TESTIMONY OF VAUGHN R WALKER

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON BANKING AND FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

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Mr Chairman and members of the subcommittee, my name is Vaughn R Walker. I am chief judge of the United States District Court, Northern District of California. The court is headquartered in San Francisco.

I am honored to be invited today to testify about proposed legislation amending the 1933 and 1934 federal securities statutes. Private securities class actions are a useful and valuable adjunct to enforcement of the securities laws by federal and state regulatory bodies. These actions help to protect investors from fraud and other abuses, redress injuries when investors have suffered from fraud and abuse and thereby promote vital capital markets which are essential to the economic health of the nation and, indeed, because of the prominence of the American economy, the world. In this, class actions, although private, perform essentially a public function. Class actions are essentially public in another sense, as well.

The class members on whose behalf class actions are brought and prosecuted do not initiate, maintain or control the litigation in the same way that members of the general public do not initiate, maintain or control litigation brought by public officials or agencies. By contrast, of course, individual litigation is brought by clients who have a personal relationship with their lawyers and who can make decisions about the conduct of the litigation, when and if to settle and all other aspects of the litigation. But in class actions, except for the named representative or lead plaintiff, there is no direct client involvement.

In this sense, therefore, class actions are in important respects privatized public law enforcement; it is as though the public agencies responsible for enforcement of the nation's securities laws have outsourced a part of their public responsibilities to private attorneys and parties. Such outsourcing or privatization makes sense in important ways because it conserves the resources of the public agencies. When the defendants are solvent and able to satisfy a damages judgment and the wrongdoing not so reprehensible as to warrant criminal prosecution, it makes sense for the public agencies to stand by and let private class actions do much of the work needed to enforce the securities laws. And, I hasten to add, a great many

of the lawyers who practice on the plaintiffs' side in class actions are extremely able and wholly honest in their work.

Because class actions perform an essentially public function, however, safeguards are needed to protect class members that are not needed in individual actions. Litigation by public agencies is subject to many checks and balances. The members of the Securities & Exchange Commission, for example, are appointed by the President, must answer to this subcommittee and the corresponding body of the Senate, must work with the various self-regulatory bodies and industry groups and so forth. All of this helps to ensure the integrity of enforcement by the Commission and to direct its enforcement endeavors so that they are vigorous, but not overbearing or counter-productive. Now, of course, not everyone agrees that the proper balance is struck at all times or maybe even at anytime, but oversight of the Commission helps to strike an appropriate balance of these important and legitimate countervailing interests.

With class actions, however, this balancing process is very limited, indeed. Few of the measures that guard against abuse when other public functions have been outsourced to private parties have been imposed on class actions. In the area of securities class actions, Congress recognized this problem and sought to ensure against abuses by enacting in 1995 the Private

Securities Litigation Reform Act. The theory underlying that legislation was that by putting control of securities litigation into the hands of the largest investor, abuses that Congress perceived in lawyer-driven securities class actions would be corralled. Unfortunately, events have not substantiated this theory.

Mention has been made here today of the recent indictment of the Milberg Weiss law firm and two of its partners. The factual recitals of the Milberg indictment tell of millions in illegal kickbacks to lead plaintiffs, misrepresentations to courts and breaches of fiduciary duties to investor class members.

An indictment, of course, is merely a charge of wrongdoing. The defendants in that case are entitled to a fair trial and the government may not be able to prove the facts alleged in the indictment or persuade the courts that those facts, if proved, constitute the crimes alleged. But the indictment is significant nonetheless. These allegations need not be proved true beyond a reasonable doubt for them to awaken Congress to the need to review the operation of securities class actions. Lawyers are and should be held to higher standard than merely that they have avoided criminal liability. Lawyers should avoid impropriety and even the appearance of impropriety in the

conduct of their profession. This should be especially true of class action lawyers who, after all, are exercising the public responsibilities that I have mentioned.

The allegations of the Milberg indictment carry even more impact because at least some of the alleged events occurred after the 1995 Reform Act took effect. Indeed, the largest kickback payment alleged in the Milberg indictment occurred in a case governed by the 1995 Reform Act.

Furthermore, on June 22, 2006, the Chicago Tribune broke a story raising serious questions about financial relationships between the general counsel of several large pension funds that had served as lead plaintiffs in four class actions and the law firms that had served as lead counsel.[1] According to the Tribune, the general counsel received over $750,000 in fees associated with four class actions in which pension funds he represented acted as lead plaintiff. No billing records substantiated the general counsel's work and his role was never disclosed to the judges presiding over those class actions. Notably, two of the judges who presided in those cases were quoted that the relationships of which they were not informed would have been an important consideration in selecting lead

[1] David Kidwell, *Illinois Lawyer Tied to Indicted Law Firm*, Chi Trib C1 (June 22, 2006).

plaintiff and lead counsel. Again, regardless whether the <u>Tribune</u> story can be proved true in a court of law, its publication takes on special significance because a key premise of the 1995 Reform Act was that institutional investors would come forward to take charge of securities class actions.

Frankly, I am unsurprised by these unhappy developments. In my view, the 1995 Reform Act failed to require the elements essential to effective delegation of public responsibility to private parties and, in the case of securities class actions, for the protection of investors. These elements are: transparency, accountability and appropriate restraints on the ability to bring and maintain securities class actions.

TRANSPARENCY

The 1995 Reform Act attempted to place control of securities class actions in the hands of institutional investors who it was thought would be more responsible than the figurehead plaintiffs that had typically been named lead plaintiffs in securities class actions prior to the 1995 Reform Act. Congress took this idea from a law review article[2] that appeared while the

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[2] Elliot J Weiss & John S Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L J 2053 (1995).

legislation was under consideration.[3] Many good things appear in law reviews. That doesn't mean that the ideas in law reviews should find their way into law, however. One of the co-authors of the article has told me that he had no idea that the idea of institutional investor lead plaintiffs would become a statutory command.

Originally, the authors thought this was an idea that courts should consider and experiment with to see if it worked. I believe that I was the first judge in the United States to try this idea in an actual case.[4] This was before the Reform Act took effect. It is, of course, one thing to suggest that courts try an approach to litigation and quite another to mandate it. After all if an idea from a law review or elsewhere doesn't work out in practice, it can be abandoned or altered in a way to make it work. But when mandated by statute, the idea is locked in and courts have little ability to alter or amend it. Enacting the lead plaintiff provisions of the federal securities statutes has not worked as, I think, Congress intended.

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[3] See H R Rep No 104-369, 104th Cong, 1st Sess 34 n 3 & 35 n 6 (1995), reprinted in 1995 USCCAN 733-34 (citing Weiss and Beckerman); S Rep No 104-98, 104th Cong, 1st Sess 11 n 32, reprinted in 1995 USCCAN 690 n 32 (stating that the Weiss and Beckerman article "provided the basis for the 'most adequate plaintiff' provision").

[4] See In re California Micro Devices Securities Litigation, 168 FRD 257 (ND Cal 1996).

First, despite Congress' clear desire to see that securities class actions are managed by institutional investors with the know-how and capability to monitor and control the lawyers who represent the class, studies have shown that this has not been the experience under the Reform Act. In a report to the President and Congress on the first year of practice under the Reform Act, the SEC found that institutional investors sought lead plaintiff status in only 8 out of 105 sample cases.[5] More recently, Professor John C Coffee, Jr, of Columbia Law School, reported studies showing institutional participation ranging between 18% and 35%.[6] While institutional investors have assumed lead plaintiff responsibilities in some prominent and widely publicized cases, this has too often been the exception rather than the rule. Lawyers still run many, if not most, securities class actions with little or no oversight by an actual client. If institutional investors are unwilling to come forward and serve as lead plaintiffs, the logical assumption is that these investors do not believe the case is worth the time and effort required for them to serve as lead plaintiff.

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[5] Securities & Exchange Comm'n Office of General Counsel, *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995* (April 1997), available at http://www.sec.gov/news/studies/lreform.txt.

[6] John C Coffee, Jr, *Milberg Weiss Indictment*, Nat'l L J 18 (June 19, 2006).

Second, the 1995 Reform Act has effectively called a halt to transparency and competition in the selection of class counsel in securities class actions. In 1990, I conducted a competitive selection of class counsel and it worked.[7] Although the practice was criticized by some lawyers and commentators, I continued the practice in several later cases and several other judges began to pick up on the idea and applied a number of variations and improvements.[8] In two court of appeals decisions, competitive selection of class counsel was held to be contrary to the lead plaintiff and lead counsel provisions of the 1995 Reform Act.[9] I cannot say that these decisions are incorrect interpretations of the 1995 Reform Act, but their consequence has been unfortunate.

There is no little irony in this. While judges were for a long time lax in monitoring the conduct of class counsel,

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[7] See In re Oracle Securities Litigation, 131 FRD 688 (ND Cal 1990).

[8] See, for example, In re Bank One Shareholders Class Actions, 96 F Supp 2d 780 (ND Ill 2000) (Shadur); In re Lucent Technologies, Inc, Securities Litigation, 194 FRD 137 (DNJ 2000) (Lechner); Sherleigh Associates v Windmere-Durable Holdings, Inc, 184 FRD 688 (SD Fla 1999) (Lenard); see also In re Auction Houses Antitrust Litigation, 197 FRD 71 (SDNY 2000) (Kaplan) (antitrust).

[9] In re Cendant Corp Litigation, 264 F3d 201 (3d Cir 2001); In re Cavanaugh, 306 F3d 726 (9th Cir 2002).

the influence of the bidding cases has begun to be felt.[10] The Advisory Committee Notes to Rule 23 of the Federal Rules of Civil Procedure now expressly provide that a court may consider the price of counsel's services in awarding lead counsel designation.[11] Furthermore, the cases in which a competitive selection is perhaps most suitable are open-market securities fraud cases. This suitability arises from the fact that, unlike many other cases, the event that discloses the possibility of wrongdoing is a publicly announced or revealed event. Further, the legal claims actionable in the case of open market securities fraud are well established and fairly standardized. Under the Third and Ninth Circuit's interpretations of the 1995 Reform Act, competition is essentially impossible.

Section 4 of HR 5491 attempts to correct this shortcoming of the 1995 Reform Act by enabling courts to conduct alternative means, including competitive bidding, of approving lead counsel. If anything, this provision could and should be made even stronger by providing that the court shall not permit a

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[10] A Third Circuit task force and the Federal Judicial Center studied the auction process. Third Circuit Task Force on the Selection of Class Counsel, *Final Report* (January 2002), available at http://www.ca3.uscourts.gov; Laural L Hooper & Marie Leary, *Auctioning the Role of Class Counsel in Class Action Cases: A Descriptive Study* (Federal Judicial Center 2001), available at http://www.fjc.gov.

[11] Federal Rule of Civil Procedure 23, Advisory Committee Notes, 2003 Amendments, subsection (e), paragraph (1)(C).

securities class action to proceed unless and until the lead plaintiff has demonstrated that the lead plaintiff has evaluated competing proposals for representation of the class.

A lead plaintiff's failure to shop around for legal services raises two concerns. First, it should cause the court to question whether lead counsel has been chosen based on the perceived value of his services as opposed to some improper inducement. In this regard, requiring a lead plaintiff to select lead counsel on a competitive basis has salutary effects similar to an auction conducted by the court. Second, a lead plaintiff's failure to shop the market for legal services suggests that the plaintiff, although he may have the most at stake, cannot adequately represent the interests of the class. A plaintiff that has not exercised a calculated judgment in selecting counsel cannot be expected to direct or supervise counsel in a meaningful way. Accordingly, a plaintiff's failure to select counsel through a competitive selection process should constitute evidence that can rebut the "most adequate plaintiff" presumption and allow the court to conduct such a process or dismiss the case.[12]

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[12] For an example of a court requiring the lead plaintiff to select counsel through a competitive selection process, see <u>In re Network Associates, Inc, Securities Litigation</u>, 76 F Supp 2d 1017 (ND Cal 1999) (Alsup).

Section 3 of HR 5491 also seeks to promote transparency in securities class actions. This provision would amend subsection (a) of section 27 and section 21D of the 1933 and 1934 acts, respectively, by requiring that each plaintiff and the plaintiff's attorney provide sworn certifications that identify conflicts of interest, "including any direct or indirect payment, between such attorney and such plaintiff and between such attorney and any affiliated person of such plaintiff." Disclosing conflicts of interest is, of course, essential to transparency in securities class actions. Yet as suggested by the Milberg indictment and the Chicago Tribune article, this kind of disclosure has been lacking. One can scarcely doubt that section 3 takes a step in the right direction by requiring plaintiffs and their lawyers to disclose conflicts of interest.

Beyond conflicts of interest, I suggest that section 3 should also require disclosure of any financial relationship between an attorney representing a plaintiff in the class action and the plaintiff, any attorney that represents the plaintiff in other matters (including the plaintiff's general counsel) or any person related to or affiliated with either the plaintiff or attorneys that represent the plaintiff in other matters. Although much of this is covered by section 3 as currently drafted, there simply is no reason not to draft the section as

broadly as possible. Furthermore, I suggest adding a provision that requires court approval for any payment by the plaintiff's attorney to the plaintiff, any attorney that represents the plaintiff in other matters (including the plaintiff's general counsel) or any person related to or affiliated with either the plaintiff or attorneys that represent the plaintiff in other matters.

ACCOUNTABILITY

This highlights another problem with the lead plaintiff provisions of the 1995 Reform Act: the most adequate plaintiff may not always be the class member with the largest stake in the outcome of the case. What matters is the willingness and ability of the lead plaintiff actually to lead the litigation and monitor class counsel. The total number of dollars at stake may not determine this. A class member with a smaller stake may have more of its net worth at stake and be more keenly interested in securing relief.

The 1995 Reform Act created a statutory presumption that the plaintiff with the "largest financial interest in the relief sought by the class" is the "most adequate plaintiff," assuming that this plaintiff satisfies certain requirements of Rule 23 of the Federal Rules of Civil Procedure. One question

left unanswered by the 1995 Reform Act was whether plaintiffs could be grouped and their financial interests aggregated for purposes of the statutory presumption. As amended by the 1995 Reform Act, section 27 and section 21D of the 1933 and 1934 acts, respectively, both provide that the court "shall appoint as lead plaintiff the member or members of the purported plaintiff class that the court determines to be most capable of adequately representing the interests of class members." Similarly, both sections elsewhere suggest that a "person or group of persons" may qualify as the "most adequate plaintiff."

Courts interpreting this language have reached different conclusions. Some courts have rightly found that aggregating plaintiffs is antithetical to the 1995 Reform Act's goal of taking lawyers out of the driver's seat.[13] At the other end of the spectrum, courts have appointed groups of unrelated plaintiffs to act as "co-lead" plaintiffs.[14] Courts in the middle have allowed aggregation only if some pre-existing relationship binds members of the group such that agency costs

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[13] See, for example, In re Donnkenny Inc Securities Litigation, 171 FRD 156 (SDNY 1997).

[14] See, for example, In re Oxford Health Plans, Inc, Securities Litigation, 182 FRD 42 (SDNY 1998).

and collective action problems are not likely to emerge.[15] Underlying this middle approach is the notion that a closely related group will, as a practical matter, act in unison.[16]

Aggregating unrelated plaintiffs presents several problems. First, the larger the group, the more difficult it is for group members to communicate with each other. In the same vein, it becomes more difficult for the group to act cohesively when making decisions about the conduct of the litigation and to coordinate supervision of the lawyers. Second, cobbling together unrelated plaintiffs to satisfy the "largest financial interest" criterion amounts to an end-run around the statutory presumption. All of this enables lawyers to run the show.

Significantly, in at least two of the class actions listed in the indictment against the Milberg Weiss firm were governed by the 1995 Reform Act, Milberg Weiss was able to inject itself into the litigation with a client or collection of clients who, individually, would not have met the criteria of the "most adequate plaintiff."[17] It is worth noting that one of these

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[15] See, for example, In re Telxon Corp Securities Litigation, 67 F Supp 2d 803 (ND Ohio 1999).

[16] Aronson v McKesson HBOC, Inc, 79 F Supp 2d 1146 (ND Cal 1999).

[17] See In re Baan Co Securities Litigation, 186 FRD 214 (DDC 1999); In re Oxford Health Plans, Inc, Securities Litigation, 182 FRD 42 (SDNY 1998).

cases, Oxford Health, involved the largest single kickback payment alleged in the Milberg indictment: $1.1 million.

One approach to the problem of aggregating plaintiffs would be to draw a bright line forbidding the practice of allowing more than one individual or entity to serve as lead plaintiff. This might be as simple as eliminating the existing phrases "or members" and "or group of persons" from clause (a)(3)(B)(I) and subclause (a)(3)(B)(iii)(I), respectively. Alternatively, the subcommittee might consider codifying the middle approach taken by courts, whereby only a small, closely knit group of individuals or entities with a pre-existing relationship can act as lead plaintiff. But in no event should separate groups of plaintiffs and their lawyers be permitted to act as "co-lead" plaintiffs and "co-lead" counsel in order to qualify for designation.

APPROPRIATE RESTRAINT

The 1995 Reform Act sought appropriate restraint on the bringing of securities class actions by imposing a heightened pleading requirement for complaints alleging securities law violations. Whether that requirement has reduced the number of filings or simply prolonged and complicated the pleading stage of securities actions is open to debate. But it is clear that

securities complaints are now distended, prolix and circumlocutory. More significantly, this prompts securities issuers to lard mounds of cautionary language in their securities offering documents with little, if any, additional informational value to investors. Section 2 of HR 5491 would amend subsection (c) of section 27 and section 21D of the 1933 and 1934 acts, and impose a more effective restraint.

Currently, paragraph (c)(1) requires the court to make findings regarding compliance by the parties and attorneys with Rule 11 of the Federal Rules of Civil Procedure, which proscribes filings that are legally or factually baseless or made for an improper purpose. Paragraph (c)(2) provides that the court shall impose sanctions for filings that violate Rule 11. Paragraph (c)(3) creates a rebuttable presumption that the appropriate sanction for improper filings is an award of attorney fees and expenses. Subsection (c) does "not in any way purport to alter the substantive standards for finding a violation of Rule 11, but functions merely to reduce courts' discretion in choosing whether to conduct the Rule 11 inquiry at all and whether and how to sanction a party once a violation is found."[18]

Section 2 of HR 5491 would amend subsection (c) by

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[18] Simon DeBartolo Group, LP v Richard A Jacobs Group, Inc, 186 F3d 157, 167 (2d Cir 1999).

adding new paragraph (c)(4) providing that upon motion by a defendant who has obtained final judgment against a plaintiff through a dispositive motion or a trial on the merits, the court shall determine whether (1) the plaintiff's position was "not substantially justified," (2) imposing defendant's fees and expenses upon the plaintiff's attorney would be just and (3) fees and expenses incurred by the defendant are "substantially burdensome or unjust." The defendant bears the burden of persuading the court that the plaintiff's position was not substantially justified. If the court finds these three conditions are satisfied, the court shall award the defendant fees and expenses to be paid by the plaintiff's attorney.

I would offer the following comments.

The subcommittee might wish to consider making the standard for an award of fees and expenses more objective than the rather elastic standards of Rule 11. The Rule 11 standards can change with judicial interpretations in cases not involving the securities laws. Furthermore, Rule 11 sanctions are closely tied to pleadings filed in court and have other limitations that make their imposition often impossible. Lead counsel's pleadings are only one aspect of securities litigation. It should be possible for a court to evaluate lead counsel's conduct of the litigation as a whole. A standard that would shift fees to lead

counsel in securities litigation if the court finds that the action or its conduct was not substantially justified would better serve the intent of this legislation.

Finally, conditioning a fee award upon a finding that it would be unjust or substantially burdensome for a defendant to bear its own fees and expenses does not further the purpose of the fee-shifting provision. Whether a particular frivolous class action is burdensome and therefore warrants an award of fees against the plaintiff’s attorney simply should not depend on the depth of the defendant’s pockets.

Once again, I am honored to have been invited to testify before the subcommittee. HR 5491 plainly seeks to promote transparency and accountability in securities class actions and protect the investing public. I hope my comments have been helpful to the subcommittee and would be pleased to answer your questions.