# Turning Point for Rule 10b-5: Will Congressional Reforms Protect Small Corporations?

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## I. INTRODUCTION

We have reached a critical point in the debate over whether to reform current principles of private securities litigation. For roughly fifty years, investors have looked to Rule 10b-5[1] as a remedy for losses caused by securities fraud. Private actions under 10b-5 not only provide compensation for investor losses, but they are also an indispensable means of enforcing federal securities laws because the Securities and Exchange Commission (SEC) lacks the resources to thoroughly police potential violations.[2]

In recent years, however, critics have argued that current principles of shareholder class action litigation impose a heavy burden on American

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[1] 17 C.F.R. § 240.10b-5 (1993). The Securities Exchange Commission (SEC) promulgated the rule pursuant to its powers under the Securities Exchange Act of 1934, § 10(b), 15 U.S.C. §§ 78a-78*ll* (1988 & Supp. V 1993). The rule provides as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> (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.

17 C.F.R. § 240.10b-5 (1993).

[2] *See* Berner v. Lazzaro, 730 F.2d 1319, 1322–23 (9th Cir. 1984) ("The resources of the [SEC] are adequate to prosecute only the most flagrant abuses. To this end, private actions brought by investors have long been viewed as a necessary supplement to SEC enforcement actions.") (citation omitted).

business.[3] These critics say that 10b-5 provides a basis for frivolous litigation that undermines the efficiency of American business and hinders America's global competitiveness.[4] Many critics argue that shareholders also suffer under the current system because, after subtracting attorney's fees, the average shareholder recovers only a small percentage of her actual loss.[5]

The call for reform has been intensified by recent reports that small and high-tech corporations are faced with an increasing and disproportionate share of private securities actions.[6] The increase in suits against emerging businesses is particularly relevant to concerns about the effect of shareholder litigation on American competitiveness because these firms, which often introduce innovative products, are the least able to bear the costs of shareholder suits.[7]

In response to concerns about abuse of Rule 10b-5 litigation, six bills to amend the Securities Exchange Act have been introduced in both houses of the Congress.[8] Each of these bills contains provisions designed to deter frivolous

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[3] *See, e.g.*, 141 CONG. REC. S1075 (daily ed. Jan. 18, 1995) (statement of Sen. Domenici); 140 CONG. REC. S3695 (daily ed. Mar. 24, 1994) (statement of Sen. Dodd); 138 CONG. REC. S12,599-601 (daily ed. Aug. 12, 1992) (statement of Sen. Domenici); 138 CONG. REC. E2463 (daily ed. Aug. 12, 1992) (statement of Rep. Tauzin); Brent Bowers & Udayan Gupta, *Shareholder Suits Beset More Small Companies*, WALL ST. J., Mar. 9, 1994, at B1.

[4] *See id.* Frivolous suits, also called "nuisance" or "strike" suits, are actions in which the plaintiff is able to obtain a favorable settlement from the defendant even though the defendant knows that the plaintiff's claim would be unlikely to prevail at a trial. David Rosenberg & Steven Shavell, *A Model in Which Suits Are Brought for Their Nuisance Value*, 5 INT'L REV. L. & ECON. 3 (1985). *See* John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 669-70 n.1 (1986).

[5] *See* Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991); Frederick C. Dunbar & Vinita M. Juneja, *Recent Trends II: What Explains Settlements in Shareholder Class Actions?* (National Economic Research Assoc., White Plains, N.Y.), Oct. 1993.

[6] *See* Bowers & Gupta, *supra* note 3, at B1 (citing a study conducted by Securities Class Action Alert); Udayan Gupta & Brent Bowers, *Small Fast-Growth Firms Feel Chill of Shareholder Suits*, WALL ST. J., Apr. 5, 1994, at B2; Dunbar & Juneja, *supra* note 5; *The Impact of Securities Frauds on Entrepreneurial Companies*, Survey (VentureOne, San Francisco, Cal.), Jan. 1994.

[7] *See* 140 CONG. REC. S3695, 3706-07 (daily ed. Mar. 24, 1994) (statements of Sen. Dodd and Sen. Domenici); 138 CONG. REC. S12,599-601 (daily ed. Aug. 12, 1992) (statement of Sen. Domenici); 138 CONG. REC. E2463 (daily ed. Aug. 12, 1992) (statement of Rep. Tauzin); Bowers & Gupta, *supra* note 3.

[8] *See* S. 240, 104th Cong., 1st Sess. (1995); S. 667, 104th Cong., 1st Sess. (1995); H.R. 10, 104th Cong., 1st Sess. (1995); H.R. 555, 104th Cong., 1st Sess. (1995); H.R.

litigation and to restructure class-action representation principles to better serve the interests of investors.[9] The sponsors of the bills expressed a particular concern for entrepreneurial corporations.[10] The major provisions include fee shifting, proportionate liability, a heightened burden of proof, more stringent pleading requirements, minimum holding requirements (ten thousand dollars or one percent) for named plaintiffs, and a safe harbor for predictive statements.[11]

This Article examines the particular vulnerability of small corporations to frivolous suits under Rule 10b-5. This Article also considers the likelihood that the proposed congressional reforms will protect small corporations, while still providing adequate protections for shareholders. Part II sets forth the values traditionally attached to private actions for securities fraud. Part III summarizes a model of shareholder suits that suggests plaintiffs have economic incentives to pursue claims with little or no merits. Part IV examines two studies that may support this model. These studies provide empirical evidence that the merits of a suit are in fact irrelevant to its settlement value. Part V addresses the recent increase in shareholder suits against entrepreneurial corporations as well as some possible explanations for this phenomenon. Part VI then examines the provisions of the House and Senate Bills that are intended to deter frivolous litigation. This Article asserts that many of the proposed reforms are not well suited for protecting either investors or small corporations. This Article

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681, 104th Cong., 1st Sess. (1995); H.R. 1058, 104th Cong., 1st Sess. (1995). Similar versions of Senate Bill 240 and House Bill 681 were introduced in the 103rd Congress, but the Congress did not act upon those bills before the session ended. *See* S. 1976, 103d Cong., 2d Sess. (1994); H.R. 417, 103d Cong., 1st Sess. (1993). For an updated listing of the co-sponsors of the current bills, *see* Private Securities Litigation Reform Act of 1995 (for S. 240), Private Securities Enforcement Improvements Act of 1995 (for S. 667), Common Sense Legal Reforms Act of 1995 (for H.R. 10), Private Securities Litigation Reform Act of 1995 (for H.R. 555), Securities Private Enforcement Reform Act (for H.R. 681), and Securities Litigation Reform Act (for H.R. 1058), Bill Tracking Report, *available in* LEXIS, Legis Library, BLTRCK file. The House of Representatives passed House Bill 1058 on March 8, 1995.

[9] The bills include many other provisions, such as provisions to protect investor plaintiffs from their own attorneys, but these reforms are beyond the scope of this Article, which focuses on the effects of shareholder suits on small corporations.

[10] House Bill 681 states that "professional plaintiffs extract settlements from entrepreneurs, regardless of the merits of the cases filed . . . investment bankers and accounting firms [are compelled] to resist working with new venture firms." H.R. 681, 104th Cong., 1st Sess. § 2 (1995). Representative Bilbray, in introducing House Bill 10, stated that "high tech, bio-tech and other growth companies . . . fear these abusive strike lawsuits . . . ." 141 CONG. REC. E124 (daily ed. Jan. 18, 1995) (statement of Rep. Bilbray). *See also* 141 CONG. REC. E115 (daily ed. Jan. 18, 1995) (statement of Rep. Markey); 141 CONG. REC. S1075 (daily ed. Jan. 18, 1995) (statements of Sen. Dodd and Sen. Domenici).

[11] *See infra* part VI.

concludes, however, that some of the proposed reforms, particularly the safe harbor for predictive statements, can be modified to strike a more suitable balance between the interests of investors and small corporations.

## II. THE VALUES OF PRIVATE ENFORCEMENT

To examine the principles of shareholder litigation in any meaningful way, one must first identify the policies that underlie private securities actions. Therefore, before analyzing the theoretical and practical problems of shareholder suits, this Article first addresses the goals sought to be attained through these private actions.

Congress' declared purpose in enacting section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act" or the "1934 Act")[12] was to prevent conduct designed to defraud or deceive investors.[13] The Supreme Court has observed that the purpose of the 1934 Act and its companion legislation is "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* . . . in the securities industry."[14] In order to meet this goal, section 10(b) authorizes the SEC to promulgate rules implementing the policies of section 10(b).[15] Pursuant to this authority, the SEC promulgated Rule 10b-5.

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[12] 15 U.S.C. §§ 78a–78*ll* (1988 & Supp. V 1993). Section 10(b) provides in relevant part:

> 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—
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> . . . .
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> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j (1988).

[13] *See* Aaron v. SEC, 446 U.S. 680, 689–90 (1980); Chiarella v. United States, 445 U.S. 222, 226 (1980).

[14] Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963)).

[15] 15 U.S.C. §§ 78a–78*ll* (1988 & Supp. V 1993).

Although 10b-5 does not expressly provide a private right of action, the courts have interpreted 10b-5 to imply such a right.[16]

In light of the enormous resources that would be required for the government to guard against violations of Rule 10b-5, courts and commentators have endorsed the use of private actions to insure effective enforcement.[17] The role of shareholder suits in policing securities markets is often described as the deputizing of "private attorney generals."[18] In theory, these private attorney generals provide corporate management with an incentive to improve the quality and quantity of public disclosures.[19] Accurate and timely disclosures (1) aid capital formation by reducing the uncertainty surrounding the issuing of new securities, (2) reduce research costs because corporate management is the lowest-cost provider of information, and (3) allow better stockholder monitoring of management.[20]

Because enforcement of securities laws serves the dual purposes of compensating losses and deterring future wrongdoing,[21] reforms that target shareholder suits run the risk of undermining the effectiveness of private enforcement and thus the enforcement of securities laws in general.[22] This Article will address these risks following a discussion of the difficulties associated with shareholder class actions.

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[16] *See* Lampf v. Gilbertson, 501 U.S. 350, 358-59 (1991); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975); Kardon v. National Gypsum Co., 69 F. Supp. 512, 513 (E.D. Pa. 1946).

[17] *See* Berner v. Lazzaro, 730 F.2d 1319, 1322-23 (9th Cir. 1984); 5A ARNOLD S. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 8.01, at 1-228 (2d ed. 1992) (Private actions are "the most effective way to police 10b-5 breaches.").

[18] Judge Jerome Frank introduced this term to describe individuals who are authorized to bring actions in the greater public interest. Associated Indus. Inc. v. Ickes, 134 F.2d 694, 704-05 (2d Cir.), *cert. granted*, 319 U.S. 739, *vacated as moot*, 320 U.S. 707 (1943). For a summary of the history of private enforcement of the securities laws, see Coffee, *supra* note 4. An excellent discussion of the current justifications for the private attorney general concept is provided in Bryant Garth et. al., *The Institution of the Private Attorney General: Perspectives from an Empirical Study of Class Action Litigation*, 61 S. CAL. L. REV. 353 (1988).

[19] *See* Dunbar & Juneja, *supra* note 5, at 14.

[20] *Id.*

[21] Mills v. Electric Auto-Lite Co., 396 U.S. 375, 396-97 (1970); J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).

[22] *See* Adam F. Ingber, Note, *10b-5 or Not 10b-5?: Are the Current Efforts to Reform Securities Litigation Misguided?*, 61 FORDHAM L. REV. S351 (1993). Ingber argues that the proposed Rule 10b-5 reforms of fee shifting, proportionate liability, and higher burden of proof, all contained in House Bill 417, should be abandoned because "all embody the danger that they will increase the litigation burdens carried by plaintiffs; and all embody the danger of hindering private enforcement of the securities laws." *Id.* at S366.

## III. THE ECONOMICS OF SHAREHOLDER SUITS

Deferring a discussion of empirical evidence until Part IV, this Part first outlines an economic model of shareholder suits that indicates strong incentives for plaintiffs to pursue claims with dubious merits. This Part then examines the particular relevance of this economic model to the circumstances of small corporations.

### A. *The General Economic Model*

Once a plaintiff has initiated an action, the corporate defendant has two alternative means of protecting itself: (1) attempt to settle, or (2) prepare a defense and seek a favorable judgment. As a rational creature of economic self-interest,[23] the corporate defendant will ordinarily pursue the least expensive route. Therefore, a settlement will be more appealing whenever the cost of settlement is less than the expected costs of litigation.

The choice described above is, of course, no different than the choice facing any defendant in any civil action. Under an economic theory of typical settlement behavior, we would expect that the settlement value of a particular suit is determined by the estimated amount of a verdict favorable to the plaintiffs, discounted by the probability of the plaintiffs' success on the merits.[24] In 10b-5 litigation, however, the plaintiffs have a strategic advantage, because their litigation costs are typically much lower than those of the defendant.[25] As long as the complaint asserts an actionable legal claim,[26] the

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[23] Corporate officers and directors are under pressure to keep the market price of their company's stock from falling. William C. Baskin III, Note, *Using Rule 9(b) to Reduce Nuisance Securities Litigation*, 99 YALE L.J. 1591, 1598 n.50 (1990); *see also* Andrew E. Serwer, *What to Do About Legal Blackmail*, FORTUNE, Nov. 15, 1993, at 136, 137. A partner with Shearman & Sterling says that companies facing a one hundred million dollar lawsuit often think it prudent to settle for several million dollars, even after spending a million dollars in legal fees. Serwer, *supra*. The stock price is influenced by the corporation's reported earnings. *Id.* Therefore, managers must keep quarterly earnings high, even at the expense of total long-term earnings. *Id.* This practice creates a focus on the dollar value of settling versus litigating as the deciding criterion in the decision whether to fight or settle. *Id.* Corporate managers also may not feel that their personal reputations have been impugned or need defending, which makes them less inclined to fight based on reasons not related to relative costs. *Id.*

[24] *See* Janet C. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 503 (1991).

[25] *See* John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, LAW & CONTEMP. PROBS., Summer 1985, at 5, 17 [hereinafter Coffee, *The Unfaithful Champion*]; Coffee, *supra* note 4, at 697 n.79 ("The conventional

plaintiffs' attorney will be able to use the discovery process to conduct numerous depositions of the defendant's officers, and to request extensive production of documents. The costs of this process to the corporate defendant include not only attorney's fees, but loss of executives' time, loss of reputational capital, and loss of managerial certainty.[27]

In contrast, the average discovery costs imposed on 10b-5 plaintiffs are much smaller. Liability in a 10b-5 suit turns mainly on issues relevant only to the defendant's conduct such as scienter,[28] due diligence, and the adequacy and accuracy of prospectuses, annual reports, or company press releases. Due to the nature of these issues, the individual shareholder will possess little relevant information. The discovery burden on the plaintiff has been further reduced by the development of the "fraud-on-the-market" doctrine in shareholder litigation, which may eliminate the need to prove actual reliance on the alleged inadequate or misleading disclosures.[29]

In *Blue Chip Stamps v. Manor Drug Stores*,[30] the Supreme Court recognized the potential for abuse of the discovery provisions in shareholder suits, describing the plaintiffs' ability to burden the defendant's resources with a largely groundless claim as the "*in terrorem* increment of the settlement

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wisdom is that litigation costs [in class and derivative actions] tend to be lower for plaintiffs than defendants.").

[26] *See infra* part VI.F (discussion of pleading requirements).

[27] See Coffee, *supra* note 4, at 701–02 & nn.93–94 for a more detailed discussion of these costs.

[28] Scienter is "a mental state embracing intent to deceive, manipulate, or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976). Scienter is a required element of a 10b-5 claim. *Id.* at 192 n.7, 193.

[29] The fraud-on-the-market theory is based on the semi-strong form of the efficient market hypothesis, which posits that the price of a security reflects all relevant publicly available information. Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059 (1990). Under the efficient market hypothesis, relevant misrepresentations defraud all investors, regardless of their reliance on the misrepresentations, because misrepresentations unfairly affect the market price of the security. Use of the fraud-on-the-market theory in shareholder suits was adopted by the United States Supreme Court in Basic Inc. v. Levinson, 485 U.S. 224, 250 (1988). Commentary on the fraud-on-the-market doctrine is extensive. *See, e.g.*, Barbara Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C. L. REV. 435 (1984); Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1 (1982); Macey & Miller, *supra*; Zachary A. Starr, *Fraud on the Market and the Substantive Theory of Class Actions*, 65 ST. JOHN'S L. REV. 441 (1991).

[30] 421 U.S. 723 (1975).

value."[31] Not surprisingly, experienced securities attorneys become aware of the relative difference between the litigation expenses of the opposing sides, and learn to assess the size of that gap.[32] Awareness of this imbalance works to the plaintiffs' advantage, because it means that both parties will favor settlement for an amount somewhere between the plaintiffs' cost of bringing and maintaining the action and the defendant's cost of preparing a defense.[33] With the knowledge that the defendant will prefer to settle for some amount below the costs of preparing a defense, a reliable estimate of the cost differential enables plaintiffs to capitalize on some portion of the imbalance merely by filing suit, regardless of the merits.[34] This theory, applied to small corporations, makes the potential for encouraging meritless suits even more apparent.

### B. *Small Corporations and the Economic Model*

For many large corporations, there may be incentives to resist frivolous cases, even when doing so represents a significant cost above settlement. Corporations that expect to become repeat defendants in shareholder suits might choose to focus on the long-term effects of settling meritless claims, opting to defend some actions now in order to deter others in the future.[35]

However influential this rationale may be for large corporations, it is unlikely to affect the decisions of small corporations,[36] because these businesses necessarily focus on short-term interests. Small, thinly-capitalized corporations cannot afford to prefer protracted litigation over settlements. In a

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[31] *Id.* at 741.

[32] *See* Coffee, *supra* note 4; Rosenberg & Shavell, *supra* note 4.

[33] *See* Baskin, *supra* note 23, at 1597.

[34] This Article presents only a basic outline of the factors that encourage non-merit-based settlements in shareholder suits. For additional theories, see Alexander, *supra* note 24, at 524–67. Theories include agency problems inherent in class actions; astronomically high potential damages; the hours-based contingency compensation system for plaintiff's lawyers; and insurance and indemnification rules that make substantial sums of money, not paid directly by the parties, available for settlements but not for judgments. *Id.*

[35] *See* Coffee, *The Unfaithful Champion*, *supra* note 25, at 14. Repeat defendants such as accounting firms and insurance companies seek reputations as "tough, hard-nosed litigators who will not settle weak cases." *Id.*

[36] This Article uses the terms "small corporation" and "entrepreneurial corporation" interchangeably to refer to publicly held companies with limited assets and resources. The words "business," "company," and "corporation" are also used interchangeably, and are not intended to have individual significance.

recent survey of publicly held venture-capital-backed corporations,[37] those companies that were targets of shareholder suits reported that they had spent an average of $692,000 on legal fees alone.[38] This figure included dismissed or settled cases, as well as pending cases, which means that the average legal costs of litigating to a verdict would be much higher.[39] This figure was also limited to the quantifiable expense of legal fees, without considering the other burdens that litigation imposes on a company.[40] In light of the incredible costs, it would be absurd for most small companies to defend shareholder claims in the interest of long-term concerns, because the costs of the defense could bring an end to the company.

As in any field of civil litigation, defendant corporations always have the option of litigating cases they perceive as unfounded up to the summary judgment stage before they consider settlement. This approach would allow these corporations to isolate the costs of discovery from the costs of going to trial, as well as permitting them to balance the discovery costs against the likelihood of prevailing at summary judgment. Although the imbalance in costs to opposing sides would still be present, some companies might find the reputational interests discussed above more persuasive if they perceived a likelihood of prevailing at summary judgment and cutting their costs short at that point.

Several difficulties exist with this approach in shareholder suits. First, the blend of law and facts inherent in 10b-5 issues makes these cases poor candidates for summary judgment. Issues such as the materiality of undisclosed information, the defendant's state of mind, and the reasonableness of defendant's beliefs involve drawing inferences from a given set of facts and circumstances, and these assessments are reserved for the trier of fact.[41]

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[37] A venture-capital-backed corporation is a corporation embarking on a new or turnaround venture that entails some investment risk but offers the potential for above average returns. *See* BLACK'S LAW DICTIONARY 1556 (6th ed. 1990). Venture capital is often provided by specialized firms whose investors are interested in speculative or high risk investments. *Id.*

[38] *The Impact of Securities Frauds on Entrepreneurial Companies*, *supra* note 6, at 4.

[39] *Id.* The $692,000 legal costs figure was computed as an average of the responses of all those companies which had been sued, including cases from the following categories: dismissed voluntarily by the plaintiff (7%), dismissed on motion to dismiss (12%), settled (21%), and still pending (60%). *Id.* None of the cases had reached a verdict for the plaintiff or the defendant. *Id.*

[40] *See* Coffee, *supra* note 4, at 701-02 & nn.93-94.

[41] Alexander, *supra* note 24, at 527 (citing TSC Indus., Inc. v. Northway Inc., 426 U.S. 438, 450 (1976)).

Therefore, summary judgment is usually unavailable for 10b-5 litigation.[42] Second, the option of litigating weak cases to the summary judgment stage is even less attractive to smaller corporations. Many of these defendants will have a resource base that is too small to justify the risk of incurring the costs of discovery for an unlikely hope of prevailing at summary judgment. For small corporations then, the safest course will be to settle early, when legal costs are low.

## IV. THE RELEVANCE OF MERITS

In recent years, researchers have conducted two detailed studies on the prevalence and effects of shareholder suits.[43] These empirical studies indicate that current principles of 10b-5 litigation do produce the situation suggested by the economic analysis described above: the settlement value of a shareholder suit bears little relation to its merits. Whether these results actually validate the economic model discussed in Part III or result from some other aspect of shareholder suits remains open to debate,[44] but these studies clearly lend support to the argument that the current system of shareholder class action litigation is being abused.

### A. *The Stanford Study*

In 1991, the *Stanford Law Review* released a study by Professor Janet Cooper Alexander regarding seventeen high-tech companies that made initial public offerings (IPOs) during the first half of 1983.[45] Of these seventeen companies, twelve companies experienced large declines in their stock price, and nine of these twelve companies were targets in securities fraud class actions.[46] At the time the study was published, eight of the suits had been settled, with striking results: five settled for between 24.5 and 27.5 percent of the damages sought, a sixth settled at 20.6 percent, and the remaining two settled outside this range due to unusual circumstances.[47] This narrow range is

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[42] *Id.* at 526–28. Professor Alexander notes that recent trends may indicate an increased availability of summary judgment. *Id.* at 527.

[43] *See id.* at 505; Dunbar & Juneja, *supra* note 5.

[44] For an attack on the assertion that plaintiff's attorneys have strong incentives to bring meritless actions, see Coffee, *supra* note 4, at 698.

[45] *See* Alexander, *supra* note 24, at 507, 510.

[46] *See id.* at 511.

[47] *See id.* at 517. The settlements in the two cases which fell outside the narrow range of the other suits can be explained by factors not related to the merits. *Id.* In one of the cases, the corporation had become insolvent and the individual defendants had no significant

inconsistent with a general economic model of settlement behavior.[48] Under a general economic model, settlements would be expected to vary widely as a percentage of the damages sought, due to the wide degree of possible variations in the merits of a given plaintiff's case.[49] However, the narrow range of the settlements in Professor Alexander's study does comport with results predicted by the model of shareholder suits, which suggests that settlements in securities class actions will be independent of the merits of a particular case.

Professor Alexander's study also noted that several of the cases experienced events in the course of litigation that ordinarily would be expected to have an impact on the outcome of a case.[50] For example, in a case that settled at almost exactly twenty-five percent of the damages sought, a district court granted the defendant's motion for partial summary judgment on damages while settlement negotiations were underway. In the opinion of Professor Geoffrey Hazard, who testified as an expert for the plaintiffs, this ruling reduced the plaintiffs' maximum recovery at trial from approximately forty-five million dollars to fifteen million dollars.[51] None of the other cases in Professor Alexander's sample experienced an event of such significance, and yet the case in question settled within the same narrow percentile range as the other cases, further suggesting the irrelevance of the merits of a case to its settlement value.

### B. *The NERA Study*

A 1993 study conducted by National Economic Research Associates[52] (NERA) also provides evidence that settlements in shareholder suits bear little relation to the merits of a claim. This study examined 154 settlements in shareholder suits from July 1991 through June 1993 and attempted to determine the extent to which the merits of these cases affected their settlement values.[53]

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personal assets from which to satisfy a judgment. *Id.* at 517–18. In the other case, the unusually low settlement can be explained by a combination of two factors. *Id.* at 518. First, the market price of the securities in question had plummeted sharply before the time of the alleged fraud, so that the overall stakes of the suit were comparatively low. *Id.* Second, this case was the only case not filed in the Northern District of California; it was filed in the District of Utah, where few securities cases are brought and where the presiding judge appears to have been unsympathetic to plaintiffs in such cases. *Id.* at 518.

[48] *See* Alexander, *supra* note 24 and accompanying text.

[49] *See id.* at 514. For two cases to have identical merits, "the [defendants'] degree of culpability and the evidence available to prove it [must be] equal." *Id.*

[50] *See id.* at 519.

[51] *Id.* at 519–20.

[52] *See* Dunbar & Juneja, *supra* note 5.

[53] *Id.*

The approach taken by the NERA study was to examine two factors that, in theory, should improve the plaintiffs' chances of winning, and then determine whether the presence of either of these factors actually resulted in higher than average settlements.[54] The first factor that the NERA study identified was whether or not the case involved a securities offering.[55] If a securities offering is involved, there is a potential claim for a violation of section 11 of the Securities Act of 1933, in addition to the Rule 10b-5 claim.[56] Whereas 10b-5 requires the plaintiffs to prove scienter,[57] section 11 imposes strict liability for material misstatements in a registration statement unless the defendant can prove nonnegligence.[58] Because the plaintiffs' burden is reduced, one would suspect that a verdict in their favor is more likely under section 11 than under Rule 10b-5.[59] In practice, however, the study showed that the presence of a section 11 claim was always statistically insignificant to the settlement amount, a result that is "discouraging for the argument that the merits matter."[60]

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[54] *Id.* at 10.

[55] *Id.* at 1-2.

[56] *See* 15 U.S.C. § 77k(a) (1988). Section 11 provides a statutory remedy to persons who acquired securities issued under a registration statement containing a false statement of a material fact or omitting a statement of material fact that the registrant was under a duty to disclose. *See id.*

[57] *See supra* note 29.

[58] *See* 15 U.S.C. § 77k(b) (1988); Herman & MacLean v. Huddleston, 459 U.S. 375, 381-82 (1983); Chang v. Moon, [1992-93 Transfer Binder] Fed. Sec. L. Rep. (CCH) 97,209, at 94,863 (D. Or. Oct. 21, 1992); Moore v. Keegan Management Co., 794 F. Supp. 939, 946 (N.D. Cal. 1992).

[59] *See* Ingber, *supra* note 22, at S361. Ingber argues that Professor Alexander's conclusions are in error because she failed to account for the presence of § 11 claims in some of the cases in her study. *Id.* Ingber's premise is that because § 11 allows a presumption of negligence for faulty registration statements, the presence of § 11 claims will render the facts irrelevant in the cases where the defendants cannot rebut this presumption. *Id.* Therefore, he argues, similar settlement values do not necessarily mean that merits are unrelated, because the presence of § 11 claims greatly reduces the number of variables in the merits of a case. *Id.* at 361-62. There are at least two problems with this argument. First, the NERA study demonstrates that the presence of a § 11 claim has a statistically insignificant impact on settlement value. *See supra* notes 45-49 and accompanying text. Second, if § 11 claims did have an impact on settlement value, we should expect a lesser variance in Professor Alexander's sample only if all the cases involved § 11 claims, which is by no means clear from her article. *See* Alexander, *supra* note 24, at 509 n.36 (stating that "legal theories *included* claims for violations of federal securities laws, section 11 . . . and Rule 10b-5." (emphasis added)).

[60] Dunbar & Juneja, *supra* note 5, at 11.

The second factor that the NERA study identified as a potential indicator of merit was an independent enforcement action by a federal or state agency.[61] The presence of such activity, especially if it resulted in an order, indictment, or plea, might indicate a stronger case for the plaintiffs.[62] Like the presence of section 11 claims, the statistical impact of government action was also found to be insignificant.[63] To see if more severe enforcement action mattered, the study divided cases into three levels, from simple investigations up to a finding that violations had occurred.[64] Here the NERA study found that even a government finding of securities violations produced no correlative increase in the settlement value of a private action.[65]

## C. *The Significance of Meritless Settlements*

Given the evidence that settlements in shareholder suits do not reflect the merits of a case, a serious question arises as to whether private securities actions are meeting their asserted goals. In a system in which the settlement amount of a lawsuit does not reflect estimated liability, corporate management has little incentive to increase the quality of its disclosures. Good management behavior is not rewarded where all management behavior, regardless of intent, is subject to penalty.[66]

The absence of any correlation between merits and settlement value also places a burden on publicly-held companies that may not be justified by the asserted benefits of shareholder suits, even if these benefits are actually being achieved. A system in which weak claims have the same settlement value as strong claims encourages plaintiffs to proceed with claims that they would not otherwise pursue. This increases the total number of 10b-5 suits, which results in an unjustified cost for publicly-held corporations. Frivolous suits not only impose immediate expenses upon defendant corporations, but they may have other repercussions as well. Potential defendants, such as banks, accounting firms, and outside directors, may shy away from companies which are more likely to be targets of shareholder suits.[67]

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[61] *Id.*

[62] *Id.*

[63] *Id.* The correlation factor for government actions, although statistically insignificant, actually had a negative effect on the settlement value. *Id.*

[64] *Id.*

[65] *Id.*

[66] *See id.* at 14.

[67] *See* 138 CONG. REC. S12,600-01 (daily ed. Aug. 12, 1992) (statement of Sen. Domenici).

## V. THE BURDEN ON SMALL BUSINESS

Recent trends indicate that shareholder suits are focusing more on smaller corporations, and less on the major corporations that were involved in giant takeovers, mergers, and the collapse of the junk-bond market in the 1980s and early 1990s.[68] In addition, a disproportionate amount of the total number of shareholder suits filed between 1991 and 1993 were against companies in the volatile high-growth technology industry.[69]

While no existing research suggests that entrepreneurial or high-tech companies are more deceitful or negligent than other companies, a number of factors may explain the increase in suits against these companies. As observed earlier, shareholder suits are more burdensome for smaller companies because these companies have fewer available resources and thus a stronger incentive to settle in order to avoid extensive legal fees.[70] In a system that encourages meritless suits, the burden on small companies is magnified. Plaintiffs will be aware of the substantial incentives for small companies to settle claims for an amount below their costs, and these companies will become more attractive targets. Thus, the very companies that can least afford to take a hit will be targeted more frequently.

Small companies also prove attractive targets for shareholder suits because they are more likely to show large fluctuations in stock prices.[71] The fortunes of emerging companies are inherently unpredictable, and therefore earnings often fall short of analyst's expectations. Shares of small high-technology and biotechnology firms in particular tend to trade at high price-to-earnings ratios, reflecting hopes of a big payoff.[72] For the same reason, however, the stock price can plunge at the first hint of a setback.[73] Class action securities litigation against small companies also appeals more to plaintiffs because these companies have less burdensome shareholder-notification requirements than

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[68] *See* Bowers & Gupta, *supra* note 3, at B1 (quoting James Newman, editor and publisher of Securities Class Action Alert); Walter Wingo, *How Class-Action Suits Impede Innovation*, DESIGN NEWS, Aug. 16, 1993, at 16 (quoting Edward R. McCracken, president and CEO of Silicon Graphics, Inc., who describes abusive suits against small, risk-taking corporations as a "tax on innovation").

[69] *See* Serwer, *supra* note 23, at 137; 140 CONG. REC. S3695 (daily ed. Mar. 24, 1994) (statement of Sen. Dodd); Dunbar & Juneja, *supra* note 5, at 15, table 5.

[70] *See supra* part III.B.

[71] *See* Bowers & Gupta, *supra* note 3, at B1.

[72] *Id.*

[73] *Id.*

those of large corporations, which can cost more than one million dollars in mailings alone for some major corporations.[74]

Shareholder suits are particularly burdensome for small companies. In a survey of small businesses released by the National Venture Capital Association (Venture Capital survey) in January 1994, seventy-one percent of those companies polled said that they were more reluctant to discuss company performance with analysts, sixty-one percent reported increased liability insurance costs, and thirty percent said they had experienced difficulties in retaining outside directors.[75] In addition, these companies reported spending an average of $692,000 on legal fees,[76] 1,055 hours of management time, and $4.5 million for a typical settlement.[77]

The experience of Exabyte Corporation, a Longmont, Colorado maker of computer-data storage devices, provides a typical example of how shareholder suits burden small companies. In 1992, Exabyte reported that its third-quarter earnings would be lower than analysts' projections, because of the introduction of a new product.[78] Exabyte's stock dropped from twenty-three dollars per share to fourteen dollars per share, and a number of shareholder suits followed. Even though the cases were dismissed in June 1993, the company experienced many of the typical symptoms reported by companies in the Venture Capital survey. Exabyte spent more than $100,000 in legal costs, saw its insurance premiums double between 1992 and 1994, and reported difficulties in recruiting new board members and senior executives.[79] Exabyte's CEO also announced that in order to avoid future suits, the company would make no predictions or forward-looking statements in its 1993 annual report.[80] The experience of Exabyte is not an unusual one; in fact, the prevalence of such cases has lead to a business environment in which a drop in stock price of more than a few percent virtually guarantees a shareholder suit.[81]

The increase in shareholder suits against small corporations presents an enormous obstacle to innovation. For many entrepreneurial businesses, going

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[74] *See id.* (quoting James Newman, editor and publisher of Securities Class Action Alert).

[75] *The Impact of Securities Frauds on Entrepreneurial Companies*, *supra* note 6.

[76] *See supra* note 39 and accompanying text.

[77] *See The Impact of Securities Frauds on Entrepreneurial Companies*, *supra* note 6.

[78] Bowers & Gupta, *supra* note 3, at B1 (citing Peter Behrendt, CEO of Exabyte Corporation).

[79] *Id.*

[80] *Id.*

[81] *See* Wingo, *supra* note 68, at 16; Tower C. Snow, Jr., *Stock Crash Needn't Lead to Legal Hash*, WALL ST. J., Nov. 8, 1993, at A14 (stating that a stock decline of just 10% can provide a sufficient basis for a shareholder suit; a drop of 25% or more virtually guarantees a lawsuit).

public is the only way to raise enough capital to develop a new product or technology. But the large legal fees, increased liability insurance, and hefty settlement amounts imposed by the current system can be enough to drive an incipient company into bankruptcy.[82] The innovative capacity of those companies that can survive a shareholder suit is also hampered, because payments for settlements are often paid out of a young company's research and development budget.[83]

The likelihood of shareholder suits also makes it difficult for small corporations to attract outside directors. Outside directors can provide valuable business experience to startup companies,[84] but these directors will avoid many small corporations because these businesses are often unable to obtain directors and officers liability insurance (D&O insurance).[85] D&O insurance insulates corporate managers from personal liability for securities violations, but few insurance carriers offer D&O coverage to small corporations, and those that do charge exceptionally large premiums.[86] For example, Armada Corporation saw its rates for ten million dollars of D&O insurance coverage increase from $47,000 in 1985 to $720,000 in 1989; the deductible meanwhile increased from $125,000 to $750,000.[87] In response, Armada eliminated its coverage and eight of its ten directors resigned.[88] The company's president stated that Armada decided they could only afford to have low-net worth individuals to replace the directors who left; the company was forced to elevate net-worth above experience as a determining criteria for selecting new directors.[89]

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[82] Testifying before the Senate Securities Subcommittee, the general counsel for Intel stated that, had Intel been sued when it was starting up, such a suit probably would have bankrupted the company long before it invented the microchip. 140 CONG. REC. S3706 (daily ed. Mar. 24, 1994) (statement of Sen. Domenici).

[83] *See id.*

[84] For commentary on the value of outside directors, see Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991); Donald E. Pease, *Outside Directors: Their Importance to the Corporation and Protection from Liability*, 12 DEL. J. CORP. L. 25 (1987); Paul H. Zalecki, *The Corporate Governance Roles of the Inside and the Outside Directors*, 24 U. TOL. L. REV. 831 (1993).

[85] *See* John S. Demott, *Duck and Cover*, CFO, Feb. 1994, at 38 (citing a Louis Harris & Assoc. poll which showed that approximately 90% of outside directors believe inadequate D&O insurance is a disincentive to joining a board).

[86] *See* Judy Semas, *Ripe Targets for Lawsuits; Focus: Business Insurance*, BUS. J., Jan. 31, 1994, at 19; David C. Jones, *Special Report: Professional Liability Review*, NAT'L UNDERWRITER, Nov. 8, 1993, at 10.

[87] 138 CONG. REC. S12,601 (daily ed. Aug. 12, 1992) (statement of Sen. Domenici).

[88] *Id.*

[89] *See id.*

The effects of this system on American business are obvious: discouraging innovation cripples global competitiveness.[90] The current system also undermines one of the fundamental principles of the Securities Acts: encouraging disclosure.[91] Drawing from the misfortunes of companies like Exabyte, corporate attorneys have learned that any predictions or forward-looking statements should be avoided because they may come back to haunt the company if stock prices drop.[92] This reticence to issue forward-looking statements undermines the adequacy and accuracy of corporate disclosure.[93] Because investments are inherently forward-looking, such statements have great value to investors.[94] Forward-looking statements are particularly valuable with regard to new businesses, because these companies lack the record of past performance that analysts would ordinarily consider in gauging the value of the securities. In light of these problems, it is clear that we must change the current system if we are to nurture small businesses and encourage complete disclosure.

## VI. ANALYSIS OF PROPOSED REFORM

In response to an increasing cry for reform, provisions to reduce abusive litigation were included in six separate bills to amend the Securities Exchange Act of 1934.[95] The sponsors of these bills argued that they are necessary to safeguard the interests of new and high-technology corporations.[96] This Part examines whether the key provisions of these bills will in fact protect small corporations while still encouraging private enforcement. This Part concludes

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[90] 140 CONG. REC. S3706-07 (daily ed. Mar. 24, 1994) (statements of Sen. Domenici and Sen. Mikulski).

[91] *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963)).

[92] *See* Snow, *supra* note 81, at A14. "Whether a projection had a reasonable basis, whether adverse facts were known at the time of the projection, and whether the projection was made in good faith invariably become the focus of litigation. Leave the forecasting to the financial community." *Id.*; *see also* Bowers & Gupta, *supra* note 3, at B1.

[93] *See infra* part VI.E.

[94] *See* John S. Poole, *Management Forecasts: Do They Have a Future in Corporate Takeovers?*, 42 SW. L.J. 765, 792-93 (1988).

[95] *See* S. 240, 104th Cong., 1st Sess. (1995); S. 667, 104th Cong., 1st Sess. (1995); H.R. 10, 104th Cong., 1st Sess. (1995); H.R. 555, 104th Cong., 1st Sess. (1995); H.R. 681, 104th Cong., 1st Sess. (1995); H.R. 1058, 104th Cong., 1st Sess. (1995).

[96] *See* 141 CONG. REC. S1075 (daily ed. Jan. 10, 1995) (statements of Sen. Domenici, Sen. Dodd, and Sen. Mikulski); 141 CONG. REC. E115 (daily ed. Jan. 18, 1995) (statement of Rep. Markey); 141 CONG. REC. E124 (daily ed. Jan. 18, 1995) (statement of Rep. Bilbray).

that many of the proposed reforms would either fail to protect small corporations or would deter private actions altogether. Some of the proposals, however, particularly the safe harbor for predictive statements, show more promise for an adequate balance between encouraging private enforcement and protecting small businesses.

### A. *Fee Shifting*

All of the proposed bills for securities reform contain a provision for fee shifting of one form or another.[97] These provisions would displace the "American rule" of civil litigation, in which each side pays its own litigation costs,[98] in favor of the "English rule," in which the loser pays the winner's costs.[99] Upon motion by the opposing party, the prevailing party would be entitled to full attorney's fees. Except for House Bill 10, the bills would limit fee shifting to those cases where the losing side's position was not "substantially justified."[100] The purpose of fee shifting is to create "adequate incentives for evaluating the merits of a case prior to filing and to create disincentives for filing meritless securities fraud lawsuits."[101]

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[97] *See* S. 240, 104th Cong., 1st Sess. § 102(a) (1995); S. 667, 104th Cong., 1st Sess. § 102 (1995); H.R. 10, 104th Cong., 1st Sess. § 203(a) (1995); H.R. 555, 104th Cong., 1st Sess. § 102(a) (1995); H.R. 681, 104th Cong., 1st Sess. § 3 (1995); H.R. 1058, 104th Cong., 1st Sess. § 3 (1995). Ironically, the fee shifting provision of Senate Bill 240 appears in a section entitled "Alternative Dispute Resolution Procedure," S. 240 § 102(a), which supposedly encourages private actions by speeding up the recovery for plaintiffs with strong cases. *See* 141 CONG. REC. 1091 (daily ed. Jan. 18, 1995) (statement of Sen. Dodd).

[98] *See* Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240, 247 (1975). Fee shifting exists by statute in other areas of litigation and may in fact be as prevalent as the traditional American rule. *See* Coffee, *supra* note 4, at 670 n.2.

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

[100] S. 240, 104th Cong., 1st Sess. § 102(a) (1995); S. 667, 104th Cong., 1st Sess. § 102 (1995); H.R. 10, 104th Cong., 1st Sess. § 203(a) (1995); H.R. 555, 104th Cong., 1st Sess. § 102(a) (1995); H.R. 681, 104th Cong., 1st Sess. § 3 (1995); H.R. 1058, 104th Cong., 1st Sess. § 3 (1995).

[101] S. 3181, 102d Cong., 2d Sess. § 2(b)(2) (1992). This language is from the securities reform bill that was introduced in the Senate in 1992. Senate Bill 240 does not explicitly state the purpose for the fee shifting provision, but Senator Dodd, who co-sponsored the bill, offered a similar justification to that found in Senate Bill 3181: "[t]hese and other reforms should end the race to the courthouse by lawyers eager to file a case without investigating the facts . . . ." 141 CONG. REC. S1091 (daily ed. Jan. 18, 1995) (statement of Sen. Dodd).

The practical effect of fee shifting would be to deter not only frivolous suits, but meritorious ones as well. This is because the only sensible way for plaintiffs' attorneys to locate potentially meritorious suits is by filing suit whenever there is a sudden and significant decrease in stock price.[102] There is no way to evaluate the merits of a case before filing, because the essence of the claim is that the managers of the corporation had knowledge of adverse information that they withheld from the shareholders. The only method for determining whether a violation actually occurred is through the tools of discovery.[103]

The exemption from fee shifting for cases that are "substantially justified" does nothing to protect meritorious claims. Because discovery provides the only practical method for determining whether a claim is substantially justified, plaintiffs will be discouraged from filing any claims at all, for fear that discovery would fail to yield a substantially justified claim. If no violations were discovered, the plaintiffs would then be forced to pay not only their own discovery costs, but the discovery costs of the defendants as well.[104] This harsh result would provide a strong disincentive to the discovery of securities fraud. Given the importance of these private actions to the effective functioning of the securities laws, this solution is unacceptable.[105]

The fee shifting provision of Senate Bill 240 contains an additional twist. It provides that fee shifting shall not apply to plaintiffs who never owned more than one million dollars of the securities in question.[106] To the extent that the one million dollar exemption would remove the deterrent effect of fee shifting for some meritorious suits, Senate Bill 240 does encourage private actions, at least in comparison to the broad fee shifting provisions in House Bill 10 and House Bill 681.[107] What remains unclear, however, is the rationale for applying fee shifting to plaintiffs with holdings in excess of one million dollars.

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[102] *See* Alexander, *supra* note 24, at 513.

[103] *See id.* at 513–14 (citing Coffee, *supra* note 4, at 679).

[104] House Bill 555 would apply fee shifting only after an early evaluation period. H.R. 555, 104th Cong., 1st Sess. § 102 (1995). The other bills would apply fee shifting after any final judgment. S. 240, 104th Cong., 1st Sess. § 102 (1995); S. 667, 104th Cong., 1st Sess. § 102 (1995); H.R. 10, 104th Cong., 1st Sess. § 202 (1995); H.R. 681, 104th Cong., 1st Sess. § 3 (1995); H.R. 1058, 104th Cong., 1st Sess. § 3 (1995). House Bill 1058 mitigates the harshness of fee shifting by allowing the court to determine if fee shifting would be "just." House Bill 1058, 104th Cong., 1st Sess. § 3 (1995).

[105] *See* Ingber, *supra* note 22, at S369 n.126. Ingber criticizes the "substantially justified" exemption on the grounds that it will lead to additional litigation. *Id.* He argues that the exemption will raise problems such as the number of issues or the amount of damages the plaintiff must win to "prevail." *Id.*

[106] S. 240, 104th Cong., 1st Sess. § 102(a) (1995).

[107] *See id.*

As noted, plaintiffs are unable to determine the merits of a case before filing and would thus be discouraged from filing at all if they had to take the risk of absorbing the legal fees for both parties. Although wealthier shareholders will be in a better position to accommodate this risk, there is no reason to believe they would be willing to do so, unless one assumes that most large drops in stock price are accompanied by securities violations. If this were true, the risk of fee shifting might be outweighed by the high probability of discovering a meritorious claim. This assumption, however, appears highly suspect. Even in a world where fraud never occurred, price drops would still exist whenever a company's fortunes, or the market in general, took a sudden downward turn. In these situations, corporate managers will often be without advance notice of a sudden price drop; when they do have notice, fear of lawsuits will provide a strong incentive for disclosure. Thus, Senate Bill 240's fee shifting provision would deter any claims by wealthy shareholders, while still permitting even meritless claims by shareholders with an interest of less than one million dollars. This provision is not well tailored to meet the needs of small business or shareholders, and should be abandoned.

### B. *Burden of Proof*

House Bill 681 also contains a proposal to change the burden of proof in securities fraud cases.[108] The Bill proposes changing the current "preponderance of the evidence" standard to a requirement of "clear and convincing evidence."[109] Because the clear and convincing evidence standard is more rigorous than the preponderance of the evidence standard, securities fraud claims would be more difficult to prove, and theoretically, plaintiffs would then be deterred from filing frivolous claims.

The burden of proof provision fails to remedy the problem of frivolous litigation for small corporations. The chief problem for small corporations is not that securities fraud is too easy to prove at trial, the problem is that the enormous costs of litigation force many smaller corporations to settle claims before they ever get to trial.[110] To the extent that the potential risks of a trial would be reduced, some companies might be less inclined to settle, but a heightened burden of proof would do little to discourage frivolous suits against

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[108] *See* H.R. 681, 104th Cong., 1st Sess. § 3 (1995).

[109] The clear and convincing evidence standard governs common law fraud, but this standard was rejected for securities fraud for two reasons: common law remedies were thought to be ineffective against securities law violations, and the Congress wished to impose a higher standard of conduct in the securities industry. Herman & MacLean v. Huddleston, 459 U.S. 375, 387–89 (1983). *See* Ingber, *supra* note 22, at S372–74.

[110] *See supra* part V.

businesses that are forced by economic necessity to settle before the case ever reaches a verdict. Changing the burden of proof would only provide those companies that can afford to mount a defense with a better chance of prevailing in close cases. This change would not only fail to discourage meritless claims against small businesses, but it could arguably encourage violations by large corporations by making securities claims easier to defend.[111]

## C. *Proportionate Liability*

The third major provision is a proposal to replace joint and several liability with proportionate liability for those defendants whom the trier of fact does not specifically determine to have engaged in "knowing securities fraud."[112] Under current law, a court that finds a defendant guilty of a Rule 10b-5 violation will hold that defendant responsible for the entire amount of damages, regardless of degree of fault.[113] Critics of joint and several liability in securities cases argue that plaintiffs are able to settle against some defendants to pursue litigation against a "deep pocket" joint tortfeasor.[114] The deep pocket defendant is then forced to settle in order to avoid the prospect of full liability. This may result in a situation where a less culpable defendant ends up paying more than a more culpable defendant. Proportionate liability aims to avoid this situation by holding minor participants liable only for the damages attributable to their respective degree of culpability.[115]

Like the burden of proof provision, the proportionate liability provision does little to ease the plight of small business. With the adoption of

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[111] *See* Ingber, *supra* note 22, at S372–74. Ingber argues that raising the burden of proof would undermine the high standard of conduct sought to be imposed on the securities industry. *Id.*

[112] *See* S. 240, 104th Cong., 1st Sess. § 203 (1995); S. 667, 104th Cong., 1st Sess. § 104 (1995); H.R. 681, 104th Cong., 1st Sess. § 3 (1995); H.R. 1058, 104th Cong., 1st Sess. § 3 (1995). The proposal for proportionate liability in Senate Bill 240 actually differs from the House Bill 681 proposal in a number of ways. First, Senate Bill 240 requires that in the event that a plaintiff is unable to recover damages from a defendant, other defendants would be forced to contribute, but their contribution would be limited to a percentage of the outstanding balance proportionate to their fault, or five times their gain from the fraudulent transaction, whichever is greater. S. 240, 104th Cong., 1st Sess. § 203 (1995). Second, a plaintiff who loses a significant portion of her net worth would be entitled to full recovery from the defendants, who are in that case jointly and severally liable. *Id.*

[113] *See* 5D JACOBS, *supra* note 17, § 260.03[j], at 11–228 (2d ed. 1992).

[114] *See* 140 CONG. REC. S3706-07 (daily ed. Aug. 12, 1992) (statement of Sen. Domenici).

[115] *See* 141 CONG. REC. S1075-76 (daily ed. Jan. 18, 1995) (statement of Sen. Domenici).

proportionate liability, plaintiffs might in fact lose some of their leverage for forcing deep pocket defendants into settlement. Smaller corporations, however, would not benefit from proportionate liability unless they had the resources necessary to fund a lengthy litigation. As noted, corporations with fewer resources have a strong incentive to settle due to the expense of litigation, irrespective of their potential liability at trial. Proportionate liability would not prevent meritless suits against companies who are forced to prefer a settlement which is less than the costs of litigation.

### D. *Elimination of Professional Plaintiffs*

The proposed bills all contain provisions that could potentially reduce frivolous suits by doing away with "professional plaintiffs," who own small amounts of stock in many companies and bring a suit whenever one of their investments goes down.[116] In addition to receiving a share of the eventual settlement or award, judges often reward these plaintiffs with "incentive payments" as a reward for stepping forward.[117]

All six bills would eliminate the use of "incentive payments" for named plaintiffs.[118] Senate Bill 240 and House Bill 10 would also set minimum qualifications for named plaintiffs.[119] These provisions would require that, in order to obtain certification as a class representative, named plaintiffs show that they owned either one percent or ten thousand dollars in market value of the securities in question.[120] In addition, House Bill 10 and House Bill 1058 would require that named plaintiffs could not participate in more than five class actions during any three year period,[121] and Senate Bill 667 as well as House Bill 555 would require them to certify that they did not purchase the securities

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[116] *See* 141 CONG. REC. S1091 (daily ed. Jan. 18, 1995) (statement of Sen. Dodd).

[117] *See* Andrew Leigh, *Being a Plaintiff Sometimes Amounts to a Profession*, INVESTOR'S BUS. DAILY, Nov. 1, 1991, at 8. ("Incentive payments" may be $10,000, $15,000, or as high as $100,000).

[118] S. 240, 104th Cong., 1st Sess. § 101 (1995); S. 667, 104th Cong., 1st. Sess. § 101 (1995); H.R. 10, 104th Cong., 1st Sess. § 203 (1995); H.R. 555, 104th Cong., 1st Sess. § 101(a) (1995); H.R. 681, 104th Cong., 1st Sess. § 3 (1995); H.R. 1058, 104th Cong., 1st Sess. § 3 (1995).

[119] S. 240, 104th Cong., 1st Sess. § 101 (1995); H.R. 10, 104th Cong., 1st Sess. § 203 (1995).

[120] *Id.*

[121] H.R. 10, 104th Cong., 1st Sess. § 203 (1995); H.R. 1058, 104th Cong., 1st Sess. § 3 (1995).

in question with either the intent of commencing litigation or at the direction of plaintiffs' counsel.[122]

The existence of professional plaintiffs has been well documented by courts and commentators,[123] and some repeat players are legendary. For example, Harry Lewis is a retired attorney who has been the lead plaintiff in an estimated three to four hundred lawsuits.[124] In *Steiner v. Tektronix, Inc.*,[125] the court described the potential for abuse of the securities laws at the hands of professional plaintiffs. The court stated that:

> [t]he goals of these acts—protection against fraud, promotion of honesty and fair dealing—are indeed worthy. . . . At the same time, the court must guard against litigious stock market profiteers who, in response to stock downturns, hire seasoned lawyers to look for any evidence or act that might through tortured reasoning give some vague implication of fraud.[126]

This description of the professional plaintiff sounds like a clear abuse of the legal system. Instead of turning to the legal system for redress of a harm, the professional plaintiff deliberately seeks out claims from which a profit can be made. This view of the professional plaintiff, however, may not square with reality. Professor John Coffee of the Columbia University Law School has said that "[a]s a practical matter, the lawyer has hired the client rather than the client hiring the lawyer."[127] Professor Coffee refers to a system in which plaintiffs' attorneys use computers to monitor stock prices and maintain lists of potential plaintiffs. When the computer alerts the attorney of a potential case, he checks his list for available plaintiffs.[128]

The limit of five suits per three years and the threshold requirements for named plaintiffs would indeed make it more difficult for individual plaintiffs to

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[122] S. 667, 104th Cong., 1st Sess. § 102 (1995); H.R. 555, 104th Cong., 1st Sess. § 102 (1995).

[123] *See, e.g.*, Hanon v. Dataproducts Corp., 976 F.2d 497, 508 (9th Cir. 1992); Koenig v. Benson, 117 F.R.D. 330 (E.D.N.Y. 1987). In *Koenig*, the court observed that the plaintiff had filed 39 securities actions in three years, and had such a heavy caseload that he could not remember whether his cases were still active or had been settled. *Id.* at 334; *see also* John C. Coffee, Jr., *Rethinking the Class Action: A Policy Primer on Reform*, 62 IND. L.J. 625 (1987); William M. Lafferty & W. Leighton Lord III, *Towards a Relaxed Summary Judgment Standard for the Delaware Court of Chancery: A New Weapon Against "Strike" Suits*, 15 DEL. J. CORP. L. 921 (1990); Macey & Miller, *supra* note 5.

[124] *See* Leigh, *supra* note 117.

[125] 817 F. Supp. 867 (D. Or. 1992).

[126] Steiner v. Tektronix, Inc., 817 F. Supp. 867, 886 (D. Or. 1992).

[127] *See* Leigh, *supra* note 117.

[128] *Id.*

hunt for claims, and the prohibition on incentive payments would reduce the motivation to do so. But these provisions would not keep plaintiffs' attorneys from doing their own hunting. They could still monitor stock prices and seek out appropriate plaintiffs whenever they observed a sharp decline. Plaintiffs' attorneys would simply have to keep larger lists of investors, which is easily done through a referral network of brokers, dealers, accountants, and attorneys in other fields.[129]

E. *Safe Harbor for Predictive Statements*

Another provision that is intended to reduce frivolous shareholder suits is a proposed safe harbor for predictive statements.[130] The objective of this provision is to encourage disclosure and to provide procedural tools to deal with frivolous cases based on corporate predictions.[131]

The first part of this provision encourages the SEC to adopt a rule or recommend legislation establishing criteria for an exemption from Rule 10b-5 for forward-looking statements concerning future economic performance.[132] This part of the provision would make no change in the current law, because the SEC has already enacted a rule establishing a safe harbor for predictive statements.[133]

However, the safe harbor provision does include some measures that would effect significant changes in the current law. The provision creates a procedure whereby a defendant can apply for a summary judgment determination of whether the safe harbor exemption applies.[134] In Senate Bill 240 and House Bill 10, plaintiffs are allowed sixty days of discovery before such a motion can be made, but once the motion is filed, the court must grant a

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[129] *See* Coffee, *supra* note 123. The use of referral networks may be somewhat curtailed by provisions in the proposed bills preventing the payment of referral fees. *See* S. 240, 104th Cong., 1st Sess. § 101 (1995); H.R. 555, 104th Cong., 1st Sess. § 101(a) (1995); H.R. 681, 104th Cong., 1st Sess. § 3 (1995). Nothing in these bills, however, would prevent the use of referral networks altogether.

[130] S. 240, 104th Cong., 1st Sess. § 201 (1995); S. 667, 104th Cong., 1st Sess. § 107(a) (1995); H.R. 10, 104th Cong., 1st. Sess. § 205 (1995); H.R. 555, 104th Cong., 1st Sess. § 104 (1995); H.R. 1058, 104th Cong., 1st Sess. § 5 (1995).

[131] 141 CONG. REC. S1075-76 (daily ed. Jan. 18, 1995) (statement of Sen. Domenici).

[132] S. 240, 104th Cong., 1st. Sess. § 201(a) (1995); S. 667, 104th Cong., 1st Sess. § 107(d) (1995); H.R. 10, 104th Cong., 1st Sess. § 205(a) (1995); H.R. 555, 104th Cong., 1st Sess. § 104 (1995).

[133] *See* 17 C.F.R. §§ 230.175, 240.3b-6 (1993).

[134] S. 240, 104th Cong., 1st Sess. § 201(c) (1995); S. 667, 104th Cong., 1st Sess. § 107(d) (1995); H.R. 10, 104th Cong., 1st Sess. § 205(c) (1995); H.R. 555, 104th Cong., 1st Sess. § 104 (1995); H.R. 1058, 104th Cong., 1st. Sess. § 5 (1995).

stay of discovery until it rules on the motion.[135] The safe harbor provision encourages the SEC to enact rules or make recommendations regarding the standards applying to these motions.[136]

Although the SEC already provides a safe harbor for predictive statements, this safe harbor affords little protection from suits based upon predictions gone sour. The current safe harbor provides that forward-looking statements will not be considered fraudulent "unless it is shown that such statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith."[137] Whether a prediction was reasonable or made in good faith are frequently topics of litigation; the current safe harbor is thus unable to prevent lawsuits over predictive statements.[138] Because this safe harbor cannot prevent litigation of predictive statements, corporations have a strong incentive to avoid these statements altogether.

Discouraging predictive statements harms the interests of businesses and investors alike. Forward-looking information allows efficient allocation of resources, providing the market with additional information with which to gauge the value of a given security.[139] As long as predictions are characterized as predictions, and not as statements of fact, they will be looked upon with suspicion in the market, and the market price of the securities will reflect the discounted value of the prediction.[140] In this way, predictive statements allow investors to make more informed investment decisions, because the price of a security will incorporate a greater amount of information. The use of forward-looking statements is also very valuable to small businesses as a method of raising capital for new projects. By offering estimates of upcoming trends, businesses can generate investor interest, which probably explains why companies still use predictive statements despite their potential as litigation weapons.

The safe harbor provision would remove much of the disincentive against forward-looking statements by resolving the applicability of the safe harbor in the early stages of litigation. Because the provision would limit the amount of

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[135] S. 240, 104th Cong., 1st Sess. § 201(c) (1995); S. 667, 104th Cong., 1st Sess. § 107(d) (1995); H.R. 10, 104th Cong., 1st Sess. § 205(c) (1995); H.R. 555, 104th Cong., 1st Sess. § 104 (1995).

[136] S. 240, 104th Cong., 1st. Sess. § 201(a) (1995); H.R. 10, 104th Cong., 1st Sess. § 205(a) (1995); H.R. 555, 104th Cong., 1st Sess. § 104 (1995).

[137] 17 C.F.R. §§ 230.175(a), 240.3b-6(a) (1993). The SEC's safe harbor is also limited to forward-looking information that eventually appears in documents filed with the SEC. *See id.* §§ 230.175(b)(1), 240.3b-6(b)(1).

[138] *See* Poole, *supra* note 94, at 774–75; Snow, *supra* note 81, at A14.

[139] 140 CONG. REC. S3705 (daily ed. Mar. 24, 1994).

[140] *See* Paul P. Brountas, Jr., Note, *Rule 10b-5 and Voluntary Corporate Disclosures to Securities Analysts*, 92 COLUM. L. REV. 1517, 1541 (1992).

discovery permitted before a ruling on the safe harbor issue, small corporations could defend claims based on predictive statements without incurring the ordinarily prohibitive costs of a resolution at trial.

Assuming that the SEC would apply the safe harbor requirements already in effect, shareholders could still recover for fraud based on predictions that were unreasonable or made in bad faith. These issues, however, would be resolved according to SEC standards in a summary judgment proceeding, rather than after a trial. To the extent that shareholders would be denied the benefits of a lengthy discovery period and a full trial on the applicability of the safe harbor, this rule would partially restrict private enforcement. Unlike the fee shifting provision, however, this restriction of private enforcement would be a minor one. The safe harbor provision would not remove a class of Rule 10b-5 claims altogether, but would provide a procedure for a less expensive resolution of these claims. The restriction on private enforcement would be outweighed by the benefits gained through encouraging predictive statements and reducing the burden of frivolous lawsuits on small corporations.

One difficulty with the proposal for an early resolution of the safe harbor issue is that the limited discovery aspects of that provision in Senate Bill 240 and House Bill 10 are not well focused. These Bills propose allowing sixty days of discovery before the filing of a motion for resolution of the safe harbor issue, and the scope of the discovery during that period would be unlimited. This would undermine the cost-saving purposes of early resolution by subjecting defendants to two months of discovery on issues potentially irrelevant to the applicability of the safe harbor.

A method of focusing the discovery measures in the safe harbor provision would be the use of a Limited Discovery Proceeding (LDP).[141] Under an LDP, if the defendants asserted the safe harbor defense in their answer to a complaint, the judge would permit discovery for the limited purpose of resolving issues relevant to that defense. Discovery would be permitted only as reasonably necessary to discover facts indicating that the predictive statement in question was made unreasonably or in bad faith.[142]

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[141] *See* Baskin, *supra* note 23, at 1604–09. Baskin discusses "LDP" in the context of pleading requirements, but this technique could also be successfully applied to the safe harbor exemption. *See infra* part VI.F.

[142] Three of the bills have a procedure similar to the LDP suggested here. Senate Bill 240 and House Bill 10 contain an "alternative dispute resolution procedure." S. 240, 104th Cong., 1st. Sess. § 102 (1995); H.R. 10, 104th Cong., 1st Sess. § 206 (1995). Senate Bill 667 and House Bill 555 contain an "early evaluation procedure." S. 667, 104th Cong., 1st Sess. § 102 (1995); H.R. 555, 104th Cong., 1st Sess. § 102 (1995). These provisions could greatly reduce the cost of defending shareholder suits by limiting the time for resolution and the cost of discovery. Unfortunately, no strike suits would actually be deterred by these

The LDP would provide plaintiffs with access to any available facts to rebut defendants' arguments for the application of the safe harbor rule. The LDP would also postpone discovery on other issues until after the resolution of the safe harbor issue. The specific methods of discovery to be allowed would be left to the discretion of the judge, who could apply a standard that minimizes the cost of compliance while still allowing the plaintiffs to discover the necessary information. If the plaintiffs prevailed on the safe harbor issue, then they would be allowed to proceed with full discovery on other issues. Adding an LDP provision would further reduce litigation costs for defendants without obstructing the path to private enforcement.

## F. *Pleading Requirements*

The six bills also include a provision setting forth specific guidelines for pleading securities fraud.[143] This provision would require plaintiffs to allege specific facts demonstrating the state of mind of each defendant at the time of the alleged violations.[144] Senate Bill 240 states that the purpose of the pleading requirement provision is to "provide a filter at the pleading stage to screen out allegations that have no factual basis, to provide a clearer statement of the plaintiff's claims, and to provide greater clarity about the scope of the case."[145]

Since the 1976 Supreme Court decision in *Ernst & Ernst v. Hochfelder*, scienter has been a required element of private actions under Rule 10b-5.[146] Although the Supreme Court did not indicate in *Hochfelder* what pleading standard should be applied to the scienter requirement, the circuits had already applied the pleading standards of Rule 9(b) of the Federal Rules of Civil Procedure to 10b-5 actions.[147] Rule 9(b) requires that allegations of fraud or

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procedures, because they require the consent of all the parties. The plaintiffs in a strike suit have absolutely no incentive to consent to a quick and inexpensive early evaluation; the more expensive and time consuming the process is for the defendants, the more leverage the plaintiffs have in forcing a settlement. *See supra* part III. The safe harbor provision of House Bill 1058 does contain an LDP type provision, which limits discovery to issues relating to the safe harbor. H.R. 1058, 104th Cong., 1st Sess. § 5 (1995).

[143] S. 240, 104th Cong., 1st Sess. § 104 (1995); S. 667, 104th Cong., 1st Sess. § 103 (1995); H.R. 10, 104th Cong., 1st Sess. § 204 (1995); H.R. 681, 104th Cong., 1st Sess. § 3 (1995); H.R. 1058, 104th Cong., 1st Sess. § 4 (1995).

[144] *Id.*

[145] 141 CONG. REC. S1076, 1086 (daily ed. Jan. 18, 1995).

[146] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976); *see supra* note 28 (definition of scienter).

[147] *See, e.g.*, Walling v. Beverly Enters., 476 F.2d 393, 397 (9th Cir. 1973); Kellman v. ICS, Inc., 447 F.2d 1305, 1309 (6th Cir. 1971).

mistake must be stated with particularity.[148] The Federal Circuit Courts have failed to agree on exactly how Rule 9(b) applies to the pleading of scienter, and two opposing approaches have emerged. The Second Circuit Court of Appeals requires plaintiffs to plead specific circumstances that lay a factual foundation for scienter.[149] The First,[150] Third,[151] Sixth,[152] Ninth,[153] and Tenth[154] Circuits do not require specific circumstances or evidence indicating scienter in a Rule 10b-5 complaint.

The proposals here would adopt the interpretation of Rule 9(b) set forth by the Second Circuit. This position would reduce frivolous litigation in two ways. First, instead of being pressured into a quick settlement, defendants would be offered the opportunity to dispose of suits at the pleading stage for a relatively low cost.[155] Second, this position would reduce the disparity between litigation costs for plaintiffs and defendants because plaintiffs have an increased level of inquiry necessary to meet the stricter pleading requirement.[156]

Like the fee shifting provision, however, the requirement that scienter be pled with particularity disposes of meritorious claims as well as meritless ones. Evidence indicating a defendant's state of mind is virtually impossible to discover without conducting depositions and examining documents. Requiring plaintiffs to produce such evidence before discovery is "putting the cart before the horse."[157] For this reason, a number of commentators have criticized the position of the Second Circuit.[158]

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[148] FED. R. CIV. P. 9(b) provides: "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."

[149] *See* Stern v. Leucadia Nat'l Corp., 844 F.2d 997, 1004 (2d Cir.), *cert. denied*, 488 U.S. 852 (1988); Connecticut Nat'l Bank v. Fluor Corp., 808 F.2d 957, 962 (2d Cir. 1987); Ross v. A.H. Robins Co., 607 F.2d 545, 558 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); *see also* Haroco, Inc. v. American Nat'l Bank & Trust Co., 747 F.2d 384, 405 (7th Cir. 1984), *aff'd*, 473 U.S. 606 (1985) (requiring pleading with particularity for fraud claims under RICO).

[150] McGinty v. Beranger Volkswagen, Inc., 633 F.2d 226, 228 (1st Cir. 1980).

[151] Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259, 273 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979).

[152] Auslender v. Energy Management Corp., 832 F.2d 354, 356-57 (6th Cir. 1987).

[153] *In re* Glenfed, Inc. Securities Litigation, 42 F.3d 1541 (9th Cir. 1994).

[154] Seattle-First Nat'l Bank v. Carlstedt, 800 F.2d 1008, 1011 (10th Cir. 1986).

[155] *See* Baskin, *supra* note 23, at 1601.

[156] *Id.*

[157] Richard L. Marcus, *The Revival of Fact Pleading Under the Federal Rules of Civil Procedure*, 86 COLUM. L. REV. 433, 468 (1986).

[158] *See id.*; E.A. Lees, *Rule 9(b)—Who Needs It?*, 3 J. CONTEMP. L. 105 (1976); William M. Richman et al., *The Pleading of Fraud: Rhymes Without Reason*, 60 S. CAL. L.

Like the safe harbor for predictive statements provision, the provision for pleading with particularity could balance the interests of deterring frivolous suits and promoting private enforcement if it included a measure for limited discovery. If plaintiffs otherwise meet pleading requirements for 10b-5 but failed to allege scienter with particularity, the court could authorize an LDP.[159] If plaintiffs failed to uncover specific facts giving rise to an inference of scienter after an LDP, their case would then be dismissed. Relative to the current proposal, an LDP provision would represent an additional cost to defendants, but this cost would be outweighed by allowing plaintiffs to use the tools of discovery to uncover potentially meritorious cases.[160]

## VII. CONCLUSION

The increasing number of shareholder suits against small corporations, along with evidence that the settlement values of these suits do not reflect their merits, raises serious concerns about current principles of shareholder litigation. The costs of these suits include settlement payments, lost executive time, managerial uncertainty, and difficulty in attracting outside directors. The combined effect of these costs is tantamount to a tax on innovation.[161]

Reformers of securities litigation, however, must be ever wary of the danger of overcompensating for current problems and discouraging the private actions necessary to enforce the federal securities laws. The current proposals are not well tailored to meet the needs of either investors or small businesses. Perhaps this is because these bills were introduced more as a political response to a societal perception of excessive litigation than out of concern over the particular problems of shareholder suits.[162]

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REV. 959 (1987); Jeff Sovern, *Reconsidering Federal Civil Rule 9(b): Do We Need Particularized Pleading Requirements in Fraud Cases?*, 104 F.R.D. 143 (1985).

[159] *See supra* part VI.F. For a detailed discussion of the use of LDP for scienter issues in 10b-5 suits, see Baskin, *supra* note 23, at 1604.

[160] House Bill 1058 has an LDP type provision that provides for limited discovery on the issue of scienter, but this provision only applies where the complaint already satisfies the strict pleading requirements. H.R. 1058, 104th Cong., 1st Sess. § 4 (1995). This would not alleviate the harshness of the Second Circuit rule.

[161] *See supra* note 68.

[162] *See* Ingber, *supra* note 22, at S357. Ingber notes Senator Domenici's comments on behalf of the original Senate Bill that "[society is] suffering from hyperlexia, a serious disease caused by an excessive reliance on law and lawyers. It is pervasive throughout our society but has reached epidemic dimensions in the court-created private actions brought under section 10(b) of the [1934 Act]." *Id.* (quoting 138 CONG. REC. S12,599 (daily ed. Aug. 12, 1992) (statement of Sen. Domenici)).

The provisions for fee shifting and strict pleading requirements would serve to discourage all securities suits, not just meritless ones, and the provisions for a higher burden of proof, proportionate liability, and threshold requirements for named plaintiffs would do little to protect small corporations from abuse. The Congress should focus on the provisions for particularized pleading and the safe harbor for predictive statements, in combination with the LDP, in order to reach a compromise between allowing frivolous suits and discouraging private enforcement altogether. This focus would provide the sort of finely calibrated approach that is needed in an area of complex litigation.