsequently experienced precipitous declines in their stock price.[65] Of these twelve, nine were sued in class actions alleging securities fraud.[66] Six of the suits settled for between 20 and 27.5% of the damages sought. The three other cases had settlements outside of this range due to special circumstances. The study concludes that "the most likely explanation for the similarity of outcomes [of the

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57. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739-40 (1975).

58. *See id.* at 739-40.

59. 421 U.S. 723 (1975).

60. *Id.* at 739-40. The case involved a class action Rule 10b-5 suit and the Court's statement was directed at the abuses of the attorneys who represent the class. Thus the statement was not an indictment of all Rule 10b-5 suits. *See* John C. Coffee, Jr., *supra* note 14, at 670-71 n.3.

61. Coffee, *supra* note 14, at 670-71 n.3.

62. *Id.* at 673.

63. *See* John C. Coffee, Jr., *Suspect Settlements In Securities Litigation*, N.Y. L.J., Mar. 28, 1991, at 5.

64. *See* Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements In Securities Class Actions*, 43 Stan. L. Rev. 487, 517 (1991).

65. *See id.* at 511.

66. *See id.*

six settled suits] is that the merits did not affect the settlement amounts."[67]

This conclusion suggests that where the merits do not matter in class action settlements a dangerous incentive for vexatious litigation exists. Under such a system, the incentive to bring meritless suits is identical to the incentive to bring meritorious ones because each is likely to settle for approximately the same percentage of the damages sought. The cumulative result of this phenomenon is that likely defendants, i.e., the accounting firms and banks, will be reluctant to service clients in high risk industries where stock prices are particularly volatile.[68] And, again, because it is the incipient companies whose stock prices are often the most volatile, these companies will find it more difficult to raise capital in the markets.[69] Although these conclusions seem to support reform of Rule 10b-5,[70] their validity is suspect for the following reasons. First, Professor Alexander's analysis involved a study of class actions that were not predicated exclusively on violations of Rule 10b-5. The cases were also predicated on violations of section 11 of the Securities Act of 1933[71]—a critical distinction.[72] Under section 11, an issuer of securities is held strictly liable for material misstatements and must prove nonnegligence.[73] Thus, in contrast to Rule 10b-5, actions under section 11 often render the usual facts of a case irrelevant.[74] It is therefore not surprising

67. *Id.* at 523. This conflicts with an economic analysis of settlement behavior which posits that the settlement value of a case is a function of the merits of a case, i.e., probability of success, multiplied by the damages sought. *See id.* at 509 n.36; John C. Coffee, Jr., *Suspect Settlements in Securities Litigation*, N.Y. L.J., Mar. 28, 1991, at 5; George L. Preist & Benjamin Klein, *The Selection of Disputes For Litigation*, 13 J. Legal Stud. 1, 7 (1984).

68. *See* 138 Cong. Rec. S12,600-01 (daily ed. Aug. 12, 1992) (statements of Sen. Domenici).

69. *See id.*

70. *See id.*

71. *See* 15 U.S.C. §§ 77k(a) (1988). Section 11 provides an express statutory remedy to persons who acquired securities issued under a registration statement that contained an untrue statement of a material fact or that omitted to state a material fact required to be stated. *See id.*

72. *See* Alexander, *supra* note 64, at 509 n.36 (all the suits alleged that the offering documents did not provide adequate disclosure and the "legal theories included claims for violations of federal securities laws, section 11 . . . and Rule 10b-5").

73. *See* 15 U.S.C. § 77k(b) (1988); Herman & MacLean v. Huddleston, 459 U.S. 375, 381-82 (1983); *In re* Wonder Worlds, No. C 87-5491 SC, 1993 WL 63940, at *28 (N.D. Cal. Jan. 20, 1993); Chang v. Moon, No. Civ. 92-733-MA, 1992 WL 420866, at *1 (D. Or. Oct. 21, 1992); Moore v. Keegen Management Co., 794 F. Supp. 939, 946 (N.D. Cal. 1992).

74. Other defendants, like the accountants who certified the registration statement, are presumed to be liable. *See* 15 U.S.C. § 77(b)(3) (1988). This presumption, however, can be rebutted by a showing of nonnegligence. *See id.* Although facts are generally irrelevant in cases where § 11 is used against issuers, facts are relevant where plaintiffs assert a § 11 violation against accountants. Because the cases included in Professor Alexander's study included § 11 claims against both issuers and accountants, the facts may not have been completely irrelevant. They would likely have been relevant to the claims against the accountants. Nonetheless, Professor Alexander's conclusions are precarious since she extrapolates from a group of defendants, some of whom faced strict liability, to

to see similar settlement values in these cases.[75]

Second, even assuming that the study is accurate, and securities fraud class actions predicated on violations of Rule 10b-5 are for the most part frivolous in nature, such a conclusion supports reform of class action litigation in general, not Rule 10b-5 litigation in particular. Because class actions constituted only fifteen to twenty percent of all securities litigation in 1991,[76] reforms that fail to distinguish between class actions and individual actions cut too wide a swath.[77] Such wide sweeping reforms engender a risk that they will diminish the effectiveness of the securities laws by inhibiting the function of private attorneys general upon which our securities markets so heavily rely.[78]

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a situation where the facts of the cases were relevant. This leap facilitates the conclusion that the merits of the cases were likely irrelevant to their settlement values.

75. *See* John C. Coffee, Jr., *Suspect Settlements In Securities Litigation*, N.Y. L.J., Mar. 28, 1991, at 5. The economic theory of settlement behavior posits that the settlement value of a particular suit is a function of the "expected award if the plaintiff wins and the probability of a plaintiff's verdict." Alexander, *supra* note 64, at 503. These two variables, in turn, are "functions of the expected strength of plaintiff's proof on the merits." *Id.* Two cases seeking the same amount in damages will have identical settlement values only if their merits are identical. *See id.* at 514. The merits of two cases, however, are almost never the same. This is true because for two cases to have identical merits, "the [defendants'] degree[s] of culpability and the evidence available to prove it [must be] equal." *Id.* Such a conincidence is unlikely. Even if the facts of two cases are identical, the probability of success at trial will be affected by other factors that a jury may subconsciously consider, such as counsels' and the client's courtroom appearance. *See id.* at 503-04 n.14. Where strict liability is at issue, however, the number of variables that may affect the merits of the case are circumscribed. Under § 11, the relevant inquiry is whether the registration statement contained a material misstatement—not whether defendants' acted with the necessary culpable intent. Thus, two cases seeking the same amount in damages under § 11 may have similar settlement values.

76. *See* Richard Y. Roberts, *Gridlock on Securities Law*, Legal Times, Feb. 3, 1992, at 22 (quoting from statements of SEC chairman, Richard C. Breeden).

77. Professor Alexander recognizes the difficulties inherent in reforming procedural rules for litigation. *See* Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements In Securities Class Actions*, 43 Stan. L. Rev. 487, 587-88 (1991). Specifically, she notes that procedural rules are "trans-substantive"—meaning procedural rule changes will likely affect areas of litigation that are not problematic. *See id.* at 588. For example, some have suggested lowering the summary judgment standards of Rule 56 to enable courts to dispose of abusive class action suits. *See id.* at 587. Professor Alexander, however, cautions against such a procedural change because it could not be contained to class action litigation and "would be equally applicable to other sorts of cases in which there is no reason to believe that summary judgment or settlement work poorly—including securities cases that are not brought as class actions." *Id.* Substantive changes, like defining scienter and materiality more restrictively, embody similar dangers. *See id.* at 588.

78. In addition, suggestions that Rule 10b-5 class action litigation hinders the introduction of new products by blocking new companies' access to capital markets is reminiscent of claims made by the supporters of general litigation reform. Once again, they appear unsupported in light of the boom in initial public offerings ("IPO's") of stock over the past few years. The rise in the number of IPO's in the past few years runs counter to assertions in Professor Alexander's study and of proponents of reform that meritless litigation is inhibiting the raising of capital on the markets. Indeed, the period between 1986 and 1991 "has seen a 'going public' boom which has raised billions [of dollars] in capital . . . [and t]hese actual results are totally inconsistent with any notion that abusive securities litigation is stifling the raising of capital or creation of new public companies." Wil-

C. *Supporters of Reform: Irony in Self-Interest*

The most ardent supporters of reform consist of those organizations who, because of their deep pockets and their involvement in almost all types of securities transactions, are frequent and likely targets of securities fraud actions. Among these organizations are securities issuers, insurance companies, large banking institutions, and accounting firms. These organizations have joined together to form the Coalition to Eliminate Abusive Securities Suits ("CEASS"), a lobby group consisting of approximately 300 corporate, accounting, and financial institutions,[79] created to press Congress to reform Rule 10b-5. Indeed, CEASS played an " 'active role' " in drafting the reform legislation.[80]

Of the organizations that comprise CEASS, the accounting industry is the most vocal and, perhaps, the most in need of reform because it is facing a self-declared "liability crisis."[81] The increase in litigation against accounting firms raises concerns regarding the continued vitality of many of the largest accounting firms.[82] By mid-1992, accountants faced more than 4000 suits and over $15 billion in damages and legal expenses.[83] In 1991 alone, the "Big Six" accounting firms[84] spent nearly $500 million, or nine percent of their revenues and sixteen percent of partners' capital, defending and settling these suits.[85] In addition, their insurance premiums have risen precipitously[86] as a result of the increased

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liam Lerach, *Who Wants to Curtail Private Enforcement of the Federal Securities Laws and Why?* 2 (unpublished manuscript, on file with the *Fordham Law Review*); *see also* Richard C. Breeden, Remarks at Corporate Counsel Institute 2 (Oct. 16, 1991) (transcript on file with the *Fordham Law Review*); Guy Halverson, *Securities Firms Dub 1992 Dandy*, Christian Sci. Monitor, Jan. 6, 1993, at 9 ("The United States securities industry turned out to be one of the big winners in 1992. . . . Most analysts here attribute the industry's current success to three main factors [including] [a] strong IPO market: Companies issued a record $ 39.4 billion worth of new stock offerings . . . last year."); Kathy M. Kristof, *Companies Creating Investment Frenzy By Going Public*, Atlanta J. & Const., Jan. 11, 1993, at E2 ("Little companies are 'going public' at a record rate.").

79. *See Securities Suits Reform Bill Lauded by Business Coalition*, PR Newswire, Aug. 13, 1992, *available in* LEXIS, Nexis Library, Curmt File.

80. *Bills Introduced in Both Houses to Curb Securities Fraud Litigation*, 24 Sec. Reg. & L. Rep. (BNA) 1442 (Sept. 4, 1992) (quoting spokeswoman for CEASS).

81. *See* Arthur Andersen & Co. et al., *supra* note 21.

82. *See* Lee Berton, *Investors Call CPAs to Account*, Wall St. J., Jan. 28, 1985, at 30 (proliferation of liability suits is beginning to erode the financial health of the largest accounting firms); Arthur Andersen & Co. et al., *supra* note 21.

83. *See* Thomas McCarroll, *Who's Counting?*, Time, Apr. 13, 1992, at 48.

84. The "Big-Six" accounting firms are Arthur Andersen & Co.; Coopers & Lybrand; Deloitte & Touche; Ernst & Young; KPMG Peat Marwick; and Price Waterhouse.

85. *See* Lee Berton, *Inventory Chicanery Tempts More Firms, Fools More Auditors*, Wall St. J., Dec. 14, 1992, at A1, A4 [hereinafter *Inventory Chicanery*]; Dennis J. Block & Jonathan M. Hoff, *Defining the Limits of Accountants' Liability*, N.Y. L.J., Oct. 15, 1992, at 5, 7 n.3.

86. *See* McCarroll, *supra* note 83, at 48; *Campaign for Tort Reform*, World Ins. Rep., Sept. 11, 1992, *available in* LEXIS, Nexis Library, Curmt File (reporting that "[n]inety-six per cent[sic] of those firms with more than 50 certified public accountants reported increased exposure to liability and the same group had experienced a 300% increase in liability insurance premiums since 1985").

incidence of securities litigation.

Accounting firms' interest in litigation reform, arguably, is based upon an instinctual effort toward self-preservation. Rule 10b-5 reform, however, is merely a cosmetic, short-sighted remedy to liability troubles accountants have faced for decades. Focusing on Rule 10b-5 reform, as will be seen, fails to address the underlying causes of increased litigation against accounting firms and creates a troubling paradox. While engendering the possibility of short term relief from litigation, Rule 10b-5 reform may concomitantly diminish the credibility of the accounting profession in the long-run.

1. Accountant Independence

Accountants perform duties that are essential to the efficient functioning of our free market system.[87] Financial statements audited by accountants provide information that is used by investors in the securities markets to accurately assess the value of particular enterprises.[88] The accuracy of financial statements "is essential to the efficient use and exchange of property."[89] The accountant's duties are suffused with public trust and public purpose; the auditor serves as guardian of economic and political freedom.[90] Indeed, as watchdog of the public interest, an auditor's duty to the public is paramount and "takes precedence over any duty to the client."[91]

To fulfill their duties to the public, accountants must perform their audits with "independence." The "independent audit" is a metonymy associating the auditor's duties with "integrity, honesty, and objectivity."[92] Accountants are guided by rules proscribing certain relationships that jeopardize their independence.[93] For example, they may not hold a financial interest, whether direct or indirect, in their clients.[94]

Rules and regulations of conduct, however, merely create a semblance of independence; they fall short of creating independence in fact. Indeed, the relationship between auditor and client precludes complete independence. Because clients hire and pay auditors, financial ties inextricably bind the auditor to the client. Increased competition among auditors intensifies the auditor's attachment to the client. Such an environment

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87. *See* Denzil Y. Causey, Jr., Duties and Liabilities of Public Accountants 1 (1982).

88. *See id.* (citing Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 357 (2d Cir. 1973), *rev'd on other grounds,* 430 U.S. 1 (1977)).

89. *Id.* at 1.

90. *See id.* at 1-2. Auditors prevent corporations from making illegal bribes and campaign contributions and thus prevent the loss of political freedom. *See id.*

91. *Id.* at 2; *see also* United States v. Arthur Young & Co., 465 U.S. 805, 817 (1984) ("By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client.").

92. Causey, *supra* note 87, at 25.

93. *See id.* at 25-26.

94. *See id.* at 26.

jeopardizes the auditor's ability to adhere to rules which require the auditor to focus on fulfilling both their duties to the public and to their clients.[95] Auditors must then either adhere to rules of conduct prescribed to ensure independence and most likely lose business or sacrifice independence for self-preservation.

In the past, auditors' conflicts concerning independence from their clients subjected them to increased liability. During the 1960s, accounting firms faced increased liability and diminished credibility in the eyes of the public, for their "[failure] to give clear warning of impending disaster or to discover massive fraud."[96] Critics argued that auditors should be held accountable to investors for losses resulting from misrepresentations in financial statements.[97] In the mid-1970s, Congress began investigations to uncover the causes of accountant failures to detect client abuses.[98] Those investigations revealed two underlying causes. First, auditors lacked independence from their clients due to financial ties.[99] Second, auditors lacked uniformity in their financial reporting standards.[100] Such issues and conflicts of the past persist today.

2. Current Difficulties Caused by Lack of Independence

Current accountant liability troubles mirror those of the past. In a most recent and telling address to the American Accounting Association, Walter P. Schuetze, the chief accountant for the SEC, cited increased competition, lack of independence, and problems with financial reporting standards as the underlying causes for the current rise in litigation against accountants.[101] Moreover, he argued that recent efforts towards Rule 10b-5 reform do not address these problems:

> [T]he profession, with a few exceptions, is not doing anything about

95. *See id.* at 2.

96. *Id.* at 3. Compare these criticisms of the accounting industry with recent criticism of the accountant's role in the savings and loan scandal. *See infra* note 103 and accompanying text.

97. *See* Causey, *supra* note 87, at 3.

98. *See id.* at 5.

99. *See id.*

100. *See id.* Specific examples of lapses in independence include auditors engaging in lobbying efforts on behalf of their clients and auditors exercising control of a corporation's financial management. *See id.* at 6.

101. *See* Walter P. Schuetze, Relevance and Credibility in Financial Accounting and Reporting 10-11, Address Before the American Accounting Association (Aug. 12, 1992) (transcript on file with the *Fordham Law Review*). For support of the notion that accounting firms have experienced increased competition, see *Inventory Chicanery*, *supra* note 85, at A4. The slumping economy over the past few years forced accounting firms to give their clients audit-fee concessions. These concessions reduced accounting firms' revenues and the firms responded by cutting expenses through lay-offs of employees. Some have attributed accounting firms' widespread failure to detect inventory fraud to these developments. *See id.* at A4; Lee Berton, *Auditor Changes by Public Companies Set High as Accountants Compete More*, Wall St. J., Jan. 29, 1985, at 12 (record number of publicly traded companies changed auditors last year and competition is up); Lee Berton, *Investors Call CPAs to Account*, Wall St. J., Jan. 28, 1985, at 30.

> the underlying causes of litigation against itself. It will not pull on its own bootstraps. The profession will not go to its clients and tell those clients that their balance sheets have to have realism in order to elicit unqualified opinions. Why not? . . . Maybe the client will go across the street to another auditing firm and that firm will agree to report on a balance sheet that has outdated or irrelevant representations in it.[102]

Similarly, the General Accounting Office has cited a lack of auditor independence as an underlying cause of the rise in litigation against accountants in the wake of the demise of the savings and loan industry.[103] Once again, a lack of independence and accurate financial reporting standards give rise to accountant liability.

Current efforts to reform Rule 10b-5 are not a panacea for problems that have plagued the accounting industry for decades.[104] Such a short-sighted remedy would be ineffectual, for it fails to address the underlying issues of accounting liability—auditor independence and accurate reporting standards.

III. Discussion of Three Suggested Reforms

The discussion above raises doubts concerning the underlying premises of Rule 10b-5 reform. In addition to faulty premises, the specific reform proposals are controversial. Indeed, courts and commentators have addressed the majority of the reforms suggested, either in the context of securities litigation or in other areas. The rationales for past reluctance to adopt these reforms retain their persuasiveness today. The proposed reforms of fee shifting, proportionate liability, and a higher burden of proof all share at least two characteristics that continue to make each unattractive: all embody the danger that they will increase the litigation burdens carried by plaintiffs; and all embody the danger of hindering private enforcement of the securities laws.

A. *Attorney Fee Shifting*

Generally, under current principles of securities litigation, each side

102. Schuetze, *supra* note 101, at 10; *see also Inventory Chicanery*, *supra* note 85, at A4 (according to Howard Schilit, an associate professor of accounting at American University in Washington, D.C., " 'With their jobs in peril, remaining auditors are less likely to make waves for fear of losing a client and possibly their jobs.' ").

103. *See* McCarroll, *supra* note 83, at 49. Accountants often failed to provide independent verification of management claims that problem loans were collectible. This is similar to the criticisms that the financial industry, media, and general public directed at accounting firms over 30 years ago. *See supra* text accompanying note 96.

104. In a joint position paper, the Big-Six acknowledged that Rule 10b-5 reform would not solve their liability troubles since less than one third of the securities fraud claims filed against them contained Rule 10b-5 claims. Of those claims, less than 10% were exclusively claims under Rule 10b-5. *See* Arthur Andersen & Co. et al., *supra* note 21, at 6. Moreover, the accounting firms cited state liability laws as providing the greatest source of liability exposure and the greatest threat to the future viability of the accounting profession. *See id.* at 7.

pays its own litigation costs. This is known as the "American rule."[105] The proposed reforms have provisions for fee shifting that are variations on what is known as the "English Rule.[106] Under the English Rule, the loser pays the winner's litigation costs.[107] The bills propose that after filing a motion, the prevailing party *shall* recover reasonable attorney fees and costs from the losing party.[108] To mitigate the harshness of automatic fee shifting, the reforms exempt claims that courts determine to be "substantially justified."[109]

The stated purpose of the fee shifting provision is to create "adequate incentive for evaluating the merits of a case prior to filing and to create disincentives for filing meritless securities fraud lawsuits."[110] Economic studies of fee shifting arrangements have concluded that fee shifting achieves these goals by increasing the risks associated with litigation and thereby discouraging frivolous claims.[111] It is also generally accepted, however, that fee shifting discourages meritorious claims as well.[112]

1. The Fee Shifting Debate

Debate over the saliency of attorney fee shifting has resounded in this country for at least two hundred years. The arguments for and against fee shifting have been relatively consistent. One side argues the need to prevent wily plaintiffs from using litigation as a nuisance device or for extortionate purposes. The other side aserts the need to encourage resolution of legitimate disputes through judicial disposition.[113]

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105. *See* Alyeska Pipeline Serv. Co. v. Wilderness Soc. 421 U.S. 240, 247 (1975); Roxanne Barton Conlin & Clarence L. King, Jr., *The 'Loser Pays' Rule: Who Pays For Injustice?*, Trial, Oct. 1992, at 58, 58. In class action suits, however, the attorneys' fees for the class may be paid out of the damage award to the class. This is known as the "common fund" doctrine. Alternatively, the class attorneys' fees may be paid by contingency fee arrangements. Although statutory fee shifting exists in other areas of litigation and in fact may be as common as the traditional American Rule, there is no statutory, automatic fee shifting under the securities laws. *See* Coffee, *supra* note 14, at 670 n.2.

106. *See* Herbert M. Kritzer, *The English Rule*, 78 A.B.A. J., Nov. 1992, at 55.

107. *See id.*; Lawrence W. Newman & Michael Burrows, *'Loser Pays'—Attorneys' Fees in England, Germany*, N.Y. L.J., Oct. 15, 1992, at 3, 3.

108. *See* H.R. 417, 103d Cong., 1st Sess., § 3(b) (1993).

109. *See id.*

110. S. 3181, 102d Cong., 2d Sess., § 2(b)(2) (1992).

111. *See* Coffee, *supra* note 14, at 720-21 n.138.

112. *See id.*; Kritzer, *supra* note 106, at 55.

113. An analogue to the debate over attorney fee awards is the debate over adoption of Rule 11 of the Rules of Civil Procedure. Rule 11 admonishes a person contemplating submitting a paper to the court that their signature on such a paper certifies that it is not frivolous but is "well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law." Fed. R. Civ. P. 11. Where Rule 11 is violated, the court must sanction the person who signed the paper, or a representative, or both. The sanction can consist of an order to pay the other party reasonable attorneys' fees and costs. *See id.* One commentator succinctly summed up that debate in the following way:

> [T]he sanctions debate is a distributional political battle that has some unavoidable aspects of a zero-sum game. If Rule 11 is written or interpreted stringently, some claims are sacrificed in the name of efficiency, deterring the

The Supreme Court took sides in this debate when it decided against fee shifting almost two hundred years ago.[114] Recognizing the chilling effects fee shifting would have on meritorious suits, the Court rejected the English Rule and stated that "[t]he general practice of the *United States* is in oposition [sic] to [the English Rule]."[115] The Court clarified its reasoning almost two centuries later by stating that under the English Rule a person "might be unjustly discouraged from instituting actions to vindicate their rights if the penalty for losing included the fees of their opponents' counsel."[116]

2. "Substantially Justified" Standard

Under the proposed reforms, claims that a court determines to be "substantially justified" are exempted from fee shifting treatment.[117] The proposed reforms adopt the "substantially justified" standard from the Equal Access to Justice Act of 1985 ("EAJA").[118] Proponents of reform argue that this standard introduces an element of judicial discretion into the fee shifting statute. Such discretion is said to mitigate the harshness of straight fee shifting.

Applying the "substantially justified" standard to securities litigation is problematic for a number of reasons. First, the circumstances that motivated Congress to design and enact the "substantially justified" standard under the EAJA do not exist in most cases under securities litigation. Congress designed the "substantially justified" standard to balance the significant litigation advantages a governmental unit enjoyed over individual and small business adversaries.[119] While a governmental unit could sustain the high costs of litigation, individual and small business defendants—with their limited financial resources—could not. Thus, Congress implemented fee shifting under the EAJA to enable individuals and small businesses adequately to defend their rights in litigation against the Government.[120] Consistent with the Act's concerns for protecting those individuals and businesses with limited financial means, only those litigants with a net worth of less than $2 million qualify under EAJA's fee shifting provision.[121]

> unfounded or abusive, and thinning court dockets. If Rule 11's text or application is made more forgiving, some of these values are sacrificed in favor of zealous advocacy, innovative lawyering, and claimants' rights.

Jeffrey W. Stempel, *Sanctions, Symmetry, and Safe Harbors: Limiting Misapplication of Rule 11 by Harmonizing It with Pre-Verdict Dismissal Devices*, 60 Fordham L. Rev. 257, 260-61 (1991).

114. *See* Arcambel v. Wiseman, 3 Dall. 306, 306 (1796).

115. *Id.* (emphasis in original).

116. Fleischmann Distilling Corp. v. Maier Brewing Co., 386 U.S. 714, 718 (1967).

117. *See* H.R. 417, 103d Cong., 1st Sess., § 3(b) (1993).

118. 5 U.S.C. § 504 (1985).

119. *See* Donald J. Kinlin & Michael T. Kavanaugh, A Current Guide To Recovery Under The Equal Access To Justice Act 3 (1989).

120. *See id.*

121. *See id.* app. C at 7.

Ironically, those who support application of the "substantially justified" standard to securities litigation are parties, like the Government, who in the majority of cases may enjoy significant litigation-cost advantages over individual plaintiffs.[122] Unlike the individuals of limited financial means which the EAJA protects, those arguing for Rule 10b-5 reform are not in need of similar protections.[123]

A second difficulty with the "substantially justified" standard is that it may produce additional litigation. As noted above, fee shifting in securities litigation is designed to deter frivolous claims and trim excess litigation.[124] Reformers hope that attorneys will look to the EAJA to determine how the courts have interpreted the term "substantially justified" and will screen their cases accordingly. Contrary to the goals of litigation reform, the proposed fee shifting provision and its "substantially justified" standard in particular will likely produce increased litigation.[125] Additional sources of litigation emanating from the fee shifting provision will likely center around the definition of "prevailing plaintiff"[126] and "reasonable" attorney fees and costs.[127]

B. *Proportionate Liability*

Some supporters of reform attribute the primary cause of litigation abuse to the doctrine of joint and several liability.[128] Under current law, a court that finds a defendant guilty of violating Rule 10b-5 will hold that defendant jointly and severally liable for all of a plaintiff's damages.[129] Accordingly, each defendant is responsible for the entire amount of damages caused by the violation—regardless of degree of fault.[130] Reformers assert that joint and several liability enables a plaintiff to settle against one defendant to pursue litigation against a "deep pocket" joint tortfeasor.[131] The deep pocket defendant must then face the prospect of shouldering all the costs of defense and the burden of full liability in the case of an adverse judgment. In such a situation, the defendant may have no choice but to settle and avoid the risk of facing the caprice of a

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122. Nearly 80% of all securities fraud claims involve individuals as plaintiffs. *See supra* note 76 and accompanying text.

123. Indeed, the reforms are silent about a net worth limitation similar to the one under the EAJA.

124. *See* S. 3181, 102d Cong., 2d Sess. (1992).

125. *See* Kinlin & Kavanaugh, *supra* note 119, at 46.

126. For example, how many issues must the plaintiff win? How much of the damages sought by the plaintiff must the court award? *See id.* at 45-46.

127. *See id.*

128. *See* Arthur Andersen & Co. et al., *supra* note 21, at 6.

129. *See* Arnold S. Jacobs, Litigation and Practice Under Rule 10b-5, § 260.03[j] (2d ed. 1992).

130. *See id.* For a brief account of the genesis of joint and several liability, see Michael Hoenig, Products Liability: Substantive, Procedural and Policy Issues 421-22 (1992) (tracing the doctrine of joint and several liability back to a Lord Mansfield opinion in an 18th century English case).

131. *See* 138 Cong. Rec. S12,599 Aug. 12, 1992 (daily ed. Aug. 12, 1992) (statements of Sen. Domenici); Arthur Andersen & Co. et al., *supra* note 21, at 6.

jury. Equity, it is argued, compels the use of proportionate liability because joint and several liability may result in a less culpable defendant paying more than a more culpable defendant.[132]

In response to these concerns, reformers propose replacing joint and several liability with proportionate liability.[133] Under such a proposal, a defendant who is found to have violated Rule 10b-5 will be held jointly and severally liable only where the defendant "engaged in knowing securities fraud."[134] To constitute a "knowing" securities fraud, the defendant must "know[ ] that other persons are likely to rely on that misrepresentation or omission."[135] In the absence of "knowing securities fraud," each defendant will be held liable for the damages attributable to his or her respective degree of culpability, rather than for the full amount of damages.[136] Furthermore, the reforms expressly exclude reckless conduct from joint and several liability.[137] By excluding reckless conduct from the purview of joint and several liability, the bills provide added security to repeat defendants since the liability of these defendants is often established by a showing of scienter predicated upon recklessness.[138]

While principles of equity are said to support proportionate liability, in fact, equity compels the full retention of joint and several liability in securities fraud litigation. Joint and several liability has been a consistent common-law tort principle because it appropriately balances the interests

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132. *See* 138 Cong. Rec. S12,599 (daily ed. Aug. 12, 1992) (statements of Sen. Domenici); Arthur Andersen & Co. et al., *supra* note 21, at 6. Arguments for abrogating joint and several liability are not new and have appeared as suggested reforms in other areas of litigation such as products liability. *See* Hoenig, *supra* note 130, at 419-23 (1992) (describing certain "tensions" in product liability litigation caused by "massive uncertainty" concerning trial outcomes; "the upward spiral of [damage] awards"; and the debate in product liability "over the last fifteen years" concerning whether products liability is . . . a system of fault determination or a compensation scheme," and arguing that one way to "fairly, simply and rationally alter many of the foregoing sources of tension in one dramatic and meaningful way [would be to] abolish the doctrine of 'joint and several liability.' ").

133. *See* H.R. 417, 103d Cong., 1st Sess., § 3 (1993).

134. *Id.* Currently, defendants are jointly and severally liable if they act with scienter, i.e., when they "intentionally or knowingly engage[ ] in the prohibited activities, or acts with reckless disregard for the truth or falsity of a material statement." SEC v. Electronics Warehouse, Inc., 689 F. Supp. 53, 59 (D. Conn. 1988) (citations omitted), *aff'd*, 891 F.2d 457 (2d Cir. 1989), *cert. denied*, 110 S.Ct. 3228 (1990). Under the proposed reforms, a defendant engages in knowing securities fraud in two possible ways. Knowing securities fraud is defined as either a "material representation with actual knowledge that, the representation is false" or as an omission, "with actual knowledge that as a result of the omission, one of [defendant's] material representations is false." H.R. 417, 103d Cong., 1st Sess., § 3 (1993).

135. H.R. 417, 103d Cong., 1st Sess., § 3 (1993).

136. *See id.*

137. *See* H.R. 417, 103d Cong., 1st Sess. (1993); S. 3181, 102d Cong., 2d Sess. (1992).

138. *See* Van Dyke v. Coburn Enterprises, Inc., 873 F.2d 1094, 1100 (8th Cir. 1989) (noting that "[t]he majority rule in the Courts of Appeals is that recklessness satisfies [the] scienter requirement").

of victim and tortfeasor.[139] The typical Rule 10b-5 case illustrates this balance. To establish liability a plaintiff must show that the defendant acted culpably with scienter.[140] Once plaintiffs establish liability, they can then recover the full damages from any culpable defendant, regardless of that defendant's degree of fault. A defendant who is found jointly and severally liable, however, is, in most cases, not relegated to paying more than her or his fair share of the damages. Under the doctrine of contribution, such a defendant usually can recover any amounts paid to plaintiff in excess of that defendant's degree of fault.[141]

In the case where defendants pay more than their proportionate share of damages and are unable to recover from an impecunious joint defendant, the equities are still in favor of joint and several liability. In such a case, if proportionate liability were the rule, the innocent plaintiff would bear the loss.[142] By contrast, under joint and several liability, the culpable defendant bears the loss. This is clearly the more equitable result because equity favors the innocent over the culpable.

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139. *See* Arnold S. Jacobs, Litigation and Practice Under Rule 10b-5, § 260.03[j] (2d ed. 1992).

140. *See* Dirks v. SEC, 463 U.S. 646, 664 n.23 (1983); Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983); Aaron v. SEC, 446 U.S. 680, 695 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

141. *See* Employers Ins. v. Musick, Peeler & Garrett, 954 F.2d 575, 577-80 (9th Cir.), *cert. granted*, 113 S. Ct. 54 (1992); Franklin v. Kaypro Corp., 884 F.2d 1222, 1226 (9th Cir. 1989), *cert. denied*, 111 S. Ct. 232 (1990); Heizer Corp. v. Ross, 601 F.2d 330, 334 (7th Cir. 1979) (right of contribution exists under section 10(b) of the '34 Act and Rule 10b-5 promulgated thereunder); *In re* Nucorp Energy Securities Litigation, 661 F. Supp. 1403, 1406 (S.D. Cal. 1987) (court assumes, without deciding, that where an implied private right of action for violation of the federal securities laws exists, a right to contribution also exists); Alvarado Partners, L.P. v. Mehta, 723 F. Supp. 540, 550 (D. Colo. 1989); *In re* Sunrise Securities Litigation, 698 F. Supp. 1256, 1258 (E.D. Pa. 1988); Nelson v. Bennett, 662 F. Supp. 1324, 1328 (E.D. Cal. 1987). *But see* Chutich v. Green Tree Acceptance, Inc., 759 F. Supp. 1403, 1407 (D. Minn. 1988) (no implied right of contribution exists under § 10(b) of the '34 Act); *In re* Professional Financial Management, Ltd., 683 F. Supp. 1283, 1286 (D. Minn. 1988) (same). The Supreme Court has granted certiorari to resolve this conflict in the jurisdictions. *See* Employers Ins. v. Musick, Peeler & Garrett, 954 F.2d 575, 577-80 (9th Cir.), *cert. granted*, 113 S. Ct. 54 (1992). Even in those jurisdiction holding that a right to contribution exists under Rule 10b-5, that right may not extend to contribution from defendants who had settled on condition that the court approve a settlement bar order prohibiting contribution from the settling defendants. *See Franklin*, 884 F.2d at 1232. To be effective, however, the settlement bar order must "limit the subsequent exposure of the nonsettling defendants [to the] actual percentage of liability for the amount of total damages determined at trial." *Id.* Thus, even where a settlement bar order precludes contribution from settling defendants, the nonsettling defendants who are jointly and severally liable for their combined share of liability may seek contribution from each other. *See id.* at 1231.

142. *But see* Hoenig, *supra* note 130, at 423 (Hoenig argues for abolition of joint and several liability in the context of products liability litigation even in cases where one defendant is insolvent because "when one plaintiff sues one defendant, plaintiff bears the risk of the defendant being insolvent[,] [therefore, 'o]n what basis does the risk shift if there are two defendants and one is insolvent?' " (quoting Bartlett v. New Mexico Welding Supply, Inc., 646 P.2d 579, 585 (N.M. Ct. App. 1982)). A response to this argument is simply that equity provides a basis for shifting the risk of insolvency onto a culpable party.

C. *A Change in the Burden of Proof Standard*

Finally, reformers propose a change in the burden of proof standard applicable in Rule 10b-5 litigation.[143] Generally, a plaintiff in a Rule 10b-5 action must prove by a preponderance of the evidence that the defendant acted with scienter.[144] Reforms would heighten the burden of proof from a preponderance of the evidence standard to one requiring clear and convincing evidence.[145]

The clear and convincing evidence standard governs common-law fraud.[146] Because the clear and convincing evidence standard is a heightened standard of proof, securities fraud will be more difficult to prove. This more rigorous standard will likely deter plaintiffs from filing frivolous claims.

There is, however, a danger in looking to common-law fraud as a paradigm for the establishment of a heightened burden of proof in Rule 10b-5 fraud cases. Such a comparison deemphasizes significant differences in the natures of the two causes of action.[147] Indeed, in *Herman &*

143. *See* H.R. 417, 103d Cong., 1st Sess., § 3 (1993).

144. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 389-90 (1983).

145. A burden of proof standard instructs fact finders as to the certainty with which they should come to their decisions. *See In re* Winship, 397 U.S. 358, 370 (1970) (Harlan, J., concurring). Generally, there are three standards of proof. *See* Addington v. Texas, 441 U.S. 418, 423 (1979). They are, from the most lenient to the most onerous, the following: the preponderance of the evidence, clear and convincing evidence, and evidence beyond a reasonable doubt. *See id.* Courts choose the standard to apply in specific cases based upon the importance society places on the ultimate decision. *See id.* at 423-24. For example, society places a heightened importance upon protecting the rights of a criminal defendants because the consequences of an erroneous verdict are so great. Therefore, courts have instructed juries that a criminal defendant must be found guilty beyond a reasonable doubt—the heaviest burden. *See id.* Conversely, society places a lower value upon the outcomes of monetary disputes. Courts have therefore chosen to allocate the risk of error between the two parties through application of the preponderance of the evidence standard to these actions. *See id.* at 423. The clear and convincing evidence standard falls in between. Courts have applied it to cases that have elements of both criminal and monetary suits. The clearest example is the case of common-law fraud. Although the fraud defendant faces a pecuniary penalty, the interests at stake in a fraud case are elevated above the interests at stake in a mere monetary dispute. A fraud suit has the added risk of stigmatizing the defendant as a fraud, and impugning a defendant's reputation. Hence courts have applied the clear and convincing evidence standard here to reflect the hybrid nature of a fraud suit. *See id.* at 424. One exception to the general rule that clear and convincing evidence should govern fraud suits is the securities fraud suit. Congress removed securities fraud suits from the rubric of common-law fraud suits when it enacted the Exchange Act. *See Herman & MacLean*, 459 U.S. at 387-90.

146. *See* Addington v. Texas, 441 U.S. 418, 424 (1979).

147. Suits alleging common-law fraud and suits alleging fraud under the federal securities laws differ in the following ways: (1) whereas a plaintiff must prove reliance to recover under a common-law fraud claim, reliance may be presumed under the federal securities laws where there is an omission of material fact or there is an allegation of "fraud on the market." *See, e.g.*, Basic Inc. v. Levinson, 485 U.S. 224, 241-45 (1988) (allegation of fraud on the market gives rise to a presumption of reliance); Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972) (material omission give rise to presumption of reliance); (2) while scienter is an element of both common-law fraud and

MacLean v. Huddleston,[148] the Supreme Court explicitly noted the current disparity in burdens of proof that exist between common-law fraud and actions for fraud predicated on violations of Rule 10b-5.[149] The Court decided that a preponderance of the evidence standard should govern the burden of proof in Rule 10b-5 cases.[150] In reaching this conclusion, the Court rejected the common law fraud standard of proof by noting historical and practical differences in the natures of the two remedies.[151]

The Court reasoned that a major objective of the federal securities statutes was to replace common-law fraud remedies which were ineffective against securities fraud violations.[152] Common-law fraud remedies were designed to counter frauds involving "tangible items of wealth."[153] Securities fraud, however, often involves fraud of a different kind—fraud involving intangible items of wealth such as stocks.[154] Furthermore,

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Rule 10b-5 fraud, the former requires scienter be proven with a showing of a specific intent to defraud, however, most courts of appeal agree that recklessness will satisfy the scienter requirement of the latter. *See, e.g.*, Van Dyke v. Coburn Enters., 873 F.2d 1094, 1100 (8th Cir. 1989) ("[M]ajority rule in the Courts of Appeals is that recklessness satisfies this scienter requirement."); Woods v. Barnett Bank, 765 F.2d 1004, 1010 (11th Cir. 1985) (requiring "severe recklessness"); Dirks v. SEC, 681 F.2d 824, 844-45 (D.C. Cir. 1982), *rev'd on other grounds*, 463 U.S. 646 (1983); (3) common-law defense of in pari delicto is not available to certain defendants in actions under the federal securities laws. *See* Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 319 (1985); (4) common-law fraud requires proof by clear and convincing evidence while securities fraud claims under Rule 10b-5 may be shown by the lower burden of proof of a preponderance of the evidence. *See Herman & MacLean*, 459 U.S. at 390-91; (5) the Supreme Court rejected arguments that common-law fraud should provide, by analogy, the statute of limitations for action under Rule 10b-5. The Court looked to other federal securities acts instead. *See, e.g.*, Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 111 S. Ct. 2773, 2781 (1991) (rejecting the "assertion that state-law fraud provides the closest analogy to § 10(b)"); (6) some commentators have argued that Rule 9(b) of the Federal Rules of Civil Procedure which requires fraud to be pleaded with particularity should not be applied to claims under the federal securities laws because of the disparities in the natures of these two frauds; pleading with particularity is often impossible in securities fraud cases because the evidence of the fraud may be located in the defendant's files. *See* William M. Richman et al., *The Pleading of Fraud: Rhymes Without Reason*, 60 S. Cal. L. Rev. 959, 977-79 (1987); Note, *Pleading Securities Fraud Claims With Particularity Under Rule 9(b)*, 97 Harv. L. Rev. 1432, 1434-39 (1984); Richard D. Greenfield & Robin Resnick, *Rule 9(B): Docket Control Device or Safeguard Against Charges of Fraud?*, ALI-ABA Course of Study (Apr. 23, 1992), *available in* Westlaw, ALI-ABA File, C751 ALI-ABA 707.

148. 459 U.S. 375 (1983).

149. *See id.* at 387-91.

150. *See id.* at 390.

151. *See id.*

152. *See id.* at 389.

153. *Id.* at 389 n.28.

154. *See id.* One commentator has argued that common law fraud claims differ from securities fraud claims because of the way each claim arises. A common law fraud claim generally arises from face-to-face dealings. Such dealings can be detailed and chronicled by the victim. Securities fraud claims, however, generally arise out of transactions where there is often no personal contact between the parties. In such a case, the facts of the particular fraud are likely to be in the possession of the defendant. Securities fraud there-

Congress designed the federal securities fraud statutes not only to punish those who commit securities fraud but also to deter others who would contemplate such fraud. This deterrent objective is furthered by instituting a higher standard of conduct in the securities industry.[155] A lower burden of proof facilitates enforcement of the federal securities laws and, therefore, contributes to maintaining higher standards of conduct within the securities industry.

Furthermore, the Court compared the plaintiff's interests in securities litigation with the interests of defendants in such suits. The Court reasoned that the interests of defendants in suits brought under Section 10(b) are indistinguishable from the interests of defendants in actions brought under other federal statutes such as antitrust or civil rights laws where the preponderance of the evidence governs.[156] In contrast, plaintiffs' interests in Rule 10b-5 suits are significant because "[d]efrauded investors are among the very individuals Congress sought to protect."[157]

A heightened burden of proof in securities fraud suits is antithetical to the purposes of the federal securities statutes. It jeopardizes the goals of such statutes—creating and fostering a higher standard of conduct in the securities industry—by increasing the burdens upon those who seek to enforce such laws. In addition, such a reform may send the wrong signal to those contemplating fraud. In light of recent scandals in the financial industry and the publicity surrounding those events, any dilution of the security fraud statute's deterrent capabilities is ill-advised.

IV. Alternative to Reform: Civil RICO

Present efforts to reform Rule 10b-5 are troublesome. In light of the essential role private litigants play in the effective functioning of the securities laws and markets,[158] any reforms that hinder their access to the courts must be undertaken, if at all, with extreme caution. The premises underlying proposed Rule 10b-5 reforms, however, are questionable since they identify issues and implicate effects that are only tangentially related to Rule 10b-5—an alleged litigation explosion in society, problems with the class action form of litigation, and accountant liability.

Although Congress should abandon its current efforts at Rule 10b-5 reform, it should nevertheless seize this opportunity to address the abuses that continue to grow in another area of securities fraud litigation. The particular reform suggested by some commentators[159] and considered by

fore is often more difficult for a plaintiff to prove. *See* Note, *Pleading Securities Fraud Claims With Particularity Under Rule 9(b)*, 97 Harv. L. Rev. 1432, 1435-39 (1984).

155. Herman & MacLean v. Huddleston, 459 U.S. 375, 386-87 (1983).

156. *See id.* at 390.

157. *Id.*

158. *See* discussion *supra* part I.

159. *See* Richard C. Breeden, Remarks at Corporate Counsel Institute 9-10 (Oct. 16, 1991) (transcript on file with the *Fordham Law Review*); 138 Cong. Rec. S12,603 (daily ed. Aug. 12, 1992) (comments of Richard C. Breeden on proposed Rule 10b-5 reforms, arguing that he would "support the repeal of securities fraud as a predicate offense for

Congress in the past, is civil RICO reform.[160]

Civil RICO is an alluring reform alternative because it is included in many Rule 10b-5 actions. Reform of civil RICO is capable of addressing the concerns of those who currently support Rule 10b-5 reform while also catering to the concerns of those who oppose it. Like Rule 10b-5, RICO provides a remedy for securities fraud violations. And, as will be seen below, RICO litigation contains many of the vices currently attributed to Rule 10b-5 lawsuits—especially the potential for extortionate litigation and frivolous suits. In addition, Civil RICO reform can be undertaken without the danger of a significant impingement on the effectiveness of the private attorney general patrol.

A. *Brief History of RICO and Its Application to Securities Fraud*

In 1970, Congress enacted RICO[161] to shield legitimate business from the "infiltration of organized crime."[162] Despite this limited intent, plaintiffs now use RICO to sue legitimate businesses more often than they use it to target organized crime.[163] Indeed, the Supreme Court has decried RICO's transformation into something different from that which Congress originally intended.[164] RICO's broad application is, in part, a result of its capacious language:[165] RICO contains a liberal construction

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civil actions under [RICO]. Civil RICO is an unnecessary duplication of existing securities law remedies."); *Roberts Urges Industry Course Change On Litigation Reform*, 24 Wall St. Letter (Institutional Investor, Inc.) at 6, Sept. 21, 1992, *available in* LEXIS, Nexis Library, Currnt File.

160. *See Securities Investor Protection Act of 1991: Hearings on S. 1433 Before the Subcommittee on Securities of the Senate Comm. on Banking, Hearing, and Urban Affairs*, 102nd Cong., 1st Sess. 9, 14 (1991) (statements of Richard C. Breeden, Chairman of the SEC arguing for elimination of securities fraud predicate under RICO); H.R. 5445, 99th Cong., 2d Sess. (1986); H.R. 2983, 100th Cong., 1st Sess. (1987); H.R. 3240, 100th Cong., 1st Sess. (1987); S. 1523, 100th Cong., 1st Sess. (1987).

161. 18 U.S.C. §§ 1961-1968 (1988).

162. Douglas E. Abrams, The Law of Civil RICO 4 (1991) ("According to the Senate Report, RICO's primary purpose was to 'eliminat[e] . . . the infiltration of organized crime and racketeering into legitimate organizations operating in interstate commerce.'" (citations omitted)); *see also* United States v. Turkette, 452 U.S. 576, 593 (1981) (Congress enacted RICO "as a measure to deal with the infiltration of legitimate business by organized crime").

163. *See* Abrams, *supra* note 159, at 8; William H. Rehnquist, *Remarks of the Chief Justice*, 21 St. Mary's L.J. 5, 9 (1989) ("Virtually everyone who has addressed the question agrees that civil RICO is now being used in ways that Congress never intended."). *But see* G. Robert Blakey, *Forward*, Symposium, *Law and the Continuing Enterprise: Perspectives on RICO*, 65 Notre Dame L. Rev. 873, 880 (1990) (citing statements of Supreme Court that RICO's language and legislative history militate against restrictive application of RICO to organized crime).

164. *See* Abrams, *supra* note 162, at 5 (citing to opinion in Sedima S.P.R.L. v. Imrex Co., 473 U.S. 479, 500 (1985) ("'RICO is evolving into something quite different from the original conception of its enactors.'"). *But see* Blakey, *supra* note 163, at 875 & nn.49-54 (1990) (RICO's legislative history contains numerous statements of the bill's sponsors indicating that RICO applies to actions against defendants not involved in organized crime).

165. *See* Abrams, *supra* note 159, at 15-16 & nn. 4-5.

clause which constrains courts from interpreting RICO restrictively.[166]

RICO provides a remedy for securities fraud violations.[167] Commentators have raised concerns that RICO's securities fraud provision threatens to supplant traditional federal securities fraud remedies such as Rule 10b-5.[168] Indeed, it has become commonplace for a plaintiff who asserts an implied remedy under the securities laws to append a RICO claim to the complaint.[169] In fact, some have warned that an attorney's failure to allege a violation of RICO when filing a securities fraud action constitutes legal malpractice.[170]

Plaintiffs' use of RICO as a concomitant to federal securities fraud provisions is problematic for a number of reasons. First, Congress did not intend RICO's provision permitting its application to securities fraud to be coextensive with section 10(b) of the '34 Act.[171] Nor did Congress intend that RICO supplant the traditional remedies for common securities fraud provided under the '33 and '34 Acts.[172] Second, while the courts have been restricting the traditional securities fraud remedies of the '33 and '34 Acts, they generally have not done so with RICO.[173]

A plaintiff who pursues a RICO claim in addition to or instead of a Rule 10b-5 claim enjoys manifold benefits. RICO provides for mandatory trebling of damages.[174] In addition, reasonable attorneys'

166. In contrast, the courts have not had difficulty restricting the contours of Rule 10b-5. *See, e.g.*, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739-40 (1975) (imposing a buyer/seller standing limitation for suits predicated on violation of Rule 10b-5).

167. *See* 18 U.S.C. § 1961(1) (1988). This section provides in relevant part that "racketeering activity, means . . . any offense involving . . . fraud in the sale of securities . . . punishable under any law of the United States." *Id.*

168. *See* 1A Harold S. Bloomenthal, Going Public and the Public Corporation § 10, at 64 (1992); Arthur F. Mathews, *Shifting the Burden of Losses in the Securities Markets: The Role of Civil RICO in Securities Litigation*, 65 Notre Dame L. Rev. 896, 896-98 (1990).

169. *See* 1A Harold S. Bloomenthal, Going Public and the Public Corporation § 10.08, at 64 (1992).

170. *See* Abrams, *supra* note 162, at 6.

171. *See* Michael N. Glanz, *RICO and Securities Fraud: A Workable Limitation*, 83 Colum. L. Rev. 1513, 1534-39 (1983).

172. *See* L. Gordon Crovitz, *How the RICO Monster Mauled Wall Street*, 65 Notre Dame L. Rev. 1050, 1055 (1990) ("[T]here is no evidence that Congress intended to replace the Securities Act of 1933 and 1934 with RICO . . . .").

173. *See* Mathews, *supra* note 168, at 896-98. Because the Courts implied a private remedy for securities fraud under § 10(b) of the '34 Act, they have more freedom to define its boundaries than if Congress had explicitly legislated the right as in RICO. *See* Holmes v. Securities Investor Protection Corp., 112 S. Ct. 1311, 1326-27 (1992) (O'Connor, J., concurring) (O'Connor arguing that because the Court implied the right of action under § 10(b) it was free to adopt a purchaser/seller limitation in § 10(b) cases "as a prudential means of avoiding the problems of proof when no security was traded and the nuisance potential of vexatious litigation"). *But see* Reves v. Ernst & Young, No. 91-886, 1993 WL 52169 (U.S. March 3, 1993) (limiting application of RICO to persons who either operated or managed a RICO enterprise).

174. *See* Abrams, *supra* note 162, at 152.

fees must be awarded to a successful plaintiff.[175] Finally, a recent Supreme Court opinion suggests that RICO permits a broader class of plaintiffs to sue under its provisions than does Rule 10b-5.[176] In *Holmes v. Securities Investors Protection Corp.*,[177] the Supreme Court faced the issue of whether a RICO claim predicated on violation of Rule 10b-5 incorporates that Rule's buyer/seller standing limitation.[178] The Court avoided the issue by finding an alternative route to dispose of the claim.[179] Two concurring opinions in which a total of four Justices joined, argued, however, that standing to bring a RICO claim predicated on securities fraud violations is not limited to buyers and sellers of securities.[180] This decision portends that persons who are neither buyers nor sellers, and precluded from suing under Rule 10b-5, can turn to RICO for a remedy. Such a possibility subverts the Court's carefully crafted standing limitations of Rule 10b-5 and opens the door to increased litigation.[181]

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175. *See id.* at 168.

176. *See Holmes*, 112 S. Ct. at 1322 (concurring opinions suggesting that buyer/seller limitation does not apply to RICO claim predicated on Rule 10b-5 offense). For cases explicitly rejecting a buyer/seller limitation for RICO claims predicated on Rule 10b-5 violations, see Securities Investor Protection Corp. v. Vigman, 908 F.2d 1461, 1465-67 (9th Cir. 1990) (purchaser/seller limitation does not apply to RICO claim for fraud in the sale of securities); Warner v. Alexander Grant & Co., 828 F.2d 1528, 1530 (11th Cir. 1987) (rejecting buyer/seller limitation for RICO claims predicated on acts of securities fraud). For cases adopting a buyer/seller limitation for RICO claims predicated on acts of fraud in the sale of securities, see International Data Bank, Ltd. v. Zepkin, 812 F.2d 149, 151-54 (4th Cir. 1987) (buyer/seller limitation applies to RICO claims predicated on acts of fraud in the sale of securities); Brannan v. Eisenstein, 804 F.2d 1041, 1046 (8th Cir. 1986) (buyer/seller limitation applies to RICO claims predicated on acts of fraud in the sale of securities).

177. 112 S. Ct. 1311 (1992).

178. *See id.* at 1316 n.7. The SIPC is a private non-profit corporation formed under the Securities Investor Protection Act of 1970. *See* 15 U.S.C. §§ 78aaa-78*lll* (1988). It is designed to protect the customers of failed broker-dealers. *See id.* §§ 78eee(a)(3)-(b)(3). Generally, after certain statutory conditions are satisfied, the SIPC can ask a court to appoint a trustee to liquidate a failed broker-dealer's business. *See id.* The SIPC insures the customers of a failed broker dealer by advancing up to $500,000 per customer to the trustee in the event that funds collected by the trustee through the liquidation are insufficient to satisfy the customers' claims. *See id.* § 78fff-3(a).

In *Holmes*, the SIPC advanced $13 million to cover the claims of customers of two defunct broker-dealers. *See Holmes*, 112 S. Ct. at 1315. As subrogee to the customers' claim, the SIPC instituted a suit against 75 defendants alleging that those defendants manipulated stock in violation of § 10(b) of the '34 Act, and that those manipulations caused the demise of the broker-dealers and the customers' damages. *See id.* Furthermore, the SIPC alleged that these violations constituted a pattern of racketeering actionable under RICO. *See id.*

179. The Court found that there was no need to address the buyer/seller question because the plaintiff's claim failed to establish proximate cause. *See Holmes*, 112 S. Ct. at 1311, 1321-22.

180. *See id.* at 1322 (O'Connor, J., concurring). Justices White and Steven joined her concurrence. Justice Scalia wrote a separate concurring opinion. *See id.* at 1327.

181. In her concurring opinion, Justice O'Connor acknowledged this danger when she stated that "problems of expansive standing identified in *Blue Chip Stamps* are exacerbated in RICO." *Id.* at 1327.

B. *Elimination of RICO's Application to Securities Fraud in Lieu of Rule 10b-5 Reform*

RICO reform is capable of alleviating some abuses cited by supporters of Rule 10b-5 reform. Because RICO provides for mandatory trebling of damages and awarding of attorney fees to the successful plaintiff, RICO embodies a danger of extortionate litigation.[182] In addition, although the recent Supreme Court decision in *Reves v. Ernst & Young*[183] attenuates the dangers RICO poses to accountants by holding RICO applicable only against persons who operated or managed an enterprise, plaintiffs will nonetheless continue to use RICO against legitimate businesses.[184] Thus, RICO reform would address problems of extortionate litigation.

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182. *See* Jay Kelly Wright, *Why Are Professionals Worried About RICO?*, 65 Notre Dame L. Rev. 983 (1990). The author describes RICO's threat to professionals as follows:

> Treble damages become a weapon to induce settlement. . . . "[T]o induce an earlier and more favorable settlement, the [liquidator] will wish to charge the auditor not merely with negligence or breach of contract, but with common law and statutory fraud (such as RICO) because the latter counts create the prospect of recovering punitive or treble damages as well as costs and counsel fees."

Id. at 993. (alterations in original) (citation omitted).

183. No. 91-886, 1993 WL 52169 (U.S. Mar. 3, 1993).

184. Accounting groups have long targeted RICO for legislative reform. *See* Wright, *supra* note 182, at 984. "Professionals *are* worried about RICO. The American Institute of Certified Public Accountants, for example, has been in the forefront of some of the legislative efforts to amend RICO to limit the statute's reach." *Id.* Professionals are susceptible to RICO claims because

> civil RICO has exacerbated those tendencies of the law to target professionals as deep pockets. Not only has RICO spurred the search for deep pockets by the lure of treble damages, the rhetoric of RICO has significantly distorted the formulation of legal principles and has skewed analysis in favor of greater liability.

Id. at 984-85; *see also* 1A Harold S. Bloomenthal, Going Public and the Public Corporation § 10.08, at 64 (1992) (noting plaintiff use of RICO as a securities fraud remedy will likely exacerbate the trend that is currently moving towards greater professional liability without regard to the significance of the professional's role in the fraud).

Although the accounting industry's efforts have not resulted in legislative curtailment of RICO, the Supreme Court recently responded to the accounting industry's call for relief. In Reves v. Ernst & Young, No. 91-886, 1993 WL 52169 (U.S. Mar. 3, 1993), the Supreme Court held, in a seminal decision, that "one must participate in the operation or management of [an] enterprise" in order to be liable under RICO. *Id.* at *9. *Reves* is a landmark decision because it represents one of the first times the Supreme Court has limited RICO's application by side-stepping RICO's "liberal construction" clause which directs the Court to interpret RICO's provisions liberally. *See, e.g.*, Sedima S.P.R.L. v. Imrex Co., 473 U.S. 479, 497 (1985) ("[A] less restrictive reading [of RICO] is amply supported by our prior cases and the general principles surrounding this statute. RICO is to be read broadly."); United States v. Turkette, 452 U.S. 576, 587 (1981) (Congress did not act beyond the scope of its power when it enacted RICO. "[T]he courts are [therefore] without authority to restrict the application of the statute.").

The plaintiff in *Reves* was a trustee in Bankruptcy who brought suit on behalf of the debtor and some of the debtor's creditors, against Arthur Young, the debtor's auditor. *See Reves*, 1993 WL 52169, at *4. The Trustee alleged that as the debtor's auditor, Arthur Young had violated RICO by committing mail and securities fraud. *See* Arthur Young & Co. v. Reves, 937 F.2d 1310, 1323-24 (8th Cir. 1991). The Circuit court found that although "Arthur Young committed a number of reprehensible acts," including acts in violation of Rule 10b-5, Arthur Young's involvement with the debtor did not "rise to

Regardless of whether one agrees with the notion of a litigation explosion, reforming RICO by eliminating its applicability to securities fraud

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the level of participation in the management or operation of the [debtor]" sufficient to meet the requirements of a RICO claim. *Id.* at 1324.

The Supreme Court granted certiorari to resolve a conflict between circuit courts concerning interpretation of one of RICO's provisions. *See Reves*, 1993 WL 52169, at *4. The provision in question makes it unlawful " 'for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity.' " *Id.* at *2 (quoting 18 U.S.C. § 1962(c) (1988)). The Eighth Circuit and the District of Columbia Circuit both interpreted this provision as limiting RICO's application to those who participated in the operation and management of an enterprise. *See* Bennett v. Berg, 710 F.2d 1361, 1364 (en banc), *cert. denied*, 464 U.S. 1008 (1983); Yellow Bus Lines, Inc. v. Drivers Local Union 639, 913 F.2d 948, 954 (1990) (en banc), *cert. denied*, 111 S.Ct. 2839 (1991). The Eleventh Circuit, however, rejected such a limitation. *See* Bank of America Nat'l Trust & Sav. Ass'n v. Touche Ross & Co., 782 F.2d 966, 970 (11th Cir. 1986).

The *Reves* Court adopted the Eighth Circuit's interpretation of § 1962(c). In arriving at its conclusion, the Court first interpreted the word "conduct" in § 1962(c) of RICO. That section makes it unlawful "to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs." *Id.* at *5. The Court determined that the word "conduct," in context, contemplates some "degree of direction." *Id.* The Court then interpreted the word "participate" to mean "to take part in." *Id.* (citing Webster's Third New International Dictionary 1646 (1976)). Applying these two interpretations to § 1962(c), the Court conluded that "[i]n order to 'participate, directly or indirectly, in the conduct of such enterprise's affairs,' one must have some part in directing those affairs." *Id.* at *6 (quoting 18 U.S.C. § 1962(c)). The Court buttressed its conclusions by looking to RICO's legislative history to find that "Congress did not intend RICO to extend beyond the acquisition or operation of an enterprise." *Id.* at *7.

Significantly, the Court adopted the more restrictive "operation or management" requirement despite Congress' directive that courts construe liberally RICO's provisions. *See id.* at *8. According to the Court, RICO's liberal construction clause should only be used to resolve an ambiguity. *See id.* Because the Court found RICO's legislative history to support clearly the "operation or management" standard, no ambiguity existed and it found RICO's liberal construction clause to be inapplicable.

The dissent disagreed. Justices Souter and White argued in dissent that RICO's liberal construction clause is "dispositive" and RICO's provisions could not therefore be limited to those involved in operation or management of the enterprise. *See id.* at *10 (Souter, J., dissenting). The dissenters pointed to more liberal alternative definitions of the word "conduct," to challenge the majority's assertion that "conduct" be interpreted to import some degree of direction. *See id.* at *10-11. For example, as a noun "conduct" means " 'carrying forward' or 'carrying out' "—definitions that do not imply direction or control. *Id.* at *10 (quoting Webster's Third New International Dictionary 473 (1976)). The dissent argued that in light of at least two plausible alternative definitions to the word "conduct" some level of ambiguity existed. Therefore the Court should invoke RICO's liberal construction clause to resolve the ambiguity and adopt the more inclusive definition—one that does not limit "conduct" to connote direction or control. *See id.* at *11.

Because *Reves* limits RICO's reach to those who operated or managed an enterprise, many accountants, lawyers, investment bankers, and others who have been subjected to RICO suits in the past will no longer be targets for such suits. The *Reves* limitation will no doubt curtail, to some extent, plaintiff abuse of RICO's provisions. Nonetheless, many of the abuses caused by RICO's overlap of Rule 10b-5 persist. Plaintiffs will continue to supplement their Rule 10b-5 claims with allegations of RICO violations in cases where the defendant did operate or manage an enterprise. Furthermore, RICO claims against accountants may continue despite *Reves* because the degree of management necessary to support a RICO claim will likely be litigated and applied to different facts.

will curtail some excessive litigation created by the overlap of securities fraud remedies.[185] RICO reform does not embody the dangers inherent in Rule 10b-5 reform—a restriction of its provisions will not hinder the private enforcement of the securities laws. As noted above, Congress' original intent in imbuing RICO with a securities fraud remedy was to allow for its application to organized crime.[186] Congress did not intend for RICO to replace the federal securities fraud remedies under the '33 and '34 Acts.[187] RICO's current use extends beyond that limited purpose and encroaches on areas of securities fraud traditionally remedied by federal securities fraud statutes. Thus, reform that eliminates RICO's application to securities fraud will not jeopardize the private enforcement of the federal securities laws because traditional securities fraud remedies remain.

CONCLUSION

The prospect of Rule 10b-5 reform has wide ramifications for the securities markets, investors, and the financial services industry. It may hinder the private enforcement of the securities laws and threaten the integrity of the financial markets. These concerns are particularly acute because faulty premises underlie efforts towards reform. The premises of Rule 10b-5 reform are faulty because they attribute to the Rule the adverse effects of other problematic areas including problems associated with accountant independence, societal perceptions of a litigation explosion, and class action litigation. While Congress should take steps to recognize and solve these issues, it should first direct its attention to RICO reform because RICO reform avoids the dangers inherent in restriction of Rule 10b-5. Congress can, thereby, achieve the appropriate balance between deterrence of securities fraud, remedies for securities fraud, and limitations on excessive litigation.

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185. *See* Richard C. Breeden, Remarks at the Meeting of the Corporate Counsel Institute 9 (Oct. 16, 1991) (transcript on file with the *Fordham Law Review*).

186. *See* Michael N. Glanz, *RICO and Securities Fraud: A Workable Limitation*, 83 Colum. L. Rev. 1513, 1522-26 (1983).

187. *See id.*