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LEGISLATIVE FOREWORD

Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action

Michael A. Perino*

The passage of the Private Securities Litigation Reform Act of 1995 has engendered a significant forum shift in class action securities fraud litigation, from federal to state court. This unintended by-product of the Act has reignited debate over our dual federal-state system of securities regulation and in turn has inspired a discussion as to whether Congress should now preempt state securities fraud causes of action. This article argues that preemption is an appropriate, but not the only, solution to these concerns. To support this argument, this article first traces the history of dual state-federal securities regulation within the context of private rights of action. The article then analyzes the new incentives to file state court litigation and extends current empirical analyses by examining more closely the nature and extent of post-Reform Act state litigation. The compiled data demonstrate significant differences between state and federal litigation that suggest that plaintiffs are using state courts to avoid some of the Reform Act's procedural hurdles, a strategy that threatens to undermine the policy choices Congress made in the Act. The article then analyzes the traditional theoretical bases for allocating governmental authority to the states in our federal system, in particular the benefits associated with interstate competition. Such competition cannot occur in the system as currently structured, but the article suggests a choice of law regime that may permit competition. Recognizing that such a structural change is unlikely to be adopted, the article concludes by critiquing current preemption proposals.

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INTRODUCTION

The express delegation of governmental authority to the states is a dominant theme in recent federal legislation.¹ Devolution of power from the federal government to the states, however, can also be unintended, a by-product and not the object of legislative activity. In 1995, Congress introduced major procedural reforms into private securities litigation when it passed the Private Securities Litigation Reform Act (the "Reform Act" or the "Act").² A consequence of the Act—which, although inadvertent, is consistent with the current devolution trend—was to shift a significant portion of securities fraud class action litigation from federal to state court.³ This shift has helped to reignite debate over an issue that is as old as federal securities regulation—whether the federal securities laws should preempt state securities laws.⁴ Although much is still written about state "blue sky" laws,⁵ until re-

1. See Richard E. Levy & Stephen R. McAllister, *Defining the Roles of the National and State Governments in the American Federal System: A Symposium*, 45 U. KAN. L. REV. 971, 972-73 (1997) ("In the past few years, federalism has reemerged as a focal point of debate in the halls of Congress, the offices of the White House, and the chambers of the Supreme Court.").

2. Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.).

3. See texts accompanying notes 126-133 (Part III, Section B) & 154-172 (Part IV, Section A) *infra*. Another by-product of the Act was a bruising political battle over California's Propositions 201 and 211, two competing state ballot initiatives. Proposition 201 purported to apply many of the Reform Act's provisions to state causes of actions, whereas Proposition 211 would have established private securities fraud causes of action that were more plaintiff-favorable than federal law. For varying discussions and analyses of the propositions, see, e.g., Bill Ainsworth, *Prop. 211 Spending Nearing \$50 Million Mark*, RECORDER, Oct. 28, 1996, at 1; Vivien Lou Chen & Joshua Reynolds, *Ballot Battle*, CALIF. L. BUS., Sept. 23, 1996, at 16; William Claiborne, *Battle over Lawsuits Raging in California: Ballot Initiatives Pit Silicon Valley Computer Titans Against Trial Lawyers' Lobby*, WASH. POST, Mar. 17, 1996, at A3; Reynolds Holding, *Look for More Lawsuit Measures on Ballot: Four New Initiatives Scheduled for Vote in November*, S.F. CHRON., Mar. 28, 1996, at A20; Dan Morain, *Meet the Attorney That Proposition 201 Backers Love to Hate*, L.A. TIMES, Mar. 24, 1996, at A42R; Ben Sherwood, *The Hidden Powers Behind High-Sounding Campaign Names*, L.A. TIMES, Mar. 31, 1996, at M6.

Certain provisions of Propositions 201 and 211 were either significantly more restrictive or more liberal than federal law. Other provisions, including a "loser pays" provision and a private right of action for aiding and abetting a securities fraud violation, embodied policy choices that Congress had considered but rejected. Ultimately, both propositions were defeated, with Proposition 211 losing by a wide margin. See, e.g., *Ballot Initiatives Around the Nation*, N.Y. TIMES, Nov. 7, 1996, at B7 (noting that 74% of voters opposed Proposition 211); G. Pascal Zachary, *California's Defeat of Legal, Insurance Overhaul Raises Questions About Tort Reform Nationwide*, WALL ST. J., Mar. 28, 1996, at A16 (stating that 59% of voters opposed Proposition 201).

4. See 1 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 57-60 (1989) (highlighting scholarly discussion of preemption spanning from the 1950s to the 1980s); Francis J. Facciolo & Richard L. Stone, *Avoiding the Inevitable: The Continuing Viability of State Law Claims in the Face of Primary Jurisdiction and Preemption Challenges Under the Securities Exchange Act of 1934*, 1995 COLUM. BUS. L. REV. 525, 538-627 (reviewing case law and literature on preemption from the 1930s to the present); see also SEC, *REPORT OF SPECIAL STUDY OF SECURITIES MARKETS*, H.R. DOC. NO. 88-95, pt. 4, at 734 (1963) ("There has not been and should not be Fed-

cently, the debate over the costs and benefits of this dual system had waned for a few simple reasons. The passage of more than sixty years made it highly unlikely that the system would be altered in any significant way.⁶ Moreover, some of the dual system's more controversial aspects, such as

eral preemption in the field of securities regulation."); 2 FEDERAL SECURITIES CODE 966-67 (1980) (providing citations for complete preemption and for duplicate regulation). For sources on the longstanding history of this debate, see also Hal M. Bateman, *State Securities Registration: An Unresolved Dilemma and a Suggestion for the Federal Securities Code*, 27 SW. L.J. 759, 784-87 (1973) (advocating federal preemption of state registration requirements that are based on a merit standard rather than a disclosure philosophy); Edward M. Cowett, *Federal-State Relationships in Securities Regulation*, 28 GEO. WASH. L. REV. 287, 290 (1959) (noting that the existence of parallel systems is justified only insofar as they are not duplicative); Thomas Lee Hazen, *Allocation of Jurisdiction Between the State and Federal Courts for Private Remedies Under the Federal Securities Laws*, 60 N.C. L. REV. 707, 708-09 (1982) (describing various tensions between state corporate and federal securities laws). See generally J. Sinclair Armstrong, Comment, *The Blue Sky Laws*, 44 VA. L. REV. 713 (1958) (concluding that preemption is the best solution to the problems presented by blue sky legislation); Rutheford B. Campbell, Jr., *An Open Attack on the Nonsense of Blue Sky Regulation*, 10 J. CORP. L. 553 (1985) (characterizing blue sky laws as costly to society and superfluous); Brian J. Fahrney, Comment, *State Blue Sky Laws: A Stronger Case for Federal Preemption Due to Increasing Internationalization of Securities Markets*, 86 NW. U. L. REV. 753 (1992); Edward R. Hayes, *State "Blue Sky" and Federal Securities Laws*, 11 VAND. L. REV. 649 (1958) (comparing Tennessee law with federal law and the Uniform Act); Richard W. Jennings, *The Role of the States in Corporate Regulation and Investor Protection*, 23 LAW & CONTEMP. PROBS. 193 (1958) (evaluating the Model Business Corporation Act and the Uniform Act); Robert J. Millonzi, Comment, *Concurrent Regulation of Interstate Securities Issues: The Need for Congressional Reappraisal*, 49 VA. L. REV. 1483 (1963) (suggesting that Congress consider preemption); Manning Gilbert Warren III, *Reflections on Dual Regulation of Securities: A Case Against Preemption*, 25 B.C. L. REV. 495 (1984) (arguing that state and federal securities regulation are complementary rather than duplicative); and Eugene V. Rostow, Book Review, 62 YALE L.J. 675 (1953) (reviewing LOUIS LOSS, *SECURITIES REGULATION* (1950)) (noting that Professor Loss saw the need to coordinate uniform securities regulation acts with federal legislation).

5. See, e.g., Therese H. Maynard, *Blue Sky Regulation of Rule 415 Shelf-Registered Primary Offerings: The Need for a Limited Form of Federal Preemption*, 22 ARIZ. ST. L.J. 89, 102-46 (1990) (analyzing different state policies toward Rule 415); Mark A. Sargent, *A Future for Blue Sky Law*, 62 U. CIN. L. REV. 471, 473-85 (1993) [hereinafter Sargent, *A Future for Blue Sky Law*] (noting the diminishing impact of state merit regulation); Mark A. Sargent, *The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform*, 68 WASH. U. L.Q. 225, 243-62 (1990) (describing the dynamics of coordination and the problems of inconsistency between state and federal regulators). See generally Rutheford B. Campbell, Jr., *Blue Sky Laws and the Recent Congressional Preemption Failure*, 22 J. CORP. L. 175 (1997) (arguing that the National Securities Markets Improvement Act does little to eliminate the costs and restraints on capital formation of blue sky laws); Joseph C. Long, *Developments and Issues in Civil Liability Under Blue Sky Law*, 62 U. CIN. L. REV. 439 (1993) (reviewing civil and criminal liability under the Uniform Securities Act); Therese H. Maynard, *Commentary: The Future of California's Blue Sky Law*, 30 LOY. L.A. L. REV. 1573 (1997) (arguing for the elimination of merit regulation provisions of California's blue sky laws); Mark A. Sargent, *State Disclosure Regulation and the Allocation of Regulatory Responsibilities*, 46 MD. L. REV. 1027 (1987) [hereinafter Sargent, *State Disclosure Regulation*] (describing different state disclosure regimes and arguing that overlap between state and federal regulations should be reduced); Marc I. Steinberg, *The Emergence of State Securities Laws: Partly Sunny Skies for Investors*, 62 U. CIN. L. REV. 395 (1993) (examining state policies on limited offerings in light of state interests in consumer protection and attracting corporations). For a discussion of the origins of the term "blue sky" laws, see note 15 *infra*.

6. See 1 LOSS & SELIGMAN, *supra* note 4, at 59.

merit regulation, had become far less important.⁷

But times have changed. The debate over preemption of state securities fraud causes of action exists within a much broader reexamination of the dual state-federal regulatory structure.⁸ In 1996, Congress passed the National Securities Markets Improvement Act (the "NSMIA")⁹ to "modernize and rationalize . . . the respective responsibilities of Federal and State gov-

7. See Sargent, *A Future for Blue Sky Law*, *supra* note 5, at 473-85 (noting the declining importance of merit regulation).

8. After the sweeping Republican victory in the 1994 congressional elections, the SEC, Congress, and the North American Securities Administrators Association (the "NASAA") began to reanalyze this dual system. See Arthur Levitt, Remarks at the North American Securities Administrators Association Conference (Oct. 23, 1995) (last modified Aug. 26, 1997) <<http://www.sec.gov/news/speeches/spch058.txt>> (stating that "[t]his Congress [elected in November 1994] has been characterized by a call for fundamental change" regarding securities regulation). The NASAA appointed a Task Force on the Future of State and Federal Securities Regulation in 1995. See 1 LOSS & SELIGMAN, *supra* note 4, at 17-18 (Supp. 1996).

Efforts to create more uniformity between and among state and federal offering rules, such as the creation of Regulation D and the Uniform Limited Offering Exemption (the "ULOE"), obviously predate this recent reexamination. See Securities Act Release No. 6561, [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,717, at 87,193 (Dec. 6, 1984) ("In recent years it has been recognized that there is a need to increase uniformity . . . so that capital formation can be made easier while appropriate investor protections are retained."); Securities Act Release No. 6389, [1981-82 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,106, at 84,908 (Mar. 8, 1982) (describing the goals of Regulation D as simplifying existing regulations, eliminating unnecessary restraints on capital formation, and achieving state-federal uniformity); Steinberg, *supra* note 5, at 401-08 (describing NASAA's cooperation with the SEC toward "the adoption of a uniform limited offering exemption framework"). Unlike the National Securities Market Improvement Act, which was aimed at national securities, these earlier efforts involved mainly smaller offerings. See Sargent, *A Future for Blue Sky Law*, *supra* note 5, at 476-79 (emphasizing smaller offering exemptions from certain federal regulation); Steinberg, *supra* note 5, at 398-411 (describing the NASAA's concern for the individual unsophisticated investor). In many cases, these coordination efforts were unsuccessful. See Sargent, *A Future for Blue Sky Law*, *supra* note 5, at 498-99 (describing how state interests in attracting incorporation fees and protecting consumers are at odds with national regulatory interests); Mark A. Sargent & Hugh H. Makens, *ULOE: New Hope, New Challenge*, 45 BUS. LAW. 1319, 1330 (1990) (stating that the lack of an automatic coordinating mechanism in the ULOE has resulted in "confusion and unpredictability"). The causes of that lack of success lay, in part, at a fundamental philosophical level: Many state securities regulators viewed their primary mission as protecting unsophisticated investors in their jurisdictions and felt that these exemptions needlessly exposed investors to fraudulent practices. See Sargent, *A Future for Blue Sky Law*, *supra* note 5, at 498 (noting that state "administrators have institutionalized a regulatory style that is highly consumer-protection oriented"); Steinberg, *supra* note 5, at 408-14 (analyzing states' reactions to the SEC's Regulation A amendments). These fundamental philosophical differences also emerged in the NSMIA, which preserves state enforcement authority over fraudulent activities from preemption, see note 69 *infra*, and in current debates over preempting private rights of action, see *Oversight of the Private Securities Litigation Reform Act of 1995: Hearing before the Subcomm. of the Senate Comm. on Banking, Hous., and Urban Affairs*, 105th Cong. (1997) (written Statement of Mark J. Griffin, Director, Utah Securities Division) (speaking on behalf of NASAA and of state securities agencies and emphasizing the state agencies' role as "a 'safety net' for investors").

9. National Securities Market Improvements Act, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in scattered sections of 15 U.S.C.).

ernmental authorities over the securities markets."¹⁰ Determining whether to preempt private causes of action adds an important new twist to the debate because the NSMIA and much of the past preemption debate focused on offering rules rather than on litigation.¹¹ But the familiar federalism questions arise both in offerings and litigation. According to classical theories of federalism, a federal system in which the states maintain significant control promotes beneficial competition, creates laboratories for experimentation, provides a check on national power, fosters diversity, and allows individual states to respond to local concerns.¹² At the same time, however, such a system may impose significant costs through inconsistent and duplicative rules that interfere with interstate commerce.¹³ How are these costs and benefits to be balanced with respect to securities fraud causes of action, particularly those that apply to nationally traded securities?

This article is at odds with current devolution trends.¹⁴ It argues that carefully constructed federal preemption may be appropriate because preemption addresses the unintended shift of litigation to state court and because such an allocation of governmental authority comports well with principles of federalism. Part I briefly describes the history of dual state-federal authority over securities and suggests that, in securities class actions involving publicly traded issuers, state law causes of action played a largely secondary role to causes of action derived from the federal securities laws. Part II provides a brief overview of the legislative debate that led to the passage of the Reform Act and describes how a number of Reform Act provisions create incentives for plaintiffs to file complaints in state rather than federal court. Part II also suggests that Congress' focus on procedural reforms and its inattention to the effect of state laws on the regulatory scheme contributed to the

10. H.R. REP. NO. 104-622, at 16 (1996), reprinted in 1996 U.S.C.C.A.N. 3877; 3878; see also notes 237-244 *infra* and accompanying text (discussing the allocation of state and federal authority in the NSMIA). For discussion and criticism of the statute, see Robert G. Bagnall & Kimble Cannon, *The National Securities Markets Improvement Act of 1996: Summary and Discussion*, 25 SEC. REG. L.J. 3, 3 (1997); Campbell, *supra* note 5, at 196-203; and *Special Issue: The National Securities Markets Improvements Act of 1996*, INSIGHTS, May 1997, at 2-26. The NSMIA also required the SEC to study the extent of uniformity of state regulations over securities not covered by its provisions. See § 102(b), 110 Stat. at 3420.

11. See, e.g., Campbell, *supra* note 5, at 180-96 (analyzing offerings prior to and after the passage of the NSMIA); Sargent, *State Disclosure Regulation*, *supra* note 5, at 1027 & n.2 (citing sources for literature on the past debate). But see Campbell, *supra* note 4, at 575-77 (stating that state law antifraud provisions are "essentially innocuous" and cause "little pernicious effect" through duplication).

12. See notes 190-197 *infra* and accompanying text.

13. See notes 198-201 *infra* and accompanying text; see also Christopher DeMuth, *A Note About the Book*, in ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* at vii (1993) (questioning the benefits of federalism "in the case of business regulation").

14. See Kathleen M. Sullivan, *The Balance of Power Between the Federal Government and the States*, in ALAN BRINKLEY, NELSON W. POLSBY & KATHLEEN SULLIVAN, *THE NEW FEDERALIST PAPERS: ESSAYS IN DEFENSE OF THE CONSTITUTION* 111-12 (1996).

current shift to state court class actions.

Part III reviews empirical evidence on litigation following the Reform Act, focusing particularly on the increase in state court litigation and examining certain changes in pleading patterns; both may indicate strategic responses to the Act's higher procedural hurdles. Part IV extends these analyses by taking a much closer look at post-Reform Act state court cases. This part provides empirical evidence supporting the (generally accepted) notion that, before passage of the Reform Act, plaintiffs' attorneys rarely filed class actions against publicly traded issuers in state court. The data in this part, on the size and timing of the shift to state court, support the inference that the increase in state filings corresponds with attempts to avoid several of the Reform Act's procedural hurdles.

The data also demonstrate significant differences between the kinds of cases filed in federal court and those filed solely in state court. State court litigation is associated with a lower frequency of allegations of misrepresentations or omissions in financial statements and of smaller stock price drops around the end of the class period. These data are consistent with the hypothesis that plaintiffs are filing "weaker" cases in state court, i.e., cases in which the plaintiffs' attorney has a lower expectation that the complaint will survive a motion to dismiss under the Act's "strong inference of fraud" pleading standard. These results are enormously important from a federal policy perspective because the ability of plaintiffs to pick and choose from among alternative causes of action and fora calls into question the effectiveness of the Reform Act. Part IV concludes by discussing why such a system has the potential to undermine significantly the Reform Act's policy initiatives and how it may impose significant costs, in the form of inconsistency and duplicative litigation, on national issuers.

The article then turns to the broader question that this strategic response raises: How should regulatory authority over securities matters be allocated in a federal system? Part V examines the theoretical literature discussing the costs and benefits of federalism. It suggests that none of the traditional justifications for allocating authority to the states applies to the regulation of private causes of action against issuers whose securities trade on national markets. In particular, Part V analyzes whether competition among states is likely to yield efficient securities fraud rules. The part demonstrates that beneficial interjurisdictional competition is unlikely in this context because the fundamental prerequisites for such competition—mobility, an elastic supply of jurisdictions, and the absence of spillover effects—are missing in the securities fraud market. Finally, Part V notes an alternative to preemption: a statutory scheme that would permit issuers to opt in to one state's securities rules. Although such a change would create mobility, other practical problems remain that may make preemption a better response to the problems of multiple standards.

Part VI discusses some of the considerations that should guide federal policy makers in structuring a preemption provision. It suggests that the allocations that Congress made in the NSMIA provide useful guideposts for allocating authority over the creation and administration of private rights of action. These allocations suggest an important state role for the regulation of certain types of securities, particularly penny stocks and certain nonpublicly traded securities where fraud has been rampant and securities sold in intrastate or other smaller regional offerings. Structuring preemption in this fashion permits states to act as a "local cop on the beat" and to fulfill their traditional consumer protection role. Federal law, however, should preempt private state causes of action against issuers whose securities trade on national markets. Based on these parameters, Part VI then provides an overview of the currently proposed preemption bills and notes certain concerns those bills raise. Brief concluding remarks follow.

I. STATE SECURITIES LITIGATION BEFORE THE REFORM ACT

State securities fraud laws, more commonly known as blue sky laws,¹⁵ predate the federal securities laws. The first state securities antifraud rules appeared in the 1910s,¹⁶ with Kansas passing the first comprehensive licensing scheme in 1911.¹⁷ Within two years, twenty-three states followed

15. The derivation of the term is somewhat unclear. One source suggests that Kansas securities laws were called "blue sky laws" because they were meant to "check stock swindlers so barefaced they 'would sell building lots in the blue sky.'" JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 44 (rev. ed. 1995) (quoting Thomas Mulvey, *Blue Sky Law*, 36 CAN. L. TIMES 37 (1916)); see also Cowett, *supra* note 4, at 287 n.1. Another source cites a Midwestern state legislator who stated that if securities legislation were not passed, "financial pirates would sell citizens everything in his state *but* the blue sky." MICHAEL E. PARRISH, *SECURITIES REGULATION AND THE NEW DEAL* 5 n.1 (1970). Either way, the point is clear. For other possible sources of this term, see Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 359 n.59 (1991).

Blue sky laws come in many shapes and sizes, from merit regulation to mutual fund and broker-dealer registration requirements. See generally 1 LOSS & SELIGMAN, *supra* note 4. Most are beyond the scope of this article, which focuses exclusively on statutory antifraud provisions and common law claims.

16. Unlike the private rights of action at issue in the current preemption debate, these early state fraud laws were "usually enforced through investigation by State officers, by criminal prosecutions, or by the issuance of injunctions by the courts." Gerald D. Nash, *Government and Business: A Case Study of State Regulation of Corporate Securities: 1850-1933*, 38 BUS. HIST. REV. 144, 151 (1964).

17. See SELIGMAN, *supra* note 15; 1 LOSS & SELIGMAN, *supra* note 4, at 34. Some state securities regulations are even older, predating the Civil War, and contain provisions relating to such matters as maximum capital stock issuances and books and records requirements. See Nash, *supra* note 16, at 146-47. From 1860-1900, in response to significant growth in the number of securities transactions, state constitutional provisions and statutes began to address specific abuses, often focusing on particular types of issuers that seemed prone to manipulative or fraudulent activities, such as railroads and mining companies. See *id.* at 148-49, 153-54 (noting, respectively, a Massachusetts statute requiring commission approval of railroad shares and a California statute requiring

suit; most passed laws substantially similar to Kansas'.¹⁸ Lingering concerns over the constitutionality of these statutes¹⁹ persisted until the Supreme Court upheld state blue sky laws in 1917.²⁰ By 1933, when Congress passed the first federal securities laws, every state but Nevada had enacted some form of securities regulation.²¹

Federal securities regulation was thus premised, in part, on over twenty years of state regulation, and the principal drafters of the federal securities laws looked to state sanctions as guidelines for the new federal legislation.²² President Roosevelt's securities policy was, however, in large part an attempt to remedy weaknesses in state securities laws that the 1929 stock market crash and the Pecora securities fraud hearings had made all too apparent.²³

mining companies to provide disclosure to shareholders). By 1905, some states had enacted statutes that prohibited speculation and at least certain kinds of short sales. *See id.* at 148 n.8. Blue sky laws differed from these early state regulations in that the states, for the first time, began to: (1) use "semi-coercive" methods (e.g., licensing and inspections); (2) use coercive methods (e.g., license revocations, judicial proceedings and orders, or fines and seizures); and (3) delegate these functions to administrative agencies. *See id.* at 145, 151.

18. *See* SELIGMAN, *supra* note 15, at 45; Macey & Miller, *supra* note 15, at 377-80.

19. *See* Macey & Miller, *supra* note 15, at 381-82.

20. *See* Merrick v. N.W. Halsey & Co., 242 U.S. 568 (1917) (upholding Michigan blue sky laws); Caldwell v. Sioux Falls Stock Yards Co., 242 U.S. 559 (1917) (upholding North Dakota blue sky laws); Hall v. Geiger-Jones Co., 242 U.S. 539 (1917) (upholding Ohio blue sky laws).

21. *See* SELIGMAN, *supra* note 15, at 45. For differing accounts of the reasons for this proliferation of state statutes, compare VINCENT P. CAROSSO, INVESTMENT BANKING IN AMERICA—A HISTORY 162-64 (1970) (contending that statutes were a response to pervasive fraud), with Macey & Miller, *supra* note 15, at 350-52 (arguing that these statutes were largely the product of chance, broader economic conditions, and local interest group pressure).

22. *See* 1 LOSS & SELIGMAN, *supra* note 4, at 171-73; Edmund W. Kitch, *A Federal Vision of the Securities Laws*, 70 VA. L. REV. 857, 858 (1984); Nash, *supra* note 16, at 161. One of the drafters, Professor James Landis, had previously spent several years studying state blue sky laws as part of a larger exploration of "the nature and variety of the sanctions available to government to bring about conformance with its statutory mandates." James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 33 (1959). Benjamin Cohen, another drafter, was said to have "considerable experience in the drafting of state [securities] laws." RAYMOND MOLEY, AFTER SEVEN YEARS 180 (1939). The disclosure philosophy embodied in the Securities Act of 1933 was primarily modeled on the English Companies Act, *see* JOSEPH P. LASH, DEALERS AND DREAMERS 131 (1988), whereas the Act's antifraud provisions were drawn from New York's Martin Act, *see* 1 LOSS & SELIGMAN, *supra* note 4, at 180.

23. For a detailed account of the Pecora investigation and how it impacted Roosevelt's administration, *see* ARTHUR M. SCHLESINGER, JR., THE COMING OF THE NEW DEAL 434-40 (1958); SELIGMAN, *supra* note 15, at 1-38, 42; and Landis, *supra* note 22, at 30; *see also* COMMITTEE ON BANKING AND CURRENCY, FED. SEC. ACT OF 1934, S. REP. NO. 73-792, at 1-5 (1934) (summarizing the Pecora hearings). Indeed, Professor Landis criticized a predecessor bill drafted by Huston Thompson, in part, because it relied too heavily on the blue sky model that had proved so ineffective. *See* Landis, *supra* note 22, at 30-32.

For a description of some of the fraudulent or questionable practices of the time, *see* Laylin K. James, *The Securities Act of 1933*, 32 MICH. L. REV. 624, 625-30 (1934). Commentators analyzing the need for and benefits of a mandatory disclosure system and the historical antecedents of the blue sky laws have questioned whether fraud was really rampant prior to passage of the federal securities laws. *See* George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, AM. ECON. REV., Mar. 1973, at 132, 134-36 (reporting little evi-

State laws were typically riddled with exceptions and exemptions, and state regulators were usually woefully underfunded and understaffed.²⁴ Moreover, state laws could often be avoided just by making offerings across state lines or through the mail, and thus the state laws provided little deterrent to the fraudulent and manipulative practices identified by Congress.²⁵ Despite these shortcomings, the Securities Act of 1933 (the "1933 Act")²⁶ and the Securities Exchange Act of 1934 (the "1934 Act")²⁷ both contain explicit savings clauses that preserve state authority over securities matters.²⁸

Congress had a number of reasons for creating this dual structure. First, the federal securities laws were passed in the very earliest days of the New Deal. The 1933 Act was rushed quickly through Congress in the famous first 100 days of the Roosevelt administration.²⁹ A year later, the 1934 Act faced considerably more opposition,³⁰ but was still an early and expansive interpretation of federal regulatory authority.³¹ At that time, there were significant constitutional questions concerning the permissible scope of these regulatory regimes,³² and displacing state authority in this area would have

dence of fraud in the preparation of financial statements prior to 1934); George J. Benston, *The Value of the SEC's Accounting Disclosure Requirements*, 44 ACCT. REV. 515, 517-18 (1969) (suggesting that "the evidence seems to indicate that the securities . . . were not so much fraudulent as highly speculative"); Macey & Miller, *supra* note 15, at 390-93 (suggesting that fraud was not as prevalent as generally thought). Other commentators have, in turn, challenged both the methodology of these studies and the historical accuracy of their conclusions. See, e.g., Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 10-33 (1983). Determining the actual level of fraud that occurred during this period is, of course, exceedingly difficult. At a minimum, the historical record suggests the existence of a "widely held belief that securities fraud was prevalent and that state laws often could do little to prevent or punish it." *Id.* at 18.

24. See 1 LOSS & SELIGMAN, *supra* note 4, at 148-52; PARRISH, *supra* note 15, at 28-30; Macey & Miller, *supra* note 15, at 387-88.

25. See 1 LOSS & SELIGMAN, *supra* note 4, at 148-49; PARRISH, *supra* note 15, at 29; SELIGMAN, *supra* note 15, at 46; Macey & Miller, *supra* note 15, at 388-89.

26. 15 U.S.C. § 77a (1994).

27. 15 U.S.C. § 78a (1994).

28. See 15 U.S.C. § 78bb(a) (1994); 15 U.S.C.A. § 77r(c) (West 1997). These provisions were designed to save blue sky laws from preemption. See *Leroy v. Great W. United Corp.*, 443 U.S. 173, 182 n.13 (1979) (noting that the legislative history of the 1934 Act indicated congressional intent to leave the states with significant authority). Although most courts agree that Congress did not mean to occupy the field, an argument can be made that the Reform Act implicitly preempts conflicting state law provisions. See note 188 *infra*. In addition to its explicit savings clause, the 1933 Act contains exemptions for intrastate offerings and permits state courts to hear private causes of action brought under the provisions of the Act. See 15 U.S.C. §§ 77c(a)(11), 77w (1994); 17 C.F.R. § 230.147 (1997).

29. See LASH, *supra* note 22, at 130-36; SCHLESINGER, *supra* note 23, at 1-26; SELIGMAN, *supra* note 15, at 50-70.

30. See LASH, *supra* note 22, at 139-47, 162-69; SCHLESINGER, *supra* note 23, at 457-67.

31. See RICHARD J. PIERCE, JR., SIDNEY A. SHAPIRO & PAUL R. VERKUIL, *ADMINISTRATIVE LAW AND PROCESS* 29-31 (2d ed. 1992) (describing the development of administrative agencies during the first Roosevelt administration).

32. See H.R. REP. NO. 73-1383, at 5-7 (1934) (describing the scope and constitutionality of

increased those concerns.³³ Second, despite the failure of state securities regulation, the state system was arguably still needed because no significant federal infrastructure or expertise existed when the federal regulations were enacted.³⁴ Third, preservation of state authority was consistent with the regulatory philosophy of the Acts' principal draftsmen, who were leery of large, centralized bureaucracies and preferred that authority be dispersed more broadly.³⁵ Finally, dual authority may also have been the product of political compromise. One noted securities law historian has commented that preservation of state securities regulation was the price Speaker Rayburn exacted from the Roosevelt administration for quick passage of the 1933 Act.³⁶

Great care, however, must be taken not to read too much into this statutory preservation of state authority, particularly when it comes to the judicially implied private rights of action under section 10(b)³⁷ and Rule 10b-5.³⁸ Rule 10b-5, which has become the primary weapon in federal securities liti-

the bill); SELIGMAN, *supra* note 15, at 18-19, 64-65 (citing, respectively, Hoover's rejection of federal regulation for constitutional reasons and Frankfurter's treatment of constitutional concerns during the drafting of the 1933 Act); *see also* Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 426-27 & n.183 (1990) (noting that the drafters of the 1934 Act explicitly described the Act as "imperative in the public interest for the protection of interstate commerce" in order to satisfy the Supreme Court) (quoting S. 2693, 73d Cong. § 24 (1934)).

33. *See* Erwin Chemerinsky, *Federalism Not As Limits, but As Empowerment*, 45 U. KAN. L. REV. 1219, 1224-25 (1997) (noting that, before 1937, the Supreme Court aggressively used the doctrine of federalism to limit federal encroachment on what were viewed as traditional state interests).

34. *See* PARRISH, *supra* note 15, at 4 (citing the absence of a "continuous, national administrative experience" in securities regulation); *see also* Landis, *supra* note 22, at 34 n.10 (noting the inexperience of the Federal Trade Commission, which originally had jurisdiction over securities matters).

35. *See* PARRISH, *supra* note 34, at 61-62.

36. *See* Joel Seligman, Remarks at University of Washington Securities Law Conference (Mar. 1997); *cf.* SELIGMAN, *supra* note 15, at 56-57 (noting that "[i]n the interest of speed, President Roosevelt was willing to compromise" on the proposed legislation).

37. 15 U.S.C. § 78j(b) (1994). Section 10(b) is an express grant of authority to the SEC to adopt necessary or appropriate rules and regulations to proscribe "any manipulative or deceptive device or contrivance" in the purchase or sale of securities.

38. Rule 10b-5 provides:

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 material fact necessary in order to make the statements made, in light of the 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.

17 C.F.R. § 240.10b-5 (1997).

gation,³⁹ was not promulgated until 1942, eight years after the passage of the 1934 Act.⁴⁰ Even then, the rule was not drafted in order to create a private right of action; rather, it was directed at closing a loophole that precluded Security and Exchange Commission ("SEC" or "Commission") actions against defrauding purchasers, as opposed to sellers.⁴¹ The courts only recognized a private right of action under Rule 10b-5 in 1946, twelve years after the passage of the 1934 Act.⁴² Precisely what Congress originally intended is, at best, murky. The legislative history is not enlightening,⁴³ but many commentators suggest that Congress did not intend to create a private right of action.⁴⁴ Under these circumstances, it seems unreasonable to expect that Congress would have preempted state securities fraud causes of action in favor of a catch-all section 10(b) private right of action, when it did not even know that it was creating such a provision.

Nor is it likely that Congress anticipated anything like the current state of private securities litigation.⁴⁵ The class action device did not exist until

39. See 3 THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 456 (3d ed. 1995); see also Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 961, 976 & n.54 (1994) (describing the implied private right of action under section 10(b) and Rule 10b-5 as a "linchpin of the Federal Securities Law"). Professors Bromberg's and Lowenfels' multivolume treatise, large parts of which are devoted to Rule 10b-5, is itself an indication of the explosive growth of litigation under the rule. See generally ALAN R. BROMBERG & LEWIS D. LOWENFELS, *BROMBERG & LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD* (2d ed. 1996).

40. See Exchange Act Release No. 34-3230 (May 21, 1942); 7 LOSS & SELIGMAN, *supra* note 4, at 3417.

41. See Exchange Act Release No. 34-3230, *supra* note 40 ("The new rule closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase."); see also Milton V. Freeman, *Foreword to Colloquium, Happy Birthday 10b-5: 50 Years of Antifraud Regulation*, 61 FORDHAM L. REV. S1-6 (1993) (relating the impetus for drafting Rule 10b-5 and describing the minimal debate that accompanied its adoption); Grundfest, *supra* note 39, at 979-80 & nn.70-71 (same).

42. See *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 514-15 (E.D. Pa. 1946); see also *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983) (recognizing that the existence of an implied private right of action under Rule 10b-5 "is simply beyond peradventure").

43. See Grundfest, *supra* note 39, at 978-79 (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1976) (noting that the legislative history contains no explanation of Congress' specific intent)).

44. See Michael P. Dooley, *The Effects of Civil Liability on Investment Banking and the New Issues Market*, 58 VA. L. REV. 776, 811 (1972); Grundfest, *supra* note 39, at 976-82; Kitch, *supra* note 22, at 861 n.17; David S. Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U. L. REV. 627, 635, 685 (1963). All that can safely be said is that section 10(b) is a broad delegation of authority to the SEC to define fraudulent securities activities. See Grundfest, *supra* note 39, at 978; Thel, *supra* note 32, at 385-86.

45. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975) ("[I]t would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5."); see also Thel, *supra* note 32, at 461 (noting that even before the Supreme Court began to cabin expansive interpretations of Rule 10b-5, "section 10(b) had evolved into a very different animal from anything the drafters intended").

Congress passed the Federal Rules of Civil Procedure in 1938. Modern class action litigation and the rise in securities fraud class actions had to await the SEC's support of private securities law enforcement in the early to mid-1960s⁴⁶ and the liberalization of Rule 23 in 1966.⁴⁷ Thus, although it is true that Congress did not preempt state securities fraud causes of action in the early 1930s, that fact alone should not determine whether changed circumstances now warrant preemption.

Despite their longer lineage, blue sky and common law claims generally took a back seat to federal private rights of action prior to the Reform Act, especially in class action litigation involving publicly traded companies. Pendent state law claims were often included in federal complaints,⁴⁸ but, in a typical case, most efforts were directed at federal claims. It was generally believed that plaintiffs traditionally filed most of these cases in federal court⁴⁹ for one simple reason—federal courts have exclusive jurisdiction over Rule 10b-5 actions.⁵⁰ Rule 10b-5 gives plaintiffs advantages that may be unavailable under state law. First, in aftermarket cases, plaintiffs can employ the fraud-on-the-market doctrine to obviate any need to plead individual reliance and to shift the evidentiary burden to defendants to rebut plaintiffs' presumed reliance on the integrity of the price set by the market.⁵¹ The doc-

46. See *J.I. Case Co. v. Borak*, 377 U.S. 426, 427 (1964); *In re Cady, Roberts & Co.*, Exchange Act Release No. 6668, [Decisions, 1961-1964] Fed. Sec. L. Rep. (CCH) ¶ 76,803, at 81,013 (Nov. 8, 1961); SELIGMAN, *supra* note 15, at 344-47.

47. See Arthur R. Miller, Comment, *Of Frankenstein Monsters and Shining Knights: Myth, Reality, and the "Class Action Problem,"* 92 HARV. L. REV. 664, 665-68 (1979) (summarizing anecdotal evidence and attempting to analyze empirical evidence of the effect of the 1966 amendments). For a prominent plaintiffs' attorney's analysis, see William S. Lerach, *Securities Class Actions and Derivative Litigation Involving Public Companies: One Plaintiff's Perspective*, available in Westlaw 399 PLI/Lit 65, *94-*95 (1990). On the liberalization of Rule 23, see Judith M. Resnick, *From "Cases" to "Litigation,"* 54 LAW & CONTEMP. PROBS. 5, 7-9 (1991).

48. See *In re Activision Sec. Litig.*, 621 F. Supp. 415, 426 (N.D. Cal. 1985); *Weinberger v. Jackson*, 102 F.R.D. 839, 847 (N.D. Cal. 1984); *In re Victor Technologies Sec. Litig.*, 102 F.R.D. 53, 55 (N.D. Cal. 1984), *aff'd*, 792 F.2d 862 (9th Cir. 1986); *Schneider v. Vennard*, 183 Cal. App. 3d 1340, 1349 (Cal. Ct. App. 1986).

49. See Nicholas E. Chimicles, *The Future of Securities Litigation Under the Private Securities Litigation Reform Act of 1995*, available in Westlaw, Q253 ALI-ABA 33, *54 (1996) (stating that, before the Reform Act, plaintiffs usually pursued claims under the federal securities laws in federal court); Mark Thompson, *Securities Forum-Shopping*, S.F. DAILY J., Jan. 29, 1997, at 1 (noting that federal courts were the preferred forum prior to the Reform Act).

50. See 15 U.S.C. § 78aa (1994); Hazen, *supra* note 4, at 713 (explaining that most private suits contained federal claims that could not be brought in state court).

51. The fraud-on-the-market theory assumes that "in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements." *Basic Inc. v. Levinson*, 485 U.S. 224, 241-42 (1988) (quoting *Peil v. Speiser*, 806 F.2d 1154, 1160-61 (3d Cir. 1986)). Thus, class-wide presumption of reliance may be based on publicly disseminated statements for securities that trade in open developed markets. See Sherrie R. Savett, *Trial and Preparation of a Securities Class Action Fraud Case from a Plaintiff's Standpoint*, available in Westlaw, 509 PLI/Lit 11, *20 (1992).

trine also facilitates class certification, because it eliminates the need to prove that each class member specifically heard or read the allegedly false or misleading statement, and thereby helps to assure that individual issues do not overwhelm common ones.⁵² Certification of nationwide classes is easier under federal law, and the manageability issues that tend to arise when class actions are brought under state law are limited.⁵³ All things being equal, plaintiffs' attorneys should rationally prefer nationwide classes because they will tend to generate greater potential damages and fees.

In contrast, state statutory and common law causes of action present plaintiffs with a number of limitations, particularly in aftermarket cases against publicly traded companies. First, the fraud-on-the-market doctrine has not found widespread acceptance under state law.⁵⁴ Indeed, before 1995, federal court opinions analyzing whether the fraud-on-the-market doctrine exists with respect to pendent state law claims far outnumber state law opinions on the subject.⁵⁵ Second, many state statutory causes of action have ter-

Although derived from finance theory, the purpose underlying the fraud-on-the-market doctrine is eminently practical—to facilitate Rule 10b-5 litigation, thereby encouraging private enforcement of the federal securities laws. See *Basic*, 485 U.S. at 245; Donald Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 891-92 (1992); Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 662-63 (1992).

52. See FED. R. CIV. P. 23(a)(2), (b)(3); *Basic*, 485 U.S. at 242.

53. See *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 818 (1985) (holding that the application of Kansas law to a class action when most class members and transactions were out of state was unconstitutional); *Castano v. American Tobacco Co.*, 84 F.3d 734, 741-42 (5th Cir. 1996) (noting that variations in state law may undermine predominance and defeat certification in multi-state litigation); *In re One Bancorp Sec. Litig.*, 136 F.R.D. 526, 533 (D. Me. 1991) (certifying class for federal law claims but not for state law claims).

54. See *Mirkin v. Wasserman*, 858 P.2d 568, 579-80 (Cal. 1993) (rejecting the fraud-on-the-market doctrine under statutory fraud provision, but noting in dicta that one California blue sky provision did not require proof that the plaintiff relied upon the statements or acts of the defendant); *Gaffin v. Teledyne, Inc.*, 611 A.2d 467, 474-75 (Del. 1992) (requiring proof that individual class members justifiably relied on false statements); *Kahler v. E.F. Hutton & Co.*, 558 So. 2d 144, 145 (Fla. Ct. App. 1990) (finding that fraud-on-the-market claim is unavailable at common law). *But see* *Rosenthal v. Dean Witter Reynolds, Inc.*, 883 P.2d 522, 526-28 (Colo. Ct. App. 1994) (adopting fraud-on-the-market doctrine under state securities laws), *aff'd in part and rev'd in part*, 908 P.2d 1095 (Colo. 1995).

55. Most federal courts have found that there is no fraud-on-the-market theory under the applicable state laws. See, e.g., *Peil v. Speiser*, 806 F.2d 1154, 1163 n.17 (3d Cir. 1986); *In re Newbridge Networks Sec. Litig.*, 926 F. Supp. 1163, 1175 (D.D.C. 1996); *O'Neil v. Appel*, 165 F.R.D. 479, 505 (W.D. Mich. 1996); *In re Soybean Futures Litig.*, 892 F. Supp. 1025, 1060 (N.D. Ill. 1995); *In re Medimmune, Inc. Sec. Litig.*, 873 F. Supp. 953, 968 (D. Md. 1995). *But see*, e.g., *Hurley v. FDIC*, 719 F. Supp. 27, 34 n.4 (D. Mass. 1989) (speculating that, if the state Supreme Court reached the issue, it would approve fraud-on-the-market theory); *Minpeco, S.A. v. Hunt*, 718 F. Supp. 168, 175-76 (S.D.N.Y. 1989) (stating that the New York courts might accept the fraud-on-the-market doctrine). For citations to post-Reform Act cases discussing the issue, see note 160 *infra*.

ritorial limitations that require the sale or solicitation to occur within the state.⁵⁶ Beyond these factors, other important limitations exist in a number of key states. For example, New York does not recognize a private right of action under its state blue sky law, the Martin Act,⁵⁷ and Delaware law limits recovery to rescission or rescissory damages.⁵⁸ The elements⁵⁹ and burdens of proof⁶⁰ for fraud or negligent misrepresentation claims also vary from state to state. These differences would tend to make it more difficult for plaintiffs to certify nationwide classes under state law.⁶¹

For these reasons, it was generally believed at the time the Reform Act was debated that plaintiffs brought most securities class actions involving publicly traded companies in federal court under predominantly federal causes of action.⁶² Because Congress was primarily concerned with securities fraud actions against publicly traded companies,⁶³ it naturally focused on Rule 10b-5 litigation and paid scant attention to state blue sky laws.⁶⁴ Some

An alternative explanation for the paucity of state court opinions might be that state litigation yields relatively fewer reported decisions than federal litigation. See Wayne Klein, *The Idaho Securities Act: An Analysis of Idaho Courts' Securities Opinions*, 29 IDAHO L. REV. 95, 111-12 (1992-93).

56. See, e.g., *In re Activision Sec. Litig.*, 621 F. Supp. 415, 431-32 (N.D. Cal. 1985) (certifying nationwide class of purchasers in an IPO where corporation was headquartered in California, but refusing to certify nationwide class of aftermarket purchasers); *In re Victor Tech. Sec. Litig.*, 102 F.R.D. 53, 60 (N.D. Cal. 1984) (same) *aff'd*, 792 F.2d 862 (9th Cir. 1986); *Dofflemeyer v. W.F. Hall Printing Co.*, 558 F. Supp. 372, 377 (D. Del. 1983) (finding no liability under Delaware Securities Act when solicitation and sale did not take place in Delaware); *Singer v. Magnavox Co.*, 380 A.2d 969, 981 (Del. 1977) (same).

57. See *CPC International, Inc. v. McKesson Corp.*, 514 N.E.2d 116, 119 (N.Y. 1987).

58. See *Hill v. Equitable Trust Co.*, 562 F. Supp. 1324, 1338 (D. Del. 1983).

59. Compare *Jo Ann Homes at Bellmore, Inc. v. Dworetz*, 250 N.E.2d 214, 217 (N.Y. 1969) (finding recklessness sufficient in New York common law fraud claim), with *Towpath Unity Tenants Ass'n v. Barba*, 440 A.2d 51, 54 (N.J. Ct. App. 1981) (holding that, to obtain money damages in fraud claim under New Jersey law, plaintiff must prove knowledge of falsity).

60. Compare *Liodas v. Sahadi*, 562 P.2d 316, 322-23 (Cal. 1977) (requiring proof by a preponderance of the evidence for California fraud claim), with *Katara v. D.E. Jones Commodities, Inc.*, 835 F.2d 966, 970 (2d Cir. 1987) (requiring clear and convincing proof of fraud under New York law).

61. See note 53 *supra*; *Steinberg*, *supra* note 5, at 419-21 (noting that state courts' rejection of fraud-on-the-market theory militates against class certification).

62. See Thomas A. Dickerson, *State Court Class Actions*, in *STOCKHOLDER SUITS AND CLASS ACTIONS* 1986, at 110 (PLI Litig. & Admin. Practice Course Handbook Series No. 300, 1986) (describing the kinds of claims often brought in state court).

63. See S. REP. NO. 104-98 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 684 [hereinafter SENATE REPORT] (specifically referring to "the financial condition of publicly traded companies"); H.R. CONF. REP. NO. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 731 [hereinafter STATEMENT OF MANAGERS] (referring to the national securities market).

64. See SENATE REPORT, *supra* note 63, at 4. The references to 10b-5 litigation appear throughout the Senate Report and previous congressional hearings:

The Committee heard substantial testimony that today certain lawyers file frivolous "strike" suits alleging violations of the Federal securities laws in the hope that defendants will quickly settle to avoid the expense of litigation. . . . These actions typically rest upon the so called "catch-all" fraud provision in Section 10(b) of the 1934 Act and SEC Rule 10b-5. . . . The

commentators noted that a post-Reform Act increase in state court litigation was possible,⁶⁵ and one of the leading plaintiffs' class action attorneys even hinted obliquely that state litigation was a possibility.⁶⁶ For the most part, however, Congress seems to have viewed litigation reform as a federal problem that required a federal solution.⁶⁷ The legislative history contains only scattered references to state court, most of which are unrelated to the possibility of a shift in litigation strategy.⁶⁸ It is unclear whether the inattention to state litigation was simply an oversight or whether, as a political matter, it was impossible to pass a statute that preempted state causes of action.⁶⁹ Whatever the reason, the Act's incremental and largely procedural

mere specter of 10b-5 liability, however, has become more than a deterrent to fraud. Private securities class actions under 10b-5 inhibit free and open communication among management, analysts, and investors.

Id. at 4-5; see also *Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs*, 103d Cong. 5-7 (1994) [hereinafter *1993 Senate Hearings*] (statements of Sen. Domenici and Sen. Shelby).

65. See, e.g., Harvey L. Pitt & Karl A. Groskauffman, *The House Bill's "Loser Pays" Provision and Its Single Standard of Recklessness Would Affect Much Private Securities Litigation*, NAT'L L.J., Apr. 24, 1995, at B4. These commentators speculated that federal reforms might cause plaintiffs' attorneys to file actions in what are generally viewed as plaintiff-friendly jurisdictions, such as Texas, and cited *Prudential Securities Inc. v. Abascal*, No. 94-02-12341-CV (Tex Ct. App. Dec. 1995), as a possible precursor of things to come. The actual pattern of state securities class action activity is somewhat different. Issuers sued in state court proceedings have largely been sued in states where they are incorporated or where they maintain a principal place of business. This practice is consistent with federal court practice before passage of the Reform Act. See Savett, *supra* note 51, at *20 (noting that federal venue doctrines usually require "that the case be brought where the issuer has its principal place of business").

Even before the Reform Act debate, a number of commentators observed that increasingly restrictive interpretations of federal statutes warranted greater consideration of state court alternatives. See 8 LOSS & SELIGMAN, *supra* note 4, at 3674; Steinberg, *supra* note 5, at 418-27. These comments, however, were often accompanied by warnings concerning the problems associated with state actions, particularly in class action litigation. See, e.g., Steinberg, *supra* note 5, at 419-21.

66. See *1993 Senate Hearings*, *supra* note 64, at 79 (statement of William Lerach) (suggesting that plaintiffs be given "an opportunity to go into State court and sue rather than always be[ing] forced to go into Federal court").

67. See STATEMENT OF MANAGERS, *supra* note 63, at 31 (describing the intent of House and Senate bills as reforming "Federal securities litigation").

68. See SUBCOMMITTEE ON SEC. OF THE SENATE COMM. ON BANKING, HOUS., AND URBAN AFFAIRS, STAFF REPORT ON PRIVATE SECURITIES LITIGATION 65-66 (May 17, 1994) [hereinafter *1994 STAFF REPORT*] (discussing a case study of securities class action brought against Public Service Company of New Mexico and noting that a state securities class action was brought on behalf of shareholders who were residents of New Mexico), reprinted in *Abandonment of the Private Right of Action for Aiding and Abetting Securities Fraud/Staff Report on Private Securities Litigation: Hearing Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs*, 103d Cong. 166, 235-36 (1994); *1993 Senate Hearings*, *supra* note 64, at 37-38 (statement of William R. McClucas, Director of Enforcement, SEC) (noting that many of the claims filed against accountants involved state claims of negligent misrepresentation rather than federal securities fraud claims).

69. See William S. Lerach, *Private Securities Litigation Reform Act of 1995—20 Months Later*, in *SECURITIES LITIGATION 1997*, at 9, 26 (PLI Corp. L. & Practice Course Handbook Series No. B-1015, 1997) (suggesting, without citation, that "Congress could have chosen to preempt state

reforms gave plaintiffs' attorneys incentives to shift some litigation against publicly traded issuers from federal to state court.

II. THE REFORM ACT AND THE NEW INCENTIVES TO SUE IN STATE COURT

The Reform Act was the product of a highly contentious debate over the relative costs and benefits of securities class action litigation.⁷⁰ Although

securities fraud remedies when it enacted the New Act. However, it has been publicly stated by many participants in the process that had such a preemptive provision been included, the New Act could not have been enacted over President Clinton's veto.)

The text and legislative history of the NSMIA, which was enacted less than a year after the Reform Act, also suggests that such political considerations have played an important role in recent securities legislation. In the NSMIA, Congress preempted state merit regulation and registration requirements for certain "covered securities," which include securities traded on national markets, securities offered or sold to certain qualified purchasers, and securities exempted under certain provisions of the 1933 Act. See 15 U.S.C.A. § 77r(b) (West 1997). Congress was careful, however, to preserve state enforcement authority over fraudulent and deceptive practices in such offerings. See 15 U.S.C.A. § 77r(c) (West 1997). The NSMIA's legislative history makes clear that the statute does not "alter, limit, expand, or otherwise affect in any way any State statutory or common law with respect to fraud or deceit." H.R. REP. NO. 104-622, at 34 (1996), reprinted in 1996 U.S.C.C.A.N. 3877, 3897. Moreover, at least one cosponsor of a predecessor bill in the Senate made clear that he would withdraw his support for the bill if any changes were made that undermined "the ability of defrauded investors to recover their losses in court under State laws." 142 CONG. REC. S5598 (daily ed. May 23, 1996) (statement of Sen. Bryan).

70. The challenges associated with securities class action litigation were certainly not new at that time. See, e.g., *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739-40 (1975) (suggesting that, under 10b-5, plaintiffs may be provided with settlement value out of proportion to the prospect of success at trial). See generally Janet C. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN L. REV. 497 (1991) (arguing that securities class actions are not necessarily settled on their merits); 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 (1986) (describing the incentives underlying a plaintiffs' attorney's decision to bring a case); 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) (applying an economic analysis to the hypothesis that class action attorneys are entrepreneurs bearing substantial risk and exercising plenary control over cases, rather than agents acting under their clients' control).

In the early 1990s, however, two factors caused the debate to intensify. First, in a series of cases, the Supreme Court began to cabin the Rule 10b-5 private right of action more aggressively. See, e.g., *Central Bank v. First Interstate Bank* 511 U.S. 164 (1994) (eliminating private right of action for aiding and abetting under Rule 10b-5); *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991) (holding that Rule 10b-5 action must be brought within at least one year of discovery of fraud and in no event more than three years from the date of the allegedly fraudulent transaction). But see John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff As Monitor in Shareholder Litigation*, LAW & CONTEMP. PROBS., Summer 1985, at 5 (tracing trend to the 1970s). Lower courts were also active in limiting section 10(b) through the interpretation of pleading requirements under Federal Rule of Civil Procedure 9(b), see note 98 *infra* and accompanying text, and by creating the "bespeaks caution" doctrine and the "truth on the market" defense. See, e.g., *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1412 (9th Cir. 1994) (holding that, under the "bespeaks caution" doctrine, optimistic statements in a prospectus are not actionable when precise cautionary language elsewhere in the prospectus adequately discloses the risks involved); *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 364 (3d Cir. 1993) (holding that the

there seemed to be broad agreement in Congress and at the SEC that problems existed in these cases,⁷¹ intense and often rancorous debate erupted over the extent of and the appropriate solutions to those problems.⁷² Nonetheless, the Act passed with ample majorities in both the House and the Senate, and early indications were that President Clinton would sign it into law. At the last minute, however, the President vetoed the bill, citing concerns that it went too far in curtailing private securities causes of action.⁷³ Within two days, Congress overrode that veto.⁷⁴

“bespeaks caution” doctrine was viable and applicable to the case); *Brown v. E.F. Hutton Group*, 991 F.2d 1020, 1032-33 (2d Cir. 1993) (citing warnings in a prospectus as sufficient to prevent plaintiffs from claiming that they justifiably relied on defendants’ misrepresentation); *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 516 (7th Cir. 1989) (noting that prompt incorporation of news into stock price supports the truth-on-the-market doctrine). Both the SEC and politically powerful plaintiffs’ attorneys sought legislative reversals of the Supreme Court’s opinions. See *Securities Investor Protection Act of 1991: Hearing Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs*, 102d Cong. 6-7 (1991) (statement of Richard Breeden, Chairman of the SEC); *Securities Investors Legal Rights: Hearing Before the Subcomm. on Telecomm. and Fin. of the House Comm. on Energy and Commerce*, 102d Cong. 1-2 (1991) (statement of Rep. Markey). At the same time, two other constituencies—accountants and the high-technology industry—began to complain that they were unfairly and disproportionately targeted in securities fraud class actions. See 1994 STAFF REPORT, *supra* note 68, at 2. See generally 1993 Senate Hearings, *supra* note 64 (noting accountants’ criticism of assessment of liability under securities fraud law). They sought to capitalize on the perception that securities litigation had gotten “out of hand” by seeking legislation that would further curb private causes of action. See *id.* at 2 (statement of Sen. Dodd).

Such perceptions, whether accurate or not, can cause real, adverse economic effects in the capital markets. See *Securities Litigation Reform: Hearings Before the Subcomm. on Telecomm. and Fin. of the House Comm. on Energy and Commerce*, 103d Cong. 120 (1994) (testimony of Professor Donald C. Langevoort, Vanderbilt University School of Law) (“[F]ear of dysfunctional litigation is adversely affecting capital marketplace decisions.”). Ultimately, this perception, rather than conclusive proof of abuses in securities litigation, seems to have been the driving force behind passage of the Act. See 1993 Senate Hearings, *supra* note 64, at 36” (statement of William R. McLucas, Director of Enforcement, SEC) (“[I]t is vital not just that the process be fair, but the participants in the process, both the plaintiffs and the defendants, believe that the litigation system is fair . . .”).

71. See SENATE REPORT, *supra* note 63, at 5 (citing statements by Committee Chairman Alfonso D’Amato, Sen. Christopher Dodd, and SEC Chairman Arthur Levitt).

72. Indeed, during the congressional debates over securities litigation reform, Senator Dodd, then Chair of the Senate Subcommittee on Securities, commented:

[A]fter a long hearing . . . we found no agreement on whether there is in fact a problem, the extent of the problem, or the solution to the problem. In my experience with this subcommittee, I’ve never encountered an issue where there is such disagreement over the basic facts. We often argue about policy, we argue about ideology, we often argue about politics, but it is rare that we spend so much time arguing about basic facts.

1993 Senate Hearings, *supra* note 64, at 280; see also 1994 STAFF REPORT, *supra* note 68, at 28-29 (Sen. Dodd remarking that, during two hearings before the Subcommittee, “[T]here was little agreement among witnesses seeking relief from frivolous litigation and witnesses arguing that there are few, if any, problems in current securities litigation practices.”).

73. See President’s Message to the House of Representatives Returning Without Approval the Private Securities Litigation Reform Act, 31 WEEKLY COMP. PRES. DOC. 2210 (Dec. 19, 1995), reprinted in 141 CONG. REC. S19034 (Dec. 21, 1995) [hereinafter Veto Message].

74. See 141 CONG. REC. S19180 (daily ed. Dec. 22, 1995); 141 CONG. REC. H15214 (daily

To provide a contextual framework for understanding the litigative responses to the Act, this part discusses the terms of the congressional debate, identifies the problems Congress perceived when it passed the Act, and sketches Congress' solutions to those problems, which, when implemented, created incentives to pursue state law remedies in state court.

A. *The Terms of the Congressional Debate*

The Reform Act's legislative history focuses on a number of perceived problems in federal securities litigation practices.⁷⁵ The solutions to three of these problems, however, create significant incentives to pursue state causes of action. First, Congress was concerned that "the current system of private liability under the federal securities laws d[id] not adequately distinguish between meritorious and frivolous claims."⁷⁶ Congress heard testimony that it was too easy to file securities class actions, even in cases where an issuer may have engaged in no wrongdoing.⁷⁷ Indeed, one controversial (and clearly overstated) claim was that a significant drop in an issuer's stock price would often be sufficient in and of itself to trigger a securities fraud class action⁷⁸ within days or even hours of a stock price drop, with little or no ap-

ed. Dec. 20, 1995).

75. It is important to note that the legislative history, particularly the Statement of Managers that accompanies the final bill, paints with a very broad brush. For the most part, the hearings relied more on anecdote than hard empirical data. As a contemporary colloquy in the pages of the *Harvard Law Review* between two of the more astute observers of securities issues demonstrates, widely different inferences can be drawn from the empirical data collected on both sides of the debate. See generally Joel Seligman, *Commentary, The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority,"* 108 HARV. L. REV. 438 (1994) [hereinafter Seligman, *The Merits Do Matter*] (interpreting the data to mean that nonmeritorious suits do not get through the system); Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727 (1995) (critiquing Professor Seligman's argument); Joel Seligman, *The Merits Still Matter: A Rejoinder to Professor Grundfest's Comment, Why Disimply?*, 108 HARV. L. REV. 748 (1995).

76. 1994 STAFF REPORT, *supra* note 68, at 13. Evidence that it was too easy to file securities litigation and arguments that companies were sued in nonmeritorious class actions for settlement purposes suggest that Congress also believed that there was too much securities litigation. See, e.g., 1993 Senate Hearings, *supra* note 64, at 47, 49, 292 (statements of Dr. Vincent O'Brien, Law and Economic Consulting Group, and Rep. Tauzin).

77. See, e.g., SENATE REPORT, *supra* note 63, at 8 ("A complaint alleging violations of the Federal securities laws is easy to craft and can be filed with little or no due diligence."); 1993 Senate Hearings, *supra* note 64, at 14-15 (statement of John G. Adler, President and CEO, Adaptec, Inc.) (describing a complaint that was filed that alleged "every wrong-doing under the sun without any specificity to anything").

78. See, e.g., SENATE REPORT, *supra* note 63, at 8 (identifying a drop in stock price as a factor that may trigger litigation); STATEMENT OF MANAGERS, *supra* note 63, at 31 (stating that abusive practices in securities class action litigation included "the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer"); 1993 Senate Hearings, *supra* note 64, at 12 (statement of Edward R. McCracken) ("Our stock dropped 10 percent. Several weeks later, I was sued."); *id.* at 24 (statement of Thomas Dunlap, Jr., General Counsel, Intel Corp.) ("I think that what happens, if the stock price drops more than 10 percent, irrespective of the reason, without the

parent investigation of the underlying merits of the action.⁷⁹

Second, Congress found that nonmeritorious litigation often proved profitable because defendants faced asymmetrical discovery burdens.⁸⁰ As a result, defendants often chose to settle even nonmeritorious cases early in the process to avoid incurring substantial discovery and other pretrial costs.⁸¹ Other incentives to settle included the large theoretical damages generated in open-market securities fraud cases, which exacerbated the reluctance of defendants to risk an adverse jury verdict.⁸²

facts, the computer just says, these are the stocks that dropped 10 percent. So, therefore, we ought to take the complaint that we have on the computer and just bring it up and put the names in it.”)

However, it is clear that 10% stock price drops do not invariably lead to securities class actions. See Baruch Lev, *Disclosure and Litigation*, CAL. MGMT. REV., Spring 1995, at 8, 9-11 (concluding that “shareholder lawsuits are not filed in Pavlovian manner subsequent to a large stock price decline”); Seligman, *The Merits Do Matter*, *supra* note 75, at 442-45. The fact that a sharp stock price decline does not inevitably result in a securities class action lawsuit does not mean that stock price declines are unimportant. The majority of securities class actions appear to be brought after disclosures that lead to stock price declines. See generally Douglas J. Skinner, *Why Firms Voluntarily Disclose Bad News*, 32 J. ACCT. RES. 38 (1994) (describing prior studies of management disclosure). Among other things, significant stock price declines, like SEC investigations, earnings restatements, and other dramatic events, lower search costs for entrepreneurial plaintiffs’ attorneys because they provide a signal of possible securities law violations. See Coffee, *Understanding the Plaintiff’s Attorney*, *supra* note 70, at 682 (noting the signaling effect of stock price declines); Grundfest, *Why Disimply?*, *supra* note 75, at 734 (noting that stock price declines are important because “other factors being equal, a sharp stock price decline is likely correlated with a greater probability of recovery and a greater certainty that significant damages can be established”). Other factors, such as share turnover and market capitalization, which affect damage calculation models and the resulting expected economic recovery for the plaintiffs’ attorney, also seem to play important roles in triggering litigation. See CHRISTOPHER L. JONES & SETH E. WEINGRAM, *THE DETERMINANTS OF 10B-5 LITIGATION RISK 3* (John M. Olin Program in Law and Economics, Stanford Law School, Working Paper No. 118, June 1996); Alexander, *supra* note 70, at 511 n.42; Lev, *supra*, at 9. There is likely to be a complex interaction among the relevant factors. Thus, in some cases a stock price drop that is less than 10% in a firm with a sufficiently large market capitalization and share turnover may be enough to trigger litigation, depending on the other relevant facts and circumstances. The significant question, which Congress did try to address, is whether courts can adequately distinguish “innocent” stock price drops from those caused by fraud.

79. Cf. STATEMENT OF MANAGERS, *supra* note 63, at 32-33 (describing an allegedly headlong “race to the courthouse”); 1993 Senate Hearings, *supra* note 64, at 17 (statements of John G. Adler) (noting a case filed four days after a stock drop); *id.* at 327 (statement of Sen. Dodd) (suggesting that frivolous lawsuits may be hastily filed because a plaintiff “want[s] to be the first [one] at the window”).

80. A number of witnesses testified about the high cost of discovery. See, e.g., STATEMENT OF MANAGERS, *supra* note 63, at 37 (testimony of J. Carter Beese, former Commissioner, SEC; Chairman, Capital Markets Regulatory Reform Project for the Center for Strategic and International Studies) (stating that discovery costs account for about 80% of a defendant’s total litigation costs); 1993 Senate Hearings, *supra* note 64, at 15 (statement of John G. Adler) (detailing how his company produced 1500 boxes of documents in response to over 100 separate requests for production at a cost of about \$1.5 million).

81. See, e.g., 1993 Senate Hearings, *supra* note 64, at 13 (statement of Edward R. McCracken, President & CEO, Silicon Graphics Inc.).

82. See, e.g., 1993 Senate Hearings, *supra* note 64, at 16, 591 (statements of Richard J. Egan, Chairman, EMC Corporation, and Scott G. McNealy, Chairman, President & CEO of Sun Micro-

A third problem Congress identified was that the threat of class litigation chilled disclosure of forward-looking information.⁸³ Testimony from the business and investment communities suggested that issuers that made predictions about future results often faced securities lawsuits when those predictions proved to be inaccurate, regardless of any proof that the company intended to deceive investors.⁸⁴ Congress found that the "fear of baseless and extortionate securities lawsuits" imposed significant costs on the United States' economy and the investing public,⁸⁵ because this type of forward-looking information was valuable for evaluating the future prospects of a company.⁸⁶

B. *The Reform Act's Solutions and the New Incentives to Pursue State Court Litigation*

Congress' approach to these problems was essentially to craft a set of procedural hurdles designed to make it more difficult to bring and maintain class action litigation in federal court.⁸⁷ In large part, the Act creates a separate subset of the Federal Rules of Civil Procedure that applies only to securities fraud cases. Because the Act consists predominantly of procedural reforms applicable only in federal court,⁸⁸ it sets the stage for plaintiffs' attor-

systems, Inc.). For a full discussion of the factors that create strong incentives to settle securities class action cases, *see generally* Alexander, *supra* note 70.

83. *See, e.g., 1993 Senate Hearings, supra* note 64, at 18 (statement of Richard J. Egan); *see also* 141 CONG. REC. S9137 (1995) (letter from Arthur Levitt, Chairman, SEC, to Sen. Alfonse M. D'Amato) ("[C]orporate America is hesitant to disclose projections and other forward-looking information, because of excessive vulnerability to lawsuits if predictions ultimately are not realized."); Arthur Levitt, "Final Thoughts on Litigation Reforms," Remarks by Chairman Arthur Levitt, United States Securities and Exchange Commission, 23d Annual Securities Regulation Institute, San Diego, Cal., Jan. 24, 1996, *in* 33 SAN DIEGO L. REV. 835, 837 (1996) ("[O]ne of the main arguments of proponents of reform was that liability concerns were preventing companies from disclosing information—especially forward-looking information.").

84. *See, e.g., 1993 Senate Hearings, supra* note 64, at 108-09 (statement of Richard J. Egan). There is empirical data that supports this contention. Professor Lev, for example, used a matched sample design to study 20 companies sued in securities litigation and 20 companies that were not sued. He found that sued issuers communicated more extensively with the public and had a higher incidence of inconsistent forecasts. *See Lev, supra* note 78, at 9.

85. STATEMENT OF MANAGERS, *supra* note 63, at 32.

86. *See id.* at 42-43 (quoting former SEC Chairman Richard Breeden); *see also* Baruch Lev, *Information Disclosure Strategy*, CAL. MGMT. REV., Summer 1992, at 9, 9 (1992) (collecting empirical data on the impact of disclosure); Baruch Lev & Stephen H. Penman, *Voluntary Forecast Disclosure, Nondisclosure, and Stock Prices*, 28 J. ACCT. RES. 49 (1990) (finding that stock prices of nondisclosing firms are not negatively affected compared to disclosing firms in the same industry). On the theoretical benefits of increased disclosure and the problems of overdeterrence, *see* Mahoney, *supra* note 51, at 656.

87. *See* STATEMENT OF MANAGERS, *supra* note 63, at 32 ("This legislation implements needed procedural protections to discourage frivolous litigation.").

88. Many of the Act's provisions only apply to actions governed by the Federal Rules. *See, e.g.,* 15 U.S.C. § 78u-4(a)(1) (1994) (governing any private plaintiff class action brought under the Federal Rules of Civil Procedure); 15 U.S.C.A. § 77z-1(a)(1) (West 1997) (same); *see also* Edward

neys to shift some portion of their cases to state court in order to avoid those provisions. Although a number of other provisions of the Act significantly affect the securities law landscape,⁸⁹ three in particular appear to be most responsible for this migration to state court: (i) the heightened pleading standard; (ii) the discovery stay; and (iii) the safe harbor for forward-looking information.

1. *The heightened pleading standard.*

Among the most controversial provisions of the Act was a pleading requirement designed to make it harder for unwarranted allegations of fraud to survive a motion to dismiss.⁹⁰ The pleading standard was a significant factor in the President's veto⁹¹ and continues to be at the center of significant debate and commentary.⁹² Because it prescribes what is required to be alleged in the complaint, the provision has had the most immediate impact in securities litigation.⁹³

The new standard contains two significant prongs that raise the bar for

Brodsky, *Discovery Abuses: A Shifting Target?*, N.Y. L.J., Apr. 9, 1997, at 3 (discussing how litigation is affected by discovery provisions in the Reform Act).

89. For example, the Act created a "lead plaintiff" provision intended to encourage greater institutional investor participation in securities class actions; the provision also significantly curtailed joint and several liability for secondary participants and created a controversial damages limitation rule. See 15 U.S.C.A. §§ 78u-4(a)(3), (e), (g) (West 1997). For assessments of these provisions, see Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 ARIZ. L. REV. 533, 537-50 (1997); Joseph A. Grundfest & Michael A. Perino, *The Pentium Papers: A Case Study of Collective Institutional Investor Activism in Litigation*, 38 ARIZ. L. REV. 559, 599-604 (1996). See generally Jonathan C. Dickey & Marcia Kramer Mayer, *Effect on 10b-5 Damages of the 1995 Private Securities Litigation Reform Act: A Forward-Looking Assessment*, 51 BUS. LAW. 1203 (1996); Donald C. Langevoort, *The Reform of Joint and Several Liability Under the Private Securities Litigation Reform Act of 1995: Proportionate Liability, Contribution Rights and Settlement Effects*, 51 BUS. LAW. 1157 (1996); and Robert B. Thompson, "Simplicity and Certainty" in the Measure of Recovery Under Rule 10b-5, 51 BUS. LAW. 1177 (1996).

90. See 15 U.S.C.A. § 78u-4(b) (West 1997); see also STATEMENT OF MANAGERS, *supra* note 63, at 41 ("Naming a party in a civil suit for fraud is a serious matter. Unwarranted fraud claims can lead to serious injury to reputation for which our legal system effectively offers no redress."). Congress found that Federal Rule of Civil Procedure 9(b), which addresses this concern by requiring plaintiffs to plead fraud with specificity, failed to stem abusive lawsuits, in part because the circuits had differed on its requirements. See *id.* at 41.

91. See Veto Message, *supra* note 73 (objecting to Congress' raising the pleading standard above the Second Circuit's level, because the President "believe[d] that the pleading requirements of the Conference Report with regard to a defendant's state of mind impose an unacceptable procedural hurdle to meritorious claims being heard in Federal courts").

92. See, e.g., John C. Coffee, Jr., *The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung*, 51 BUS. LAW. 975, 977-85 (1996) (discussing pleading standard, legislative history, and early case law). See generally Elliott J. Weiss, *The New Securities Fraud Pleading Requirement: Speed Bump or Road Block?*, 38 ARIZ. L. REV. 675 (1996) (evaluating whether the Act's pleading standard will preclude or merely delay meritorious claims); D.M. Osborne, *Getting Back at Lerach*, AM. LAW., Sept. 1997, at 48 (highlighting the contentiousness of the pleading standard in high-technology securities fraud cases).

93. The new standard applies equally to individual securities fraud cases and class actions.

filing in federal court. First, when a complaint is pleaded on information and belief—as is often the case in securities class actions—it must state “with particularity all facts on which that belief is formed.”⁹⁴ At least one court has held that this provision requires plaintiffs to disclose the names of confidential informants, employees, competitors, and others who provided information leading to the filing of the case.⁹⁵ Second, plaintiffs are required to “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”⁹⁶ The “strong inference” language was drawn from Second Circuit authority that predated the Reform Act, but the President’s veto was premised in part on language in the legislative history suggesting that Congress meant to erect a pleading barrier even higher than that which the Second Circuit had articulated.⁹⁷ The dispute over the Act’s precise meaning and the facts that will satisfy the standard has continued, and there is a significant split among the courts over its interpretation.⁹⁸

This pleading standard, and some courts’ strict interpretations of it, cre-

94. 15 U.S.C.A. § 78u-4(b)(1) (West 1997).

95. See *In re Silicon Graphics, Inc. Sec. Litig.*, 970 F. Supp. 746, 767-68 (N.D. Cal. 1997) (stating that “plaintiffs must provide more details,” such as “the titles of the [negative internal] reports, when they were prepared, who prepared them, to whom they were directed, their content, and the sources from which plaintiffs obtained this information” to survive a motion to dismiss).

96. 15 U.S.C.A. § 78u-4(b)(2) (West 1997).

97. See Veto Message, *supra* note 73. The legislative history of the Reform Act on this point is extensively analyzed in Michael A. Perino, *A Strong Inference of Fraud? An Early Interpretation of the 1995 Private Securities Litigation Reform Act*, 1 SEC. LITIG. REFORM ACT REP. 397 (1996).

98. A number of courts have held that the provision codifies or is substantially similar to the Second Circuit standard. See, e.g., *In re Oak Tech. Sec. Litig.*, No. 96-20552 SW at 7 (N.D. Cal. Aug. 1, 1997) (visited Nov. 11, 1997) <<http://securities.stanford.edu/decisions/oaktech>> (order dismissing consolidated amended complaint with leave to amend); *Fugman v. Arogenex, Inc.*, 961 F. Supp. 1190, 1195 (N.D. Ill., 1997) (non-class action); *Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1253-55 (N.D. Ill., 1997); *Fischler v. AmSouth Bancorp.*, No. 96-1567-CIV-T-17A, 1996 U.S. Dist. LEXIS 17670 (M.D. Fla., Nov. 14, 1996) (applying Second Circuit tests for pleading a strong inference of fraud); see also *Sloane Overseas Fund, Ltd. v. Sapiens Int’l Corp.*, 941 F. Supp. 1369, 1377 (S.D.N.Y. 1996) (dictum); *STI Classic Funds v. Bollinger Indus.*, No. 3-96-CV-823-R (N.D. Tex., Nov. 12, 1996) (visited Nov. 11, 1997) <<http://securities.stanford.edu/decisions/bollinger>> (order denying motion to dismiss first amended class action complaint and plaintiffs’ objection to the Report and Recommendation of the U.S. Magistrate Judge) (accepting magistrate’s finding that “[p]laintiff’s complaint contains sufficient facts to demonstrate a motive for filing false reports with the SEC,” Report and Recommendation of United States Magistrate Judge, *STI Classic Funds v. Bollinger Indus.*, No. 3-94-CV-823-R (N.D. Tex.)) (visited Nov. 11, 1997) <<http://securities.stanford.edu/decisions/bollinger>>); *Zeid v. Kimberley*, 930 F. Supp. 431, 437-38 (N.D. Cal. 1996); *Marksman Partners, L.P. v. Chantal Pharmaceutical Corp.*, 927 F. Supp. 1297, 1308-10 (C.D. Cal. 1996).

Courts finding that the Act created a higher pleading standard include *In re Silicon Graphics Sec. Litig.*, 970 F. Supp. at 754-57; *Norwood Venture Corp. v. Converse Inc.*, 959 F. Supp. 205, 208-09 (S.D.N.Y. 1997) (non-class action); *Friedberg v. Discreet Logic, Inc.*, 959 F. Supp. 42, 47-50 (D. Mass. 1997); *Powers v. Eichen*, No. Civil 96-1431-B (AJB) (S.D. Cal., Mar 13, 1997) (order denying motion to dismiss); *In re Silicon Graphics, Inc. Sec. Litig.*, No. C 96-0393 FMS, 1996 U.S. Dist. LEXIS 16989, at 16 (N.D. Cal. 1996) (order dismissing plaintiffs’ claims with prejudice).

ate incentives for plaintiffs to file certain categories of cases in state court, where the higher pleading standards do not apply. Plaintiffs reluctant to disclose the sources of their information, or who lack such sources and are proceeding on educated guesswork, may prefer to file in state court. This is particularly true if plaintiffs can obtain sufficient discovery in a state proceeding to avoid pleading on information and belief in a subsequent federal suit. The absence of a strong inference standard under state law also increases the incentive to file in state court, particularly if more federal courts hold plaintiffs to a standard higher than the Second Circuit's. Even if federal courts apply the strong inference standard in accordance with prior Second Circuit precedent, plaintiffs still have, on average, a significantly higher threshold for surviving a motion to dismiss in federal court than they had before the Reform Act.

At a minimum, plaintiffs should be reluctant to file cases in federal court if the facts do not fall within pre-Reform Act precedents finding that the strong inference standard had been satisfied. The dominant tests developed in the Second Circuit required plaintiffs to plead specific facts demonstrating that the defendant had either a motive and opportunity to defraud, or facts that constituted strong circumstantial evidence of conscious misbehavior or recklessness.⁹⁹ The difficulties associated with marshaling sufficient facts in the initial complaint are likely to be particularly acute in two types of cases. A number of pre-Reform Act cases found a strong inference of fraud when the complaint alleged either some sort of misrepresentation or omission in the issuer's financial statements, or unusual or suspicious trading by officers or directors while the fraud was alive in the market.¹⁰⁰ All things being equal, it is reasonable to expect that cases with these kinds of facts are more likely to be filed in federal court after the Reform Act and that plaintiffs might have increased incentives to pursue state court litigation in cases without these facts. Similar considerations should apply for cases involving fact patterns that Congress found to be emblematic of abusive securities class actions, such as those that premise liability on allegedly false forward-looking statements.¹⁰¹ If plaintiffs believe that it will be difficult for such

99. See, e.g., *San Leandro Emergency Med. Group Profit Sharing Plan v. Phillip Morris Cos.*, 75 F.3d 801, 813 (2d Cir. 1996); *Acito v. IMCERA Group*, 47 F.3d 47, 52 (2d Cir. 1995); *Shields v. CityTrust Bancorp.*, 25 F.3d 1124, 1128 (2d Cir. 1994); *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 269 (2d Cir. 1993).

100. See, e.g., *Acito*, 47 F.3d at 54 (finding that "unusual insider trading activity during the class period may permit an inference of bad faith and scienter") (citing *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1117 (9th Cir. 1989)); *Citytrust*, 25 F.3d at 1130 (finding no strong inference of fraud where there was no claim "that false statements were made in an effort to sell off shares held by management"); *Goldman v. Belden*, 754 F.2d 1059, 1070-71 (2d Cir. 1985) (upholding a fraud complaint alleging the sale of tens of thousands of shares by the CFO during the class period).

101. See SENATE REPORT, *supra* note 63, at 5 ("The mere specter of 10b-5 liability . . . has caused corporate management to refrain from providing shareholders forward-looking information about companies."); STATEMENT OF MANAGERS, *supra* note 63, at 43-47 (discussing the Reform

cases to survive a motion to dismiss in federal court, then they may file in a state court that has less stringent pleading requirements.

2. *The mandatory discovery stay.*

To "prevent unnecessary imposition of discovery costs on defendants,"¹⁰² the Act mandates a discovery stay in private securities actions while a motion to dismiss is pending.¹⁰³ Federal courts have interpreted the discovery stay broadly, thereby creating strong incentives for plaintiffs to avoid application of the stay to their cases by filing in state court.¹⁰⁴ State courts have reinforced this incentive because they generally have been reluctant to stay discovery.¹⁰⁵ Indeed, one California appellate court held that

Act's safe harbor for forward-looking information).

102. STATEMENT OF MANAGERS, *supra* note 63, at 32.

103. See 15 U.S.C.A. §§ 77z-1(b), 78u-4(b)(3)(B) (West 1997). The Act creates a limited exception to the stay that permits "particularized discovery" to proceed if it is "necessary to preserve evidence or to prevent undue prejudice to" the moving party. 15 U.S.C.A. §§ 77z-1(b)(2), 78u-4(b)(3)(C) (West 1997). When combined with the heightened pleading standard, the discovery stay may also tend to slow the race to the courthouse because plaintiffs will be required to engage in more extensive pre-filing investigations.

104. See *Medhekar v. United States Dist. Ct. for the N. Dist. of Cal.*, 99 F.3d 325, 328-29 (9th Cir. 1996) (finding that discovery stay applies equally to mandatory disclosure provisions of the Federal Rules of Civil Procedure and local rules of procedure); *Kane v. Madge Networks, N.V.*, No. C96-20653 RMW PVT at 2 (N.D. Cal. Jan. 13, 1997) (order denying plaintiffs' motion to compel nonparty Cisco Systems, Inc. to produce documents) (staying third-party discovery before motion to dismiss was filed); *Medical Imaging Ctrs. of Am., Inc. v. Lichtenstein*, 917 F. Supp. 717, 720-21 (S.D. Cal. 1996) (applying discovery stay to proxy contests); *Levy v. United HealthCare Corp.*, Civ. No. 3-96-750 (D. Minn. Sept. 10, 1996) (order denying motion to dismiss and request for relief from discovery stay) (defendant not permitted to depose plaintiff in order to test veracity of certification filed with complaint); *Novak v. Kasaks*, 96 Civ. 3073 (AGS), 1996 U.S. Dist. LEXIS 11778, at *3 (S.D.N.Y. Aug. 16, 1996) (order granting defendants' motion to stay discovery) (holding that plaintiff's "speculative assertions as to the risk of lost evidence and undue prejudice" were insufficient to permit discovery of subpoenaed third parties).

105. See, e.g., *Marinero v. Super. Ct.*, S055594 1996 Cal. LEXIS 6105 (Cal. Oct. 30, 1996) (order to show cause why relief sought in petition should not be granted) (issuing order for lower court to show cause for denying stay of state action even when four parallel federal actions were pending); *Oak Tech. v. Super. Ct.*, No. CV 758510, slip op. at 2 (Cal. Ct. App. Aug. 14, 1997) (denying stay of discovery in three separate state court class actions involving Oak Technology, Diamond Multimedia Systems, Inc., and IMP, Inc.); *Lee v. IMP, Inc.*, No. CV 760793 (Cal. Super. Ct. Dec. 26, 1996) (order denying motion to stay discovery); *In re Oak Tech. Sec. Litig.*, No. CV 758510 (Cal. Super. Ct. Dec. 6, 1996) (requiring defendants to comply with discovery requests before plaintiffs filed an amended complaint); Transcript at 40-41, *Shores v. Cinergi Pictures Entertainment, Inc.*, No. BC 149861 (Cal. Super. Ct. L.A. County Sept. 19, 1996) (staying discovery on 1933 Act claim but permitting discovery to proceed on a common law negligent misrepresentation claim).

At least one pre-Reform Act case has held that it is within a state court's discretion to deny class certification in a state action where a federal action based on the same facts and circumstances is pending. See *Schneider v. Vennard*, 183 Cal. App. 3d 1340, 1347-50 (Cal. Ct. App. 1986). Among the factors the court considered in finding that a parallel state class action would be an "unwarranted extravagance" were: the prevention of duplicative litigation; the elimination of inconsistent results; and the ability to avoid undue burdens on the parties and the judiciary. See *id.* at 1349-50.

arguments that plaintiffs were seeking to avoid the Reform Act's discovery stay were "irrelevant . . . because the current state of the law permits securities fraud plaintiffs to maintain [a] dual-track litigation strategy."¹⁰⁶

Attempts to avoid the discovery stay may take several forms. Plaintiffs can file parallel actions in both federal and state court. The state action may allege federal claims if the case involves an initial or secondary offering,¹⁰⁷ or may involve solely state claims if plaintiffs believe the state court is less likely to stay discovery in cases without federal claims. Alternatively, a plaintiff may be unable to identify facts that a court is likely to find sufficient to satisfy the federal pleading standard through prefiling investigation, for the reasons described above. In such a case, a plaintiff may file a state court action, conduct discovery, and, should more compelling facts come to light, file a follow-up federal complaint.¹⁰⁸

3. *The safe harbor for forward-looking information.*

To address the chilling effect that nonmeritorious lawsuits have "on the robustness and candor of disclosure" regarding an issuer's prospects,¹⁰⁹ the Reform Act provides for a two-pronged safe harbor for forward-looking statements. Under the first prong, statements are protected if they are identified as forward-looking statements and are "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."¹¹⁰ The second prong focuses on the speaker's state of mind and requires that the forward-looking statement be made with actual knowledge that it was false or misleading.¹¹¹

The statutory safe harbor has a number of important exclusions and ex-

106. *Oak Tech.*, slip op. at 9. The court acknowledged that trial courts may stay discovery, but it refused to overturn contrary decisions because they were not an abuse of discretion. *See id.* at 10-11.

107. The Securities Act of 1933 creates concurrent federal and state jurisdiction. *See* 15 U.S.C. § 77v(a) (1994).

108. *See* JONATHAN C. DICKEY & PAUL J. COLLINS, AMERICAN ELECTRONICS ASSOCIATION: A WHITE PAPER ON SECURITIES LITIGATION REFORM 11 (1997) (on file with author) (noting at least one case, involving Symantec Corporation, in which plaintiffs filed a federal securities class action complaint only after obtaining substantial discovery in a previously filed state court action). Several scholars have suggested that potential plaintiffs use state inspection statutes to obtain discovery about potential securities fraud cases before filing a federal class action lawsuit. *See, e.g.*, Randall S. Thomas & Kenneth J. Martin, *Using State Inspection Statutes for Discovery in Federal Securities Fraud Actions*, 77 B.U. L. REV. 69, 71 (1997).

109. STATEMENT OF MANAGERS, *supra* note 63, at 43 (quoting testimony of Richard C. Breedren, former SEC Chairman, before the Securities Subcommittee of the Senate Committee on Banking, Housing, and Urban Affairs, Mar. 2, 1995).

110. 15 U.S.C.A. §§ 77z-2(c)(1)(A)(i), 78u-5(c)(1)(A)(i) (West 1997).

111. *See* 15 U.S.C.A. §§ 77z-2(c)(1)(B)(1), 78u-5(c)(1)(B)(1) (West 1997).

ceptions¹¹² that could affect the kinds of allegations made in post-Reform Act complaints. For example, the safe harbor does not apply to forward-looking statements included in financial statements prepared in accordance with generally accepted accounting principles.¹¹³ When combined with the higher pleading standard, the presence of this exclusion suggests that a higher proportion of financial misstatement cases may be filed in federal courts. If a case is based on allegedly false forward-looking statements that fall within the safe harbor, the combined effects of the safe harbor and the higher pleading standard may cause plaintiffs to file cases based solely on false forward-looking statements in state rather than federal court.

III. PRIOR EMPIRICAL STUDIES OF POST-REFORM ACT LITIGATION

What effect have the incentives described in the preceding part had on the shape of securities class action litigation? Three empirical studies have examined post-Reform Act class actions: (i) a study I coauthored with Joseph Grundfest¹¹⁴ (the "Grundfest-Perino Study"); (ii) a study conducted by National Economic Research Associates¹¹⁵ (the "NERA Study"); and (iii) a report prepared by the SEC¹¹⁶ (the "SEC Report"). The three studies observe

112. See 15 U.S.C.A. §§ 77z-2(b), 78u-5(b) (West 1997). Congress did not extend safe-harbor protections to forward-looking statements: (1) contained in financial statements prepared in accordance with generally accepted accounting principles ("GAAP"); (2) issued by or included in the registration statement of an investment company; (3) made in connection with a tender offer or an initial public offering; (4) made in a partnership or limited liability company offering; or (5) made as part of a disclosure of beneficial ownership pursuant to section 13(d) of the 1934 Act. See 15 U.S.C.A. § 78u-5(b)(2) (West 1997). The safe harbor also excluded certain types of issuers, such as those previously convicted of felonies or misdemeanors, blank check companies, or penny stock issuers. See 15 U.S.C.A. § 78u-5(b)(1) (West 1997).

113. See 15 U.S.C.A. §§ 77z-2(b)(2), 78u-5(b)(2)(A) (West 1997).

114. JOSEPH A. GRUNDFEST & MICHAEL A. PERINO, *SECURITIES LITIGATION REFORM: THE FIRST YEAR'S EXPERIENCE* (John M. Olin Program in Law and Economics, Stanford Law School, Working Paper No. 140, Feb. 1997).

115. DENISE M. MARTIN, VINITA M. JUNEJA, TODD S. FOSTER & FREDERICK C. DUNBAR, *RECENT TRENDS IV: WHAT EXPLAINS FILINGS AND SETTLEMENTS IN SHAREHOLDER CLASS ACTIONS?* (National Economic Research Associates, Nov. 1996) [hereinafter NERA STUDY]. The NERA Study is the latest in series of studies of securities class actions. See, e.g., FREDERICK C. DUNBAR, *RECENT TRENDS IN SECURITIES CLASS ACTION SUITS* (NERA, Aug. 1992); FREDERICK C. DUNBAR & VINITA M. JUNEJA, *RECENT TRENDS II: WHAT EXPLAINS SETTLEMENTS IN SHAREHOLDER CLASS ACTIONS?* (NERA, Oct. 1993); FREDERICK C. DUNBAR, TODD S. FOSTER, VINITA M. JUNEJA & DENISE M. MARTIN, *RECENT TRENDS III: WHAT EXPLAINS SETTLEMENTS IN SHAREHOLDER CLASS ACTIONS?* (NERA, June 1995). These previous studies focused primarily on the variables associated with class action settlements, but the 1996 NERA Study expanded its emphasis to examine the effect of the Reform Act on federal and state filing rates.

116. OFFICE OF GENERAL COUNSEL, SEC, *REPORT TO THE PRESIDENT AND THE CONGRESS ON THE FIRST YEAR OF PRACTICE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995* (Apr. 1997) [hereinafter SEC REPORT]. The SEC Report differs in emphasis from the other studies because it was specifically designed in response to a request by President Clinton that "the Commission advise him and the Congress about the impact of the Act on the effectiveness of the securities laws and on investor protection, and on the extent and nature of litigation under the Act."

similar trends, although the exact data reported in each differs slightly due to methodological differences and the difficulties inherent in collecting data on class actions filings.¹¹⁷

At least three significant points can be drawn from these studies. First, there is no evidence that the Reform Act has caused a significant decline in the annual volume of class action litigation. Second, as all three studies begin to document, a portion of this litigation has shifted from federal to state court. The studies hypothesize that this shift is driven by attempts to avoid some of the procedural hurdles of the Reform Act, but they do not compile any statistically significant data to support this inference. Third, the studies document changes in federal pleading patterns, involving both the frequency of particular kinds of allegations and the stock price drops associated with class litigation. The studies suggest that these changes reflect attempts to satisfy the new heightened pleading standard. Again, however, without compiling statistically significant evidence of state court pleading patterns, the present studies cannot support the inference that forum selection is being driven by the new federal standard.

A. Overall Filing Rates

Perhaps the most basic question regarding the impact of the Reform Act is: Has the Act caused a decline in the number of issuers sued in securities class actions?¹¹⁸ The short answer is that it is too early to draw any reliable

Letter from Richard H. Walker, General Counsel of the Securities and Exchange Commission, to Chairman and Commissioners of the Securities and Exchange Commission (Apr. 14, 1997), reprinted in SEC REPORT, *supra*. Given this mandate, much of the Report focuses on judicial decisions interpreting the Act. But the staff also reviewed post-Reform Act state, see SEC REPORT, *supra*, at 71-74, and federal complaints, see *id.* at 22, and discussed the Act's effects with plaintiff's counsel, defense counsel, and institutional investors, see *id.* at 3.

117. For example, a recent Federal Judicial Center ("FJC") study of class actions enumerated significant difficulties in quantifying the amount of class action in a given district. See THOMAS E. WILLGING, FEDERAL JUDICIAL CTR., EMPIRICAL STUDY OF CLASS ACTIONS IN FOUR FEDERAL DISTRICT COURTS: FINAL REPORT TO THE ADVISORY COMMITTEE ON CIVIL RULES (1996). In its analysis of class action activity in the federal courts, the FJC initially relied on the statistics the Administrative Office of the Federal Courts publishes each year. After examining court dockets, however, the FJC found that the Administrative Office data identified only between one-fifth to one-half of the class action activity in the four districts. See *id.* at 198.

118. Like the Grundfest-Perino Study, this article uses the number of issuers sued rather than the number of class action complaints filed to measure changes in litigation activity. This statistic is a more reliable indication of litigation activity; in many class action securities cases a single issuer is named in multiple suits by different lead plaintiffs. For example, as of October 1997, at least 22 securities class action complaints have been filed against Informix Corporation in the United States District Court for the Northern District of California. See *Informix Case Information, in Stanford Securities Class Action Clearinghouse* (last modified Oct. 20, 1997) <<http://securities.stanford.edu/cases/informix.html>>. These complaints are often consolidated and litigated as a single proceeding. The number of issuers sued is, therefore, a superior predictor of the volume of postconsolidation litigation. See Seligman, *The Merits Do Matter*, *supra* note 75, at 444 (suggesting that the number of companies sued is the appropriate statistic for measuring aggregate litigation levels); see also Thomas M. Jones, *An Empirical Examination of the Incidence of Shareholder*

conclusions about the Act's long-term affect on filing rates. The data on the first eighteen months of post-Reform Act litigation activity, however, suggest that the volume of securities class actions in the wake of the Reform Act is roughly equivalent to pre-Reform Act levels.

The Grundfest-Perino Study was the first to analyze all of the class action litigation activity in the first year under the Reform Act. Table I reports that a total of 150 issuers were sued in securities fraud class actions in 1996.¹¹⁹ The amount of litigation activity in the first quarter of the year was likely depressed by certain one-time effects, such as an increase in filings prior to the effective date of the Reform Act and a "learning curve effect" that may have slowed filings as plaintiffs' attorneys determined how best to plead their cases under the new statutory regime.¹²⁰ Absent these effects, the Grundfest-Perino Study predicted that 163 issuers would have been sued.¹²¹ Although the estimated and observed litigation rates represent a decline of about 7-15% from the average of 176 issuers sued per year in the period from 1991-1995, there was a great deal of variance in the pre-Reform Act filings, and the number of issuers sued in 1996 was not materially different from the number sued in 1991, 1993, and 1995.¹²² The filing data in the SEC

Derivative and Class Action Lawsuits, 1971-78, 60 B.U. L. REV. 306, 313 (1980) (noting the sensitivity of aggregate filing statistics to the presence of multiple suits).

119. These figures have been revised to include cases uncovered in additional research conducted after the study was published. The Grundfest-Perino Study reported a total of 148 issuers sued. See GRUNDFEST & PERINO, *supra* note 114, at 9.

120. See *id.* at 4-5. The NERA Study and anecdotal evidence suggest that there was a significant upswing in filing activity immediately before the effective date of the Reform Act and a concomitant decrease in early 1996. See NERA STUDY, *supra* note 115, at 5 (noting that filing data for December 1995-February 1996 support the inference that "the law's enactment had a one-time effect of shifting some lawsuits that would have been filed in early 1996 to late 1995"); see also Steve Bailey & Steven Syre, *Avid Suit Filed Before Law OK'd*, BOSTON GLOBE, Dec. 27, 1995, at 41 (reporting a case that was filed on December 21, the day before the Act's effective date, and only 10 minutes before the court's deadline for accepting cases on that day); Richard B. Schmitt, *Laws Intended to Limit Suits Clog Up Courts*, WALL ST. J., Jan. 24, 1996, at B1 ("Plaintiffs' lawyers [were] trying to beat the clock."). The NERA Study also notes that in December 1995 there was a significant decrease in the lag time between the end of the alleged class period and the first filed complaint, which suggests that plaintiffs were rushing to file actions in anticipation of passage of the Reform Act. See NERA STUDY, *supra* note 115, at 6.

The data collected on 1997 filings support this hypothesis. In the first quarter of 1997, 35 issuers were sued in federal court as compared to 16 for the same period in 1996. See *Securities Class Action Clearinghouse* (last modified Aug. 21, 1997) <<http://securities.stanford.edu>>.

121. See GRUNDFEST & PERINO, *supra* note 114, at 9. The Grundfest-Perino Study estimates that absent these one-time effects, 124 issuers would have been sued in federal court in 1996. See *id.* at 4. This figure represents a decline of 30-38% from average pre-Reform Act federal filings when viewed in isolation. As noted below, however, much of the decline appears to be the result of a substitution effect to state court.

122. See GRUNDFEST & PERINO, *supra* note 114, at 9. These baseline figures are drawn from federal court filing data contained in the NERA Study, which reports that for 1991, 1993, and 1995, federal filings were 153, 158, and 162, respectively. See NERA STUDY, *supra* note 115, at tbl.1. The Grundfest-Perino Study relied on these data rather than on the Administrative Office data—the traditional source for studies of federal litigation rates—because the Administrative Office data can

Report do not differ materially from the data in the Grundfest-Perino Study.¹²³

The data in the Grundfest-Perino Study have been updated to reflect litigation activity in the first six months of 1997. These data tend to confirm that a net decline in overall securities class action activity does not appear to be correlated with the Reform Act. Table I demonstrates that through June 30, 1997, 97 issuers were sued in securities class actions, which suggests an annualized total of 194 issuers in 1997. This estimate represents a 29.3% increase from 1996 and a 10.2% increase from the average number of companies sued in federal court per year in the period from 1991-1995. Still, annual filings before the Reform Act ranged as high as 220 issuers sued per year. Thus, the 1997 data support the conclusion that the Reform Act has had apparently little effect on the overall volume of class activity.

systematically overstate or understate securities class action activity. See GRUNDFEST & PERINO, *supra* note 114, at 5; WILLGING, *supra* note 117, at 198-99.

The difficulties associated with obtaining accurate estimates of the volume of pre-Reform Act litigation activity have been detailed both in the Grundfest-Perino Study and elsewhere. See GRUNDFEST & PERINO, *supra* note 114, at 5-6; see also Seligman, *The Merits Do Matter*, *supra* note 75, at 444-45 (noting misleading data and the frequency with which complaints alleging stock drops are dismissed in federal court). Indeed, other estimates of the volume of pre-Reform Act consolidated litigation activity would suggest that passage of the Act had very different effects on the volume of litigation activity. For example, a study of postconsolidation class action activity prepared by the publisher and editor of *Securities Class Action Alert* ("SCAA") suggests that from 1989-1992 the average number of companies sued was 123.5 per year, with a range of 108-151 per year. See *1993 Senate Hearings*, *supra* note 63, at 777 (statement of James M. Newman, publisher & editor, SCAA); see also Seligman, *The Merits Do Matter*, *supra* note 75, at 444 (relying on these data as a measure of the true volume of class action litigation). If those estimates are correct, then: (1) the 1996 observed federal court filings represent only an 11% drop from the pre-Reform Act average; (2) the estimated 1996 federal filing figure matches pre-Reform Act averages; and (3) the inclusion of state court filings would actually represent an increase of 21-32% in the overall volume of class action activity. This anomalous result suggests that the SCAA estimate may understate the actual volume of pre-Reform Act litigation activity.

123. See SEC REPORT, *supra* note 116, at 20-21. The actual number of cases reported in federal court is not materially different—the SEC Report identifies a total of 105 cases, whereas the Grundfest-Perino Study identifies 109. See *id.* at 20; GRUNDFEST & PERINO, *supra* note 114, at 4.

Slightly different results are found in the NERA Study, which finds, for example, no net decline in federal class action lawsuits filed in 1996. See NERA STUDY, *supra* note 115, at 6. NERA also identifies slightly more filings than the other studies. See *id.* In part, the differences in these figures may reflect differences in what each report is counting—"federal filings" versus "issuers sued." The Grundfest-Perino Study also seems to have taken a more conservative approach toward including cases within its database than did the NERA Study. Ultimately, the only way to reconcile these different figures is to analyze each study's underlying data. Unfortunately, unlike the Grundfest-Perino Study, the NERA Study does not list every filing included in its 1996 count, and thus an accurate comparative analysis is not possible. The empirical studies agree, however, that there is no evidence of a net increase in federal class action lawsuits in 1996 and that overall filing rates appear to have changed little in 1996. See SEC REPORT, *supra* note 116, at 4-5 (noting, however, that the lower number of companies sued in the year following the passage of the Reform Act might be an aberration and stating that more time was needed to determine if the number of cases had been affected); GRUNDFEST & PERINO, *supra* note 114, at 4-6; NERA STUDY, *supra* note 115, at 6.

TABLE I
FEDERAL AND STATE COURT LITIGATION
JANUARY 1, 1996-JUNE 30, 1997

	1996	1997 ¹²⁴	TOTAL ¹²⁵
Companies Sued in Federal Court	110	83	193
Companies Sued in State Court (adjusted for multiple state court filings)	70	24	94
Companies Sued Solely in State Court	40	14	54
Companies Sued in Both Federal and State Court	30	10	38
Total Federal and State Court	150	97	238

B. *The Shift to State Court Litigation*

The relative stability in overall filing activity masked a significant shift in litigation from federal to state court. Although none of the previous studies attempted to quantify pre-Reform Act levels of state court activity in order to measure the exact size of this shift, all three studies agree that this increase in state court litigation is one of the most significant developments in the wake of the Reform Act.¹²⁶

The data reported in Table I demonstrate that a total of ninety-four issuers were sued in state court in the first eighteen months after passage of the Reform Act.¹²⁷ Fifty-four issuers were sued in state proceedings without parallel federal claims, whereas thirty-eight issuers were sued in both federal and state court proceedings. These data represent the minimum amount of state court activity. They may not reflect all activity at the state court level, due to the difficulty in compiling data on state class actions, but the extent of this problem remains unclear.¹²⁸

124. The figures for 1997 are for filings in the first six months of 1997. Issuers were included in the "sued solely in state court" category if no federal complaint were filed during the relevant time period.

125. The total number of companies sued in federal and state court is less than the totals reflected in the columns for 1996 and 1997 state and federal litigation because nine companies sued in federal court in 1997 were previously sued in state court in 1996.

126. See SEC REPORT, *supra* note 116, at 68-69 (declaring the shift to state courts to be "the most significant development in securities litigation post-Reform Act"); GRUNDFEST & PERINO, *supra* note 114, at 9 (discussing how the Reform Act appears to have shifted litigation from federal to state court); NERA STUDY, *supra* note 115, at 8 (observing that there has been "a significant surge" in state court filings).

127. This figure has been updated to reflect the results of additional research. The Grundfest-Perino Study reported 69 issuers sued in state proceedings in 1996. See GRUNDFEST & PERINO, *supra* note 114, at 8.

128. The NERA Study reaches similar conclusions with respect to state court filings, but it

The Grundfest-Perino Study speculated that these figures represented an increase in state court filings, based on anecdotal reports that securities class action litigation was rarely filed in state court prior to the Reform Act.¹²⁹ The Grundfest-Perino Study hypothesized that this increase in state filings was consistent with the presence of two phenomena. First, "state only" class actions were thought to be the result of a substitution effect whereby plaintiffs' counsel file in state court when the underlying facts appear not to be sufficient to satisfy the Reform Act's heightened pleading standard, or where plaintiffs are attempting to avoid other procedural or substantive hurdles of the Act.¹³⁰ In other words, instead of eliminating these cases, as proponents of the Reform Act had hoped,¹³¹ the Act appears to have increased the relative profitability of filing this subset of cases in state court.¹³² Second, the increased use of parallel proceedings was thought to be consistent with attempts by plaintiffs to circumvent the Reform Act's discovery stay provisions by seeking discovery in state court actions.¹³³

C. Changes in Pleading Practice

Both the Grundfest-Perino Study and the SEC Report examine allega-

likely overcounts the amount of state court activity. The NERA Study reported 78 state court filings through October 1996. See NERA STUDY, *supra* note 115, at 7. The discrepancies between the figures these two studies report are likely due to methodological differences. Most significantly, the NERA Study includes all cases compiled by SCAA. See *id.* at 7 n.9. However, SCAA reports two very different kinds of state court cases, the increase in only one of which is likely tied to passage of the Reform Act. The only cases included in the Grundfest-Perino Study of state court filings are class action filings alleging misrepresentations or omissions in the purchase and sale of securities in state court. The filing of such cases in state court is likely evidence of a substitution effect. The second kind of action in which companies can, and have traditionally been, sued in state court are class or derivative actions alleging breaches of officers' and directors' duties of loyalty, care, or candor. These cases are unlikely to be related to the Reform Act. However, SCAA reports these latter kinds of state court filings as well. For example, the June 1996 SCAA describes four state breach of fiduciary duty cases involving various corporate restructuring, merger, sale, or tender offer transactions. See SEC CLASS ACTION ALERT, June 1996, at 57, 60, 60, 62 (describing, respectively, suits against Smith's Food and Drug Ctrs., Inc., Professional Sports Care Management, Inc., Systemed, Inc., and Guaranty National Corp.). Similar examples can be found in other editions of SCAA that would have been included in the NERA Study.

The inclusion of these cases in the NERA state court filing figures means that NERA's data should not be used as a measure of the substitution effect from federal to state court.

129. See GRUNDFEST & PERINO, *supra* note 114, at 7 ("Counsel with substantial experience in litigating securities fraud matters suggest that the volume of class action securities fraud litigation in state court has, until passage of the Reform Act, been *de minimis*.").

130. See GRUNDFEST & PERINO, *supra* note 114, at 7 (describing how "new pleading requirements, rules governing joint and several liability, discovery stays, and other provisions of the Reform Act" create a substitution effect from federal to state court). Anecdotal evidence supports the same conclusion. See Thompson, *supra* note 49, at 1 (quoting plaintiffs' attorney that the decision to file in state court is "law-and-procedure shopping").

131. See note 76 *supra* and accompanying text.

132. See GRUNDFEST & PERINO, *supra* note 114, at 7.

133. See SEC REPORT, *supra* note 116, at 69; GRUNDFEST & PERINO, *supra* note 114, at 7.

tions made in post-Reform Act complaints. The Grundfest-Perino Study focuses on changes in the frequency of particular kinds of allegations in pre- and post-Reform Act federal complaints. It reports an increase in the number of complaints alleging: (1) insider trading during the period when the fraud was allegedly alive in the market; and (2) misrepresentations or omissions in financial statements as the basis for liability.¹³⁴ These data are reported in Table II, below. The observed increases in the appearance of these kinds of allegations are consistent with the theory that plaintiffs are relying increasingly on such allegations to satisfy the Reform Act's strong inference pleading requirement¹³⁵ because they are the kinds of allegations that courts found sufficient prior to the Reform Act.¹³⁶ Additional support for this conclusion comes from the relatively small percentage (12.7%) of federal cases that allege false forward-looking information as the sole basis for liability. These were among the kinds of cases Congress singled out as potentially abusive, and they are much less likely to satisfy the heightened standard.¹³⁷ The SEC Report reaches similar conclusions with respect to the frequency of false forward-looking statement allegations in federal complaints.¹³⁸

The Grundfest-Perino Study did not analyze complaints against companies sued in state court proceedings. Such an analysis is important because if the shift to state court is a substitution effect tied to the higher cost of federal litigation in the wake of the Reform Act—here measured in terms of the decreased likelihood of obtaining a settlement or judgment in excess of expected costs—then the cases filed in state court should be those that are expected to be less likely to survive a federal motion to dismiss or motion for summary judgment. The significant increase in federal complaints of allegations of material accounting irregularities and insider trading¹³⁹ suggest that plaintiffs' attorneys believe these kinds of allegations may be sufficient to satisfy new heightened pleading standards.

134. See GRUNDFEST & PERINO, *supra* note 114, at 18 tbl.9.

135. See text accompanying notes 90-101 *supra*.

136. See notes 99-101 *supra* and accompanying text.

137. See notes 83-86 *supra* and accompanying text.

138. See SEC REPORT, *supra* note 116, at 22 ("Few of the complaints (12%) are based solely on forecasts that have not proved true."). The SEC also found that insider trading allegations appeared in 48% of the 105 complaints it analyzed and that allegations of accounting irregularities appeared in 43%. See *id.* Although the Grundfest-Perino Study also reported increases in these kinds of allegations, it found these allegations to be more prevalent than the SEC Report suggests. See GRUNDFEST & PERINO, *supra* note 114, at 17-18 & tbl. 9.

139. See Table II.

TABLE II
COMPARISON OF ALLEGATIONS CONTAINED IN
PRE- AND POST-REFORM ACT CASES¹⁴⁰

TYPE OF ALLEGATION	PRE-REFORM ACT 10B-5 CASES (174 Observations)		POST-REFORM ACT 10B-5 CASES (1996) (71 Observations)		ALL POST-REFORM ACT CASES (1996) (91 Observations)	
	Number	Percent	Number	Percent	Number	Percent
	Misrepresentations in Financial Statements	59	33.9%	44	61.9%	53
Trading by Insiders During Class Period	36	20.7%	39	54.9%	49	53.8%
False Forward-Looking Statement as Sole Allegation	N/A	N/A	9	12.7%	11	12.1%

As a result, it is reasonable to expect that allegations of accounting irregularities or insider trading should be less frequent in actions filed solely in state court. Similarly, because provisions in the Reform Act reflect Congress' concern about actions brought against companies making forecasts that proved to be incorrect,¹⁴¹ it is reasonable to expect that actions based solely on allegedly false forward-looking information should be more frequent in stand-alone state court actions. By contrast, the frequency of allegations in parallel actions pending in state and federal court is likely to be roughly equivalent to the frequency of such allegations in federal complaints because the plaintiffs file the state action for a different reason (e.g., avoiding the Reform Act's discovery stay provision).

The SEC Report begins to examine these issues. In a sample containing both actions filed solely in state court and actions with parallel federal complaints,¹⁴² the SEC found no material differences between the federal and state cases with respect to the frequency of alleged insider trading, accounting irregularities, or false forecasts as the basis for liability.¹⁴³ When the SEC examined cases filed solely in state court, however, it found that the incidence of complaints involving failed forecasts as the sole basis for liability was double that found in federal court complaints.¹⁴⁴ At the same time,

140. See GRUNDFEST & PERINO, *supra* note 114, at 18 tbl.9. Data in Table II have been updated to reflect an analysis of additional federal complaints filed in 1996.

141. See notes 83-86 *supra* and accompanying text.

142. See SEC REPORT, *supra* note 116, at 71-74.

143. See *id.* at 71-72.

144. See *id.* at 73-74 (observing 25% of complaints including failed forecasts filed in federal

the proportion of complaints alleging trading by insiders was half that found in federal complaints.¹⁴⁵ There were similar but less marked decreases in the percentage of complaints alleging either accounting irregularities, restatement of financials, or the existence of governmental investigations in stand-alone state actions.¹⁴⁶ The SEC Report, however, has two important limitations. First, the SEC's small sample did not permit it to draw any statistically significant conclusions concerning the nature and extent of the state court substitution effect.¹⁴⁷ Second, the SEC sample includes suits involving nonpublicly traded securities, which may tend to skew the results obtained to the extent that those complaints contain markedly different allegations than those found in complaints against publicly traded issuers.¹⁴⁸

D. Federal Stock Price Declines

The Grundfest-Perino Study also examined the stock price declines around the end of the class period in post-Reform Act federal cases. It reported that post-Reform Act litigation in 1996 seemed to follow larger price declines than those observed prior to the Reform Act.¹⁴⁹ Prior to passage of the Reform Act, the average price decline around the end of the class period was approximately 19.3%.¹⁵⁰ In 1996, there was a statistically significant increase in the mean stock price drop, which jumped to 28.6% for a sample of seventy-one companies sued in federal Rule 10b-5 actions.¹⁵¹ This increase in the size of stock price declines is consistent with the theory that plaintiffs must, on average, demonstrate more dramatic wrongdoing to satisfy the new federal pleading standard.¹⁵² The Grundfest-Perino Study recognized that further statistical evidence, particularly an analysis of whether

court and only 12% in state court).

145. *See id.* (observing 48% of complaints alleging insiders trading filed in federal court and 25% in state court).

146. *See id.*

147. The SEC Report examined 10 state complaints with a parallel federal action and 16 stand-alone state court actions. *See id.* at 71.

148. *See id.* at 73 (observing that whereas 14% of allegations filed in federal court fell into the "none of the above" category, 25% of the allegations in state court could be categorized as "none of the above").

149. *See* GRUNDFEST & PERINO, *supra* note 114, at 14-15 ("[T]he decline triggering post-Reform Act litigation is greater than the decline triggering pre-Reform Act litigation.").

150. *See id.* at 14 (citing Laura E. Simmons, Rule 10b-5 Litigation: An Examination of Merit and Non-Merit Factors Associated with Litigation Outcomes (Aug. 1996) (unpublished database compiled for Ph.D. dissertation) (on file with author)).

151. Statistical significance was determined using an approximate t-statistic because the variances of the two samples were determined to be different ($t=3.42$; *probability* < 0.05). This data is drawn from an expanded sample of 71 post-Reform Act, federal Rule 10b-5 cases. The Grundfest-Perino Study reported a 30.7% drop around the end of the class period for a smaller sample of 59 companies sued in post-Reform Act federal proceedings. *See* GRUNDFEST & PERINO, *supra* note 114, at 14.

152. *See id.* at 15.

average price declines in class actions filed solely in state court were systematically smaller than the price declines observed in federal cases, was necessary to support this conjecture.¹⁵³

IV. AN EMPIRICAL ANALYSIS OF STATE COURT CLASS ACTIONS

This part extends these previous empirical studies by providing a much closer analysis of state class actions, based on a somewhat larger sample. This part answers two questions: (1) how large is the shift to state court litigation after the Act? and (2) is there evidence that the shift is driven by attempts to avoid the Act's procedural hurdles? The results reported here suggest that strategic attempts to evade the Act are driving forum selection. First, there has been a large increase in the number of publicly traded issuers sued in state court proceedings since the Act's passage. Second, there are differences in the frequency of allegations lodged in complaints filed in state versus federal court. Third, the stock price declines around the end of the class period are significantly larger in federal cases than they are for issuers sued solely in state court. The differences in the frequency of particular allegations and in the size of the stock price declines support the inference that plaintiffs are filing "weaker" cases, i.e., cases in which the plaintiffs' attorney has a lower expectation that the complaint will survive a motion to dismiss under the Act's strong inference of fraud pleading standard, in state court.

A. *State Court Class Action Litigation Before the Reform Act*

The first issue in analyzing post-Reform Act state litigation is determining whether there actually has been an increase in state court filings, and, if so, how large an increase. Prior studies either relied on anecdotal evidence suggesting that plaintiffs rarely brought actions in state court,¹⁵⁴ or contained methodological problems that likely overstated the number of state court securities fraud class actions.¹⁵⁵ To test whether securities class actions are more frequent since the Reform Act, I collected a sample of pre-Reform Act cases consisting of all actions reported in the "New Cases" section of *Securities Class Action Alert* ("SCAA") from 1992-1994.¹⁵⁶ The results, pre-

153. *See id.*

154. *See id.* at 7.

155. *See* note 128 *supra*.

156. *SCAA* is the most readily accessible source of pre-Reform Act filing data and has been relied on in a number of empirical studies of securities class actions. *See, e.g.,* Willard T. Carleton, Michael S. Weisbach & Elliot J. Weiss, *Securities Class Action Lawsuits: A Descriptive Study*, 38 ARIZ. L. REV. 491, 493 (1996). Data from 1992-1994 was chosen to eliminate anticipation of passage of the Reform Act in late 1995 as a confounding variable that may have increased state court filings. These data may understate the total volume of state court activity prior to the Act for two reasons. First, *SCAA* may simply miss some state court filings. Second, some of the case descriptions did not precisely describe the court in which the action was filed, and so were not included in

sented in Table III, suggest that the previous assessments of low volumes of state court activity were accurate. The vast majority of reported state court cases involve corporate law claims alleging breaches of fiduciary duty in connection with mergers or other corporate transactions, which have traditionally been filed in state court. By contrast, the number of reported securities fraud cases against publicly traded issuers ranges from one to four per year.¹⁵⁷ The remaining cases involve nonpublicly traded securities, such as limited partnership interests, bonds, and brokerage accounts.

TABLE III
PRE-REFORM ACT STATE CLASS ACTIONS
JANUARY 1, 1992-DECEMBER 31, 1994¹⁵⁸

	1992	1993	1994
State Court Cases Reported	19	25	41
Cases Alleging Breaches of Fiduciary Duty in Connection with Corporate Transactions	12	22	32
Fraud Cases Involving Nonpublicly Traded Securities	3	2	8
Cases Alleging Fraud in the Sale of Publicly Traded Securities	4	1	1

The data reported in Table IV and Figure 1 suggest that the increase in state court actions is largely driven by a shift in the number of publicly traded issuers sued in state court since the Reform Act. The number of class

the state court counts. Some of these cases may have been filed in state court.

There is some anecdotal evidence that plaintiffs were increasingly relying on state court actions in the early 1990s. Even if this anecdotal evidence is accurate, the available data still suggest a more significant shift to state court following the Reform Act. See text accompanying note 160 *infra*.

157. A recent Price Waterhouse study reports a somewhat higher number of pre-Reform Act state securities class actions. See Letter from Daniel V. Dooley, Partner, Price Waterhouse LLP, to Senator Alphonse [sic] M. D'Amato, Exhibit A (Feb. 20, 1998) [hereinafter *Dooley Letter*] (on file with the *Stanford Law Review*) (reporting an average of 16 state cases per year in the period from 1991-1995). The different results are not surprising for at least three reasons. First, it is quite difficult to obtain precise counts of state court activity. See GRUNDFEST & PERINO, *supra* note 114, at 8. Second, as noted previously, the *SCAA* descriptions that this article relies on were insufficient to determine whether certain cases were filed in either state or federal court. See note 156 *supra*. Price Waterhouse may have relied on additional data to determine whether some of these omitted cases were in fact state court cases. Finally, the Price Waterhouse study also includes state class actions involving limited partnership interests that were omitted from the data collected here. See *Dooley Letter, supra*, at Exhibit A. Ultimately these differences appear to be unimportant because both studies conclude that there has been a substantial increase in state court activity since passage of the Reform Act. See *id.* at 2 ("[F]or the two years after the Reform Act was enacted into law, parallel and state-federal equivalent cases averaged 253% of the average number of cases during the period 1991-1995."). Thus, although it remains difficult to quantify the precise size of the shift to state court, the fact that a substantial shift has occurred has substantial empirical and anecdotal support.

158. Data compiled from reviewing "New Cases" reported in SEC. CLASS ACTION ALERT, Jan. 1992-Dec. 1994.

actions involving nonpublicly traded securities has seen a modest increase since the passage of the Act, most likely because the same procedural hurdles apply to both these cases and to aftermarket fraud cases. The most significant changes, however, involve suits against publicly traded issuers. In the sample of 1992-1994 state class actions, only six involved publicly traded issuers.¹⁵⁹ By contrast, in only the first eighteen months under the Reform Act, the vast majority of state court class actions, seventy-seven in all, involved publicly traded securities. The timing of this sudden upswing in state court filings supports the inference that the shift in forum selection was driven by the passage of the Reform Act.¹⁶⁰

159. See text accompanying notes 156-157 *supra*. Again, these data may understate the total volume of state court activity both before and after passage of the Act. See note 156 *supra*. The dramatic increase in state filings may also be partly attributable to greater transparency of state court securities fraud litigation in the post-Reform Act period. Thus, although these data are unlikely to describe precisely the volume of litigation at the state level, the large increase in the observed volume of litigation and the extensive anecdotal evidence since passage of the Act suggest a substantial change in the frequency of state filings. See Lerach, *supra* note 69, at 24; Pete Barlas, *Local Court Calendars Getting Full with Securities Lawsuits*, BUS. J., June 16, 1997, at 6, available in LEXIS, News Library, BUSDTL File (“[M]ore securities fraud cases are being filed in the county and other state courts because of tougher standards being imposed in federal courts . . .”); Pamela Sherrid, *The General Custer of Shareholder Lawsuits?: How One Lawyer Helps Thwart Legal Reform*, U.S. NEWS & WORLD REP., Apr. 21, 1997, at 66, 67 (reporting that prominent securities litigator William Lerach “is filing an unprecedented number of shareholder claims in state court”); Thompson, *supra* note 49, at 1 (“An increasing number of plaintiffs lawyers in California are choosing . . . to pursue shareholders’ claims of fraud in state courts.”).

160. The data reported in Table IV suggest a possible decline in the number of state filings in 1997. There is simply too little data to determine whether this decline is a short-term aberration or a permanent reduction in the use of state court proceedings. One possibility is that plaintiffs may have determined that federal pleading standards are not as difficult a procedural hurdle as originally anticipated. See note 98 *supra* and accompanying text. This would explain both the decrease in state filings and the increase in federal filings. Second, plaintiffs’ attorneys may have determined that the costs associated with state court litigation outweigh its benefits. A number of state court actions filed in 1996 were dismissed. See, e.g., *Adler v. Prism Solutions, Inc.*, No. CV 764547, slip op. at 1-2 (Cal. Super. Ct. Santa Clara County Aug. 7, 1997) (dismissing California state blue sky claims and federal 1933 Act claims); *David v. Simware Inc.*, No. 602143-96, 1997 N.Y. Misc. LEXIS 201, at *11 (Sup. Ct. Mar. 13, 1997) (holding that a negligent misrepresentation claim does not extend to the investing public at large); *Stuart Auerbach, Judge Dismisses Stockholder Suit Against MAMSI*, WASH. POST, Apr. 4, 1997, at G3 (describing Maryland judge’s dismissal of state class action suit and rejecting the fraud-on-the-market doctrine under Maryland law); *Favorable Result for Nellcor Puritan Bennett in State Securities Class Action*, BUS. WIRE, Apr. 17, 1997 (noting that, after state court dismissed securities fraud class action, plaintiffs refiled in federal court); *Suit Hits Rockwell’s Brooktree Unit*, ELECTRONIC NEWS, May 12, 1997, at 28 (noting a similar refiling in federal court after state court dismissal). If plaintiffs had difficulties certifying nationwide classes under state law, then this would tend to decrease such suits’ economic viability. However, filing a suit in state court could still be useful if plaintiffs were able to obtain discovery that would be stayed in a federal proceeding, or if discovery in the state action allowed plaintiffs to file a later federal proceeding.

Despite the observed declines, the shift to state court remains one of the most significant consequences of the Reform Act. At a minimum, 94 of 238 post-Reform Act litigations (39.5%) involve at least some state component. The percentage of publicly traded issuers sued in state court in 1997 is still substantially higher than it was prior to the Reform Act. These data suggest that the

TABLE IV
PUBLICLY TRADED ISSUERS SUED IN STATE COURT
JANUARY 1, 1996-JUNE 30, 1997

	1996	JAN.-JUN. 1997	TOTAL
Total Number of Companies Sued	70	24	94
Number of Publicly Traded Issuers	59	18	77
Percent of Total	84.3%	75.0%	81.9%

Certainly, a state forum may appear to be more desirable than a federal forum for reasons unrelated to attempts to avoid the provisions of the Reform Act.¹⁶¹ Foremost among these are the incentives created by the Supreme Court's recent decision in *Matsushita v. Epstein*.¹⁶² The *Matsushita* decision permitted state court settlements to extinguish associated Rule 10b-5 claims, even though federal courts have exclusive jurisdiction over 10b-5 claims.¹⁶³ *Matsushita* creates the potential for what Professor Coffee has dubbed a "re-

current overall decline in state filings may not represent a long-term rejection of state courts as a forum for securities fraud litigation. Indeed, it is possible that this decline may even result from plaintiffs' attorneys' strategic choices. In order to decrease the apparent necessity for Congress to pass a federal preemption statute, plaintiffs' attorneys may have chosen not to pursue a significant number of state cases. Past experience, particularly the December 1995 increase in federal filings that preceded passage of the Act, indicates that plaintiffs respond strategically to legislative initiatives that might alter the costs and benefits of securities litigation. See note 120 *supra* and accompanying text.

161. Other commentators note additional reasons unrelated to the Act that may make state court a more advantageous forum, including longer statutes of limitation, the availability of non-unanimous juries, the potential for awards of punitive damages, differing liability standards, broader jury pools, and differing procedural rules. See Lerach, *supra* note 69, at 26; see also SEC REPORT, *supra* note 116, at 69 (citing similar reasons for choosing federal versus state court); Steinberg, *supra* note 5, at 421-27 (describing some procedural and substantive advantages that may be available under state law). The difficulty in attributing the sudden rise in state filings to these procedural advantages is that they were readily available prior to passage of the Act. Yet before 1996, securities fraud class action lawsuits were rarely filed in state court. See Table III.

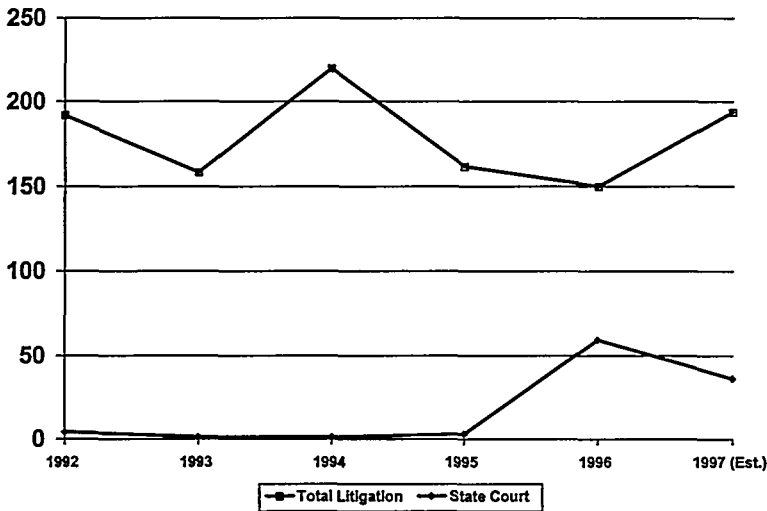
Moreover, other data suggest that these procedural advantages did not provoke this sudden shift. Take, for example, the hypothesis that state courts offer longer limitations periods. In a sample of 22 cases filed solely in state court, the mean and median intervals between the end of the class period and the filing date are 85 and 42 days, respectively. These intervals are quite similar to the observed intervals in federal court filings. See SEC REPORT, *supra* note 116, at 23 (noting mean and median lag times of 79 and 38 days, respectively). There is a great deal of variance in the data, but all 22 cases were brought within the one-year federal limitations period.

162. 116 S. Ct. 873 (1996).

163. See *Oak Tech. v. Super. Ct. of Santa Clara County*, No. H016141, slip op. at 6 (Cal. Ct. App. Aug. 14, 1997) (noting federal courts' exclusive jurisdiction over some federal securities law claims); see also GRUNDFEST & PERINO, *supra* note 114, at 7. For a discussion of the *Matsushita* decision, see Marcel Kahan & Linda Silberman, *Matsushita and Beyond: The Role of State Courts in Class Actions Involving Exclusive Federal Claims*, 1996 SUP. CT. REV. 219 (1997).

verse auction,"¹⁶⁴ in which a plaintiffs' attorney who is willing to enter a cheap settlement in exchange for a fee award files a state court action arising out of the same facts and circumstances as a presumably more aggressively litigated federal action. The defendant then has the option of negotiating a cheap global settlement with the "friendly" state court attorney, thereby precluding further litigation of the federal claims.¹⁶⁵ If a number of lawyers file separate actions in multiple states, the result could be a round of destructive competition in which each tries to underbid the others. These problems may be exacerbated if attorneys are able to identify courts that are "willing to approve settlements with less than rigorous oversight."¹⁶⁶

FIGURE 1
SECURITIES CLASS ACTIONS IN STATE AND FEDERAL COURT (1992-1997)¹⁶⁷



164. John C. Coffee, Jr., *Class Wars: The Dilemma of the Mass Tort Class Action*, 95 COLUM. L. REV. 1343, 1370 (1995); see also Kahan & Silberman, *supra* note 163, at 238-42 (noting other effects of *Matsushita*).

165. See Coffee, *supra* note 164, at 1370-73.

166. Kahan & Silberman, *supra* note 163, at 242.

167. Total Litigation represents the total amount of litigation reported in federal and state court. Total Litigation data from 1992-1995 is drawn from the NERA Study. See NERA STUDY, *supra* note 115, at tbl.1. State Court litigation data for 1992-1995 is drawn from SCAA, which is also the data source for the NERA Study. Data on Total and State Litigation for 1996 and 1997 is drawn from SCAA and the *Securities Class Action Clearinghouse* (available on the Internet at <http://securities.stanford.edu>). State Litigation for 1996-1997 includes both publicly traded issuers sued solely in state court and publicly traded issuers sued in parallel federal and state court proceedings. The total for 1997 is an annualized estimate based on filings in the first six months of 1997.

Although such a reverse auction is possible, the available evidence suggests that the Reform Act's procedural hurdles have been a larger driving force behind the shift to state court. First, the large number of issuers sued solely in state court does not suggest the presence of a reverse auction. Second, in many parallel federal-state actions, the same plaintiffs' attorney files a federal and state action arising out of the same facts and circumstances, often on the same day and with the same named plaintiff.¹⁶⁸ This fact pattern is consistent with an attempt to evade the Reform Act's discovery stay, and significant anecdotal evidence suggests that plaintiffs are using state actions for discovery purposes.¹⁶⁹ This pattern is inconsistent with a reverse auction theory—an attorney is certainly not going to bid against herself in settling with the defendants. In some cases, different class action attorneys appear in federal and state actions,¹⁷⁰ but there is often an overlap between the attorneys appearing in the federal and state cases, which may tend to decrease the chances for destructive competition.¹⁷¹ Finally, most state actions have been filed in the issuer's state of incorporation.¹⁷² This trend does not suggest that plaintiffs' attorneys are searching out state courts that may be willing to give less than careful scrutiny to settlements.

B. *State Court Allegations*

Analysis of a somewhat larger sample of state suits against publicly traded companies provides some support for the hypothesis that the federal heightened pleading standard is causing plaintiffs to file weaker cases in state court. Table V demonstrates that there are differences between the claims made in federal and state class actions. First, Table V demonstrates that allegations of misrepresentations or omissions in financial statements appear in 45.5% of state cases versus 61.9% of federal cases. This result suggests that plaintiffs' attorneys are filing financial misrepresentation cases—precisely the kind of cases that are more likely to satisfy the Reform Act's higher

168. See, e.g., Complaint, *Yourish v. California Amplifier, Inc.* (C.D. Cal. 1997) (No. 97-4293 CBM (Mx)); Complaint, *Yourish v. California Amplifier, Inc.* (Cal. Super. Ct. Ventura County 1997) (Civ. No. 173569).

169. Cf. *Oak Tech*, slip op. at 2, 6-8 (restating plaintiffs' arguments that "(1) they were entitled to bring state law claims and federal law claims in separate fora, and (2) the claims are different in the sense that the state claims afford broader relief").

170. Compare, e.g., *Class Action Suit Filed Against Discreet Logic and Its Officers and Directors Alleging Misrepresentations and Insider Trading*, BUS. WIRE, Oct. 23, 1996 (noting the filing of a California state court suit by one law firm), with *Notice of Pendency of Class Action*, BUS. WIRE, June 14, 1996 (noting federal court suit against same issuer but filed by a different law firm).

171. See Robert Ablon, *Turf War Tests Securities Reform*, RECORDER, Jan. 14, 1997, at 1 (describing two law firms' competing claims to be class counsel in a shareholder suit).

172. See *Concerning the Impact of the Private Securities Litigation Reform Act of 1995: Hearing Before The Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs*, 105th Cong. (July 24, 1997) [hereinafter *1997 Senate Hearings*] (testimony of Arthur Levitt, Chairman, SEC, at 16).

pleading standard—more frequently in federal court, although the state sample size remains too small to determine statistical significance within generally accepted social science conventions.¹⁷³ Second, there are approximately twice as many state court complaints based solely on false forecasts as there were in the federal sample, although the number of observations is too small to determine whether this result is statistically significant. The differences in the frequency of both types of allegations thus suggest that the substitution to state court is correlated with attempts to avoid the Reform Act's higher pleading standards.

TABLE V
COMPARISON OF ALLEGATIONS IN STATE AND FEDERAL COMPLAINTS
AGAINST PUBLICLY TRADED COMPANIES¹⁷⁴

	OBSERVATIONS	NUMBER	PERCENT
Pre-Reform Act Federal Rule 10b-5 Cases	174	59	33.91%
Post-Reform Act Federal Rule 10b-5 Cases	71	44	61.97%
Post-Reform Act State Cases	22	10	45.45%

One surprising result is that insider trading allegations appear in roughly equivalent proportions of the federal (54.9%) and state (59.1%) cases sampled. This result is probably explained by the fact that the percentage of high-technology companies in the state sample is significantly higher than that in the federal sample (54.5% versus 39.4%). A large percentage of federal complaints against high-technology companies (75.0%) contain allegations of insider trading, a result that is likely driven by the greater use of option-based compensation in the technology sector and the resulting greater baseline level of "normal" insider sales.¹⁷⁵ Because much of the state court

173. The hypothesis that cases with this allegation are equally likely in federal and state court cannot be rejected at the 10% confidence level, although it can be rejected at the 12% level ($\chi^2 = 3.4497$; *probability* = 0.1191). Statistical significance was determined using a standard chi-square goodness of fit test.

174. Data on pre-Reform Act federal allegations is drawn from Laura E. Simmons, *The Importance of Merit-Based Factors in 10b-5 Litigation*, Table 2 (Nov. 14, 1996) (unpublished manuscript, on file with author). The Simmons study analyzes federal securities class actions alleging Rule 10b-5 violations filed against publicly traded issuers during the period from January 1, 1991-December 31, 1994. Data on post-Reform Act federal allegations is drawn from GRUNDFEST & PERINO, *supra* note 114, at C1-C3, D1. The data is drawn from a sample of 71 federal securities class actions alleging Rule 10b-5 violations filed against publicly traded issuers in 1996. The data on post-Reform Act state cases is drawn from a sample of 22 publicly traded issuers sued solely in state court since passage of the Reform Act.

175. See GRUNDFEST & PERINO, *supra* note 114, at 21.

activity has occurred in California, where many high-technology companies are based, it is unsurprising to see both a higher percentage of high-technology companies in the sample and a concomitantly higher percentage of insider trading allegations. Moreover, the fact that the complaint contains insider trading allegations tells us nothing about the quality of those allegations. There may be systematic differences in the amounts, timing, or other characteristics of the alleged trading at issue in the case that these data do not reveal.

C. State Court Stock Price Declines

An additional piece of evidence that supports a finding that plaintiffs are strategically evading the Reform Act in state court is the difference between the stock price declines around the end of the class period for issuers sued in state rather than federal court. If factual differences in the complaints and the higher pleading burden in federal court are driving plaintiffs' attorneys' forum choices, then it is reasonable to expect that the mean stock price decline in state court cases will be smaller than that in federal cases. Such a result makes sense because larger stock price declines create the appearance of more dramatic wrongdoing, making it more likely that the case will survive under the tougher federal pleading burdens.

TABLE VI
COMPARISON OF STOCK PRICE DECLINES IN
PRE- AND POST-REFORM ACT STATE AND FEDERAL CASES¹⁷⁶

	OBSERVATIONS	MEAN	MEDIAN	STANDARD DEVIATION
Pre-Reform Act Section 10(b) Sample	161	-19.32%	-17.54%	14.32%
Post-Reform Act Section 10(b) Sample	71	-28.59%	-27.13%	20.39%
Post-Reform Act State Sample	20	-19.34%	-16.50%	12.24%

176. Data on pre-Reform Act stock price declines in federal Rule 10b-5 cases is drawn from Simmons, *supra* note 174. The Simmons study analyzes federal securities class actions alleging Rule 10b-5 violations filed against publicly traded issuers during the period from January 1, 1991-December 31, 1994. Data on post-Reform Act stock price declines in federal Rule 10b-5 cases concerns 71 federal securities class actions alleging Rule 10b-5 violations filed against publicly traded issuers in 1996. Like the Simmons sample, the post-Reform Act state sample excludes offering cases alleging violations of section 11 of the 1933 Act. The data on post-Reform Act state cases is drawn from a sample of 20 publicly traded issuers sued solely in state court since passage of the Reform Act. The state sample is smaller than the state sample discussed in Table V because all necessary stock price data was not available for two issuers.

The sample of post-Reform Act state cases shows just such differences. Table VI demonstrates that the average price decline for a sample of issuers sued solely in state court is approximately 10% smaller than that for companies sued in federal court and is virtually identical to the pre-Reform Act sample. The hypothesis that the mean stock price drops are the same in both the federal and state samples can be rejected at the 0.5% confidence level.¹⁷⁷ The differences in the mean stock price data thus suggest that, in federal court, plaintiffs are filing cases that have larger stock price drops and that therefore appear to involve more dramatic wrongdoing. It seems reasonable to infer that these decisions are being driven, at least in part, by the new heightened federal pleading standard. The data suggest that cases with smaller stock price drops, i.e., those with less dramatic facts, appear to be filed more frequently in state court proceedings where the "strong inference of fraud" standard does not apply.

D. *Summary and Implications*

The available data suggest that the most reasonable explanation for the increase in state court litigation is plaintiffs' desire to evade the Reform Act's procedural hurdles. Among the strongest pieces of evidence that supports this conclusion is simply the timing of the increase in state court filings against publicly traded issuers, which dramatically increased immediately after passage of the Reform Act. The statistically significant differences in mean stock price drops and the differences between the proportion of state and federal cases that allege financial statement misrepresentations also strongly support the inference that plaintiffs are filing what appear to be weaker cases in state court. Taken together, these data suggest that many of the cases that Congress hoped to eliminate when it passed the Reform Act have simply been filed in state court under state causes of action. Moreover, the prevalence of parallel federal state actions suggests systematic attempts to avoid the federal discovery stay.

These results are enormously important because they call into question the effectiveness of the Reform Act, given the existence of a dual federal-state regulatory scheme.¹⁷⁸ If plaintiffs' attorneys can recast federal claims

177. Statistical significance was determined using an approximate t-statistic because the variances of the two samples were determined to be different ($t = 2.709$; *probability* < 0.05).

178. The SEC Report concludes that "if state law provides advantages to plaintiffs in a particular case, it is reasonable to expect that plaintiffs' counsel will file suit in state courts." SEC REPORT, *supra* note 116, at 69. The SEC correctly notes that the strategic decision to take advantage of these differences in state court is merely an aspect of good lawyering, and an attorney who chooses one appropriate forum over another is certainly not engaging in any improper conduct. But the question of whether an attorney is using the tools available to her to advocate her client's position effectively is materially different from the question of whether, as a policy matter, it is appropriate to balkanize the regulation of securities traded on national markets in this fashion. The question that we are concerned with here is not whether the attorney is acting properly in choosing a federal or state forum, but rather whether as a policy matter it is appropriate to give attorneys the

under alternative state causes of action and bring those claims in an alternative state forum, then congressional attempts to address problems in securities litigation may well prove futile. Instead of eliminating weak securities law claims, as Congress hoped to do, the Reform Act may simply have shifted those claims to state court. Instead of encouraging more prefiling investigation and limiting the ability to impose large discovery costs on defendants, the Reform Act seems to have simply changed the forum in which that discovery takes place.

The rise in state court actions and the greater prevalence of false forecasting cases in state courts may also significantly undermine the effectiveness of the federal safe harbor.¹⁷⁹ If one or more states do not have similar safe harbors, then issuers face potential state court lawsuits and liability for actions that do not violate federal standards. Under these circumstances, issuers will naturally be reluctant to provide the forward-looking information Congress sought to elicit. Instead, they are likely to tailor their disclosures to state liability standards. For disclosures like Form 10-Qs and Form 10-Ks, which are released to market participants nationwide, the state with the most plaintiff-favorable rules for forward-looking disclosures, rather than the federal government, is likely to set the standard to which corporations will conform. In the unlikely event that issuers could somehow limit their disclosures to particular jurisdictions, corporations will face increased disclosure costs if they want to tailor different disclosures to different liability standards.¹⁸⁰ The federal policy initiative embodied in the safe harbor is thus likely to fail because of the existence of inconsistent state laws.

Allowing individual states to assert jurisdiction over transactions in national markets also imposes significant costs on companies that do business in more than one state or who have a significant corporate presence in multiple states. If state law causes of action are permitted, such companies could

choice between the two. See text accompanying notes 188-281 *infra*.

179. According to the SEC Report, "[C]ompanies have been reluctant to provide significantly more forward-looking disclosure than they had prior to enactment of the safe harbor." SEC REPORT, *supra* note 116, at 25. Corporate officers and interested attorneys most frequently cited the following two explanations for not using the safe harbor more frequently: "(i) the safe harbor provision is still new and companies are waiting to see how courts will interpret it and how other companies are using it; and (ii) fear of state court liability, where forward-looking statements might not be protected by the federal safe harbor." *Id.* Company representatives also expressed concern that "a complete list of cautionary statements would be 'cumbersome' and might 'water down' the company's disclosures." *Id.* at 25-26.

180. *Cf. Guice v. Charles Schwab & Co.*, 674 N.E.2d 282, 290 (N.Y. 1996), *cert. denied*, 117 S. Ct. 1250 (1997) (holding that the plaintiffs' state common law and statutory causes of action against securities brokers who received order flow payments were preempted because, without preemption, "[s]ecurities broker-dealers, confronted with the risk of nationwide class action civil damage liability . . . would be impelled to tailor their disclosures to each State's common-law agency jurisprudence, and the carefully crafted SEC disclosure requirements would have little, if any, influence").

be exposed to litigation in multiple states under multiple procedural and substantive standards. Even if litigation could be confined to one forum, enormously complicated choice of law questions will likely arise regarding the application of different states' laws to different members of the class. A court may have to apply as many as fifty different substantive legal standards to members of the class. The resulting confusion and complexity could replicate many of the management problems that pervade mass tort and other kinds of class actions based on state law.¹⁸¹ With different liability standards, enormous time and energy may also be devoted to resolving arcane legal questions, such as determining the particular state where the fraud allegedly took place or whether the particular state court may properly assert personal jurisdiction over the defendant. Moreover, if federal and state actions or multistate actions proceed simultaneously, both the courts and the parties face a significant increase in the time and costs associated with resolving the litigation.¹⁸²

State law decisions significantly restricting aftermarket securities fraud class actions under state blue sky laws will not necessarily remedy these problems. Plaintiffs' attorneys may respond in entirely unexpected ways to what seem to be substantial setbacks in the interpretation of state causes of action. Consider, for example, *Diamond Multimedia Systems v. Superior Court of Santa Clara County*,¹⁸³ a California state case that has received a considerable amount of attention because much of the state court activity has been in California. In *Diamond Multimedia*, the California Supreme Court granted a writ of mandate to review a number of important questions, including whether a cause of action under section 25400 of the California Corporations Code, upon which most post-Reform Act class actions brought in California state courts have been based, is only available to California residents.¹⁸⁴

The California Supreme Court may rule that the statute requires a strict territorial nexus between the plaintiff and California for an action to be brought. One possible result of such a ruling is that once forming a class becomes more difficult, the number of California state court class actions will decrease. Although such a result would not be surprising, plaintiffs may

181. See *Amchem Prods. v. Windsor*, 117 S. Ct. 2231, 2237 (1997) (denying certification of a class that was intended by all parties to facilitate a global settlement of all present and future asbestos related claims); *Castano v. American Tobacco Co.*, 84 F.3d 734 (5th Cir. 1996) (denying certification of a class that was intended to obtain relief for all victims of "nicotine-dependent persons" and their estates and relatives).

182. See Bill Kisliuk, *Are Two Securities Cases Better Than One?*, RECORDER, July 14, 1997, at 1 (noting a defense counsel estimate that the cost of pretrial proceedings has increased by about one-third as a result of dual filings).

183. 97 Daily Journal D.A.R. 4021 (Mar. 28, 1997).

184. Robert Ablon, *Justices Take On Issue of Securities Suit Jurisdiction*, RECORDER, Mar. 28, 1997, at 1.

respond much differently. Securities litigation could begin to look more like tobacco litigation and other mass tort cases.¹⁸⁵ After federal rulings denying certification of a nationwide class due to differences in state laws applicable to different plaintiffs, attorneys in the tobacco litigation followed a disaggregative strategy in which they filed multiple class actions in different states.¹⁸⁶ Plaintiffs could follow a similar strategy in securities litigation. As a result, a finding of a strict territorial nexus in *Diamond Multimedia* may have the perverse result of increasing the costs associated with litigating securities class actions and causing securities class actions to display many of the problems that beset mass tort class actions. Alternatively, plaintiffs may still find state actions useful: (1) for purposes of obtaining discovery that might be barred pursuant to the Reform Act's stay provision; (2) if they can create subclasses of investors from different states; (3) if the state action still provides favorable settlement opportunities;¹⁸⁷ or (4) if they have a large enough class of intrastate investors to make a single state class action cost effective.

V. THE THEORY OF FEDERALISM AND THE CASE FOR UNIFORM FEDERAL STANDARDS

Is preemption of state causes of action the answer to these unintended consequences of the Reform Act?¹⁸⁸ Regardless of the immediate effects of

185. See, e.g., *Castano*, 84 F.3d at 737.

186. See Milo Geyelin, *Lawyers Battling the Tobacco Industry Are Confronting Logistical Nightmare*, WALL ST. J., May 28, 1996, at A4 (explaining that, in the wake of the *Castano* decision, suits would be filed in "30 to 40 states where plaintiffs' lawyers say they believe judges and juries might be receptive to their claims").

187. See notes 161-172 *supra* and accompanying text.

188. Some commentators suggest that the Reform Act may already preempt state causes of action. Although Congress has the power to preempt state causes of action, the relevant question is always whether Congress actually did so. See *American Airlines v. Wolens*, 115 S. Ct. 817, 820 (1995) (holding that the Airline Deregulation Act of 1978 preempted "state-imposed regulation of air carriers, but allows room for court enforcement of contract terms set by the parties themselves"). Courts can find preemption in three situations: express preemption; implied occupation; and implied preclusion. See GERALD GUNTHER & KATHLEEN M. SULLIVAN, *CONSTITUTIONAL LAW* 342-44 (13th ed. 1997); Stephen A. Gardbaum, *The Nature of Preemption*, 79 CORNELL L. REV. 767, 767 n.3 (1994). First, Congress can expressly preempt state law. See *Pacific Gas & Elec. Co. v. State Energy Resources Conservation & Dev. Comm'n.*, 461 U.S. 190, 203 (1983) ("[I]t is well-established that within constitutional limits Congress may preempt state authority by doing so in express terms."). Second, courts can find implied preemption when federal legislation "so thoroughly occupies a legislative field 'as to make reasonable the inference that Congress left no room for the States to supplement it.'" *Cipollone v. Liggett Group, Inc.*, 505 U.S. 504, 516 (1992) (quoting *Fidelity Fed. Sav. & Loan Ass'n v. De la Cuesta*, 458 U.S. 141, 153 (1992)). Third, implied conflict (or obstacle) preemption may be found when "it is impossible for one to act in compliance with both the Federal and State laws, or when 'the state law . . . stan[ds] as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress'" as manifested in the language, structure, and goals of the federal statute. *Guice v. Charles Schwab & Co.*, 674 N.E.2d 282, 285 (N.Y. 1996) (quoting *Barnett Bank v. Nelson*, 116 S. Ct. 1103, 1108 (1996)); *id.* at 290 (holding that SEC regulations governing order flow payments preempted state law because

the Reform Act, does it make sense for Congress to preempt at least some state securities fraud causes of action? The answer to these questions involves an analysis of the costs and benefits of federalism as a system for determining the stratum of government that should have responsibility for a particular task, in this case, for creating, administering, and adjudicating securities fraud causes of action.¹⁸⁹

“[p]ermitt[ing] the courts of each State to impose civil liability on national securities brokerage firms . . . would inevitably defeat the congressional purpose of enabling the SEC to develop and police [a] ‘coherent regulatory structure’ for a national market system”).

The first and second bases for a finding of preemption are inapplicable to the Reform Act. There is no express preemptive language in the statute. Moreover, the 1933 and 1934 Acts both contain savings clauses that negate any inference of field preemption, although they do not preclude a finding of implied conflict preemption. See *Edgar v. MITE Corp.*, 457 U.S. 624, 631 (1982) (noting that although “Congress did not explicitly prohibit States from regulating takeovers . . . [a] state statute is void to the extent that . . . ‘compliance with both Federal and state regulations is a physical impossibility’”) (quoting *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142-43 (1963)); *Facciolo & Stone*, *supra* note 4, at 541-68 (reviewing case law under section 28(a)).

An argument can be made, however, that at least certain provisions of the Reform Act, particularly the safe-harbor and discovery-stay provisions, implicitly preempt conflicting state laws. This argument would be based on the premise that state court litigation upsets a “careful balance” that Congress has struck. For example, it is clearly impossible to achieve the objectives Congress intended under the mandatory stay if plaintiffs can evade the stay simply by filing individual or class action complaints in state courts. It is similarly impossible for the Reform Act to stimulate greater forward-looking disclosure if issuers continue to be subject to state court liability that is more expansive than the Act’s forward-looking safe harbor. If state laws discourage forward-looking disclosures, then a court may find preemption because the state laws frustrate “federal regulatory goals by hindering conduct that federal law intends to encourage.” Richard C. Ausness, *Federal Preemption of State Products Liability Doctrines*, 44 S.C. L. REV. 187, 197 (1993).

Although this argument has some force, it is not at all clear how it will fare in the courts. The Supreme Court has often refused to find preemption where Congress has not made its intention clear, particularly regarding the preemption of state common law doctrines or causes of action, or where preemption affects powers historically reserved to the states. See *Medtronic, Inc. v. Lohr*, 116 S. Ct. 2240, 2245 (1996) (refusing to preempt state law product liability claims, which are an exercise of states’ traditional “police powers to protect the health and safety of their citizens”); *Cipollone*, 505 U.S. at 518 (refusing to preempt state law damages actions “in light of the presumption against the pre-emption of state police power regulations”); *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947) (refusing to preempt state law “in a field which the States have traditionally occupied”). *But see Gade v. National Solid Wastes Management Ass’n*, 505 U.S. 88, 108-09 (1992) (holding that Illinois’ Licensing Acts were preempted by the Occupational Health and Safety Act of 1970, insofar as they established occupational health and safety standards).

189. Implicit in this analysis is a recognition that federalism acts not only as a shield against excessive federal activity, but also as a sorting device that assigns governmental functions to the level or levels of government best capable of administering them. See *Chemerinsky*, *supra* note 33, at 1219-21 (“[I]n determining the proper allocation of power between the national and state governments, the goal must be effective government.”); Larry Kramer, *Understanding Federalism*, 47 VAND. L. REV. 1485, 1502 (1994) (“There are, after all, two sides to federalism: not just preserving state authority where appropriate, but also enabling the federal government to act where national action is desirable.”); Lawrence Lessig, *Translating Federalism: United States v. Lopez*, 1995 SUP. CT. REV. 125, 135 (explaining that federalism is partly about “protecting federal interests”). Concerns about allocation have been central to most economic theories of federalism. See Robert P. Inman & Daniel L. Rubinfeld, *The Political Economy of Federalism*, in PERSPECTIVES

Commentators offer a familiar menu of benefits and costs of federalism.¹⁹⁰ Federalism is said to foster flexibility by permitting states to respond individually to purely local concerns.¹⁹¹ Because different states approach policy problems in different ways, diffusion of authority permits state and local governments to act as laboratories for experimentation¹⁹² that may yield innovative responses to public policy problems.¹⁹³ Moreover, states are seen as competing with each other for revenues.¹⁹⁴ Like competition in business, under certain conditions competition among states can spur innovation, make government more responsive to the needs of its citizenry, and permit a more efficient allocation of goods and services.¹⁹⁵ Federalism is also said to pro-

ON PUBLIC CHOICE 73, 94 (Dennis C. Mueller ed., 1997); WALLACE E. OATES, *FISCAL FEDERALISM* 3 (1972) (listing three functions of the public sector and asking "[w]hat form of government promises the greatest success in" carrying out these functions). Allocation questions are and should be wholly separate from the merits of any particular substantive or procedural statute, such as the Reform Act. For this reason, this article takes no position on the ultimate wisdom of the reforms introduced in the Act, although I recognize that many of the Act's critics have raised legitimate and substantial concerns. The appropriate question from a federalism perspective is whether those concerns should be addressed at the federal level or whether they should be subject to ad hoc resolution in individual states.

190. See Inman & Rubinfeld, *supra* note 189 (reviewing the empirical evidence on the costs and benefits of federalism); see also ADVISORY COMM. ON INTERGOVERNMENTAL RELATIONS, INTERJURISDICTIONAL TAX AND POLICY COMPETITION: GOOD OR BAD FOR THE FEDERAL SYSTEM 47-57 (1991) [hereinafter ACIR STUDY] (discussing the effects of intergovernmental competition for regulation and economic development). For an analysis that suggests that federalism does not in fact secure many of these benefits, see Edward L. Rubin & Malcolm Feeley, *Federalism: Some Notes on a National Neurosis*, 41 UCLA L. REV. 903, 907 (1994).

191. See Michael W. McConnell, *Federalism: Evaluating the Founders' Design*, 54 U. CHI. L. REV. 1484, 1493 (1987) ("[D]ecentralized decision making is better able to reflect the diversity of interests and preferences of individuals in different parts of the nation.").

192. See THOMAS R. DYE, *AMERICAN FEDERALISM: COMPETITION AMONG GOVERNMENTS* 20-21 (1990) (discussing competitive federalism as fostering innovation and policy experimentation); DAVID OSBORNE, *LABORATORIES OF DEMOCRACY* 3-11 (1988) (asserting that state governments are modern political laboratories designing new approaches to economic and social problems). The Supreme Court has relied on this explanation in a number of its federalism decisions. See *Gregory v. Ashcroft*, 501 U.S. 452, 458 (1990) (noting that federalism "allows for more innovation and experimentation in government"); cf. *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) ("It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory . . .").

193. See DANIEL J. ELAZAR, *AMERICAN FEDERALISM: A VIEW FROM THE STATES* 1-23 (1966) (presenting a detailed analysis of the extent to which states innovate); Daniel B. Rodriguez, *Turning Federalism Inside Out: Intrastate Aspects of Interstate Regulatory Competition*, 14 YALE J. ON REG. 149, 151 (1996) ("[O]ne of the essential values of federalism is that states may act differently.").

194. See William J. Carney, *The Political Economy of Competition for Corporate Charters*, 26 J. LEGAL STUD. 303, 304-05 (1997) (citing the "interest group" model of regulation to show how states will adopt different corporate law provisions depending on the extent to which they rely on chartering revenues).

195. See DYE, *supra* note 192, at 20-21 (noting the innovation and policy experimentation fostered by competitive federalism); see also *Gregory*, 501 U.S. at 458 (listing the many advantages of federalism).

tect individual rights by providing a check on national power¹⁹⁶ and by increasing opportunities for citizen involvement in government.¹⁹⁷

These benefits may involve significant tradeoffs.¹⁹⁸ A federal system may impose costs through inconsistency, duplication of efforts, and interference with interstate commerce. Dual state-federal authority may increase costs to the extent that it requires intergovernmental coordination.¹⁹⁹ Federalism may also impose substantial costs if there are significant spillover effects, i.e., if the costs and benefits of a rule do not fall within one jurisdiction's boundaries.²⁰⁰ The tradeoffs associated with these costs and benefits mean that allocating responsibility in a federal system requires a careful balancing that is responsive to potentially changing economic and political conditions.²⁰¹

An analysis of these costs and benefits suggests that there is only a weak case for maintaining dual state-federal authority over the nationally traded securities that have been most affected by the post-Reform Act shift to state court. First, causes of action related to the purchase and sale of these securities do not implicate purely local interests. Moreover, national securities markets pay no heed to state boundaries: Whether buyers are located in New York, California, Montana, Connecticut, or elsewhere makes no difference to disclosure rules, price discovery mechanisms, or trading practices that govern transactions in national markets. Designing causes of action that apply to such securities, furthermore, would also seem not to implicate concerns about protecting individual rights or fostering opportunities for citizen in-

196. See *United States v. Lopez*, 514 U.S. 549, 552 (1995) (“[A] healthy balance of power between the States and the Federal Government will reduce the risk of tyranny and abuse from either front.” (quoting *Gregory v. Ashcroft*, 501 U.S. 452, 458 (1991))); Inman & Rubinfeld, *supra* note 189, at 74; McConnell, *supra* note 191, at 1500 (“The most important reason offered by the defenders of state sovereignty was that state and local governments are better protectors of liberty.”).

197. See *Gregory*, 501 U.S. at 458 (noting that a federalist structure “increases opportunity for citizen involvement in democratic processes”); Inman & Rubinfeld, *supra* note 189, at 74 (same).

198. See Robert P. Inman & Daniel L. Rubinfeld, *Making Sense of the Antitrust State-Action Doctrine: Balancing Political Participation and Economic Efficiency in Regulatory Federalism*, 75 TEX. L. REV. 1204, 1229 (1997) (noting that, although shifts toward a decentralized structure increase political participation, economic efficiency first rises and then declines with greater decentralization).

199. See ROMANO, *supra* note 13, at 5-6.

200. See *id.*; McConnell, *supra* note 191, at 1494-95 (“Externalities present the principal . . . consideration in favor of centralized government.”). Examples of such externalities include pollution that crosses state borders or taxes for which out-of-state firms or individuals are liable. See ROMANO, *supra* note 13, at 5-6 (“[S]tates may export the cost of providing goods and services for their residents to non residents by adopting taxes that are more likely to be paid by out-of-state than in-state individuals or firms.”); Richard L. Revesz, *Federalism and Interstate Environmental Externalities*, 144 U. PA. L. REV. 2341, 2342-43 (1996) (“The problem of interstate externalities arises because a state that sends pollution to another state obtains the labor and fiscal benefits of the economic activity that generates the pollution but does not suffer the full costs of the activity.”).

201. See Inman & Rubinfeld, *supra* note 189, at 105.

volvement in democratic processes.

As a result, proponents of maintaining dual state and federal systems of securities regulation typically rest their primary arguments on the remaining rationales for maintaining state authority: fostering beneficial interstate competition and maintaining laboratories for experimentation.²⁰² With respect to the competition argument, the analogy that comes most immediately to mind is the long-running debate over the utility of state competition for corporate charters. In this debate over the expected consequences of interjurisdictional competition, those advocating federal corporate standards argue that competition for corporate chartering revenues creates a "race to the bottom" as states compete to provide the most lax set of standards.²⁰³ The upshot of this competition is a race to create laws which systematically benefit management over shareholders and permit the transfer of wealth from shareholders to managers. By contrast, proponents of state competition suggest that any tendency to race toward the bottom is lessened by the effects of the capital, product, and corporate control markets, which place constraints on

202. See 1 LOSS & SELIGMAN, *supra* note 4, at 58-59 (arguing that limiting federal involvement to disclosure enables states to experiment with various substantive protections for investors). The authors note, however, that cooperation between state and federal regulators is essential to assure that the price of experimentation is not too high. See *id.* at 59-60. The problems with allowing uncontrolled experimentation among the states have been brought forcefully home in connection with the ULOE. See Sargent & Makens, *supra* note 8, at 1323-24 (noting difficulties caused by inconsistencies between state and federal application of the Rule 508(a) substantial compliance concept); Ronald L. Fein, Hugh H. Makens & Richard D. Cahalan, *Review of Developments in State Securities Regulations: Part II, ULOE: Comprehending the Confusion*, 43 BUS. LAW. 737, 739, 756 (1988) (noting that state modifications to the ULOE have undercut its effectiveness and uniformity, creating "a world where different definitions are attached to the same words, where slight wording variations can produce significant impact, [and] where inconsistency of requirements creates hundreds of traps for the unwary"). See generally Therese H. Maynard, *The Uniform Limited Offering Exemption: How "Uniform" Is "Uniform?"—An Evaluation and Critique of the ULOE*, 36 EMORY L.J. 357 (1987) (describing how changes in the 27 implementing states have imposed costs on investors without increasing investor protection).

The remainder of this part analyzes the competition debate, although many of the points apply equally to the "laboratories for experimentation" argument.

203. Professor Cary is most closely associated with this view, although others share it. See William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 663 (1974) (noting that, in an attempt to maximize corporate chartering revenue, "Delaware is both the sponsor and the victim of a system contributing to the deterioration of corporation standards"); see also RALPH NADER, MARK GREEN & JOEL SELIGMAN, *TAMING THE GIANT CORPORATION* 38-61 (1976) (describing the role of states wishing to attract large corporations in the development of state incorporation charters); Richard W. Jennings, *Federalization of Corporation Law: Part Way or All the Way?*, 31 BUS. LAW. 991, 991-93 (1976) (commenting that state legislatures consider only management's interests when making corporate law more permissive in an effort to follow Delaware's "lead"); Donald E. Schwartz, *Federalism and Corporate Governance*, 45 OHIO ST. L.J. 545, 556-57 (1984) ("State corporation laws compete with the laws of other states because a corporation may incorporate in one state and do business everywhere. State statutes must be attractive to those who decide where the corporation will be incorporated."); Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 MD. L. REV. 947, 966 (1990) (noting that the incentives of state legislatures considering tender offer statutes are to "compete to design the most pro-incumbent management statutes as a device to attract or retain incorporations.").

managers who might otherwise seek to act in their own best interests, at the expense of shareholders. They argue that these constraints actually create a "race to the top" that promotes efficient capital formation, thereby maximizing shareholder wealth and firm values.²⁰⁴

Since these two positions were first articulated, others have suggested more textured views of the state competition debate.²⁰⁵ In particular, some scholars suggest that the effects of state competition will vary with the particular corporate law rule at issue.²⁰⁶ These more subtle views of competi-

204. See ROMANO, *supra* note 13, at 14 (citing Ralph Winter's critique that Cary's "race for the bottom" thesis overlooked "the capital, product and corporate control markets . . . that constrain managers from choosing a legal regime detrimental to the shareholder's interest"); Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 550 (1984) (describing research by Peter Dodd and Richard Leftwich that produces "substantial support for the hypothesis that markets induce managers to act in investors' interest"); Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 418-19 (1983) (noting that interstate competition facilitates rules of corporate voting that maximize the welfare of investors); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 919-20 (1982) (arguing that permissive corporation law maximizes shareholder welfare by enabling market mechanisms that encourage managers to pursue shareholder interests); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 289-90 (1977) (concluding that capital markets and markets for management control prevent management abuse and that liberal state corporate law reflects the fact "that state law has moved in a direction consistent with an economic model of the management function").

205. See Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437, 1455-58 (1992) (arguing that although interstate competition is beneficial, it corrects neither for negative externalities nor for all of managers' incentives to pursue their own interests at the expense of shareholders); Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 586-87 (1990) (employing a "triviality hypothesis" to argue that corporate law has negligible effect on companies and that the "chartermongering race"—to the top or bottom—has been replaced by incremental change); see also Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 471-73 (1987) (examining the effects of interest group politics on the production of corporate laws and concluding that Delaware rules may be viewed as an attempt to maximize revenues to the corporate bar); Rodriguez, *supra* note 193, at 149 (discussing the impact of intrastate structures and institutions on federalism and the issue of interstate regulatory competition and competence); Roberta Romano, *Law As a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 225-27, 279-81 (1985) (advocating a "transaction explanation of reincorporation" as a more complex and accurate description of Delaware's preeminence in the corporate charter market); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 720-25 (1987) (explaining Delaware's prominence in corporate law matters as the result of a first-mover advantage and of the state's credible commitment to responsiveness).

206. For example, even the strongest adherents of the race to the top acknowledge that state antitakeover laws are the product of failed interstate competition. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 222-23 (1991) ("Competition among states does not eliminate the possibility of opportunistic behavior [by managers] but imposes a constraint."); Bebchuk, *supra* note 205, at 1458-84 (identifying three types of issues that state competition cannot rectify: transfer of value from shareholders to managers, such as self-dealing and insider trading; the strength of market discipline, such as takeover bids and proxy contests; and potential transfers between public and controlling shareholders, such as going-private and freeze-out regulations).

tion in a federal system are critical to understanding the need for uniform national standards for securities fraud causes of action. The more nuanced descriptions of the federal system emphasize that the quality and caliber of interjurisdictional competition is highly contextual.²⁰⁷ As a result, it is insufficient simply to invoke a model of state competition. Instead, this literature teaches, it is important to examine the conditions under which competition can be expected to produce socially desirable results and to determine whether those conditions prevail in the particular context at issue.²⁰⁸ Viewed from this perspective, it is apparent that a competitive market for state fraud causes of action, at least as that market is currently structured, cannot exist for issuers whose securities trade on national markets. To understand why, we need to look more carefully at the assumptions that underlie the competitive model.

The competitive corporate law model is a species of the Tiebout model of the efficient local provision of public services.²⁰⁹ Under the Tiebout model, local governments compete for a mobile citizenry that can choose from among the packages of taxes and services various governments offer, just as consumers choose which goods to buy in the competitive private marketplace.²¹⁰ The resulting resource allocations are efficient because governments will only attract citizens if they provide the optimal level of local public services at the minimum cost.²¹¹ This result, however, is based on very strong assumptions.²¹² At least three of these assumptions—(1) that citizens are fully mobile between communities and will move to the community that

207. See Alvin K. Klevorick, *The Race to the Bottom in a Federal System: Lessons from the World of Trade Policy*, 14 YALE J. ON REG. 177, 179 (1996) (noting that because a race to the bottom is often the result of a government effort to establish and attain a standard, any theoretical explanation is "bound to be highly contextual").

208. See *id.* at 179-82 (discussing the nature of competition, the impact of market imperfections, the nature of the proposed remedy, and the construction of the social good as influencing the race to the bottom).

209. See Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956).

210. See ACIR STUDY, *supra* note 190, at 12-13 (describing the Tiebout model and its assumptions about local governments); Joseph A. Stiglitz, *The Theory of Local Public Goods Twenty-Five Years After Tiebout: A Perspective*, in LOCAL PROVISION OF PUBLIC SERVICES: THE TIEBOUT MODEL AFTER TWENTY-FIVE YEARS 18 (George R. Zodrow, ed. 1983) (discussing the "fundamental question posed by Tiebout . . . : What implications does the ability of individuals to choose a community have for the provision of local goods?"); Inman & Rubinfeld, *supra* note 198, at 1219 (analogizing the Tiebout model "to the purely competitive market model with complete information").

211. See George R. Zodrow, *The Tiebout Model After Twenty-Five Years: An Overview*, in LOCAL PROVISION OF PUBLIC SERVICES, *supra* note 210, at 13-14; Inman & Rubinfeld, *supra* note 189, at 80.

212. See ACIR STUDY, *supra* note 190, at 13 (noting that the assumptions of the Tiebout model "are similar in nature to the assumptions of the perfectly competitive model of market competition"); Inman & Rubinfeld, *supra* note 198, at 1241 (noting that "[i]f Tiebout's assumptions do not hold, then . . . economic competition alone" may not produce regulatory efficiency).

best satisfies their preferences; (2) that there is an elastic supply of jurisdictions; and (3) that there are no interstate externalities or spillover effects—are crucial to obtaining efficient results and simply do not hold true in the securities fraud market.

Mobility is the touchstone for successful interjurisdictional competition because it replaces willingness to buy in the marketplace.²¹³ Without mobility, citizens cannot reveal preferences through their choice of residence.²¹⁴ The structure of the securities fraud market essentially precludes mobility for publicly held companies whose securities trade on national markets. Unlike the corporate charter market, the securities fraud market has nothing equivalent to the corporate internal affairs doctrine,²¹⁵ which preserves mobility by giving corporations the ability to opt in to one state's regulatory scheme simply by reincorporating there.

The market for securities fraud causes of action does not work this way because it is transaction based, rather than domicile based.²¹⁶ To be sure, certain state offering rules can be avoided simply by precluding residents of certain states from purchasing in the offering.²¹⁷ But a corporation that is

213. See DYE, *supra* note 192, at 15 (“The act of moving or failing to move is crucial. Moving or failing to move replaces the usual market test of willingness to buy a good” (quoting Tiebout, *supra* note 209, at 420)); Carney, *supra* note 194, at 304 (characterizing the mobility of firms as the most important feature of a model of competition for firms and states seeking chartering revenues).

214. Cf. Inman & Rubinfeld, *supra* note 198, at 1221 (noting that, when the conditions of full information and costless relocation are not satisfied, “local government competition loses its clear advantage over a larger central government”).

215. This doctrine provides that most questions involving the operation of the corporation will be resolved under the laws of the state of incorporation, regardless of where the corporation is headquartered or doing business. See *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 90 (1987) (“[A] corporation—except in the rarest situations—is organized under, and governed by, the law of a single jurisdiction, traditionally the corporate law of the State of its incorporation.”); *Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982). The Court in *MITE* stated:

The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders—because otherwise a corporation could be faced with conflicting demands.

Id. Assuming sufficiently low reincorporation costs, mobility is preserved because the corporation can comparison shop for corporate governance standards among potential corporate domiciles.

216. See ROMANO, *supra* note 13, at 85 (noting that the jurisdiction for state securities regulation “is based on the site of the securities transaction (that is, the state of residence of the citizen-purchaser) and not the issuer's domicile”); Black, *supra* note 205, at 547 (noting that blue sky laws govern sales of securities within a state, regardless of where the company is incorporated); Carney, *supra* note 194, at 309-11 (describing state strategies that preclude competition by prohibiting firms from relocating to other jurisdictions).

217. If state regulatory review of an offering reveals problems that are “insurmountable,” an offeror will usually withdraw a registration application and “sell around” that state. See Black, *supra* note 205, at 547 (“The stringent blue sky laws found in a few states can often be avoided by selling securities in other, more liberal states.”). Significant problems in nationwide offerings arise only when states with large numbers of investors, such as California and Texas, raise substantial concerns about an offering. See Sargent, *State Disclosure Regulation*, *supra* note 5, at 1034.

going public could not prevent leakage into other jurisdictions in aftermarket trading. Thus, if companies want to avail themselves of the public equity markets, they must at the same time forego any opportunity to choose the set of state securities regulations that will apply to aftermarket securities fraud claims lodged against them. Instead of domicile, the law applicable to a given transaction will depend in large part on the place where the offer or sale is deemed to have occurred.²¹⁸ As a practical matter, because issuers cannot prevent the residents of particular states from buying their securities on impersonal national exchanges, corporations will have no choice but to subject themselves to the laws of all states. Under these conditions, there can be little or no competition in any meaningful sense and states have little or no incentive to adopt efficient rules.

The second constraint of the Tiebout model, an elastic supply of jurisdictions, is necessary because it assures that individual jurisdictions contain homogeneous groups of citizens who share the same policy preferences. If there is a finite supply of jurisdictions, then each jurisdiction will be made up of citizens with different demands for goods and services.²¹⁹ Under these conditions, public choice problems come to the fore, and the rules a jurisdiction adopts may not be efficient if there is a considerable divergence of preferences among citizens.²²⁰ Local political institutions and intrastate structures will have a significant influence over any rules adopted.²²¹ Investors who would be harmed by such rules typically have little ability to prevent

218. See UNIFORM SEC. ACT § 414, 7B U.L.A. 673 (1985); ROMANO, *supra* note 13, at 4 (noting that state securities jurisdiction is based on the location of the securities transaction and not on the corporation's domicile). As Professor Hazen has noted, blue sky statutes "generally are directed at the locus where the securities are offered for sale regardless of the issuer's state of incorporation, state of organization, or principal place of business." 1 HAZEN, *supra* note 39, at 495 (footnote omitted). An offer to sell, whether or not it was accepted, may also be considered in this analysis. See *id.*

219. See Inman & Rubinfeld, *supra* note 198, at 1242 (noting that citizens must choose from a limited number of locations and that therefore "finding a perfect combination of private amenities and public policies for each citizen is unlikely").

220. See Klevorick, *supra* note 207, at 179-80 (discussing the Oates-Schwab model of interjurisdictional competition); Wallace E. Oates & Robert M. Schwab, *Economic Competition Among Jurisdictions: Efficiency Enhancing or Distortion Inducing?*, 35 J. PUB. ECON. 333, 350-51 (1988) (finding that "conflicts of interest within a heterogeneous community" can also distort public decisions).

221. See Rodriguez, *supra* note 193, at 151-52 (discussing the critique that "decentralization and devolution of power to appropriate public and private authorities," rather than states *qua* states, should be the focus of a federalism analysis). For example, commentators have noted in the corporate charter literature that with only 50 jurisdictions, local interest groups may be able to benefit themselves by structuring laws in certain ways. See Carney, *supra* note 194, at 306 (noting that corporate attorneys can appropriate quasi rents "by making legal procedures more elaborate and costly than otherwise necessary, by increasing the frequency of corporate litigation, and by creating some amount of market power over advising and litigating under a set of corporate laws"); see also Macey & Miller, *supra* note 15, at 350-52 (describing how local and regional interest groups influenced state securities regulations).

their adoption, because the investors are widely dispersed and frequently are not residents of the state in question.²²²

The limited supply of jurisdictions is closely related to the lack of mobility. With only fifty jurisdictions to choose from, corporations and citizens are unlikely to be able to find an optimal mix of public policies, goods, and services.²²³ Instead, most will have to settle for a mix of good and bad. Consider, for example, high-technology companies located in Silicon Valley. If Proposition 211²²⁴ had passed, a company making a relocation decision would have to balance the costs inherent to a greater litigation threat with the benefits of remaining in a location that has an abundant supply of highly trained workers and significant access to venture capital and other sources of funding.²²⁵ In such a trade-off, the company might well choose the latter benefits even if the litigation rules are inefficient. Under these conditions, inefficient rules might survive if the jurisdiction provides a significant number of other benefits that limit the opportunity for citizens to vote with their feet.²²⁶

Finally, interstate externalities will significantly impede beneficial inter-jurisdictional competition. If the residents of a state do not bear the costs of lax securities liability standards, then states cannot be truly competitive.²²⁷ Negative spillover effects can be a significant problem in the market for securities fraud causes of action because most shareholders of a given publicly traded company will not reside in the jurisdiction. In-state plaintiffs will benefit from more lax liability rules while the costs of such rules, e.g., a higher cost of capital, are largely exported out-of-state.²²⁸ Under these conditions, states have incentives to create plaintiff-favorable laws that may permit excessive securities litigation, one of Congress' primary concerns when it enacted the Reform Act.²²⁹ The policy objectives Congress sought to

222. See Carney, *supra* note 194, at 306-07 ("Investors in publicly held corporations will be numerous, widely dispersed, and frequently nonresidents of the jurisdiction of incorporation and, as a result, will have little prospect of influencing legislation.").

223. See Inman & Rubinfeld, *supra* note 198, at 1242.

224. See note 3 *supra*.

225. See generally Andy Reinhardt, Joan O'C. Hamilton & Linda Himelstein, *Silicon Valley: How It Really Works*, BUS. WK., Aug. 25, 1997, at 68 (discussing the critical role that a "deep talent pool," infrastructure, and a culture of risk taking have played in creating the high-technology successes in Silicon Valley).

226. See Inman & Rubinfeld, *supra* note 198, at 1242 ("With a limited number of jurisdictions, bad government policies can survive in those states with sufficient compensating benefits from the private economy.").

227. See DYE, *supra* note 192, at xvi ("Nor can state or local governments be truly competitive if the costs of their decisions can be externalized—shifted . . . to taxpayers throughout the nation.").

228. See McConnell, *supra* note 191, at 1499 (stating that the state-by-state determination of products liability rules has created a "liability monster," such that states have implemented generous liability rules for in-state plaintiffs, thereby shifting costs to out-of-state defendants).

229. See notes 76-79 *supra* and accompanying text.

achieve may thereby be thwarted because the availability of differing state standards may mean that too many resources will continue to be devoted to litigation and to litigation avoidance.²³⁰

Consequently, as currently structured, the securities fraud market essentially precludes beneficial interjurisdictional competition. Preemption, which would essentially preclude competition in favor of a central regulator, is not the only answer to these difficulties. For example, it is at least theoretically possible to create mobility in the market for private securities fraud causes of action, and therefore at least the possibility of competition, by permitting: (1) individual states to adopt their own securities antifraud regimes that could preempt federal law and (2) issuers to opt into any state's antifraud regime or into the federal regime.²³¹ Such a system would come close to replicating our federal approach to corporation law.

There are several potential problems with adopting such an approach. First, creating mobility through a domicile-based system does not address the two other constraints on the Tiebout model: the inelastic supply of jurisdictions and the presence of interstate externalities. For example, even if corporations could opt into a particular state's liability and disclosure rules, externality problems may still exist that may impede the effectiveness of the Reform Act's safe-harbor provision. A system of state disclosure rules may not achieve optimal disclosure because states competing for corporations may not have incentives to take into account the positive externalities associated with disclosure rules.²³² In particular, the disclosure of forward-looking information can have significant benefits for shareholders, competing companies, and for the market as a whole.²³³ Because most of those who benefit from disclosure of this information reside outside of the jurisdiction, states may not take into account the externality effects of the disclosure rules they adopt and may create rules that have less protection for forward-looking statements than current federal law. As a result, the proposed system may simply replicate the same debate over "race to the bottom" or "race to the top" effects that continues to persist in the corporate governance literature.

Of course, we should not reject the competitive model simply because it does not precisely replicate the idealized competitive model. Indeed, the arguments with respect to an inelastic supply of jurisdictions and interstate

230. Cf. Grundfest, *supra* note 75, at 732 ("If there is excessive securities litigation, too many resources will be spent on litigation and on litigation avoidance.").

231. Professor Romano has suggested a similar approach. See Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation 2* (Jan. 11, 1998) (unpublished manuscript, on file with the *Stanford Law Review*). For a proposal that seeks to create competition among exchanges, see Paul Mahoney, *The Exchange As Regulator*, 83 VA. L. REV. 1453 (1997).

232. See Bebchuk, *supra* note 205.

233. See STATEMENT OF MANAGERS, *supra* note 63, at 43; Bebchuk, *supra* note 205, at 1490-91; Frank L. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 669-87 (1984).

spillover effects are in many ways indistinguishable in the securities and corporate law contexts. Although these constraints may limit beneficial corporate charter competition in important ways, there is some evidence suggesting that such competition still has a positive impact on shareholder welfare.²³⁴ Thus, although a competitive market approach may not be perfect, there is at least some possibility that it may still yield better results than preemption. Ultimately, however, practical political concerns suggest that it is unlikely that a competitive model for securities fraud will be adopted. Such a proposal would likely face strong opposition from particular states, especially those that have more expansive investor protections.²³⁵ Moreover, although such a system is possible in theory, no pending legislation suggests that uniformity be attained by allowing state law to preempt federal standards. The only proposed legislative responses to the post-Reform Act shift to state court are bills that create uniform federal standards that preempt conflicting state laws.

VI. STRUCTURING PREEMPTION

Because federal preemption is the only solution on the political horizon, it is useful to analyze how such a statutory provision should be structured. Is there still a role for state private causes of action? Several bills have been introduced in Congress that seek to preempt some state securities fraud causes of action. Do those bills structure preemption appropriately?

The problems identified in the empirical and theoretical parts of this article do not suggest that federal law should preempt all state causes of action. Even a casual weighing of the costs and benefits of federalism suggests that the states can and should play an important role with respect to certain types of securities. A useful starting point for allocating governmental authority over private securities fraud claims is the statutory scheme Congress created in the NSMIA to allocate regulatory authority over securities offerings.²³⁶ In altering that portion of the traditional dual state-federal regulatory structure, Congress sought to apply federal rules and regulations to certain "covered securities" that it determined were "inherently national in nature," whereas "[s]maller, regional, and intrastate offerings remain[ed] subject to state regulation."²³⁷ These same divisions make sense for private rights of action

234. See Romano, *supra* note 231, at 36-44.

235. See *Partly Sunny Skies*, *supra* note 5, at 413-14 (noting the hostility of certain states in the debates over small offering exemptions in the early 1990s and observing that "many states, even though their resources are quite limited, remain firmly committed to vigorous regulation to protect unsophisticated individual investors residing in their respective states").

236. See notes 8-10 *supra* and accompanying text.

237. JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE, H.R. CONF. REP. NO. 104-864, at 40 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3920, 3921.

as well.

The NSMIA defined covered securities to include securities listed on the New York Stock Exchange, the American Stock Exchange, or securities included in the National Market System of the NASDAQ Stock Market.²³⁸ Covered securities also include: (1) sales to qualified purchasers, as defined by SEC rules;²³⁹ (2) securities issued by investment companies;²⁴⁰ (3) securities sold in transactions exempt from registration pursuant to any Commission rules or regulations issued under section 4(2);²⁴¹ or (4) securities sold in transactions exempt under section 3(a), except for intrastate offerings under section 3(a)(11)²⁴² and certain securities offered by nonprofit entities under

238. See 15 U.S.C.A. § 77r(b)(1)(A) (West 1997). This exemption was said to codify, in the 1933 Act, similar exemptions to those found in existing state blue sky laws. See H.R. REP. NO. 104-622, at 30 (1996), reprinted in 1996 U.S.C.C.A.N. 3877, 3892-93; see also Campbell, *supra* note 5, at 189 (noting that states sometimes exempt nationally traded securities from state registration); Sargent, *A Future for Blue Sky Law*, *supra* note 5, at 474-75 (discussing these marketplace exemptions). To avoid competitive disparities, the SEC is "given discretionary authority to extend similar preemption treatment to other national securities exchanges (or tiers or segments thereof) that have substantially similar listing standards." H.R. REP. NO. 104-622, at 30 (1996); see 15 U.S.C.A. § 77r(b)(1)(B) (West 1997). Not all publicly traded securities, however, fall into a category that merits preemption. For example, the SEC has asserted that certain publicly traded securities not listed under the definition of "covered securities" in the NSMIA are still subject to state regulation, including "securities quoted on the NASDAQ SmallCap Market, securities quoted on the NASDAQ over-the-counter Electronic Bulletin Board, and securities quoted on the over-the-counter "pink sheets." Securities Uniformity: Annual Conference on Uniformity of Securities Laws, Exchange Act Release No. 33-7413 (Apr. 4, 1997), available in 1997 WL 160356.

Preemption also applies to securities of the same issuer that are equal or senior to the listed securities. See 15 U.S.C.A. § 77r(b)(1)(C) (West 1997). A senior security is defined to include "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends." 15 U.S.C.A. § 77r(d)(4) (West 1997). The intent of this exemption was "to afford to issuers of debt securities the same benefits of preemption . . . enjoyed by issuers of equity securities." H.R. REP. NO. 104-622, at 30 (1996).

239. See 15 U.S.C.A. § 77r(b)(3) (West 1997). Currently, "qualified purchaser" is undefined. Congress delegated authority to the SEC to define qualified purchasers, with explicit directions that the SEC move promptly to define the term and that, in doing so, it consider investor protection and "the public interest (including consideration of efficiency, competition and capital formation)." H.R. REP. NO. 104-622, at 32.

240. See 15 U.S.C.A. § 77r(b)(2) (West 1997).

241. See 15 U.S.C.A. § 77r(b)(4)(D) (West 1997). Because preemption requires Commission rules or regulations, securities sold under a Regulation D exemption would be preempted, but securities sold in transactions relying solely on the section 4(2) exemption are not. See Richard H. Rowe, *The Capital Formation Provisions of the 1996 Act*, INSIGHTS, May 1997, at 8, 9.

242. See 15 U.S.C.A. § 77r(b)(4)(C) (West 1997). Although these securities are exempt from federal registration requirements, they are not exempt from potential liability under federal antifraud rules. See *Leoni v. Rogers*, 719 F. Supp. 555, 565 (E.D. Mich. 1989) (citing Notice of Adoption of Rule 147, Securities Act Release No. 5450, [topical Index Securities Act] Fed. Sec. L. Rep. (CCH) ¶ 2340 (Jan. 7, 1974)); 1 HAZEN, *supra* note 39, at 184-85. In practice, the exemption is quite limited and applies "only to issues genuinely local in character, which in reality represent local financing by local industries, carried out through local investment." 17 C.F.R. § 230.147 (1997). Rule 147, which creates a nonexclusive safe harbor for intrastate offerings, requires, for example, that: (1) the issuer be a resident and doing business within the offering state; (2) 80% of

section 3(a)(4).²⁴³ Municipal securities exempt pursuant to section 3(a)(2) are defined as covered securities, except in the state in which the issuer is located.²⁴⁴

The allocations of governmental authority made in the NSMIA translate well to allocating authority and control over the creation and administration of private causes of action. For the reasons already discussed, it makes little sense to preserve state antifraud causes of action for issuers whose securities trade on national markets. But state causes of action can play an important role with respect to other types of securities. There is a strong case for maintaining state authority over causes of action involving smaller securities offerings, such as penny stock offerings, investment contracts, limited partnership programs, and blank-check offerings. These sorts of offerings often target unsophisticated investors and have been at the heart of many securities fraud scams.²⁴⁵ States have traditionally regulated these types of offerings²⁴⁶ and act as a sort of "cop on the beat" to help enforce antifraud rules. A state antifraud role, both in terms of enforcement authority and private causes of action, is consistent with the blue sky laws' traditional focus on individual investors, because these smaller securities markets are often characterized by informational asymmetries and little financial intermediation.²⁴⁷

Similar considerations underlie the rationale for preserving state causes of action applicable to intrastate securities offerings. Intrastate offerings are exempt from federal registration.²⁴⁸ Any attempt to preempt state causes of action for such securities may well leave defrauded investors with no practicable means of recovery if a necessary jurisdictional element for a federal cause of action—the use of a means or instrumentality of interstate commerce—is lacking.²⁴⁹ Preservation of state authority also permits states to tailor their laws to particular local concerns—intrastate offerings aimed at senior citizens in Florida may look quite different from, and create problems

an issuer's gross revenues and assets be derived from activity or be located in the offering state in order for an issuer to be deemed to be "doing business" in the state; (3) 80% of the offering proceeds be used in the state; and (4) resales to out-of-state residents be prohibited for nine months. See 17 C.F.R. § 230.147(a), (c), (e) (1997); see also 1 HAZEN, *supra* note 39, at 184-85.

243. See 15 U.S.C.A. § 77r(b)(4)(C) (West 1997).

244. See *id.*

245. See Sargent, *A Future for Blue Sky Law*, *supra* note 5, at 507-09. These findings appear to persist over time. SEC studies released in 1941, 1946, and 1963 and a General Accounting Office study in 1980 found a high incidence of fraud among small issuers. See Seligman, *supra* note 23, at 33-36.

246. See *Edgar v. MITE Corp.*, 457 U.S. 624, 640-42 (1982) ("States have traditionally regulated intrastate securities transactions."). Indeed, federal-state coordination efforts that predate NSMIA generally allocated authority over smaller offerings to the states. See Sargent, *A Future for Blue Sky Law*, *supra* note 5, at 476.

247. See Sargent, *A Future for Blue Sky Law*, *supra* note 5, at 485-87, 507-08.

248. See 15 U.S.C. § 77c(a)(11) (1994).

249. See, e.g., 17 C.F.R. § 240.10b-5 (1997).

not found with, intrastate offerings to farmers in Iowa. In addition, there is less concern about interstate externalities with respect to such offerings.

The NSMIA's definition of covered securities provides other useful guidelines. As in the NSMIA, it makes sense to preserve state authority over fraud in connection with municipal securities sales, but only in the state in which the issuer is located.²⁵⁰ These causes of action raise primarily local concerns for which preserving state causes of action for fraud makes sense. Certain claims against broker-dealers or other securities professionals, such as churning or suitability claims, may also implicate more local concerns, especially where such actions focus on individual employees or local offices operating within state borders. Preservation of state claims is particularly important for intrastate securities dealers who are exempt from federal registration requirements.²⁵¹

In contrast, it may be appropriate to restrict state authority over other kinds of nonpublicly traded securities. For example, large private placements to institutional or other sophisticated investors are typically sold in interstate commerce.²⁵² Because these offerings are typically made to sophisticated investors capable of protecting themselves, additional state causes of action are likely unnecessary.²⁵³ Moreover, any fraudulent practices in connection with the sale of privately placed securities would subject the seller to liability under the implied and express liability provisions of the federal securities laws. These claims also would be subject to at least some of the provisions of the Reform Act, such as the higher pleading standard, which applies to both individual and class action claims. As with class actions, inconsistent state provisions for privately placed securities create incentives for plaintiffs to evade the Reform Act's provisions.

This brief discussion suggests that any preemption statute must be carefully drafted so that it does not usurp authority that is better left with the states. Do current preemption proposals sufficiently address the appropriate distinctions that must be made in structuring preemption? Three bills currently pending in Congress, H.R. 1653 (introduced by Representative Camp-

250. See 15 U.S.C.A. § 77r(b)(4)(C) (West 1997).

251. See 15 U.S.C. § 78o(a)(1) (1994) (exempting securities dealers "whose business is exclusively intrastate and who [do] not make use of any facility of a national securities exchange" from federal registration requirements); see also Thomas E. Geyer, *Viewing the Columbus Skyline: Incorporating Federal Law into the Anti-Fraud Standard of the Ohio Securities Act*, 28 U. TOL. L. REV. 301, 307-10 (1997) (discussing Ohio Division of Securities case against intrastate securities dealer who traded primarily penny stocks).

252. When it passed the NSMIA, Congress found that many of these offerings, including mortgage-backed, asset-backed, and other structured securities as well as securities issued in connection with project financings, were fundamentally national in character. See H.R. REP. NO. 104-622, at 31 (1996).

253. See *id.*

bell),²⁵⁴ H.R. 1689 (introduced by Representatives Eshoo and White),²⁵⁵ and S. 1260 (introduced by Senators Gramm and Dodd),²⁵⁶ create uniform federal standards, although through slightly different means. All three bills would prohibit any state private civil action alleging either a misrepresentation or omission, or the use of a manipulative or deceptive device or contrivance in connection with the purchase or sale of a "covered security." Although the definition of a "covered security" varies slightly in each bill, in all cases these definitions are narrower than the NSMIA version.²⁵⁷ In all three bills the definition of "covered security" includes securities that are listed or quoted on national exchanges or markets.²⁵⁸ In addition, S. 1260 applies to the securities of investment companies registered under the Investment Company Act of 1940.²⁵⁹ H.R. 1689 is even broader because it preempts class actions against companies that have issued covered securities, even if the security at issue was not itself a covered security.²⁶⁰

The bills also contain significant differences in the kinds of actions that would be preempted. H.R. 1653 applies to any action, individual or class, involving a covered security.²⁶¹ H.R. 1689 and S. 1260, by contrast, only preempt class actions involving covered securities.²⁶² None of the bills appears intended to limit the authority of state securities regulators to bring enforcement actions alleging violations of state law.²⁶³

There are at least four concerns that may make the bills either too broad or too narrow. The first involves the kinds of actions that are preempted.

254. Securities Litigation Improvement Act of 1997, H.R. 1653, 105th Cong. (1997). I provided technical assistance to Rep. Campbell's office in drafting this legislation.

255. Securities Litigation Uniform Standards Act of 1997, H.R. 1689, 105th Cong. (1997).

256. Securities Litigation Uniform Standards Act of 1997, S. 1260, 105th Cong. (1997).

257. See 15 U.S.C.A. § 77r(b) (West 1997).

258. See H.R. 1653 § 2; H.R. 1689 § 2; S. 1260 § 2.

259. See S. 1260 § 2; 15 U.S.C.A. § 77r(b)(2) (West 1997).

260. See H.R. 1689 § 2.

261. See H.R. 1653 § 2.

262. See H.R. 1689 § 2; S. 1260, § 2. A "class action" is defined in both bills as a single lawsuit, or any group of lawsuits filed in or pending in the same court involving common questions of law or fact; in which: (a) damages are sought on behalf of more than twenty-five persons; (b) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated; or (c) one or more of the parties seeking to recover damages did not personally authorize the filing of the lawsuit.

H.R. 1689 § 2; S. 1260 § 2.

263. See H.R. 1653 § 2 (limiting preemption to private civil actions); H.R. 1689 § 2 (limiting preemption to class actions brought by private parties); S. 1260 § 2 (same); see also Letter from Rep. Anna G. Eshoo and Other Members of Congress to President William J. Clinton 1 (Mar. 13, 1997) (noting that members of Congress who sought uniform national standards legislation did "not seek to affect the power of state regulatory agencies to bring enforcement actions"). This structure is consistent with the Reform Act, which is intended to regulate only private litigation and has no effect on the SEC's enforcement authority. See, e.g., 15 U.S.C.A. § 78u-4(b) (West 1997) (limiting higher pleading standard to private actions).

H.R. 1653 preempts all private actions and thus would prevent a plaintiff from filing an individual action in state court that may not be economically viable, simply to obtain discovery that might be stayed in a parallel federal action or to obtain discovery in contemplation of filing a federal court action.²⁶⁴ Under H.R. 1689 and S. 1260, however, the plaintiffs' attorney would be able to file an individual action in state court to obtain discovery because that provision applies only to class actions.²⁶⁵ Empirical data²⁶⁶ and anecdotal evidence²⁶⁷ from post-Reform Act litigation suggest that attempts to avoid the discovery stay are a prime motivation for filing state securities lawsuits. To be sure, many of the state lawsuits filed to date are class actions that would be preempted by H.R. 1689 and S. 1260. But plaintiffs' attorneys have already demonstrated their adaptability to changes in statutory schemes, and there appears to be no reason why they would be unable to obtain the same discovery in an individual action. H.R. 1689 and S. 1260 thus may permit state actions that undermine the discovery stay provisions of the Reform Act.

The second issue involves the bills' definitions of "covered securities." The inclusion of securities that trade on national markets certainly makes sense because most of the shift to state court has involved cases alleging some type of fraudulent activity in connection with the purchase or sale of these securities. The bills define these securities in much the same way as the NSMIA did, thereby maintaining state authority over securities, like penny stocks or securities sold through intrastate offerings, that do not trade in open and developed national markets and which may involve significant local interests. None of the provisions, however, is coextensive with the NSMIA. There are securities that Congress found to be essentially national in character that may or may not be preempted under the proposed preemption bills.²⁶⁸ At a minimum, it would appear to make sense to structure preemption of state securities fraud causes of action consistently with preemp-

264. See H.R. 1653 § 2.

265. See H.R. 1689 § 2; S. 1260 § 2.

266. See notes 114-188 *supra* and accompanying texts.

267. See Kisliuk, *supra* note 182, at 1 (citing a defense attorney's statements that plaintiffs are filing in state court to gather discovery for their federal suits); DICKEY & COLLINS, *supra* note 108, at 9 (concluding that plaintiffs' counsel are filing parallel actions "to obtain the benefits of a federal forum while avoiding the more restrictive discovery rules"); Thompson, *supra* note 49, at 1 (quoting plaintiffs' attorney that a primary reason for filing in state court is because "[o]n day one in state court, you can attempt to get discovery and the defense can attempt to shut you down, and it's a fair fight").

268. See H.R. REP. NO. 104-622, at 31 (1996). For example, actions involving securities sold to "qualified purchasers" or in transactions exempt under Regulation D may be preempted under H.R. 1689 if they are sold by issuers who have other securities that trade on national markets, but would not be preempted under H.R. 1653. See H.R. 1653 § 2; H.R. 1689 § 2; 15 U.S.C.A. §§ 77r(b)(3), (b)(4)(D) (West 1997); see also Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933, 17 C.F.R. § 230.501 (1997) (defining the terms used in Regulation D).

tion of state offering rules under the NSMIA.

A third concern involves the different approaches to removal under the bills. H.R. 1689 and S. 1260 permit the defendant to remove a securities action that was filed in state court to federal court in order to have the federal court rule on the scope of preemption.²⁶⁹ H.R. 1653 does not address the removal issue.²⁷⁰ These differences raise at least two issues. First, a limitation on removal might disadvantage defendants to the extent that state courts are more likely than federal courts to interpret any preemption of state causes of action narrowly. H.R. 1653, however, can easily be amended to permit removal.

The removal question also implicates the jurisdictional dichotomy that exists between the 1933 and 1934 Acts. As noted previously, under current law 1933 Act claims may be brought in state courts and are not removable to federal courts, whereas federal courts have exclusive jurisdiction over 1934 Act claims.²⁷¹ All three bills eliminate concurrent state jurisdiction over 1933 Act claims in favor of exclusive jurisdiction in the federal courts. But exclusive jurisdiction may not be essential to achieving uniformity—the bills could preempt private state causes of action yet permit both state and federal courts to hear federal claims.²⁷² Indeed, the exclusive jurisdiction provision of the 1934 Act is the exception rather than the rule, and a strong presumption exists in favor of concurrent state court jurisdiction, unless Congress strips the state courts of jurisdiction.²⁷³

269. See H.R. 1659 § 2; S. 1260 § 2.

270. See H.R. 1653 § 2. An explicit removal provision is arguably necessary because removal is only permissible when the action originally could have been brought in federal court. See FLEMING JAMES, JR., GEOFFREY C. HAZARD, JR. & JOHN LEUBSDORF, *CIVIL PROCEDURE* 118 (4th ed. 1992). Without such a provision, a state complaint that alleges only state causes of action, even if the defendant has a federal defense or counterclaim to the action, may not be removable under the well-pleaded complaint rule. See *Metropolitan Life Ins. Co. v. Taylor*, 481 U.S. 58, 63 (1987) (“[A] cause of action arises under federal law only when the plaintiff’s well-pleaded complaint raises issues of federal law.”); *Louisville & Nashville R.R. v. Mottley*, 211 U.S. 149, 152-53 (1908) (noting that “[i]t is not enough that the plaintiff alleges some anticipated defense” that will be invalidated by federal law to confer federal jurisdiction). But see *Metropolitan Life*, 481 U.S. at 63-64 (noting that exceptions to the well-pleaded complaint rule exist, but only where Congress so completely preempted “a particular area that any civil complaint raising this select group of claims is necessarily federal in character”).

271. See 15 U.S.C. §§ 77v(a), 78aa (1994).

272. See *Hazen*, *supra* note 4, at 744-45 (arguing that exclusive federal jurisdiction over 1934 Act claims should largely be eliminated). The American Law Institute’s Federal Securities Code adopts this approach for its model code. With a few somewhat limited exceptions, it provides for concurrent federal-state jurisdiction with a right of removal in private rights of action. See FEDERAL SEC. CODE § 1822(a); see also Margaret V. Sachs, *Exclusive Federal Jurisdiction for Implied Rule 10b-5 Actions: The Emperor Has No Clothes*, 49 OHIO ST. L.J. 559, 589-90 (1988) (arguing for concurrent jurisdiction in state and federal courts for Rule 10b-5 actions).

273. See *Yellow Freight System, Inc. v. Donnelly*, 494 U.S. 820, 823-25 (1990); *Tafflin v. Levitt*, 493 U.S. 455, 458-59 (1990); *Gulf Offshore Co. v. Mobil Oil Corp.*, 453 U.S. 473, 477-78 (1981); *Charles Dowd Box Co. v. Courtney*, 368 U.S. 502, 507-08 (1962); RICHARD H. FALLON,

Exclusive jurisdiction, however, might be desirable for several reasons. First, to achieve uniformity in this area, courts must apply the substantive federal provisions and the largely procedural requirements of the Reform Act. It seems incongruous at best for Congress to dictate what procedures state courts must follow in adjudicating federal claims. And indeed, such micromanagement may represent a more unseemly federal intrusion into state prerogatives than preemption of substantive remedies. Second, limiting private securities fraud causes of action to federal courts may make it somewhat easier to obtain uniformity of results.²⁷⁴ Although the federal courts have not been models of uniformity in securities matters, conflict problems are likely to be compounded by adding numerous state courts into the mix. Any inconsistencies in state law may also be more persistent because they will only be eliminated through relatively infrequent Supreme Court review.²⁷⁵ The inevitable conflicts may also be troublesome when it comes to implementing novel federal policy choices, such as those embodied in the safe harbor for forward-looking statements or the discovery stay provision, if state courts are less sympathetic to those new federal provisions.²⁷⁶

Third, the federal courts, particularly those in jurisdictions with a significant number of class action filings, have built up significant institutional expertise in handling securities law matters.²⁷⁷ Such expertise, if it develops at all at the state level, will only come after many years of handling these cases. Fourth and finally, a significant portion of class action securities fraud litigation involves complex factual and legal claims, multiple parties, and in many cases competing actions brought in multiple jurisdictions. The federal courts

JR., DANIEL J. MELTZER & DAVID L. SHAPIRO, HART AND WECHSLER'S THE FEDERAL COURTS AND THE FEDERAL SYSTEM 453 (4th ed. 1996) (noting that concurrent jurisdiction with a right of removal is the jurisdictional arrangement Congress most commonly employs); Martin H. Redish, *Reassessing the Allocation of Judicial Business Between State and Federal Courts: Federal Jurisdiction and "The Martian Chronicles,"* 78 VA. L. REV. 1769, 1811-14 (1992) (advocating the abolition of exclusive federal jurisdiction in most cases).

274. See *Gulf Offshore*, 453 U.S. at 483-84; 9 LOSS & SELIGMAN, *supra* note 4, at 4373. But see *Hazen*, *supra* note 4, at 731 (arguing that, given inconsistency among circuits, concurrent state court jurisdiction would not significantly harm uniformity).

275. See 9 LOSS & SELIGMAN, *supra* note 4, at 4373.

276. See Note, *Exclusive Jurisdiction of the Federal Courts in Private Civil Actions*, 70 HARV. L. REV. 509, 512 (1957).

277. See *Gulf Offshore*, 453 U.S. at 483-84 (noting that the expertise of federal judges may provide support for a finding of exclusive federal jurisdiction). The commentary to the ALI's Federal Securities Code suggests that this argument for maintaining exclusive federal jurisdiction "is outweighed by the desirability of giving the small claimant, particularly, a forum close to his home (as well as his lawyer's) . . ." FEDERAL SEC. CODE § 1822(a) cmt. 3. Although this point may be significant with respect to simple actions involving nonpublicly traded securities, this argument carries less weight when it comes modern class action securities fraud class actions, in which most of the initiative and control is lodged with a well-capitalized and concentrated plaintiffs' bar. See note 70 *supra*; GRUNDFEST & PERINO, *supra* note 114, at 25-27 (noting that one plaintiffs' law firm appeared in approximately 59% of actions brought in 1996).

have superior procedural mechanisms²⁷⁸ and greater resources to better process these complex cases.

Finally, it has been suggested that these bills, if enacted, may intrude upon traditional state police powers and on the dominant corporate law causes of action that are traditionally the province of the states.²⁷⁹ As a practical matter, the area of most concern seems to involve allegations arising out of the proxy context or in connection with tender offers or other extraordinary corporate transactions. In particular, it has been suggested that a strict reading of the current bills would preempt state class actions alleging that corporate directors breached their duty of candor to shareholders in connection with a merger or other transaction.²⁸⁰ Although current preemption proposals have trained a spotlight on this issue, the problem of interjurisdictional coordination in this area is not new.²⁸¹ The current bills do not seem intended to cover such cases; however, it would be a straightforward matter to add language assuring that uniform securities fraud litigation standards do not intrude on traditional corporate law causes of action. For example, the bills could carve out an exclusion from preemption for cases involving voting matters.

CONCLUSION

The empirical data on securities class actions following the Reform Act provide significant support for the inference that, in filing state causes of action in state courts, plaintiffs' attorneys are seeking to evade the policy choices Congress made when it passed the Reform Act. In particular, the results reported in this article demonstrate that plaintiffs' attorneys are filing apparently weaker claims in state court under state causes of action in an apparent attempt to avoid the Reform Act's higher pleading standards. Attorneys are also employing state actions as a means to obtain discovery that might be barred in federal court proceedings. These strategic responses to the Reform Act have the potential to significantly undermine the policy initiatives embodied in the Act and to impose significant costs on issuers whose securities trade on national markets. Although there still is significant debate over the merits of the Reform Act, that debate should not cloud the resolution of the important question of how to best allocate governmental authority

278. *See, e.g.*, 28 U.S.C. § 1407 (1994) (detailing procedures for consolidating and transferring multidistrict litigation); *MANUAL FOR COMPLEX LITIGATION* § 20.123 (3d ed. 1995).

279. *See 1997 Senate Hearings, supra* note 172 (testimony of Arthur Levitt, Chairman, SEC, at 22-23).

280. *See id.*

281. *See* 9 LOSS & SELIGMAN, *supra* note 4, at 4360-75 (noting the difficult jurisdictional issues that arise when, for example, a particular course of conduct potentially violates section 14 of the 1934 Act and state law); FEDERAL SEC. CODE § 1822(a) cmt. 1.

over securities regulation. Even if the Reform Act is flawed, is the best way to address those concerns to permit individual states to create their own, possibly inconsistent, rules?

The answer to that question is clearly “no,” particularly because there are only weak rationales for maintaining state control over securities fraud causes of action applicable to issuers whose securities trade on national markets. These securities do not implicate purely local concerns. Interjurisdictional competition in the “market” for state securities fraud causes of action is unlikely to produce efficient rules because mobility is precluded among jurisdictions and because of the presence of significant spillover effects. To be sure, it is possible to create choice of law rules to promote mobility and the possibility of competition, but the likelihood that such proposals will be enacted seems quite slim. For these reasons, it makes sense to create some sort of uniform federal legislation. At a minimum, uniform federal standards will give the Reform Act’s provisions a legitimate chance to either fail or work. It is only then that a truly informed decision can be made as to the merits of those reforms and as to whether additional reforms are needed.