Brooklyn Law Review

Volume 61 | Issue 2 Article 9

2-1-1995

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Recommended Citation

D. Brian Hufford, *SECURITIES: Deterring Fraud vs. Avoiding the "Strike Suit": Reaching an Appropriate Balance*, 61 Brook. L. Rev. 593 (1995).

Available at: https://brooklynworks.brooklaw.edu/blr/vol61/iss2/9

DETERRING FRAUD VS. AVOIDING THE "STRIKE SUIT": REACHING AN APPROPRIATE BALANCE*

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INTRODUCTION

Section 10(b) of the Securities Exchange Act of 1934 (the "Act")[1] and Rule 10b-5, promulgated by the Securities and Exchange Commission ("SEC") thereunder,[2] remain the primary basis upon which securities fraud cases are litigated in the federal courts.[3] The Act was designed "to deter fraud and

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From the author: This article is dedicated to my wife Wendy, and to our three wonderful and precocious children: Ashley, Austen and Axel. Without their love, support and tireless energy, life would have little meaning.

[1] 15 U.S.C. § 78j(b) (1934). Section 10(b) makes it

> unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.

[2] 17 CFR § 240.10b-5 (1994). Rule 10b-5, adopted by the SEC to clarify the reach of section 10(b), specifies that

> [i]t shall be unlawful for any person . . . (a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) [t]o 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.

Id.

[3] To present a valid cause of action under section 10(b) and Rule 10b-5, plaintiffs must allege material misstatements or omissions that were knowingly or recklessly made in connection with the purchase or sale of a security. Luce v. Edelstein, 802 F.2d 49, 55 (2d Cir. 1986); *see also* Basic Inc. v. Levinson, 485 U.S.

manipulative practices in the securities market, and to ensure full disclosure of information material to investment decisions."[4] Although not expressly provided for by Congress, courts have long implied a private cause of action for investors under the Act.[5] They have done so "on the theory courts should recognize private remedies to supplement federal statutory duties, not on the theory Congress had given an unequivocal direction to the courts to do so."[6] The private cause of action has become a critical part of the enforcement mechanism behind section 10(b). As the head of enforcement for the SEC recently stated in expressing his support for a strong and active securities plaintiffs' bar:

224, 230-31 (1988) (listing elements of 10(b) claim); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976) (holding that scienter is required for 10(b) violations); Breard v. Sachnoff & Weaver, Ltd., 941 F.2d 142, 144 (2d Cir. 1991) (holding that recklessness is sufficient to show scienter under 10b-5).

[4] Musick, Peeler & Garrett v. Employers Ins. of Wausau, 113 S. Ct. 2085, 2090 (1993) (quoting Randall v. Loftsgaarden, 478 U.S. 647, 664 (1986)).

[5] *Hochfelder*, 425 U.S. at 196. ("Although § 10(b) does not by its terms create an express civil remedy for its violation, and there is no indication that Congress, or the Commission when adopting Rule 10b-5, contemplated such a remedy, the existence of a private cause of action for violations of the statute and the Rule is now well established."); *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975); Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 150-54 (1972); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971).

[6] *Musick*, 113 S. Ct. at 2088 (citing *Blue Chip Stamps*, 421 U.S. at 730). The *Musick* decision was issued at the same time that the Supreme Court was making clear its strong reluctance to imply causes of action under the securities laws. *See, e.g.*, Central Bank of Denver v. First Interstate Bank of Denver, 114 S. Ct. 1439, 1448 (1994) (finding that a cause of action for aiding and abetting securities fraud cannot be inferred under Section 10(b)). The *Musick* opinion does not suggest, however, that there is any question about the existence of the implied cause of action under Rule 10(b). In *Musick*, the Court took comfort in reinforcing its conclusion that a private cause of action can be implied under the Act by two recent statutes: (1) Section 20A(d) of the Insider Trading and Securities Fraud Enforcement Act of 1988, 15 U.S.C. § 78t-1 (1993), which states that "nothing in this section shall be construed to limit or condition . . . the availability of any cause of action implied from a provision of this chapter;" and (2) 15 U.S.C. § 78aa-1, the statute designed to limit the retroactive effect of Lampf, Pleva, Lipkind, Purpis & Petigrow v. Gilbertson, 501 U.S. 350 (1991), which inferred a three-year statute of limitations period for private actions under Section 10(b). That statute set forth the applicable limitation period "for any private civil action implied under section 78j(b) of this title [§ 10(b) of the 1934 Act] that was commenced on or before June 19, 1991 [the day prior to issuance of *Lampf, Pleva*]." From these statutes, the Court inferred "an acknowledgement of the 10b-5 action without any further expression of legislative intent to define it." *Musick*, 113 S. Ct. at 2089.

> Due to the Commission's inability to address all violations, the implied private right of action under Section 10(b) and Rule 10b-5 thereunder is critically important to the effective operation of the federal securities laws. As the Supreme Court has stated repeatedly over the last thirty years, private actions under the federal securities laws are a "necessary supplement" to the Commission's own enforcement activities. Given the continued growth in the size and complexity of our securities markets, and the absolute certainty that persons seeking to perpetuate financial fraud will always be among us, private actions will continue to be essential to the maintenance of investor protection.[7]

The general support of securities regulators for the right of the plaintiffs' bar to seek enforcement of the securities laws is not surprising.[8] After all, the goal of securities plaintiffs' attor-

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[7] Testimony of William R. McLucas, Director, Division of Enforcement, Securities and Exchange Commission, *Concerning Private Litigation Under the Federal Securities Laws Before the Subcomm. on Securities, Comm. on Banking, Housing and Urban Affairs* (on file with *Brooklyn Law Review*). The same conclusions have been expressed by the state securities regulators, as reflected in the statement of a representative of the National Association of Securities Administrators Association ("NASAA"):

> NASAA believes it would be unwise, in the name of "reform," to further restrict the ability of defrauded investors to be made whole. Private rights of action under the securities laws are essential to deter prospective wrongdoers, compensate the victims of fraud, and maintain public confidence in the marketplace. No one—save those who have committed or assisted the fraud in the first place—benefits from a wholesale assault on private rights of action.

Testimony August 10, 1994 Mark Griffin, Director, Division of Securities Utah Dep't of Commerce House Energy/Telecommunications and Finance Securities Litigation, Fed. Document Clearinghouse Cong. Testimony, Aug. 10, 1994, *available in* LEXIS, Legis Library, CNGTST File [hereinafter "Griffin Testimony"]. Similar sentiments were expressed by former SEC Chairman Richard Breeden testifying in 1991 before the Senate Banking Committee, when he said that "[b]ecause the Commission does not have adequate resources to detect and prosecute all violations of the federal securities laws, private actions perform a critical role in preserving the integrity of our securities markets." *Private Securities Litigation Reform Act of 1995*, Cong. Rep. No. 104-98, 104th Cong., [Current] Fed. Sec. L. Rep. ¶ 85,629, 86,777 (June 19, 1995) [hereinafter "Report No. 104-98"].

[8] While the regulators generally oppose substantial limits on plaintiffs' actions, the SEC has expressed some concern about unnecessary shareholder litigation. In a speech to the Securities Regulation Institute in early 1994, SEC Chairman Arthur Levitt, for example, suggested that the SEC intervene in cases which it thought were frivolous and stated, "I am especially interested in ways to give shareholders greater control over their own litigation and curb potential conflicts of interest between class-action lawyers and the shareholders they represent." Christi Harlan, *SEC's Levitt Talks of Active Attempts to Curb Litigation*, WALL ST. J., Jan. 27, 1994, at B7. *See* Arthur Levitt, *Between Caveat Emptor and Caveat Ven-*

neys is to recover damages on behalf of investors for violations of the securities laws, a goal entirely consistent with the aims of the regulators. It is for this reason that courts acknowledge the legitimate role of plaintiffs acting as "private attorneys general" to enforce the securities laws.[9] The public and private sectors work together to deter misconduct and to obtain relief for aggrieved investors.

What conduct violates section 10(b), however, remains a question of some controversy, as does the means by which an appropriate section 10(b) cause of action can be pled. Indeed, the corporate world, led by large accounting firms which perceive themselves as being the prime targets of securities litigations, may soon succeed in pushing through revisions in the Act which could have the effect of severely limiting plaintiffs' suits, and make much of the current law moot. In response to aggressive lobbying by business groups,[10] and fresh from their

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dor: The Middle Ground of Litigation Reform, Remarks at the 22nd Annual Securities Regulation Institute, San Diego, California (Jan. 25, 1994). These statements, of course, were made well before the November 1994 elections and the substantial reforms proposed by the Republican Congress, reforms that go far beyond anything the SEC has ever suggested were necessary.

More recently, Levitt has reaffirmed his belief in the need for private securities actions, stating:

> Besides serving as the primary vehicle for compensating defrauded investors, private actions also provide a "necessary supplement" to the Commission's own enforcement activities by serving to deter securities law violations. Private actions are crucial to the integrity of our disclosure system because they provide a direct incentive for issuers and other market participants to meet their obligations under the securities laws.

Testimony of Arthur Levitt before the Senate Securities Subcommittee, Nov. 10, 1993, *quoted in* Report No. 104-98, *supra* note 7, at 86,777.

[9] *See, e.g.,* Bateman Eichler, Hill Richards Inc. v. Berner, 472 U.S. 299, 310 (1985) (private sector actions are a "necessary supplement" to the SEC's enforcement regime) (citation omitted).

[10] Federal Election Commission data compiled by Citizen Action, an activist consumer organization, reveals that groups lobbying for reform of the tort and securities laws donated $23 million to federal candidates for the 1994-1995 elections, with the Big Six accounting firms contributing $3.6 million of that total. In contrast, trial lawyers representing the plaintiffs' bar contributed less than $2 million during the same time period. *Reversal of Fortunes: Big Business Wins a Battle with Trial Lawyers, but the War Isn't Over,* U.S. NEWS & WORLD REP., Mar. 20, 1995, at 30. More recently, the Wall Street Journal reported that six congressmen with oversight of key committees covering securities regulation received a total of more than $5.5 million in contributions from financial services firms. *Securities Firms Make Large Gifts to Congressmen,* WALL ST. J., Aug. 22, 1995, at C1.

dominating victory in the November 1994 elections, the Republicans in Washington have recently—and precipitously—passed legislation designed to limit plaintiffs' lawsuits,[11] a goal that had been incorporated into the Republicans' highly publicized "Contract with America." As passed by the House, the amendments to the Act include a number of provisions which threaten the efficacy of existing laws, such as a modified "loser pay" rule pursuant to which a court may award a defendant attorneys' fees if it determines, following dismissal, that an action "was not substantially justified."[12] While rejecting such a stringent loser pay provision, the Senate version would require courts to make specific findings upon adjudication of a matter as to whether parties and their counsel complied with Rule 11(b) of the Federal Rules of Civil Procedure[13] and to

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[11] The Securities Litigation Reform Act, H.R. 1058, 104th Cong., 1st Sess. (1995) (passed on March 8, 1995 by a vote of 325-99) [hereinafter "H.R. 1058"]; The Private Securities Litigation Reform Act of 1995, S. 240, 104th Cong. (1995) (passed on June 28, 1995 by a vote of 69-30) [hereinafter "S. 240"]. The House and Senate leadership must now meet in conference to resolve the differences between the bills and submit a formal product to the President for signature.

[12] H.R. 1058, *supra* note 11, § 3(c)(1). The House bill also includes a number of other measures designed to limit what are perceived to be frivolous litigations, such as: (i) requiring explicit pleading of scienter, including "specific allegations which, if true, would be sufficient to establish scienter as to each defendant at the time the alleged violation occurred"; (ii) requiring that any allegedly fraudulent statement be made "knowingly or recklessly," with recklessness defined to be "an extreme departure from standards of ordinary care"; (iii) staying discovery during the pendency of a motion to dismiss; (iv) requiring a class action steering committee to be established to oversee class action securities litigation; (v) eliminating bonus payments to named plaintiffs in such actions; (vi) prohibiting a named plaintiff from serving as a class representative in more than five class actions during any three-year period; (vii) requiring plaintiffs to obtain an undertaking in an amount the court determines to be "just and equitable" towards the possible payment of attorneys fees; (viii) prohibiting brokers or dealers from soliciting or accepting payment for assisting attorneys in locating plaintiffs for class actions; and (ix) removing joint and several liability for defendants found liable only for reckless conduct.

[13] Rule 11(b) specifies that, by submitting pleadings or other matters to the courts, an attorney is certifying that, to the best of his or her knowledge, information and belief, such submissions are not being presented "for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation," that any legal contentions "are warranted by existing law or by a nonfrivolous argument for the extension, modification, or reversal of existing law or the establishment of new law," and that any factual allegations "have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation and discovery." FED. R. CIV. P. 11(b).

impose sanctions if they did not.[14] These provisions are not only unnecessary, since the courts already have a means under the existing Rule 11 to sanction frivolous pleadings by either plaintiffs *or defendants*, but they are clearly designed for only one purpose—to have an in terrorem effect on plaintiffs by discouraging the filing of litigation. The effect will be to discourage not only so-called frivolous litigation, but also meritworthy cases that plaintiffs' attorneys, who are paid only on a contingency, will not be willing to file due to the added risk imposed by the legislation.

Moreover, both the House and Senate bills would codify a "safe harbor" for "forward-looking statements" pursuant to which projections, estimates or descriptions of future events would be immune from serving as the basis for litigation so long as the party making such projections specifies that they may not be realized.[15] Thus, a company could escape liability for projections or other "forward-looking statements," even if it knew those projections were unreasonable when made and insiders earned windfalls through sales of inflated stock prices as a result. Indeed, unless a plaintiff could prove that a defendant deliberately intended to mislead *investors*, as opposed to mislead customers or competitors, or that the plaintiff lied for some other purpose, an intentionally false statement about a future event would not be subject to the securities laws.[16] Al-

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[14] Among other things, S. 240 would require plaintiffs in a securities class action to publish notice of the action to solicit class representatives. It specifies that, in selecting the class representative, a court would presume that the "most adequate plaintiff" is a member of the class "with the largest financial stake" in the litigation. Report No. 104-98, *supra* note 7, at 86,761. The bill would also require courts to stay discovery during the pendency of motions to dismiss, *id.* at 86,764, 86,771; specify pleading standards under Section 10(b) pursuant to which plaintiffs must specifically identify each misleading statement and the reasons why it is misleading and must specifically allege facts giving rise to a strong inference that the defendant acted with the required state of mind, *id.* at 86,764, 86,771; provide that joint and several liability shall only apply to "knowing"—and not reckless—securities fraud, *id.* at 86,769, 86,773; and prohibit fees to brokers for providing plaintiffs and bonuses to named plaintiffs for serving as class representatives, *id.* at 86,770.

[15] *See* H.R. 1058, *supra* note 11, § 5 (establishment of "safe harbor" for predictive statements); S. 240, *supra* note 11, § 105 (safe harbor for forward-looking statements).

[16] The sole limitation to this broad immunity, provided in the Senate bill but not the House version, would provide liability only if plaintiffs could prove that such statements were "knowingly made with the expectation, purpose, and actual

though the new legislation has been strongly criticized by securities regulators and Democratic officials,[17] and has become subject to increasingly scathing attacks in the press,[18] it now

intent of misleading investors." S. 240, *supra* note 11, § 105(c)(1). As explained in the Senate Report on the bill, "expectation," "purpose" and "actual intent" are considered to be "independent elements of the exclusion [from the immunity clause], and plaintiffs have the burden of pleading and proving each of these elements." Report No. 104-98, *supra* note 7, at 86,766. Chairman Levitt has expressed opposition to these safe harbor provisions, even with the exception provided under the Senate bill. In a May 25, 1995 letter to the Senate, he expressed his "serious concerns about the safe harbor fraud exclusion as it relates to the stringent standard of proof that must be satisfied before a private plaintiff can prevail," and warned that the standard of "knowingly made with the expectation, purpose and actual intent of misleading investors" was more stringent than that currently used by the SEC and the courts. Report No. 104-98, *supra* note 7, at 86,780-86,781 (quoting Levitt letter).

[17] Before the bill was submitted to the House for a vote, Attorney General Janet Reno and White House Counsel Abner Mikva sent a letter on March 6, 1995 to Speaker of the House Newt Gingrich warning that "certain provisions of H.R. 1058 are problematic, while others are manifestly unfair and could lead to inadequate deterrence against financial fraud." *House Amends and Passes Legislation to Reform Private Securities Litigation*, SEC. REG. & L. REP., Mar. 10, 1995, at 392. Moreover, SEC Chairman Arthur Levitt has criticized the less extreme Senate bill, finding that it does not strike "the appropriate balance between curbing abusive practices and protecting investors." *Litigation Reform Bill Criticized*, BLOOMBERG REPORT, June 5, 1995. In comments added to Senator Alfonse D'Amato's report on S. 240, Senators Paul S. Sarbanes, Richard W. Bryan and Barbra Boxer also expressed strong objections to many provisions in the Senate bill, including the safe harbor provision which "will, for the first time, provide immunity under the Federal securities laws for fraudulent statements," and the proportionate liability provision which "will, for the first time, transfer responsibility from participants to a fraud to innocent victims of that fraud." Report No. 104-98, *supra* note 7, at 86,776.

[18] *See, e.g., Bill Could Harm Fraud Policing*, A.P. NEWSWIRE, July 4, 1995, *available in* LEXIS, News Library, AP File (quotes Professor Peter Navarro of the University of California at Irvine as stating: "[T]he bill contains four provisions, any one of them on its own is a significant deterrent to litigation. . . . Taken together, they essentially amount to a neutron bomb on private litigation."); *Bills Could Make Wall Street Fraud Harder to Deter*, SEATTLE POST-INTELLIGENCER, July 5, 1995, *available in* LEXIS, News Library, BUSDTL File; Jeff Brown, *Reform? What Reform?*, PHILADELPHIA INQUIRER, June 27, 1995, *available in* LEXIS, News Library, PHI File; Judy Fahys, *Changes in Securities Laws May Harm Investors, Says Utah's Top Regulator*, SALT LAKE TRIB., Aug. 1, 1995, *available in* LEXIS, News Library, SLTRIB File; Craig T. Ferris, *Litigation Reform Can Only Get Worse*, THE BOND BUYER, July 3, 1995, *available in* LEXIS, News Library, ASAPII File (recommends a veto of the bill, even if it followed "the more moderate, but flawed, Senate version"); James D. Grisso, *Public Investments Are at a Risk*, ROANOKE TIMES & WORLD NEWS, Aug 2, 1995, *available in* LEXIS, News Library, ROANOK File ("In a direct threat to our financial markets, the U.S. Congress is being extremely reckless by proposing drastic changes to federal laws that protect us from financial scams"); Frank Lalli, *Congress Aims at Lawyers and*

appears quite likely that legislation which is extremely friendly to industry will soon become law and thereby threaten the power of Section 10(b) as a weapon for "the private attorney general." It is therefore a particularly appropriate time to examine carefully the current state of the law in order to determine whether such "reforms" are necessary and to understand their impact should they be implemented.

The Second Circuit has often interpreted Section 10(b). One recent significant example is *In re Time Warner Inc. Securities Litigation* in which the Second Circuit noted the need for courts to attempt to "balance" the interests of deterring fraud and discouraging frivolous lawsuits.[19] This Article examines the Second Circuit's attempts to provide that balance through its interpretation of Rule 9(b) of the Federal Rules of Civil Procedure.[20] In so doing, this Article also considers the need for the "reforms" reflected in the recently passed legislation.

This Article first describes how courts have used Rule 9(b) to discourage frivolous litigation by requiring particularity in the pleading of securities fraud. Next, this Article argues that through Rule 9(b) the system provides an effective means for

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Ends Up Shooting Small Investors in the Back, MONEY, Sept. 1995, *available in* LEXIS, News Library, TIME File (the legislation would "[a]llow executives to deliberately lie about their firm's prospects"); *Less Protection for Investors*, CONSUMER REP., Sept., 1995, *available in* LEXIS, News Library, CONSMR File (the proposed legislation "giv[es] corporations broad protections that are likely to free them from fear of meritorious investor lawsuits as well as curbing 'frivolous' litigation"); Gene Marlowe, *Securities Fraud Victims Out of Luck?*, TAMPA TRIB., Aug 6, 1995, *available in* LEXIS, News Library, TAMTRB File; *More Help For Financial Giants*, ATLANTA J. CONST., July 6, 1995, *available in* LEXIS, News Library, ATLJNL File; *New Security Investment 'Reform' by Congress, May Be Swindler's Protection Act*, CINCINNATI ENQUIRER, Aug 15, 1995, *available in* LEXIS, News Library, CINNQR File; Robert Reno, *GOP Betrays Constituents By Helping the Swindlers*, N.Y. NEWSDAY, June 28, 1995, *available in* LEXIS, News Library, BUSDTL File; *Safe Harbors for Financial Fraud*, THE BALTIMORE SUN, June 26, 1995, *available in* LEXIS, News Library, BALSUN File; Ben Stein, *License to Conceal*, NEW YORK, Aug 21, 1995, at 22 ("In 1995, in conjunction with the Republican-dominated Congress, the entity most harmful to the legal rights of ordinary Americans . . . was the Big Six national accounting firms."); *Stock Fraud Redefined*, WASH. POST, July 6, 1995, *available in* LEXIS, News Library, WPOST File (states that House bill, "swept through in great haste last winter, contains a number of exaggerations that would create real trouble," and notes that the Senate bill "also has substantial defects"); *Toothless Watchdog Can't Stop Investment Fraud*, USA TODAY, July 31, 1995, *available in* LEXIS, News Library, USATDY File.

[19] 9 F.3d 259 (2d Cir. 1993), *cert. denied*, 114 S.Ct. 1397 (1994).

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

deterring so-called "strike suits"—actions which are "begun 'with the hope of winning large attorney's fees or private settlements, and with no intention of benefiting the corporation [or class] on behalf of which suit is theoretically brought.'"[21] This Article then analyzes how Rule 9(b) was applied in *Time Warner*, considering the extent to which the court found the proper balance between deterring fraud and discouraging frivolous litigation. Based on this analysis, this Article concludes that the system is now overly aggressive in dealing with the potential for frivolous litigation. The holding of *Time Warner* goes too far: by reaffirming the Second Circuit's imposition of an unnecessary obligation on plaintiffs to plead scienter with some form of specificity, the court has imposed a requirement that is neither necessary nor logical. Finally, this Article evaluates the debate that has erupted over the purported need to "reform" the law of securities fraud to "protect" corporate America from what is perceived to be needless litigation. Upon closer examination of the arguments for reform, it appears that there is little empirical evidence to support substantial revisions of the status quo. This Article therefore concludes that its recommendations with respect to the pleading standards for scienter provide a principled approach to securities law without creating an unnecessary risk of meritless lawsuits.

I. The Role Of Rule 9(b) in Discouraging Frivolous Litigation

A. *The "Tension Between Two Powerful Interests"*

In *Time Warner*, the Second Circuit noted that any interpretation of Section 10(b) involves an "inevitable tension between two powerful interests."[22] In describing these "interests," the court stated:

> On the one hand, there is the interest in deterring fraud in the securities markets and remedying it when it occurs. That interest is served by recognizing that the victims of fraud often are unable to detail their allegations until they have had some opportunity to conduct discovery of those reasonably suspected of having perpetrated a

[21] Levine v. Bradlee, 378 F.2d 620, 623-24 (3d Cir. 1967).

[22] *Time Warner*, 9 F.3d at 263.

> fraud. Consistent with that interest, modern pleading rules usually permit a complaint to survive dismissal unless, in the familiar phrase, "it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief."
>
> On the other hand, there is the interest in deterring the use of the litigation process as a device for extracting undeserved settlements as the price of avoiding the extensive discovery costs that frequently ensue once a complaint survives dismissal, even though no recovery would occur if the suit were litigated to completion.[23]

The court then went on to lament the difficulties inherent in the effort to balance "these competing interests," stating that "[i]t has never been clear how [they] . . . are to be accommodated, and the adjudication process is not well suited to the formulation of a universal resolution of the tensions between them."[24] The court concluded that: "[i]n the absence of a more refined statutory standard than the vague contours of section 10(b) or a more detailed attempt at rule-making than the SEC has managed in Rule 10b-5, despite 50 years of unavailed opportunity, courts must adjudicate the precise cases before them, striking the balance as best they can."[25] In effect, the court was chiding the legislature for abdicating its responsibility to more carefully define the securities laws for the judiciary,[26] a challenge the Republican-controlled Congress has been more than happy to accept.

By emphasizing the competing goals of deterring both fraud and frivolous lawsuits, while proclaiming the inability of

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[23] *Id.* at 263 (citing Conley v. Gibson, 355 U.S. 41, 45-46 (1957)).

[24] *Id.*

[25] *Id.* at 264.

[26] For example, the court stated:

> In [striking the balance as best we can], we do well to recognize several consequences of this common law approach to what is supposed to be a statutory standard. First, our outcomes will not necessarily evolve a discernible pattern. Second, the absence of a clear pattern will inevitably create uncertainty in the fields of both securities and litigation. Third, however sensibly we strike the balance in a particular case, we will not avoid the risks of adverse consequences: in the aftermath of any ruling that upholds the dismissal of a 10b-5 suit, there will be some opportunity for unremedied fraud; in the aftermath of any ruling that permits a 10b-5 suit to progress beyond a motion to dismiss, there will be some opportunity to extract an undeserved settlement. Unattractive as those prospects are, they neither indicate a sound basis for decision nor permit avoidance of decision.

Id.

the judicial system to strike an appropriate balance, the Second Circuit in *Time Warner* assumes two propositions that—although accepted by many in the current debate over securities reform—are not necessarily accurate: first, that the courts have not already succeeded in structuring a system that provides the necessary balance; and second, that the concern over "frivolous" lawsuits is significant enough to be considered equal to the need to deter fraud. Notwithstanding the court's apparent dismay over its own limitations, an examination of the section 10(b) caselaw indicates that the judiciary has been quite successful in developing a system that effectively deters frivolous litigation while providing a means for combatting corporate fraud. Whether that success can continue under the proposed reforms is the critical question.

B. *Implementation Of Rule 9(b)*

The Supreme Court concluded over twenty years ago, in *Blue Chip Stamps v. Manor Drug Stores*,[27] that, in interpreting section 10(b), courts should be cognizant of the impact on the potential for frivolous litigation. In that case, the Court held that only purchasers or sellers of securities—as opposed to those who were discouraged from purchasing or selling—had standing under the securities laws.[28] This decision was based, in part, on consideration of the effect of broadening the class of potential plaintiffs able to bring suit under the securities laws.[29] Noting that there had been "widespread recognition

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[27] 421 U.S. 723 (1975).

[28] *Id.* at 754-55.

[29] To justify its consideration of "policy" concerns, the Court cited Title II of the 1934 Act, which amended § 11 of the 1933 Act to provide that "[i]n any suit under this or any other section of this title the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees" 421 U.S. at 740 (quoting § 206(d), 48 Stat. 881, 908). In introducing this amendment on the Senate floor, Senator Duncan Fletcher, then chairman of the Senate Banking & Finance Committee, had stated that it was designed, among other things, to provide "a defense against blackmail suits." *Id.* at 741 (quoting 78 CONG. REC. 8669). The Court then concluded:

> Where Congress in those sections of the 1933 Act which expressly conferred a private cause of action for damages, adopted a provision uniformly regarded as designed to deter "strike" or nuisance actions, that fact alone justifies our consideration of such potential in determining the limits of the class of plaintiffs who may sue in an action wholly implied

that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general,"[30] the Court explained:

> [I]n the field of federal securities laws governing disclosure of information even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment.[31]

Today, the Supreme Court maintains the same concern. In *Central Bank of Denver v. First Interstate Bank of Denver*, for example, the Court held that aiding and abetting liability could not be implied under Section 10(b), citing *Blue Chip*'s concern for the "danger of vexatiousness" in securities lawsuits, where "[l]itigation under 10b-5 . . . requires secondary actors to expend large sums even for pretrial defense and the negotiation of settlement."[32] Thus, the need to ensure that corporations are not unnecessarily subjected to frivolous lawsuits has long been recognized by the courts. It is not as if Congress is required to step in to halt an overly aggressive judiciary that is continually expanding the reach of the securities laws. If anything, just the opposite is true.

The courts have always possessed, and have been more than willing to use, the necessary tool to ensure that plaintiffs are not free to allege securities fraud against corporations without some reasonable basis. That tool is Rule 9(b), which

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from the language in the 1934 Act.

Id. at 741 (citation omitted).

[30] *Id.* at 739 (referring to Judge Friendly's statement in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 867 (2d Cir. 1968), that unduly expansive imposition of civil liability "will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers").

[31] *Id.* at 740. The Court also stated that:

> a plaintiff with a largely groundless [securities] claim [will be able] to simply take up the time of a number of other people [through discovery], with the right to do so representing an in terrorem increment of settlement value, rather than a reasonably founded hope that the process will reveal relevant evidence.

Id. at 741.

[32] 114 S. Ct. 1439 (1994). *See also* Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991) ("to recognize liability on mere disbelief or undisclosed motive without any demonstration that the proxy statement was false or misleading about its subject . . . would threaten just the sort of strike suits and attrition by discovery that *Blue Chip Stamps* sought to discourage").

specifies that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity."[33] The Second Circuit has previously recognized that a primary purpose behind Rule 9(b) is discouraging frivolous suits, stating:

> The purpose of Rule 9(b) is three-fold—it is designed to provide a defendant with fair notice of plaintiff's claim, to safeguard a defendant's reputation from "improvident charges of wrongdoing," and to protect a defendant against the institution of a strike suit.[34]

By using Rule 9(b) to ensure that every plaintiff alleges fraud with particularity, and thus that the plaintiff has a reasonable basis for bringing the action, courts can discourage the "strike suits" that so many businesses and politicians seem to fear.

The existence of Rule 9(b) by itself, of course, does not mean anything if it is not used, but the facts speak for themselves. Courts in the Second Circuit and throughout the country have used the rule aggressively to dismiss any case that does not appear to have a valid basis. As the First Circuit put it in *Romani v. Shearson Lehman Hutton*, "[w]e have been especially rigorous in demanding such factual support in the securities context to minimize the chance that a plaintiff with a largely groundless claim will bring a suit and conduct extensive discovery in the hopes of obtaining an increased settlement."[35]

To satisfy the requirements of Rule 9(b), a complaint must "(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when

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

[34] O'Brien v. National Property Analysts Partners, 936 F.2d 674, 676 (2d Cir. 1991) (citations omitted); *see also* Denny v. Barber, 576 F.2d 465, 469 (2d Cir. 1978). *Denny* has frequently been cited in explaining the importance of Rule 9(b) in discouraging groundless litigation. *See, e.g.,* Arazie v. Mullane, 2 F.3d 1456, 1465 (7th Cir. 1993); Ross v. Bolton, 904 F.2d 819, 823 (2d Cir. 1990); DiVittorio v. Equidyne Extractive Indus., Inc., 822 F.2d 1242, 1247 (2d Cir. 1987); *In re* Ramada Inns Sec. Litig., 550 F. Supp. 1127, 1132 (D. Del. 1982); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Del Valle, 528 F. Supp. 147, 149 (S.D. Fla. 1981).

[35] 929 F.2d 875, 878 (1st Cir. 1991) (citations omitted). *See also* Kowal v. MCI Communications Corp., Civ.A.No. 90-2862, 1992 WL 121378, at *7 (D.D.C. May 20, 1992), *aff'd*, 16 F.3d 1271 (D.C. Cir. 1994) ("Rule 9(b). . . obligates the Court to police such allegations with heightened scrutiny, in order to protect defendants from harm to their reputation and goodwill and to reduce the number of strike suits." (citing DiVittorio v. Equidyne Extractive Indus., Inc., 822 F.2d 1242, 1247 (2d Cir. 1987).

the statements were made, and (4) explain why the statements were fraudulent."[36] In other words, plaintiffs must allege "the who, what, when, where, and how" of the fraud.[37] In applying these requirements, courts have freely dismissed complaints where the plaintiffs have failed to allege fraud with sufficient particularity, by, for example, asserting "mere conclusory allegations to the effect that defendant's conduct was fraudulent or in violation of Rule 10b-5,"[38] or that the defendant corporation's representations presented a "false, misleading, and inflated picture of assets, earnings, and business" without sufficient explanation as to how or why such representations were false.[39]

Courts have been especially aggressive in dismissing cases that merely plead "fraud by hindsight," i.e., that claim that because a company's projections turned out to be wrong, they "must have been" fraudulent.[40] Thus, for example, complaints

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[36] Acito v. Imcera Group, Inc., 47 F.3d 47, 51 (2d Cir. 1995) (quoting Mills v. Polar Molecular Corp., 12 F.3d 1170, 1175 (2d Cir. 1993)); *see also* Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1127-28 (2d Cir. 1994) (same); Cosmas v. Hassett, 886 F.2d 8, 11 (2d Cir. 1989) (under Rule 9(b) a complaint must "adequately specify the statements it claims were false or misleading, give particulars as to the respect in which plaintiff contends the statements were fraudulent, state when and where the statements were made, and identify those responsible for the statements") (citing Goldman v. Belden, 754 F.2d 1059, 1069-70 (2d Cir. 1985)); CHARLES A. WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1241 (2d ed. 1990) (to avoid dismissal, there "must be detailed . . . averments such as the time, the place, the identity of the parties involved, and the nature of the fraud").

[37] DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir.), *cert. denied*, 498 U.S. 941 (1990); *see also In re* Abbott Lab. Sec. Litig., 813 F. Supp. 1315, 1318 (N.D. Ill. 1992).

[38] Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 444 (2d Cir. 1971). *See also* Farlow v. Peat, Marwick, Mitchell & Co., 956 F.2d 982, 989 (10th Cir. 1992); Moore v. Kayport Package Express, Inc., 885 F.2d 531, 540 (9th Cir. 1989); Segal v. Gordon, 467 F.2d 602 (2d Cir. 1972).

[39] Decker v. Massey-Ferguson, Ltd., 681 F.2d 111, 115 (2d Cir. 1982). *See also* Roots Partnership v. Lands' End, Inc., 965 F.2d 1411, 1418-19 (7th Cir. 1992) (plaintiff "alleged no facts suggesting that the problems were significant enough to jeopardize previously stated financial goals, and . . . did not state with specificity what the operational goals were"); Havsy v. Just Toys, Inc., No. 93 Civ. 8077, 1994 U.S. Dist. LEXIS 9882 (S.D.N.Y. July 20, 1994) (plaintiffs could not demonstrate that the defendants "knew or should have known [the alleged misrepresentations] to be false at the time they were made") (citing Schwartz v. Novo Industri, A/S, 658 F. Supp. 795, 799 (S.D.N.Y. 1987)).

[40] Denny v. Barber, 576 F.2d 465, 469 (2d Cir. 1978) (holding that the defendants' failure to foresee New York City's financial collapse was merely "fraud by hindsight" and thus did not constitute a fraud under the securities laws);

that allege that "substantial increases in loan loss reserves provide factual support for a claim that earlier statements of adequate reserves were fraudulent . . . have not survived scrutiny under Rule 9(b),"[41] nor have cases which fail "to show that defendants' opinions and projections were issued 'without reasonable genuine belief.'"[42] As explained by the Seventh Circuit:

> The story in this complaint is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less than rosy. The plaintiff contends that the difference must be attributed to fraud. 'Must be' is the critical phrase, for the complaint offers no information other than the differences between the two statements of the firm's condition. Because only a fraction of financial deteriorations reflect fraud, plaintiffs may not proffer the different financial statements and rest. Investors must point to some facts suggesting that the difference is attributable to fraud. Rule 9(b) required the district court to dismiss the complaint, which discloses none of the circumstances that might separate fraud from the benefit of hindsight.[43]

Thus, concern that plaintiffs can "extort" settlements by bringing suit every time a stock price falls because of disappointing results is unwarranted. Courts will not allow such conclusory allegations of fraud by hindsight to withstand a motion to dismiss.

Similarly, courts have refused to find defendants liable for projections or estimates that, although ultimately proven to be

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Arazie v. Mullane, 2 F.3d 1456, 1465 (7th Cir. 1993) (unhappy investors may not simply proffer the fact that the defendant company's financial results differed from the earlier-offered projections (as described in *In re* Healthcare Compare Corp. Sec. Litig., No. 93C 1970, 1995 U.S. Dist. LEXIS 1733, at *5 (N.D. Ill. Feb. 13, 1995)); Lindner Dividend Fund, Inc. v. Ernst & Young, 880 F. Supp. 49, 59 (D. Mass. 1995) ("The mere allegation of later substantial increases in loan loss reserves does not provide adequate factual support for a claim that earlier statements of adequate reserves may be attributable to fraud or misrepresentation . . . . There is no 'fraud by hindsight.'" (citing *Denny*, 576 F.2d at 470)).

[41] *Lindner Dividend Fund*, 880 F. Supp. at 58 (citing Driscoll v. Landmark Bank for Sav., 758 F. Supp. 48, 53 (D. Mass. 1991) ("Plaintiff's allegations of [defendant's] insufficient loan loss reserves . . . are all so conclusory in nature that they could easily apply to any bank in New England."); Vachon v. BayBanks, Inc., 780 F. Supp. 79, 80-82 (D. Mass. 1991) (first quarter loss and doubling of reserves did not indicate that earlier statements were the result of fraud).

[42] Hershfang v. Citicorp, 767 F. Supp. 1251, 1257 (S.D.N.Y. 1991) (quoting Herskowitz v. Nutri/System, Inc., 857 F.2d 179, 184 (3d Cir. 1988)).

[43] DiLeo v. Ernst & Young, 901 F.2d 624, 627-28 (7th Cir.), *cert. denied*, 498 U.S. 941 (1990).

incorrect, were "tempered by warnings of risk," pursuant to the so-called "bespeaks caution doctrine."[44] As one district court recently explained "[t]he bespeaks caution doctrine . . . provides that where the totality of statements is generally cautious, and projections are tempered by warnings of risks, those statements are not actionable."[45] Both through refusing to recognize fraud by hindsight and by implementing the bespeaks caution doctrine, courts have effectively enforced the safe harbor that the SEC has created for good faith forecasts. Pursuant to this safe harbor, the SEC has declared that a forward-looking statement "shall be deemed not to be a fraudulent statement . . . unless it is shown that such statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith."[46]

From an empirical basis, there is no question that courts have frequently used Rule 9(b) to dismiss securities actions. And with the large number of Reagan appointees dominating the federal judiciary,[47] as well as the increasing public disdain

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[44] Havsy v. Just Toys, Inc., No. 93 Civ. 8077, 1994 U.S. Dist. LEXIS 9882, at *8 (S.D.N.Y. July 20, 1994).

[45] *Id.* at *10; *see also* Romani v. Shearson Lehman Hutton, 929 F.2d 875 (1st Cir. 1991); Meyer Pincus & Assoc. v. Oppenheimer & Co., 936 F.2d 759 (2d Cir. 1991); *In re* Donald Trump Casino Sec. Litig., 7 F.3d 357 (3d Cir. 1993); Sinay v. Lamson & Sessions Co., 948 F.2d 1037 (6th Cir. 1991); Moorhead v. Merrill Lynch, 949 F.2d 243 (8th Cir. 1991); *In re* Worlds of Wonder Sec. Litig., 35 F.3d 1407 (9th Cir. 1994); Sable v. Southmark Corp., 819 F. Supp. 324, 335 (S.D.N.Y. 1993); Hayden v. Feldman, 753 F. Supp. 116, 120 (S.D.N.Y. 1990).

[46] SEC Rule 175(a), 17 C.F.R. § 230.175(a) (1994). *See* Krim v. BancTexas Group, Inc., 989 F.2d 1435, 1446 (5th Cir. 1993) (Rule 175 protects companies from liability for forward-looking statements "even if in hindsight [they are] shown to have been incorrect, as long [as they were] made or reaffirmed with a reasonable basis in fact and in good faith."); Kowal v. MCI Communications Corp., 16 F.3d 1271, 1278-79 (D.C. Cir. 1994) (complaint "failed to set forth sufficient facts to suggest that [the defendant's] optimistic statements and earnings projections lacked a reasonable basis").

While the SEC rule and the judicially-created "bespeaks caution" doctrine still require companies to have a reasonable basis for their projections, the new legislation passed by the House would remove that requirement, effectively immunizing companies from liability for all forward-looking statements, regardless of whether there was a reasonable basis for them. *See infra* note 59 and accompanying text.

[47] During Reagan's eight years in office, he appointed three members to the Supreme Court, 89 of the then 168 circuit court judges (51%) and 291 of the then 575 district court judges (51%). *Summing Up Reagan's Impact on the United States*, THE ASSOCIATED PRESS, Jan. 15, 1989, *available in* LEXIS, News Library, AP File. In describing the impact of Reagan on the United States, a representative of the conservative Washington Legal Foundation stated that "a more conser-

for lawyers and litigation in general, this trend is not likely to stop. A report of the Big Six accounting firms, for example, concluded that, between 1990 and 1992, more than thirty-three percent of the securities law cases filed against them were dismissed,[48] while the Securities Industry Association has reported that in 1992 forty-six motions to dismiss were filed, of which twenty-nine, or sixty-three percent, were successful.[49] Although proponents of further limiting securities actions may protest either that plaintiffs can merely refile complaints after initially being dismissed (which, of course, the court can then dismiss again if they are inadequate) or that the number of dismissals demonstrates the number of meritless suits that have been filed,[50] this nevertheless demonstrates that courts are taking an active role in policing litigation to ensure that suits without reasonable claims are weeded out.

Given a conservative federal bench that is active in dismissing cases that do not satisfy ever-more strict pleading requirements, there appears to be no real need to reform the laws to further restrict access to the courts. The current effort

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vative federal judiciary is 'one of his more enduring legacies,' while a representative of the liberal Alliance for Justice stated that Reagan's 'appointees generally have been white, pro-business, with little respect for individual rights.'" *Id. See also* Marcia Coyle, *The Judiciary: A Great Right Hope*, NAT'L L.J., April 18, 1988, *available in* LEXIS, News Library, NTLAWJ File ("They are predominantly white, male and wealthy—the embodiment of conservative expectations. And though their impact is only beginning to be seen, Reagan judges are transforming the federal judiciary in ways that will be felt for years to come."). Reagan and Bush together appointed over 62% of the total federal judges in the country (484 of the 777 occupied seats as of January 1995). *Clinton Judge Picks Praised*, AP ONLINE, Jan. 19, 1995, *available in* LEXIS, News Library, AP File. There is little doubt that these conservative appointments have had—and will continue to have—a significant effect on the interpretation of the federal securities laws.

[48] *Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing & Urban Affairs*, 103d Cong., 1st Sess. 280 (1993), at 734 [hereinafter "*Sen. Hearings*"] (letter to Senate Securities Subcommittee from Mayer, Brown & Platt, Sept. 24, 1993), *cited in* Joel Seligman, *Commentary: The Merits Do Matter*, 108 HARV. L. REV. 438, 457 n.34 (1994). The report stated that the Big Six accounting firms had been sued 129 times and had succeeded in dismissing 43 cases.

[49] *Sen. Hearings*, *supra* note 48, at 549 (letter from Marc E. Lackritz, President, Securities Industry Association).

[50] Of course, a strong argument can be made that just because a case is dismissed does not mean that the case was without merit. It may merely mean that proof of the fraud was within the hands of the defendants, preventing the plaintiff from pleading a valid fraud case with sufficient particularity to meet the pleading requirements of Rule 9(b).

to reform the securities laws is primarily a result of potential defendant corporations taking advantage of a trend towards conservatism. Their motivation may have more to do with the inconvenience of complying with the securities laws than any real concern over the adverse impacts of having to respond to truly frivolous litigation. As this discussion demonstrates, rule 9(b) provides a potent tool which the courts freely use to ensure that plaintiffs are unable to pursue actions which do not have a reasonable basis. This is exemplified by the manner in which the Second Circuit applied the rule in *Time Warner*, substantially limiting the plaintiffs' cause of action. As argued below, however, the court's application of existing law also reveals some of the weaknesses of the current pleading standards.

II. APPLICATION OF RULE 9(B) IN *TIME WARNER*

In *Time Warner*, the company was sued for misrepresenting the potential success of its campaign to locate international "strategic partners" who could provide a necessary infusion of capital to offset the substantial debt incurred in the acquisition of Warner Communications, Inc. by Time Inc. in 1989. Plaintiffs alleged that, while failing to disclose that this search was likely to be unsuccessful, Time Warner was instead contemplating a new stock offering as an alternative method for raising capital.[51] When the stock offering was announced, it led to a substantial decline in the price of Time Warner stock, based at least in part on the fact that the stock offering would result in a dilution of the rights of the existing shareholders.[52]

A. *The Alleged Misrepresentations and Omissions*

After the case was dismissed by the district court, it was appealed to the Second Circuit, which considered three issues:

> (1) whether a corporation has a duty to update somewhat optimistic predictions about achieving a business plan when it appears that the plan might not be realized, (2) whether a corporation has a duty to disclose a specific alternative to an announced business plan

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[51] *Time Warner*, 9 F.3d at 262.

[52] *Id.*

when that alternative is under active consideration, and (3) whether a corporation is responsible for statements in newspapers and security analyst reports that are attributed to unnamed corporate personnel.[53]

Taking the last issue first, the court held that unattributed statements reported by the press and analysts, some of which admittedly would "bolster plaintiffs' case considerably,"[54] were insufficient to satisfy the particularity requirement of Rule 9(b), concluding that Rule 9(b) requires, "at a minimum, that the plaintiff identify the speaker of the allegedly fraudulent statements."[55] In reaching this decision, the court noted that "[j]ust as 10b-5 litigation, however resolved, risks adverse consequences," such as an unremedied fraud, "a strict application of Rule 9(b) in the context of unattributed statements also risks unfortunate effects," including the possibility that "[a] scheming corporation could inflate its stock price through fraudulent statements whispered to reporters or analysts."[56] The court concluded, however, that "this is not a sufficiently likely scenario to justify a rule that would permit a suit alleging unattributed statements to survive a motion to dismiss," given that "[f]ew reporters or analysts would knowingly abet a fraud, and many will detect and reveal a corporation's efforts to use them as a channel for fraudulent statements," and that "investors tend to discount information in newspaper articles and analyst reports when the author is unable to cite specific, attributable information from the com-

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[53] *Id.* at 261.

[54] *Id.* at 264.

[55] *Id.* at 265. The court distinguished various cases that permitted claims based on statements attributed to corporate "spokespersons" or otherwise instigated by the company, pointing out that they involved official press releases or offering statements, *see* DiVittorio v. Equidyne Extractive Indus., 822 F.2d 1242, 1247 (2d Cir. 1987) and *In re* Ann-Taylor Stores Sec. Litig., 807 F. Supp. 990, 1004 (S.D.N.Y. 1992); statements by named individuals to analysts or reporters, *see* Cytryn v. Cook, Fed. Sec. L. Rep. (CCH) ¶ 95,409 (N.D. Cal. July 2, 1990) and *In re* Columbia Sec. Litig., 747 F. Supp. 237, 245 (S.D.N.Y. 1990); and cases involving the defendant's placing its "imprimatur" on analysts' reports, *see* Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 163-64 (2d Cir. 1980) and Alfus v. Pyramid Technology Corp., 764 F. Supp. 598, 603 (N.D. Cal. 1991). According to the court in *Time Warner*, "[n]one of these cases sanctions the pleading of fraud through completely unattributed statements, even when the plaintiff alleges on information and belief that the unattributed statement was made by an agent of the defendant." *Time Warner*, 9 F.3d at 265.

[56] *Time Warner*, 9 F.3d at 265.

pany."[57]

With respect to whether Time Warner had made affirmative misrepresentations concerning the likelihood that its effort to find strategic partners would succeed, the court sustained the district court's finding that the statements were not actionable. Noting that the statements in question merely involved Time Warner's representations that "talks were ongoing" and that the company "hopes the talks will be successful," the court concluded that "[t]here is no suggestion that the factual assertions contained in any of these statements were false when the statements were made."[58] Thus, while defendants may have made optimistic statements concerning their intentions with respect to strategic partners, there was nothing to indicate that, at the time the statements were made, the defendants did not have a reasonable basis for holding such beliefs.

The court also reviewed two types of nondisclosures in *Time Warner*. Noting that "a duty to update opinions and projections may arise if the original opinions or projections have become misleading as a result of intervening events,"[59] the court held that the statements regarding the potential success of the search for strategic partners "lack[ed] the sort of definite positive projections that might require later correction," adding:

> The statements suggested only the hope of any company, embarking on talks with multiple partners, that the talks would go well. No identified defendant stated that he thought deals would be struck by a certain date, or even that it was likely that deals would be struck at all. . . . These statements did not become materially misleading when the talks did not proceed well.[60]

Although it dismissed these allegations of failure to up-

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[57] *Id.*

[58] *Id.* at 266.

[59] The recently passed House bill would remove any question about this duty, as it provides that "[i]n any private action arising under this title, no person shall be deemed to have any obligation to update a forward-looking statement made by such person unless such person has expressly and substantially contemporaneously undertaken to update such statement." H.R. 1058, *supra* note 11, § 5(c).

[60] *Time Warner*, 9 F.3d at 267. The court contrasted the situation in *Time Warner* to that in *In re* Apple Computer Securities Litigation, 886 F.2d 1109, 1118-19 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990), where the Chairman of the Board had stated, among other things, that a new computer product would be "phenomenally successful the first year out of the chute."

date, the court went on to find that a valid claim had been made against Time Warner for its failure to disclose that strategic alliances were not the only option it was pursuing. The company should have acknowledged that it was also contemplating a new stock offering to raise the necessary capital. In contrast to the optimistic references to ongoing negotiations, which the court found to be an inadequate basis for reliance by investors, the court held that it was reasonable for the investor to have relied on the representation that the company was pursuing only one strategy, particularly where the pursuit of a second strategy could have substantially different effects on the company's shareholders.[61]

In explaining its decision, the court stated that while an omission is only actionable when there is "a duty to disclose the omitted facts," such a duty can arise "from the combination of a prior statement and a subsequent event, which, if not disclosed, renders the prior statement false or misleading," thereby causing the inquiries as to duty and materiality to "coalesce."[62] Citing to the Supreme Court's conclusion that undisclosed information is material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information available," the Second Circuit found that "[i]f a reasonable investor would so regard the omitted fact, it is difficult to imagine a circumstance where the prior statement would not be rendered misleading in the absence of the disclosure."[63]

With respect to the omitted fact in *Time Warner*, the court concluded:

> A duty to disclose arises whenever secret information renders prior public statements materially misleading, not merely when that in-

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[61] Explaining the different effects of the two strategies, the court stated:

> A successful strategic alliance, simultaneously opening strategic markets and reducing debt, would have improved the corporation's expected profit stream and should have served to drive up the share price. An offering of new shares, in contrast, would dilute the ownership rights of existing shareholders, likely decrease dividends, and drive down the price of the stock.

Time Warner, 9 F.3d at 267.

[62] *Id.*

[63] *Id.* at 268 (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

> formation completely negates the public statement. Time Warner's public statements could have been understood by reasonable investors to mean that the company hoped to solve the *entire* debt problem through strategic alliances. Having publicly hyped strategic alliances, Time Warner may have come under a duty to disclose facts that would place the statements concerning strategic alliances in a materially different light.[64]

It then went on to stress that it was not requiring a corporation to disclose every fact in its possession that might affect the price of its stock whenever it spoke, but rather that "when a corporation is pursuing a specific business goal and announces that goal as well as an intended approach for reaching it, it may come under an obligation to disclose other approaches to reaching the goal when those approaches are under active and serious consideration."[65]

Although the court permitted the plaintiffs' claim to survive, by upholding a cause of action based on Time Warner's failure to disclose the intended stock offering, the decision nevertheless eliminated most of the plaintiffs' allegations and substantially reduced the class period. The plaintiffs had initially filed suit on behalf of a putative class of all stockholders who had acquired Time Warner stock between December 12, 1990, when the company first began announcing its plan to seek strategic partners as a means for dealing with its substantial debt, and June 7, 1991, when it announced the stock offering and the price fell. But by limiting the action solely to the undisclosed offering, the court reinstated claims only for the nondisclosure of the rights offering between May 1, 1991 and June 6, 1991, cutting what had been a six-month class period down to slightly more than one month.[66] As a result, it can hardly be considered a pro-plaintiff decision. Nevertheless, since it did permit at least some claims to survive, it has already been criticized as being too lenient toward the plaintiffs.[67] An analysis of the decision, however, does not support that conclusion.

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[64] *Id.*

[65] *Id.*

[66] *Id.* at 271 n.8. The plaintiffs asserted that they could allege that the rights offering was under consideration as early as November 1990. *Id.* at n.7. If so, they might be able to submit an amended complaint and thereby gain back much of the class period that they lost.

[67] *See infra* note 109 and accompanying text.

1. Unattributed Statements

In ruling as a matter of law that unattributed statements cannot be raised as part of a claim under the securities laws, the court was trying to strike a balance between deterring fraud that might arise through such statements and discouraging frivolous lawsuits based on such statements. In the context of the case, however, its decision seems unnecessarily restrictive. If a company did in fact manipulate the market by leaking false information to the press which reported it without attribution, the company should nevertheless be held accountable under the securities laws. The burden on the plaintiff should be to identify sufficiently what information the defendant disseminated to the press and to articulate a reasonable basis for believing that information came from the defendant.[68] In *Time Warner*, that burden seems to have been met by the fact that the unattributed statements are entirely consistent with statements admittedly disseminated to the market by the company.

There was no dispute that Time Warner was making numerous representations throughout the class period concerning the existence of ongoing talks between the company and potential foreign investors about the possibility of entering into joint ventures. Such representations were specifically quoted by the court.[69] The unattributed statements, also quoted in detail in the decision,[70] parallel public statements by the company, discussing and highlighting the same issues. Therefore the plaintiff did not merely assume that the company was "whispering" its fraudulent statements to the press in hopes of avoiding attribution. To the contrary, the alleged facts suggest that the

[68] The court's reasoning that the press or analysts would not willingly abet a fraud and would uncover it, *Time Warner*, 9 F.3d at 265, seems overly optimistic. Reporters or analysts in whom a company confides are seeking to beat their competitors to the punch by disclosing previously unreported matters. Their close ties to companies are therefore crucial to their success and, as such, they cannot be viewed as entirely independent—certainly not as a replacement for strongly enforced securities laws. Similarly, the court's suggestion that investors will simply "discount" unattributed information from a company, *id.*, also seems too cavalier, since the market often moves based on rumors and expectations about a company's prospects.

[69] *Id.* at 266 n.3.

[70] *Id.* at 264 n.2.

company was willingly and aggressively representing the status of its discussions. Accordingly, it could easily be inferred by a factfinder that the unattributed statements did indeed result from communications by company representatives with the media and analysts. In these circumstances, it was not unreasonable to permit the unattributed statements to be at issue, at least for purposes of discovery, assuming that the alleged misstatements and omissions were sufficient to state a valid cause of action under Section 10(b) and Rule 9(b).[71]

There should be little concern that this interpretation of Rule 9(b) requirements would lead to a rash of meritless suits. To satisfy the rule there would have to be a reasonable basis for attributing the statements to the defendant, such as here where there was a demonstrable link between the unattributed statements to those admittedly made by defendants. Moreover, the statements taken as a whole would have to support a valid claim. In fact, permitting the unattributed statements to be considered in *Time Warner* would probably not have affected the outcome in any event, since both the attributed and unattributed statements related only to discussions of the company's aspirations for strategic partners, the type of forward-looking statements that the court had refused to accept as a valid basis for litigation.[72] The court therefore unnecessarily limited possible claims arising from statements that, although unattributed, could nevertheless reasonably be inferred to have been made by a defendant corporation.

2. Affirmative Representations

In finding that the representations regarding the search for strategic partners did not sustain a cause of action, the court fairly applied the generally recognized rule that expressions of opinion and projections are only actionable if plaintiffs can allege sufficient facts "to support the inference that the defendants either did not have these favorable opinions on future prospects when they made the statements or that the

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[71] The court did not reach this latter issue in *Time Warner* since it held that the unattributed statements were not actionable. *Id.* at 266.

[72] *Id.* at 267.

favorable opinions were without a basis in fact."[73] After all, if a party has a reasonable basis for making projections, he should not be liable if those projections ultimately do not come to pass. The conclusion to draw from the Second Circuit's application of this rule in *Time Warner* is that courts are quite capable of dismissing claims based on forward-looking statements that do not properly allege fraud. Therefore, there is little reason to legislate additional protections for defendants who make such statements.[74]

The court also properly recognized the distinction between the generally positive assertions regarding the strategic partners, which were not actionable, and the deliberate omission of the material fact that Time Warner was also considering a stock offering—a valid basis for a cause of action. The court's ruling with respect to the duty to update has become the source of some controversy. The concern is that this rule might deter companies from speaking at all because they will have to be concerned about liability arising from future changes.[75] Here, however, the obligation placed on companies makes sense. The optimistic representations concerning the search for strategic partners were not definitive statements concerning expected results, but merely optimism expressed about events that any reasonable investor should realize might not come to

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[73] *Id.* at 266

[74] If the assumption made in the recently passed legislation is that a company should not be liable for a forward-looking statement even if it is made with absolutely no basis, the rule articulated in *Time Warner* is insufficient. *See, e.g., supra* note 59 and accompanying text. It is hard to imagine a valid justification for immunity from liability in such circumstances. Yet that is effectively what the legislation would provide.

[75] *See, e.g.*, Carl W. Schneider, *The Duty To Update: Time Requires A Reevaluation Of Basics*, INSIGHTS 2 (April 1994), *available in* LEXIS, News Library, INSITE File ("A significant tension exists, because an overly broad application of the duty to update may be counterproductive to the goal of encouraging voluntary prompt disclosure."); Gordon Jones II, Comment, In re Time Warner, Inc. Securities Litigation: *The Second Circuit Revisits Rule 10b-5—The Duties To Correct, Update And Disclose Alternative Business Plans*, 28 GA. L. REV. 1019, 1043 (1994) ("The Second Circuit may have acted too hastily in [*Time Warner*] and perhaps did not fully consider the effect this ruling will have on corporations in the future. The court's holding will require corporations to reveal various strategic alternatives merely because they disclosed one possible approach. As the district court warned, corporations now face an 'excessive burden of either never to comment on their plans or never to be free to evaluate alternate strategies without exposing most if not all of their deliberations to public scrutiny.'").

pass. Thus, these representations created no valid claim under the securities laws. In contrast, any company should recognize that it is improper to publicize a particular strategy that has a positive effect on stock prices while, at the same time, actively pursuing an alternative strategy that could well have the opposite effect on the market. In short, if you are going to speak, do not do so in a way that is clearly misleading. The court here simply held that plaintiffs had set forth a valid claim under that rule. Although it is true that this ruling might deter some forms of corporate speech, it is appropriate to do so if that speech could be used to mislead.

B. *Scienter*

As an alternative basis for dismissing the complaint, the district court also concluded that plaintiffs had failed to plead scienter with sufficient particularity. The Second Circuit reversed this holding as well, finding that plaintiffs had met the pleading standards.

While fraud must be pled with particularity under Rule 9(b), the rule expressly provides that "malice, intent, knowledge, and other condition of mind of a person may be averred generally."[76] The relaxed pleading requirement for scienter is predicated on the notion that "a plaintiff realistically cannot be expected to plead a defendant's actual state of mind."[77] Despite Rule 9(b)'s specification that intent, or scienter, can be "averred generally," however, the Second Circuit has nevertheless imposed a stricter pleading requirement for scienter, requiring a pleading to pass what has become known as the "strong inference" test.[78]

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

[77] Connecticut Nat'l Bank v. Fluor Corp., 808 F.2d 957, 962 (2d Cir. 1987) (citing Ross v. A.H. Robins Co., 607 F.2d 545, 558 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980)).

[78] S. 240 would codify this pleading standard, noted by Senator D'Amato as being the "most stringent pleading standard" applied by the courts. Report No. 104-98, *supra* note 7, at 86,764 (citing *Time Warner*, 9 F.3d at 268). The House bill would go even further, requiring "specific allegations which, if true, would be sufficient to establish scienter as to each defendant at the time the alleged violation occurred." H.R. 1058, *supra* note 11, § 4. The bill further provides that "[i]t shall not be sufficient for this purpose to plead the mere presence of facts inconsistent with a statement or omission alleged to have been misleading." *Id.*

This test was first articulated in *Ross v. A.H. Robins Co.*, when the court held that "plaintiffs can be required to supply a factual basis for their conclusory allegations regarding [a defendant's] knowledge" of the alleged fraud.[79] The court concluded that "it is reasonable to require that plaintiffs specifically plead those events that they assert give rise to a *strong inference* that the defendants had knowledge of the facts contained in . . . the complaint or recklessly disregarded their existence."[80] The Second Circuit has articulated two means by which this standard can be satisfied. Plaintiffs can either "allege facts establishing a motive to commit fraud and an opportunity to do so," or can "allege facts constituting circumstantial evidence of either reckless or conscious behavior."[81]

In applying the strong inference test in *Time Warner*, the court analyzed the potential motive and opportunity for defendants to commit the alleged fraud. Dismissing the need to focus on opportunity, given that "no one doubts that the defendants had the opportunity, if they wished, to manipulate the price of Time Warner stock,"[82] the court focused its attention on the defendants' motive. The court explained that it was a close question "whether the defendants [were] adequately alleged to have had a motive to benefit from the nondisclosure [of the stock offering], thereby satisfying the scienter requirement."[83]

According to the plaintiffs, Time Warner had an incentive not to disclose its consideration of the stock offering. By keeping the planned offering secret, the company could keep the price of the common stock artificially high and thereby lessen

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[79] 607 F.2d 545, 558 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980).

[80] *Id.* (emphasis added). A number of subsequent decisions by the Second Circuit, including *Time Warner*, have applied this requirement leading to the frequent dismissal of cases for the failure to plead sufficient facts from which scienter can be "strongly inferred." *Id.* at 268; *see also* O'Brien v. National Property Analysts Partners, 936 F.2d 674, 676 (2d Cir. 1991); Wexner v. First Manhattan Co., 902 F.2d 169, 172 (2d Cir. 1990); Cosmas v. Hassett, 886 F.2d 8, 12-13 (2d Cir. 1989); Beck v. Manufacturers Hanover Trust Co., 820 F.2d 46, 50 (2d Cir. 1987), *cert. denied*, 484 U.S. 1005 (1988); Stern v. Leucadia Nat'l Corp., Inc., 844 F.2d 997, 1004 (2d Cir. 1988) ("[C]ircumstances must be pleaded that provide a factual foundation for otherwise conclusory allegations of scienter."); *Connecticut Nat'l Bank*, 808 F.2d at 962.

[81] *Time Warner*, 9 F.3d at 269 (citing *Beck*, 820 F.2d at 50).

[82] *Id.* at 269.

[83] *Id.* at 270.

the dilutive effect of the offering once it was implemented. In response, the defendants argued that such a motive was "facially irrational," since any increase in the price would be lost as soon as the offering was announced, thereby losing any benefit that might have been achieved by not disclosing the plan earlier.[84] Explaining the motive theory of the case, the court stated:

> The unresolved issue is whether the effects of the alleged artificial raising of the stock price by the combination of the glowing reports of potential strategic alliances and the nondisclosure of the active consideration of a rights offering could reasonably have been expected by the company not to have been completely dissipated by the announcement of the rights offering, thereby enabling the company to set the rights offering price somewhat higher than would have been possible without the misleading statements and to lessen the dilutive effect of the offering.[85]

For the plaintiffs' theory to work, Time Warner had to hope that the stock price inflation caused by its omission of material facts would not be lost entirely once those facts were disclosed, thereby permitting the company to raise more capital through its offering with less stock.

The Second Circuit ultimately accepted the plaintiffs' rationale, finding that "a motive theory emerges with sufficient reasonable possibilities to withstand a motion to dismiss."[86] In reaching this decision, the court noted the normal assumption under the securities laws that an "efficient market" can adequately absorb information released to the public, but distinguished the market's ability to correct for misrepresentations: "however efficiently markets may be thought to work when disclosures are proper, it is not beyond doubt that they may not *fully* correct for prior misleading information."[87]

After finding that plaintiffs had alleged a sufficient motive to withstand a motion to dismiss, the court went on to hold that this provided their only means for alleging scienter. There

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[84] *Id.* at 269

[85] *Id.* at 270.

[86] *Id.* at 270.

[87] *Time Warner*, 9 F.3d at 270. The court went on to explain that "the issue is not whether the misleading aspect of the prior statement in fact lingered; it is only whether the plaintiffs can show that the defendants had a motive not to promptly correct the misleading aspect of the prior statement." *Id.* at 270-71.

was no "circumstantial evidence of conscious or reckless behavior," because "the complaint lacked allegations that could give rise to a strong inference that Time Warner began to consider the stock offering significantly before it was announced."[88]

In a strong dissenting opinion, Judge Winter argued that the complaint should have been dismissed in its entirety. He did so, however, based solely on his belief that plaintiffs did not adequately allege scienter, as he agreed that Time Warner had a duty to disclose the stock offering. With respect to the duty to disclose, Judge Winter explained that the stock offering at issue in the case was not a standard offering pursuant to which the company merely offered more of its stock to the public for sale. Rather, it was a "variable-price rights offering" which was restricted to existing shareholders.[89] By so restricting the offer, according to Judge Winter, Time Warner disclosed for the first time "that outside capital was not available," with "the only source of capital available for the debt payments . . . the locked-in shareholders of Time Warner who might lose all if the company defaulted on the debt."[90] As a result, Judge Winter concluded that Time Warner should have disclosed its plans to conduct the offering:

> [T]he variable-price rights offering was dilutive but in a very different sense from that indicated by my colleagues. If all shareholders exercised their rights, each would purchase one new share for $105. If only 60% exercised the rights, those shareholders would purchase 1-2/3 shares for $63. As alleged in the complaint, therefore, the offering was coercive because shareholders hoping to minimize their losses would feel compelled to come up with fresh money. Unlike an infusion of capital from outside that would dilute but also benefit shareholders, this new issue of equity would necessarily lessen the value of the common shares because existing shareholders had either to put up more money or to incur a disproportionate loss in

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[88] *Id.* at 271. The court, however, did note that plaintiffs might be able to meet this standard as well if they could amend their complaint to allege sufficient evidence that defendants had begun to consider the rights offering some time before it was announced. *Id.*

[89] *Id.* at 273 (Winter, J., dissenting). Time Warner had first proposed the variable-price rights offering to the SEC on June 6, 1991, but it was never consummated because it was rejected by the SEC. The company subsequently obtained approval for a second proposal, which it announced on July 12, 1991. It was the June 6th announcement of the variable-price rights offering which led to the substantial decline in Time Warner's stock price. *Id.* at 262, 273.

[90] *Id.* at 273.

> value. In light of the prior statements, therefore, active consideration of the variable-price option should have been disclosed . . . .[91]

Although Judge Winter found that Time Warner was under a duty to disclose consideration of the stock offering, he nevertheless urged that the complaint be dismissed because there was no motive for Time Warner not to have made timely disclosure. He critiqued the majority's assumption that the ultimate disclosure of the rights offering may not have completely offset the artificial increase in the stock price caused by the previous misrepresentation. Instead, according to Judge Winter, there could have been no doubt that the offering, once disclosed, would cause the market to react by taking away all past price increases, given that it was "a tangible, high-profile, and unmistakable negation" of the earlier statements," which is what made the omission material in the first place.[92] Judge Winter then attacked the plaintiffs' inconsistent arguments about the efficiency of the market in assimilating information:

> The result of the present ruling is that appellants are allowed to establish reliance in their pleadings by stressing the efficiency of the market in Time Warner's shares [through fraud on the market] while establishing scienter by positing a market that cannot absorb a current registration statement's negation of weeks-old information.[93]

Judge Winter's dissent contains some powerful arguments concerning the motive suggested by the plaintiffs, and even the majority opinion raises substantial questions concerning whether the motive that was described was plausible. That, however, does not lead to Judge Winter's conclusion that the complaint should have been dismissed. If, as he concludes, the variable-price rights offering was indeed a material fact which Time Warner was under a duty to disclose, it should not matter, at least at the pleading stage, why the company decided not to disclose it. The point is, it did not. That should be enough.

Under the Second Circuit's interpretation of Rule 9(b), the ability to allege motive is of paramount importance. While

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[91] *Id.*

[92] *Id.*

[93] *Time Warner*, 9 F.3d at 274-75 (Winter, J., dissenting).

scienter may be pled even in the absence of a clear motive "by identifying circumstances indicating conscious behavior by the defendant," courts have held that "the strength of the circumstantial allegations" in such an event "must be correspondingly greater,"[94] and hence, that plaintiffs "face a more stringent standard for establishing fraudulent intent."[95] Thus, unless motive can be established, it becomes very difficult for plaintiffs to meet the pleading standard for scienter notwithstanding Rule 9(b)'s provision that scienter may be alleged generally.

While requiring motive to be pled, however, the courts have established a standard for motive that is inconsistent with reality, proclaiming that defendants' interests in enhancing their executive positions, compensation and prestige is an insufficient motive for the commission of securities fraud.[96] The Fifth Circuit summed up this standard in *Melder v. Morris*:

> The defendants' motive to commit securities fraud is not readily apparent, as there is no allegation that any of the corporate defendants actually profited from the allegedly inflated stock values or the money raised from the two offerings. The plaintiffs therefore face a tougher standard for establishing fraudulent intent.[97]

Yet, there is no reason to believe that for individual defendants, making themselves and their company look good by increasing stock prices is *not* a sufficient motive for securities fraud, even if defendants do not sell their stock and thereby directly profit from the fraud. In fact, there is no reason to believe that a defendant must always have a rational reason for committing fraud. It might well be that a defendant simply took steps which defrauded the public for completely irrational or personal reasons that are not easily articulated or evaluated in monetary terms. That does not mean that the actions in

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[94] Beck v. Manufacturers Hanover Trust Co., 820 F.2d 46, 50 (2d Cir. 1987) (citing United States v. Simon, 425 F.2d 796, 808-09 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970)), *cert. denied*, 484 U.S. 1005 (1988).

[95] Tuchman v. DSC Communications Corp., 14 F.3d 1061, 1068 (5th Cir. 1994) (citing *Beck*, 820 F.2d at 50).

[96] *See, e.g.*, Melder v. Morris, 27 F.3d 1097, 1102 (5th Cir. 1994) (allegation that desire of defendants to "protect and enhance their executive positions and the substantial compensation and prestige they obtained thereby" were insufficient to establish a motive to commit securities fraud); *Tuchman*, 14 F.3d at 1068 (same).

[97] *Melder*, 27 F.3d at 1102 (citing *Tuchman*, 14 F.3d at 1068).

question are any less fraudulent or that the defendant should be any less liable under the securities laws.[98]

The debate in *Time Warner* between Judges Newman and Miner, for the majority, and Judge Winter, in the dissent, exemplifies the inherent difficulty in defining the motive, i.e., the internal thoughts, beliefs and motivations of defendants at the pleading stage. At best, the requirement imposed on plaintiffs to allege motive leads to creative lawyering in which the plaintiffs try to articulate all the many possible reasons the defendants may have had for committing fraud while defendants try to dispute them, when, in fact, it is impossible to know prior to discovery what the motive was. In *Time Warner*, for example, there may have been a simpler motive for the decision not to disclose the contemplated rights offering. Time Warner may have elected not to disclose the offering in the hope that, if its negotiations with strategic partners were a success, it would never come to pass. If those negotiations had succeeded, the company would have been able to keep the stock price up without ever having to reveal that they had secretly been considering an alternative means by which to raise cash. But the negotiations failed, and stockholders who acquired stock prior to the announcement of the rights offering did so at an artificially inflated price. It makes little sense to force parties to debate internal thoughts and processes that are entirely in the hands of the defendants prior to discovery.[99]

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[98] *See, e.g.*, Robbins v. Moore Medical Corp., 788 F. Supp. 179, 185, 191 n.8 (S.D.N.Y. 1992) ("Defendants argue that the alleged scheme would have been irrational for defendants to follow since West-ward's failure was to be announced within two years, and that therefore the alleged scheme cannot reasonably be inferred from the facts alleged. This argument fails for two reasons: at the time of the defendants' statements, defendants may not have expected to announce West-ward's problems and irrational schemes have as much potential to defraud investors as do rational schemes.").

[99] It is for this very reason that courts permit plaintiffs to allege conspiracy generally in antitrust cases, since evidence of the conspiracy is in the hands of the conspirators. *See, e.g.*, Hospital Bldg. Co. v. Trustees of the Rex Hosp., 425 U.S. 738, 746 (1976) ("in antitrust cases, where 'the proof is largely in the hands of the alleged conspirators, dismissals prior to giving the plaintiff ample opportunity for discovery should be granted very sparingly") (citation omitted); Perington Wholesale, Inc. v. Burger King Corp., 631 F.2d 1369, 1373 (10th Cir. 1979) (pleading on information and belief held appropriate under Rule 8(a) in antitrust actions "where the proof is in the hands of the alleged conspirators") (citation omitted); Ben Sheftall Distrib. Co., Inc. v. Mirta de Perales, Inc., 791 F. Supp. 1575, 1579

Instead of requiring plaintiffs to plead sufficient facts from which scienter can be strongly inferred, a more logical approach that does not entail reading the defendants' minds is to require that plaintiffs' adequately particularize their allegations of fraud. Plaintiffs should have to plead sufficient facts from which it can be inferred that the statements alleged to be false were untrue at the time they were made or that the omissions were known at the time plaintiffs contend that they should have been disclosed. In short, plaintiffs should be required only to plead the circumstances underlying their allegations of fraud with sufficient particularity, not to construct theories about what the defendants might have been thinking at the time.

The Ninth Circuit recently rejected the Second Circuit's "strong inference" test under Rule 9(b), concluding in *In re Glenfed, Inc. Securities Litigation* that the test is facially inconsistent with the declaration in the rule that knowledge "and other condition of the mind may be averred generally," therefore holding that "plaintiffs may aver scienter generally, just as the rule states—that is, simply by saying that scienter exists."[100] The court, however, did not discuss the merits of the conclusion, but merely held that it had no choice, stating:

> The Second Circuit's test may or may not have the effect of deterring or weeding out "strike suits," which various courts have seen as imposing undesirable social and economic costs. Whether the test has such an effect is beside the point. We are not permitted to add new requirements to Rule 9(b) simply because we like the effects of doing so. That is a job for Congress, or for the various legislative,

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(S.D.Ga. 1992) ("[T]he Court is mindful that in antitrust actions, where the proof is largely in the hands of the alleged conspirators, summary dismissals prior to allowing the plaintiff ample opportunity for discovery should be granted even more sparingly.") (citation omitted); Capital Imaging Assoc. v. Mohawk Valley Medical Assocs., Inc., 725 F. Supp. 669, 676 (N.D.N.Y. 1989) (Because the proof of a conspiracy "is often in the hands of the conspirators, and the plaintiff may need an opportunity to discover the facts," a defendant in an antitrust case "must meet a more stringent standard" to dismiss a case under Rule 12(b)(6).).

[100] 42 F.3d 1541, 1546-47 (9th Cir. 1993). The Ninth Circuit also found that the Second Circuit's test was inconsistent with Rule 22 of the English Rules of Practice of 1937, which was the model for Rule 9(b). The English Rule provides: "Whenever it is material to allege malice, fraudulent intention, knowledge, or other condition of the mind of any person, it shall be sufficient to allege the same as a fact without setting out the circumstances from which the same is to be inferred." *Id.* at 1545 (quoting The Annual Practice, Order 19, Rule 22 (1937)).

judicial, and advisory bodies involved in the process of amending the Federal Rules.[101]

Thus, the decision does little to support a rejection of the strong inference test on policy grounds, but merely invites Congress to take up the challenge and pass more stringent pleading rules under section 10(b) and Rule 9(b). Yet, there is a valid reason to reject the test. It simply does not make sense to require a plaintiff to plead what one can never really know: what is in the minds of the defendants.

To the extent the courts or Congress reject the "strong inference" test and follow the Ninth Circuit's lead in permitting scienter to be pled generally as called for under Rule 9(b), the focus will turn from whether scienter has been pled adequately to whether plaintiffs have pled sufficiently the existence of misrepresentations or omissions. In *Glenfed*, the court summarized the standard:

> To allege fraud with particularity, a plaintiff must set forth more than the neutral facts necessary to identify the transaction. The plaintiff must set forth what is false or misleading about the statement, and why it is false. In other words, the plaintiff must set forth an explanation as to why the statement or omission complained of was false or misleading. A plaintiff might do less and still identify the statement complained of; indeed, the plaintiff might do less and still set forth some of the circumstances of the fraud. But the plaintiff cannot do anything less and still comply with Rule 9(b)'s mandate to set forth with particularity those circumstances which constitute fraud.[102]

In Judge Norris's concurring opinion in *Glenfed*, he supported the majority's conclusion with respect to pleading scienter generally, but raised the concern that the court's standard for pleading fraud extended well beyond existing law, creating what he termed "an inference of falsity" test "by requiring the pleading of evidentiary facts giving rise to an inference that the allegedly fraudulent statements were false when made."[103] Although his conclusion that an "inference of falsi-

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[101] *Id.* at 1546. The court cited in support of this position the recent conclusion in *Central Bank of Denver v. First Interstate Bank of Denver*, 114 S. Ct. 1439, 1448 (1994), that "[t]he issue . . . is not whether imposing private civil liability on aiders and abettors [of securities fraud] is good policy but whether aiding and abetting is covered by the statute." *Id.*

[102] *Id.* at 1548.

[103] *Id.* at 1557. Judge Norris's concern was that this would require plaintiffs to

ty" test is being imposed may be correct, he appears to distinguish the majority's holding from existing law unnecessarily.

While Judge Norris argues that the requirement that plaintiffs "set forth an explanation as to why the statement or omission complained of was false or misleading" goes too far,[104] it in fact seems quite consistent with the current state of the law. The courts already require that plaintiffs do more than merely assert that a representation is false; they must "explain why the statements were fraudulent"[105] or "give particulars as to the respect in which plaintiff contends the statements were fraudulent."[106] In other words, plaintiffs cannot merely identify statements and give conclusory allegations that they were false because of their inconsistency with subsequent disclosures—that is "fraud by hindsight."[107] Rather, they must demonstrate that defendants "knew or should have known [the alleged misrepresentations] to be false at the time they were made."[108] A plaintiff who is able to show that much should be able to pursue the cause of action. Plaintiffs should not also have to identify independently a basis for inferring defendants' scienter for committing the fraud that has been alleged.

Proponents of securities reform undoubtedly will argue that adherence to the suggestions made in this Article will

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plead evidentiary matter in their complaints in order to avoid dismissal, contradicting Rule 8's prescription of a short and plain statement of the facts. Rather than using Rule 9(b) to require sufficient facts to be pled to avoid frivolous litigation, Judge Norris proposed that plaintiffs be permitted more freedom in pleading securities fraud claims but that courts exercise greater control over the litigation by keeping plaintiffs from using excessive discovery to exert pressure on defendants for settlements that exceed the true value of the case. *Id.* at 1555-57.

[104] Judge Norris cites to Professor James Moore's statement that "the pleader is required to specify the time, place, and content of any allegedly false representation, the fact misrepresented, the identity of the perpetrator, and what was obtained or given up as a consequence of the fraud." *Id.* at 1559 (quoting 2A JAMES W. MOORE, ET AL. MOORE'S FEDERAL PRACTICE ¶ 9.03[1] (2d ed. 1972)). He then argues that "[t]here is no requirement of making any kind of demonstration, no need to state facts that 'explain why' or otherwise substantiate the allegation of falsity." *Id.*

[105] Romani v. Shearson Lehman Hutton, 929 F.2d 875, 878 (1st Cir. 1991). *See supra* note 39 and accompanying text.

[106] Cosmas v. Hassett, 886 F.2d 8, 11 (2d Cir. 1989).

[107] *See supra* note 40 and accompany text.

[108] Havsy v. Just Toys, Inc., No. 93 Civ. 8077, 1994 U.S. Dist. LEXIS 9382, *3-4 (S.D.N.Y. 1994). *See supra* note 42 and accompanying text.

encourage frivolous litigation. *Time Warner*, itself, has already been criticized as opening the door to more meritless lawsuits through its conclusions about the duty of corporations to disclose alternate plans which are under "active and serious consideration."[109] But by implementing Rule 9(b)'s requirement of pleading fraud with particularity, courts can adequately deter frivolous lawsuits without imposing the unnecessary and illogical hurdle of pleading scienter with specificity.

The most important result is that a cause of action would be sustained whenever plaintiffs are able to plead with sufficient particularity that a materially false statement was made to the public, thereby artificially inflating the price of stock and misleading the public. Otherwise, fraud will not be deterred. Requiring further specificity with regard to the defendant's motivations at the time it made such fraudulent statements should not be required at this early stage of the litigation.

As for the concern over frivolous litigation, a suit is *not* frivolous if a material misrepresentation can be pled with sufficient particularity. Even if a case is ultimately proven to be invalid, that does not mean that the original lawsuit had no merit. If actual fraud is to be combatted, society must bear the risk that some suits will be brought when fraud has not occurred. The courts act as the ultimate protector in such situations. Moreover, the concern over the so-called "explosion"[110] of frivolous litigation is vastly overblown and does not justify restricting what would otherwise be an appropriate standard by which to plead securities fraud.

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[109] *See, e.g.*, Jones, *supra* note 75, at 1021, which states:

> By allowing the plaintiffs to proceed in their action without more than speculative grounds for showing the scienter of Time Warner officials, the Second Circuit has encouraged vexatious litigation. As a result, corporate speech will be further chilled, and frivolous litigation will continue. In the end, the losers will be the marketplace and those individuals who invest in it, along with anyone seeking judicial relief in an already backlogged federal court system.

[110] *See, e.g.*, Press Release by the American Electronics Association, *AEA Supports Securities Litigation Bill Passed Today by House Commerce Committee*, 1995 PR Newswire, Feb. 16, 1995 (quoting William T. Archery, President and CEO of the American Electronics Association) [hereinafter "AEA Press Release"].

III. A CASE FOR THE STATUS QUO

Arguments in support of legislation designed to weaken the securities laws suggest that virtually every case that is brought under section 10(b) has no merit. After all, as these arguments run, if securities litigations are uniformly frivolous then there should be little concern if legislation is adopted to discourage such suits. The problem with this analysis, however, is that there is little support for the bare assertion that the suits are without merit. The fact is, fraud does occur.

In Senator Alfonse D'Amato's report in support of S. 240 he cites to the "[a]pproximately 300 securities lawsuits filed each year," and, after pointing out that "almost 93% settle at an average settlement cost of $8.6 million," boldly asserts that "[t]hese cases are generally settled based not on the merits but on the size of the defendant's pocketbook."[111] Similarly, Representative Christopher Cox, the author of the Republicans' legislation in the House to "reform" the securities laws, claims that "[l]egalized extortion by self-interested unethical strike suit lawyers is a national outrage that has become intolerable."[112] With virtually no basis for their position, Senator D'Amato, Congressman Cox and other supporters of the legislation are *assuming* that most of the litigation is without merit. In other words, they are assuming the ultimate conclusion—that securities class actions are frivolous—in order to justify legislation to curb such litigation. Without that assumption, the validity of their position weakens considerably. If, in contrast, the litigation is worthwhile, then settlements averaging $8.6 million are entirely reasonable and should be applauded. Indeed, in the largest cases where companies settle securities claims for multimillion-dollar amounts, it is difficult to believe the defendants' claims that they were merely attempting to avoid defense costs.[113]

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[111] Report No. 104-98, *supra* note 7, at 86,760.

[112] Robert A. Rosenblatt, *Orange County Residents Fight for the Right to Sue*, L.A. TIMES, Jan. 19, 1995, *available in* LEXIS, News Library, LAT File (quoting letter by Representative Christopher Cox issued in response to news conference held to attack the Republicans' proposed legislation).

[113] The number of securities litigations in which the settlements are so high as to belie any claim that they were merely designed to settle "frivolous" claims are

While the extreme claims of Senator D'Amato and Representative Cox can be attributed more to political exigencies than to a true understanding of the issues involved, even calmer voices by advocates of securities reform make similar, albeit less emotional, assertions. For example, Saul S. Cohen, a vocal advocate of such "reforms," recently testified before Congress that:

> The abuses of securities class action suits have been widely reported in recent years. It has been noted that these suits are filed not because an individual has approached a law firm seeking to redress a perceived wrong or even because a law firm has reason to believe that a fraud has occurred. Rather, a law firm simply observes a large drop in the price of a particular stock, identifies an individual who owns shares of that stock (often from a pre-existing computer database created expressly for that purpose) and files a class action complaint accusing the company or its officers and directors of fraud. Cases are filed within days or even hours of an announcement which causes a drop in the price of a company's stock, making it apparent that no investigation of any type could have been done. The complaints themselves often consist of nothing more than boilerplate allegations of fraud supplemented by a few public statements of company officials which proved to be overly optimistic in light of the company's results.[114]

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legion. For example, settlements in only those cases in which the author's firm, Pomerantz Haudek Block & Grossman, was lead or co-lead counsel include the following: *In re* National Health Lab. Sec. Litig., CV-92-1949-B (S.D. Cal. 1995) ($64 million cash recovery); *In re* Salomon Brothers Sec. Treasury Litig., No. 91 Civ. 5471, (S.D.N.Y. 1994) ($100 million cash recovery); ; *In re* First Executive Corp. Sec. Litig., CV-89-7135 DT (C.D.Cal. 1994) ($56 million partial settlement); *In re* Boardwalk Marketplace Sec. Litig., M.D.L. Docket No. 712 (D.Conn. 1994) (over $66 million benefit including $16 million cash recovery plus over $50 million reduction in class members' indebtedness on promissory notes); Hurley v. FDIC, Civil Action No. 88-1940—T (D. Mass. 1992) ($29 million judgment after trial against two former officers of First Service Bank for Savings); Wool v. Tandem Inc., Civ. No. C 85134 (N.D. Cal. 1988) ($16 million recovery); *In re* AM Int'l, Inc. Sec. Litig., M-21-31, MDL Docket No. 494 (S.D.N.Y. 1987) ($23 million recovery); *In re* Data Point Sec. Litig., SA-82-CA-338 (W.D.Tex. 1987) ($28.4 million recovery); Kaplan v. General Motors Corp., 81 Civ. 1252 (E.D.N.Y. 1984) ($22.5 million recovery); *In re* National Student Marketing Sec. Litig., MDL Docket No. 105 (D.D.C. 1983) ($35 million recovery); *In re* Ocean Drilling & Exploration Co. Shareholders Litig., Civ. No. 11898 (Del. Ch. 1991) ($38 million cash benefit); *In re* Freeport-McMoRan Inc. Shareholders Litig., Civil Action No. 11667 (Del. Ch. Nov. 1990) ($25.4 million recovery); *In re* Telerate, Inc. Shareholders Litig., Civ. 1115 (Del. Ch. 1989) ($95 million benefit). This list, of course, excludes many other noteworthy cases involving multimillion dollar settlements, as well as numerous cases with substantial settlements where Pomerantz Haudek was not lead counsel.

[114] Statement of Saul S. Cohen Before the Subcommittee on Telecommunications

Even Cohen's concerns, however, have already been addressed by the courts. If complaints are brought that "consist of nothing more than boilerplate allegations of fraud supplemented by a few public statements of company officials which proved to be overly optimistic in light of the company's results," *they are dismissed.*[115] Plaintiffs need to do much more to sustain a cause of action. Since plaintiffs' firms sue on a contingency basis—earning fees only if they obtain a recovery through a settlement or otherwise and, even then, only with court approval—they have little incentive to waste their resources suing companies without some reasonable basis for doing so.[116]

In addition to the fact that the courts are already dismissing the lawsuits attacked by "reformers" such as Cox and Cohen, it is evident that securities litigations are not merely automatic reactions to declining stock prices.[117] From 1986 through 1992, lawsuits were filed on only 4.7 percent of the

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and Finance Commerce Committee, U.S. House of Representatives, Fed. News Service, Feb. 10, 1995, *available in* LEXIS, Legis Library, FEDNEW File [hereinafter "Cohen Statement"]. Cohen is a partner at the New York law firm of Rosenman and Colin and generally represents firms that are subject to securities fraud suits.

[115] *See* Cohen Statement, *supra* note 114, at *1. In Cohen's testimony, for example, he cites as "illustrative of this problem" the In re *Philip Morris Securities Litigation* where the court criticized the plaintiffs for filing a complaint shortly after a drop in prices and even including a typographical error from a previous case misidentifying the main business of the defendant. *Id.* The court recognized the issue, and *it dismissed the complaint.* Obviously, congressional intervention was not necessary; the court took the necessary action under the current law.

[116] While it cannot be denied that the current system encourages a "race to the courthouse" by plaintiffs' counsel seeking to position themselves for leadership positions in major fraud litigations, that does not suggest that the lawsuits themselves are without merit. Indeed, with the computer resources available to firms today it is not surprising that it takes little time after a public announcement to determine whether it is reasonable to believe that there was underlying fraud.

[117] "Reformers" insist that securities litigation is triggered by market losses. Cohen Statement, *supra* note 114. *See also Sen. Hearings*, cited in Seligman, *supra* note 48, at 442 n.16 (citing statement of Richard J. Egan, Chairman of EMC Corp., claiming that strike suits "are typically filed within days or sometimes hours of a company's announcement of adverse news and disappointing earnings"); *id.* at 442 n.17 (citing statement of Edward R. McCracken, President, Silicon Graphics, stating that "companies can be exposed to potential litigation whenever the stock price falls by approximately 10%, even if there's absolutely no violation of security laws or fiduciary responsibility"); *id.* (citing statement of Thomas Dunlap, Jr., General Counsel of Intel Corp., referring to "automatic" 10% rule).

occasions on which companies' stock declined by more than ten percent in one day, indicating that class-action attorneys do not simply sue every time stock prices decline.[118] Similarly, there is little merit to the oft-repeated accusation that plaintiffs' lawyers have contributed to an "explosion" of litigation accusing law-abiding companies of securities fraud.[119] Contrary to the suggestion that securities fraud cases represent a substantial cause of the judicial backlog existing throughout the country, an average of only 123 consolidated securities litigations were filed annually between 1989 and 1992, although more than 17,400 companies file reports with the SEC each year.[120] As Senator D'Amato stated before deciding to champion the cause of the "reformers" in the Senate, the number of securities fraud cases actually filed "doesn't seem like an explosion." The facts are "far different than the picture described—that whenever there is a glitch in the market, everyone is the subject of a frivolous securities suit and . . . companies can be blackmailed into paying a settlement."[121] If there is a problem with excess litigation in this country, it may well derive more from businesses themselves engaging in intrabusiness litigation than from the relatively few securities actions that are brought.

The number of securities fraud cases actually filed each year belies any need to "reform" the securities laws. Proponents of such reform nevertheless argue that those cases which are brought cost millions of dollars in unnecessary legal ex-

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[118] Seligman, *supra* note 48, at 443 n.19 (citing a report of an economics expert retained by a plaintiffs' securities firm to examine the number of times a company trading on the New York Stock Exchange, the American Stock Exchange or NASDAQ has been sued after its stock fell by more than 10% in one day). This number is also inflated by reporting all cases filed rather than merely all companies which were sued, thereby not discounting multiple suits against one company. *Id.*

[119] *See, e.g.*, AEA Press Release, *supra* note 110 ("This bill is the right answer for reducing the explosion of securities litigation that has strangled technology firms throughout the country. . . . Most of these cases have no merit and only end up paralyzing technology companies—thereby hurting their stockholders and employees.") (quoting William T. Archey, AEA's President and CEO).

[120] Seligman, *supra* note 48, at 444 (citing a report of an economics expert retained by a plaintiffs' securities firm). The annual number of securities fraud lawsuits filed from 1989 through 1992 totalled 169, 326, 256 and 265, respectively. The numbers of individual companies sued were substantially smaller, totalling only 108, 151, 122 and 113, respectively. *Id.*

[121] *See* Seligman, *supra* note 48, at 444.

penses and often are settled, without regard to the merits, solely to avoid the expense and risks of defending "frivolous" suits. Such claims, however, are based more on rhetoric than on empirical proof. As Professor Joel Seligman has demonstrated impressively, there is no valid evidence to support the claim that merits have no bearing on settlements.[122] While some studies have been cited which purportedly suggest that settlements are not affected by the merits, they are universally limited in their relevance as a result of flaws in their assumptions, including how to measure the damages so as to be able to compare them to the ultimate settlement that is reached.[123] Yet, proponents of limiting the scope of the securities laws accept such studies without reservation.[124] Moreover, there is just as much evidence suggesting that the merits underlying securities actions have a substantial bearing on settlements.[125]

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[122] *See* Seligman, *supra* note 48, at 445. *See also* Lester B. Snyder & Jerry G. Gonick, *The Interrelationship of Securities Class Action Litigation and Pension Plan Tax Policy: What's Really at Stake?*, 21 SEC. REG. L.J. 123, 126-28 (1993) (contending that studies concluding merits do not matter were flawed and ignored the oversight provided by courts); Adam F. Ingber, Note, *10b-5 or Not 10b-5?: Are the Current Efforts to Reform Securities Litigation Misguided?*, 61 FORDHAM L. REV. 351, 360-61 (1993) (rejecting conclusion that merits do not matter in settlements).

[123] Seligman, *supra* note 48, at 450-52. Seligman explains in substantial detail the flaws in the studies most often cited by proponents of restricting the securities laws, including Vincent E. O'Brien & Richard W. Hodges, *A Study of Class Action Securities Fraud Cases 1988-1993*, summarized in *Sen. Hearings* at 46-48, 138-141; Frederick C. Dunbar & Vinita M. Juneja, *Recent Trends in Securities Class Action Suits* (1992); Frederick C. Dunbar & Vinita M. Juneja, *Recent Trends II: What Explains Settlements in Shareholder Class Actions?* (1993), reprinted in *Sen. Hearings*, at 739-75; and Janet C. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 501 (1991). *See also* Nicholal E. Chimicles & Kathleen P. Balon, *Assessing the Need For Class Action Reform*, N.Y.L.J., Aug. 26, 1993, *available in* LEXIS, News Library, NYLAWJ File (summarizing the flaws in the various studies suggesting that merits do not matter in securities fraud settlements).

[124] In supporting S. 240, for example, Senator D'Amato relies on studies which purportedly conclude that investors recovered only 7 to 14 cents for every dollar lost as a result of securities fraud. Report No. 104-98, *supra* note 7, at 86,758. Such studies, however, depend entirely on how the ultimate damages are valued. If the defendants' estimates of damages were used, the percentage of recovery for damages would undoubtedly be substantially higher. Indeed, given that defendants often claim that they caused virtually *no* damages, it could be argued that most settlements compensate investors for virtually their entire loss. The important fact to recognize is that the numbers used by proponents of limiting plaintiffs actions are often without empirical support, being misused for partisan purposes.

[125] Seligman, *supra* note 48, at 453-54. *See also* Steven P. Marino & Renée D.

Another argument often raised by proponents of reform is that businesses are seriously harmed by the expense of defending frivolous litigation. Senator D'Amato, for example, has publicly exclaimed that "[f]rivolous lawsuits . . . are making it difficult for companies to raise the capital needed to fuel our economy,[126] and, in his report in support of S. 240, has adopted the position that the number of securities class actions have had "an in terrorem effect on Corporate America," adding "significantly to the cost of raising capital and represent[ing] a 'litigation tax' on business."[127] Yet, at the same time, the actual numbers which he cites in his report directly contradict such dire assertions:

> The United States securities markets are the most liquid and deep in the world. In just the past ten years, capital raised has risen 1,000%. Over the last three years, the U.S. securities industry has set new records in corporate underwriting and raising capital for new business. In 1994, the industry raised $1 trillion for businesses, including $34 billion for small businesses making their first foray into the capital markets.[128]

The evidence, in short, simply does not support the assertion

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Marino, *An Empirical Study of Recent Securities Class Action Settlements Involving Accountants, Attorneys, or Underwriters,* 22 SEC. REG. L.J. 1115 (1994), *cited in* Seligman, *supra* note 48, at 454 n.72 (finding that accountants paid an average of $10.5 million per settlement where "flagrant fraud" was alleged, compared with $2.1 million for all other cases); Letter from John B. Torkelson, President, Princeton Venture Research Inc. (June 15, 1993), reprinted in *Sen. Hearings* at 153, *cited in* Seligman, *supra* note 48, at 454 n.73 (estimating that recoverable damages were equal to 27.7% of investor market losses and thereby concluding based on cases in which PVR served as a consultant that settlements were equal to 59.78% of recoverable damages after fees and expenses); *Sen. Hearings* at 172-82, 783-92, *cited in* Seligman, *supra* note 48, at 454 n.73, citing data from the two largest class action claims administrators reporting that settlements, on average, equalled 24.6% of market losses. Seligman notes that these studies also suffer from flaws which limit the significance of the conclusions to be drawn from them. Seligman, *supra* note 48, at 454.

[126] David Skidmore, *Senate Passes Bill to Curb Frivolous Securities Fraud Suits,* AP WORLDSTREAM, June 28, 1995.

[127] Report No. 104-98, *supra* note 7, at 89,760.

[128] Report No. 104-98, *supra* note 7, at 86,759 (footnote omitted). As Professor Seligman has noted, the data demonstrate that securities registrations, including initial public offerings, have continued to rise, leading to the conclusion that, "[d]espite claims that litigation is destroying capital formation, capital formation remains healthy." Seligman, *supra* note 48, at 440 (citing, inter alia, the SEC's 1992 report that the total dollar amount of securities filed for registration reached $700 billion, a 40% increase over the prior year, while the number of initial public offerings increased some 53% to $66.5 billion).

that securities litigation is harming corporate America. Rather, it indicates that the capital markets are working well; companies are continuing to develop new products and raise capital by the billions.

In fact, the threat of litigation in the event of fraud may be part of the reason our capitalist system is working so well. Without investor confidence in the integrity of the markets, businesses would not have been able to attract the substantial amount of investments they have received, and without a viable and effective plaintiffs' bar to deter fraud, that confidence could be lost. Even Senator D'Amato has conceded that "[t]he success of the U.S. securities markets is largely the result of a high level of investor confidence in the integrity and efficiency of our markets," acknowledging that "[t]he SEC enforcement program and the availability of private rights of action together provide a means for defrauded investors to recover damages and a powerful deterrent against violations of the securities laws."[129] As noted in the comments of Senators Paul S. Sarbanes, Richard W. Bryan and Barbara Boxer in opposition to S. 240:

> Our securities markets have been operating under the Federal securities laws since those laws were enacted over 60 years ago [and] our markets today are the largest and most vibrant in the world. This is so not in spite of the Federal securities laws, but in part because of the Federal securities laws. . . . Even more important to ensuring the success of our markets is investor confidence. That confidence is maintained because investors know they have effective remedies against persons who would defraud them.[130]

Of course companies do spend substantial sums to defend

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[129] Report No. 104-98, *supra* note 7, at 89,760.

[130] Report No. 104-98, *supra* note 7, at 86,777. The logical conclusion that strong securities laws enhances the viability of capital markets is supported by efforts to build such markets in eastern-bloc nations. Bulgaria, for instance has recently passed a new Stock Exchange Securities Act as part of its effort to encourage its own capital markets. Consultants, however, stress the need to adopt additional rules to prevent market manipulation in order to add "the ingredient of investor confidence." Elisaveta Konstantinova, *Bulgaria Needs Better Market Rules-Consultants*, REUTERS, July 6, 1995, *available in* LEXIS, News Library, REUFIN File (quoting Robert Finney, a partner in U.K.-based law firm, Denton Hall). As Denton explained, "[t]here is a need to back up the securities litigation with amendments to the criminal code which would impose proper penalties against [the] securities fraud, deception, [and] market manipulation that one expects to see in any market." *Id.*

cases, but the expense of defending against meritorious litigation is hardly inappropriate. As for the amount spent litigating what could be considered frivolous cases, there is little empirical evidence to suggest that companies are actually harmed beyond the fact that some additional money was spent. The issue is not whether companies could have saved money by avoiding litigation expenses. Obviously, they could have. The real question is whether the benefits of a system that can adequately deter fraud outweigh the benefits of a system that discourages both frivolous *and meritorious* fraud suits.

Professor Seligman's analysis has been critiqued by a noted supporter of securities reform, Professor Joseph Grundfest, who questions some of the conclusions Seligman draws from the data. Significantly, however, Grundfest is not able to muster the evidence to prove a need for reform. Rather, he merely concludes that we do not know one way or the other:

> At the end of the day, and despite recent congressional hearings, we simply do not know enough about the securities litigation process to propound categorical reforms with any degree of confidence that we would be doing more good than harm.[131]

In this light, it is difficult to see how proponents of reform can justify their current proposals. Without having sufficient evidence to change the current system, the old saying could well be true: the cure will be worse than the disease.

Unfortunately, the unproven rhetoric used by companies seeking to emasculate the securities laws is too often accepted without scrutiny, even by the courts. In *Central Bank of Denver v. First Interstate Bank of Denver*, for example, the Supreme Court opined that:

> [E]xcessive litigation can have ripple effects. [N]ewer and smaller companies may find it difficult to obtain advice from professionals. A professional may fear that a newer or smaller company may not survive and that business failure would generate securities litigation against the professional, among others. In addition, the increased costs incurred by professionals because of the litigation and settlement costs under 10b-5 may be passed on to their client companies, and in turn incurred by the company's investors, the intended beneficiaries of the statute.[132]

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[131] Joseph A. Grundfest, *Commentary, Why Disimply?*, 108 HARV. L. REV. 727, 746 (1995).

[132] 114 S. Ct. 1439, 1454 (1994) (citing Ralph K. Winter, *Paying Lawyers, Em-*

While the concerns expressed by the Court might arise if unnecessary litigation could not be addressed adequately by the courts, there is simply no evidence to suggest that courts today are unable to avoid these gloomy predictions by implementing existing law effectively.

Plaintiffs' securities lawyers have a difficult time defending against such excessive (and unsupported) assertions. It is simply too easy for politicians to assert that most securities cases are "frivolous" with little fear of being held accountable for their vast exaggeration, if not outright misstatement. After all, there is little substantial means by which to respond to the proposition that "most class actions have little merit" when such a claim is not based on specific cases which can be addressed. Moreover, even with respect to particular cases, the hands of the plaintiffs' attorney are often tied. As a matter of course, defendants require plaintiffs to enter into strict confidentiality agreements prior to agreeing to produce documents and to return or destroy all such documents upon the conclusion of a case. Thus, plaintiffs' attorneys are generally unable to respond to vague public attacks on the validity of their suits by pointing to specific evidence of fraud that they have uncovered. The cases are also sufficiently complex that it is difficult to compete with the sound-bite attacks against class actions in the media.

Even based on the limited arguments available to counter the rhetorical attacks, however, it cannot be disputed that cases of substantial fraud are widespread. Investors have witnessed "financial frauds and scandals of historic proportions" during the last decade, and small investors are being "victimized" every day in "less notorious—but equally devastating—cases of fraud and abuse."[133] According to Mark Griffin,

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powering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America, 42 DUKE L.J. 945, 948 (1993)).

[133] Griffin Testimony, *supra* note 7 (citing "[m]assive misconduct on the part of Prudential Securities in the sale of limited partnerships; Steven Wymer; BCCI and BNL; Charles Keating and Lincoln Savings; the savings and loan debacle; widespread fraud uncovered as a result of the FBI sting operation at the Chicago commodities markets; the so-called 'Den of Thieves" ring of junk-bond kings: Michael Milken, Ivan Boesky, Dennis Levine and Marty Siegel; and the Salomon Brothers fraud in the government securities marketplace"). Now, with the current litigation revolving around the Orange County debacle, and other investigations

testifying on behalf of the North American Securities Administrators Association, "[i]t is against this backdrop that the broader and more complex issues raised by proponents of litigation 'reform' must be considered."[134] Nor can it be disputed that substantial recoveries are obtained in many securities litigations that cannot be attributed to a company's effort merely to avoid defending against frivolous claims.[135] The only question, then, is whether it is worth risking the ability to fight widespread fraud, by effectively deterring plaintiffs from bringing suits in the first instance, in order to prevent some small number of cases which defendants label as frivolous.

The risk of restricting shareholders' ability to combat fraud through private litigation becomes especially critical in light of the heavy burden already placed on regulators who are not in a position to replace the efforts of private attorneys general. As SEC Chairman Arthur Levitt has stated: "We have neither the resources nor the desire to replace private plaintiffs in policing fraud; it makes more sense to let private forces continue to play a key role in deterrence than to vastly expand the commission's role."[136] And the likelihood of the regulators getting the necessary resources to assume such an expanded role is slim, at best.[137] Thus, there will be nothing to fill the

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into the use of derivatives, the continued need to protect investors against fraud is more important than ever. The Orange County situation has already led to certain representatives expressing additional concern over efforts to weaken the federal securities laws. *See* Senator Barbara Boxer, *Financial Lessons of the Orange County Bond Crises*, Fed. Document Clearing House, Inc., Congressional Press Releases, Jan. 25, 1995, *available in*, LEXIS, News Library, WIRES File ("[T]he courtroom door must be kept open to victims of securities fraud. Provisions in the Republican 'Contract with America,' if adopted, would make sweeping changes to the laws that protect investors who may have been misled or lied to or defrauded. . . . It is important to note . . . that the proposals in the Republican 'Contract' go far beyond what is necessary to limit frivolous suits. The Republican proposals would make it difficult—if not impossible—for legitimate victims of securities fraud to seek a remedy.").

[134] Griffin Testimony, *supra* note 7.

[135] *See supra* note 113.

[136] Rob Wells, *Taking Aim at Securities Lawsuits: Shareholders Would Suffer under New Limits on Fraud Complaints, Foes Say*, AUSTIN AMERICAN-STATESMAN, July 9, 1995, at H1.

[137] The risk becomes even more pronounced when considering that, at the same time the securities laws are being restricted, the funding for securities regulators is becoming tighter. *See, e.g.*, THE ATLANTA J. & CONST., July 6, 1995, at 14A ("The timing of this legislation (S. 240) is particularly unfortunate because Congress also is cutting funding for regulators. The overworked Securities and Ex-

void left by a plaintiffs' bar discouraged from aggressively pursuing securities fraud by the new legislation.

It also is presumptuous of litigation-reform proponents to suggest that most of the costs of litigating securities actions are caused by plaintiffs' firms. Our adversarial system presupposes that each party will be represented by advocates arguing their positions. While companies claim that frivolous litigations result in unnecessary defense costs, what they fail to acknowledge is that frivolous defenses to valid claims have perhaps an even greater impact on the costs and delays inherent in litigation. Defense firms universally choose to file substantial motions to dismiss or for summary judgment, even for cases which clearly satisfy the pleading standards with valid underlying claims. Defense attorneys also oppose class certification even in the most routine situations and usually attempt to delay or stymie legitimate discovery efforts. As a result, cases involving even the most obvious fraud take years to litigate and often result in settlements below what investors should, in all fairness, receive. In response to the argument that plaintiffs' firms file frivolous suits in order to "extort" settlements, it can just as easily be asserted that defendants delay litigation and file frivolous defenses in order to force plaintiffs to accept low settlements.[138]

Plaintiffs' attorneys also have reason to object to the ad hominem attacks on the morality of their profession and the protest that they make too much money through their "legalized extortion." Although plaintiffs' attorneys, on the whole, do well financially, they certainly do no better on average than defense counsel who earn substantial fees on an hourly basis by defending corporations from allegations of fraud.[139] De-

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change Commission can't begin to keep up with all the fraud on Wall Street. At least the threat of lawsuits by investors helped maintain some law and order."); THE ATLANTA J. & CONST., July 2, 1995, at 2R ("South Carolina Gov. David Beasley has signed legislation that slashes the state's funding for fighting securities fraud at a time when authorities are in the midst of a major investigation of NationsBank's brokerage arm. The cuts will have 'a dramatic and drastic' effect on the ability of the state's six-person securities division to guard against fraud, said Secretary of State Jim Miles, the state's top securities regulator.").

[138] For example, while defendants claim that the number of motions to dismiss which are granted suggest that frivolous cases have been brought, plaintiffs could easily respond that the number of motions denied suggest that frivolous motions to dismiss were brought. It simply depends on the perspective of the speaker.

[139] *The American Lawyer*'s annual survey of law firm earnings, for example,

fense firms do not represent only "innocent" companies, but often assert vociferous defenses on behalf of clients that are guilty of the most heinous fraud.[140] Indeed, it can easily be argued that the "best" client for the defense bar is one that commits serious fraud, so that years of private litigation and negotiation with securities regulators and even U.S. Attorneys will be required prior to the resolution of the matter, resulting in huge time-based attorney's fees. Corporate officials themselves make more than their attorneys and often without regard to the benefit they are bringing to their shareholders,[141] to say nothing of the millions provided to investment bankers, many of whom do not contribute to the nation's wealth in any real way but merely participate in large-scale gambling on interest rates and other indices upon which they choose to risk their investments.[142]

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reports that partners at the top New York defense firms earn, *on average*, over a million dollars per year. Karen Dillon, *Brand Names at the Brink*, AM. LAW., May 1995, *available in* LEXIS, News Library, AMLWR file. Moreover, plaintiffs' counsel work only on contingency fees. Thus, they are paid only if there is a settlement. In the current climate, where many cases are dismissed, attorneys have no incentive to bring cases which they know are meritless—such cases would simply cost time and money with no reward.

[140] *See, e.g., supra* note 113 (listing substantial settlements and citing cases).

[141] *See, e.g., In a Cost-Cutting Era, Many CEOs Enjoy Imperial Perks*, WALL ST. J., Mar. 7, 1995, § B, at 1 (highlighting substantial perks provided to corporate executives even when the companies they represent are losing money; citing the $723,000 salary, substantial perks, and special deals worth millions of dollars received by the chairman of Tyson Foods, which reported a net loss of $2.1 million; and the $580,000 salary, support staff and a reimbursement for expenses received by the chairman and CEO of ICN Pharmaceuticals while he took a leave of absence to serve as prime minister of Yugoslavia, all while the company was reporting a loss of $183.6 million).

[142] As a prime example of the Wall Street mentality, Kidder Peabody paid Joseph Jett $9 million in bonuses in 1993, all for profits he purportedly earned the company by buying and selling zero-coupon bonds and arbitraging interest rates. Of course, the profits ultimately proved to be illusory and merely reflected paper profits which had no connection to reality, but even if they had been real, they did not result from creating jobs or providing a service, but merely manipulating interest rates on government bonds. *See, e.g.*, Saul Hansell, *Kidder Reports Fraud and Ousts a Top Trader*, N.Y. TIMES, Apr. 18, 1994, *available in* LEXIS, News Library, NYT File. *See also* Thomas L. Hazen, *Rational Investments, Speculation, or Gambling?—Derivative Securities and Financial Futures and Their Effect on the Underlying Capital Markets*, 86 NW. U.L. REV. 987, 1006-07 (1992) ("Futures and options contracts are also noteworthy in that they do not produce wealth, but instead merely involve the transfer of wealth. Futures and options contracts are geared to reallocating risks among market participants, not to amassing capital. By way of comparison, the securities markets are designed to facilitate firms in

In sum, the attacks on the earnings of plaintiffs' counsel should be taken for what they are—partisan rhetoric. Such emotional appeals against plaintiffs' lawyers have no rational relationship to the issue of whether the securities laws should be reformed. The question is not whether plaintiffs' attorneys have a profit motive. They do. That is why the plaintiffs' bar is strong enough to stand up to the substantial resources of corporations that commit fraud. In many ways, the same profit incentives that encourage companies to develop also work to encourage attorneys to operate as private attorneys general who can assist in the effort to combat fraud. The real issue should be whether the profit motive inherent in the current system serves investors and the society at large by providing the incentive for attorneys to work to ferret out fraud. There is little question that it does. The reforms currently being advocated seek to remove much of that profit motive, thereby removing the incentive to enforce the securities laws through private actions.

Ultimately, the evidence does not support the securities-reform advocates. There is no evidence that the securities laws have contributed to a litigation explosion that hampers U.S. businesses, and no indication that plaintiffs' lawyers have become rich by extorting settlements of frivolous litigation. The broad acceptance of these charges arises from what appears to be a nationwide backlash against lawyers in general, encouraged by well-funded public relations and lobbying efforts of the very companies that the securities laws are designed to regulate.[143]

CONCLUSION

Fraud is a reality, and providing incentives for plaintiffs' lawyers to sue on behalf of injured investors is a critical tool both for compensating investors and for deterring fraud. At the same time, Rule 9(b) provides courts with the power to deter frivolous litigation by enforcing its pleading requirements, a power that courts willingly use.

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raising funds for expansion and other productive purposes, thereby indirectly contributing to the creation of wealth.").

[143] *See supra* note 10.

This Article does not argue, of course, that suits without adequate basis do not exist. Nor is it meant to suggest that problems in the system do not contribute to costs and delays without serving the interest of deterring fraud.[144] Rather, it suggests that, even with such problems, the system is working. Neither the proposed reforms nor more stringent interpretations of the law by the courts is necessary. Indeed, under either approach, there will be a substantial risk of increased fraud without sufficient recourse for the victims. When baseless cases are brought, courts should continue to dismiss them and, if appropriate, sanction attorneys who bring frivolous claims.[145] The primary focus of the courts, however, should not be on deterring frivolous suits. That deterrence will be accomplished through appropriate application of the law. The focus should be on permitting cases to be brought to deter fraud—the underlying purpose of the securities laws.

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[144] For example, there can be no dispute that plaintiffs' firms benefit by becoming lead counsel in class action litigations. To do so, under the current system, being one of the first to file enhances the possibility of assuming a leadership position in the case. Hence, there is a "race to the courthouse." Whether this situation can be addressed in a manner which does not deter worthy cases, however, is an open question.

[145] Courts have authority under Rule 11(c) of the Federal Rules of Civil Procedure to "impose an appropriate sanction upon the attorneys, law firms, or parties" which the court finds to have submitted frivolous claims. To the extent that frivolous litigation in fact becomes a problem, courts have the discretion under this provision to act accordingly.