

**“THE PRIVATE SECURITIES LITIGATION  
REFORM ACT OF 1995—27 MONTHS LATER”:  
SECURITIES CLASS ACTION LITIGATION  
UNDER THE PRIVATE SECURITIES LITIGATION  
REFORM ACT’S BRAVE NEW WORLD**

**WILLIAM S. LERACH\***

**TABLE OF CONTENTS**

I. THE REFORM ACT AND ITS INITIAL IMPACT .....	598
II. THE REFORM ACT’S SUBSTANTIVE PROVISIONS DO NOT APPLY TO FALSE STATEMENTS MADE PRIOR TO ITS EFFECTIVE DATE.....	616
III. THE REFORM ACT DID NOT ALTER THE RECKLESSNESS LIABILITY STANDARD FOR NON-FORWARD-LOOKING STATEMENTS.....	620
A. <i>The Text and Structure of the Reform Act Show That Congress Did Not Eliminate Motive, Opportunity and Recklessness as Means of Establishing Scienter</i> .....	623
B. <i>The Legislative History Shows that Congress Intended for Courts to Seek Guidance from Second Circuit Precedents and Infer Scienter from Motive, Opportunity or Recklessness</i> .....	625
IV. THE REFORM ACT’S PLEADING STANDARD IS SATISFIED BY ALLEGATIONS OF MOTIVE AND OPPORTUNITY TO COMMIT FRAUD OR FACTS SHOWING CONSCIOUS MISBEHAVIOR OR RECKLESS DISREGARD .....	628
V. THE STATUTORY SAFE HARBOR AND THE BESPEAKS CAUTION DOCTRINE WILL SELDOM SHIELD DEFENDANTS’ FALSE FORWARD-LOOKING STATEMENTS AS A MATTER OF LAW .....	633
VI. NONSPEAKER DEFENDANTS MAY BE LIABLE AS CONTROL PERSONS UNDER THE “GROUP-PUBLISHED INFORMATION” OR “DISCLOSE-OR-ABSTAIN” DOCTRINES OR FOR PARTICIPATING IN A SCHEME TO DEFRAUD .....	634
A. <i>Group-Published Information</i> .....	634
B. <i>Disclose-or-Abstain Doctrine</i> .....	635
C. <i>Fraudulent Scheme</i> .....	638
VII. DEFENDANTS MAY BE LIABLE FOR STATEMENTS THEY MADE TO ANALYSTS AND FOR STATEMENTS CONTAINED IN ANALYSTS’ REPORTS .....	641
VIII. CONCLUSION .....	644

---

\* Partner, Milberg Weiss Bershad Hynes & Lerach LLP, 600 West Broadway, Suite 1800, San Diego, CA 92101. Telephone: (619) 231-1058.

## I. THE REFORM ACT AND ITS INITIAL IMPACT

In late December 1995, over the veto of President Clinton, Congress passed the most sweeping revision of the federal securities laws since 1933-34, the Private Securities Litigation Reform Act of 1995 ("PSLRA" or "Reform Act").<sup>1</sup> The view that the securities litigation system did not work and needed repair provided the impetus for this legislation. The system's supposed failings were that cases were filed too often, based merely upon the fact that a stock price had dropped ten percent or more. In addition, it was asserted that almost all cases settled, on terms which did not relate to the merits of the claims asserted but rather were formulaic.<sup>2</sup>

The resulting changes were a bonanza for public companies and their insiders, investment bankers and financial accounting firms, *i.e.*, the normal defendants in securities cases. Higher pleading standards, automatic discovery stays, a "safe harbor" that arguably permits corporate executives to lie about future results even while insiders are trading, damage limitations, elimination of joint-and-several liability for reckless conduct, and—for good measure—a mandatory sanction review procedure that upon termination of *every* case threatens plaintiffs' counsel with up to one hundred percent liability for defendants' fees. Basically, the Reform Act amounted to a defense lawyer's "wish list" of new tools and tactics to delay and defeat securities fraud claims and harass and intimidate plaintiffs' counsel.

Legislation this radical is not the result of spontaneous combustion. It requires an orchestrated effort, often including some purportedly objective academic work identifying a problem that requires a legislative solution. In the case of PSLRA, proponents of curtailing investors' remedies relied heavily upon Professor Janet Cooper Alexander's article, *Do The Merits Matter? A Study of Settlements in Securities Class Actions*, published in the *Stanford Law Review* ("Alexander Study").<sup>3</sup> Alexander did a study of a group of securities cases involving initial public offerings ("IPOs") in computer-related businesses. Based on her study, Alexander claimed that:

- (i) Suits were filed "against every company in the industry whose

---

1. Pub. L. No. 104-67, 109 Stat. 737.

2. See 140 CONG. REC. S3695, S3706 (daily ed. Mar. 24, 1994) (statements of Sen. Dodd & Sen. Domenici).

3. Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991); see also S. REP. NO. 104-98, at 98 (1995); 141 CONG. REC. S1075 (daily ed. Jan. 18, 1995) (statement of Sen. Domenici); 139 CONG. REC. S16,662-63 (daily ed. Nov. 20, 1993) (statement of Sen. Domenici); 141 CONG. REC. S8895-98 (daily ed. June 22, 1995) (statement of Sen. D'Amato); H.R. REP. NO. 104-50, at 1 (1995).

stock declined significantly in the months following its initial stock offering”,<sup>4</sup>

(ii) Virtually every suit settled;<sup>5</sup> and

(iii) Most cases settled for almost precisely 25% of the damage exposure, and where they did not, the deviations could be “accounted for by non-merits-related factors.”<sup>6</sup>

Thus, to Alexander, the merits did not matter—the current system was defective, if not corrupt, and required fixing. It was, to say the least, a searing indictment of a major area of litigation.

In fact, Alexander testified in favor of Reform Act legislation before the House Subcommittee on Telecommunications and Finance. There, she claimed:

The problem is not, as it is often phrased, that there is an excessive amount of securities litigation, that there is an epidemic of frivolous litigation, or that the economy is being crippled by extortionate settlements. *The problem is more fundamental and more difficult to solve: as an institution, securities class action litigation is not doing a good job of telling good suits from bad ones, of resolving suits based on the strength of the evidence that a violation was committed, of eliminating weak and nonmeritorious suits at an early stage, or of delivering compensation to the investors in whose name the cases are brought.* As a result, some suits are filed that should not be, and some suits probably are not filed that should be; plaintiffs in some weak cases are overcompensated, and those in some strong cases are undercompensated. . . .

The primary public policy goal of private enforcement is deterrence. But if settlements do not sufficiently reflect the merits, the goal of deterrence cannot be achieved. Firms and managers cease to regard damage judgments as the consequence of illegal behavior and a powerful incentive to comply with the law. Instead, they come to view being sued as a business risk beyond their control, like a downturn in the economy or a shift in consumer preferences.

Some high technology companies, for example, have begun to treat securities class action litigation as a cost of business which cannot be avoided even by scrupulous due diligence and compliance programs, and are building it into their budgets and the price of their products.

---

4. Alexander, *supra* note 3, at 500.

5. *See id.*

6. *Id.*

The reasons why settlements in securities class actions are not sufficiently responsive to the merits are discussed in an article [*Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497 (1991)] that is attached to my testimony . . . .

....

Securities class action litigation is costly. In 1992 and 1993 alone, 145 such cases were settled for total payments of \$3 billion. Approximately 30% of this amount, or close to \$1 billion, went to plaintiffs' attorneys. The fees paid to defendants' lawyers probably totaled another \$1 billion or more. There is a serious question whether the benefits, in the form of deterrence and compensation, of securities class action litigation as it is practiced today justify these costs.<sup>7</sup>

Prior to Congress' sweeping revision of the federal securities laws via the Reform Act, Alexander's article had met with mixed reactions. A few courts cited it, assuming that its data were reliable and its conclusions valid.<sup>8</sup> Several law review articles relied upon Alexander's article as proof of the existence of meritless claims in the securities litigation area.<sup>9</sup> As discussion of the need for securities litigation reform continued, Arthur Levitt, the Chairman of the Securities and Exchange Commission ("SEC"), referred to the substance of Alexander's conclusions as an indication of flaws in the way securities cases were litigated, supporting the need for legislative action.<sup>10</sup> However, other commentators suggested in scholarly articles,<sup>11</sup> specialized

---

7. *Securities Litigation Reform, Hearings Before the Subcomm. on Telecommunication and Finance of the House Comm. on Energy and Commerce*, 103d Cong. (1994) (testimony of Janet Cooper Alexander, Professor of Law, Stanford Law School) (emphasis added).

8. See, e.g., *Kamen v. Kemper Fin. Servs., Inc.*, 939 F.2d 458, 462 (7th Cir. 1991); *Weinberger v. Great N. Nekoosa Corp.*, 925 F.2d 518, 524 (1st Cir. 1991); *In re Urcarco Sec. Litig.*, 148 F.R.D. 561, 566 (N.D. Tex. 1993); *In re VeriFone Sec. Litig.*, 784 F. Supp. 1471, 1485 n.22 (N.D. Cal. 1992), *aff'd*, 11 F.3d 865 (9th Cir. 1993); *Mirkin v. Wasserman*, 5 Cal. 4th 1082, 1107 (1993).

9. See, e.g., Margaret A. Berger, *Civil Litigation in the Twenty-First Century: A Panel Discussion*, 59 BROOK. L. REV. 1199, 1215-16 & n.20 (1993); Jill E. Fisch, *As Time Goes By: New Questions About the Statute of Limitations for Rule 10b-5*, 61 FORDHAM L. REV. S101, S125 & n.167 (1993); Anthony Q. Fletcher, *Curing Crib Death: Emerging Growth Companies, Nuisance Suits, and Congressional Proposals For Securities Litigation Reform*, 32 HARV. J. ON LEGIS. 493, 503 & nn.53-57 (1995); Bryant Garth, *From Civil Litigation to Private Justice: Legal Practice at War with the Profession and its Values*, 59 BROOK. L. REV. 931, 943 & n.50 (1993); Adam F. Ingber, *10b-5 or not 10b-5?: Are the Current Efforts to Reform Securities Litigation Misguided?*, 61 FORDHAM L. REV. S351, S360-61 & n.64 (1993); Stephen E. Morrissey, *State Settlement Class Actions that Release Exclusive Federal Claims: Developing a Framework for Multijurisdictional Management of Shareholder Litigation*, 95 COLUM. L. REV. 1765, 1765-66 & n.3 (1995).

10. See Chairman Arthur Levitt, U.S. Securities and Exchange Commission, Address at Securities Regulation Institute, University of California, San Diego (Jan. 26, 1994). According to Levitt, "some allege that settlements often fail to reflect the underlying merits of the cases. If true, this means that weak claims are overcompensated and strong claims are undercompensated." *Id.*

11. See Ingber, *supra* note 9, at S361-62; Steven P. Marino & Renée D. Marino, *An Empirical Study*

publications,<sup>12</sup> and congressional testimony<sup>13</sup> that Alexander was wrong. Nevertheless, Congress accepted Alexander's work and enacted the Reform Act.

Recently, a careful review of Alexander's statistical analysis by Leonard B. Simon and William S. Dato has been published ("Simon/Dato Study").<sup>14</sup> The results are startling. Not only is Alexander's study fundamentally flawed, but her conclusions are inconsistent with both a replication of her study done with her most obvious flaws corrected, and a broader, more reliable study.<sup>15</sup> Alexander adjusted her data, which had the effect of creating the conclusion she wanted.<sup>16</sup>

According to the Simon/Dato Study, there is little doubt now that Congress legislated on the basis of erroneous data in 1995.<sup>17</sup> Although it remains to be seen what Congress has wrought, the Reform Act cannot solve the "problem" identified by Alexander, because the problem she described does not exist. Whatever one's view on securities litigation and the Reform Act, the history of Alexander's study should be carefully scrutinized as it provides a cautionary tale about the use of seemingly objective academic studies, even from a prestigious institution, as a basis for legislation.<sup>18</sup>

Every experienced practitioner in the field of securities law that I know found Alexander's conclusions surprising and contrary to their intuition and experience. All experienced practitioners know that strong cases generally settle for more than weak cases, other things being equal. Those who actually

*of Recent Securities Class Action Settlements Involving Accountants, Attorneys, or Underwriters*, 22 SEC. REG. L.J. 115, 142 (1994); Lester B. Snyder & Jerry G. Gonick, *The Interrelationship of Securities Class Action Litigation and Pension Plan Tax Policy: What's Really at Stake?*, 21 SEC. REG. L.J. 123, 126 n.4 (1993).

12. See *In Camera*, 14 CLASS ACTION REP. 1, 70 (1991).

13. See *Securities Litigation Reform, Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 103d Cong. (1994) (testimony of Professor John C. Coffee, Jr., Columbia University Law School). Labeling as a "myth" Professor Alexander's conclusion that "[t]he merits don't matter," Professor Coffee offers his personal judgment "that the merits do matter—but not enough." *Id.* at 1, 5.

14. See Leonard B. Simon & William S. Dato, *Legislating on a False Foundation: The Erroneous Academic Underpinnings of the Private Securities Litigation Reform Act of 1995*, 33 SAN DIEGO L. REV. 959 (1996). Simon and Dato are partners of mine. The Simon/Dato Study relied heavily upon data provided by Princeton Venture Research, which has appeared as an expert for our firm in several securities class actions. See *id.* at 959 n.\*.

15. See *id.* at 962-64.

16. See *id.* at 978-984.

17. See generally *id.*

18. Compounding the problems caused by Alexander's *Stanford Law Review* article, she has published two additional articles which utilize the same data and has relied on her prior conclusions in addressing other related topics. See Janet C. Alexander, *The Value of Bad News in Securities Class Actions*, 41 UCLA L. REV. 1421, 1422-23, 1439 (1994); Janet C. Alexander, *The Lawsuit Avoidance Theory of Why Initial Public Offerings are Underpriced*, 41 UCLA L. REV. 17, 50, 53, 57 (1993).

litigate and settle securities class actions know that the strength of a case is often the first matter discussed in settlement talks and, along with defendants' ability to pay, typically drives the discussion and the result. If Alexander was right, the real life experiences of virtually every practitioner were delusional.

For instance, settlements in *In re American Continental/Lincoln Savings & Loan Securities Litigation* yielded approximately \$250 million, over eighty percent of total damages of \$288 million.<sup>19</sup> One of approximately one hundred defendants in that case, Ernst & Young alone paid \$63 million to settle the case. Did the merits matter in *Lincoln Savings*? Of course. What about those other securities cases where \$50 million or greater settlements were achieved, that is, *L.A. Gear*, *Miniscribe*, *Salomon Brothers*, *U.S. Financial*, *Equity Funding*, *IDB Communications*, *National Health Labs*? Were they all "formulaic" settlements without regard for the merits? Of course not. How did Alexander reach a conclusion so at odds with real life experience?

Simon and Dato undertook a scientific review of Alexander's work. They found that:

1. "The sample utilized in Professor Alexander's study [was] far too small and too homogenous to prove anything conclusive."<sup>20</sup>
2. Alexander "did not apply consistent principles to the samples contained in the study, but rather made *ad hoc* adjustments to conform the data to her thesis"; that is, she "fixes" her result.<sup>21</sup>
3. "Alexander made several errors in data gathering and calculation which call into question her scholarship and undermine her conclusions."<sup>22</sup>

Simon and Dato also repeated Alexander's study as she defined it (still too small and homogeneous) but without her data errors and omissions. The resulting eleven settlements range from a high of nearly seventy percent of gross market loss to a low of two percent, with only five of the settlements falling within Alexander's twenty to thirty percent range.<sup>23</sup> Further, if the damage "stakes" are adjusted to account for the general movement of the market—which always occurs in the real world settlement context—the eleven settlements range from a high of nearly eighty percent to a low of less

---

19. MDL Docket No. 834 (D. Ariz.).

20. Simon & Dato, *supra* note 14, at 964.

21. *Id.*

22. *Id.*

23. *See id.* at 990.

than three percent, with only three of the settlements falling within Alexander's twenty to thirty percent range.<sup>24</sup> Thus, the corrected Alexander Study tells a very different story than the one Alexander presented—a story of “formulaic” twenty-five percent settlements.

Not satisfied to simply critique and reanalyze Alexander's work, to show its gross errors, Simon and Dato performed their own study in a broader but still limited subset of the universe from which Alexander sought to draw conclusions: *all securities class action lawsuits*. The purpose of the Simon/Dato Study was to see if the results of the Alexander Study could be replicated in a larger sample. If Alexander's conclusions were valid, they should apply not only to her sample—venture capital-backed computer companies which went public in early 1983—but also to other industries and other time periods. *The Simon/Dato Study shows Alexander's results cannot be replicated.*

No case more graphically demonstrates the deficiency of Alexander's study than *Knapp v. Gomez*.<sup>25</sup> That venture capital-backed IPO was within Alexander's universe. She knew of the company and IPO and dismissed it as a situation where no litigation was filed because the stakes were too small to attract plaintiffs' attorneys. Yet, *before* Alexander's study was published, the company (ATV) had been sued for securities fraud in a class action suit. The suit resulted not in a twenty-five percent formulaic settlement, but a one hundred percent recovery after trial and appeal to the United States Supreme Court—a ten-year ordeal! In fact, this case was completely inconsistent with all the core findings of Alexander's study. No doubt this case was yet another example of avaricious plaintiffs' lawyers who sue fast, settle quickly for twenty-five percent, and then move on to their next prey. Omission of a case so key—even if it was due to oversight—completely discredits the Alexander study.

Because Alexander's study contains methodological flaws and her findings cannot be replicated in a broader, more representative sample, it seems clear that Alexander's conclusions were incorrect. Others can judge for themselves if this was due to sloppy scholarship or deliberate manipulation of data to reach a preconceived result. But the Simon/Dato Study suggests that the merits *do* matter in settling securities cases, and more incontrovertibly, that Alexander's contrary hypothesis is not supported by her—or objective—data.

Well, tough luck. It is not the first time Congress has been deceived by

---

24. *See id.*

25. No. CV 87-0067 H(M), 1993 WL 305940 (S.D. Cal. May 5, 1993).

biased academic data. For now, we are stuck with the Reform Act. Some believe that a coming stockmarket collapse coupled with an already observable upsurge of securities fraud may later produce a legislative "rollback" of the Reform Act, but no one knows when or if that will ever happen. So, what is its impact so far?

In late February 1997, two colleagues of Professor Alexander, Professors Grundfest and Perino of Stanford Law and Business Schools, published a report in conjunction with Cornerstone Research entitled *Securities Litigation Reform: The First Year's Experience* ("Grundfest/Perino Study").<sup>26</sup> Cornerstone Research is a California-based consulting firm that works for corporate defendants in securities cases. The data gathered for the Grundfest/Perino Study came mostly from a website, known as the Securities Class Action Clearinghouse maintained by Stanford. The Securities Class Action Clearinghouse was established with funding from, among others, George Roberts of Kohlberg, Kravis & Roberts (a leveraged-buyout firm that has repeatedly been sued for securities and corporate law violations). It is supported by the National Center for Automated Information Research, Sun Microsystems, and Apple Computer Corporation, two high-tech companies that had paid millions to settle the securities fraud claims against them and were strong advocates of the Reform Act.

The Grundfest/Perino Study reaches several conclusions:

- **Overall litigation rates are little changed.**

Our best estimate is that class action securities fraud litigation in federal and state court is being filed at an annual rate of 148 to 163 defendant issuers per year. Prior to the Reform Act, litigation was being filed at a rate of approximately 176 defendant issuers per year. The total volume of litigation activity in 1996 is thus down by about 7% to 16%, but is not very different from the level of activity observed in 1991, 1993, and 1995. In addition, increasing stock market prices in 1996 may have depressed litigation activity. It is therefore too soon to draw any firm conclusions as to whether litigation reform has had any material effect on the aggregate securities class action litigation rate.

- **About 26% of litigation activity has moved from federal court to state court.**

The relative stability of the aggregate litigation rate masks a significant shift of activity from federal to state court. Approximately

---

26. Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year's Experience*, in PRACTICING LAW INSTITUTE, SECURITIES REGULATION 1997, at 955, 958 (1997).

26% of class action claims are state court proceedings without parallel federal claims filed in 1996. This increase in state court litigation is likely the result of a "substitution effect" whereby plaintiffs' counsel file state court complaints when the underlying facts appear not to be sufficient to satisfy new, more stringent federal pleading requirements, or otherwise seek to avoid the substantive or procedural provisions of the Act. Plaintiffs may also be resorting to increased parallel state and federal litigation in an effort to avoid federal discovery stays or to establish alternative state court venues for the settlement of federal claims.

- **Allegations of accounting irregularities or trading by insiders now explain the lion's share of federal class action litigation.**

Approximately 67% of post-Reform Act Section 10(b) complaints involving publicly-traded companies allege accounting fraud as a basis for liability. In sharp contrast, similar allegations are found in only 34% of pre-Reform Act cases. Allegations of trading by insiders now appear in about 57% of post-Reform Act cases, whereas these allegations are found in only 21% of pre-Reform Act cases. Alleged trading by insiders is particularly important in cases against high technology companies, appearing in 73% of those cases, but that statistic must be interpreted with caution because of the prevalence of option-based compensation in the high technology sector.

- **Pure "false forecast" cases explain a relatively small percentage of pending Reform Act claims.**

Complaints alleging false forward-looking statements as the sole basis for liability account for only about 14% of all post-Reform Act complaints analyzed, and only about 6.5% of post-Reform Act federal complaints involving publicly-traded companies.

- **Litigation typically follows larger price declines than observed prior to the Reform Act.**

Prior to the Reform Act, the average stock price decline preceding the filing of a claim was about 19%. During 1996, the average decline jumped to 31%. This increase is consistent with the observation that heightened pleading requirements induce plaintiffs' counsel to pursue cases that are correlated with larger price declines, and therefore seem to be more apparent instances of fraud.

- **Federal claims are now rarely filed against the largest issuers.**

The average company sued in a federal securities fraud class action in 1996 had a market capitalization of \$529.3 million. Prior to the Reform Act, the average market capitalization was \$2080 million. This decline appears to be attributable almost exclusively to a

reduction in litigation naming issuers with market capitalization in excess of \$5.0 billion. Prior to the Reform Act, these large corporations represented about 8.4% of federal court activity, but very few of these companies appear to have been sued in 1996.

- **High technology issuers continue to be the most frequent targets of class action litigation.**

High technology companies represent 34% of all issuers sued in federal court since the effective date of the Reform Act. That statistic is not materially different from the pre-Reform Act experience.

- **The dominant plaintiffs' class action law firm, Milberg Weiss Bershad Hynes & Lerach, appears to have increased its significance nationally and in California in particular.**

Milberg Weiss' appearance ratio nationwide stood at approximately 31% prior to the Reform Act. Aggregating parallel federal and state activity, Milberg Weiss' appearance ratio today stands at about 59% nationwide and 83% in California. Milberg Weiss' increased significance can be explained by the fact that it is likely the best capitalized plaintiffs' firm and therefore best able to finance the delays associated with slower procedures under the Reform Act. It also has the most diversified portfolio of plaintiffs' claims and is therefore better able to absorb the risk associated with litigation under the new regime. In addition, it is best situated to internalize the externalities associated with the need to invest to create new precedent interpreting the Reform Act's novel provisions.

- **In the courthouse, judges appear to be resolving legal questions regarding the interpretation of the "strong inference" requirement in favor of plaintiffs.**

The most frequently litigated issue to date—the interpretation of the "strong inference" pleading requirement—has with but a single exception been uniformly interpreted to apply the Second Circuit standard, not some higher pleading requirement. This is the position espoused by plaintiffs. Moreover, no complaint subject to the "strong inference" pleading standard has been dismissed without permitting plaintiffs the opportunity to replead a material portion of the claims asserted in the original complaint.

- **The growth of parallel state and federal litigation, with concomitant disputes over discovery stays and other matters, suggests that attention to federal preemption issues is warranted.**

In addition to the growth in "pure" state class action fraud claims, at least 28% of federal class action securities fraud cases also have pending parallel state securities fraud class action claims. Parallel state

court securities fraud class actions were quite rare prior to the Reform Act. This parallel litigation appears to be brought to avoid the Reform Act stay on discovery, and perhaps for other strategic and settlement-related reasons as well. This boom in state class action securities fraud litigation raises issues regarding the optimal coordination of federal and state litigation regimes and suggests that a systematic review of the issue by Congress is in order.<sup>27</sup>

The Grundfest/Perino Study's conclusion that securities fraud litigation after the Reform Act continued at approximately the same levels as in previous years should be viewed with caution. If the inference to be drawn from this is that the Reform Act is benign to victims of securities fraud, that is likely an erroneous conclusion. The absolute number of securities fraud class actions filed is meaningful only as compared to the amount of fraud that is occurring in the marketplace. In other words, if the amount of fraud doubled, but litigation rates to remedy fraud remained constant, one might well conclude that the Reform Act had drastically curtailed the access to civil justice by victims of securities fraud. Of course, measuring the amount of fraud that is going on in the market place at any one time is a very difficult task. However, many believe that the amount of fraud going on in the securities markets today is higher than it has ever been, as opportunistic companies and dishonest underwriters take advantage of the frothiest market in history to foist overvalued issues on the public. Corporate executives, emboldened by what they think is legal immunity for false forecasts of future corporate performance, have been emboldened to overstate corporate prospects, even while engaging in insider trading. And even, as *Business Week* and *The New York Times* have recently reported, the mafia has moved to Wall Street to exploit IPOs and stock manipulation opportunities.<sup>28</sup> Thus, one should be very cautious about what, if any, conclusions to draw about investor protection from looking at absolute litigation rates in the post-Reform Act era.

There are additional reasons to be cautious in drawing conclusions about the impact of the Reform Act. It is one thing to file a securities fraud class action complaint. It is quite another to accomplish a significant financial recovery for victims of fraud. Thus far, only a handful of Reform Act cases have survived the motion to dismiss stage, and the financial recoveries to

---

27. *Id.*

28. See, e.g., Benjamin Weiser, *More Copies of U.S. Strategy are Missing in Mob Stock Case*, N.Y. TIMES, Mar. 10, 1998, at B3; Gary Weiss, *The Mob is Busier than the Feds Think*, BUS. WEEK, Dec. 15, 1997, at 130.

date are very limited. The procedural mechanics of the Reform Act involving the automatic discovery stay and the time-consuming lead plaintiff designation procedures have served to slow down the progress of these litigations and likely are increasing the overall legal costs involved in these cases. It will take many more years to evaluate whether victims of real fraud are able to achieve significant financial recoveries under the Reform Act. Unless and until the possibility of such recoveries is demonstrated, no valid conclusion can be reached as to the impact of the Reform Act on cheated investors.

The Grundfest/Perino Study is undoubtedly correct in concluding that there has been an increase in the number of securities fraud class action cases filed in state court. However, its suggestion that state court cases are being filed because the facts alleged there could not survive the enhanced pleading standards imposed by the Reform Act is unsupported by any evidence, empirical or otherwise. The SEC in mid-April 1997 issued its own study of the impact of the Reform Act in a report to President Clinton. The *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995* stated:

The discovery stay imposed by the Act during the pendency of a motion to dismiss, coupled with the heightened pleading standards, has made it more difficult for plaintiffs to bring and prosecute securities class action lawsuits. No cases to date have been dismissed without leave to amend because of the new pleading standards. Plaintiffs who are unable to uncover evidence of wrongdoing sufficient to meet those new standards prior to filing their complaints, however, may find it difficult to amend their complaints without access to discovery.

....

The number of securities class actions filed in state court has reportedly increased. Moreover, many of the state cases are filed parallel to a federal court case in an apparent attempt to avoid some of the procedures imposed by the Reform Act, particularly the stay of discovery pending a motion to dismiss. This may be the most significant development in securities litigation post-Reform Act. While the allegations contained in state court complaints are generally similar to those of the federal complaints, state complaints having no parallel federal action are more likely to be based solely on forecasts which have not materialized and less likely to include insider trading allegations.

....

There are still many uncertainties about the effects of the Reform Act and the staff expects to continue carefully monitoring the cases. The staff believes that it is too soon to draw any firm conclusions about the effect of the Reform Act on frivolous securities litigation, or, for that matter, on meritorious litigation. Accordingly, the staff does not recommend any legislative changes at this time.<sup>29</sup>

*The Wall Street Journal* on July 9, 1997, reported:

The number of securities-fraud class-action suits filed in federal court this year has climbed back to the levels of the early 1990s, despite a 1995 law aimed at curbing such suits, two new studies show.

The studies indicate that plaintiffs lawyers have returned to federal court after adjusting to higher pleading standards and other hurdles presented by the Private Securities Litigation Reform Act, passed over a presidential veto in December 1995. Meanwhile, the number of shareholder suits filed in state courts is down sharply this year, after spiking last year, the studies show.

"The plaintiffs lawyers have figured out that it's not so bad to file in federal court, and there's no significant advantage to filing in state court," says Vinita Juneja, a vice president of National Economic Research Associates Inc., a White Plains, N.Y., consulting firm that studied both federal and state court filings.

The group found that 78 suits were filed in federal court through May, compared with 47 last year. In state courts, it found that 19 shareholder class actions were filed through April, down from 40 in the same period last year.

In its study, the Securities Class Action Clearinghouse, a research project run by Stanford University law school, found that 83 securities-fraud suits were filed this year in federal court through July 3. If the filings continue at that rate, there will be 166 suits filed this year. That's roughly the same number as in the early 1990s, when business groups lobbied Congress to make it harder for shareholders to bring "meritless" suits in federal court. Back then, the number of shareholder suits filed in federal court averaged about 178 a year.

....

Last year, the number of suits filed in federal court dropped to about 123, as more suits were filed in state court. Observers also

---

29. Security & Exchange Comm'n, *Report to the President and the Congress on the First Year of Practice under the Private Securities Litigation Act of 1995* (last modified Apr. 16, 1997) <<http://www.sec.gov/news/studies/lreform.txt>>.

attributed the decline to a rush by lawyers to file federal claims in late 1995 before the law went into effect.

Both groups say the filings are back up because federal courts haven't been as inhospitable to shareholder suits as proponents of the new law had hoped.<sup>30</sup>

Our federal system has always had a system of dual state and federal remedies for securities fraud, as both the 1933 and 1934 Acts were expressly nonpreemptive. Representative Christopher Cox, a leading proponent of the PSLRA, stated during one hearing: "if you were a plaintiff, who like any plaintiff has a choice of forum . . . you might file your suit in state court or in federal court, *depending on how you saw your advantage.*"<sup>31</sup> Congress could have chosen to preempt state securities fraud remedies when it enacted the Reform Act. However, many participants in the process have publicly stated that had such a preemptive provision been included, the Reform Act could not have been enacted over President Clinton's veto.

In any event, there are many good reasons why victims of securities fraud might prefer to attempt to litigate their claims in state court. Many state courts permit plaintiffs to recover on a nine-to-three jury vote, as opposed to the unanimous verdict required in the federal system. Many state laws permit a recovery upon a showing of negligence, as opposed to reckless or intentional misconduct. Some states permit recovery without any showing of reliance by the plaintiff on the misrepresentations. Further, several state laws provide procedural advantages for plaintiffs such as a broader jury pool (drivers license holders versus registered voters), the ability to require a defendant to pay the cost of class notice, interlocutory appeal procedures for a denial of class certification and writ of mandamus procedures by which erroneous pretrial rulings can be promptly reviewed by appellate courts. Such advantages are normally nonexistent in the federal system.

The Grundfest/Perino Study's conclusion that more of the cases filed under the Reform Act allege accounting fraud or insider trading is neither surprising, nor significant. In recent years, the amount of accounting chicanery by public companies has increased greatly. This is especially true in the high-tech sector where the pressure to meet quarterly earnings forecasts is intense and the companies often "pre-ship" merchandise, "stuff the channel" and grant "sale or return" privileges to do so. That plaintiffs'

---

30. Dean Starkman, *Securities Class-Action Lawsuits Make Comeback in Federal Court*, WALL ST. J., July 9, 1997, at B11.

31. *Common Sense Legal Reform Act, Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Commerce*, 104th Cong. 110 (1995) (Statement of Rep. Christopher Cox).

lawyers have become more sophisticated in figuring this out and are more frequently utilizing forensic accountants to help plead claims should surprise no one. There is also no doubt that the amount of insider trading by corporate executives is at the highest levels in history.

The market is now really beginning to reap the bitter harvest of the SEC's accommodation of the corporate community several years ago when the SEC changed the rules relating to stock options and section 16 of the 1934 Act. Section 16 had prohibited a corporate insider from exercising a stock option and then selling the stock on the open market in the next six months, giving force to Congress's mandate that corporate insiders not be allowed to reap short-swing profits. However, some years ago, under intense pressure from the corporate community, the SEC adopted the completely illogical rule that, for section 16 purposes, the stock purchase in a stock option scheme occurs when the option is granted—when no money changes hands, the executive is at no risk of loss, and has no ability to sell the stock—and not when the executive later actually exercises the option, pays for the stock, is at risk, and obtains the ability to sell the stock. As a result, corporate executives have now learned that they have immunity from section 16's short-swing profit disgorgement rule and can exercise stock options and sell the stock *on the same day*. They may thereby avoid any market risk whatsoever and instantly capitalize on their knowledge of negative developments in their business and industry which are not yet known to the marketplace. It is for this reason more than any other that insider selling by corporate executives is reaching shockingly high levels. This in turn is the reason why more and more securities fraud cases are pleading insider trading.

The Grundfest/Perino Study's conclusion that there are relatively few pure false forecast cases filed under the Reform Act is undoubtedly correct, but this conclusion has little, if anything, to do with the Reform Act. As they admit, there were relatively few pure false forecast cases filed before the Reform Act was adopted. Pure false forecast cases, that is, cases where there was no motive to lie (such as insider selling or merger or acquisition activities), are extremely weak cases. The existing economic incentives of the securities class action litigation system where plaintiffs' counsel must work on a contingency basis and invest large out-of-pocket sums to prosecute these cases, has always made pure false forecast cases very high risk and, thus, few in number.

The Grundfest/Perino Study's conclusion that cases filed in the Reform Act era are being filed following larger price declines than was the case before, if statistically correct, is again of uncertain significance. Two factors probably account for this. First, because plaintiffs' lawyers are now taking longer to prepare securities class action suits, many of them are being filed

several weeks after the initial stock drop caused by the unanticipated revelation of bad news, rather than several days after that adverse revelation. Thus, by the time most Reform Act cases are filed, the stock has declined further than would have been the case with a pre-Reform Act filing. Also, we cannot lose sight of the fact that during 1996-97, the stock market had been trading at extraordinarily high (some would say inflated) levels. As a result, the market has become even more unforgiving upon the disclosure of negative information, resulting in larger stock collapses when the truth comes out.

The Grundfest/Perino Study also concluded that smaller companies are being sued more frequently in the Reform Act era. If true, this increase may be because the amount of fraud by smaller companies coming public to benefit from unprecedented markets has significantly increased. Numerous publications have reported that the quality of IPOs is at an all-time low. We repeatedly encounter the phenomenon of new public companies coming out at high prices, pushed even higher in the aftermarket with the help of a “booster shot” or two from the underwriters, and reporting a good quarter or two before the stock collapses on an earnings disappointment. Investigation then reveals that insiders sold large amounts of stock shortly after the expiration of the “lockup period” imposed by the underwriters. Thus, it seems of no particular significance that smaller companies are being sued more frequently in this late, frothy phase of the bull market of our generation.

The Grundfest/Perino Study’s conclusion that companies in the high-tech sector continue to account for the largest single group sued for securities violations is again, of dubious significance. Given the accounting tricks high-tech companies regularly employ to boost their quarterly earnings and the persistent high levels of insider selling by high-tech corporate executives who depend on stock-option-related sales for compensation, it is not surprising that these companies end up in securities fraud litigations more frequently than more staid, stable enterprises.

The Grundfest/Perino Study’s conclusion that my firm, Milberg Weiss Bershad Hynes & Lerach LLP, has supposedly increased its “appearance rate” in the Reform Act era strikes rather close to home. But, as Congress was warned when it was considering the Reform Act, the mandatory sanction review provision of the Reform Act was so draconian that it inevitably would result in many competent but smaller firms or sole practitioners refusing to bring securities class action suits, no matter how meritorious they might believe the case to be. I told Congress that the mandatory sanction provision in the hands of a mean-spirited or ideological judge (and there are some of both) was a tool to destroy a lifetime’s law practice as a result of one suit. Under those circumstances, I warned, many practitioners would refuse to

become involved in these types of litigations. My predictions have proved true. We have seen smaller firms or sole practitioners either not file securities class action cases, even though they were meritorious, or to seek out larger, more well-capitalized litigation partners to joint-venture cases with them.

Finally, I must take exception to the Grundfest/Perino Study's conclusion that the courts are interpreting the strong inference standard "in favor of plaintiffs." This is a ridiculous conclusion to reach after only a few motions to dismiss Reform Act complaints have even been determined. It is even more absurd in light of the fact that several federal judges have held that the Reform Act's heightened pleading standard eliminates the recklessness liability standard. One federal judge, the Honorable Fern Smith, in *In re Silicon Graphics, Inc. Securities Litigation*,<sup>32</sup> held that the Reform Act required the pleading of intentional or knowing misconduct, that is, it eliminated recklessness liability, and dismissed as inadequate a complaint that alleged top insiders at Silicon Graphics sold off 388,000 shares of their stock for about fourteen million dollars in just a thirty-day period. This sell-off occurred while Silicon Graphics insiders were using the corporation's money to repurchase one million shares of SGI stock on the open market, thus supporting the stock's price while they unloaded their shares. Just several weeks later, the stock collapsed to all-time lows when it was revealed that new products could not be shipped due to technical problems.<sup>33</sup>

District courts have dismissed several cases that contain highly specific allegations of accounting fraud and insider trading.<sup>34</sup> Judge Patel went even further in *Hockey v. Medhekar*,<sup>35</sup> where he held that not only does an actual intent standard apply, but also that the license to lie granted by the safe harbor for forward-looking statements covers statements about the current condition of the business because they are necessary assumptions underlying or relating to the forward-looking statements and entitled to the same protection.

*Silicon Graphics* and *Hockey* are not benign decisions. They threaten the very underpinnings of honesty in our securities markets and, if they spread,

---

32. 970 F. Supp. 746 (N.D. Cal. 1997).

33. A second federal judge, the Honorable Rudi Brewster, in *Powers v. Eichen*, 997 F. Supp. 1031 (S.D. Cal. 1997), followed Judge Smith's erroneous holding that the Reform Act eliminated recklessness scienter but sustained the *Powers* complaint, holding it met even the higher actual knowledge standard because of the massive insider selling alleged. A third federal judge, the Honorable Edward Harrington, in *Friedberg v. Discreet Logic, Inc.*, 959 F. Supp. 42 (D. Mass. 1997), followed *Silicon Graphics* but also upheld the complaint due to large insider stock sales.

34. See *Orman v. America Online, Inc.*, No. 97-264-A (E.D. Va. July 11, 1997); *Zeid v. Kimberley*, 930 F. Supp. 431 (N.D. Cal. 1996).

35. [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,465 (N.D. Cal. 1997).

could lead to more fraud—unremedied fraud—that will undermine investor confidence in the markets and, in time, impair capital formation.

A recent Ninth Circuit decision, *Cooper v. Pickett*,<sup>36</sup> however, indicates that these anti-investor decisions by district court judges in the Northern District of California are unlikely to be upheld. *Cooper* reversed the district court's dismissal of a complaint alleging that a public company, two underwriting firms, and the company's public accountants schemed to defraud investors by making false positive statements about the company's business and future prospects while falsifying its reported financial results.<sup>37</sup> The Ninth Circuit ruled that plaintiffs' allegations of accounting fraud were sufficiently specific in describing the accounting tricks used, the customers involved, and the approximate amounts by which the company's financial results were overstated, even though the complaint did not identify a single specific transaction involving a specific customer which was bogus.<sup>38</sup> The Ninth Circuit also held that the company was liable for false information it disseminated to the market indirectly through analysts, either in conference calls or by privately feeding information to analysts for inclusion in reports written by the analysts. Although the complaint alleged the conference calls took place, the Ninth Circuit ruled that defendants could not present purported transcripts of the conference calls, which they claimed contradicted plaintiffs' allegations, at the 12(b)(6) motion stage.<sup>39</sup> The Ninth Circuit in *Cooper* also ruled that even though *Central Bank* stated there is no longer "aiding and abetting" or "conspiracy" liability, liability still exists under Rule 10b-5 for participating in a *fraudulent scheme*. The court therefore held that a fraudulent scheme was adequately alleged involving the company, its top officers, two underwriting houses whose analysts issued false reports on the company, and the company's independent auditors.<sup>40</sup>

While *Cooper* is a pre-PSLRA decision, it is likely to have a significant impact on post-PSLRA litigation. The Ninth Circuit's holding that the complaint satisfied Rule 9(b), in essence, provides guidance on what types of allegations of falsity, especially false financial statement allegations, will satisfy the first prong of the PSLRA's heightened pleading standard. Further, *Cooper's* holdings regarding what may be considered on a motion to dismiss, the responsibility of a company for false information its insiders disseminate to the market indirectly through analysts, and its recognition of scheme

---

36. 122 F.3d 1186 (9th Cir. 1997).

37. *See id.* at 1190.

38. *See id.* at 1198.

39. *See id.* at 1192.

40. *See id.* at 1191, 1195.

liability in the post-*Central Bank* world will all be of significance in post-PSLRA cases.

However, prior to enactment of the PSLRA, the Ninth Circuit required only scienter to be alleged under *GlenFed*. Thus, the Ninth Circuit did not reach the issue of whether the allegations in the *Cooper* complaint raised a strong inference of scienter. *Cooper* merely noted the passage of the PSLRA and its heightened pleading standard in a footnote, without indicating one way or another how the *Cooper* complaint would have fared. Certainly, *Cooper* indicates that, in the Ninth Circuit, the great battleground in post-PSLRA litigation will be over the "strong inference of the required state of mind" pleading requirement.

It is still far too early to conclude that the enhanced pleading standard will not be either misapplied by courts to create an actual knowledge/intentional wrongdoing standard or, even if properly applied, will nevertheless not be used to dismiss meritorious cases.<sup>41</sup> As of January 25, 1998, here is the scorecard on motions to dismiss under the Reform Act after twenty-four months. There have been fifty-five motions to dismiss decided under the PSLRA. In twenty-nine cases, the district court upheld the complaint as meeting the heightened pleading standard. In twenty-six cases, district courts held the complaint did not meet the heightened standard.

The geographic location of the dismissals is quite interesting. In the Northern District of California—home to the largest concentration of venture capital outfits, high-tech/bio-tech public companies, and underwriting houses specializing in high-tech/bio-tech IPOs—*every motion to dismiss a Reform Act complaint was granted*, two with prejudice and five without prejudice. Thus, one hundred percent of the complaints filed in the Northern District were held not to meet the heightened pleading standard of the PSLRA.

---

41. The PSLRA did not change traditional 12(b)(6) rules. See *Epstein v. Itron*, No. CS-97-214-RHW (E.D. Wash. Jan. 22, 1998); *In re Ride, Inc. Sec. Litig.*, No. C97-402WD (W.D. Wash. Dec. 1, 1997); *In re Grand Casinos, Inc. Sec. Litig.*, 988 F. Supp. 1273 (D. Minn. 1997); *Cherednichenko v. Quarterdeck Corp.*, No. CV 97-4320-GHK(CWX) (C.D. Cal. Nov. 26, 1997); *In re Valujet, Inc. Sec. Litig.*, 984 F. Supp. 1472 (N.D. Ga. 1997); *Galaxy Inv. Fund v. Fenchurch Capital Mgmt.*, No. 96 C 8098, 1997 U.S. Dist. LEXIS 13207 (N.D. Ill. Aug. 29, 1997), *adopted as a finding of the court*, *Galaxy Inv. Fund v. Fenchurch Capital Mgmt.*, No. 96 C 8098 (N.D. Ill. Sept. 23, 1997); *In re Cephalon Sec. Litig.*, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶99,562 (E.D. Pa. 1997); *Gross v. Medaphis Corp.*, 977 F. Supp. 1463 (N.D. Ga. 1997); *Powers v. Eichen*, 977 F. Supp. 1031 (S.D. Cal. 1997); *In re Health Management, Inc. Sec. Litig.*, 970 F. Supp. 192 (E.D.N.Y. 1997); *OnBank & Trust Co. v. FDIC*, 967 F. Supp. 81 (W.D.N.Y. 1997); *In re Wellcare Management Group Sec. Litig.*, 964 F. Supp. 632 (N.D.N.Y. 1997); *Norwood Venture Corp. v. Converse Inc.*, 959 F. Supp. 205 (S.D.N.Y. 1997); *Friedberg v. Discreet Logic, Inc.*, 959 F. Supp. 42 (D. Mass. 1997); *Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246 (N.D. Ill. 1997); *Fischler v. AmSouth Bancorporation*, No. 96-1567-CIV-T-17A, 1996 WL 686565 (M.D. Fla. Nov. 14, 1996); *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297 (C.D. Cal. 1996).

Outside the Northern District, however, the story is quite different. Over sixty percent of post-PSLRA complaints filed outside the Northern District were sustained, and just four were dismissed with prejudice. In the Central and Southern Districts of California, *every* post-PSLRA complaint challenged to date was held to satisfy the Reform Act's pleading standard. Over sixty percent of the complaints filed outside the Northern District (twenty-nine of forty-eight complaints) were held to meet the heightened pleading standard of the PSLRA while no complaints filed in the Northern District were held to meet the heightened pleading standard.

This geographical divergence is quite interesting and may be due to any number of factors. It may be that district judges in the Northern District of California, applying a new scienter pleading standard with which they were completely unfamiliar prior to the passage of the PSLRA, are deciding all these cases perfectly correctly. Another explanation may be that there simply is no fraud being committed by high-tech/bio-tech companies in the Northern District. Of course, there also may be other explanations as well. In any event, it is clear that there will be a number of appellate court decisions over the next several years before the real parameters of the PSLRA's pleading standard are delineated.

## II. THE REFORM ACT'S SUBSTANTIVE PROVISIONS DO NOT APPLY TO FALSE STATEMENTS MADE PRIOR TO ITS EFFECTIVE DATE

The Reform Act applies only to conduct occurring after December 22, 1995.<sup>42</sup> The Reform Act's language dealing with applicability prohibits retroactivity: "The amendments made by this title shall not affect or apply to any private action arising under title I of the Securities Exchange Act of 1934 or title I of the Securities Act of 1933, commenced before and pending on [December 22, 1995]."<sup>43</sup>

The Reform Act states it *will not* apply to *pending* cases. However, it does not relate if it applies to *conduct* occurring before the Reform Act's effective date, but alleged in cases filed after December 22, 1995. This silence should be understood to foreclose retroactivity. Where Congress has not stated whether legislation applies to preenactment conduct, *there is a strong presumption against retroactivity*. The Supreme Court has mandated a strong presumption against retroactive application of statutes to preenactment conduct *in the absence of an explicit congressional intention to the contrary*,

---

42. See Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 108, 109 Stat. 737, 758.

43. *Id.*

so that parties can predict the consequences of their actions.<sup>44</sup> Thus, the Reform Act cannot apply to preenactment conduct, because it does not express an intention to do so.<sup>45</sup>

A recent Supreme Court decision sheds light on this issue. In *Hughes Aircraft Co. v. United States ex rel. Schumer*,<sup>46</sup> the Supreme Court *unanimously* reversed the Ninth Circuit for giving retroactive effect to 1986 amendments to the False Claims Act and applying the amended law to a case alleging *pre-1986* conduct. The Court wrote:

We have frequently noted, and just recently reaffirmed, that there is a "presumption against retroactive legislation [that] is deeply rooted in our jurisprudence." *Landgraf v. USI Film Products*, 511 U.S. 244, 265, 114 S. Ct. 1483, 1497, 128 L.Ed.2d 229 (1994). "The 'principle that the legal effect of conduct should ordinarily be assessed under the law that existed when the conduct took place has timeless and universal appeal.'" *Ibid.* (quoting *Kaiser Aluminum & Chemical Corp. v. Bonjorno*, 494 U.S. 827, 855, 110 S. Ct. 1570, 1586, 108 L.Ed.2d 842 (1990) (Scalia, J., concurring)). *Accordingly, we apply this time-honored presumption unless Congress has clearly manifested its intent to the contrary.* 511 U.S. at 268, 114 S. Ct. at 1498-1499.<sup>47</sup>

Of course, the PSLRA contains no such clearly manifested intent. The Reform Act states only that "[t]he amendments made by this title shall not affect or apply to any private action arising under title I of the Securities Exchange Act of 1934 or title I of the Securities Act of 1933, commenced before and pending on [December 22, 1995]."<sup>48</sup> Since the PSLRA is *silent* on whether or not it applies to suits filed *after* December 22, 1995, involving

44. *Landgraf v. USI Film Prods.*, 511 U.S. 244 (1994); *accord* *SEC v. Fehn*, 97 F.3d 1276, 1285-86 (9th Cir. 1996) (legal consequences as of time of actions apply). *Landgraf* mapped out the retroactivity analysis:

When a case implicates a federal statute enacted after the events in suit, the court's *first task* is to determine *whether Congress has expressly prescribed* the statute's proper reach. If Congress has done so, of course, there is no need to resort to judicial default rules. When, however, *the statute contains no such express command*, the court must determine whether the new statute *would have retroactive effect, i.e., whether it would impair rights a party possessed when he acted, increase a party's liability for past conduct, or impose new duties* with respect to transactions already completed. If the statute would operate retroactively, *our traditional presumption teaches that it does not govern absent clear congressional intent* favoring such a result.

*Landgraf*, 511 U.S. at 280 (emphasis added).

45. *See* *United States v. \$814,254.76 in United States Currency*, 51 F.3d 207, 212 (9th Cir. 1995).

46. 117 S. Ct. 1871 (1997).

47. *Id.* at 1876 (emphasis added).

48. Pub. L. No. 104-67, § 108, 109 Stat. 737, 758 (1995).

conduct *before* December 22, 1995, the presumption against retroactive legislation controls.

An article by Susan S. Golnick and Joseph D. Daley extensively explored the retroactivity issue, and agrees with the conclusion that the Reform Act cannot be applied to pre-Reform Act conduct.<sup>49</sup>

The Ninth Circuit has repeatedly recognized *Landgraf's* emphasis<sup>50</sup> on the time of the conduct and its distinction between the impermissible/missible application of *substantive* versus *procedural* amendments. *United States v. Bacon*,<sup>51</sup> examined the effect of a 1988 act on conduct which took place in 1982, and concluded that the 1988 Act would have an impermissible retroactive effect if applied in a post-enactment lawsuit:

With [*Landgraf's*] principles in mind we turn to the Transfer Act's claim extinguishment provision. This provision is not merely remedial or procedural; it seeks to affect substantive rights. . . .

Because the Transfer Act . . . seeks to affect the government's substantive right to bring a fraudulent transfer action, we hold that it should not have been applied here.<sup>52</sup>

*United States ex rel. Newsham v. Lockheed Missiles & Space Co.*<sup>53</sup> also applied *Landgraf*, holding that *substantive changes like scienter and damages do not apply retroactively*. Thus, the *Newsham* court refused to apply heightened damages and penalties provisions to preamendment conduct due to their "retroactive effect":

The Court finds that eliminating proof of specific intent to defraud

---

49. Susan S. Golnick & Joseph D. Daley, *The Nonretroactivity of the Private Securities Litigation Reform Act of 1995*, 25 SEC. REG. L.J. 60 (1997). Golnick was a partner of mine, while Daley is an associate of mine.

50. The Ninth Circuit has consistently applied the *Landgraf* analysis where a suit alleging pre-amendment conduct was not filed *until after* the effective date. See *Landgraf v. USI Film Prods.*, 511 U.S. 244 (1994). See, e.g., *Alvarez-Machain v. United States*, 96 F.3d 1246, 1253 (9th Cir. 1996) (new "Torture Victim Protection Act" not applied in impermissible retroactive manner because torture has always been condemned); *Kuehner v. Dickinson & Co.*, 84 F.3d 316, 320 (9th Cir. 1996) (application of new arbitration rule allowed only because it took away *non-substantive* right to jury trial); *United States ex rel. Schumer v. Hughes Aircraft Co.*, 63 F.3d 1512, 1517 (9th Cir. 1995) (application of amended False Claims Act allowed only because Court erroneously held that jurisdictional provisions did not infringe on defendants' substantive rights), *vacated*, 117 S. Ct. 293 (1996) (holding that jurisdictional provisions did in fact infringe on the defendants' substantive rights); *United States ex rel. Lindenthal v. General Dynamics Corp.*, 61 F.3d 1402, 1408 (9th Cir. 1995) (same), *cert. denied*, 116 S. Ct. 1319 (1996); see also, e.g., *supra* note 44 (setting forth the *Landgraf* analysis).

51. 82 F.3d 822, 824 (9th Cir. 1996).

52. *Id.* (citations omitted).

53. 907 F. Supp. 1349, 1359 (N.D. Cal. 1995).

changes the legal consequences of past conduct and therefore, has retroactive effect. Accordingly, the Court finds that *Ninth Circuit law, as it existed prior to 1986, applies to conduct predating* the effective date of the 1986 Amendments. For conduct occurring after [the effective date], the scienter requirement prescribed by the 1986 Amendments applies.<sup>54</sup>

Recent decisions interpreting the Reform Act comport with *Landgraf*. After noting the Reform Act's silence on retroactivity, *District 65 Retirement Trust v. Prudential Securities, Inc.*<sup>55</sup> held that the Reform Act's elimination of RICO claims for securities fraud *did not eliminate defendants' RICO liability for pre-enactment conduct*:

[T]he Court focuses upon whether section 107 "impair[s] rights a party possessed when he acted."

....

In this case, *no questions of procedural rules or jurisdictional scope* are presented. And, to apply the statute retrospectively in light of the Supreme Court's admonition that *retroactive application is disfavored, would work a "manifest injustice"* on plaintiffs. No expectations of defendants are altered by this decision.<sup>56</sup>

Likewise, *In re Prudential Securities Inc. Ltd. Partnerships Litigation*,<sup>57</sup> cited *District 65* as "[t]he only district court to address the question of whether there was a clear expression in this statute," finding that Congress had *deliberately chosen not to apply the "expansive securities law changes retroactively."*<sup>58</sup> It rejected the defendants' attempt to bar RICO claims as it would *"impair the plaintiffs' ability to recover for actions which may have violated federal law."*<sup>59</sup> Quoting the Reform Act's effective-date language,

---

54. *Id.* (emphasis added). Courts from other circuits have similarly applied *Landgraf*. See, e.g., *Maitland v. University of Minn.*, 43 F.3d 357, 361 n.3 (8th Cir. 1994) ("*The date of filing is irrelevant; the date of 'the events in suit,'* [citing *Landgraf*, 511 U.S. at 244] determines whether a court must consider a statute's potential retroactive effect." (emphasis added)); *Reid v. Kraft Gen. Foods, Inc.*, No. 93-5796, 1995 U.S. Dist. LEXIS 5595, at \*22 (E.D. Pa. Apr. 27, 1995) ("*Based on [Landgraf's] rationale and focus on preenactment conduct, I conclude that Landgraf compels the conclusion that the Act does not apply retroactively to cases where . . . the alleged . . . conduct occurred before [the effective date of the Act], but the complaint was filed after that date.*" (emphasis added)).

55. 925 F. Supp. 1551, 1569-70 (N.D. Ga. 1996).

56. *Id.* at 1569-70 (citation omitted and emphasis added). Moreover, *District 65* stated: "Had this action primarily involved securities fraud claims . . . Congress's *explicit requirement of prospective application may very well have encompassed the entire action* and allowed both the RICO claims and securities fraud claims to proceed." *Id.* at 1570 n.8 (emphasis added).

57. 930 F. Supp. 68 (S.D.N.Y. 1996).

58. *Id.* at 79 (emphasis added).

59. *Id.* (emphasis added).

the *Prudential Securities, Inc. Ltd. Partnership* court concluded: "This section thus makes it clear that the Act applies only prospectively to actions under the securities laws."<sup>60</sup> Other courts recently reached similar conclusions: *McKowan Lowe & Co. v. Jasmine*<sup>61</sup> held that the PSLRA does not have retroactive applications.

As this litany of precedent cases proves, *Zeid v. Kimberley*,<sup>62</sup> *In re Silicon Graphics Inc. Securities Litigation*,<sup>63</sup> and *Hockey v. Medhekar*,<sup>64</sup> all holding the PSLRA may be applied retroactively, were decided before *Hughes* and are incorrect.

### III. THE REFORM ACT DID NOT ALTER THE RECKLESSNESS LIABILITY STANDARD FOR NON-FORWARD-LOOKING STATEMENTS

In moving to dismiss Reform Act cases, defendants often suggest that because Congress did not include motive, opportunity, and recklessness language from Second Circuit decisions in the Reform Act, legislators must have intended to require that a plaintiff allege conscious behavior pleading and that mere motive and opportunity will not do. The legislative structure and history, however, demonstrates this conclusion is incorrect.<sup>65</sup>

*Ernst & Ernst v. Hochfelder*<sup>66</sup> held that the 1934 Act requires "some element of scienter" and could not be read to impose liability for "wholly faultless conduct," "negligent conduct alone," or acts conducted in "good faith."<sup>67</sup> The Court indicated that recklessness—which does not impose liability for negligent, faultless, or good faith conduct—may satisfy the scienter requirement because "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct . . ."<sup>68</sup> Since *Hochfelder*, every court of appeals that has considered whether recklessness suffices for the scienter requirement under Rule 10b-5 has held that it does and none has rejected it.<sup>69</sup>

---

60. *Id.* (emphasis added).

61. 976 F. Supp. 293 (D.N.J. 1997).

62. 973 F. Supp. 910 (N.D. Cal. 1997).

63. 970 F. Supp. 746 (N.D. Cal. 1997).

64. 932 F. Supp. 249 (N.D. Cal. 1996).

65. See John C. Coffee, Jr., *The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung*, 51 BUS. LAW. 975, 977-85 (1996); Michael A. Perino, *A Strong Inference of Fraud? An Early Interpretation of the 1995 Private Securities Litigation Reform Act*, 1 SEC. REFORM ACT LITIG. REP. 397, 402-05 (1996).

66. 425 U.S. 185 (1976).

67. *Id.* at 198, 201, 206.

68. *Id.* at 193 n.12.

69. See, e.g., *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 n.6 (9th Cir. 1990) (en banc); *Woods v. Barnett Bank*, 765 F.2d 1004, 1010 (11th Cir. 1985); *Hackbart v. Holmes*, 675 F.2d 1114, 1117-

Since *Hochfelder*, Congress had twenty years to overturn its holding that recklessness is sufficient, *yet it declined to do so*. Congress is presumed to be aware of a longstanding judicial interpretation when it amends a statute.<sup>70</sup> In passing the Reform Act, Congress could have changed the liability standard. It chose to do so with respect to certain forward-looking statements,<sup>71</sup> and to limit joint-and-several liability,<sup>72</sup> however, *it declined to disturb the recklessness standard in any other respect*. No provision in the Reform Act explicitly *eliminates* recklessness as a standard of liability for all actions under Rule 10b-5. In fact, *the Reform Act carefully eliminated recklessness liability in only two enumerated contexts*, that is, forward-looking statements and joint-and-several liability.

If Congress intended for an actual-knowledge requirement to apply to statements outside the safe harbor, why did it expressly limit the safe harbor to certain forward-looking statements,<sup>73</sup> subject to numerous exclusions?<sup>74</sup> The exclusion of most statements from the safe-harbor's actual-knowledge requirement provisions obviously was designed to *preserve* recklessness liability for any statements not within the safe harbor. The statute's provisions limiting the safe-harbor scope would be nullified by holding an actual-knowledge requirement applies without regard to whether statements are forward looking.

Thus, several courts have concluded that the Reform Act did not eliminate recklessness liability or the motive-and-opportunity pleading test. *Marksman Partners v. Chantal Pharmaceutical Corp.*,<sup>75</sup> held that there is "no basis to conclude that Congress altered the mental state requirement"; thus, recklessness was still sufficient to establish the scienter required for a violation.<sup>76</sup> *Marksman Partners* further held "that Second Circuit jurisprudence comes closest to approximating the PSLRA's new [pleading] requirements," and "the 'motive and opportunity' test has not been discarded."<sup>77</sup> Judge Williams reached a similar conclusion in *Zeid v.*

---

18 (10th Cir. 1982); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 193 (3d Cir. 1981); *Stokes v. Lokken*, 644 F.2d 779, 783 (8th Cir. 1981); *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 961-62 (5th Cir. 1981) (en banc); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1024 (6th Cir. 1979); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 46 (2d Cir. 1978); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044 (7th Cir. 1977).

70. *See Cannon v. University of Chicago*, 441 U.S. 677, 698-99 (1979); *Lorillard v. Pons*, 434 U.S. 575, 581 (1978).

71. *See* U.S.C. § 78u-5(c) (Supp. II 1996).

72. *See id.* § 78u-4(g).

73. *See id.* § 78u-5(c).

74. *See id.* § 78u-5(b).

75. 927 F. Supp. 1297 (C.D. Cal. 1996).

76. *See id.* at 1309 n.9.

77. *Id.* at 1310.

*Kimberley*<sup>78</sup>: “There are two distinct ways in which a plaintiff may plead scienter . . . First, a plaintiff can allege ‘facts constituting circumstantial evidence of either reckless or conscious behavior.’ Second, a plaintiff can allege facts ‘establishing a motive to commit fraud and an opportunity to do so.’”<sup>79</sup> Most courts, it seems, are holding that the PSLRA adopted the Second Circuit’s pleading standard, including its “motive-and-opportunity” test.<sup>80</sup>

78. 930 F. Supp. 431 (N.D. Cal. 1996).

79. *Id.* at 438 (citations omitted).

80. *See Zeid*, 930 F. Supp. at 438 (“[A] plaintiff can allege ‘facts constituting circumstantial evidence of either reckless or conscious behavior’ [or] allege facts ‘establishing a motive to commit fraud and an opportunity to do so.’” (citations omitted)); *Marksmen*, 927 F. Supp. at 1309 n.9, 1310 (finding “no basis to conclude that Congress altered the mental state requirement”); *Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1252 (N.D. Ill. 1997) (saying “§ 78u-4(b)(2) adopts the Second Circuit standard”); *Fugman v. Arogenex, Inc.*, 961 F. Supp. 1190, 1195 (N.D. Ill. 1997) (following *Rehm* and holding “‘motive and opportunity’” or “‘facts that constitute a strong circumstantial evidence of conscious misbehavior or recklessness’” are sufficient to establish a strong inference of scienter (citation omitted)); *STI Classic Fund v. Bollinger Indus.*, No. CA 3:96-CV-0823-R, 2 (N.D. Tex. Oct. 25, 1996) (report and recommendation of magistrate judge), *adopted as a finding of the court*, *STI Classic Fund v. Bollinger Indus., Inc.*, No. CA 3:96-CV-0823-R, 1996 U.S. Dist. LEXIS 21082 (N.D. Tex. Nov. 12, 1996) (following *Marksmen*, using the “motive and opportunity” test); *Fischler v. AmSouth Bancorp.*, No. 96-1567-CIV-T-17A, 1996 U.S. Dist. LEXIS 17670, at \*8 (M.D. Fla. Nov. 14, 1996) (finding the “motive and opportunity” standard for raising a “strong inference” of scienter remains); *Page v. Derrickson*, No. 96-842-CIV-T-17C, 1997 U.S. Dist. LEXIS 3673, at \*27 (M.D. Fla. Mar. 25, 1997) (following *Fischler* and applying the “motive and opportunity” and “strong circumstantial evidence” test); *In re Health Management, Inc. Sec. Litig.*, 970 F. Supp. 192, 201 (E.D.N.Y. 1997) (determining the “Second Circuit’s pleading standard was not abrogated by the PSLRA”); *OnBank & Trust Co. v. FDIC*, 967 F. Supp. 81, 88 (W.D.N.Y. 1997) (saying the PSLRA standard is based on Second Circuit precedent); *In re Wellcare Mgmt. Group Sec. Litig.*, 964 F. Supp. 632, 638-40 (N.D.N.Y. 1997) (applying the “motive and opportunity” and “conscious or reckless behavior” test); *Galaxy Inv. Fund v. Fenchurch Capital Management*, No. 96 C 8098, 1997 U.S. Dist. LEXIS 13207 (N.D. Ill. Aug. 29, 1997), *adopted as a finding of the court*, *Galaxy Inv. Fund v. Fenchurch Capital Management*, No. 96 C 8098, 1997 U.S. Dist. LEXIS 21498 (N.D. Ill. Sept. 23, 1997); *see also Williams v. WMX Techs., Inc.*, 112 F.3d 175, 178 (5th Cir. 1997); *Shahzad v. H.J. Meyers & Co.*, No. 95 Civ. 6196 (DAB), 1997 U.S. Dist. LEXIS 1128, at \*19-20 & n.6 (S.D.N.Y. Feb. 6, 1997); *Sloane Overseas Fund v. Sapiens Int’l Corp.*, 941 F. Supp. 1369, 1377 (S.D.N.Y. 1996).

However, five decisions have gone the other way. *See In re Silicon Graphics, Inc., Sec. Litig.*, 970 F. Supp. 746 (N.D. Cal. 1997); *Friedberg v. Discreet Logic*, 959 F. Supp. 42 (D. Mass. 1997); *Powers v. Eichen*, 977 F. Supp. 1031 (S.D. Cal. 1997); *Hockey v. Medhekar*, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,465 (N.D. Cal. 1997); *Voit v. Wonderware Corp.*, 977 F. Supp. 363 (E.D. Pa. 1997). In *Silicon Graphics*, Judge Smith mistakenly held that the Reform Act rejects the motive-and-opportunity test and requires allegations of actual knowledge of falsity or conscious behavior, eliminating recklessness liability. *See* 970 F. Supp. at 763. In connection with the briefing on defendants’ renewed motion to dismiss the plaintiffs’ amended complaint, the SEC responded by filing an *amicus curiae* brief. In *Friedberg*, Judge Edward Harrington followed *Silicon Graphics*, but upheld the complaint based on allegations of insider selling. *See* 959 F. Supp. at 51. Similarly, in *Powers*, Judge Rudi Brewster followed *Silicon Graphics* but upheld the complaint based on allegations of insider selling, explaining that Judge Smith’s prior opinion was in error on this point. *See* 977 F. Supp. at 1039. *Voit* also upheld the complaint under the higher standard based on allegations of insider selling and use of corporate stock to make an acquisition. *See* 977 F. Supp. at 374.

*A. The Text and Structure of the Reform Act Shows That Congress Did Not Eliminate Motive, Opportunity and Recklessness as Means of Establishing Scienter*

Congress clearly intended for recklessness to suffice for establishing liability outside the narrow safe-harbor provision and to allow for such recklessness to be established by allegations of motive and opportunity to defraud. Section 21D(b)(2) does not reject the recklessness standard for establishing scienter in section 10(b) cases. It states that plaintiffs must plead facts "giving rise to a strong inference" of "*the required state of mind.*"<sup>81</sup> The "*strong inference*" standard comes from Second Circuit case law; the Second Circuit has long held that plaintiffs must raise a "strong inference" of scienter by alleging motive and opportunity *or* by pleading facts that show either reckless or conscious behavior.<sup>82</sup> Nothing in the text of section 21D(b)(2) suggests that it overrules the Second Circuit case law, whose very language it enacted, as to the kind of facts which suffice to raise "a strong inference" of intentional fraud or recklessness. Nor does anything in section 21D(b)(2) suggest that it overrules the decisions holding that allegations of motive and opportunity or recklessness establish scienter.<sup>83</sup> Had Congress intended to abrogate the Second Circuit precedents creating the "strong-inference" pleading standard, it would not have explicitly adopted its "strong-inference" formulation.

Moreover, the "*required state of mind*" for a section 10(b) violation encompasses recklessness. "Scienter may be satisfied by either proof of

---

81. 15 U.S.C. § 78u-4(b)(2) (Supp. II 1996) (emphasis added).

82. *See, e.g., Turkish v. Kasenez*, 27 F.3d 23, 28 (2d Cir. 1994); *Cohen v. Koenig*, 25 F.3d 1168, 1173 (2d Cir. 1994); *IUE AFL-CIO Pension Fund v. Herrmann*, 9 F.3d 1049, 1057 (2d Cir. 1993); *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 268-69 (2d Cir. 1993); *Breard v. Sachnoff & Weaver, Ltd.*, 941 F.2d 142, 143-44 (2d Cir. 1991); *Ouaknine v. MacFarlane*, 897 F.2d 75, 79-80, 80-82 (2d Cir. 1990); *Cosmas v. Hassett*, 886 F.2d 8, 12-13 (2d Cir. 1989); *Beck v. Manufacturers Hanover Trust Co.*, 820 F.2d 46, 50 (2d Cir. 1987); *Ross v. A.H. Robins Co.*, 607 F.2d 545, 556 (2d Cir. 1979).

83. In the Ninth Circuit, insider trading or other allegations of motive and opportunity plead scienter. *See, e.g., Provenz v. Miller*, 102 F.3d 1478, 1491 (9th Cir. 1996) (indicating stock sales by insiders is evidence of scienter); *Fecht v. Price Co.*, 70 F.3d 1078, 1084 (9th Cir. 1995) (saying a corporate offering of securities and insider stock sales "are circumstantial evidence that the defendants knew or had reason to know that the financial condition of the Company was deteriorating well before they disclosed the problems with the expansion program"); *cert. denied*, 116 S. Ct. 1422 (1996); *Kaplan v. Rose*, 49 F.3d 1363, 1379 (9th Cir. 1994) (saying insider stock sales raise an inference of scienter); *In re Wells Fargo Sec. Litig.*, 12 F.3d 922, 931 (9th Cir. 1993) (noting "allegations of motive and opportunity in the complaint are sufficient to establish a basis for inferring . . . fraudulent intent"); *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1117 (9th Cir. 1989) (saying "[I]nsider trading in suspicious amounts or at suspicious times is probative of bad faith and scienter"); *Deutsch v. Flannery*, 823 F.2d 1361, 1365 & n.3 (9th Cir. 1987) (concluding an opportunity to sell options raised an inference of scienter under Second Circuit standards).

actual knowledge or recklessness.”<sup>84</sup> Had Congress intended to overrule the established law and require actual knowledge of falsity, it would have said so. Instead, its choice of the phrase “*the required state of mind*,” was designed to *preserve recklessness* as a basis of liability for most section 10(b) claims.

When in other parts of the Reform Act Congress eliminated liability for reckless conduct, *it said so*. Congress chose to provide in section 21E a narrow “safe harbor” from recklessness liability for “forward-looking statements.”<sup>85</sup> Section 21E’s new requirement that plaintiffs prove “actual knowledge” of falsity only for certain forward-looking statements would be meaningless if plaintiffs were always required to prove “actual knowledge” of falsity for any section 10(b) violation.<sup>86</sup> Congress *excluded* many statements from the safe harbor and its actual-knowledge requirement.<sup>87</sup> Extending the safe-harbor’s actual-knowledge scienter standard to *all* statements would frustrate all of these carefully-framed qualifications and exclusions.

Similarly, the provisions of the Reform Act which limit joint liability for reckless conduct carefully preserve the rule that reckless conduct gives rise to liability. Section 21D(g) states that “[f]or purposes of this subsection” only, a defendant “‘knowingly commits a violation of the securities laws’” only if it acts “with actual knowledge” of falsity.<sup>88</sup> Section 21D(g) also specifies that, *for this subsection alone*, “reckless conduct by a covered person shall not be construed to constitute a knowing commission of a violation of the securities laws by that covered person.”<sup>89</sup> *This limitation, however, does not affect the basic scienter standards for establishing a violation of section 10(b): “Nothing in this subsection shall be construed to create, affect, or in any manner modify, the standard for liability associated with any action arising under the securities laws.”*<sup>90</sup> The Reform Act thus expressly preserves the existing decisional law holding that recklessness suffices to establish the scienter element for a section 10(b) violation.<sup>91</sup>

---

84. *Hanon v. Dataproducts Corp.*, 976 F.2d 497, 507 (9th Cir. 1992); *see also Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1232-33 & n.20 (10th Cir. 1996).

85. 15 U.S.C.A. § 78u-5(c)(1)(B) (Supp. II 1996). To establish liability for a statement within the safe harbor, plaintiffs must show that the statement “if made by a natural person, was made with actual knowledge by that person that the statement was false or misleading.” *Id.*

86. *See id.* § 78u-5(c).

87. *See id.* § 78u-5(b).

88. *Id.* § 78u-4(g)(10)(A) (emphasis added).

89. *Id.* § 78u-4(g)(10)(B).

90. *Id.* § 78u-4(g)(1) (emphasis added).

91. The joint-and-several liability scheme of the Reform Act provides that any defendant “against whom a final judgment is entered in a private action shall be liable for damages jointly and severally only if

*B. The Legislative History Shows that Congress Intended for Courts to Seek Guidance from Second Circuit Precedents and Infer Scierter from Motive, Opportunity or Recklessness*

Two sentences in the Conference Report,<sup>92</sup> some argue, suggest that section 21D(b)(2) was intended to prevent a plaintiff from raising a strong inference of scierter by pleading motive and opportunity; instead, conscious behavior, not mere recklessness, must be pled.<sup>93</sup> However, a review of the legislative history shows that Congress intended courts to seek guidance from Second Circuit precedents on how a "strong inference" of scierter may be pled. Congress did not intend to reject decisions adopting motive and opportunity as a means of establishing scierter. The "strong inference" language was added to bring all courts into line with Second Circuit

the trier of fact specifically determines that such covered person *knowingly committed a violation of the securities laws.*" *Id.* § 78u-4(g)(2)(A) (emphasis added). This section recognizes that "final judgment" may be entered without such a finding, but will result in joint-and-several liability only upon a finding of *knowing conduct*, and in less-sweeping "proportionate liability" on a finding of recklessness. To impose a knowing-conduct standard for liability for all statements or conduct would render the entire joint-and-several liability section of the Reform Act meaningless, as there could never be nonknowing liability for which a person would only be proportionately liable.

92. H.R. CONF. REP. NO. 104-369 (1995).

93. The Managers stated, "Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard." *Id.* at 41. A footnote added that "the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness." *Id.* at 48 n.23. Such language was proposed for inclusion by Senator Arlen Specter. *See* 141 CONG. REC. S9170 (daily ed. June 27, 1995). However, since Congress did strengthen the Second Circuit pleading standard by *adding* as the first prong of its pleading standard the Ninth Circuit's *GlenFed* standard (requiring the pleading of each false statement and why it is false), these statements are consistent with a continued use of the Second Circuit's motive-and-opportunity test *plus* the Ninth Circuit's *GlenFed* test. *See In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541 (9th Cir. 1994). The rejection of the Specter Amendment, which sought to insert specific language about motive, opportunity, and recklessness, *see* 141 CONG. REC. S9170 (daily ed. June 27, 1995), does not mean that Second Circuit precedents were expressly rejected or overruled. Senator Dodd explained that the Specter Amendment was rejected *for deviating* from Second Circuit case law. *See* 141 CONG. REC. S19,068 (daily ed. Dec. 21, 1995) (quoting Professor Grundfest's characterization of the Specter Amendment as "*an incomplete and inaccurate* codification of case law in the [Second] circuit"). Senator Dodd explained that, far from foreclosing reliance on Second Circuit precedent, the Conference Committee actually *expected courts to look to that court's decisions for guidance*:

You could have gone in, I suppose, and said why did you not include the other language [from the Second Circuit precedents] here? The problem was, in a sense, by codifying [judicial] guidance you get into an area where you can get some differences of opinion on this. And arguably it could have, I suppose gone back and included all of it, but *the decision was to take it out on the assumption that the courts will look to the guidance.*

*Id.* (emphasis added). Senator Dodd believed that with the standard established in the statute, "[*when the guidance of the court would be followed.*" *Id.* (emphasis added). He explained: "We have met the second circuit standard here, as indicated by the memorandum from Judge Grundfest, Professor Grundfest at Stanford. We have met that standard. We have left out the guidance. *That does not mean you disregard it.*" *Id.* (emphasis added). Indeed, Senator Dodd observed that "the suggestion that somehow the courts are going to disregard the guidance . . . I think overstates the case." *Id.* at S19,071.

precedents on pleading scienter.

The courts of appeals had interpreted Rule 9(b) in different ways, creating distinctly different pleading standards among the circuits.

The Committee does not adopt a new and untested pleading standard that would generate additional litigation. Instead, the Committee chose a uniform standard modeled upon the pleading standard of the Second Circuit. Regarded as the most stringent pleading standard, the Second Circuit test requires that the plaintiff plead facts that give rise to a “strong inference” of defendant’s fraudulent intent. The Committee does not intend to codify the Second Circuit’s caselaw interpreting this pleading standard, *although courts may find this body of law instructive*.<sup>94</sup>

The legislative history contradicts any notion that the Conference Committee disavowed recklessness and motive and opportunity as methods of establishing liability. Senator Moseley-Braun observed that while “the original House bill abolished liability for reckless conduct; the Senate bill did not, and the Senate position prevailed in conference.”<sup>95</sup> Representative Bliley, who served as Manager for the House on the Conference Committee, confirmed that, with the exception of the safe harbor and proportionate-liability provisions, “[t]he conference report is careful not to change standards of liability under the securities laws.”<sup>96</sup> The Managers themselves uniformly understood the Conference Report to adopt the pleading standard from the Second Circuit case law. Senator Dodd explained that the Reform Act “*adopt[ed]* the Second Circuit Court of Appeals standard.”<sup>97</sup> The Conference Report therefore contrasted with the earlier House Bill, which “established pleading standards that were so high . . . that it would have been impossible to bring a suit . . . had the [earlier] House language been adopted.”<sup>98</sup> The Reform Act, therefore, is “*using* a pleadings standard that has been successfully tested . . . in the real world.”<sup>99</sup>

Senator Domenici similarly explained that “the conference report *adopts* the pleading standard utilized by the Second Circuit Court of Appeals, where

---

94. S. REP. No. 104-98, at 15 (1995) (footnotes omitted).

95. 141 CONG. REC. S17,984 (daily ed. Dec. 5, 1995).

96. 141 CONG. REC. H14,040 (daily ed. Dec. 6, 1995).

97. 141 CONG. REC. S17,959 (daily ed. Dec. 5, 1995).

98. *Id.* at S17,959 (statement of Sen. Dodd). *See id.* at S17,957 (statement of Sen. Dodd) (“The conference report clarifies current requirements that lawyers should have some facts . . . to back up their assertion of security fraud by adopting most of the reasonable standards established by the U.S. Second Circuit Court of Appeals.”); *Id.* at S17,959 (statement of Sen. Dodd) (the conferees intended to “adopt the Second Circuit Court of Appeals standard”).

99. *Id.* at S17,957 (emphasis added).

a large number of securities fraud lawsuits are brought.”<sup>100</sup> Domenici stated that *among its advantages was the body of precedent applying the “strong-inference” standard*: “This court-tested standard requires plaintiffs to plead facts in their complaint which give rise to a strong inference of securities fraud.”<sup>101</sup> Senators Dodd and Domenici knew what they were talking about: they authored this, “the Dodd-Domenici bill,” shepherded it through Congress, and served as Managers for the Senate on the Conference Committee.<sup>102</sup>

When Senator Specter asked if the Conference Report repudiated Second Circuit case law, Senator Dodd told him that it did not: “Basically, *what we intended to do here was to codify the second circuit’s pleadings standards*.”<sup>103</sup> Senator Dodd added that courts would be free to follow the Second Circuit case law, explaining that although “the committee does not intend . . . to codify the second circuit’s case law *interpreting* this pleading standard,” nonetheless “*courts may find this body [of] law instructive*.”<sup>104</sup> Senator Dodd elaborated, explaining:

[I]nstead of trying to take each case that came under the second circuit, we are trying to get to the point where we would have well-pleaded complaints. We are using the standards in the second circuit in that regard, then letting the courts—as these matters will—test. They can then refer to specific cases, the second circuit, [or] otherwise, to determine if these standards are [met] based on facts and circumstances in a particular case. That is what we are trying to do here.<sup>105</sup>

100. *Id.* at S17,969.

101. *Id.*

102. Other members of the Conference Committee agreed with them that the statute came from the Second Circuit case law. Senator Grams, who served with Senators Dodd and Domenici on the Conference Committee as a Manager for the Senate, confirmed that the legislation provided for “[c]odification of the pleading standard adopted by the second circuit court of appeals.” *Id.* at S17,993. Another Conference Committee Manager, Senator D’Amato, explained that the Conference Report “creates a uniform standard for complaints that allege securities fraud,” and that “[t]his standard is already the law in New York,” *i.e.*, the Second Circuit. *Id.* at S17,934. “It requires a plaintiff plead facts giving rise to a strong inference of the defendant’s fraudulent intent.” *Id.*

103. *Id.* at S17,960 (emphasis added).

104. *Id.*

105. *Id.* Other legislators took the Managers at their word. Senator Moseley-Braun concluded that, although “[i]n the area of pleading, the House bill adopted a standard that was significantly higher than the second circuit standard, *which was the standard adopted in the Senate bill*,” it was “[t]he Senate position [that] prevailed at conference.” *Id.* at S17,984 (emphasis added). Senator Hatch agreed that “*the legislation adopts the second circuit pleading standard . . .*” *Id.* at S17,966 (emphasis added). Senator Dole also believed that the bill “*adopts the second circuit’s pleading standard*.” *Id.* at S17,983 (emphasis added).

According to the bill’s leading proponent, “motive” would provide the necessary “strong

Thus far, most courts have held the PSLRA did not eliminate recklessness liability.<sup>106</sup>

#### IV. THE REFORM ACT'S PLEADING STANDARD IS SATISFIED BY ALLEGATIONS OF MOTIVE AND OPPORTUNITY TO COMMIT FRAUD OR FACTS SHOWING CONSCIOUS MISBEHAVIOR OR RECKLESS DISREGARD

Nothing about the Reform Act indicates an intention to hinder vigorous prosecution of meritorious suits. To the contrary, Congress reaffirmed the importance of private enforcement of the securities laws. The Conference Report<sup>107</sup> states:

The overriding purpose of our Nation's securities laws is to *protect investors . . . .*

The private securities litigation system is *too important to the integrity of American capital markets* to allow this system to be undermined by those who seek to line their own pockets by bringing abusive and meritless suits. *Private securities litigation is an indispensable tool with which defrauded investors can recover their*

inference" of scienter. In debate on the veto override, Senator Dodd adopted the conclusion of a former SEC commissioner that under "the securities litigation conference report, the pleading standard is faithful to the Second Circuit's test." 141 CONG. REC. S19,067 (daily ed. Dec. 21, 1995) (statement of Senator Dodd) (quoting letter of Stanford University Professor Joseph Grundfest). Senator Dodd assured Congress that this "'pleading standard articulated by the Second Circuit Court of Appeals is intended simply to require the plaintiff to allege facts sufficient to give rise to a *strong inference of motive* to defraud.'" *Id.* (emphasis added). Senator Dodd explained, "We have established the standard clearly. We have clearly established the standard of alleging facts with particularity, showing a *strong inference of motive.*" *Id.* at S19,068 (emphasis added).

106. See, e.g., *Epstein v. Itron*, No. CS-97-214-RHW (E.D. Wash. Jan. 22, 1998); *Fugman v. Aprogenex, Inc.*, 961 F. Supp. 1190 (N.D. Ill. 1997); *In re Health Mgmt., Inc. Sec. Litig.*, 970 F. Supp. 192 (E.D.N.Y. 1997); *In re Wellcare Mgmt. Group Sec. Litig.*, 964 F. Supp. 632 (N.D.N.Y. 1997); *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297 (C.D. Cal. 1996); *Page v. Derrickson*, No. 96-842-CIV-T-17C, 1997 U.S. Dist. LEXIS 3673 (M.D. Fla. Mar. 25, 1997); *Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246 (N.D. Ill. 1997); *In re Baesa Sec. Litig.*, 969 F. Supp. 238 (S.D.N.Y. 1997); *Weikel v. Tower Semiconductor Ltd.*, No. 96-3711 (D.N.J. Oct. 2, 1997); *Galaxy Inv. Fund v. Fenchurch Capital Management*, No. 96 C 8098, 1997 U.S. Dist. LEXIS 13207 (N.D. Ill. Aug. 29, 1997), *adopted as a finding of the court*, *Galaxy Inv. Fund v. Fenchurch Capital Management*, No. 96 C 8098 (N.D. Ill. Sept. 23, 1997).

107. H.R. CONF. REP. NO. 104-369 (1995). Few if any of the suits bear any indicia of the types of suits which prompted the Reform Act. The complaints are not being filed by "professional plaintiffs," but rather by investors who never before brought a class action suit. The complaints are not filed *immediately* following, nor are they based merely on, a stock drop. Rather, they are detailed and reflect significant pre-filing investigation, including specific allegations of motive, positive representations contradicted by undisclosed internal business problems which were inconsistent with these representations, *plus*—in many cases—very significant insider selling. The suits are *the very kind of carefully prepared cases, attacking real fraud by insider traders, that Congress, by weeding out frivolous or abusive suits, wanted victims to be able to prosecute more effectively.*

*losses without having to rely upon government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs.* This legislation seeks to return the securities litigation system to that high standard.

....

This Conference Report seeks to *protect investors*, issuers, and all who are associated with our capital markets *from abusive securities litigation*. This legislation . . . *discourage[s] frivolous litigation*.<sup>108</sup>

The Reform Act *does not* change Rule 12(b)(6). The allegations still must be taken as true and suits must be dismissed *only if no conceivable set of facts could be proved entitling plaintiffs to relief*.<sup>109</sup> The Reform Act does require that “the complaint shall specify *each* statement alleged to have been misleading, the reason or reasons *why* the statement is misleading,” and “state with particularity facts giving rise to a strong inference that the defendant acted with *the required state of mind*.”<sup>110</sup>

However, these requirements are not new. The Reform Act combined the Ninth Circuit’s *GlenFed* requirement that a plaintiff plead the false statements and why they are false with the Second Circuit’s requirement that facts be plead to support an inference of scienter to create a *uniform pleading standard*.<sup>111</sup> The Reform Act requires that a complaint raise “a strong inference of scienter.”<sup>112</sup> While “great specificity [is] not required with respect to . . . allegations of . . . scienter,” a plaintiff must provide “a minimal factual basis” for its conclusion that a defendant acted with scienter.<sup>113</sup> A “minimal factual basis” suffices if the allegations give rise to a “strong inference’ of scienter,”<sup>114</sup> through either of two approaches.<sup>115</sup>

One method for establishing an inference of scienter is to allege facts showing *a motive* for committing fraud and *a clear opportunity* for doing

108. *Id.* at 31-32 (emphasis added).

109. *See, e.g.,* Conley v. Gibson, 355 U.S. 41, 45-46 (1957) (stating that “a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief”); *Marksman Partners*, 927 F. Supp. at 1304.

110. 15 U.S.C. § 78u-4(b)(1) & (b)(2) (Supp. II 1996) (emphasis added).

111. *See* H.R. CONF. REP. 104-369, at 91 (1995).

112. *Turkish v. Kasenetz*, 27 F.3d 23, 28 (2d Cir. 1994); *see also In re Time Warner Sec. Litig.*, 9 F.3d 259, 268 (2d Cir. 1994); *Breard v. Sachnoff & Weaver, Ltd.*, 941 F.2d 142, 143-44 (2d Cir. 1991).

113. *Cohen v. Koenig*, 25 F.3d 1168 (2d Cir. 1994) (citations omitted); *see Turkish*, 27 F.3d at 28; *Time Warner*, 9 F.3d at 268-69; *Breard*, 941 F.2d at 143-44; *Goldman v. Belden*, 754 F.2d 1059, 1070 (2d Cir. 1985).

114. *Turkish*, 27 F.3d at 28.

115. *See Time Warner*, 9 F.3d at 268-69.

so.<sup>116</sup> This may be done “through allegations of a motive to deceive and access to accurate information.”<sup>117</sup> Another approach “is to allege facts constituting circumstantial evidence of either reckless or conscious behavior.”<sup>118</sup> Opportunity, however, is normally clear. The insiders control the public dissemination of information about their company. They are the ones speaking to analysts and the markets. Under such circumstances, “no one doubts that the defendants had the opportunity, if they wished, to manipulate the price of [the] stock.”<sup>119</sup>

Insider selling constitutes a motive and establishes scienter under both Second and Ninth Circuit decisions. *Goldman v. Belden*<sup>120</sup> sustained a complaint based on an assertion that “failure to qualify the bullish statements was intended to permit individual defendants to profit from an inflated market price before the truth became known.”<sup>121</sup> *Goldman* held that scienter was adequately alleged as to a defendant who sold twenty-six percent of his stock.<sup>122</sup>

*Dolgow v. Anderson*<sup>123</sup> is instructive. There, the plaintiff alleged the officers and directors of Monsanto engaged in a scheme to inflate Monsanto stock during a two-year period by false statements that exaggerated Monsanto’s future performance. The officers and directors then exercised stock options and sold large amounts of their Monsanto shares near the stock’s all-time high of over eighty dollars, before it fell to thirty-nine dollars

116. See *Cohen*, 25 F.3d at 1173-74; *Cosmas v. Hassett*, 886 F.2d 8, 12-13; *Goldman*, 754 F.2d at 1070; accord *In re Wells Fargo Sec. Litig.*, 12 F.3d 922, 931 (9th Cir. 1993) (stating that “allegations of motive and opportunity . . . are sufficient to establish a basis for inferring . . . fraudulent intent”); *Blake v. Dierdorff*, 856 F.2d 1365, 1369-70 (9th Cir. 1988).

117. *Cohen*, 25 F.3d at 1173-74.

118. *In re Time Warner Sec. Litig.*, 9 F.3d 259, 269 (2d Cir. 1994); see also *Breard*, 941 F.2d at 144.

119. *Time Warner*, 9 F.3d at 269; see also *Cohen*, 25 F.3d at 1174; *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1312 (C.D. Cal. 1996).

120. 754 F.2d 1059 (2d Cir. 1985).

121. *Id.* at 1070 (emphasis added).

122. See *id.* at 1070-71. *Cosmas* held that allegations that insiders owned stock that they might sell raised a strong inference that the defendants acted with scienter:

[T]he allegations in the amended complaint herein do establish a motive. The amended complaint asserts that the defendants owned shares . . . and that the allegedly fraudulent statements artificially inflated or maintained the prices of [the stock]. . . . [W]e conclude that the amended complaint satisfied the scienter requirement of Rule 9(b).

*Cosmas*, 866 F.2d at 12-13. See also *Deutsch v. Flannery*, 823 F.2d 1361, 1365 n.3 (9th Cir. 1987), which similarly held that the opportunity to sell options raised an inference of scienter. *Time Warner* held that a corporate rights offering provided the motive for insiders to manipulate the price of its stock, “thereby enabling the company to set the rights offering price somewhat higher than would have been possible without the misleading statements and to lessen the dilutive effect of the offering.” *Time Warner*, 9 F.3d at 269 (emphasis added).

123. 438 F.2d 825 (2d Cir. 1970).

when bad news came out.<sup>124</sup> The defendants claimed their stock sales were “in line with their transactions in Monsanto stock in previous periods,”<sup>125</sup> and were due to innocent motives, that is, to diversify their holdings, obtain cash, and repay loans. In denying summary judgment, the Second Circuit noted that even though defendants’ overall holdings of Monsanto stock *increased* during the class period due to stock option purchases, summary judgment was not proper as their “alleged innocent motives are not inconsistent with plaintiffs’ allegations that they were selling on the basis of material inside information,” and the stock sales were evidence of scienter.<sup>126</sup> In the Ninth Circuit, meanwhile, insiders’ sales are “evidentiary facts” indicating the insiders knew their statements were false.<sup>127</sup> The insider trading allegations in these cases are sufficient to raise a strong inference of scienter.

A complaint also pleads scienter under the second approach if it pleads facts indicating reckless or conscious behavior.<sup>128</sup> In the Ninth Circuit, plaintiffs supplied sufficient evidence of scienter in various cases with the following allegations:

- Allegations that defendants *knew or recklessly ignored* that their statements were false.<sup>129</sup>
- Allegations that the defendants *knew* the statements were false.<sup>130</sup>

124. *See id.* at 827.

125. *Id.* at 828.

126. *See id.* at 827-28.

127. *See Provenz v. Miller*, 102 F.3d 1478, 1491 (9th Cir. 1996) (involving one insider who sold 20% of shares for \$1.3 million, a second who sold 90,000 shares, and a third who—after making many of the false statements—sold 3265 shares); *Fecht v. Price Co.*, 70 F.3d 1078, 1084 (9th Cir. 1994) (sales of 30,000 shares for \$1.6 million by two insiders); *Kaplan v. Rose*, 49 F.3d 1363, 1379 (9th Cir. 1994) (\$13.5 million in sales by two officers); *Marksman Partners L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1313 (C.D. Cal. 1996) (sale of 20% of one insider’s holdings); *Fisher v. Acuson Corp.*, No. C-93-20477-RMW(EAJ), 1995 U.S. Dist. LEXIS 19968, at \*3 (N.D. Cal. Apr. 26, 1995) (960,000 shares sold for \$29.7 million); *In re Gupta Corp. Sec. Litig.*, 900 F. Supp. 1217, 1231-32 (N.D. Cal. 1994) (sales by six insiders totaling \$4.2 million); *In re Seagate Technology II Sec. Litig.*, 843 F. Supp. 1341, 1371 (N.D. Cal. 1994) (sale of 30% of one insider’s holding—125,000 shares—for \$2.5 million); *O’Sullivan v. Trident Microsystems*, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,116, at 98,905 (N.D. Cal. 1994) (\$10 million in stock sales); *Rogal v. Costello*, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,245, at 95,094 (N.D. Cal. 1992) (814,489 shares sold for \$25.6 million); *Alfus v. Pyramid Tech. Corp.*, 764 F. Supp. 598, 605 (N.D. Cal. 1991) (sales of 271,459 shares for \$4.5 million by five officers and directors—11%, 21%, 61%, 68% and 80% of their holdings); *In re 3COM Sec. Litig.*, 761 F. Supp. 1411, 1417 (N.D. Cal. 1990) (\$2 million in stock sales by two corporate insiders); *Klein v. King*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,002, at 95,605 (N.D. Cal. 1990) (sales by 11 insiders for \$36 million).

128. *See Breard v. Sachnoff & Weaver, Ltd.*, 941 F.2d 142, 144 (2d Cir. 1991).

129. *See In re Wells Fargo Sec. Litig.*, 12 F.3d 922, 931 (9th Cir. 1993); *Blake v. Dierdorff*, 856 F.2d 1365, 1369-70 (9th Cir. 1988).

130. *See Hanon v. Dataproducts Corp.*, 976 F.2d 497, 507 (9th Cir. 1992); *Wells Fargo*, 12 F.3d at 930-31.

- Allegations tending to show defendants *knew or recklessly ignored* that the statements were misleading, *and that the insiders “stood to receive more compensation because of the alleged non-disclosure of material information.”* For example, allegations that officers issued false statements to protect their positions and their compensation and to increase bonus compensation *plead the specific intent to commit fraud with the requisite particularity.*<sup>131</sup>
- Allegations that a serious stock decline—from forty-five to thirty-two dollars (twenty-eight percent)—when the company reported an earnings decline followed shortly (three months) after positive statements, such that there was “*circumstantial evidence that the optimistic statements were false when made*” in the absence of any intervening catastrophic event.<sup>132</sup>

For instance, in *Hanon v. Dataproducts, Inc.*,<sup>133</sup> *no insider trading was alleged.* However, the court found other allegations sufficed for the case to survive a motion to dismiss.

Dataproducts argued its statements regarding its S1480 printer were made with a good-faith belief in their accuracy. As evidence of its good faith, Dataproducts asserted that it continued to manufacture, sell and invest millions of dollars in the S1480 from May 1988 to April 14, 1989, and that its officers did not sell their stock during the class period.

This may all be true. *However, Hanon produced evidence that Dataproducts, through its responsible employees, knew about the cold start and ink durability problems with the SI 480 in late 1987 and early 1988. . . . [T]here is a genuine issue of material fact on the issue of scienter.*<sup>134</sup>

Similarly, in *Wells Fargo*,<sup>135</sup> where no insider trading was alleged, plaintiffs provided an inference of scienter by alleging facts showing defendants *knew or recklessly ignored* that the statements were misleading, *and that the insiders “stood to receive more compensation because of the alleged non-disclosure of material information.”*<sup>136</sup>

131. *Wells Fargo*, 12 F.3d at 931 (emphasis added).

132. *Fecht v. Price Co.*, 70 F.3d 1078, 1083 (9th Cir. 1994) (emphasis added).

133. 976 F.2d 497 (9th Cir. 1992).

134. *Id.* at 507 (emphasis added).

135. 12 F.3d 922 (9th Cir. 1993).

136. *Id.* at 931.

V. THE STATUTORY SAFE HARBOR AND THE BESPEAKS CAUTION DOCTRINE WILL SELDOM SHIELD DEFENDANTS' FALSE FORWARD-LOOKING STATEMENTS AS A MATTER OF LAW

First, a forward-looking statement qualifies for protection *only* if it was "accompanied by a cautionary statement that [the statement] is a forward-looking statement."<sup>137</sup> If the forward-looking statement is oral, the particular statement must be so identified. While defendants often claim they made meaningful cautionary statements in their SEC filings of the factors that could cause their company's actual results to differ from those forecast, those warnings are often "*boilerplate*."<sup>138</sup> Even though the problems affecting a company's business *often change for the worse over time*, the generalized cautionary language in their SEC filings *does not change in any meaningful way*, thus undercutting any claim by defendants that the cautionary statements in its filings were, in fact, "meaningful cautionary" warnings, as opposed to boilerplate language to be utilized later as a defense. Often, the vague and generalized warning language in SEC filings is itself false and misleading.<sup>139</sup> Cautionary language in SEC filings cannot qualify as a meaningful cautionary statement at the pleading stage if it is alleged to be *both boilerplate and false and misleading*. Judge Smith held such allegations would prevent dismissal based on the safe harbor in a Reform Act case.<sup>140</sup>

The bespeaks-caution doctrine also can seldom result in dismissal at the pleadings stage. Often the language in SEC filings that defendants claim shields them from liability under the bespeaks-caution doctrine is nothing but a generic statement of the kind of risks that affect any rapidly growing company. Such statements may be viewed as boilerplate because they

137. 15 U.S.C. § 78u-5(c)(2)(A)(i) (Supp. II 1996).

138. "[B]oilerplate warnings will not suffice as meaningful cautionary statements . . . . A cautionary statement that misstates historical facts is not covered by the Safe harbor, it is not sufficient . . . ." H.R. CONF. REP. 104-369, at 43-44 (1995).

139. "To warn that the untoward may occur when the event is contingent is prudent; to caution that it is only possible for the unfavorable events to happen when they have already occurred is deceit." *In re Convergent Tech. Sec. Litig.*, 948 F.2d 507, 515 (9th Cir. 1991) (citation omitted); *accord Hanon v. Dataproducts Corp.*, 976 F.2d 497, 502-03 (9th Cir. 1992); *Pommer v. Medtest Corp.*, 961 F.2d 620, 624-25 (7th Cir. 1992). Thus, general statements of potential risks which conceal specific existing problems are actionable. *See Rubinstein v. Collins*, 20 F.3d 160, 171 (5th Cir. 1994); *Mayer v. Mylod*, 988 F.2d 635, 639 (6th Cir. 1993); *see also Kline v. First W. Gov't Sec.*, 24 F.3d 480, 489 (3d Cir. 1994); *In re Prudential Sec. Inc. Ltd. Partnership Litig.*, 930 F. Supp. 68, 74 (S.D.N.Y. 1996) ("The logic behind these decisions is clear. Warnings of possible detriment are insufficient if they are simply a smoke screen to cover a company's internal reasonably informed certainty of detriment." (emphasis added)).

140. *See In re Silicon Graphics Sec. Litig.*, [1996 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 99,325, at 95,967 (N.D. Cal. 1996).

contain *no disclosure of the adverse factors which were then actually negatively impacting the company's business*, and thus, in fact, are false and misleading if the business was actually being adversely affected by the problems the warnings characterized as merely risks.<sup>141</sup>

Bespeaks-caution decisions such as *In re Worlds of Wonder Securities Litigation*,<sup>142</sup> and *In re Stac Electronics Securities Litigation*,<sup>143</sup> where the challenged forward-looking statement was contained in a prospectus, that is, the document that *itself* contained explicit warnings directly related to the allegedly misrepresented matter are unusual. Most cases involve a series of false and misleading statements made over a period of months in various contexts, that is, press releases, interviews, analysts' conference calls, analysts' meetings, private communications with analysts, etc., *which were not accompanied by cautionary language*. Cases like *Provenz v. Miller*,<sup>144</sup> *Fecht v. Price Co.*,<sup>145</sup> *Warsaw v. Xoma Corp.*,<sup>146</sup> and *Silicon Graphics*,<sup>147</sup> in which defendants' claim that cautionary language in SEC filings cancelled out, as a matter of law, the false and misleading impression created by a series of optimistic statements made to the market unaccompanied by warning language, rejected the bespeaks-caution doctrine.

#### VI. NONSPEAKER DEFENDANTS MAY BE LIABLE AS CONTROL PERSONS UNDER THE "GROUP-PUBLISHED INFORMATION" OR "DISCLOSE-OR-ABSTAIN" DOCTRINES OR FOR PARTICIPATING IN A SCHEME TO DEFRAUD

Defendants often contend that only the insiders who actually made the false statement or signed the document containing the false statement are legally responsible. This is wrong. Other defendants can be held under the "group-published information" doctrine for participating in a scheme or course of business that operated as a fraud and deceit on purchasers of the stock in issue or under the "abstain-or-disclose" doctrine.

##### *A. Group-Published Information*

"In cases of corporate fraud where the false and misleading information is conveyed in prospectuses, registration statements, *annual reports*, *press*

---

141. *See id.* at 95,967-68.

142. 35 F.3d 1407 (9th Cir. 1994).

143. 89 F.3d 1399 (9th Cir. 1996).

144. 102 F.3d 1478 (9th Cir. 1996).

145. 70 F.3d 1078 (9th Cir. 1995).

146. 74 F.3d 822 (9th Cir. 1996).

147. [1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,325 (N.D. Cal. 1996).

releases, or other 'group-published information,' it is reasonable to presume that these are the collective actions of the officers."<sup>148</sup> The presumption of group publication applies to defendants who are officers<sup>149</sup> or directors<sup>150</sup> of the company. Under the group-publication doctrine, individual defendants jointly "make" corporate statements. While "aiding and abetting" and "conspiracy" theories did not survive *Central Bank, N.A. v. First Interstate Bank, N.A.*,<sup>151</sup> group publication remains a valid theory of primary liability.<sup>152</sup>

### B. Disclose-or-Abstain Doctrine

Defendants may also be liable under the disclose-or-abstain doctrine, whereby a corporate insider is liable under section 10(b) for not disclosing adverse nonpublic information if he sells corporate stock, *even if he does not actually make any false statements*. A recent First Circuit decision confirms this doctrine. In reversing dismissal of a securities class action complaint, the First Circuit stated:

There is no doubt that an individual corporate insider in possession of material nonpublic information is prohibited by the federal securities laws from trading on that information unless he makes public disclosure. He must disclose or abstain from trading. *See SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969); *see also SEC v. MacDonald*, 699 F.2d 47, 50 (1st Cir. 1983) (en banc). A central justification for the "disclose or abstain" rule is to deny corporate insiders the opportunity to profit from the inherent trading advantage they have over the rest of the contemporaneously trading market by reason of their superior access to information. *See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 235 (2d Cir. 1974); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc). The rule eliminates both the incentives that insiders would otherwise have to delay the disclosure of material information, and minimizes any

---

148. *In re GlenFed, Inc. Sec. Litig.* ("*GlenFed II*"), 60 F.3d 591, 593 (9th Cir. 1995) (emphasis added) (quoting *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1440 (9th Cir. 1987)).

149. *See GlenFed II*, 60 F.3d at 593; *Wool*, 818 F.2d at 1440.

150. *See In re Digital Microwave Corp. Sec. Litig.*, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,044, at 94,594 (N.D. Cal. 1992).

151. 511 U.S. 164 (1994); *see also GlenFed II*, 60 F.3d at 592.

152. *See GlenFed II*, 60 F.3d 593; *accord In re Health Management, Inc. Sec. Litig.*, CV 96-889 (ADS), 1997 U.S. Dist. LEXIS 10665 (E.D.N.Y. July 21, 1997); *Powers v. Eichen*, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,483 (S.D. Cal. 1997).

efficiency losses associated with the diversion of resources by insiders to "beating the market." See Robert C. Clark, *Corporate Law* 8.2, at 273-75 (1986).<sup>153</sup>

The First Circuit in *Shaw v. Digital Equipment* used a doctrine explained in *Chiarella v. United States*.<sup>154</sup> *Chiarelli* explains the disclose-or-abstain doctrine as follows:

The SEC took an important step in the development of § 10(b) when . . . [i]n *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), the Commission decided that a corporate insider must abstain from trading in the shares of his corporation unless he has first disclosed all material inside information known to him. The obligation to disclose or abstain derives from [a]n affirmative duty to disclose material information[, which] has been traditionally imposed on corporate "insiders," particular officers, directors, or controlling stockholders. We, and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. *Id.* at 911.

The Commission emphasized that the duty arose from (i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure. *Id.* at 912, and n.15. . . .

. . . But one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information "that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them." In its *Cady, Roberts* decision, the Commission recognized a relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation. This relationship gives rise to a duty to disclose because of the "necessity of preventing a corporate insider from . . . tak[ing] unfair advantage of the uninformed minority stockholders." *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del. 1951).

---

153. *Shaw v. Digital Equip.*, 82 F.3d 1194, 1203 (1st Cir. 1996) (footnote omitted).

154. 445 U.S. 222 (1980).

The federal courts have found violations of § 10(b) where corporate insiders used undisclosed information for their own benefit. *E.g.*, *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (CA2 1968), *cert. denied*, 404 U.S. 1005, 92 S. Ct. 561, 30 L.Ed.2d 558 (1971). . . .

....

. . . Application of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information.<sup>155</sup>

In a very recent decision, *United States v. O'Hagan*,<sup>156</sup> the Supreme Court reaffirmed this doctrine, stating:

Under the "traditional" or "classical theory" of insider trading liability, § 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information. Trading on such information qualifies as a "deceptive device" under § 10(b), we have affirmed, because "a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation." *Chiarella v. United States*, 445 U.S. 222, 228, 100 S. Ct. 1108, 1114, 63 L.Ed.2d 348 (1980). That relationship, we recognized, "gives rise to a duty to disclose [or to abstain from trading] because of the 'necessity of preventing a corporate insider from . . . tak[ing] unfair advantage of . . . uninformed . . . stockholders.'" *Id.*, at 228-229 (citation omitted). The classical theory applies not only to officers, directors, and other

---

155. *Chiarella*, 445 U.S. at 226-30 (footnotes omitted, emphasis added); *accord Dirks v. SEC*, 463 U.S. 646, 654 (1983) ("an insider will be liable . . . for inside trading only where he fails to disclose material nonpublic information before trading on it and thus makes 'secret profits'" (citation omitted)).

Numerous post-*Chiarella* and *Dirks* decisions have found that insiders owe a duty to a corporation's shareholders not to trade on material, non-public information. *See Feldman v. Simkins Indus., Inc.*, 679 F.2d 1299, 1303-04 (9th Cir. 1982) ("[C]orporate insider must abstain from trading in the shares of his corporation unless he has first disclosed all material inside information known to him. . . . Insider status is normally reserved for officers, directors, controlling shareholder of a corporation or those having a special relationship affording access to inside information."). In *Kronfeld v. Trans World Airlines, Inc.*, 832 F.2d 726, 732 (2d Cir. 1987), the court reversed a summary judgment ruling in favor of the defendants in a section 10(b) action where the plaintiffs claimed the defendants failed to disclose the relationship between the company and a holding company while they traded on the basis of that information. *See also SEC v. Shapiro*, 494 F.2d 1301, 1305-06 (2d Cir. 1974) (insider liable for trading in securities of the company while possessing non-public information about the company's prospects for a merger).

156. 117 S. Ct. 2199 (1997)

permanent insiders of a corporation, but also to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation. *See Dirks v. SEC*, 463 U.S. 646, 655, n.14, 103 S. Ct. 3255, 3262, 77 L.Ed.2d 911 (1983).<sup>157</sup>

### C. Fraudulent Scheme

Defendants may also be liable for the allegedly false statements that were allegedly issued as part of a *fraudulent scheme* or *course of business* which operated as a fraud or deceit on purchasers of the stock in issue even when the defendants did not personally issue such statements. A complaint that alleges each of the defendants participated in a scheme to defraud purchasers of the stock and/or course of business which operated as a fraud or deceit on the purchasers of the stock can hold all corporate insiders liable under Rule 10b-5.<sup>158</sup> While the Supreme Court in *Central Bank v. First Interstate Bank* recently held there is no aiding-and-abetting liability under section 10(b),<sup>159</sup> nothing in *Central Bank* undercut the liability of a defendant who is alleged to have participated in a fraudulent scheme or a course of business which operated as a fraud or deceit on purchasers of securities. Participating in a fraudulent scheme or course of business that operates as a fraud or deceit is a *primary violation* of Rule 10b-5. *Central Bank* stated: “*In any complex securities fraud, moreover, there are likely to be multiple violators . . .*”<sup>160</sup>

Courts have also helped define the scope of this liability. A scheme is a “plan or program of something to be done.”<sup>161</sup> A “scheme to defraud”

157. The district court of Rhode Island also explained the doctrine:

The duty to disclose triggered by insider trading is commonly known as the “disclose or abstain” rule, which prohibits an individual corporate insider from trading on inside information unless he first makes public disclosure. *See Chiarella*, 445 U.S. at 228-29, 100 S. Ct. at 1114-15; *MacDonald*, 699 F.2d at 50. . . .

In the present case, the alleged insider trading by the Individual Defendants, if proven, would certainly trigger a duty to “disclose or abstain” on the part of the individuals.

*Simon v. American Power Conversion Corp.*, 945 F. Supp. 417, 425 (D.R.I. 1996); *see also Voit v. Wonderware*, 977 F. Supp. 363 (E.D. Pa. 1997) (“a corporate insider assumes an affirmative duty to disclose when she chooses to trade in shares of her corporation”).

158. *See Cooper v. Pickett*, 122 F.3d 1186 (9th Cir. 1997).

159. 511 U.S. 164 (1994).

160. *Id.* at 191 (emphasis added); *see also Cooper*, 122 F.2d at 1194.

161. *Aaron v. SEC*, 446 U.S. 680, 696 n.13 (1980) (“Webster’s International Dictionary (2d ed. 1934) defines . . . ‘scheme’ as ‘[a] plan or program of something to be done; an enterprise; a project; as, a business scheme[, or] [a] crafty, unethical project’”); *see also WEBSTER’S INTERNATIONAL DICTIONARY* (2d ed. 1934) (To “scheme” is “[t]o form plans or designs; to devise intrigue.”); *OXFORD ENGLISH DICTIONARY* (2d ed. 1989) (defining “scheme”: “A plan, design; a programme of action . . . hence, a plan of action devised in order to attain some end; a purpose together with a system of measures contrived for its accomplishment; a project, enterprise.”); *BLACK’S LAW DICTIONARY* 1344 (6th ed. 1990) (defining

encompasses any "plan designed or concocted for perpetrating a fraud."<sup>162</sup> It has long included any scheme to defraud investors by causing securities to trade at fraudulently inflated prices.<sup>163</sup> When section 10(b) was enacted, such conduct already was an unlawful "scheme to defraud" under the mail-fraud statute and today it is called a "fraud on the market" that is actionable under section 10(b).<sup>164</sup> Every person who engages in a "scheme" to defraud is a *primary violator* of Rule 10b-5 and section 10(b) and is liable.<sup>165</sup>

The Second Circuit recently applied and followed *Central Bank* in affirming the section 10(b) liability of a corporate executive who participated in a scheme to defraud investors but made no false statement himself. The Second Circuit held:

Primary liability may be imposed "not only on persons who made fraudulent misrepresentations but also on those who had knowledge of the fraud and assisted in its perpetration." *Azzielli v. Cohen Law Offices*, 21 F.3d 512, 517 (2d Cir. 1994).

The evidence presented at trial sufficed to establish that [the executive] had knowledge of [the corporation's] frauds and participated in the fraudulent scheme.<sup>166</sup>

---

"scheme" as "[a] design or plan formed to accomplish some purpose; a system").

162. *BALLENTINE'S LAW DICTIONARY* 1142 (3d ed. 1969).

163. In *Harris v. United States*, 48 F.2d 771 (9th Cir. 1931), for example, "[t]he fraudulent scheme charged ... was one for sale of [a mining company's] corporate stock at inflated values, by the manipulation of the price of the stock on the [stock exchanges] and the circulation of false reports concerning the mine through the mails." *Id.* at 774. "In fact, the whole scheme centered around the establishment of an alleged stock exchange value which is in fact wholly fictitious." *Id.* at 775.

164. See *Basic Inc. v. Levinson*, 485 U.S. 224, 241-47 (1988); *Lipton v. Documentation, Inc.*, 734 F.2d 740, 744-47 (11th Cir. 1984).

165. See, e.g., *Shores v. Sklar*, 647 F.2d 462, 468-72 (5th Cir. 1981) (en banc); *Competitive Assoc., Inc. v. Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811, 815 (2d Cir. 1975); *In re Union Carbide Corp. Consumer Prod. Bus. Sec. Litig.*, 676 F. Supp. 458, 466-70 (S.D.N.Y. 1987); *In re ZZZZ Best Sec. Litig.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,416, at 97,070 (C.D. Cal. 1990).

In the case of *In re ZZZZ Best Securities Litigation*, 864 F. Supp. 960 (C.D. Cal. 1994), the auditor never certified a financial statement, but only reviewed one interim financial statement. The auditor never made a statement, but *utilized the scheme and course of business rationale*. Judge Lew denied summary judgment, holding the auditor could be held *directly* liable for the false statements by ZZZZ Best officers in press releases, SEC filings and a ZZZZ Best prospectus, as they were issued as part of a fraudulent scheme or course of business that operated as a fraud and deceit on ZZZZ Best stock purchasers. See *id.* at 970.

166. *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1471 (2d Cir. 1996). This was already the law in the Ninth Circuit. See *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615, 628 n.31, 629 (9th Cir. 1994) (accountant who participated in letter to SEC that was a part of a fraudulent scheme was primarily liable); see also *Adam v. Silicon Valley Bancshares*, 884 F. Supp. 1398, 1401 (N.D. Cal. 1995) (recognizing the validity of *Software Toolworks* on this point); *Employers Ins. v. Musick, Peeler & Garrett*, 871 F. Supp. 381, 389 (S.D. Cal. 1994) (same); *Flecker v. Hollywood Entertainment*, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶99,436 (D. Or. Feb. 12, 1997), ("defendants' roles as

This analysis is authorized by the text of section 10(b). According to *Hochfelder*, section 10(b)'s prohibition of "any manipulative or deceptive device or contrivance" necessarily encompasses any "scheme to defraud."<sup>167</sup> The Court referred to the dictionary definitions of section 10(b)'s words, to find that a "device" is "[t]hat which is devised, or formed by design; a contrivance; an invention; project; *scheme*; often, a *scheme to deceive*; a stratagem; an artifice. . . ."<sup>168</sup> It found that a "contrivance" means "[a] thing contrived or used in contriving; a *scheme, plan, or artifice*."<sup>169</sup> Rule 10b-5 prohibits any "device, *scheme*, or artifice to defraud."<sup>170</sup> In fact, Rule 10b-5 makes it unlawful for any person "*directly or indirectly*" to employ "any device, *scheme*, or artifice to defraud . . . or . . . [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."<sup>171</sup>

*Affiliated Ute Citizens v. United States*<sup>172</sup> held that "the second subparagraph of the rule specifies the making of an untrue statement of a material fact and the omission to state a material fact," but held that "[t]he first and third subparagraphs are not so restricted."<sup>173</sup> It held defendants violated Rule 10b-5 by participating in "a 'course of business' or a 'device, *scheme* or artifice' that operated as a fraud"—*even though these defendants had never themselves said anything that was false or misleading*.<sup>174</sup> "Not every violation of the anti-fraud provisions of the federal securities law can be, or should be, forced into a category headed 'misrepresentations' or 'non-disclosures.' Fraudulent devices, practices, *schemes*, artifices and *courses of business* are also interdicted by the securities laws."<sup>175</sup>

analysts, investment bankers and business advisors with . . . superior access to non-public information and participation in both drafting and decision-making is sufficient to establish . . . primary liability").

167. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 n.20 (1976) (quoting WEBSTER'S INTERNATIONAL DICTIONARY (2d ed. 1934)) (emphasis added).

168. *Id.* (emphasis added).

169. *Id.* (emphasis added); see also *Aaron v. SEC*, 446 U.S. 680, 696 n.13 (1980).

170. 17 C.F.R. § 240.10b-5(a) (1997) (emphasis added).

171. *Id.* § 240.10b-5(a),(c) (emphasis added).

172. 406 U.S. 128 (1972).

173. *Id.* at 152-53 (emphasis added).

174. See *id.* at 153 (emphasis added).

175. *Competitive Assoc., Inc. v. Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811, 814 (2d Cir. 1975) (emphasis added). The court added that "both misrepresentations and omissions are alleged to be only one aspect of an elaborate scheme to defraud," and anyone who participated in that scheme is liable. See *id.* (emphasis added). Rules 10b-5(1) and (3) are aimed at "broader schemes of securities fraud" than are necessarily embodied in false statements or documents, and the "classic" fraud on the market case [which] arises out of transactions on an open and developed market" that easily fits within the expansive language of Rule 10b-5(1) and (3). *Lipton v. Documation, Inc.*, 734 F.2d 740, 744, 745 (11th Cir. 1984). Thus, in *Shores v. Sklar*, 647 F.2d 463, 468 (5th Cir. 1981), the Fifth Circuit held en banc that a defendant who did not make the statements in a misleading offering circular could be held primarily liable as a

VII. DEFENDANTS MAY BE LIABLE FOR STATEMENTS THEY MADE  
TO ANALYSTS AND FOR STATEMENTS CONTAINED IN ANALYSTS'  
REPORTS

Modern securities class actions frequently involve insiders' liability for false statements made by company officers to analysts in conference calls, and in presentations to *or* in meetings with analysts. Securities class actions also involve statements about the company in third party reports by analysts. Section 10(b) prohibits false statements, whether made "directly or indirectly,"<sup>176</sup> and section 20(b) specifies that it is unlawful for a person "to do any act . . . which it would be unlawful for such person to do under . . . this chapter or any rule or regulation thereunder *through or by means of any other person.*"<sup>177</sup> "No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices."<sup>178</sup> Thus, "[n]umerous courts have recognized that Section 10(b) liability can be predicated upon a defendant's false statement to securities analysts or to the financial or news media."<sup>179</sup> Many decisions uphold securities fraud claims based on false statements to analysts.<sup>180</sup>

*Basic, Inc. v. Levinson*,<sup>181</sup> adopted the fraud-on-the-market theory because "market professionals [that is, securities analysts] generally consider most publicly announced material statements about companies, thereby affecting stock market prices."<sup>182</sup> Analysts perform a crucial function that "is

participant in a scheme to defraud of which that circular was only a part: "Rather than containing the entire fraud, the Offering Circular was assertedly only one step in the course of an elaborate *scheme.*" *Id.* (emphasis added); *see also* *Lipton*, 734 F.2d at 744, 745, 747; *In re* Union Carbide Corp. Consumer Prod. Bus. Sec. Litig., 676 F. Supp. 458, 466-70 (S.D.N.Y. 1987).

176. 15 U.S.C. § 78j(b) (1994).

177. 15 U.S.C. § 78t(b) (1994) (emphasis added). Section 20(b) defines the scope of conduct that constitutes a violation of rules promulgated pursuant to section 10(b), and thus of section 10(b) itself. *See* *Dirks v. SEC*, 463 U.S. 646, 659 (1983); *Short Sales In Connection With A Public Offering*, Securities Act Release No. 6798, Exchange Act Release No. 26028, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,315, at 89,389 & n.22 (Aug. 25, 1988).

178. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477 (1977).

179. *Harvey M. Jasper Retirement Trust v. Ivax Corp.*, 920 F. Supp. 1260, 1267 (S.D. Fla. 1995).

180. *See, e.g.,* *Cooper v. Pickett*, 122 F.2d 1186 (9th Cir. 1997) (forecasts and other positive statements in conference calls and fed to analysts privately for inclusion in reports); *Provenz v. Miller*, 102 F.3d 1478, 1487-88 (9th Cir. 1996) (forecasts and statements about new product in conference calls with analysts); *Warshaw v. Xoma Corp.*, 74 F.3d 955, 959 (9th Cir. 1996) (statements to analysts); *Fecht v. Price Co.*, 70 F.3d 1078, 1080 (9th Cir. 1995) (statements in analysts' reports prepared with approval and guidance of the company); *Kaplan*, 49 F.3d at 1375 (statements in analyst report); *Marx v. Computer Sciences Corp.*, 507 F.2d 485, 488-89 (9th Cir. 1974) (earnings forecast to meeting of analysts).

181. 485 U.S. 224 (1988).

182. *Id.* at 246 n.24; *see* *Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996).

necessary to the preservation of a healthy market.”<sup>183</sup> The market relies on analysts to “‘ferret out and analyze information,’ . . . often . . . by meeting with and questioning corporate officers and others who are insiders.”<sup>184</sup> The information analysts obtain from corporate insiders provides “the basis for judgments as to the market worth of a corporation’s securities.”<sup>185</sup> Thus, a company that provides false information to analysts can expect it to mislead not just them but the entire market.<sup>186</sup>

A crucial distinction must be kept in mind, that is, liability of insiders *for their statements to analysts* versus liability of insiders for statements *about their company appearing in reports written by analysts*. As to the first category—statements to analysts—there can be no dispute as to the insiders’ liability for such statements. These are statements made to market professionals, no different from those in press releases, press interviews or corporate reports. These are *statements by the defendants to the market* and if material, false and issued with scienter, section 10(b) liability attaches.<sup>187</sup> As to the second category—liability for statements made by a third party analyst about a company without any input from the company—because these are statements *by third parties* about the issuer, liability is more restrictive and attaches only if the issuer or insider was “*entangled*” in the creation of the report or put their “*imprimatur, express or implied,*” on the report’s contents.<sup>188</sup>

Judge Orrick recently synthesized these precedents in *In re Cirrus Logic Securities Litigation*:<sup>189</sup>

A company can be liable for the opinions and statements of *third parties* only if the company “put [its] imprimatur, express or implied” on the third-party statements. *Stac*, 89 F.3d at 1410 (quoting *VeriFone*, 784 F. Supp. at 1486). To succeed on this theory of liability, *typically employed where defendants have not made misleading statements directly*, plaintiffs must show that “the company adopted, endorsed or sufficiently entangled itself with the [analysts’ opinions] to render

183. *Dirks v. SEC*, 463 U.S. 646, 658 (1983).

184. *Id.*

185. *Id.* at 659.

186. *See Basic*, 485 U.S. at 246 n.24; *Dirks*, 463 U.S. at 658-59 & n.17; *Warshaw v. Xoma Corp.*, 74 F.3d 955, 959 (9th Cir. 1996); *Fecht v. Price Co.*, 70 F.3d 1078, 1080 (9th Cir. 1995).

187. *See Provenz v. Miller*, 102 F.3d 1478, 1487-88 (9th Cir. 1996); *Warshaw*, 74 F.3d at 959; *Marx v. Computer Sciences Corp.*, 507 F.2d 485, 488-89 (9th Cir. 1974).

188. *See In re Syntex Corp. Sec. Litig.*, 95 F.3d 922, 934 (9th Cir. 1996) (“In order to be liable for . . . third-party forecasts, defendants must have put their imprimatur, express or implied, on the projections.” (citation omitted)); *In re Stac Elecs. Sec. Litig.*, 89 F.3d 1399, 1410 (9th Cir. 1996) (same).

189. 946 F. Supp. 1446, 1465-67 (N.D. Cal. 1996).

them attributable to [the company].” *Syntex*, 855 F. Supp. at 1097 . . . . The policy behind the adoption or entanglement requirement for this theory of liability is that a company should not be held responsible for the opinions of a third party over which it has no control.

. . . .

Defendants also argue that they cannot be held liable for allegedly misleading statements made *to* analysts, unless plaintiffs can prove Cirrus’s entanglement with, or adoption of, the analysts’ reports. *This is not the law*. Rule 10b-5 makes it unlawful 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 light of the circumstances under which they were made, not misleading.” 17 C.F.R. § 240.10b-5(b). *There is no exception for misleading statements made to investment analysts*.

Defendants confuse the test under which they can be held indirectly liable for misleading opinions or statements *by* analysts or other third parties with the test under which they can be held directly liable for their own misleading statements *to* analysts. Defendants “cannot escape liability simply because [they] carried out [their] alleged fraud through the public statements of third parties.” *Warshaw v. Xoma Corp.*, 74 F.3d 955, 959 (9th Cir. 1996). . . .

A company may not lie to securities analysts and avoid liability for its misrepresentations by refusing to adopt the analyst reports incorporating the misrepresentations. If a company chooses to speak to the market on a subject, through an analyst or otherwise, it is obligated to make a full and fair disclosure to ensure that its statements are not materially misleading.

. . . .

The Court finds that a company may be liable under Rule 10b-5 for its own intentional or reckless misrepresentations to analysts that reach the market, whether or not the company adopts the resulting analysts’ reports.<sup>190</sup>

And as Chief Judge Henderson recently stated:

In other words, plaintiffs have a choice with respect to analyst reports: they may *either* show that the corporate insiders adopted the reports, and thus may treat the reports as direct statements of the corporation, *or* they may show that, irrespective of the adoption of the reports,

---

190. *Id.* (emphasis added).

corporate insiders made specific misleading statements to analysts in the course of particular briefings.<sup>191</sup>

### VIII. CONCLUSION

With the passage of almost three years since the Reform Act went into effect, there has yet to be a single court of appeal decision interpreting any of the Reform Act's substantive provisions. Thus, it is still far too early to determine what impact the Act will have on the ability of the securities class action device to continue to fulfill its historic role as both an effective deterrent of securities fraud, as well as an efficient means by which individual losses sustained as a result of such fraud can be recovered. The importance of the Reform Act's provisions has been heightened by the recent passage of the Securities Litigation Uniform Standards Act of 1998, which preempts class actions under the states' securities laws. Thus, investors have lost their ability to bring class actions in state court for securities fraud. Whether the loss of this alternative forum will substantively impact investors' ability to safeguard their interests in the securities markets will be determined by the resolution of the questions regarding the interpretation of the Reform Act's various provisions outlined in this paper. If the traditional scienter standards are reaffirmed, and the pleading standards found to be no more restrictive than those formerly existing within the Second Circuit, the loss of the state court forums may not be harmful. If, however, judicial interpretation of the Reform Act embraces the tortured interpretations offered by the defendants to date, the resulting gutting of the federal securities laws will, when combined with the effect of the elimination of any alternative forum for class actions in the state courts, have disastrous consequences for our nation's investors and perhaps, ultimately, on its capital markets.

---

191. *Wiesel v. Kennedy*, No. C-95-4472 TEH, slip op. at 5 (N.D. Cal. Nov. 12, 1996) (emphasis in original).