Striking an Imbalance: The Interpretation of Section 21D(b)(2) of the Securities Exchange Act of 1934 in *Silicon Graphics*

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Since the enactment of the Private Securities Litigation Reform Act of 1995, courts have struggled to interpret the new "strong inference" standard for pleading scienter. In In re Silicon Graphics, Inc. Securities Litigation, *the Northern District of California held that the Reform Act, in new section 21(D)(b)(2) of the Securities Exchange Act of 1934, requires plaintiffs to plead facts creating "a strong inference of knowing, or intentional misconduct" and that allegations of motive and opportunity are insufficient to satisfy the "strong inference" standard. This Comment analyzes the court's decision in* Silicon Graphics *from a statutory construction perspective. The author argues that the court's interpretation of the Reform Act placed too much reliance on inconsistent and ambiguous legislative history, while ignoring text and structure. As a result, the author contends, the court's opinion provides an "imbalanced" standard for pleading scienter—one which erects too great of a barrier to meritorious fraud claims. The author concludes by proposing an alternative interpretation of section 21D(b)(2), which is not only faithful to the text, structure, and legislative history of the Reform Act, but is also consistent with the purposes behind the federal securities laws.*

I. INTRODUCTION

Enacted in December of 1995, the Private Securities Litigation Reform Act of 1995[1] (Reform Act) has been touted as the most sweeping revision of the federal securities laws since the 1933 and 1934 Acts.[2] Prompted by evidence of abuse in private securities lawsuits,[3] the Reform Act focused its attention on a rather narrow category of cases—class action lawsuits alleging securities law violations.[4]

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[1] Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995).

[2] *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, 960 (1996). The Securities Act of 1933 is codified at 15 U.S.C. §§ 77a–77aa (1994). The Securities Exchange Act of 1934 is codified at 15 U.S.C. §§ 78a–78ll (1994).

[3] *See* H.R. CONF. REP. NO. 104-369, at 31–32, *reprinted in* 1995 U.S.C.C.A.N. 679, 748; *infra* notes 73–74 and accompanying text.

[4] *See* 109 Stat. at 737.

The Reform Act implemented a number of procedural protections in order to discourage frivolous litigation.[5] One of the most controversial of these protections is the Reform Act's heightened pleading standards.[6] Under new section 21D(b)[7] of the Securities Exchange Act of 1934, a plaintiff which alleges that a defendant made an untrue statement of a material fact or a material omission, must now "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and [ ] if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."[8] In addition, in private securities actions in which a particular state of mind must be proven, the Reform Act requires that "the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[9]

The Reform Act has brought about a tide of scholarly comment since its enactment in 1995. Proponents of the legislation have hailed its passage as substantial progress toward restoring the integrity of federal securities laws,[10] while its opponents, particularly the plaintiff's bar, have sharply criticized the Act for going too far and erecting too great a barrier to meritorious claims.[11] Although it is still too early to predict the full effect of the Reform Act,[12] one significant

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[5] *See* H.R. CONF. REP. NO. 104-369, at 35–36, *reprinted in* 1995 U.S.C.C.A.N. 679, 748; *see also infra* notes 75–82 and accompanying text.

[6] *See* 15 U.S.C. § 78u-4(b) (1994 & Supp. II 1996).

[7] *See* 109 Stat. at 747.

[8] 15 U.S.C. § 78u-4(b)(1) (Supp. II 1996).

[9] 15 U.S.C. § 78u-4(b)(2) (Supp. II 1996).

[10] *See, e.g.*, Bruce G. Vanyo et al., *The Pleading Standard of the Private Securities Litigation Reform Act of 1995*, *in* SECURITIES LITIGATION 1997, at 73 (PLI Corp. L. & Practice Course Handbook Series No. B-1015, 1997) (stating that "[i]n December 1995, Congress passed an extraordinary statute."). Bruce Vanyo, an attorney with substantial experience defending technology companies against securities litigation, was a major advocate for the changes brought about by the Reform Act. *See* D.M. Osborne, *Getting Back at Lerach*, THE AM. LAW., Sept. 1997, at 49–50.

[11] *See* Paul H. Dawes, *Pleading Motions Under the Private Securities Litigation Reform Act of 1995*, *in* SECURITIES LITIGATION 1996, at 39 (PLI Corp. L. & Practice Course Handbook Series No. B4-7165, 1996).

[12] There has been a great deal of commentary on the initial impact of the Reform Act. *See, e.g.*, Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year's Experience*, *in* SECURITIES LITIGATION 1997, at 955 (PLI Corp. L. & Practice Course Handbook Series No. B-1015, 1997); Joseph A. Grundfest & Michael A. Perino, *Ten Things We Know and Ten Things We Don't Know About the Private Securities Litigation Reform Act of 1995*, *in* SECURITIES LITIGATION 1997, at 1015 (PLI Corp. L. & Practice Course Handbook Series No. B-1015, 1997) [hereinafter Grundfest & Perino, *Ten Things*]; Richard H. Walker, *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995*, *in* SECURITIES LITIGATION 1997, at 143 (PLI Corp. L. & Practice Course Handbook Series No. B-1015, 1997) [hereinafter Walker, *Report*]; Richard

effect of the Act is already discernible—the interpretation of its provisions is generating substantial litigation.[13]

The "strong inference" requirement for pleading scienter has proven to be the most troublesome provision of the Reform Act for the courts to apply.[14] Although many courts interpreting the provision have concluded that the Reform Act merely codifies the pre-Reform Act pleading standard of the Second Circuit,[15] the strictest standard in existence prior to the Act,[16] a few courts have concluded that the Reform Act's standard is even stricter than the Second Circuit's.[17]

H. Walker, *Testimony of Arthur Levitt, Chairman U.S. Securities and Exchange Commission Concerning the Impact of the Private Securities Litigation Reform Act of 1995*, *in* SECURITIES LITIGATION 1997, at 273 (PLI Corp. L. & Practice Course Handbook Series No. B-1015, 1997); Richard H. Walker et al., *The New Securities Class Action: Federal Obstacles, State Detours*, 39 ARIZ. L. REV. 641 (1997).

Thus far, there does not appear to be any substantial change in the volume of litigation as a result of the Reform Act. *See* Walker, *Report*, *supra*, at 175. There has been, however, a noticeable shift of activity from federal courts to state courts in the post-Reform Act period. *See* Grundfest & Perino, *Ten Things*, *supra* at 1021; Mike France, *Bye, Fraud Suits. Hello, Fraud Suits*, BUS. WK., June 24, 1996, at 127 (noting that the number of securities fraud actions brought in California state courts has increased five-fold since the Reform Act). As a result of this shift from federal to state courts, Congress enacted the Securities Litigation Uniform Standards Act of 1998 (SLUSA), Pub. L. No. 105-353, 112 Stat. 3227 (1998). The SLUSA amends the 1933 and 1934 Acts to provide for federal preemption of certain "covered class action[s]" involving securities fraud and for mandatory removal of certain "covered class action[s]" from state court to federal district court. *See id.* § 16(b)–(c).

For the most current information regarding securities fraud litigation under the Reform Act, including filing statistics, case decisions, settlement information, and securities-related reports and articles, see *The Securities Class Action Clearinghouse* (last modified Feb. 2, 1998) <http://securities.stanford.edu>.

[13] Some commentators immediately predicted the Act would generate litigation "over virtually every one of its provisions," primarily because of what they perceived as "ambiguous[ ] draft[ing]" and provisions which "do not fit readily into existing procedural and substantive law." Walter Rieman et al., *The Private Securities Litigation Reform Act of 1995: A User's Guide*, 24 SEC. REG. L.J. 143, 144 (1996).

[14] Although not completely void of application problems, the pleading requirements in § 78u-4(b)(1) have not proved as controversial as the "strong inference" requirement. This may be due to the fact that many courts were applying similar requirements prior to the Reform Act. *See id.* at 165.

[15] *See, e.g.*, Fugman v. Aprogenex, Inc., 961 F. Supp. 1190, 1195 (N.D. Ill. 1997); Rehm v. Eagle Fin. Corp., 954 F. Supp. 1246, 1251–53 (N.D. Ill. 1997); Zeid v. Kimberley, 930 F. Supp. 431, 438 (N.D. Cal. 1996); Marksman Partners v. Chantal Pharmaceuticals Corp., 927 F. Supp. 1297, 1311 (C.D. Cal. 1996). For discussion of the pre-Reform Act Second Circuit standard, see *infra* Part II.B.1.

[16] *See* H.R. CONF. REP. NO. 104-369, at 31–32, *reprinted in* 1995 U.S.C.C.A.N. 679, 748.

[17] *See, e.g.*, Novak v. Kasaks, 997 F. Supp. 425, 430 (S.D.N.Y. 1998); Powers v. Eichen, 977 F. Supp. 1031, 1038–39 (S.D. Cal. 1997); Voit v. Wonderware, Corp., 977 F. Supp. 363, 373 (E.D. Pa. 1997); Norwood Venture Corp. v. Converse Inc., 959 F. Supp. 205, 208 (S.D.N.Y. 1997); Friedberg v. Discreet Logic Inc., 959 F. Supp. 42, 48–50 (D. Mass. 1997).

In *In re Silicon Graphics, Inc. Securities Litigation*[18] (*Silicon Graphics I*), the Northern District of California broke from the majority position and held that the Reform Act imposes a stronger standard of pleading scienter than the pre-Reform Act Second Circuit.[19] The court relied heavily on the Conference Committee Report, as well as the President's Veto Message, to conclude that allegations of motive and opportunity were no longer sufficient to satisfy the Reform Act's "strong inference" standard, nor was recklessness sufficient to establish scienter for purposes of section 10(b).[20] Instead, the court held that plaintiffs must now "allege specific facts that constitute circumstantial evidence of conscious behavior by defendants."[21]

Retreating somewhat from its earlier position, the court in *In re Silicon Graphics, Inc. Securities Litigation*[22] (*Silicon Graphics II*) found that plaintiffs are required to plead facts creating "a strong inference of knowing or intentional misconduct."[23] This time, however, the court expressly recognized that "deliberate recklessness" is sufficient.[24] The court nonetheless reaffirmed its earlier position that allegations of motive and opportunity are insufficient to satisfy the Reform Act's "strong inference" standard.[25]

This Case Comment analyzes the *Silicon Graphics* decisions and addresses the court's dynamic approaches to statutory interpretation, which abandon traditional restraints based on consideration of legislative text, structure, and purpose. Part II reviews the parameters of the section 10(b) and Rule 10b-5 cause of action as developed by the courts prior to the Reform Act. Part III provides an overview of the Reform Act, focusing on the new pleading requirements for actions brought under section 10(b)[26] and Rule 10b-5.[27] Part IV outlines the facts and procedural history handed down by the California district court in the *Silicon Graphics* litigation and reviews the holdings and reasoning of the two decisions. Finally, Part V analyzes the *Silicon Graphics* litigation, criticizing the holdings regarding recklessness and pleading scienter under the Reform Act from a statutory construction perspective. Part V also evaluates the implications of the *Silicon Graphics* holdings and criticizes the court's interpretation of section

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[18] [1996–1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,325 at 95,957 (N.D. Cal. Sept. 25, 1996), *available in* 1996 WL 664639.

[19] *See id.* at 95,962–63.

[20] *See id.* at 95,962.

[21] *Id.*

[22] 970 F. Supp. 746 (N.D. Cal. 1997).

[23] *Id.* at 757.

[24] *Id.*

[25] *See id.* at 756–57. The court may have retreated somewhat from its earlier outright rejection of motive and opportunity in *Silicon Graphics I*. *See infra* note 158.

[26] Securities Exchange Act of 1934, Pub. L. No. 73-291, § 10(b), 48 Stat. 881, 891 (codified at 15 U.S.C. § 78j(b) (1994)).

[27] 17 C.F.R. § 240.10b-5 (1997).

21D(b)(2)[28] for effectively undermining the purposes of the federal securities laws. This Comment concludes in Part VI by suggesting an intermediate interpretation of the Reform Act's pleading standard—one that is more consistent with the text, purpose, and legislative history of the Reform Act.

II. SECTION 10(b) AND RULE 10b-5 PRIOR TO THE REFORM ACT

Federal securities regulation in this country originated in the aftermath of the stock market crash of 1929.[29] With the purpose of protecting investors and restoring credibility to the fledging securities markets,[30] Congress passed the Securities Act of 1933 (1933 Act)[31] and the Securities Exchange Act of 1934 (1934 Act).[32]

Section 10(b) of the 1934 Act is a broad anti-fraud provision which has proved to be a formidable tool for the protection of investors. Section 10(b) makes it "unlawful . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commissioner may prescribe."[33] By itself, section 10(b) does not make anything unlawful. However, in 1942, pursuant to its authority under section 10(b), the SEC promulgated Rule 10b-5:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the

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[28] The Private Securities Reform Act of 1995, Pub. L. No. 104-67, § 10(b), 109 Stat. 737, 747 (1995).

[29] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976); *see also* James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959).

[30] *See* Landis, *supra* note 29, at 30.

[31] Securities Act of 1933, ch. 38, 48 Stat. 74 (codified at 15 U.S.C. §§ 77a–77aa (1994)). The 1933 Act was enacted to provide a system of full disclosure with respect to public offerings, to protect against fraud in offers and sales of securities, and to promote honest and fair transactions. *See Hochfelder*, 425 U.S. at 195 (citing H.R. REP. NO. 73-85, at 1–5 (1933)).

[32] Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified at 15 U.S.C. §§ 78a–78ll (1994)). The purpose of the 1934 Act was "to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges." *Hochfelder*, 425 U.S. at 195 (citing S. REP. NO. 792, at 1–5 (1934)). The 1934 Act also created the Securities Exchange Commission. *See* Securities Exchange Act of 1934 § 4, 15 U.S.C. § 78d (1994).

[33] 15 U.S.C. § 78j(b) (1994).

circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.[34]

Although neither section 10(b) nor Rule 10b-5 by their terms provide for an express civil remedy for a violation of their prohibitions,[35] the lower courts began implying a private cause of action under section 10(b) and Rule 10b-5 in 1946.[36] The Supreme Court, after years of acquiescence to the practice of the lower courts, now recognizes the existence of such a private cause of action as firmly established.[37] Today, the implied private right of action under section 10(b) and Rule 10b-5 constitutes an "essential tool for enforcement of the 1934 Act's requirements."[38]

As would logically be expected of a judicially developed implied cause of action, questions have inevitably arisen regarding the precise contours of a 10b-5 action.[39] Although the Supreme Court has occasionally taken the opportunity to address particular elements of the 10b-5 action,[40] the Court has often left to the lower courts the task of hammering out the particulars. This has often resulted in conflict among the circuits as to the parameters of the 10b-5 action.

A. *Recklessness Under Section 10(b) and Rule 10b-5*

The issue of state of mind in a 10b-5 action has historically caused a great

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[34] 17 C.F.R. § 240.10b-5 (1997).

[35] Nor does it seem that Congress or the Commission contemplated such a private remedy. *See Hochfelder*, 425 U.S. at 196 ("[T]here is no indication that Congress, or the Commission when adopting Rule 10b-5, contemplated such a remedy.").

[36] The first reported decision implying a private right of action for damages for violations of § 10(b) and Rule 10b-5 was *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946).

[37] *See, e.g.*, Basic v. Levinson, 485 U.S. 224, 230–31 (1988).

[38] *Id.* at 231. Private causes of action constitute the vast majority of cases brought under § 10(b) and Rule 10b-5 today. *See* Kevin R. Johnson, *Liability for Reckless Misrepresentations and Omissions Under Section 10(b) of the Securities Exchange Act of 1934*, 59 U. CIN. L. REV. 667, 669–70 (1991).

[39] *See* Johnson, *supra* note 38, at 670. The basic elements of a 10b-5 action are generally accepted as: (1) A misstatement or omission; (2) of a material fact; (3) made with scienter; (4) in connection with the purchase or sale of securities; (5) upon which plaintiff relied; and (5) that reliance proximately caused the plaintiff injury. *See, e.g.*, Melder v. Morris, 27 F.3d 1097, 1100 (5th Cir. 1994); *In re* Phillips Petroleum Sec. Litig., 881 F.2d 1236, 1244 (3d Cir. 1989).

[40] *See, e.g.*, Central Bank v. First Interstate Bank, 511 U.S. 164, 170–92 (1994) (no private cause of action for aiding and abetting); *Basic*, 485 U.S. at 230–32 (materiality requirement); Dirks v. SEC, 463 U.S. 646, 653–54 (1983) (duty to disclose requirement for insider trading claim).

deal of conflict among the lower courts.[41] In the 1960's and early 1970's, a split developed among the courts of appeals as to whether negligence would suffice for liability under 10b-5, or whether some form of scienter was required.[42] In 1976, the Supreme Court answered this question in the landmark case of *Ernst & Ernst v. Hockfelder*.[43] The Court held that "scienter"—an "intent to deceive, manipulate, or defraud"—was a prerequisite to liability under section 10(b) and Rule 10b-5.[44] Negligence, according to the Court, was an insufficient basis for imposing liability under these provisions.[45]

While defining scienter as a "mental state embracing intent to deceive, manipulate, or defraud,"[46] the Court in *Hochfelder* refused to address the related issue of whether "scienter" under section 10(b) and Rule 10b-5 encompassed recklessness.[47] The Court left this possibility open when it stated that "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act."[48] In effect, the Court left it to the lower courts to resolve the issue.

Seizing upon the opening left by the *Hochfelder* opinion, the courts of appeals addressing the issue have unanimously concluded that a showing of recklessness is sufficient under section 10(b) and Rule 10b-5.[49] One of the first cases elaborating on this issue was *Sundstrand Corp. v. Sun Chemical Corp.*[50]

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[41] For a thorough discussion of the conflict over the definition of recklessness, see Johnson, *supra* note 38.

[42] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976) (comparing cases).

[43] 425 U.S. 185 (1976).

[44] *See id.* at 193.

[45] *See id.* In reaching its decision, the *Hochfelder* Court placed particular emphasis on the words "manipulative," "deceptive," and "contrivance" in § 10(b). *See id.* at 197–99. According to the Court, these words "strongly suggest that section 10(b) was intended to proscribe knowing or intentional misconduct." *Id.* at 197.

[46] *Id.* at 193 n.12.

[47] "We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under section 10(b) and Rule 10b-5." *Id.*

[48] *Id.*

[49] The courts of appeals that have found recklessness to be sufficient include: Searls v. Glasser, 64 F.3d 1061, 1065–66 (7th Cir. 1995); Dannenberg v. Painewebber (*In re* Software Toolworks), 50 F.3d 615, 626 (9th Cir. 1994); Melder v. Morris, 27 F.3d 1097, 1102 (5th Cir. 1994); Stone v. Kirk, 8 F.3d 1079, 1086 (6th Cir. 1993); SEC v. Steadman, 967 F.2d 636, 641–42 (D.C. Cir. 1992); Backman v. Polaroid Corp., 910 F.2d 10 (1st Cir. 1990); Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569–70 (9th Cir. 1990); Van Dyke v. Coburn Enter., 873 F.2d 1094, 1100 (8th Cir. 1989); Woods v. Barnett Bank, 765 F.2d 1004, 1010 (11th Cir. 1985); Hackbart v. Holmes, 675 F.2d 1114, 1117 (10th Cir. 1982); Broad v. Rockwell Int'l Corp., 642 F.2d 929, 961 (5th Cir.) (en banc), *cert. denied*, 454 U.S. 965 (1981); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1044–46 (7th Cir. 1977).

[50] 553 F.2d 1033 (7th Cir. 1977).

This case involved a section 10(b) and Rule 10b-5 action by Sundstrand Corporation alleging that Sun Chemical Corporation had made misrepresentations and failed to disclose material facts about the performance and financial condition of Standard Kollsman Industries (SKI) during negotiations regarding the potential merger of SKI into Sundstrand.[51] In holding defendants liable, the Seventh Circuit expressly recognized that recklessness was sufficient under section 10(b) and Rule 10b-5 and articulated a definition of recklessness that has been accepted by a majority of courts:[52]

> [R]eckless conduct . . . [is] a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.[53]

The *Sundstrand* court supported the imposition of liability in Rule 10b-5 actions based on recklessness by analogy to common law actions of fraud and deceit.[54] Because recklessness was sufficient at common law to support actions in fraud or deceit,[55] the Seventh Circuit found it "inappropriate to construe the Rule 10b-5 remedy to be more restrictive."[56] Perhaps more important to the resolution

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[51] *See id.* at 1037. The defendants consisted of SKI, the chairman of the board and president of SKI, and an outside director of SKI. *See id.* at 1036–37.

[52] Some commentators have suggested that there exists a disagreement when it comes to defining recklessness. *See* Johnson, *supra* note 38, at 685–86 ("Unfortunately, the courts are substantially less in agreement on the precise meaning of the term 'recklessness.'"). Without analyzing the actual application of the recklessness standard by the various circuit courts, however, it seems that the majority of circuits are in general agreement. Whether labeling it "extreme recklessness," *see Steadman*, 967 F.2d at 641, "severe reckless," *see, e.g.*, *Melder*, 27 F.3d at 1102, or just plain "recklessness," *see, e.g.*, *Hollinger*, 914 F.2d at 1569, the majority of circuit courts appear to employ the *Sundstrand* definition of recklessness, or a variation thereof. *See, e.g.*, Nordstrom, Inc. v. Chubb & Son, Inc., 54 F.3d 1424, 1435–36 (9th Cir. 1995); *Steadman*, 967 F.2d at 641–42; *Woods*, 765 F.2d at 1010; *Hackbart*, 675 F.2d at 1118; *Broad*, 642 F.2d at 961.

[53] *Sundstrand*, 553 F.2d at 1045 (quoting Franke v. Midwestern Okla. Dev. Auth., 428 F. Supp. 719 (W.D. Okla. 1976)). Under this definition, the Seventh Circuit noted, "the danger of misleading buyers must be actually known or so obvious that any reasonable man would be legally bound as knowing." *Id.* The Seventh Circuit noted that its standard was to serve as the "legally functional equivalent for intent." *Id.* As another circuit court has stated, it is a standard only one step down from intent, *see* Kaplan v. Rose, 49 F.3d 1363, 1378 (9th Cir. 1994), and not just a heightened form of ordinary negligence. *See Steadman*, 967 F.2d at 641.

[54] *See Sundstrand*, 553 F.2d at 1044.

[55] As one court addressing the issue noted: "[A]t common law, reckless conduct is viewed as a form of knowing conduct." Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 45 (2d Cir. 1978).

[56] *Sundstrand*, 553 F.2d at 1044.

of this issue by the courts, however, was the practical implication of their decision: "To require in all types of 10b-5 cases that a factfinder must find a specific intent to deceive or defraud would for all intents and purposes disembowel the private cause of action under § 10(b)."[57]

B. *Pleading Scienter Under Section 10(b) and Rule 10b-5*

In contrast to the general agreement concerning the sufficiency of recklessness, there was a sharp conflict among the circuits, prior to the Reform Act, regarding the pleading requirements in section 10(b) and 10b-5 actions. The most pronounced conflict could be seen between the Second and Ninth Circuits, which had adopted the strictest and the most relaxed pleading standards, respectively.[58] As discussed *infra* Part III, one of the major purposes of the Reform Act was to address the conflicting pleading standards among the circuits.

1. *The Second Circuit Pleading Standard*

Considered to be the most stringent pleading standard prior to enactment of the Reform Act,[59] the Second Circuit required a plaintiff in every 10b-5 action to allege facts in the complaint which "give [ ] rise to a 'strong inference' of fraudulent intent."[60] The Second Circuit recognized two distinct ways that this "strong inference" standard could be met. First, a plaintiff could "allege facts establishing a motive to commit fraud and an opportunity to do so."[61] Second, a

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[57] *Rolf*, 570 F.2d at 47.

[58] *Compare In re* GlenFed, Inc., Sec. Litig., 42 F.3d 1541, 1547 (9th Cir. 1993) ("[P]laintiffs may aver scienter generally . . . simply by saying that scienter existed.") *with In re* Time Warner Inc. Sec. Litig., 9 F.3d 259, 268 (2d Cir. 1993) ("[T]he facts alleged in the complaint must 'give rise [ ] to a strong inference' of fraudulent intent.") (quoting O'Brien v. National Property Analysts Partners, 936 F.2d 674, 676 (2d Cir. 1991)). While the Second and Ninth Circuits adhered to the two most extreme pleading standards, a number of other circuits adopted "intermediate" positions. The First Circuit, for example, adhered to a "reasonable belief" pleading standard prior to the Reform Act. Friedberg v. Discreet Logic, 959 F. Supp. 42, 48 (D. Mass. 1997). Under the reasonable belief standard, a plaintiff in a securities fraud action was required to state facts with such particularity as to make it reasonable to believe that the defendant acted with the requisite scienter. *See* Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1223–24 (1st Cir. 1996).

[59] *See* H.R. CONF. REP. NO. 104-369, at 41, *reprinted in* 1995 U.S.C.C.A.N. 679, 748.

[60] *In re Time Warner*, 9 F.3d at 268 (quoting O'Brien v. National Property Analysts Partners, 936 F.2d 674, 676 (2d Cir. 1991)). Although the "strong inference" standard was strict, the Second Circuit did not require that scienter be plead with "great specificity." *Id.*

[61] *Id.* at 269; *see also* Powers v. British Vita, P.L.C., 57 F.3d 176, 184 (2d Cir. 1995); Shields v. Citytrust Bancorp, 25 F.3d 1124, 1128 (2d Cir. 1994). Motive requires plaintiff to allege "concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged," while opportunity involves "the means and likely prospect of achieving concrete benefits by the means alleged." *Shields*, 25 F.3d at 1130.

plaintiff could "allege facts constituting circumstantial evidence of either reckless or conscious behavior."[62]

2. *The Ninth Circuit Pleading Standard*

In contrast to the "heightened" level of pleading required by the Second Circuit,[63] the Ninth Circuit's pleading standard mirrored the literal terms of Rule 9(b) of the Federal Rules of Civil Procedure.[64] Rule 9(b), which provides the requirements for surviving a motion to dismiss in cases based on allegations of fraud, provides that "[m]alice, intent, knowledge, and other condition of mind of a person may be averred generally."[65] Accordingly, in securities fraud cases, the Ninth Circuit permitted a plaintiff to aver scienter generally[66]—"simply by saying that scienter existed."[67]

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[62] *In re Time Warner*, 9 F.3d at 269; *see also Powers*, 57 F.3d at 184; *Shields*, 25 F.3d at 1128. As compared to motive and opportunity allegations, the strength of circumstantial allegations had to be "correspondingly greater." *Powers*, 57 F.3d at 184 (citing Beck v. Manufacturers Hanover Trust Co., 820 F.2d 46, 50 (2d Cir. 1987)).

[63] Although the Ninth and Second Circuits disagreed substantially regarding the correct standard for pleading scienter, the two circuits had similar requirements for alleging the circumstances of fraud under Rule 9(b). The Second Circuit required complaints to "(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent." Mills v. Polar Molecular Corp., 12 F.3d 1170, 1175 (2d Cir. 1993). Similarly, the Ninth Circuit required plaintiffs to "set forth what is false or misleading about a statement, and why it is false, [i.e.,] an explanation as to why the statement or omission complained of was false or misleading." *In re GlenFed, Inc.*, 42 F.3d at 1548. Commentators have noted that Congress, in enacting § 21D(b)(1), was adopting the *GlenFed* standard of pleading. *See, e.g.*, William S. Lerach & Eric Alan Isaacson, *Pleading Scienter Under Section 21D(b)(2) of the Securities Exchange Act of 1934: Motive, Opportunity, Recklessness, and the Private Securities Litigation Reform Act of 1995*, 33 SAN DIEGO L. REV. 893, 894–95 (1996) (noting that the *GlenFed* standard differed somewhat from law in some other circuits).

[64] FED. R. CIV. P. 9(b).

[65] *Id.* The full text of Rule 9(b) reads: "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally." *Id.*

[66] A complaint was sufficient if it stated "precisely the time, place, and nature of the misleading statements, misrepresentations, and specific acts of fraud." Kaplan v. Rose, 49 F.3d 1363, 1370 (9th Cir. 1994).

[67] *In re GlenFed, Inc.*, 42 F.3d at 1547. According to the Ninth Circuit, imposing a "heightened" pleading standard, as the Second Circuit did, was inappropriate: "We are not permitted to add new requirements to Rule 9(b) simply because we like the effects of doing so. This is a job for Congress, or for the various legislative, judicial, and advisory bodies involved in the process of amending the Federal Rules." *Id.* at 1546.

III. PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

Over President Clinton's veto,[68] Congress enacted the Private Securities Litigation Reform Act of 1995 in December of 1995.[69] The Act was passed in the wake of what was viewed as a "rising tide of abusive and frivolous securities litigation."[70] The Reform Act was intended to be a fix for a securities litigation system which many believed was broken,[71] and the Act addressed several perceived procedural pitfalls accordingly.[72] Although the Reform Act certainly represented a sweeping revision of the securities laws, many of the most aggressive revisions were not contained in the text of the Act, but were suggested in statements contained in its legislative history.[73] As a result, the exact meaning of many of the Reform Act's provisions is not yet clear; we must wait as the interpretation process of the courts discerns the Act's true reach.

A. *Purposes of the Reform Act*

In enacting the Reform Act, Congress was prompted by significant evidence of abuse in securities litigation.[74] As set forth in the Conference Committee

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[68] *See* H.R. DOC. NO. 104-150 (1995).

[69] *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995).

[70] Dawes, *supra* note 11, at 39.

[71] *See* Simon & Dato, *supra* note 2, at 960.

[72] *See* H.R. CONF. REP. NO. 104-369, at 31–32 (1995).

[73] *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, 975 (1996).

[74] *See* H.R. CONF. REP. NO. 104-369, at 31–32 (1995). A significant source of this evidence apparently came from a study conducted by Janet Cooper Alexander. *See* Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991). From her study of a selection of securities cases, Professor Alexander concluded that:

> (1) "[S]uits were filed against every company in the industry whose stock declined significantly."
> (2) "[T]he cases settled for approximately one quarter of the potential damages."
> (3) "[T]he strength of the plaintiff's case on the merits . . . did not appear to be a significant factor in determining the outcomes."

Id. at 500. Professor Alexander's study and statistical analysis, however, has been criticized recently. *See* Simon & Dato, *supra* note 2. Simon and Dato reviewed Alexander's study and indicated several significant methodological errors. *See id.* at 966–84 (noting sampling deficiencies, homogeneity, selective inclusion and exclusion, adjustment and omission of key data, arithmetic and data errors, and adjustment failures). After repeating Alexander's study and conducting a "broader" study of their own, Simon and Dato determined that Professor Alexander's conclusions were erroneous. *See id.* at 1014–16. Accordingly, Simon and Dato

Report, Congress had identified four primary abuses:

> (1) [T]he routine filing of lawsuits against issuers . . . whenever there was a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action;
> (2) [T]he targeting of deep pocket defendants . . . without regard to their actual culpability;
> (3) [T]he abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle; and
> (4) [T]he manipulation by class action lawyers of the clients whom they purportedly represent.[75]

In the Reform Act, Congress sought to protect investors, issuers, and the integrity of capital markets from these abuses.[76] To effect this result, Congress implemented procedural protections to discourage frivolous suits,[77] *inter alia*: (1) procedures and restrictions on the selection of lead plaintiffs in securities class actions,[78] (2) settlement disclosure requirements,[79] (3) a "safe-harbor" for forward-looking statements,[80] (4) proportionate liability for certain defendants,[81] (5) mandatory sanctions under Rule 11 for abusive litigation practices,[82] and (6)

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have argued that Congress legislated on the basis of false and misleading data. *See id.* at 962.

[75] *See* H.R. CONF. REP. NO. 104-369, at 31 (1995).

[76] *See id.* at 32.

[77] *See id.*

[78] *See* Private Securities Litigation Reform Act of 1995, § 101, 15 U.S.C. § 78u-4(a)(1)–(6) (Supp. II 1996). The Reform Act requires, *inter alia*, a certificate to be filed with the complaint, early notice to be given to class members, and a court determination as to who is the "most adequate plaintiff." *Id.* The Reform Act makes it a rebuttable presumption that the plaintiff with the largest financial interest in the relief sought is the "most adequate plaintiff." *See id.* The Reform Act also prohibits the lead plaintiff from receiving more than a per share basis of the recovery. *See id.*

[79] *See id.* § 101. The Reform Act requires disclosure of settlement terms to class members. *See id.* This disclosure shall include statements concerning the amount of the settlement, the potential outcome of the case, the amount of attorneys' fees or costs sought, identification of attorneys, and reasons for the proposed settlement. *See id.*

[80] *See id.* § 102. The Reform Act prevents the imposition of liability on individuals for making certain forward-looking statements, as long as the statement is identified as a forward-looking statement and is accompanied by meaningful cautionary statements, is immaterial, or was not made with actual knowledge that the statement was false or misleading. *See id.*

[81] *See id.* § 210. The Reform Act provides an exemption to the general rule of joint and several liability for qualifying defendants in actions arising under the 1934 Act and actions under the 1933 Act against outside directors. *See id.*

[82] *See id.* § 101. The Reform Act requires the court to make specific findings regarding Rule 11(b) compliance in every case. *See id.* The Act also imposes a rebuttable presumption in favor of attorneys fees and costs for violations of Rule 11(b). *See id.*

heightened pleading requirements in securities fraud actions.[83]

In providing for a heightened pleading standard, Congress attempted to erect a barrier to "[u]nwarranted fraud claims."[84] In essence, Congress saw two problems with the current pleading system: (1) an increase in the number of meritless lawsuits being filed and (2) a lack of uniformity in the pleading standards imposed by various circuits.[85] Rule 9(b)'s requirement that plaintiffs plead allegations of fraud with particularity, according to Congress, had "not prevented abuse of the securities laws by private litigants."[86] In addition, the conflicting interpretations of Rule 9(b)'s requirements by the circuit courts had created different standards.[87] This had led to "forum shopping," as private litigants flocked to the circuits with the least stringent pleading standards.[88] The Reform Act's heightened pleading standard, therefore, was an attempt to "establish uniform and more stringent pleading requirements to curtail the filing of meritless lawsuits."[89]

B. *The Reform Act's New Requirements for Pleading Scienter*

The Reform Act provides that, when a plaintiff is required to prove in a securities fraud action that the defendant acted with a particular state of mind, "the complaint shall . . . state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[90] On its face, this provision would seem to require, in actions based on section 10(b) and Rule 10b-5,[91] that the plaintiff plead facts that give rise to a strong inference of at least recklessness on the part of the defendant.[92]

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[83] *See id.*; *see also infra* Part III.B.

[84] H.R. CONF. REP. NO. 104-369, at 41 (1995). The Statement of Managers recognized the seriousness of bringing a securities fraud action: "Unwarranted fraud claims can lead to serious injury to reputation for which our legal system effectively offers no redress." *Id.*

[85] *See id.*

[86] *Id.*

[87] *See id.* In particular, Congress was concerned with the lack of uniform pleading requirements for scienter. As discussed Part III.B, *infra*, the greatest disparity in the pleading requirements for scienter existed between the Ninth and Second Circuits.

[88] *See supra* notes 58–67 and accompanying text.

[89] H.R. CONF. REP. NO. 104-369, at 41 (1995).

[90] Private Securities Litigation Reform Act of 1995, § 101, 15 U.S.C. § 78u-4(b) (Supp. II 1996).

[91] The pleading standards under the Reform Act apply to all securities fraud actions brought under the 1934 Act, and not just § 10(b). Although many of the points made in this Comment may apply with equal force to other provisions of the 1934 Act, this Comment focuses primarily on § 10(b) and Rule 10b-5 actions.

[92] *See* Coffee, *supra* note 69, at 978. Because recklessness has been accepted as sufficient under § 10(b) by every circuit court addressing the issue, it would seem logical that the "required state of mind" would encompass recklessness. *See supra* note 49.

The plain language of the Reform Act appears to codify the Second Circuit standard for pleading scienter.[93] The "strong inference" language mirrors the language employed by the Second Circuit prior to the Reform Act.[94] The Second Circuit pleading standard was recognized as the strictest in existence prior to the Reform Act,[95] and it could be satisfied by (1) alleging facts showing both a motive and an opportunity for committing fraud, or (2) alleging facts "constituting circumstantial evidence of either reckless or conscious behavior."[96] While a number of courts addressing the issue have concluded that the Reform Act simply codifies the pre-Act Second Circuit standard,[97] the Northern District of California in *Silicon Graphics II*[98] placed great reliance on the Reform Act's legislative history and held that the Reform Act erected a standard for pleading scienter that was stronger than even the Second Circuit's standard.[99]

IV. THE *SILICON GRAPHICS* CASES

A. *Facts*

Silicon Graphics, Inc. (SGI) is a Delaware corporation specializing in the computer technology industry.[100] After SGI's stock reached a record high in August of 1995, market concern about the company's ability to maintain its historic growth rates of 40% in the face of increased competition sent SGI's stock plummeting more than $15 per share.[101]

In October of 1995, SGI's release of its results for the first quarter of fiscal year 1996 indicated a 33% growth in revenue, which was viewed as disappointing by the market.[102] SGI assured analysts and investors that it still expected to meet its growth targets, explained the shortfall, and suggested reasons why second quarter performance would be better.[103] As a result, Silicon Graphic's stock price

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[93] *See, e.g., In re* Time Warner Inc. Sec. Litig., 9 F.3d 259, 268 (2d Cir. 1993).

[94] *See id.* ("[F]acts alleged in the complaint must [ ] give rise to a 'strong inference' of fraudulent intent." (citations omitted)).

[95] *See* H.R. CONF. REP. NO. 104-369, at 41 (1995).

[96] *In re Time Warner*, 9 F.3d at 289.

[97] *See supra* note 15 and accompanying text.

[98] 970 F. Supp. 746 (N.D. Cal. 1997).

[99] *See id.* at 755–57.

[100] *See In re* Silicon Graphics, Inc. Sec. Litig., [1996–1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,325, 95,959 (N.D. Cal. Sept. 25, 1996), *available in* 1996 WL 664639. The company designs and sells, among other things, desktop graphics workstations and application software. *Id.*

[101] *See id.* SGI's stock hit a high of $ 44-7/8 on August 21 before dipping into the high-$20 range based on the negative market information. *See id.*

[102] *See id.*

[103] *See id.* SGI reasserted its predictions in periodic updates throughout the fall of 1995.

rebounded.[104]

Based on rumors in December of 1995, which suggested Silicon Graphics' second quarter results might again be lower than anticipated,[105] SGI's stock dipped again, this time into the mid-$20 range.[106] In January of 1996, SGI confirmed these rumors and the company's stock fell to a low of $22 per share.[107] In response, plaintiff shareholders of SGI filed a class action complaint on January 29, 1996.[108]

B. *Procedural History*

Plaintiff shareholders brought a class action in the United States District Court for the Northern District of California, alleging a violation of section 10(b) and Rule 10b-5 of the 1934 Act.[109] Plaintiffs alleged that SGI and a number of named executives of the company had issued "false and misleading information about the company after the disappointing first quarter, in an effort to inflate the price of SGI stock for the purpose of selling their own stock at a substantial profit."[110] The complaint alleged that defendants devised a scheme to boost stock prices in order to protect their own interests,[111] that defendants made material misrepresentations about SGI's growth prospects and financial condition, and that defendants failed to disclose various adverse facts.[112] In addition, the complaint alleged that defendants sold over 400,000 of their own shares of company stock and reaped profits of over $14 million.[113] Plaintiff alleged that the scheme caused financial damage to both the corporation and its shareholders.[114]

See id.

[104] The stock rebounded into the high $30 range. *See In re* Silicon Graphics, Inc. Sec. Litig., 970 F. Supp. 746, 750 (N.D. Cal. 1997).

[105] *Silicon Graphics*, [1996–1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 95,959.

[106] *See id.*

[107] *See id.*

[108] *See id.* The complaint related to the December/January drop in SGI's stock price. *See id.* A derivative action was filed on March 22, 1996 relating to the same drop in stock price. *See id.*

[109] *See id.*

[110] *Id.*

[111] *See id.* at 95,959. Plaintiff alleged that the defendants were concerned about their own investments, the reputation of the company's Chairman and CEO, and the company's ability to use its stock to acquire other companies. *See id.*

[112] *See id.* Plaintiff alleged that defendants failed to disclose that the company had insufficient component parts to produce enough of its new workstations to meet demand, and that defendants disseminated this false and misleading information to the market. *See id.* at 95,960.

[113] *See id.*

[114] *See id.*

Defendant's answered plaintiff's complaint by stating that no fraud was involved, even though, in hindsight, the company's forecast could be viewed as optimistic.[115] Defendants filed a motion to dismiss pursuant to Rule 12(b)(6),[116] arguing that plaintiff's complaint was not alleged with enough specificity to meet the requirements of Rule 9(b)[117] and that plaintiff failed to adequately plead scienter under the Private Securities Litigation Reform Act of 1995.[118]

C. *Silicon Graphics I*

In *Silicon Graphics I*,[119] the Northern District of California began its analysis of the section 10(b) claims with an extensive discussion of the heightened pleading standard under the Reform Act.[120] The court began this discussion by quoting the "strong inference" language from the Act,[121] but all references to the text of the statute ended there; the court's analysis focused exclusively on the Act's legislative history. Specifically, the court placed significance on two pieces of legislative history—the Conference Committee Report[122] and President Clinton's Veto Message[123]—as evincing Congress's "'crystal clear' intent" to heighten the pleading standard beyond the Second Circuit standard.[124]

Although the court acknowledged that the Reform Act's heightened pleading standard was "adapted" from Second Circuit case law,[125] the court found that the Conference Committee Report clearly indicated that Congress did not "simply codify the Second Circuit standard."[126] Rather, according to the court, "the Conference Committee Report indicates that Congress intended to strengthen [the pleading standard]"[127] and that, consequently, Congress expressly chose not to

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115 *See id.*

116 *See* FED. R. CIV. P. 12(b)(6).

117 *See* FED. R. CIV. P. 9(b).

118 *Silicon Graphics*, [1996–1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 95,960.

119 *Id.*

120 *See* 15 U.S.C. § 78u-4(b) (Supp. II 1996); Part III.B, *supra*.

121 "[T]he complaint shall . . . state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (Supp. II 1996).

122 H.R. CONF. REP. NO. 104-369, at 41 (1995).

123 H.R. DOC. NO. 104-150 (1995).

124 *Silicon Graphics*, [1996–1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 95,962.

125 *Id.* at 95,961. The court noted that Second Circuit law applying the strong inference pleading standard permitted a plaintiff to "allege specific facts that either (1) 'constitut[e] circumstantial evidence of either reckless or conscious behavior,' or (2) 'establish a motive to commit fraud and an opportunity to do so.'" *Id.* (quoting *In re* Time Warner Inc. Sec. Litig., 9 F.3d 259, 269 (2d Cir. 1993)).

126 *Id.* at 95,961–62.

127 *Id.* This finding was predicated on a sentence in the Statement of Managers that

adopt "language from the Second Circuit standard relating to motive, opportunity, and recklessness."[128] The court cited the prior rejection by the Senate of an amendment that would have expressly codified this language as providing additional support for this conclusion.[129]

The court next turned to President Clinton's Veto Message for additional guidance. One of the President's primary reasons for vetoing the Reform Act, according to his veto message, was that the new act erected a pleading standard that went beyond that of even the Second Circuit.[130] The President placed great significance on the Statement of Managers contained in the Conference Committee Report, which he felt "ma[d]e crystal clear . . . [Congress's] intent to raise the standard even beyond [the Second Circuit standard]."[131] Congress's subsequent override of the President's veto, according to the court, "emphasiz[ed] its 'crystal clear' intent to heighten the pleading standard."[132]

Based on this legislative history, the court in *Silicon Graphics I* reasoned that allegations of motive and opportunity were insufficient to satisfy the Reform Act's heightened pleading standard.[133] In addition, because the Conference Committee Report specifically rejected language relating to motive, opportunity, and recklessness, but made no reference to conscious behavior, the court concluded that Congress must have intended that only evidence of conscious behavior would be sufficient under the new standard.[134] Accordingly, the court held that the Reform Act now required plaintiffs to "allege specific facts that

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accompanied the Conference Committee Report: "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 95,962 (quoting H.R. CONF. REP. NO. 104-369, at 41 (1995)).

[128] *Id.* This conclusion was based on a footnote to the Conference Committee Report: "For this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness." H.R. REP. NO. 104-369, at 41 n.23 (1995).

[129] *See Silicon Graphics*, [1996–1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 95,962 (citing Amend. 1485, S. 240, 140th Cong., 1st Sess. (1995) (the Specter Amendment)). The court stated that the deletion of the Second Circuit standard from the final bill "strongly militates against a judgment that Congress intended a result that it expressly declined to enact." *Id.* (quoting Gulf Oil Corp. v. Copp Paving Co., 419 U.S. 186, 200 (1974)).

[130] *See id.* President Clinton indicated that he would support a pleading standard as high as that of the Second Circuit: "I am prepared to support the high pleading standard of the U.S. Court of Appeals for the Second Circuit—the highest pleading standard of any Federal circuit court." H.R. Doc. No. 104-150, at 1 (1995).

[131] H.R. Doc. No. 104-150, at 1 (1995).

[132] *Silicon Graphics*, [1996–1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 95,962.

[133] *See id.* ("Congress must have adopted the Conference Committee view and intended that a narrower first prong apply.").

[134] Although the court did not expressly state that allegations of recklessness were insufficient, the implication of its articulation of the standard, which specifically required evidence of "conscious behavior," was clearly to reject recklessness. *See id.* at 95,963.

constitute circumstantial evidence of conscious behavior by defendants."[135]

In applying the Reform Act's new and more exacting pleading standard to the plaintiffs' complaint, the court in *Silicon Graphics I* found the allegations insufficient.[136] Although the court concluded that plaintiffs had adequately pled the falsity of most of the statements, sufficiently identifying the time, location, and content of the allegedly false statements[137] and explaining why the statements were false or misleading,[138] the court held that plaintiffs' complaint failed to adequately plead scienter under the Reform Act's new standard.[139]

The court in *Silicon Graphics I* found that plaintiffs' allegations of defendants' awareness of negative internal reports, coupled with allegations of misleading statements and stock sales, fell short of pleading a strong inference of fraud.[140] With respect to the negative internal reports,[141] the court found that plaintiffs' allegations were not specific enough in that they failed to specifically identify, *inter alia*, the names and dates of the alleged negative internal reports.[142]

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[135] *Id.* Under Second Circuit law, a plaintiff could support a strong inference of fraud in either of two ways. *See supra* notes 61–62 and accompanying text. Having found that Congress rejected opportunity and motive as insufficient, the court's standard required a plaintiff to use the only other method of pleading scienter remaining—specific facts constituting circumstantial evidence. *See Silicon Graphics*, [1996–1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 95,962.

[136] *See Silicon Graphics*, [1996–1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 95,966 ("The Court finds that plaintiff's allegations are not specific enough to raise a strong inference of fraud.").

[137] *See id.* at 95,965. The court cited Kaplan v. Rose, 49 F.3d 1363, 1370 (9th Cir. 1994), for the requirement under Rule 9(b) that the complaint "state precisely the time, place, and nature of the misleading statements, misrepresentation, and specific acts of fraud." *Id.* The court noted that this requirement ensured that defendants could "identify who is being charged and with what." *Id.*

[138] *See id.* (citing *In re* Glenfed, Inc. Sec. Litig., 70 F.3d 1541, 1549 (9th Cir. 1994)).

[139] *See id.* at 95,967.

[140] *See id.* ("Although plaintiff does not, as defendants assert, simply hold predictions up against the backdrop of what actually happened, her allegations nonetheless fall short of pleading a strong inference of fraud.").

[141] The plaintiffs' claims regarding alleged negative internal reports were that:

> Each of the Individual Defendants was aware of Silicon Graphics' fiscal 1996 forecast and budget and of internal reports, comparing Silicon Graphics' actual results to those budgeted and/or forecasted. Based on the negative internal reports of the Company's actual performance compared to that budgeted and forecasted, the Individual Defendants each knew Silicon Graphics was plagued by an inability to sell, i.e., ship, as many Indigo2 IMPACT Workstations as planned . . . .

Id. (quoting ¶ 30 of plaintiffs' complaint).

[142] *See id.* In making this finding, the court relied heavily on the fact, brought to the court's attention by the defense lawyers, that a number of securities class action complaints previously filed in U.S. district courts had contained the same "boilerplate allegations of

From a policy perspective, the court noted that every corporation uses some type of internal reporting system, and, consequently, to allow plaintiffs "to go forward with a case based on general allegations of 'negative internal reports' would expose all those companies to securities litigation whenever their stock prices dropped."[143] As a result, the court made unmistakably clear that "unsupported general claims of the existence of internal reports are insufficient to survive a motion to dismiss."[144]

Finally, the court found that, even if plaintiffs could adequately allege negative internal reports, the alleged stock trading failed to support a strong inference of fraud because the defendants' stock sales were not "unusual or suspicious."[145] The court noted that, when the millions of exercisable options held by defendants were factored into consideration,[146] the sales were actually relatively small and represented "only a small fraction of [defendants'] total SGI holdings."[147] In addition, the sales at issue were found to be generally consistent in amount with sales made in previous quarters.[148]

Having found plaintiffs' complaint to be insufficient to satisfy the heightened pleading requirements of the Reform Act, the court dismissed plaintiffs' claims.[149] The court, however, gave plaintiffs a one-time opportunity to amend their complaint.[150]

D. *Silicon Graphics II*

In *Silicon Graphics II*,[151] the sufficiency of recklessness under the Reform Act took center stage. While the plaintiffs filed an amended complaint, this time making their allegations with greater specificity,[152] the SEC filed an *amicus curiae* brief, urging the court to reconsider its prior finding that allegations of

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'negative internal reports'" found in plaintiffs' complaint. *See id.* at 95,966 n.11.

[143] *Id.* at 95,966.

[144] *Id.* (relying on Second Circuit law).

[145] *Id.*

[146] The court took judicial notice of defendants' Forms 3 and 4 and SGI's 1995 proxy statement in making its evaluation of the stock sales. *See id.* The court rejected plaintiffs' contention that the Forms 3 and 4 were misleading, noting that even under plaintiffs' calculations there were millions of exercisable options available to defendants. *See id.* at 95,966 n.12.

[147] *Id.*

[148] *See id.* at 95,967. According to the court, this "consistency" suggested that the sales were not motivated by an intent to defraud. *See id.* (citing *In re* Apple Computer, 886 F.2d 1109, 1117 (9th Cir. 1989)).

[149] *See id.*

[150] *See id.* at 95,969.

[151] *In re* Silicon Graphics, Inc. Sec. Litig., 970 F. Supp. 746 (N.D. Cal. 1997).

[152] *See infra* notes 175–76 and accompanying text.

recklessness were insufficient to plead scienter.[153] In the view of the SEC, the Reform Act had "le[ft] unchanged the degree of scienter required for private liability under Section 10(b) and Rule 10b-5."[154] After considering the SEC's contentions and plaintiffs' amended complaint, the court again dismissed the case.[155]

In addressing the sufficiency of recklessness under the Reform Act's stricter pleading standard, the court in *Silicon Graphics II* reassessed the legislative history that it had previously found to be "crystal clear."[156] Although asserting that it believed its original interpretation was correct,[157] the court nonetheless made a subtle retreat from its earlier hard-line stance regarding recklessness, ostensibly qualifying its previous holding and accepting a position materially indistinguishable from that of the SEC.[158]

The court began its analysis by reviewing the state of the law prior to the Reform Act. Although acknowledging that a majority of courts had accepted the sufficiency of recklessness under section 10(b)[159] and had defined recklessness in a manner that was compatible with the Supreme Court's decision in *Hochfelder*,[160] the court focused its attention on the small minority of courts that,

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[153] *See In re Silicon Graphics*, 970 F. Supp. at 754.

[154] Brief of Securities and Exchange Commission, *Amicus Curiae*, at 13, *In re Silicon Graphics*, 970 F. Supp. 746. The SEC faulted the court in *Silicon Graphics I* for failing to make the significant distinction between a *procedural* pleading requirement and a *substantive element* of a securities fraud violation. *See id.* at 8. According to the SEC, the Reform Act only purports to establish a pleading standard and does not in any way attempt to alter the substantive requirement of scienter; the court erred in that it "drew from a purely procedural provision the incorrect conclusion that Congress had eliminated a well established substantive standard." *Id.*

The SEC also relied heavily on what it saw as the practical necessity of a recklessness standard. *See id.* at 3. In the SEC's view, "such a standard is needed to protect investors and the securities markets from fraudulent conduct and to protect the integrity of the disclosure process." *Id.* The SEC noted that the recklessness standard discourages deliberate ignorance, helps to ensure that defendants do not escape liability simply because of the difficulty of proving knowledge or conscious intent based solely on circumstantial evidence (which often must be relied on), and strengthens the deterrent effect of § 10(b). *See id.*

[155] *See In re Silicon Graphics*, 970 F. Supp. at 768.

[156] *See supra* notes 124–32 and accompanying text.

[157] *See In re Silicon Graphics*, 970 F. Supp. at 754 ("After reviewing the arguments and the legal authorities, the court believes that its original interpretation was correct.").

[158] The court also appeared to retreat somewhat from its earlier hard-line position regarding motive and opportunity by qualifying its conclusion that motive and opportunity are insufficient: "Motive [and] opportunity, . . . may provide some evidence of intentional wrongdoing, but are not alone sufficient unless the totality of the evidence creates a strong inference of fraud." *Id.* at 757.

[159] "[M]any circuit courts imposed Section 10(b) liability for recklessness—both subjective and objective—prior to enactment of the SRA." *Id.* at 755. For cases accepting recklessness under § 10(b), see *supra* note 49.

[160] *See In re Silicon Graphics*, 970 F. Supp. at 755. In *Hochfelder*, the U.S. Supreme

in its view, had caused a "conflict[of] authority about what constitutes scienter for purposes of section 10(b)."[161] In particular, the court addressed what it perceived as three lines of conflicting authority in the pre-Reform Act Second Circuit: one line of cases allowed unqualified allegations of recklessness to be sufficient to establish scienter (the "*Lanza*[162] line"); a second line allowed recklessness to support scienter only if coupled with a fiduciary duty (the "*Rolf*[163] line"); and a third line required actual intent or circumstances implying actual intent before finding scienter (the "*Wechsler*[164] line").[165]

Again, relying primarily on the Conference Committee Report, the court found the legislative history consistent with an intent to reject the *Lanza* and *Rolf* lines in favor of the stricter *Wechsler* line of Second Circuit cases.[166] In the court's view, the rejection by both the House and Senate of similar amendments that would have codified the *Lanza* line of cases and allowed liability for unqualified recklessness,[167] coupled with the statement in a footnote to the Conference Committee Report that it "chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness,"[168] indicated that Congress had embraced the only line of cases disallowing allegations of recklessness to support scienter.[169]

Court stated that the term scienter encompassed an "intent to deceive, manipulate, or defraud," but left open the possibility that recklessness would be sufficient. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 & n.12 (1976); *see also supra* notes 46–48 and accompanying text. The court in *Silicon Graphics II* specifically referred to the definition of scienter articulated by the Seventh Circuit in *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977), and applied by the Ninth Circuit in *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990). *See In re Silicon Graphics*, 970 F. Supp. at 755. On the *Sundstrand* definition, see *supra* notes 48–49 and accompanying text.

[161] *See In re Silicon Graphics*, 970 F. Supp. at 755. The court cited cases in which a definition of recklessness was imposed that included "carelessness approaching indifference." *Id.* (citing Hoffman v. Estabrook & Co., 587 F.2d 509, 516 (1st Cir. 1978)).

[162] Lanza v. Drexel & Co., Inc., 479 F.2d 1277, 1306 (2d Cir. 1973) (en banc).

[163] Rolf v. Blyth, Eastman Dillon & Co., Inc., 570 F.2d 38, 44 (2d Cir. 1978).

[164] Wechsler v. Steinberg, 733 F.2d 1054, 1058 (2d Cir. 1984).

[165] *See In re Silicon Graphics*, 970 F. Supp. at 755.

[166] *See id.* at 756.

[167] The court noted that both the original House bill and the Specter Amendment would have imposed liability for "unqualified recklessness." *Id.*

[168] H.R. REP. NO. 104-369, at 41 n.23 (1995).

[169] *See In re Silicon Graphics*, 970 F. Supp. at 756. Surprisingly, the court did acknowledge that the legislative history was not entirely consistent. *See id.* at 756–57. However, the court used this observation in an attempt to bolster its position, noting that the inconsistencies made its firm reliance on the Conference Committee Report all the more justified. *See id.* at 757. In the court's view, the inconsistent statements of individual Congressmen revealed, at most, that legislators disagreed about what the Second Circuit standard was and thus what codifying that standard would mean. *See id.* at 756. In any event, compared to the Conference Committee Report, which is the "authoritative source for finding

Based on its extensive analysis of the Reform Act's legislative history, the court in *Silicon Graphics II* held that, "in order to state a private securities fraud claim, plaintiffs must create a strong inference of knowing or intentional misconduct."[170] In contrast to its "circumstantial evidence of conscious behavior" standard[171] articulated in *Silicon Graphics I*, however, the court's "new" standard included a significant caveat: "Knowing or intentional misconduct includes deliberate recklessness as described in *Hollinger* . . . ."[172] Ironically, the *Hollinger* standard is precisely the same standard that the SEC argued had been left unchanged by the Reform Act.[173]

In addressing plaintiffs' amended complaint, the court in *Silicon Graphics II* found that plaintiffs had again failed to plead specific facts establishing a strong inference of knowing or intentional conduct.[174] In their amended complaint, plaintiffs attempted to bolster their internal reports allegations by describing a series of reports which were alleged to have discussed the negative problems experienced by SGI.[175] Specifically, the amended complaint described a "Fiscal Year 1996/Budget" report and various monthly "Flash," "Stop Ship," and follow-up reports.[176]

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the Legislature's intent" and represents "the considered and collective understanding of those Congressmen involved in drafting and studying proposed legislation," the court noted that the statements of individual Congressman were both unreliable and irrelevant. *Id.* at 757 (citations omitted).

[170] *Id.* at 757.

[171] *See supra* note 135 and accompanying text.

[172] *In re Silicon Graphics*, 970 F. Supp. at 757.

[173] The SEC argued that the *Sundstrand* standard was followed by most of the circuit courts prior to the Reform Act and that the Reform Act left the recklessness standard intact. *See* Brief of Securities and Exchange Commission, *Amicus Curiae*, at 13, *In re Silicon Graphics*, 970 F. Supp. 746 (N.D. Cal. 1997). The Ninth Circuit in *Hollinger* expressly adopted the *Sundstrand* definition of recklessness. *See* Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990).

[174] *See In re Silicon Graphics*, 970 F. Supp. at 767.

[175] *See id.* at 765.

[176] *See id.* Plaintiffs' amended complaint provided the following details about these reports:

> (1) The Fiscal Year 1996 Plan/budget was completed in the spring of 1995, made various projections regarding operations and financials, and discussed the areas which later became problems for SGI;
> (2) Defendants received regular daily and monthly reports detailing the company's performance;
> (3) Defendants received "flash reports" regarding sales and problems with the Indigo2 Workstation in early October, November, and December of 1995, and a "stop ship" report in late September of 1995; and
> (4) Another report detailed what steps employees were taking to fix the problems being experienced with the Indigo2 Workstation.

Although the court found these reports to be "more elaborate" than those found in the original complaint, the court concluded that they were still "*too generic* to create a strong inference of fraud under the [Reform Act]."[177] According to the court, in order to establish a strong inference of fraud and to conform to the spirit of the standard,[178] more details would have to be alleged: "The allegations should include the titles of the reports, when they were prepared, who prepared them, to whom they were directed, their content, and the sources from which plaintiffs obtained this information."[179]

Finally, in readdressing plaintiffs' reliance on defendants' stock sales in attempting to create a strong inference of fraud, the court affirmed its previous finding that the defendants' stock trading collectively did not amount to unusual or suspicious sales.[180] Unlike in *Silicon Graphics I*, however, the court conducted an individual analysis of each defendant's trading.[181] Based on a comparison of the sales to trading history, the court concluded that the sales of four of the six named individual defendants did not, as a matter of law, raise a strong inference

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See id. at 766–67.

[177] *Id.* at 767 (emphasis added). The court noted that any large, well-run company announcing "low earnings would be vulnerable to allegations . . . that such reports exist and that they show 'very poor' results." *Id.*

[178] The court noted that to allow plaintiffs to go forward with these "general allegations" would undermine the strengthened pleading standards and the Reform Act would lose its meaning. *See id.*

[179] *Id.* These very demanding requirements imposed on the plaintiffs by the court in *Silicon Graphics II* can be explained, at least in part, by the court's determination that plaintiffs' complaint was based on information and belief. *See id.* Under § 21D(b)(1)(B) of the Securities Exchange Act of 1934, if a plaintiff's complaint is based on information and belief, the plaintiff is required to "state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1) (Supp. II 1996). In delineating what this required, the court looked to the legislative history for guidance. The court noted that Representative Bryant had objected to the information and belief pleading requirement because it required plaintiffs to set forth with specificity at the beginning of the case "all information . . . [forming] the basis for the allegations of the plaintiff, meaning any whistle-blower within a securities firm involved would have to be uncovered in the pleading in the very, very beginning." *In re Silicon Graphics*, 970 F. Supp. at 763 (quoting 141 CONG. REC. H2848 (Mar. 8, 1995)). Representative Dingell agreed with Representative Bryant's concern, noting that the pleading standard required a plaintiff to "literally, in [the] pleadings, include the names of confidential informants, employees, competitors, Government employees, members of the media, and others who would have provided information leading to the filing of the case." *Id.* (quoting 141 CONG. REC. H2849 (Mar. 8, 1995)). Because Congress rejected Representative Bryant's proposed amendment that would have relaxed this requirement, the court reasoned "that plaintiffs must plead precisely the sort of information described by [the Representatives]." *See id.* at 764.

[180] *See In re Silicon Graphics*, 970 F. Supp. at 768. The court also rejected plaintiffs' evidentiary challenge to the court taking judicial notice of Defendants' SEC forms. *See id.* at 758–59.

[181] *See id.* at 768.

of fraud.[182] As to the sales of the other two named defendants, however, the court held that, although not alone sufficient to raise a strong inference of fraud, their stock sales could be considered as evidence of fraud if the plaintiffs could bolster their claims regarding negative internal reports.[183] Accordingly, the court provided plaintiffs leave to file a supplement to buttress these allegations.[184]

V. ANALYSIS OF *SILICON GRAPHICS*

A. *Recklessness*

Although the Northern District of California in *Silicon Graphics II* retreated from its earlier holding regarding the sufficiency of recklessness under the Reform Act's pleading standard and appears to have arrived at the correct conclusion, the court's two decisions both suffered from the same basic flaw—blind reliance on legislative history. Although one could struggle to try to attach some form of methodological label to the court's approach to statutory construction in the two *Silicon Graphics* decisions, such a pursuit is unnecessary. The court's approach violates widely accepted, basic principles of statutory construction, irrespective of the label one attaches to the approach. Although it appears to have reached the correct result, the court's interpretation ignored the text and structure of the Reform Act and misinterpreted the Act's legislative history.

1. *Textual Limits Prevent a Finding That Congress Changed the Scienter Standard*

A major problem with *Silicon Graphics* is the court's failure to sufficiently evaluate the text of the Reform Act. By focusing exclusively on the legislative history behind the enactment of section 21D(b)(2), a purely *procedural provision*, the court overlooked the fact that section 21D(b)(2) does not in any way address the *substantive element* of scienter. Section 21D(b)(2) merely imposes a "heightened" pleading standard when a plaintiff is required to prove that a

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[182] *See id.* Defendant McCracken sold only 2.6% of his available stock and options, defendant Baskett sold 7.7%, defendant Ramsay sold 4.1%, and defendant Sekimoto sold 6.9%. *See id.* These sales were also consistent with past transactions. *See id.*

[183] *See id.* Defendant Kelly sold 43.6% of his available stocks and options, while defendant Burgess sold 75.3%. *See id.* Neither Kelly nor Burgess had a significant trading history with which to compare these transactions. *See id.*

[184] *See id.* at 769. Plaintiffs declined to accept the court's invitation, arguing, *inter alia*, that their original pleadings were sufficient. *See In re* Silicon Graphics, Inc. Sec. Litig., No. C96-0393, 1996 WL 337580 (N.D. Cal. June 5, 1997). The court subsequently dismissed plaintiffs' case with prejudice. *See id.*

defendant acted with a particular state of mind in a securities fraud action;[185] it says nothing about what state of mind is sufficient for imposing liability in such actions.[186]

One clear limit on the Supreme Court's willingness to consider legislative history is the requirement that statements be "anchored" in the text of the statute.[187] As the D.C. Circuit stated in *International Brotherhood of Electrical Workers, Local Union No. 474, AFL-CIO v. NLRB*:[188] "[C]ourts have no authority to enforce principles gleaned solely from legislative history that ha[ve] no statutory reference point."[189] Clearly violating this principle, the court in *Silicon Graphics* allowed the legislative history of the Reform Act,[190] specifically a single footnote to the Conference Committee Report,[191] to determine what the text never purported to address—whether recklessness was sufficient to satisfy the scienter requirement in securities fraud actions. Had the court properly analyzed the text of section 21D(b)(2), it would have discovered that "Congress only sought to strengthen *pleading* standards, not to change the substantive standard for scienter."[192]

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185 *See* 15 U.S.C. § 78u-4(b)(1)(B) (Supp. II 1996); *supra* Part III.B.

186 As noted in Part II.A, *supra*, every circuit court addressing the issue prior to the Reform Act had found that a showing of recklessness was sufficient under § 10(b) and 10b-5. *See supra* note 49. The Supreme Court has noted that Congress is presumed to be aware of long-standing judicial interpretations when it amends a statute. *See* Cannon v. University of Chicago, 441 U.S. 677, 698–99 (1979).

187 *See* Shannon v. United States, 512 U.S. 573, 583 (1994) ("We are not aware of any case . . . in which we have given authoritative weight to a single passage of legislative history that is in no way anchored in the text of the statute."). Professor Coffee spoke of this limitation shortly after the enactment of the Reform Act, specifically referring to the Act's new pleading standard: "[T]here is at least one clear limitation on the majority's willingness to consider legislative history: any such statement must be 'anchored' to the text of the statute." Coffee, *supra* note 73, at 981.

188 814 F.2d 697 (D.C. Cir. 1987).

189 *Id.* at 712 (emphasis omitted).

190 The Court, in both *Silicon Graphics I* and *II*, placed significant reliance on the Conference Committee Report and President Clinton's Veto Message. *See supra* notes 122–32; 166–70 and accompanying text.

191 *See supra* note 128.

192 Brief of Securities and Exchange Commission, Amicus Curiae, at 8, *In re* Silicon Graphics, Inc. Sec. Litig., 970 F. Supp. 746 (N.D. Cal. 1997); *see also In re* Stratosphere Corp. Sec. Litig., 1 F. Supp. 2d 1096, 1104 (D. Nev. 1998) ("This court does not believe the Congress would abolish the well established use of recklessness as permissible scienter under the securities laws without expressly stating so in the language of the statute.").

2. *Analysis of the Reform Act's Structure Indicates that Recklessness Survives*

A structural analysis of the Reform Act reveals that the elimination of the recklessness standard would create an absurd result. The Reform Act, in new section 21E of the 1934 Act, creates a "safe harbor" from liability for forward-looking statements.[193] Subject to certain exclusions,[194] a person may no longer be held liable in a private securities action for any forward-looking statement that is accompanied by certain cautionary language, unless the statement is proved to have been made with actual knowledge that it was false or misleading.[195] In sum, section 21E alters the scienter requirement for certain forward-looking statements to actual knowledge, eliminating liability for recklessness.

To give significance to section 21E, the provision must be read against the backdrop of a recklessness standard. To find that section 21D(b)(2) alters the general standard of scienter by eliminating recklessness essentially renders section 21E meaningless,[196] for there would be no need to single out certain statements for protection with a heightened level of scienter if the basic standard of scienter had already eliminated recklessness.[197] A basic principle of statutory construction requires courts to read statutes in a manner that gives significance to every provision.[198] By ignoring this principle, the court in *Silicon Graphics* unnecessarily struggled with the Reform Act's legislative history.

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[193] *See* Private Securities Litigation Reform Act of 1995 § 210, 15 U.S.C. § 78u-5 (Supp. II 1996); *supra* note 80.

[194] First, in order to be covered by its protections, § 21E requires that the person making the forward-looking statement be the issuer, or someone acting on behalf of the issuer. *See* 15 U.S.C. § 78u–5(a) (Supp. II 1996). Second, § 21E(b) provides specific exclusions for, *inter alia*, statements made by issuers convicted within the previous three years of criminal violations of the securities laws and statements made in connection with tender offers and initial public offerings. *See id.* § 78u-5(b).

[195] *See id.*

[196] In fact, it "frustrates Congress' desire to require actual knowledge only for forward-looking statements." Lerach & Isaacson, *supra* note 63, at 923.

[197] As the SEC has argued, "The only provision of the Reform Act that purported to alter the scienter standard in private actions under the Exchange Act was Section 21E of the Exchange Act." Brief of Securities and Exchange Commission, Amicus Curiae, at 7, *In re* Silicon Graphics, Inc. Sec. Litig., 970 F. Supp. 746 (N.D. Cal. 1997). At least one court has noted that "where Congress intended to establish knowing conduct as a prerequisite for liability, it did so explicitly within the PSLRA, such as providing a safe harbor for forward looking statements." *In re* Stratosphere Corp. Sec. Litig., 1 F. Supp. 2d 1096, 1104 (D. Nev. 1998).

[198] The Supreme Court has recognized that it is a "cardinal rule of statutory interpretation that no provision should be construed to be entirely redundant." Kungys v. United States, 485 U.S. 759, 778 (1988) (plurality opinion).

3. *The Court Misinterpreted the Reform Act's Legislative History*

Although reliance on legislative history is misplaced given the clarity of the text and structure of the Reform Act, the Reform Act's legislative history nonetheless clearly indicates that liability for recklessness was not being eliminated. This makes the court's struggle in *Silicon Graphics* all the more puzzling. While the court in *Silicon Graphics* placed significant reliance on an obscure statement in a footnote to the Conference Committee Report, the court overlooked the fact that early drafts of the Reform Act expressly required actual knowledge of falsity, but these drafts were rejected.[199] As the court itself stated in *Silicon Graphics I*, this "strongly militates against a judgment that Congress intended a result that it expressly declined to enact."[200]

B. *Standard for Pleading Scienter*

In *Silicon Graphics*, the Northern District of California held that, under the Reform Act, facts showing a motive and opportunity to commit fraud are no longer sufficient to plead the requisite "strong inference" of fraud.[201] This interpretation of section 21D(b)(2) represents a dramatic departure from prior cases.[202] Furthermore, a full evaluation of the text and legislative history of the Reform Act renders the court's interpretation highly questionable. Essentially, although it could be argued that the court was justified in seeking guidance from the legislative history, the court's finding that motive and opportunity is no longer sufficient resulted from reading too much into legislative history that was both ambiguous and inconsistent.

1. *Textualist Criticism*

From a purely textualist approach, the court's reliance on legislative history was unjustified. The "strong inference" language adopted by Congress had an established meaning in Second Circuit case law when the Reform Act was

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[199] *See* Lerach & Isaacson, *supra* note 63, at 923.

[200] *In re* Silicon Graphics, Inc. Sec. Litig., [1996–1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,325 at 95,962 (N.D. Cal. Sept. 25, 1996), *available in* 1996 WL 664639 (quoting Gulf Oil Corp. v. Copp Paving Co., 419 U.S. 186, 200 (1974)). Congress has explicitly stated since the enactment of the Reform Act that it did not in any way "intend to alter standards of liability under the Exchange Act." H.R. CONF. REP. NO. 105-803, 105th Cong., 2d Sess. (1998).

[201] *See supra* note 133 and accompanying text.

[202] *See, e.g.*, Zeid v. Kimberley, 973 F. Supp. 910 (N.D. Cal. 1997) (interpreting the Reform Act to adopt the Second Circuit standard); Rehm v. Eagle Fin. Corp., 954 F. Supp. 1246, 1251–53 (N.D. Ill. 1997) (stating that the motive and opportunity test are not eliminated); Marksman Partners v. Chantal Pharm. Corp., 927 F. Supp. 1297, 1310–11 (C.D. Cal. 1996) (same).

enacted.[203] Based on the principle that Congress is presumed to be aware of long-standing judicial interpretations when it amends a statute,[204] it could be argued that the text is clear and, therefore, that the legislative history cannot be used to contradict the unambiguous text adopting the Second Circuit's standard.[205] This is the approach that a few courts have taken with respect to the issue, concluding solely from the text that the Reform Act codifies the Second Circuit standard in its entirety.[206]

A textualist approach produces a result that, arguably, best comports with the purpose of the Reform Act's heightened pleading standard.[207] Adoption of the Second Circuit's "strong inference" standard represents a substantial heightening of the pleading standard in some circuits, particularly in the Ninth Circuit.[208] Thus, the desire to impose harsher barriers to the filing of meritless lawsuits is satisfied. Furthermore, codification of the Second Circuit's established standard, which has been developed and applied extensively by courts throughout the Second Circuit, is consistent with the purpose of providing uniformity in pleading standards.[209] As further discussed *infra*, the major problem with concluding that the Reform Act did not codify the Second Circuit standard is discerning any concrete standard that can be applied in a uniform manner.

The textualist approach clearly has its merits. Unfortunately, the large percentage of district courts interpreting section 21D(b)(2) have relied on the legislative history for guidance.[210] In addition, although the textualist approach

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[203] *See supra* Part II.B.1.

[204] *See, e.g.*, Cannon v. University of Chicago, 441 U.S. 677, 698–99 (1979).

[205] "The Supreme Court has held that where statutory text 'contains a phrase that is unambiguous—that has a clearly accepted meaning in both legislative and judicial practice—we do not permit it to be expanded or contracted by the statements of individual legislators or committees during the course of the enactment process.'" Lerach & Isaacson, *supra* note 63, at 919 (citing West Virginia Univ. Hosp., Inc. v. Casey, 499 U.S. 83, 98–99 (1991)).

[206] *See, e.g.*, Bryant v. Apple South, Inc., 25 F. Supp. 2d 1372 (M.D. Ga. 1998) (noting that the Reform Act is clear on its face and so no support from the legislative history is necessary); Zeid v. Kimberly, 930 F. Supp. 431 (N.D. Cal. 1996) (accepting the Second Circuit standard with little discussion).

[207] *See supra* notes 84–89 and accompanying text.

[208] The Ninth Circuit's pleading standard was viewed as the most lenient and permitted a plaintiff to aver scienter generally. *See supra* Part II.B.2.

[209] *See* H.R. REP. NO. 104-369, at 41 (1995) ("The House and Senate hearings on securities litigation reform included testimony on the need to establish uniform and more stringent pleading requirements . . . .").

[210] *See, e.g.*, Friedberg v. Discreet Logic, Inc., 959 F. Supp. 42, 48 (D. Mass. 1997) ("Reviewing the text of the PSLRA, this Court is left with no guidance as to the proper interpretation of the term 'strong inference' of scienter. As a result, the Court must look to the legislative history."); *see also* Rehm v. Eagle Fin. Corp., 954 F. Supp. 1246, 1251–53 (N.D. Ill. 1997) (relying on Conference Committee Report and President's veto message).

has its supporters,[211] many courts, as well as a majority of the Justices of the Supreme Court, afford great weight to legislative history in most circumstances.[212] Thus, by consulting the legislative history, the Northern District of California seems to have taken a somewhat "dynamic," but arguably legitimate, approach to statutory construction.

2. *Excessive Reliance on the Legislative History*

In concluding that evidence of motive and opportunity is insufficient to satisfy the Reform Act's strong inference requirement, the Northern District of California in *Silicon Graphics* takes certain statements in the legislative history beyond their intended meaning. Although there is strong support in the legislative history to indicate that Congress did not intend to codify the Second Circuit pleading standard in its entirety,[213] the legislative history provides little clear guidance as to what the precise contours of the new standard might be.[214] Despite this, the court "discovered" a concrete standard in the legislative history, which resulted in an interpretation of section 21D(b)(2) that Congress clearly did not intend.

The court in *Silicon Graphics* seems to have concluded correctly that Congress intended to strengthen the pleading standard beyond that of the Second Circuit. The Conference Committee Report, which is arguably the most reliable source of legislative history,[215] makes it unmistakably clear that Congress intended to strengthen its pleading standard.[216] In addition, President Clinton's veto of the Reform Act was predicated, to a large extent, on an understanding that

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[211] The most prominent advocate of the textualist approach is, of course, Justice Scalia. For a discussion of Justice Scalia's approach to statutory construction, see Stephen A. Plass, *The Illusion and Allure of Textualism*, 40 VILL. L. REV. 93 (1995); Nicholas S. Zeppos, *Legislative History and the Interpretation of Statutes: Toward a Fact-Finding Model of Statutory Interpretation*, 76 VA. L. REV. 1295 (1990).

[212] *See* Coffee, *supra* note 73, at 981 (citing Bank One Chicago, N.A., v. Midwest Bank & Trust Co., 516 U.S. 264, 272–74 (1996)).

[213] *See, e.g.*, H.R. REP. NO. 104-369, at 41 (1995); *supra* note 127 and accompanying text.

[214] The Reform Act does not indicate how much stricter the new standard is or what kinds of allegations are sufficient under the new standard. This is troubling given that a major purpose of the Reform Act was to settle a conflict among the circuits and to provided uniformity in pleading standards. Again, this lends credence to the textual approach, which provides for such a uniform and concrete standard.

[215] *See, e.g.*, Demby v. Schweiker, 671 F.2d 507, 510 (D.C. Cir. 1981) (noting that the conference committee report is "the most persuasive evidence of congressional intent besides the statute itself").

[216] *See* H.R. REP. NO. 104-69, at 41 (1995) ("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.").

Congress was going beyond the Second Circuit standard.[217] Thus, Congress's subsequent override of the President's veto provides strong additional support for the court's conclusion.

Contrary to the court's finding, however, the legislative history does not suggest an outright rejection of motive and opportunity. The court relied on a statement in a footnote to the Conference Committee Report that indicates that Congress did not intend to codify language relating to motive and opportunity.[218] According to the court, this statement indicates that only circumstantial evidence of scienter suffices under the Reform Act's pleading standard.[219] This conclusion, however, is based on flawed reasoning, for the failure to codify does not necessarily indicate that Congress meant to reject motive and opportunity as *per se* insufficient.[220] Instead, as certain statements in the legislative history suggest, Congress simply decided to omit the guidance.[221]

The court's conclusion regarding motive and opportunity was also based on an incomplete and inconsistent reading of other aspects of the Reform Act's

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[217] *See supra* note 130.

[218] *See supra* note 128 and accompanying text. It is interesting to note that the court initially found that this same footnote suggested that recklessness was eliminated as a basis of liability. *See supra* Part V.A.3. The court, of course, later retreated from this conclusion. *See supra* notes 172–73 and accompanying text.

[219] *See supra* note 134 and accompanying text.

[220] *See* Marksman Partners v. Chantal Pharm. Corp., 927 F. Supp. 1297, 1311 (C.D. Cal. 1996) ("The footnote, embedded as it is in the legislative history and not the body of the statute . . . does not indicate that Congress chose to specifically disapprove the motive and opportunity test."). There are a number of other plausible explanations for why Congress decided not to include the motive and opportunity test in the text of the statute. For instance, the SEC argued that "[f]ootnote 23 merely explains the result of the Conference Committee's decision not to codify the Second Circuit's case law interpreting the pleading standard." Brief of Securities and Exchange Commission, *Amicus Curiae*, at 12, *In re* Silicon Graphics, Inc. Sec. Litig., 970 F. Supp. 746 (N.D. Cal. 1997). Perhaps more persuasive is the suggestion that the Specter Amendment provided for a motive and opportunity test that failed to include important qualifications needed to accurately reflect the most recent Second Circuit cases. *See* Brief of Securities and Exchange Commission, *Amicus Curiae*, at 9, *In re Silicon Graphics, Inc. Sec. Litig.*, 970 F. Supp. 746 (N.D. Cal. 1997), *appeal docketed*, No. 97-16240 (9th Cir. July 10, 1997) (noting that recent Second Circuit cases required plaintiffs to show a "particularized economic benefit that defendants could rationally expect to achieve through the fraudulent scheme alleged").

[221] Senator Dodd, for example, indicated that, in rejecting the Specter Amendment, "[w]e . . . left out the guidance. That does not mean you disregard it." 141 CONG. REC. S19068 (daily ed. Dec. 21, 1995). Several district courts have recently adopted this interpretation. *See, e.g.*, Sturm v. Marriott Marquis Corp., 26 F. Supp. 2d 1358 (N.D. Ga. 1998) (holding that the Second Circuit's standard of motive and opportunity is "neither incorporated in nor repealed by the Reform Act"); Queen Uno Ltd. Partnership v. Coeur D'Alene Mines Corp., 2 F. Supp. 2d 1345, 1359 (D. Colo. 1998) (holding that the Reform Act did not establish a rigid, formalistic test, but requires that courts examine plaintiff's allegations in their entirety to determine if they permit a strong inference of fraudulent intent).

legislative history. During consideration of what became new section 21D(b)(2), an amendment was adopted that would have expressly codified the Second Circuit standard relating to motive and opportunity.[222] Although the court placed significance on the deletion of this "clarifying amendment,"[223] the court overlooked the fact that the amendment would also have expressly codified the other prong of the Second Circuit standard.[224] Thus, when the Conference Committee deleted the clarifying amendment, the Committee also deleted the language regarding circumstantial evidence of conscious misbehavior.[225] It is entirely inconsistent for the Court to find that the motive and opportunity prong was expressly rejected as insufficient and, at the same time, articulate a standard requiring circumstantial evidence of conscious misbehavior.

If Congress had intended to adopt a precise test for what is sufficient to satisfy the new "strong inference" standard, one would expect that Congress would have included this in the text of the Act. The text of section 21D(b)(2), however, provides no such guidance for applying the "strong inference" standard. Nonetheless, the court in *Silicon Graphics* takes certain statements in the legislative history to their literal extremes in order to "discover" the precise contours of the Reform Act's "strong inference" standard. Not only does this result in an interpretation of section 21D(b)(2) that Congress clearly did not intend, but it also provides a standard for pleading scienter that effectively undermines the primary purpose of securities fraud actions.

C. *Striking an Imbalance*

The overriding purpose of the federal securities laws is the protection of

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[222] *See* Amend. 1485, S. 240, 104th Cong. 1st Sess. (1995) (the Specter Amendment).

[223] The court also placed some significance on the Conference Committee Report's subsequent reference to this deletion. *See supra* notes 125–29 and accompanying text.

[224] The Specter Amendment would have provided in the text of the statute:

> (2) Strong Inference of Fraudulent Intent.—for purposes of paragraph (1), a strong inference that the defendant acted with the required state of mind may be established either:
> (A) by alleging facts to show that the defendant had both motive and opportunity to commit fraud; or
> (B) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness by the defendant.

141 CONG. REC. S9222 (June 28, 1995), *reprinted in* Brief of Securities and Exchange Commission, Amicus Curiae, at 11 n.16, *In re* Silicon Graphics, Inc. Sec. Litig., 970 F. Supp. 746 (N.D. Cal. 1997).

[225] *See* Brief of Securities and Exchange Commission, Amicus Curiae, at 12, *In re* Silicon Graphics, Inc. Sec. Litig., 970 F. Supp. 746 (N.D. Cal. 1997).

investors.[226] Courts and commentators alike have recognized that private securities fraud actions, such as those brought under section 10(b) and Rule 10b-5, have become the primary tool for effectuating this purpose.[227] The effectiveness of private securities fraud actions in achieving their purpose depends upon their ability to remedy violations that occur.[228] The courts have been mindful of this when developing the parameters of securities fraud actions, recognizing that, in order for investors to be protected, the courtroom doors must remain open to victims of securities fraud violations.[229]

Although private securities fraud actions attempt to protect investors by deterring fraud and remedying violations that occur, the courts have recognized that such actions can pose a significant threat of abuse if left unchecked.[230] With private securities fraud actions, there is a threat that the litigation process will be used to "extract[ ] undeserved settlements" by prolonging the discovery process and thereby imposing substantial costs on innocent defendants.[231] Thus, courts must be mindful of the conflicting interests implicated by securities fraud action, for an inevitable tension exists between deterring abuse on the one hand and ensuring that victims of fraud are given a sufficient opportunity to obtain redress on the other.[232]

The Reform Act can be seen as an attempt by Congress to strike a balance between these two conflicting interests.[233] Essentially, the Reform Act was enacted because Congress believed that the courts were not striking a proper balance.[234] While the existing procedural framework was keeping the courtroom

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[226] *See supra* notes 29–32 and accompanying text.

[227] *See* H.R. REP. NO. 104-369, at 104 (1995) ("Private securities litigation is an indispensable tool with which defrauded investors can recover their losses . . . ."); *supra* notes 37–38 and accompanying text.

[228] *See, e.g., In re* Time Warner Inc. Sec. Litig., 9 F.3d 259, 263 (2d Cir. 1993) ("[T]here is the interest of deterring fraud in the securities markets and remedying it when it occurs.").

[229] For instance, in *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir. 1978), the Second Circuit recognized the practical implications of not allowing liability based on recklessness: "[It] would for all intents and purposes disembowel the private cause of action under Section 10(b)." *Id.* at 47.

[230] *See In re Time Warner*, 9 F.3d at 263.

[231] *See id.*

[232] On the one hand, the interest of the federal securities laws in deterring fraud and remedying violations requires courts to recognize that plaintiffs are often unable to provide substantial detail without an opportunity to conduct discovery. *See id.* On the other hand, the interest in deterring frivolous lawsuits and preventing "undeserved settlements" requires courts to enforce certain procedural protections in order to separate the frivolous claims from the valid ones. *See id.*

[233] *See supra* notes 77–83 and accompanying text.

[234] Prior to the Reform Act, the amount of protection provided by pleading standards differed considerably among circuits. As discussed in Part II.B, *supra*, this inconsistency was most pronounced between the Second and Ninth Circuits and resulted from an inconsistent

door open to victims of securities fraud, it was also letting in an unacceptable number of frivolous law suits. Increasingly, plaintiffs were bringing unfounded claims, abusing the discovery process, and forcing "unwarranted settlements."[235] In Congress's view, this was a result of insufficient procedural protections. Thus, the Reform Act imposed a number of procedural protections, including a discovery stay,[236] stricter pleading standards, and more potent sanctions for abusive practices, in an attempt to strike a more proper balance.[237]

In *Silicon Graphics*, the court concluded that evidence establishing a motive and opportunity to commit fraud is *per se* insufficient to satisfy the Reform Act's "heightened" pleading standard.[238] This represents a substantial holding with severe implications given the fact that, under the pre-Reform Act Second Circuit standard, allegations of motive and opportunity represented an important mechanism for withstanding a motion to dismiss.[239] From a practical standpoint, this was because the proof required to establish motive and opportunity was most consistent with the type of information typically available to a victim of securities fraud prior to discovery.

Where direct or circumstantial evidence of the defendant's level of scienter was lacking, a plaintiff could allege that defendant had both the motive and the opportunity to commit fraud.[240] In order to prove motive, a plaintiff had to allege that the defendant stood to gain concrete benefits from the misrepresentations or

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application of Rule 9(b)'s pleading requirements. The Ninth Circuit applied a pleading standard that provided only a minimal procedural barrier to surviving motions to dismiss. This resulted from a literal interpretation of Rule 9(b)'s requirements for pleading scienter, which allowed a plaintiff to aver scienter generally. *See supra* note 63–67 and accompanying text. The Second Circuit, on the other hand, applied a rather stringent pleading standard that required plaintiffs to plead scienter by alleging "facts that g[a]ve rise to a 'strong inference' of fraudulent intent." *In re Time Warner*, 9 F.3d at 268. The Ninth Circuit's standard, although arguably based on a strained reading of Rule 9(b), resulted from a conscious attempt to strike a balance between the two competing interests. *See id.* at 263–64 (discussing the balancing of interests).

235 Congress was prompted by a number of perceived abuses in securities litigation. *See supra* notes 74–75 and accompanying text.

236 *See* Private Securities Litigation Reform Act of 1995, § 101, 15 U.S.C. § 78u-4(b)(3) (Supp. II 1996). Under § 21D(b)(3) of the 1934 Act, "all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss" in private securities fraud actions. *Id.*

237 *See supra* notes 77–83 and accompanying text.

238 *See supra* notes 133–35 and accompanying text. Although it is not entirely clear, it appears that the court in *Silicon Graphics II* may have retreated somewhat from its initial hard-line position. *See supra* note 158.

239 Victims of fraud often cannot obtain "hard" evidence of fraudulent intent until they have had an opportunity to conduct discovery. *See In re Time Warner*, 9 F.3d at 268 ("Victims of fraud often are unable to detail their allegations until they have had some opportunity to conduct discovery of those reasonably suspected of having perpetrated a fraud.").

240 *See supra* note 61 and accompanying text.

nondisclosures.[241] For example, a plaintiff could show that the defendants had sold a substantial amount of stock after making the allegedly false statements. In order to prove opportunity, a plaintiff was required to show that the defendants had the means to bring about concrete benefits.[242] To satisfy this, the courts required a plaintiff to demonstrate that defendants were well positioned to carry out the fraud in that they possessed a position of trust and authority.[243]

In holding that evidence establishing a motive and opportunity to commit fraud is insufficient to plead a strong inference of fraud under section 21D(b)(2), the court in *Silicon Graphics* undermined the balance struck by Congress in the Reform Act. The court's holding will require, in all securities fraud actions, that plaintiffs allege facts constituting circumstantial evidence of "deliberate recklessness" or conscious behavior.[244] This will require, for example, that plaintiffs provide details regarding negative internal reports indicating that defendants knew or should have known that their statements were false or misleading.[245] Unfortunately, in many securities fraud cases, this type of information will be exclusively within the knowledge and control of the defendants. Furthermore, because the Reform Act requires courts to stay all discovery pending a motion to dismiss, plaintiffs will frequently not have access to this information.[246] Thus, while ostensibly preventing frivolous lawsuits, requiring circumstantial evidence in all instances will effectively prevent a number of potentially meritorious securities fraud claims from surviving a motion to dismiss.

The court's interpretation of section 21D(b)(2) in *Silicon Graphics* cannot be reconciled with the purposes of the Reform Act. By eliminating the only viable method of pleading scienter available to many securities fraud plaintiffs, the court's decision effectively leaves many investors unprotected and without sufficient opportunity to remedy fraud when it occurs. In light of the strong interest of the federal securities laws in protecting investors and deterring fraud, it is hard to imagine that Congress intended to create such a result.

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[241] *See* Shields v. Citytrust Bancorp, 25 F.3d 1124, 1130 (2d Cir. 1994) ("Motive would entail concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged.").

[242] *Id.* ("Opportunity would entail the means and likely prospect of achieving concrete benefits by the means alleged.").

[243] *See* Powers v. British Vita, P.L.C., 57 F.3d 176, 185 (2d Cir. 1995).

[244] *See supra* note 62. This "second prong" of the Second Circuit standard is generally more difficult to satisfy. *Id.*

[245] This was attempted without success in *Silicon Graphics*. *See supra* notes 140–41 and accompanying text.

[246] *See supra* note 236. The court in *Silicon Graphics* failed to address this potential conflict.

VI. CONCLUSION: TOWARD A "BALANCED" INTERPRETATION

Although every district court now appears to accept that the Reform Act did not eliminate recklessness from the definition of scienter, the courts are sharply divided regarding the precise contours of the section 21D(b)(2) pleading standard. Although a few courts have taken the position that the Reform Act merely codifies the Second Circuit standard in its entirety,[247] the legislative history clearly indicates that this is not the case.[248] Nor does the text or legislative history support the position taken by the court in *Silicon Graphics* that Congress intended to eliminate the motive and opportunity test by rendering it *per se* insufficient to satisfy the "strong inference" pleading standard.[249]

The text and legislative history of the Reform Act are most consistent with an interpretation that completely divorces the "strong inference" pleading standard from any concrete test.[250] While there is clear language in the Reform Act's legislative history indicating that section 21D(b)(2) is not merely a codification of the Second Circuit standard, there is insufficient guidance in the Act to allow a court to piece together a test delineating what facts are sufficient to satisfy this new pleading standard. Upon a thorough evaluation of the Reform Act, it becomes clear that Congress only addressed the standard in the Reform Act, leaving the determination as to what will be sufficient under this standard to the courts.[251]

Such an interpretation of section 21D(b)(2) is not only faithful to the text and

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[247] *See supra* note 206.

[248] *See supra* note 214–17 and accompanying text.

[249] *See supra* note 218–25 and accompanying text.

[250] When considering the pleading standard separate from the facts that are sufficient to establish a "strong inference" of fraudulent intent, the text and legislative history of § 21D(b)(2) begin to make a great deal more sense. Essentially, § 21D(b)(2) only provides for a heightened pleading standard; it says nothing about what types of facts are sufficient to satisfy this standard.

[251] A few courts have interpreted § 21D(b)(2) in this manner. For example, the Eastern District of New York found that "the PSLRA does not delineate what facts suffice to establish a 'strong inference' of fraudulent intent. Instead, Congress . . . bestowed such duty to interpret upon the courts." *In re* Health Management, Inc. Sec. Litig., 970 F. Supp. 192, 200 (E.D.N.Y. 1997); *see also* Sturm v. Marriott Marquis Corp., 26 F. Supp. 2d 1358 (N.D. Ga. 1998); Queen Uno Ltd. Partnership v. Coeur D'Alene Mines Corp., 2 F. Supp. 2d 1345, 1359 (D. Colo. 1998).

Additional support for this interpretation was provided by Congress in a Conference Report to the Security Litigation Standards Act of 1998. *See* H.R. REP. NO. 105-803 (1998). In its Joint Explanatory Statement, the Conference Committee emphasized that the Reform Act did not make "any attempt to define [the] state of mind" required by the Reform Act's "strong inference" standard. *See id.* The court in *In re Health Management, Inc. Securities Litigation* held that a plaintiff is not restricted in the ways he may attempt to satisfy this standard. According to the court, "A plaintiff can satisfy this burden by pleading motive and opportunity, conscious misbehavior, recklessness or by impressing upon the court a novel legal theory." *Health Management*, 970 F. Supp. at 201.

legislative history of the Reform Act, but it is also consistent with the purposes of the Reform Act and federal securities laws—it strikes a proper balance between the competing interests implicated in securities fraud actions. By recognizing that the "strong inference" standard is stronger than even the Second Circuit's standard, the interpretation furthers the goal of deterring frivolous lawsuits. This is not necessarily accomplished, however, at the expense of investors with valid securities fraud actions, because the courts enjoy the flexibility to determine what types of facts suffice to establish a strong inference of fraudulent intent. Thus, the courts are given the task of molding the standard to maintain a proper balance of interests.

The decision by the Northern District of California in *Silicon Graphics* is certainly not the last judicial attempt at interpreting section 21D(b)(2)'s heightened pleading standard. The *Silicon Graphics* case is currently awaiting appellate review in the Ninth Circuit. Meanwhile, the district courts continue their struggle to come up with an interpretation that is consistent with the Reform Act's text, structure, and legislative history, while still maintaining faithful to the purposes of the Reform Act and the federal securities laws.