Private Securities Litigation: The Need for Reform

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PRIVATE SECURITIES LITIGATION: THE NEED FOR REFORM*

INTRODUCTION

Since its inception at the turn of the nineteenth century, securities law in the United States has evolved considerably.\(^1\) Industrialization and the incorporation of American companies pro-

\(^*\) The authors would like to acknowledge that since this Note was submitted for publication, Congress passed H.R. 1689. It was signed into law on Nov. 3, 1998.

vided the foundation for the modern securities market.\(^2\) In an effort to keep up with growing markets, owners of businesses searched for different methods of raising capital.\(^3\)

The distribution of stocks, through securities trading, became a common mode of raising this necessary financing.\(^4\) As the securities market grew, however, individual states realized that they were not equipped to control the fraud and misrepresentation that developed with the growth of the securities markets.\(^5\) Consequently, the price of securities escalated to exorbitant levels, ultimately causing the stock market crash of 1929.\(^6\) In re-


sponse to this economic catastrophe, Congress passed reform legislation in an attempt to protect both investors and companies.\(^7\)

Despite Congress' good intentions, the newly enacted legislation failed to combat the frivolous claims brought against companies.\(^8\) Congress again attempted to find a remedy, this time through the enactment of the Private Securities Litigation Reform Act of 1995 ("PSLRA").\(^9\) The PSLRA was intended to prevent meritless claims against companies in federal class action lawsuits by placing procedural hurdles that must be overcome.\(^10\) Unfortunately, this piece of legislation has also fallen short of


(b) Requirements for securities fraud actions. . .

(2) Required state of mind . . . In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

Id. 141 CONG. REC. H14039-02 (daily ed. Dec. 6, 1995) (statement of Rep. Bliley). This statute combats frivolous claims by placing the hurdle on plaintiffs of proving the defendant's state of mind.

\(^{10}\) See Securities Litigation Abuses, 1997: Before the Securities Subcomm. of the Senate Comm. on Banking, Housing and Urban Affairs, 105th Cong. (1997) (statement of Richard I. Miller, General Counsel, AICPA), available in 1997 WL 416660, at *3. The Reform Act also included:

[a] reform of joint and several liability to reduce coercive settlements; prohibitions on abusive practices to prevent the payment of bounties to lead plaintiffs and other such abuses; and toughened attorney sanctioned provisions under Federal Rule of Civil Procedure Rule I 1 to discourage the filing of frivolous lawsuits.

meeting its objective, thus giving rise to the need for additional remedial legislation.\footnote{11} There are currently two securities reform bills pending in Congress addressing the problem of frivolous claims.\footnote{12} The primary purpose of these bills is to prevent forum shopping in securities class action lawsuits.\footnote{13} By preventing forum shopping, the restrictions and qualifications imposed at the federal level by the PSLRA\footnote{14} will have a chance to be universally applied.\footnote{15} If either of these proposed bills are passed, thereby preempting state regulation of class action securities lawsuits, the goals of the PSLRA will be carried out.\footnote{16}

This Note focuses on the need for reform legislation in the securities market due to the increase in forum shopping among the nation's states. Part One discusses the history of securities leg-


\footnote{12} See All Eyes on Financial Services Reform, Revamping CEA is Long Shot, Securities Regulation and Law Report, Jan. 16, 1998, available in 30 SRLR 89, at *2. The predictions are that the pending litigation reform will require some securities class actions to be filed in federal rather than state court. Id.


islation beginning with the stock market crash of 1929. This section also includes a commentary on the post-PSLRA era. Part Two addresses proposed remedial legislation and its attempts to effectuate the PSLRA. Finally, this Note concludes by endorsing the preemption of securities class action lawsuits by virtue of a uniform standard for securities litigation.

I. HISTORY

A. The Outset of Securities Reform

Congress enacted the Securities Act of 1933 ("1933 Act")\textsuperscript{17} and the Securities Exchange Act of 1934 ("1934 Act")\textsuperscript{18} to promote investor confidence and regulate the American stock market after the crash of 1929.\textsuperscript{19} The public's investment in the securities market is crucial for capital formation, economic growth and increased employment.\textsuperscript{20} Congress, therefore, with the assistance of the Securities and Exchange Commission ("SEC"), created the first securities legislation.\textsuperscript{21}

Congress enacted the 1933 Act to ensure that publicly traded companies fully disclosed material information to prospective investors.\textsuperscript{22} Since its enactment, Congress has succeeded in regulating activity between corporations and their potential in-

\textsuperscript{17} 15 U.S.C. § 77a (1997).
\textsuperscript{19} See Lukens, supra note 6, at 384 (noting that both 1933 and 1934 Acts were responses to stock market crash of 1929).
\textsuperscript{20} See McGlosson, supra note 5, at 305. There is a need for capital investments for a corporation to survive. Id.; see also Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 170 (1994). The Supreme Court noted that the stock market crash of 1929, in conjunction with reports of widespread abuse in the securities industry, prompted the enactment of the 1933 and 1934 Acts. Id.; Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472 (1977).
\textsuperscript{22} See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (according to Supreme Court, 1933 Act designed to provide investors with full disclosure of material information, to protect investors from fraud, and to promote ethical standards of honesty and fair dealings); see also SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (stating that 1933 Act was one of series of enactments designed to respond to securities industry abuses found to have contributed to stock market crash of 1929 and depression of 1930's).
vestors. Congress, however, failed to extend these regulations to individual third parties trading amongst themselves. To rectify its omission Congress enacted the 1934 Act.

This subsequent Act gave the SEC broad regulatory and enforcement powers. The filing of private actions by investors against corporations for violations of federal securities law was also permitted by the 1934 Act. The most common provisions


28 See David C. Mahaffey, Pleading Standards and Discovery Stays Under the Private Securities Litigation Reform Act: An End to Fishing Expeditions?, 10 NO. 2 INSIGHTS 9, 9 (1996) (discussing PSLRA's purpose of eliminating so-called 'fishing expedition' lawsuits, in which plaintiffs file complaints containing general allegations of fraud hoping that subsequent discovery will uncover evidence to substantiate allegations); see also Miller, supra note 10, at *8 (addressing concern over plaintiff's lawyers using discovery proceedings in state courts as "fishing expeditions" for simultaneously filed federal court suits); Coalition Applauds Senate Bill to Crack Down on Speculative Stock Suits in State Courts, U.S. Newsweek, Sept. 10, 1997, available in WL 13913497, at *2 (stating law firms that specialize in "strike suits" were often filing them without any evidence of wrongdoing in attempt to extract settlements from companies).
utilized for such lawsuits were the "catch-all" fraud provision in section 10(b) of the 1934 Act and SEC Rule 10b-5. Although Congress never expressly provided for such private rights of action when it enacted section 10(b), the judiciary held that Congress impliedly authorized such actions.

B. The Need for Reform

While the 1933 and 1934 Acts sought to protect investors from corporate deception, the need for legislation to protect corporations from unscrupulous investors soon became evident. Many investors filed meritless fraud claims and "strike suits" against companies due to the broad scope of section 10(b) and rule 10(b)(5).

29 See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 765 (1975) (describing broad powers of 1934 Act specifically in regard to 10(b)). See generally Ernst & Ernst v. Hochfelder, 425 U.S. 185, 206 (1976) (explaining that since 10(b) is not explicit in its terms, courts should be careful in construing it).


32 See Curt Cutting, Turning Point for Rule 10b-5: Will Congressional Reforms Protect Small Corporations?, 56 OHIO ST. L.J. 555, 556 n.4 (1995). Frivolous suits are suits in which the plaintiff is successful although, if the case were brought to trial, it is unlikely that the party would prevail on the merits. Id.; John L. Latham et. al., Securities Regulation, 46 MERCER L. REV. 1463, 1494 (1995). In such actions the plaintiff is able to obtain a favorable settlement, even though the case would not likely win on the merits at trial. Id.; Stephen M. Muniz, The Private Securities Litigation Reform Act of 1995: Protecting Corporations From Investors, Protecting Investors From Corporations, and Promoting Market Efficiency, 31 NEW ENG. L. REV. 655, 702 (1997). A strike suit is a class action suit by shareholders against a company because its stock price dropped. Id.; see also 141 CONG. REC. S8891 (daily ed. June 22, 1995) (Statement of Sen. D'Amato). "[Strike] suits... are often based on nothing more than a company's announcement of bad news, not evidence of fraud." Id.

33 See William S. Feinstein, Securities Fraud, 63 GEO. WASH. L. REV. 851, 864 (1995) (discussing origin and reasons for a "strike suit"); David Wakmen, Causation Concerns
Strike suits are class action suits brought by investors under section 10(b) of the 1934 Act. The complaint is based upon the allegation that the defendant company used fraudulent or misleading statements to induce customers to purchase securities. These suits have historically generated much controversy due to the potential for abuse. Strike suits are feared because of the stigma attached to defendants charged with violations of the 1934 Act. A company that relies on investor confidence cannot afford the consequences associated with public accusations that it engaged in deceptive practices.

Frivolous claims are even a greater nuisance for corporations due to the prior knowledge by plaintiffs that the companies usually settle because of the high cost of pre-trial discovery. For example, there was a period in which companies and their


34 See New England Data Serv. Inc. v. Becher, 829 F.2d 286, 288 (1st Cir. 1987) (noting that plaintiff with groundless claim can wreak havoc on company); see also Natasha, Inc. v. Evita Marine Charters, Inc., 763 F.2d 468, 470 (1st Cir. 1985) (recognizing that attorney's costs are additional obstacle in strike suits). See, e.g., Haft v. Eastland Fin. Corp., 755 F. Supp. 1123, 1130 (D.R.I. 1991) (stating that corporate defendants settle strike suits in order to preserve good will).

35 See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975) (observing that strike suits cause social costs rather than benefits due to their stigma); Valerie Lee Litwin, Pleading Constructive Fraud in Securities Litigation - Avoiding Dismissal for Failure to Plead With Particularity, 33 EMOY L.J. 517, 546 (1984) (noting that strike suits should be discouraged because they represent meritless claims, yet plaintiffs still get settlement money because of social stigma of trial); see also J. Spencer Schuster, Pre-certification of Class Actions: Will California Follow the Federal Lead?, 40 HASTINGS L.J. 863, 864 (1989) (discussing strong policy reasons defendant corporation has for settling strike suits early).

36 See Lerach, supra note 8, at 11 (noting that bad press costs company); Alan S. Ritchie, The Proposed "Securities Private Enforcement Reform Act": The Introduction of Proportionate Liability in Rule 10b-5 Litigation, 42 CLEV. ST. L. REV. 339, 341 (1994) (discussing proposed changes that Congress is initiating in order to deter strike suits).

37 See David Waksman, Causation Concerns in Civil Conspiracy to Violate Rule 10b-5, 66 N.Y.U. L. REV. 1505, 1509 (1991) (noting tremendous discovery costs in security litigation cases); cf. Lance Levine, Compliance With GAAP and GAAS: Its Proper Use as an Accountant’s Defense in a Rule 10B-5 Suit, 1993 COLUM. BUS. L. REV. 109, 126 (1993) (discussing other entities, such as accounting firms, which are also exposed to strike suits).

38 See Hamilton, supra note 8, at 566 (recognizing some positive aspects of punishing executives who issue reckless promises); see also George G. Yearsich et. al., Securities Law Aspects of Partnerships, in PARTNERSHIPS, LLCs, AND LLPs, at 965, 997 (ALI-ABA Course of Study No. CA86, 1996) (discussing some safe harbor provisions for forward looking statements). But see Martha L. Cochran, Sweeping Reform: Litigation and Be-speaking Caution Under the New Securities Law, in APPENDICES, at 141 (PLI Corp. L. and Practice Course Handbook Series No. 924, 1996) (noting that well thought out forward looking statements are essential to companies' success).
executives were being sued after providing the public with forward looking statements. A statement is characterized as "forward looking" when it discloses anything that is not a current or historical fact. Investors proceeded to claim that forward looking statements were fraudulent if the future projections failed to materialize.

These suits were often filed by parties lacking any actual evidence of fraud. The plaintiffs often used pre-trial discovery proceedings to go on "fishing expeditions" to substantiate their claims. Due to the high cost of discovery incurred by companies out of court, settlements were usually favored. Motivated

42 See Mahaffey, supra note 28, at 9 (discussing PSLRA's intention of eliminating 'fishing expedition' lawsuits, where party files complaint containing general allegations of fraud in hopes that subsequent discovery will uncover enough evidence to substantiate allegations); see also Miller, supra note 10, at 8 (addressing concern over plaintiffs lawyers using discovery proceedings in state courts as "fishing expeditions" for simultaneously filed federal court suits); U.S. Newswire, supra note 28, at 2 (pinpointing certain firms which specialize in strike suits in order to coerce companies to settle without any evidence).
by fear of possible strike suits, companies refused to disclose information to the public.\textsuperscript{44} This negatively affected the securities market\textsuperscript{45} since companies ceased to provide valuable information to the public.\textsuperscript{46}

In response to this problem, Congress enacted a “safe harbor” provision\textsuperscript{47} designed to protect corporations from claims based on their future projections by prohibiting lawsuits based upon them.\textsuperscript{48} There are two exceptions to the safe harbor provisions.

\textsuperscript{44} See McGrath, supra note 16, at *2 (stating threat of being sued in state court has caused companies to be reserved with respect to providing investors with forward-looking information). See generally Feinstein, supra note 33, at 864 (explaining companies fear of strike suits); Muniz, supra note 32, at 660-61 (1997) (describing how strike suits limit information disclosed by corporated management).

\textsuperscript{45} See Miller, supra note 10, at *1-3 (explaining that abusive litigation drains even our countries most lucrative companies of their resources along with compromising integrity of securities market). See generally Securities and Exchange Commission, Division of Enforcement, Division of Enforcement-Recent Cases and Issues, in THE SEC SPEAKS IN 1997, at 199-200 (PLI Corp. L. and Practice Course Handbook Series No. 978, 1997) (describing sharing of market information as personal courtesy); Mark A. Clayton, The Misappropriation Theory in Light of Carpenter and the Insider Trading and Securities Fraud Enforcement Act of 1988, 17 PEPP. L. REV. 185, 215 (1984) (explaining that duty to disclose is especially owed in impersonal securities market); McGrath, supra note 16, at *2-4 (discussing many harms suffered by those in securities market as result of strike suits).


First, actions may be instituted based on future statements made "without a reasonable basis." The second exception allows plaintiffs to file suit when corporate disclosure is made in bad faith. As a result of the limited scope of this provision, Congress' attempt at a safe harbor was ineffective in protecting corporations.

C. The Legislature's Response- The Private Securities Litigation Reform Act of 1995

In an attempt to effectuate this safe harbor provision, Congress enacted the PSLRA. While the PSLRA mainly focused on and the "Bespeaks Caution" Doctrine, in SWEEPING REFORM: LITIGATING AND BESPEAKING CAUTION UNDER THE NEW SECURITIES LAW 1996, at 583 (PLI Corp. L. and Practice Course Handbook Series No. 923, 1996) (explaining how "safe harbor" provision will enhance market efficiency by encouraging companies to disclose forward looking information); see also Wanders, supra note 41, at 266 (referring to Congress' efforts to amend safe harbor provision); Muniz, supra note 32, at 657 (1997) (explaining that fraud claims based upon future projections were aimed to be eliminated by 1979 safe harbor provision).

See Muniz, supra note 32, at 655 (laying out exceptions to safe harbor provisions); see also Douglas M. Schwab et. al., An Update on Congressional Actions to Reform the Federal Securities Laws, in SECURITIES LITIGATION 1995, at 492-93 (PLI Corp. L. and Practice Course Handbook Series No. 905, 1995) (stating times when "safe harbor" provisions are not applicable). But see Allen I. Young, Disclosures Concerning Derivative Financial Instruments, in ADVANCED SECURITIES LAW WORKSHOP 1995, at 266 (PLI Corp. L. and Practice Course Handbook Series No. 969, 1997) (explaining when safe harbor provisions are available).

See John C. Coffee, Jr., The Future of Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung?, in 28TH ANNUAL INSTITUTE ON SECURITIES REGULATION 1996, at 534-35 (PLI Corp. L. and Practice Course Handbook Series No. 963, 1996) (stating that failure to disclose certain type of forward looking statement may be material omission giving rise to further liability); Cutting, supra note 32, at 579 (explaining that safe harbor provides little protection for predictions gone sour); see also Thomas Gilray et. al., Preparing the Management's Discussion and Analysis, in PREPARATION OF ANNUAL DISCLOSURE DOCUMENTS 1995, at 309 (PLI Corp. L. and Practice Course Handbook Series No. 874, 1995) (stating in order to be protected, statements must have adequate basis in fact as well as be issued in good faith).

In 1995, Congress, attempted to strengthen the safe harbor provision by overriding President Clinton's veto, and passing into law the Private Securities Litigation Reform Act of 1995. Id.; see also Parker, supra note 40, at 387. There is a need for a stronger safe harbor than currently exists because the current rules are ineffective. Id.; Stephen J. Schulte et. al., Safe Harbor for Forward-Looking Statements: An Overview for the Practitioner, in SWEEPING REFORM: LITIGATING AND BESPEAKING CAUTION UNDER THE NEW SECURITIES LAWS 1996, at 462 (PLI Corp. L. and Practice Course Handbook Series No. 923, 1996). Part I of the Safe Harbor provision has proven to be ineffective. Id.; Carl W. Schneider et. al., Forward Looking Information- Navigating in the Safe Harbor, 51 BUS. LAW. 1070, 1079 (1996). These authors also state that presently, the safe harbor rules are relatively ineffective. Id.

meritless strike suits, the final bill extends far beyond the regulation of frivolous litigation.

The PSLRA established uniform pleading standards among federal courts. Prior to its enactment, courts were inconsistent in deciding what was necessary to successfully plead fraud in securities cases. Under section 10(b) of the 1934 Act, plaintiffs had to plead specific facts that supported "a strong inference of scienter." Under Rule 9(b) of the Federal Rules of Civil Procedure, however, plaintiffs had to "plead fraud with particularity," while "malice, intent, knowledge, and other conditions of the mind [could be] averred [to] generally." The disparity be-

ties Litigation Reform Act Overview Summary and New Developments, in 28TH ANNUAL INSTITUTE ON SECURITIES REGULATION 1996, at 188 (PLI Corp. L. and Practice Course Handbook Series No. 962, 1996). Increasing numbers of companies have begun to utilize the Reform Act's safe harbor for forward looking statements. Id.; John C. Coffee, Jr., The Future of the PSLRA, 51 BUS. LAW. 975, 997 (1996). Safe harbor is one of the main pro-

visions of the PSLRA. See generally 141 CONG. REC. H15214-06 (daily ed. Dec, 20, 1995) (veto message of President Clinton). The President vetoed the bill because he felt the pleading standards were too stringent. Id.

See Jeffrey Silva, Lawmakers Bring to Floor New Securities Litigation (RCR Radio Comm. Report, May 26, 1997), available in 1997 WL 8324672, at *2. The "PSLRA was designed to cut down the filing of frivolous lawsuits by shareholders in high tech compa-

nies who's stock prices are prone to big jumps and declines." Id.; see also John W. Avery, Securities Litigation Reform, 51 BUS. LAW. 335, 348 (1996). Chairmen Levitt indicated that the SEC supported efforts to make private securities litigation more effective and to deter meritless lawsuits. Id.

See Marksman Partners v. Chantel Pharm., 927 F. Supp. 1297, 1311 (C.D. Ca. 1996) (indicating committee intended to create uniform pleading standard); see also Joseph P. Monteleone et. al., D & O Developments, in SECURITIES LITIGATION 1996, at 1019 (PLI Corp. L. and Practice Course Handbook Series No. 958, 1996) (indicating PSLRA was designed to protect investors, issuers, and all associated with capital markets from abusive securities litigation); Spencer, supra note 47, at 100 (stating that PSLRA in-
tended to discourage discovery abuses, targeting deep pocket defendants and client ma-
nipulation by attorneys in addition to frivolous litigation).

See McGrath, supra note 16, at *2-3 (explaining that proposed legislation is an ef-
fort to supplement Reform Act and uphold goal of uniformity).

See 15 U.S.C. § 78u-4 (1997). Under rule 10(b) of the 1934 Act, plaintiffs must plead specific facts that would support "a strong inference of scienter." Id.; FED. R. CIV. P. 9(b). Under Rule 9(b) of the Federal Rules of Civil Procedure, however, plaintiffs must "plead fraud with particularity" though "malice, intent, knowledge, and other conditions of the mind may be averred generally." Id.

See In re Glen Fed, Inc. Securities Litigation v. Glenfed Inc. 11 F.3d. 843, 847 (9th Cir. 1993) (looking at pleading standard for fraud in securities cases); see also Joseph A. Grundfest et. al., Securities Litigation Reform: The First Year's Experience, in ADVANCED SECURITIES LAWS WORKSHOP 1997, at 382 (PLI Corp. L. and Practice Course Handbook Series No. 1005, 1997) (discussing pleading standards under rule 10(b)); Survey, Sub-

FED. R. CIV. P. 9(b).

between the two regulations allowed some circuit courts to be more lenient than others in their requirements for pleading scienter in fraud cases.\textsuperscript{60}

The different interpretations of section 10(b) and rule 9(b) created confusion among the circuits.\textsuperscript{61} The standard adopted by the PSLRA mirrored the section 10(b) approach. Thus, in order to bring a securities action in federal court the complaint must specifically set forth facts which give "rise to a strong inference that the defendant acted with the required state of mind."\textsuperscript{62}

The PSLRA also prevented liability for statements made by company representatives that were not known to be false at the time they were made, or that were accompanied by meaningful cautionary statements.\textsuperscript{63} Additionally, the PSLRA provided a

\textsuperscript{60} See In re Stac Electronics Sec. Litig., 89 F.3d 1399, 1404 (9th Cir. 1996) (stating that claims brought under Rule 10(b) must meet particularity requirements of Federal Rule 9(b)); In re GlenFed, Inc. Sec. Litig., 60 F.3d 591, 592 (9th Cir. 1995) (only acts constituting fraud need be stated with particularity in accordance with 9(b) while scienter may be generally averred); Shapiro v. UJB Fin. Corp., 964 F.2d 272, 288 (3d Cir. 1992) (observing that "plain language [of Rule 9(b)] clearly encompasses section 11 and section 12(2) claims based on fraud"); Phelps v. Wichita Eagle-Beacon, 886 F.2d 1262, 1270 n.5 (10th Cir. 1989) (noting that many courts and commentators have interpreted Rule 9(b) to permit general averment of intent unaccompanied by supporting factual allegations).

\textsuperscript{61} See In re Time Warner Sec. Litig., 9 F.3d 259, 268 (2d Cir. 1993) (using standard of pleading fraud under rule 10(b) of 1934 Act); see also Breard v. Sachnoff & Weaver, Ltd., 941 F.2d 142, 143-44 (2d Cir. 1991) (applying rule 9b test for scienter).

\textsuperscript{62} See Patrick J. Coughlin et al., Commencing Litigation Under the Private Securities Litigation Reform Act of 1995, in SECURITIES LITIGATION 1996, at 15 (PLI Corp. L. and Practice Course Handbook Series No. B4-7165, 1996). The Conference Committee Report on the PSLRA indicates that the statutory language is based on the [heightened] pleading standard of the Second Circuit, thus adopting the heightened standard that plaintiffs plead both factual circumstances constituting fraud as well as scienter with particularity. Id. But see Hearings on Securities Litigation Reform Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce, 103d Cong. 2d Sess. (1994) (statement of Prof. Arthur Miller). The heightened scienter standards attempt to attain the unrealistic goal of having plaintiffs provide clear proof of the defendant's state of mind. Id. It is rare to find that this type of evidence exits. Id. Most cases require plaintiffs to draw inferences from the facts available prior to institution of the action. Id. Should these facts be unavailable, meeting these requirements would be impossible. Id.; Denis T. Rice, A Practitioner's View of the Private Securities Litigation Reform Act of 1995, 31 U.S.F. L. Rev. 283, 324 (1997). The PSLRA is unclear as to what is needed to establish a strong inference that the defendant acted with the requisite state of mind. Id. The Report of Managers explicitly stated that the Congressional Conference Committee did not intend to codify the Second Circuit's case law on this respect. Id. In fact, Congress rejected an amendment that would have codified the Second Circuit approach. Id.

\textsuperscript{63} See Latham, supra note 32, at 1479-80 (explaining protection was afforded to identify forward looking statements accompanied by meaningful precautionary statements); see also Matteson, supra note 48, at 534 (indicating safe harbor protected statements made in good faith).
stay on discovery during the pendency of a dismissal motion.\textsuperscript{64} The discovery provision was intended to end the "fishing expeditions" used to substantiate frivolous claims.\textsuperscript{65} Despite the goals of the PSLRA, the fact remains that it is only applicable at the federal level leaving the states in limbo as to what the appropriate standard should be.\textsuperscript{66}

D. The Aftermath of the Private Securities Litigation Reform Act of 1995

Although the PSLRA appeared to address legislative concerns,\textsuperscript{67} a loophole has enabled attorneys to continually initiate frivolous and meritless lawsuits that Congress clearly intended to bar.\textsuperscript{68} Since the heightened pleading standards of the PSLRA only apply in federal courts,\textsuperscript{69} attorneys are filing suit in state


\textsuperscript{66} See Rice, supra note 63, at 283 (explaining PSLRA's applicability at federal level); see also Joel W. Sternman et. al., Discovery Stays Lead Plaintiffs and the Fraud on the Market Theory: Observations on the Private Securities Litigation Reform Act of 1995 and Recommendations For Change, in SECURITIES LITIGATION 1997, at 333 (PLI Corp. L and Practice Course Handbook Series No. B4-7199, 1997) (noting that PSLRA's non applicability at state level has increased state litigation).

\textsuperscript{67} See Chimicles, supra note 48, at 593 (stating that there is much speculation about future of securities litigation in wake of PSLRA); Harvey Pitt et. al., Promises Made, Promises Kept: Practical Implications of PSLRA, 33 SAN DIEGO L. REV. 845, 866 (1996) (explaining how questions arise concerning interpretation of PSLRA); Michael S. Radford, Private Securities Litigation Reform Act of 1995: Retroactive Application, 23 J. LEGIS. 283, 283 (1997) (describing confusion over whether PSLRA was meant to be retroactive).

\textsuperscript{68} See New 'Safe Harbor' is Not Being Utilized, LEGAL TIMES, July 1, 1996, at S29 (stressing that issuers are continuing to release same type of information prior to Reform Act, but these statements do not conform with requirements for safe harbor protection); see also Amendments Proposed to Plug Loophole in Securities Reform Laws, ANDREWS SEC AND COMMODITIES LITIG. REP., June 11, 1997, at 12 (explaining new legislation needed to fill holes in PSLRA). See generally Sternman, supra note 67, at 333 (noting that Congress has taken consideration of loopholes in PSLRA and begun to address them); Lori Tripoli, Practice Development Saga, 16 NO.2 OF COUNSEL 5, 5 (1997) (stating states have discovered ways around application of statute).

\textsuperscript{69} See Stuart J. Baskin, Recent Developments in State Securities, Derivative and Cor-
courts where the heightened standards do not apply. The result has been an explosion of securities litigation in state courts.

A recent study reveals that securities class action lawsuits in state courts have increased by twenty-six percent since 1995. The PSLRA has essentially been rendered ineffective due to the ability of claimants to side-step the heightened requirements by filing in state court. In response, companies are once again

porate Law, in SECURITIES LITIGATION 1996, at 449 (PLI Corp. L. and Practice Course Handbook Series No. B4-7165, 1996). The article talks about changes in federal courts because of PSLRA, but not in state courts. Id.; see also Monteleone, supra note 55, at 1020. Comment states that PSLRA heightens pleading standards in federal courts. Id.

71 See Miller, supra note 10, at *8 (reiterating that cases that did not meet standards of federal court were still being filed in state courts bringing about same "coercive pressure to settle meritless claims that Congress sought to eliminate"); see also Keith Fleischman, Class Action Suits and the Effect of Private Securities Litigation Reform Act of 1995, in ACCOUNTANT'S LIABILITY, at 485, 486 (ALI-ABA Course of Study No. SB70, 1997) (stating that nationwide class actions may be brought in federal and state courts); Alan Hornich, Single Court Solutions, 11 No. 6 INSIDE LITIG. 9, 13 (1997) (noting securities class actions are on rise in state courts). See generally Scott Biler, Judicial Interpretation of Certain Procedural Aspects of the Private Securities Litigation Reform Act of 1995, in SECURITIES LITIGATION 1996, at 905-06 (PLI Corp. L. and Practice Course Handbook Series No. B4-7199, 1997) (describing how PSLRA was intended to create uniformity among circuits); Luther Zeigler et. al., Honoring State Class Action Settlements, 10 NO. 4 INSIGHTS 2, 4 (1996) (stating that Reform Act effected substantial modifications to federal securities law).


73 See Miller, supra note 10, at *5-6. "The uncertainty, cost, and potential exposure of state court litigation force companies to act as if the federal reforms were never passed and deny investors the benefits that Congress intended to provide." Id. See generally Hamilton, supra note 66, at 566. The introduction of safe harbor provisions will hurt the market by protecting fraudulent statements. Id.; Phillips, supra note 43, at 1030. The author describes how security suits hurt the market by lowering cash flow in corpora-

withholding information from the public to protect themselves\(^{74}\) from the initiation of strike suits.\(^{75}\) As a result, the market has returned to its pre-PSLRA condition.\(^{76}\) Companies refuse to disclose information, leaving the public uninformed.\(^{77}\) This lack of information hinders the potential for investment in such companies and may have a detrimental effect on the role of the stock market in general.\(^{78}\)

\(^{74}\) See Miller, supra note 10, at *2-3 (stating shift to state court legislation is undermining primary benefits of 1995 legislation); see also Dawes, supra note 15, at 55 (explaining difficulty to predict effect PSLRA will have on grand scheme of securities litigation); Monroe R. Sonnenborn et. al., An Underwriter and Financial Advisor’s View of the Effects of the Safe Harbor and Most Adequate Plaintiff Provisions Since Passage of Private Securities Litigation Reform Act, in SECURITIES LITIGATION 1997, at 487 (PLI Corp. L. and Practice Course Handbook Series No. B4-7199, 1997) (describing increase in state litigation as most significant development since enactment of PSLRA); Growth Companies Endorse Eshoo - White Bill, Securities Regulation & Law Report, June 27, 1997, available in 29 SRLR 1211, at *1 (reporting that more than 700 entrepreneurs and venture capitalists strongly support uniform standard legislation to stop threat of abusive suits filed in state courts, such that they may disclose beneficial information to investors); U.S. Newswire, supra note 28, at *2 (discussing chilling effect of frivolous state lawsuits on overall securities market).

\(^{75}\) See Miller, supra note 10, at *3 (noting that companies and investors are still under threats of abusive litigation since after enactment of PSLRA they now face possibility of being sued in 50 different states under 50 different laws); see also Litigation Reform: Congress Targets “Loophole” in 1995 Act Barring Vexatious Suits, Securities Regulation & Law Report, Aug. 29, 1997 [hereinafter Vexatious Suits], available in 29 SRLR 1211, at *7 (stating that one frivolous suit filed at state level is enough to deter companies from disclosing information).

\(^{76}\) See Litigation Reform: Business Leaders Urge Support for Bill to Federalize Securities Class Actions, Securities Regulation & Law Report, Sept. 19, 1997 [hereinafter Federalize Securities], available in 29 SRLR 1296, at *1 (reporting that leaders of business and high technology organizations, representing more than 25,000 companies are supporting Securities litigation Uniform Standards Act as means to stop plaintiff’s lawyers from filing abusive suits in state courts).

\(^{77}\) See Spencer, supra note 47, at 111. “The threat of opened-ended liability may have discouraged issuers from disseminating critical market information needed by investors to make decisions.” Id.

\(^{78}\) See SEC Commissioner Wallman Sees Need for Uniform Standards Law, Securities Regulation & Law Report, Sept. 12, 1997, available in 29 SRLR 1259, at *3-4 (noting that it is not possible to expect information Congress intended as result of Reform Act if management is still susceptible to lawsuits); see also Miller, supra note 10, at *5 (stating abusive litigation is costing companies tremendous resources, ultimately affecting integrity of securities market, and since growth companies are faced with possibility of meritless litigation, they continue withholding critical information from investors); Ismini Scoras, Shareholder Lawsuits Target of Legislation - Industry Favors Bills Limiting Securities Cases Filed in State Courts, Electronic Buyers News, Oct. 13, 1997, available in 1997 WL 11329877, at *2 (quoting Michael Engelhardt, Vice President of public policy at Technology Network, as saying that threat of lawsuits is detrimental to capital market and making it difficult for targeted companies, to raise more money); U.S. Newswire, supra note 28, at *3 (stating that growth in high technology industry is being hindered by expensive lawsuits).
II. PROPOSED REMEDIAL LEGISLATION

A. The Improvement Act

In response to the increase of strike suits in state courts, proposals have been set forth in Congress to fill the existing loopholes. The Securities Litigation Improvement Act of 1997 ("Improvement Act") is an expansive bill consisting of remedial legislation which amends the 1933 and 1934 Acts. It creates uniform pleading standards for individual stockholders alleging fraud with respect to federally regulated securities. This legislation fills the gaps in the present federal statute so claimants will no longer be able to access the nearest state court to file a frivolous claim.

B. The Uniform Standards Act

Shortly after the proposal of the Improvement Act, a similar, more narrowly tailored bill, was introduced to Congress entitled, the Securities Litigation Uniform Standards Act of 1997 ("Uniform Standards Act"). Its purpose is to preempt securities class action suits based upon fraud. The underlying purpose of both proposals is the same, except that the Uniform Standards Act is narrower in scope than the Improvement Act.

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81 See id. This bill amends remedies in securities actions, but for our purposes we are only discussing the bill in reference to its limitations on state actions. Id. The bill states that:

[No private civil action alleging (a) a misrepresentation or omission in connection with the purchase or sale of any covered security, or (b) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of any covered security, may be initiated or maintained in any state court or any State law (including a pendent state claim to an action under federal law).]

Id.

because it specifically regulates class action suits.\textsuperscript{83}

### III. Analysis of the Need for Reform Legislation

The pending legislation before Congress is needed in order to fully effectuate the PSLRA.\textsuperscript{84} The Uniform Standards Act, in particular appears to satisfy the need to ensure consistent application of the PSLRA.\textsuperscript{85} Opponents of reform, however, fear that it is too soon to enact new legislation.\textsuperscript{86} They argue that federalism will be sacrificed if reforms are implemented and fear that those with valid fraud claims will have no recourse if plaintiffs are deprived of state court relief.\textsuperscript{87}

#### A. The Need for Reform: Proposed Preemptive Legislation

One of the most fundamental aspects of the PSLRA is the abolition of frivolous lawsuits. However, since attorneys have the opportunity to file in state courts each company is potentially


A class action is any single lawsuit or any group of lawsuits filed in or pending in the same court involving common questions or law or fact, in which - a) damages are sought on behalf of more than 25 persons; b) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other named parties similarly situated; or c) one or more of the parties seeking to recover damages did not personally authorize the filing of the lawsuit. \textit{Id.; see also White, Eshoo, supra note 83, at *1. The Uniform Act is narrower than the Improvement Act because it requires only class actions brought on behalf of more than 25 persons to be brought in federal court. Id.}

\textsuperscript{85} See Vexatious Suits, supra note 76, at *1 (outlining Congressional efforts to curb meritless securities litigation); see also Congress Tries Again to Stop Frivolous Stock Fraud Cases, \textit{TREASURY MANAGER'S REP.}, Vol. 5, Issue: 12, June 6, 1997, available in 1997 WL 8644770, at *1 (noting Congress' attempt to close loophole in PSLRA).

\textsuperscript{86} See generally Congressional Testimony Before the Subcomm. on Finance and Hazardous Materials Comm. on Commerce, 105th Cong. (1997) (written testimony of Bruce G. Vanyo), available in 1997 WL 14152315, at *6-7. The post-Reform Act litigation is shifting from federal courts to state courts. \textit{Id.} This shift threatens to undermine the PSLRA through nullification of the PSLRA's procedural and substantive protections, as well as subversion of its heightened pleading standards and discovery stays by filing parallel class action suits in federal and state courts. \textit{Id.}

\textsuperscript{87} See Securities Litigation: Hearings on Securities Litigation Reform Act of 1995 Before the Subcomm. on Finance and Hazardous Materials House Comm. on Commerce, 105th Cong. (1997) (testimony of Leonard B. Simon), available in 1997 WL 659251, at *4-5 (explaining that it is too early to assess effects of Reform Act without any substantial litigation on matter); Perino, supra note 13, at *3 (stating that it is too early in life history of Act to draw any reliable conclusions).

subject to fifty-one different laws. In essence, attorneys have undone the notion of uniformity that the PSLRA attempted to provide.

Given the current state of securities litigation, further reform is required to prevent attorneys from filing abusive claims in state courts for the sole purpose of avoiding the requirements that Congress took great pains to enact in 1995. As an answer to the problem, the Improvement Act and the Uniform Standards Act preempt these state court claims. It is submitted that such legislation may close the loophole formed in the PSLRA.

Mandatory preemption of state securities claims is the only way to resolve the uniformity problem and to fully effectuate the PSLRA. If one state refuses to enact the standards established at the federal level, forum shopping will exist to a greater extent than it already does.

Without uniform standards, plaintiffs can choose vertically between federal and state courts, and horizontally from one state court to another. As a result, plaintiffs have been choosing the

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89 See Sonnenborn, supra note 75, at 493 (noting increase in number of securities class actions filed in state court; many of state cases are filed parallel to federal court cases in apparent attempt to avoid some procedures imposed by Reform Act, particularly the stay of discovery pending a motion to dismiss). See generally Sternman, supra note 67, at 333 (noting results of Stanford study by Joseph Grundfest and Michael A. Perino).

90 See Perino, supra note 13, at *4-7 (noting that attorneys are still seeking relief in states courts rather than federal courts).


92 See H.R. 1689, 105th Cong. § 16(c) (1997). Any class action brought in any state court involving a covered security as set forth in subsection (b) shall be removable to the federal district court for the district in which the action is pending and shall be subject to subsection (b). Id. Subsection (b) provides that, [n]o class action based upon the statutory or common law of any state of subdivision thereof may be maintained in any state or federal court by any private party alleging (1) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or (2) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

Id.

93 See, e.g., Sternman, supra note 67, at 333 (noting loophole with possibilities of closing).

94 See Vexatious Suits, supra note 76, at *1 (noting that target of new legislation is perceived 'loophole' in PSLRA which allegedly still allows plaintiffs to bring frivolous lawsuits in state courts).

forum with the most beneficial rules and regulations pertaining to their specific cause of action.95 A mandatory transfer from state court to federal court will unify the law pertaining to securities litigation and therefore, remove the possibility of forum shopping.96

Another argument supporting reform of the private securities litigation field is the role that this area plays upon the integrity of American capital markets.97 Studies have shown that poor legal enforcement fails to protect investors and may negatively affect the health of the capital markets.98 Currently corporations are faced with a double-edged sword when they decide not to disclose information for fear of being subject to liability because they are then faced with a shrinking market for capital resources.99 To a company this translates to a loss of potential investors who feel they do not have enough information about the company to enable them to invest in it.100

In contrast, if corporations choose to disclose any information, they expose themselves to litigation that significantly affects their capital assets.101 The double-edged sword faced by every...
corporation in deciding whether or not to disclose information seems to repel potential investors regardless of the choice made. Losing investors may slow the growth of these companies because it takes away a valuable source of capital. In addition to the loss of possible new investors, a company may also lose its own money by defending these meritless claims either through litigation or by settling outside of court. The cost of defending these suits are twofold, in that companies are expending money for their defense while losing a source of capital. Instead of wasting money on these suits, the money could have been reinvested, paid in dividends, or utilized in other ways to benefit the company. Each of these situations has a detrimental effect on the overall securities market which could be easily rectified by uniformity among the courts.

**B. Arguments Against Reform**

The first argument against reform is that the PSLRA has not had an opportunity to work itself out. The PSLRA has only been subjected to limited judicial review. Taking this into account, opponents of remedial legislation feel it is too soon to enact changes.

103 See id.

104 See Matteson, supra note 48, at 548 (highlighting fact that strike suits cost U.S. companies more than 2.5 billion dollars in settlements in last 4 years).

105 See Seligman, supra note 44, at 721 (noting frequency of out of court settlements related to securities litigation).

106 See Hamilton, supra note 66, at 616 (discussing corporations wasting money on strike suits instead of using money to benefit company).

107 See Levitt, supra note 91, at *3-4 (stating that Reform Act is still in its infancy and therefore has not had enough practical experience to produce data necessary to measure its success or failure).

108 See Latham, supra note 32, at 1477 n.4 (stating few published opinions can be found addressing disputes arising under PSLRA); see also Rice, supra note 63, at 283 (PSLRA has not yet been fully tested in courts); SEC Adopts Staff Conclusion, No Legislative Changes Now Needed, Securities Regulation & Law Report, April 18, 1997, available in 29 SRLR 523, at *1 (stating that proposed 1997 legislation is “preemptive” since full effects of PSLRA are still unknown). But see Perino, supra note 13, at *1-2 (concluding that regardless of uncertainties surrounding PSLRA, time is ripe for Congress to act).

109 See Simon, supra note 87, at *4. The SEC is not alone in its opinion that legislative response to the PSLRA is premature. Id. Professor Joseph A. Grundfest argues that because the PSLRA is still in its infancy and has not been tested within the courts, it is too early to gauge its success or failure and therefore would be premature to initiate additional legislation. Id. Moreover, the American Assoc. of Retired Persons, Consumer Federation of America, Consumers Union, Public Citizens Congress Watch, U.S. Public Interest Research Group, and Citizen Action further insist that Congress should wait until it has conclusive evidence of how litigation reform has affected the ability of de-
Opponents are equally concerned about the potential abuse of federalism. 109 "States have historically been given the power to protect state and local government funds and their taxpayers, regardless of the obstacles present in federal law. Preemption of this state authority would be contrary to the principles of federalism which reserves to the states those powers." 110

Moreover, opponents argue that the passage of new legislation advocating the automatic transfer from state courts to federal courts will leave valid claims without a proper forum. 111 Since 1995, the requirements to get into federal court have been raised to a higher standard. 112 There are, however, some situations where valid claims do not meet the heightened standard and therefore, rely on state courts to settle their claims. 113 Eliminating the possibility of state court hearings will leave some legitimate claimants without the possibility of legal redress. 114 A fundamental component of the United States legal system is that each person has a right to their day in court. 115 To take that right away from a certain group of people undermines our judicial system. 116

In response to this fear, it is important to note that our judicial

frauded investors to recover their losses. Id.

110 See Simon, supra note 87, at *7-8 (noting that preemption of state authority would be contrary to principles of federalism); see also Vexatious Suits, supra note 76, at *3-4 (noting that opponents of reform as SEC, National Association of Securities and Commercial Law Attorneys, an array of consumer groups and state and local government organizations raising federalism arguments).

111 See Simon, supra note 87, at *7-8 (noting federalism issues). But see Perino, supra note 13, at *32-33 (arguing that neither bill is intended to limit scope of state's authority to bring lawsuits alleging violations of state law).

112 See Simon, supra note 87, at *40-41 (arguing that legitimate claimants will be without legal remedy should recoveries become impossible in federal court under proposed legislation); see also Dawes, supra note 15, at 37 (mentioning effects on plaintiff's ability to bring suit).

113 See Panelists Dispute Reform Law's Impact on Private Class Securities Fraud Litigation, Securities Regulation & Law Report, Aug. 15, 1997, available in 29 SRLR 1134, at *2 (noting generally heightened pleading standards required by the PSLRA); see also Lerach, supra note 60, at 931 (discussing heightened pleading standard of PSLRA).

114 See Simon, supra note 87, at *4 (suggesting that judicial interpretations of PSLRA might make it all but impossible to bring even meritorious fraud claims successfully in federal court).

115 See id.

116 See St. Joseph's Stock Yards Co. v. United States, 298 U.S. 38, 84 (1935) (Brandeis, J., concurring) (stating that supremacy of law demands opportunity to have court decide whether erroneous rule of law was applied).

system is also based on the premise that a trial is a search for the truth. Standards and requirements for different proceedings are established in order to find the truth in a manner which is fair to both parties. The standards were raised in federal courts in 1995 because legislators felt that a higher standard was needed to uphold justice for plaintiffs and defendants alike. There is nothing unfair in bringing all cases up to the standard which was considered appropriate in 1995.

CONCLUSION

Securities regulations have been altered and reformed throughout time as deemed necessary. Once again it has become clear that reform is necessary for the securities market to function effectively. A primary focus of the proposed legislation discussed herein is to establish a uniform standard for securities litigation. In doing so, several necessary reforms will be accomplished. A uniform standard will not only set precedent, but put investors on notice of the requirements necessary to successfully plead a valid fraud claim. Furthermore, companies will have definite standards on which they can base their forward looking statements. Such standards will remove the fears currently instilled in companies as a result of the meritless lawsuits previously permitted. The final benefit of creating a uniform standard is the prevention of forum shopping. Examination of all the benefits of a uniform standard clearly demonstrate the need for such reform.

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119 See Sheppard v. Maxwell, 384 U.S. 333, 363 (1966) (trial courts must take necessary steps to provide fair trial).

120 The standards uphold justice for defendants because only true cases of fraud should get in, while potential plaintiffs are protected by the required disclosure.

121 Id.
