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A Case-By-Case Approach to Pleading Scierter Under the Private Securities Litigation Reform Act of 1995

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NOTE

A Case-By-Case Approach to Pleading Scienter Under the Private Securities Litigation Reform Act of 1995

Matthew Roskoski*

TABLE OF CONTENTS

INTRODUCTION	2266
I. CONGRESS DID NOT CODIFY EITHER THE MOTIVE AND OPPORTUNITY TEST OR THE CIRCUMSTANTIAL EVIDENCE OF RECKLESSNESS TEST	2272
A. <i>The Reform Act Merely Codified the Second Circuit's Pleading Standard</i>	2272
B. <i>The Deletion of Senator Specter's Proposed Amendment Conclusively Proves That the Reform Act Did Not Codify The Second Circuit's Tests</i>	2274
II. CONGRESS DID NOT REPUDIATE EITHER THE MOTIVE AND OPPORTUNITY TEST OR THE CIRCUMSTANTIAL EVIDENCE OF RECKLESSNESS TEST	2276
A. <i>The Plain Language of the Statute Read with the Contemporaneous Legislative History Demonstrates the Survival of the Second Circuit's Tests</i>	2277
B. <i>Subsequent Legislative History Confirms the Survival of the Second Circuit's Tests</i>	2282
C. <i>The Policy Rationales Underlying the Reform Act Require Retention of the Second Circuit's Tests</i>	2284
III. CONGRESS LEFT COURTS TO DECIDE ON A CASE-BY-CASE BASIS WHETHER PARTICULAR SHOWINGS OF MOTIVE AND OPPORTUNITY OR CIRCUMSTANTIAL EVIDENCE OF RECKLESSNESS GIVE RISE TO A STRONG INFERENCE OF SCIENTER	2285

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A. <i>The Baesa Rule Flows Directly from the Plain Language of the Reform Act and Is Supported by the Legislative History</i>	2286
B. <i>The Baesa Rule Is Consistent with the Policies Underlying the Reform Act</i>	2288
1. <i>The Baesa Rule Prevents "Cookie-Cutter" Complaints</i>	2288
2. <i>The Baesa Rule Properly Balances the Competing Goals of Minimizing Frivolous Litigation and Protecting Investors</i>	2289
CONCLUSION	2293

INTRODUCTION

Securities fraud litigation under Rule 10b-5¹ threatens all publicly traded companies: according to the Stanford Securities Class Action Clearinghouse, in 1998 a securities fraud lawsuit was filed for nearly every day that the stock markets were open.² Some of these lawsuits appear to be frivolous, triggered by inevitable fluctuations in stock prices (so-called "fraud by hindsight" complaints³), while others represent legitimate efforts at private enforcement of the securities laws.⁴

1. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1998), prohibits "manipulative and deceptive devices . . . in connection with the purchase or sale of any security." It was promulgated by the Securities Exchange Commission ("SEC" or "Commission") under § 10(b) of the Securities Exchange Act of 1934. *See* 7 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 3485-88 (3d ed. 1997).

2. *Securities Fraud Litigation Sets Record in 1998: Companies Sued at a Rate Close to One-A-Day* (visited Feb. 6, 1998) <<http://securities.stanford.edu/news/990125/pressrel.html>>.

The Stanford Securities Class Action Clearinghouse, at <http://securities.stanford.edu>, reports active federal securities class action lawsuits, and new suits are posted daily. To counter the perceived defense bias at the Stanford site, Milberg Weiss Bershad Hynes & Lerach (by volume the largest plaintiffs' class action securities fraud firm) sponsors its own web site, at <http://www.milberg.com>, which also reports ongoing suits and contains press releases from Milberg Weiss.

3. *See* OFFICE OF THE GEN. COUNSEL, U.S. SEC. & EXCH. COMM., REPORT TO THE PRESIDENT AND THE CONGRESS ON THE FIRST YEAR OF PRACTICE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995, at 6 (1997) [hereinafter SEC REPORT].

4. *See* H.R. CONF. REP. NO. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730 (Statement of Managers — The "Private Securities Litigation Reform Act of 1995") [hereinafter "Statement of Managers"] ("Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs."). Even though the Commission never envisioned civil liability when it promulgated Rule 10b-5, *see* LOSS & SELIGMAN, *supra* note 1, at 3487, most securities fraud plaintiffs bring suit under Rule 10b-5 rather than § 18 of the Securities Exchange Act because Rule 10b-5 is considerably more liberal than § 18. *See* JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 677 (2d ed. 1997).

The Conference Committee Report for the Reform Act is broken into a recitation of the text of the bill and a "Statement of Managers." The Statement of Managers contains the relevant legislative history, and courts considering the Reform Act tend to identify it as the "Statement of Managers" rather than as the "Conference Committee Report." This Note

Disposition on the pleadings is a critical defense strategy for all securities lawsuits. Securities fraud lawsuits that withstand a 12(b)(6) motion almost always settle, regardless of the actual merits of the case or the probability of success at trial,⁵ because of the massive discovery and defense costs associated with such suits.⁶ Because Rule 10b-5 requires a showing of scienter, a mental state embracing "intent to deceive, manipulate, or defraud,"⁷ defendants can often successfully dispose of a securities fraud case before being forced to settle by challenging the plaintiff's scienter pleading.⁸ For these reasons, the standard for pleading scienter is an appropriate context in which to balance the competing interests of eliminating abusive claims and permitting meritorious ones.⁹

Prior to the passage of the Private Securities Litigation Reform Act of 1995 ("Reform Act"),¹⁰ the federal circuit courts of appeals had varying interpretations of Federal Rule of Civil Procedure 9(b)'s¹¹ application to pleading scienter in a securities fraud lawsuit.¹² The Ninth Circuit's standard was quite liberal, while the

will follow the stylistic convention of the majority of courts, and generally refer to the "Statement of Managers."

5. Statement of Managers, *supra* note 4, at 32 ("[I]nnocent parties are often forced to pay exorbitant 'settlements.' When an [issuer] must pay lawyers' fees, make settlement payments, and expend management and employee resources in defending a meritless suit, the issuers' own investors suffer. Investors always are the ultimate losers when extortionate 'settlements' are extracted from issuers.").

6. See S. REP. NO. 104-98, at 6 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 685 ("The dynamics of private securities litigation create powerful incentives to settle, causing securities class actions to have a much higher settlement rate than other types of class actions. . . . The settlement value to defendants turns more on the expected costs of defense than the merits of the underlying claim."); see also *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975); *Securities Litigation Reform: Hearing Before the Subcomm. on Telecomms. and Fin. of the House Comm. on Energy and Commerce*, 103d Congress 35-36 (1994) (statement of SEC Chairman Arthur Levitt); H.R. REP. NO. 104-50, pt. 1, at 15 (1995).

7. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). Rule 10b-5 on its face contains no explicit scienter requirement, but the Supreme Court inferred one in *Ernst & Ernst*.

8. Cf. *Common Sense Legal Reform Act: Hearings Before the Subcomm. on Telecomms. and Fin. of the House Comm. on Commerce*, 104th Cong. 199 (1995) (testimony of Arthur Levitt, SEC Chairman) (describing Rule 9(b) challenges as "[t]he device most frequently used to screen out deficient securities fraud claims").

9. See *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 264 (2d Cir. 1993) (observing that an overly rigid standard will create "opportunity for unremedied fraud," while an overly lax standard will create "opportunity to extract an undeserved settlement"); *City of Painesville v. First Montauk Fm., Corp.*, 178 F.R.D. 180, 187 (N.D. Ohio 1998).

10. Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

11. FED. R. CIV. P. 9(b) ("In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally.").

12. Each circuit had articulated some common law pleading standard. For example, the First Circuit required plaintiffs to plead facts with such particularity as to make it reasonable to believe that the defendant acted with scienter. See, e.g., *Greenstone v. Cambex Corp.*, 975 F.2d 22, 25 (1st Cir. 1992). The Second Circuit required plaintiffs to plead facts giving rise to a strong inference of scienter. See, e.g., *O'Brien v. National Property Analysts Partners*, 936

Second Circuit's standard was quite strict. The Second Circuit required facts giving rise to a "strong inference" of scienter and permitted two approaches to pleading such facts: alleging facts establishing both motive and opportunity to commit fraud, or alleging facts sufficient to demonstrate circumstantial evidence of reckless or conscious wrongdoing.¹³

Because most corporate defendants are subject to personal jurisdiction in a variety of places, the variance among the circuits (particularly the lax Ninth Circuit standard), created strong incentives for forum shopping and abuse. To address those concerns,¹⁴ Congress drafted the Reform Act in 1995 and passed it over President Clinton's veto in December of that year.¹⁵ The key text of the Reform Act, for purposes of this Note, is section 21D(b)(2) — "Required State of Mind," which provides that:

In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.¹⁶

Federal district courts have exhibited confusion about the meaning of § 21D(b)(2), and the federal circuit courts of appeals have divided on the issue.¹⁷ As one judge has noted, "widespread disagreement on the requirements of scienter permeates the federal

F.2d 674, 676 (2d Cir. 1991). The Third Circuit followed the Second. *See, e.g., In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1418 (3d Cir. 1997) (noting absence of law in the Third Circuit prior to 1995 Reform Act and approving Second Circuit's standard for use in cases not governed by the Reform Act). *In re Burlington Coat Factory* arose before the effective date of the Reform Act. *See* 114 F.3d at 1418 n.6. The Ninth Circuit permitted plaintiffs to plead the allegedly false or misleading statements and why they were false or misleading. Plaintiffs were permitted to aver scienter generally. *See, e.g., In re Glenfed Inc. Sec. Litig.*, 42 F.3d 1541, 1546, 1548-49 (9th Cir. 1994) (en banc).

13. *See* *Shields v. CityTrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994); *In re Time Warner*, 9 F.3d at 268-69. This discussion focuses on the Second Circuit's case law because Congress focused on that case law when it undertook legislation on this issue.

14. *See* *Powers v. Eichen*, 977 F. Supp. 1031, 1038 (S.D. Cal. 1997) ("The PSLRA effectively overturned the Ninth Circuit's lenient scienter pleading requirement . . .").

15. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, 765 n.5 (enumerating the dates upon which the President vetoed the Act and both the House and Senate overrode his veto).

16. Private Securities Litigation Reform Act of 1995, § 21D(b)(2), 15 U.S.C. § 78u-4(b)(2) (Supp. III 1997).

17. There are currently four circuit court opinions addressing this issue. Two, *Press v. Chemical Inv. Services, Corp.*, 166 F.3d 529 (2d Cir. 1999) and *Williams v. WMX Technologies*, 112 F.3d 175 (5th Cir. 1997) assume without argument that the Reform Act codified the Second Circuit's pleading standard. The Third Circuit reached the same conclusion in *In re Advanta Securities Litigation*, No. 98-1846, 1999 WL 395997, at *7 (3d Cir. June 17, 1999). The *Advanta* court reviewed the legislative history in great detail, including the legislative history for the Uniform Standards Act (discussed *infra* notes 75-80 and accompanying text), but ultimately concluded that "there is little to gain in attempting to reconcile the conflicting expressions of legislative intent." *Advanta*, 1999 WL 395997, at *7. The Third

court system.”¹⁸ Although § 21D(b)(2) adopts the Second Circuit’s pleading standard verbatim — “facts giving rise to a strong inference” of scienter — it does not speak directly to the tests that the Second Circuit developed to explain that standard. Specifically, two issues remain unresolved. First, it is unclear whether a plaintiff may adequately plead scienter by pleading both motive and opportunity. Second, it is unclear whether or not a plaintiff may adequately plead scienter by pleading circumstantial evidence of reckless conduct.

To address this confusion, it is helpful to distinguish between the Second Circuit’s pleading standard and the tests developed by the Second Circuit to explain that standard. While some cases use the two concepts interchangeably,¹⁹ this Note reserves the terms “pleading standard” and “standard” for the requirement that pleadings raise a strong inference of scienter. This Note reserves the term “tests” to refer to the Second Circuit’s explanation of the ways a plaintiff might demonstrate compliance with the pleading standard — a showing of motive and opportunity or a showing of circumstantial evidence indicating conscious or reckless wrongdoing.

Federal courts have sharply divided over the question of how section 21D(b)(2) is to be interpreted. The central district of California, in *Marksman Partners v. Chantal Pharmaceutical Corp.*, has read the plain language of section 21D(b)(2) and its accompanying legislative history to mean that Congress chose to codify both the Second Circuit’s motive and opportunity test and its circumstantial evidence of recklessness tests.²⁰ The *Marksman* rule has

Circuit therefore held that the plain language of the Reform Act, by incorporating the language of the Second Circuit’s standard, also incorporated its tests. 1999 WL 395997, at *7.

The Ninth Circuit, in *In re Silicon Graphics Inc. Securities Litigation*, Nos. 97-16204 & 97-16240, 1999 WL 446521, at *1 (9th Cir. July 2, 1999), analyzed the legislative history, and concluded that the Reform Act required plaintiffs to plead “in great detail, facts that constitute circumstantial evidence of deliberately reckless or conscious misconduct.” The opinion essentially tracks the analysis of the District Court opinion, *In re Silicon Graphics Inc. Securities Litigation*, No. C 97-0494, 1996 WL 664639, at *6-7 (N.D. Cal. Sept. 25, 1996). In brief summary, the Ninth Circuit reached its holding by emphasizing elements in the legislative history suggesting that Congress intended to raise the pleading standard nationwide. Since the Second Circuit standard was in place when the Reform Act was enacted, the court reasoned, the Reform Act must impose requirements more strict than those imposed by the Second Circuit. See *In re Silicon Graphics* 1999 WL 446521, at *5. For a response to this reasoning, see *infra* note 116 and accompanying text.

18. *Chan v. Orthologic Corp.*, No. CIV-96-1514-PHX-RCS, at 19, (D. Ariz. Feb. 5, 1998) (Broomfield, J.) (available at the Stanford Securities Litigation Clearinghouse (<http://securities.stanford.edu>)).

19. When such cases rely upon portions of the legislative history stating that the Reform Act codified the pleading standard for the proposition that the Reform Act codified the tests, this Note cites such cases verbatim, even at the risk of causing confusion. The use of “standard” and “test” by the cases does not necessarily track this Note’s usage of those terms — in fact, part of this Note’s argument is that some cases often mistake legislative history referring to the standards for evidence of codification of the tests.

20. 927 F. Supp. 1297, 1309-13 (C.D. Cal. 1996).

been widely followed by other districts,²¹ and essentially embraced by the Second, Third, and Fifth Circuits.²² The Northern District of California, by contrast, in *In re Silicon Graphics, Inc. Securities Litigation*, viewed the same sources as evidence that the Reform Act rejected the Second Circuit's tests in favor of a higher pleading standard still — requiring that a plaintiff plead facts demonstrating circumstantial evidence of conscious wrongdoing.²³ The *Silicon Graphics* rule has also found a wide following,²⁴ and has been affirmed by the Ninth Circuit.²⁵

This Note concurs with a third group of cases, led by *In re Baesa Securities Litigation*,²⁶ that have held that the Reform Act neither codifies nor repudiates the Second Circuit's tests, but merely codifies the pleading standard and requires courts to evaluate specific pleadings on a case-by-case basis.²⁷ Some commentators misunder-

21. See, e.g., *Gifford Partners, L.P. v. Sensormatic Elecs. Corp.*, No. 96 C 4072, 1997 WL 757495, at *18 (N.D. Ill. Nov. 24, 1997); *OnBank & Trust Co. v. FDIC*, 967 F. Supp. 81, 88 n.4 (W.D.N.Y. 1997); *Pilarczyk v. Morrison Knudsen Corp.*, 965 F. Supp. 311, 320 n.8 (N.D.N.Y. 1997), *affd. per curiam*, No. 97-7821, 1998 WL 640447 (2d Cir. Apr. 6, 1998); *Page v. Derrickson*, No. 96-842-CIV-T-17C, 1997 WL 148558, at *9 & n.5 (M.D. Fla. Mar. 25, 1997); *Fugman v. Aprogenex, Inc.*, 961 F. Supp. 1190, 1195 (N.D. Ill. 1997); *Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1252 (N.D. Ill. 1997); *STI Classic Fund v. Bollinger Indus.*, No. 3-96-CV-823-R, 1996 WL 885802, at *1 (N.D. Tex. Oct. 25, 1996); *Zeid v. Kimberley*, 930 F. Supp. 431, 438 (N.D. Cal. 1996).

22. See *In re Advanta Sec. Litig.*, No. 98-1846, 1999 WL 395997, at *7 (3d Cir. June 17, 1999); *Press v. Chemical Inv. Servs., Corp.*, 166 F.3d 529 (2d Cir. 1999); *Williams v. WMX Techs.*, 112 F.3d 175 (5th Cir. 1997).

23. *In re Silicon Graphics, Inc. Sec. Litig.*, No. C 96-0393, 1996 WL 664639, at *6-7 (N.D. Cal. Sept. 25, 1996) (holding that the Reform Act requires plaintiffs to allege "specific facts that constitute circumstantial evidence of conscious behavior by defendants").

24. See, e.g., *Voit v. Wonderware Corp.*, 977 F. Supp. 363, 374 (E.D. Pa. 1997) (approving *Norwood and Friedberg*); *Press v. Quick & Reilly*, No. 96 CIV. 4278 (RPP), 1997 WL 458666, at *2 (S.D.N.Y. Aug. 11, 1997) (holding that motive and opportunity alone are not sufficient — additional facts must also be pleaded giving rise to a strong inference of scienter); *Norwood Venture Corp. v. Converse, Inc.*, 959 F. Supp. 205, 208 (S.D.N.Y. 1997) (holding that Congress intended to raise the pleading standard above that of the Second Circuit); *Powers v. Eichen*, 977 F. Supp. 1031, 1038-39 (S.D. Cal. 1997) (approving *Silicon Graphics*); *Friedberg v. Discreet Logic Inc.*, 959 F. Supp. 42, 48 (D. Mass. 1997) (rejecting motive and opportunity based on Conference Committee Report).

25. See *In re Silicon Graphics Inc. Sec. Litig.*, Nos. 97-16204 & 97-16240, 1999 WL 446521, at *1 (9th Cir. July 2, 1999).

26. 969 F. Supp. 238 (S.D.N.Y. 1997).

27. See *In re Baesa*, 969 F. Supp. at 242 ("[U]nder the Reform Act, and in contrast to prior Second Circuit precedent, [particulars regarding motive and opportunity] are not presumed sufficient [to raise a strong inference of scienter]. Rather . . . the pleadings must set forth sufficient particulars, of whatever kind, to raise a strong inference of the required scienter." (footnote omitted)); see also *Malin v. IVAX Corp.*, 77 F. Supp. 2d 1345, 1357 (S.D. Fla. 1998) (approving *In re Baesa*); *Queen Uno Ltd. Partnership v. Coeur D'Alene Mines Corp.*, 2 F. Supp. 2d 1345, 1359 (D. Colo. 1998) (approving *In re Baesa* and *In re Health Management*); *In re Stratosphere Corp. Sec. Litig.*, 1 F. Supp. 2d 1096, 1107-08 (D. Nev. 1998) (approving *In re Baesa*); *In re Health Management, Inc. Sec. Litig.*, 970 F. Supp. 192, 201 (E.D.N.Y. 1997) (holding that a plaintiff may raise a strong inference by "pleading motive and opportunity, conscious misbehavior, recklessness or by impressing upon the court a novel legal theory").

stand the *Baesa* holding as rejecting motive and opportunity showings.²⁸ When properly understood and read in light of subsequent cases in the *Baesa* line,²⁹ however, the *Baesa* rule merely requires courts to evaluate a plaintiff's factual allegations neutrally. Courts should have no presumptions in favor of or against fixed formalistic categories such as "motive and opportunity," and should determine on a case-by-case basis whether or not plaintiffs' pleadings raise a strong inference of scienter.

This Note argues that the Reform Act neither codified nor prohibited the Second Circuit's tests, but merely codified the Second Circuit's pleading standard and left courts to apply the standard on a case-by-case basis.³⁰ The Reform Act essentially shifted the locus of uncertainty away from the various tests in various circuits — motive and opportunity, circumstantial evidence of recklessness — to

28. One commentator misreads *Baesa* as holding that a showing of motive and opportunity is facially insufficient to meet the Reform Act formulation. Compare Ryan G. Miest, Note, *Would the Real Scienter Please Stand Up: The Effect of the Private Securities Litigation Reform Act of 1995 on Pleading Securities Fraud*, 82 MINN. L. REV. 1103, 1126 (1998) ("The Second Circuit's motive and opportunity test is inconsistent with this focus [on unifying and strengthening procedural pleading standards] and should not be applied under 21D(b)(2).") and *id.* at 1128 ("The *Baesa* standard . . . eliminates motive and opportunity as an alternative pleading method . . .") with *In re Baesa*, 969 F. Supp. at 242 ("This, of course, does not mean that particulars regarding motive and opportunity may not be relevant to pleading circumstances from which a strong inference of fraudulent scienter may be inferred. In some cases, they may even be sufficient by themselves to do so. But, under the Reform Act . . . they are not presumed sufficient to do so. Rather, under the Reform Act formulation, the pleadings must set forth sufficient particulars, of whatever kind, to raise a strong inference of the required scienter." (footnote omitted) (emphasis added)).

For a more plaintiff-oriented view of the Reform Act, see William S. LeRach & Eric Alan Isaacson, *Pleading Scienter Under Section 21D(b)(2) of the Securities Exchange Act of 1934: Motive, Opportunity, Recklessness, and the Private Securities Litigation Reform Act of 1995*, 33 SAN DIEGO L. REV. 893 (1996).

29. Even if *Baesa* did take such a harsh view of motive and opportunity showings, later cases in the *Baesa* line have clarified the continuing relevance of motive and opportunity. See, e.g., *In re Stratosphere*, 1 F. Supp. 2d at 1107 ("[M]otive and opportunity . . . in some cases . . . may be sufficiently strong standing alone."); *Queen Uno*, 2 F. Supp. 2d at 1359 ("[I]n occasional cases the inference drawn solely from motive and opportunity allegations will . . . be sufficiently strong to withstand a motion to dismiss . . ."); *Malin*, 17 F. Supp. 2d at 1357 (approving statement in *Baesa* that "[i]n some cases [particulars regarding motive and opportunity] may even be sufficient by themselves to [raise a strong inference of scienter]" (quoting *In re Baesa*, 969 F. Supp. at 242)).

30. One commentator takes the remarkable position that the Reform Act simultaneously codified the Second Circuit tests and refrained from imposing any presumption either for or against the motive and opportunity test — a conclusion that essentially endorses both *Marksmen* and *Baesa*. Michael B. Dunn, Note, *Pleading Scienter After the Private Securities Litigation Reform Act: Or, a Textualist Revenge*, 84 CORNELL L. REV. 193, 250 (1998) ("Deciding courts . . . may . . . apply both of [the Second Circuit's] tests unaltered; they may . . . eliminat[e] the presumption that pleading motive and opportunity suffices to establish a strong inference and measure the weight of such evidence on a case-by-case basis; or alternatively, they may develop novel requirements and tests by which to satisfy the strong inference pleading standard."). Rather than concluding that virtually any reading of the Reform Act other than *Silicon Graphics* must be correct, this Note will argue that the *Silicon Graphics* court was at least correct on one point: the Congress unambiguously did not leave the door open for rote application of the Second Circuit tests.

the ultimate question of whether or not a plaintiff has raised a strong inference of scienter. The *Baesa* rule serves the heuristic function of reminding courts that the standard is central and the tests are peripheral; the formalism of the tests cannot be allowed to distract attention from the ultimate inquiry mandated by the standard. Part I argues, contrary to *Marksman*, that while the Reform Act codified the Second Circuit's pleading standard, it did not codify the associated tests. Part II argues, contrary to *Silicon Graphics*, that the Reform Act also did not repudiate those tests or prohibit courts from using them. Part III then embraces the *Baesa* rule, arguing that the same plain language and legislative history arguments that undercut both the *Marksman* and the *Silicon Graphics* rules compel the *Baesa* rule.

I. CONGRESS DID NOT CODIFY EITHER THE MOTIVE AND OPPORTUNITY TEST OR THE CIRCUMSTANTIAL EVIDENCE OF RECKLESSNESS TEST

Although Congress did codify the Second Circuit's pleading standard, it did not codify either the motive and opportunity test or the circumstantial evidence of recklessness test. This Part rejects the *Marksman* rule, which holds that the Reform Act's adoption of the Second Circuit's pleading standard implicitly codified both the motive and opportunity test and the circumstantial evidence of recklessness test.³¹ Section I.A contends that the plain language of the Reform Act, as well as much of its legislative history, indicates codification of only the pleading standard, not the tests. Section I.B points out that the deletion of Senator Specter's amendment (which would have expressly codified a simplistic version of the Second Circuit's tests) by the Conference Committee conclusively refutes the *Marksman* rule.

A. *The Reform Act Merely Codified the Second Circuit's Pleading Standard*

The Reform Act on its face codifies the Second Circuit's pleading standard. The Reform Act demands that plaintiffs "state with particularity facts giving rise to a *strong inference* that the defendant acted with [scienter],"³² while the Second Circuit formerly demanded that "facts alleged in the complaint must 'give[] . . . rise to

31. See *Marksman Partners v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1309-11, 1313 (C.D. Cal. 1996).

32. Private Securities Litigation Reform Act of 1995 § 21D(b)(2), 15 U.S.C. § 78u-4(b)(2) (Supp. III 1997) (emphasis added).

a 'strong inference' of fraudulent intent."³³ This similarity is not accidental according to the legislative history.³⁴ The Senate Report denied adopting "a new and untested pleading standard that would generate additional litigation," and conceded that the standard in the draft legislation was "modeled upon the pleading standard of the Second Circuit."³⁵

The fact that the Reform Act codified the pleading standard does not, however, prove that the Act also codified the tests. Section 21D(b)(2) says nothing about the tests.³⁶ If the Reform Act codified those tests, one might reasonably expect them to appear somewhere in the statute, yet they are conspicuously absent. The Conference Committee report recognizes this deliberate omission when it emphasizes that "[t]he Conference Committee language is based in part on the pleading standard of the Second Circuit," and "[the Committee] does not intend to codify the Second Circuit's case law interpreting this pleading standard."³⁷ The report's repudiation of the *Marksman* rule is compelling because the Supreme Court has identified conference committee reports as "the authoritative source for finding the Legislature's intent"³⁸ in part because they are the only documents that involve the collective understanding of both houses of Congress.³⁹ Furthermore, the legislative history outside of the Conference Committee report is essentially a wash, with comments from the Act's sponsors specifically disclaim-

33. *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 268 (2d Cir. 1993) (alteration in original) (emphasis added) (quoting *O'Brien v. Natl. Property Analysts Partners*, 936 F.2d 674, 676 (2d Cir. 1991)).

34. Legislative history is particularly essential when, as here, the plain text of the statute is remarkably sparse and the text itself adopts a judicially constructed standard. Contemporary criticisms to the contrary notwithstanding, legislative history remains an appropriate aid to statutory construction. For a comprehensive review and response to criticisms of judicial use of legislative history, see Stephen Breyer, *On the Uses of Legislative History in Interpreting Statutes*, 65 S. CAL. L. REV. 845 (1991).

35. S. REP. NO. 104-98, at 15 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 694; see also 141 CONG. REC. S17,966 (daily ed. Dec. 5, 1995) (statement of Sen. Hatch) ("[T]he legislation adopts the [S]econd [C]ircuit pleading standard . . .").

36. See *Novak v. Kasaks*, 997 F. Supp. 425, 430 (S.D.N.Y. 1998) ("[H]ad Congress wished to adopt the 'motive and opportunity' prong of the Second Circuit standard, it would have said so.").

37. Statement of Managers, *supra* note 4, at 41.

38. *Garcia v. United States*, 469 U.S. 70, 76 (1984).

39. See *Garcia*, 469 U.S. at 76 (quoting *Zuber v. Allen*, 396 U.S. 168, 186 (1969)). Note that the Conference Committee Report trumps floor debates. The Court has "eschewed reliance on the passing comments of one Member [of Congress] and casual statements from the floor debates" in favor of the Conference Report. *Garcia*, 469 U.S. at 76 (citation omitted). Further, the Conference Committee Report trumps the House and Senate reports. See *Demby v. Schweiker*, 671 F.2d 507, 510 (D.C. Cir. 1981) ("Because the conference report represents the final statement of terms agreed to by both houses, next to the statute itself it is the most persuasive evidence of congressional intent.").

ing codification of the Second Circuit's tests⁴⁰ balancing out any comments consistent with the *Marksman* rule.⁴¹ Finally, the fact that the Congress fully intended the Second Circuit's case law to be available for reference, not as binding statutory authority but as instructive persuasive authority,⁴² accounts for most pro-*Marksman* comments.

B. *The Deletion of Senator Specter's Proposed Amendment Conclusively Proves That the Reform Act Did Not Codify the Second Circuit's Tests*

Any inference that the Second Circuit's tests were codified by implication⁴³ is disproven by the specific deletion of Senator Specter's proposed amendment. The Supreme Court has held that when a conference committee explicitly considers and then rejects text — for example, by deleting a portion of a bill in conference — that consideration and rejection is compelling evidence of legislative intent and precludes interpretations that would reach the deleted result by implication.⁴⁴ This rule is precisely applicable to the Reform Act.

40. See 141 CONG. REC. S19,149 (daily ed. Dec. 22, 1995) (statement of Sen. Bradley) (“In fact, the language of the bill does codify the [S]econd [C]ircuit standard *in part* — and the statement of managers says so. . . . [T]he conference report *deliberately rejects a complete codification of the [S]econd [C]ircuit* and adopts language which is substantially similar to the language in the Senate-passed bill” (emphasis added)); see also Memorandum from Professor Joseph A. Grundfest of the Stanford Law School and former Commissioner of the SEC to President William J. Clinton (Dec. 19, 1995), reprinted in 141 CONG. REC. S19,067-68 (daily ed. Dec. 21, 1995) [hereinafter Grundfest memorandum] (“As I read the securities litigation conference report, the pleading standard is faithful to the Second Circuit's test. Indeed, I concur with the decision to eliminate the Specter amendment language, which was an incomplete and inaccurate codification of case law in the circuit.”).

41. For example, Representative Lofgren essentially endorsed the *Marksman* result during the veto override debates. See 141 CONG. REC. H15,219 (daily ed. Dec. 20, 1995) (statement of Rep. Lofgren). Senator Dodd reached a similar conclusion during the Senate override debates. See 141 CONG. REC. S17,959 (daily ed. Dec. 5, 1995) (statement of Sen. Dodd). Although both Lofgren and Dodd spoke of the Second Circuit's standard, their comments are typically taken (at least by plaintiffs' lawyers) as support for the *Marksman* rule. See, e.g., Appellants' Opening Brief at 42, 43 n.20, *In re Silicon Graphics Sec. Litig.*, (9th Cir. 1997) (No. 97-16240).

42. See S. REP. NO. 104-98, at 15 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 694 (“The Committee does not intend to codify the Second Circuit's caselaw interpreting this pleading standard, although courts may find this body of law instructive.”).

43. See, e.g., *In re Advanta Sec. Litig.*, No. 98-1846, 1999 WL 395997, at *7 (3d Cir. June 17, 1999) (“We believe Congress's use of the Second Circuit's language compels the conclusion that the Reform Act establishes a pleading standard approximately equal in stringency to that of the Second Circuit.”); *Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1252 (N.D. Ill. 1997) (inferring incorporation of the tests from Congress's decision “to incorporate verbatim the language of the Second Circuit Rule 9(b) standard”).

44. See *INS v. Cardoza-Fonesca*, 480 U.S. 421, 442-43 (1986) (“Few principles of statutory construction are more compelling than the proposition that Congress does not intend *sub silentio* to enact statutory language that it has earlier discarded in favor of other language.” (quoting *Nachman Corp. v. Pension Benefit Guar. Corp.*, 446 U.S. 359, 392-93 (1980) (Stewart, J., dissenting) (internal quotation marks omitted))); *Gulf Oil Corp. v. Copp Paving*

The Senate version of the Reform Act, S. 240, included an amendment originally proposed by Senator Specter. The Specter amendment would have replaced section 21D(b)(2) with the following:

(b) REQUIRED STATE OF MIND. —

(1) IN GENERAL. — . . . [T]he complaint shall . . . specifically allege facts giving rise to a strong inference that the defendant acted with the required state of mind.

(2) STRONG INFERENCE OF FRAUDULENT INTENT. — For purposes of paragraph (1), a strong inference that the defendant acted with the required state of mind may be established either —

(A) by alleging facts to show that the defendant had both motive and opportunity to commit fraud;
or

(B) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness by the defendant.⁴⁵

Subparagraph (2)(A) would have codified the motive and opportunity test and subparagraph (2)(B) would have codified the circumstantial evidence of recklessness test. The Specter amendment passed the Senate, and was part of the bill that the Senate sent to the Conference Committee. The Conference Committee removed the amendment,⁴⁶ compelling the conclusion that they did not intend to codify the Second Circuit's tests by implication.

The sponsors of the bill explained their intention in removing the Specter amendment. In the floor debates on the Conference Committee Report, Senator Specter inquired about the disappearance of his amendment, and Senator Dodd (one of the bill's managers) explained the Conference Committee's rationale:

Basically, what we intended to do here was to codify the [S]econd [C]ircuit's pleadings standards, not to indicate disapproval of *each individual case* that came before it. . . .

. . . [T]he Banking Committee . . . does not intend before we consider the bill to codify the [S]econd [C]ircuit's *case law* interpreting this pleading standard, although courts may find this body [of] law instructive.⁴⁷

Co., 419 U.S. 186, 200 (1974) (holding that a conference committee's deletion of a phrase from a bill that is later passed "strongly militates against a judgment that Congress intended a result that it expressly declined to enact"); see also Brief of the American Electronics Association, *Amicus Curiae* at 12, *In re Silicon Graphics Sec. Litig.*, (9th Cir. 1997) (No. 97-16240).

45. 141 CONG. REC. S9,170 (daily ed. June 27, 1995) (Amendment No. 1485).

46. See 141 CONG. REC. S17,959 (daily ed. Dec. 5, 1995) (statement of Sen. Specter) ("The conference report struck out the language which my amendment had inserted which would have given guidance to how plaintiffs could meet that very stringent standard.")

47. 141 CONG. REC. S17,960 (daily ed. Dec. 5, 1995) (statement of Sen. Dodd) (emphasis added). Following the quoted language, Senator Dodd also explained that:

Senator Dodd expressly confirms the obvious inference — the Conference Committee did not intend to codify Senator Specter's articulation of the Second Circuit's tests, and therefore removed language that would have done so, leaving only language that codifies the "strong inference of scienter" standard.⁴⁸

* * *

The Reform Act did not codify either the Second Circuit's motive and opportunity test or circumstantial evidence of recklessness test. The plain text of the Act and its legislative history make that clear, as does the deletion of the Specter amendment.

II. CONGRESS DID NOT REPUDIATE EITHER THE MOTIVE AND OPPORTUNITY TEST OR THE CIRCUMSTANTIAL EVIDENCE OF RECKLESSNESS TEST

Although not codified by the Reform Act, the Second Circuit's tests may still guide courts in their case-by-case evaluations of plaintiffs' pleadings. The *Silicon Graphics* court held that the motive and opportunity test and the circumstantial evidence of recklessness test were repudiated by the Reform Act, with the result that plaintiffs must plead circumstantial evidence of conscious wrongdoing.⁴⁹ This argument typically relies upon footnote 23 in the Statement of Managers, which states that "the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness."⁵⁰ This Part

The Senator's amendment adopted the guidance of the [S]econd [C]ircuit, but the amendment of the Senator from Pennsylvania completely omits a critical qualification in the case law. The courts have held that "where motive is not apparent, a plaintiff may plead scienter by identifying circumstances" indicating wrongful behavior, but "the strength of the circumstantial allegations must be correspondingly greater" from the number of cases.

141 CONG. REC. S17,960 (daily ed. Dec. 5, 1995) (statement of Sen. Dodd). In other words, the rationale for removing Senator Specter's amendment was that the amendment failed to clarify the full effect that the presence or absence of motive and opportunity has upon a plaintiff's showing. The Committee did not reason that motive and opportunity are now irrelevant — to the contrary, the Specter amendment failed to capture the full extent to which motive and opportunity are relevant.

48. *In re Advanta Sec. Litig.*, No. 98-1846, 1999 WL 395997, at *7 (3d Cir. June 17, 1999) ("[I]f Congress had desired to eliminate motive and opportunity or recklessness as a basis for scienter, it could have done so expressly in the text of the Reform Act. In our view, the fact that Congress considered inserting language directly addressing this line of cases, but ultimately chose not to, suggests that it intended to leave the matter to judicial interpretation."); *In re Silicon Graphics Inc. Sec. Litig.*, Nos. 97-16204 & 97-16240, 1999 WL 446521, at *20 (9th Cir. July 2, 1999) (Browning, J., concurring and dissenting) (citing *Advanta* for the same point).

49. *In re Silicon Graphics, Inc. Sec. Litig.*, No. C 96-0393, 1996 WL 664639, at *6-7 (N.D. Cal. Sept. 25, 1996) (holding that the Reform Act requires plaintiffs to "allege specific facts that constitute circumstantial evidence of conscious behavior by defendants").

50. Statement of Managers, *supra* note 4, at 48 n.23. The Statement of Managers is the Conference Committee Report for the Reform Act. For examples of reliance upon footnote 23 for the proposition that the Reform Act raised the pleading standard above that of the

rejects the *Silicon Graphics* rule. Section II.A argues that the plain language of the statute and the contemporaneous legislative history support the proposition that the Second Circuit's tests have not been repudiated by the Reform Act. Section II.B then turns to subsequent legislative history for additional evidence that the Second Circuit's tests retain some viability. Finally, section II.C concludes that complete rejection of the Second Circuit's tests would undercut the policy goals of the Reform Act.

A. *The Plain Language of the Statute Read with the Contemporaneous Legislative History Demonstrates the Survival of the Second Circuit's Tests*

Since the Reform Act fails to present any interpretation of the strong inference standard that might replace the Second Circuit's tests,⁵¹ the most natural inference is that it at least permits the use of the Second Circuit's tests.⁵² There is a significant contrary indication in the legislative history, however, because the Statement of Managers explains that "[b]ecause the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard."⁵³ After that sentence, the Managers appended footnote 23, which stated that mention of motive and opportunity and recklessness had been omitted.⁵⁴ Courts that follow the *Silicon Graphics* rule often rely on footnote 23.⁵⁵ These courts are incorrect.

Footnote 23 should not be read as repudiating the Second Circuit's tests because Congress did not intend the Reform Act to change the substantive law of scienter but rather intended it to change the procedure through which plaintiffs plead scienter.⁵⁶

Second Circuit, see *Silicon Graphics*, 1996 WL 664639, at *6-7; Message to the House of Representatives Returning Without Approval the Private Securities Litigation Reform Act of 1995, 31 WEEKLY COMP. PRES. DOC. 2210, 2210 (Dec. 19, 1995) [hereinafter Clinton Veto Message].

51. See *Zeid v. Kimberley*, 973 F. Supp. 910, 917 (N.D. Cal. 1997) (inferring support for the Second Circuit's tests from the absence of any alternative articulated in the Reform Act).

52. See *Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1252 (N.D. Ill. 1997) ("That Congress chose to incorporate verbatim the language of the Second Circuit Rule 9(b) standard is a strong indication of its intent to enact in § 78u-4(b)(2) a pleading standard of approximately the same specificity.").

53. Statement of Managers, *supra* note 4, at 41.

54. See *id.* at 48 n.23.

55. See, e.g., *In re Silicon Graphics Inc. Sec. Litig.*, Nos. 97-16204 & 97-16240, 1999 WL 446521, at *5 (9th Cir. July 2, 1999) (citing footnote 23 and accompanying text for the proposition that "the joint committee expressly rejected the Second Circuit's two prong test").

56. This Note uses the label "substantive" to refer to the plaintiff's burdens *at trial*, and uses the term "procedural" to refer to the plaintiff's burdens of *pleading*. The distinction is highly relevant, see *COX ET AL.*, *supra* note 4, at 698 (distinguishing "whether scienter has been shown" from the "very different question" of "whether plaintiffs' complaint adequately

Section 21D(b)(2) specifies that a pleading must give rise to a strong inference of “the required state of mind” — a phrase that necessarily incorporates the scienter requirements of the underlying substantive law.⁵⁷ This means that Congress sought only to change the pleading standard, not the underlying substantive law, with § 21D(b)(2).

Because every circuit court to consider the question has held that recklessness suffices substantively (to prove liability)⁵⁸ it would be anomalous to read footnote 23 as prohibiting plaintiffs from pleading recklessness, thereby imposing a higher burden on plaintiffs at the pleading stage (before discovery) than they would bear at trial (after discovery).⁵⁹ One might argue that Congress intended to change the substantive securities law “through the back door” and merely chose to pursue that goal through procedural reform in order to avoid the political difficulty of appearing to be “pro-securities fraud.”⁶⁰ As Chairman Levitt has suggested, however, it

pleads scienter”), because the Reform Act changed only the pleading requirement, not the substantive law defining various securities fraud offenses.

For discussion of this distinction in subsequent legislative history, see S. REP. NO. 105-182, at 5-6 (1998) (clarifying that Congress did not intend the Reform Act to change the substantive scienter requirement); 144 CONG. REC. S4,798-99 (daily ed. May 13, 1998) (statement of Sen. Dodd) (affirming that he did not intend the Reform Act to alter the substantive scienter requirement). Cf. *Zuckerman v. Foxmeyer Health Corp.*, 4 F. Supp. 2d 618, 622 & n.2 (N.D. Tex. 1998) (noting that the Reform Act “by its own terms, does nothing to alter the level of intent previously required” and “clearly does not attempt to supply a specific level of intent, but refers the reader to whichever cause of action in the Securities and Exchange Act a plaintiff brings suit”).

57. See *In re Baesa Sec. Litig.*, 969 F. Supp. 238, 240 (S.D.N.Y. 1997) (stating that the definition of “required state of mind” must necessarily come from the Exchange Act or the underlying common law); see also Brief of the SEC, *Amicus Curiae* at 18, *In re Silicon Graphics Sec. Litig.*, (9th Cir. 1997) (No. 97-16240) [hereinafter SEC Brief].

58. The Supreme Court reserved opinion on whether recklessness sufficed substantively in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n.12 (1976). Every circuit court of appeals to consider the question, however, has found recklessness sufficient under Rule 10b-5. See *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 & n.6 (9th Cir. 1990) (en banc) (collecting cases). Even the Fourth Circuit essentially accepts recklessness. It has twice held, albeit both times in unpublished opinions, that severe recklessness suffices to satisfy the scienter requirement imposed in *Ernst & Ernst*. See *SEC v. Gotchey*, 981 F.2d 1251, 1992 WL 385284 (4th Cir. 1992) (holding that “severe recklessness satisfies scienter requirement” (citation omitted)); *Kessler v. Falbo (In re Hughes Creek, Inc.)*, 980 F.2d 727, 1992 WL 301956 (4th Cir. 1992) (same).

59. See SEC Brief, *supra* note 57, at 19; David M. Lavine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws*, 54 BUS. LAW. 1, 35 (1998) (“It would hardly make sense to find recklessness insufficient at the pleading stage, but sufficient to impose liability.”); see also SEC REPORT, *supra* note 3, at 41 (noting that an interpretation of § 21D(b)(2) that prohibited pleadings of recklessness would also eliminate recklessness as a basis of liability).

60. This argument would note that “[t]he Reform Act revised both the substantive standards and procedural rules governing private actions.” *Implementation of the Private Securities Litigation Reform Act of 1995: Hearing Before the Subcomm. on Fin. and Hazardous Materials of the House Comm. on Commerce*, 105th Cong. 18 (1997) [hereinafter *1997 Act Hearing*] (statement of Arthur Levitt, SEC Chairman). Chairman Levitt has described cases raising the pleading standard as “indirectly [affecting] the substantive liability require-

is unlikely that this was Congress's intent,⁶¹ and courts should not assume duplicity on the part of the legislature in the face of a clear, textual command and even clearer legislative history. Moreover, the safe harbor provision, which protects certain classes of reckless statements, would be superfluous if recklessness were not within the scope of the Reform Act. Footnote 23 lists motive and opportunity and recklessness all in the same sentence: "For this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness."⁶² That sentence cannot mean one thing for the first two elements in the clause ("motive, opportunity") and something entirely different for the third element ("recklessness"). Footnote 23 is an all-or-nothing affair: if it does not prohibit the recklessness test, it cannot prohibit the motive and opportunity test either.

A comparison between the scienter pleading provision of the Reform Act and the safe harbor provision further proves that Congress did not intend footnote 23 to imply an "actual knowledge" standard. In the safe harbor provision, Congress expressly requires a showing of "actual knowledge . . . that the statement was false or misleading."⁶³ The stark absence of any similar language in § 21D(b)(2) strongly implies that Congress did not intend § 21D(b)(2) to require "actual knowledge."⁶⁴ The contrast with the safe-harbor provision also goes to show that the Reform Act could not have been meant to compel strict adherence to the Second Circuit's tests.⁶⁵

ments of the securities laws themselves." *1997 Act Hearing, supra*, at 23 (statement of Arthur Levitt). If one were prone to believe that the *Silicon Graphics* line of cases is correct, one could believe that Congress intended to change indirectly the substantive liability requirements — in other words, to change the substantive securities law through the back door. One might defend that argument by suggesting that the political difficulties associated with overtly sanctioning securities fraud might compel Congress to approach the substantive law through the vehicle of procedure.

61. *1997 Act Hearing, supra* note 60, at 23 (statement of Arthur Levitt).

62. Statement of Managers, *supra* note 4, at 48 n.23.

63. Private Securities Litigation Reform Act of 1995 § 27A(c)(1)(B), 15 U.S.C. § 78u-5(c)(1)(B) (Supp. III 1997). The safe harbor provision provides, *inter alia*, that certain classes of forward-looking statements are generally not subject to liability if they prove to be false or misleading. Liability for such statements will only be imposed upon a showing that the statement "was made with actual knowledge by [the person making the statement] that the statement was false or misleading." 15 U.S.C. § 78u-5(c)(1)(B).

64. See *In re Health Management, Inc. Sec. Litig.*, 970 F. Supp. 192, 201 (E.D.N.Y. 1997) ("Congress knew well how to state [a 'knowing misbehavior'] standard. . . . The Court finds the omission of such language in the statute significant. . . .") (citation omitted).

65. See *In re Silicon Graphics Inc. Sec. Litig.*, Nos. 97-16204 & 97-16240, 1999 WL 446521 at *20 (9th Cir. July 2, 1999) (Browning, J., concurring and dissenting) ("Moreover, the Specter Amendment's codification of a specific test for pleading scienter would have been inconsistent with the provisions of the Reform Act requiring a different state of mind for different statements. Under the Reform Act's 'save harbor' provisions, plaintiffs must prove that 'forward-looking' statements were made with 'actual knowledge' that they were false or misleading. . . . A recklessness standard for pleading that would apply to all statements, such as that

Footnote 23 should instead be understood as a reference to the Specter amendment.⁶⁶ The Ninth Circuit's conclusion to the contrary notwithstanding,⁶⁷ the conclusion that Congress deliberately declined to codify Senator Specter's articulation of the tests does not entail the conclusion that they affirmatively rejected all use of the Second Circuit case law.⁶⁸ In fact, as Senator Dodd explained, one rationale for rejecting the Specter amendment was that it failed to capture the full detail and sophistication of the contemporary Second Circuit case law.⁶⁹ Numerous statements in the legislative history to the effect that courts may find the Second Circuit's case law instructive⁷⁰ indicate that removal of the Specter amendment did not constitute a conclusive rejection of the Second Circuit's tests.

proposed in the Specter Amendment, would have been inconsistent with the safe harbor's requirement of 'actual knowledge' for forward-looking statements." (citation omitted)).

66. See Clinton Veto Message, *supra* note 50, at 2210; SEC REPORT, *supra* note 3, at 29 (identifying footnote 23 as an explanation of the deletion of the Specter amendment).

67. *In re Silicon Graphics Inc. Sec. Litig.*, Nos. 97-16204 & 97-16240, 1999 WL 446521, at *4 (9th Cir. July 2, 1999) (citing as evidence of a raised standard, the fact that "Congress declined to enact an amendment that would have adopted the Second Circuit rule").

68. See, e.g., *Silicon Graphics* 1999 WL 446521, at *20 (Browning, J., concurring and dissenting) ("The legislative history suggests, however, that the Committee rejected language added by the Specter Amendment because it was 'an incomplete and inaccurate codification' of Second Circuit case law, not because the Committee intended to restrict the ways in which a 'strong inference' of scienter might be shown. Indeed, supporters of the defeated Specter Amendment were assured that while the Reform Act did not expressly provide that plaintiffs could plead scienter based on recklessness or motive and opportunity to defraud, 'the guidance [provided by Second Circuit case law] is still going to be there.'" (citation omitted)); *OnBank & Trust Co. v. FDIC*, 967 F. Supp. 81, 89 n.4 (W.D.N.Y. 1997) ("Simply because Congress did not codify that case law by making those factors an express part of the pleading standard does not mean that Congress intended to overturn that case law."). It is noteworthy that the Specter amendment would have codified the "strong circumstantial evidence of conscious misbehavior" standard alongside the recklessness and motive and opportunity standards. See 141 CONG. REC. S9,170 (daily ed. June 27, 1995) (Amendment No. 1485). Yet the same courts that see the Specter amendment as decisive on the question of whether recklessness or motive and opportunity survived do not hold that "circumstantial evidence of conscious misbehavior" was prohibited as well. See SEC REPORT, *supra* note 3, at 40 ("This conclusion was reached [by Judge Smith in *Silicon Graphics*] despite the fact that in deleting the clarifying amendment, the Conference Committee deleted not only the language regarding motive, opportunity, and recklessness, but also the language regarding conscious misbehavior.").

69. 141 CONG. REC. S17,960 (daily ed. Dec. 5, 1995) (statement of Sen. Dodd) (stating that "the amendment of the Senator from Pennsylvania completely omits a critical qualification in the case law [namely that] 'where motive is not apparent, a plaintiff may plead scienter by identifying circumstances' indicating wrongful behavior, but 'the strength of the circumstantial allegations must be correspondingly greater'").

In later debates, Senator Dodd made clear that the removal of the Specter amendment ought not be interpreted as prohibition of the Second Circuit's tests. See 141 CONG. REC. S19,071 (1995) (statement of Sen. Dodd) (explaining that even after the removal of the Specter amendment, the guidance provided by Second Circuit case law will still be available to courts).

70. See, e.g., S. REP. NO. 104-98, at 15 (1995), reprinted in 1995 U.S.C.A.N. 679, 694.

President Clinton's veto message, which asserted that the Reform Act set the standard so far above the Second Circuit level as to bar too many meritorious claims,⁷¹ does not compel a contrary result, because the post-veto debates override the veto message.⁷² President Clinton vetoed the Reform Act because he interpreted footnote 23 and the accompanying text, along with the removal of the Specter amendment, as evidence of a pleading standard higher than the Second Circuit's.⁷³ The Supreme Court, however, has expressed significant skepticism about reliance on the comments of a bill's opponents as legislative history, on the grounds that such opponents tend to "overstate [the bill's] reach."⁷⁴ The Court has therefore held that it is not the "fears and doubts of the opposition" to which one looks when interpreting a statute, but rather the sponsors,⁷⁵ who in this case said that President Clinton overestimated the import of footnote 23.⁷⁶ For example, in the veto override debate, Senator Domenici inserted a bill summary stating that the objective of section 21D(b)(2) was "[t]o codify the requirements in the [Second] Circuit."⁷⁷ Other comments by nonsponsor supporters make the same point.⁷⁸ President Clinton himself appears to have recently recanted the main points in the veto message, suggesting that even he now concurs that the original veto message misstated the reach of the Reform Act.⁷⁹

71. Clinton Veto Message, *supra* note 50, at 2210.

72. See *NLRB v. Robbins Tire & Rubber Co.*, 437 U.S. 214, 235 (1978). *But see* *Landgraf v. USI Film Prods.*, 511 U.S. 244, 255-56 (1994) (relying on veto as guide to legislative intent when Congress failed to override veto of bill with retroactivity provision, but succeeded in passing and obtaining signature of identical bill without retroactivity provision).

73. See Clinton Veto Message, *supra* note 50, at 2210 ("[T]he conferees make crystal clear in the Statement of Managers their intent to raise the standard even beyond [the Second Circuit's]. I am not prepared to accept that.").

74. *NLRB v. Fruit & Vegetable Packers Local 760*, 377 U.S. 58, 66 (1964); *accord* *Shell Oil Co. v. Iowa Dept. of Revenue*, 488 U.S. 19, 29 (1988); *Gulf Offshore Co. v. Mobil Oil Co.*, 453 U.S. 473, 483 (1981) (citing *Schwegmann Bros. v. Calvert Distillers Corp.*, 341 U.S. 384, 394 (1951)).

75. *Fruit & Vegetable Packers*, 377 U.S. at 66 (quoting *Schwegmann Bros.*, 341 U.S. at 394).

76. See 141 CONG. REC. S19,150 (daily ed. Dec. 22, 1995) (statement of Sen. Domenici) ("The President objected to the pleading standard. Yet it is the Second Circuit's pleading standard.").

77. 141 CONG. REC. S19,151 (daily ed. Dec. 22, 1995).

78. See, e.g., 141 CONG. REC. H15,219 (daily ed. Dec. 20, 1995) (statement of Rep. Lofgren) ("The President says he supports the [S]econd [C]ircuit standard for pleading. So do I. That is what is included in this bill.").

79. See Statement on Signing the Securities Litigation Uniform Standards Act of 1998, 34 WEEKLY COMP. PRES. DOC. 2247, 2248 (Nov. 3, 1998) ("In signing the Uniform Standards Act, I do so with the understanding . . . that investors with legitimate complaints meeting the Second Circuit pleading standard will have access to our Nation's courts. . . . the Statement of Managers confirms that the Second Circuit pleading standard will be the uniform standard for pleading securities fraud.").

B. *Subsequent Legislative History Confirms the Survival of the Second Circuit's Tests*

In the legislative history for the Securities Litigation Uniform Standards Act of 1998, Congress clarified the intended meaning of the Reform Act.⁸⁰ This subsequent legislative history, while not controlling, is entitled to some persuasive weight. In response to the *Silicon Graphics* line of cases, the Uniform Standards Act Conference Report directly states that Congress did not intend to remove recklessness as a basis of liability under Rule 10b-5. The necessary implication is that the Reform Act was not intended to prohibit pleading recklessness.

Subsequent legislative history deserves weight in the interpretive process, even though it lacks both the force of law and of contemporaneous legislative history.⁸¹ Subsequent legislative history is at its most relevant when courts have based decisions on legislative history and Congress has then reviewed the same materials and drawn an opposite conclusion.⁸²

Precisely such a review and clarification has occurred with respect to the Reform Act: the Securities Litigation Uniform Standards Act of 1998 arose out of legislative hearings on the effects of the Reform Act. Congress heard testimony that a primary result of the Reform Act was to drive lawsuits from federal court into state court, to evade the strict federal pleading standard. The

80. Note that the "uniformity" referred to in the title of the Act is uniformity across the federal-state line. The purpose of the Uniform Standards Act is to preempt certain state securities fraud class action lawsuits, thereby preventing plaintiffs from circumventing the Reform Act by shifting to state courts. *See id.* at 2248. The Uniform Standards Act does not purport to legislate away the nonuniformity across the federal circuits.

81. The *Advanta* court declined to give the subsequent legislative history any weight at all. *See In re Advanta Sec. Litig.*, No. 998-1846, 1999 WL 395997, at *6 (3d Cir. June 17, 1999) ("[O]ur interpretation of the Reform Act is unaffected by the legislative history of the Standards Act."). While the *Advanta* court correctly cited *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 185 (1994) for the point that the "interpretation given by one Congress (or a committee or Member thereof) to an earlier statute is of little assistance in discerning the meaning of that statute," courts should nevertheless not dismiss subsequent legislative history entirely. *See, e.g.*, *Cannon v. University of Chicago*, 441 U.S. 677, 687 n.7 (1979) (acknowledging rule that subsequent legislative history does not control, but stating that courts are remiss to ignore it completely); *see also* *North Haven Bd. of Educ. v. Bell*, 456 U.S. 512, 535 (1982) (approving *Cannon*).

82. *See* *Glidden Co. v. Zdanok*, 370 U.S. 530, 541 (1962) (Harlan, J.) (plurality opinion) (endorsing the use of subsequent legislative history in construing legislation "[e]specially . . . when the Congress has been stimulated by decisions of this Court to investigate the historical materials involved and has drawn from them a contrary conclusion"). The *Glidden* Court equates subsequent legislative history with subsequent interpretive legislation: "Typical is a statement in the 1958 House Report Subsequent legislation which declares the intent of an earlier law is entitled to weight when it comes to the problem of construction." 370 U.S. at 541 (internal question marks and citations omitted). To the extent that such an equivocation is plausible, other Supreme Court precedents approve the use of subsequent legislation as an interpretive aid. *See, e.g.*, *NLRB v. Bell Aerospace Co.*, 416 U.S. 267, 275 (1974); *Red Lion Broad. Co. v. FCC*, 395 U.S. 367, 380-81 (1969); *FHA v. Darlington, Inc.*, 358 U.S. 84, 90 (1958).

Senate therefore initiated the Uniform Standards Act to raise the bar in state court.⁸³ During the debate over the Uniform Standards Act, the SEC expressed concern that it might lock in erroneous district court holdings that rejected recklessness as a basis for pleading scienter.⁸⁴ The Conference Committee addressed this concern by stating that “the clear intent in 1995 and our continuing intent in this legislation is that neither the Reform Act nor S. 1260 in any way alters the scienter standard in Federal securities fraud suits.”⁸⁵ This passage attempts to remove any ambiguity surrounding the purpose of the Reform Act: Congress did not intend the Reform Act to change the underlying liability rules. The clear implication is that the pleading standard should not be interpreted so as to eliminate recklessness as a method of pleading securities fraud. If recklessness was not eliminated, neither was the motive and opportunity test,⁸⁶ and the Second Circuit’s interpretation of the pleading standard remains viable even under the Reform Act.

83. See S. REP. NO. 105-182, at 3 (1998).

84. See Letter from Arthur Levitt, Chairman of the SEC and Commissioners Isaac C. Hunt, Jr. and Laura S. Unger to Senators Alfonse M. D’Amato, Phil Gramm, and Christopher Dodd (Mar. 24, 1998) (“[W]hen the Commission testified . . . we stated that a uniform standard for securities fraud class actions that did not permit investors to recover losses attributable to reckless misconduct would jeopardize the integrity of the securities markets. In light of this profound concern, we were gratified by the language in your letter of today agreeing to restate in S. 1260’s legislative history, and in the expected debate on the Senate floor, that the Private Securities Litigation Reform Act of 1995 did not, and was not intended to, alter the well-recognized and critically important scienter standard.”); *1997 Act Hearing, supra* note 60 (testimony of Arthur Levitt, SEC Chairman) (“The Commission was able to support S. 1260 only upon receiving assurances that legislative history would be inserted into the record making clear that the Reform Act was not meant to define or alter the state of mind requirements for securities fraud liability.”).

85. S. REP. NO. 105-182 at 3-4 (1998) (Statement of Managers — The Securities Litigation Uniform Standards Act of 1998). Similar language is found in the Senate Report. See S. REP. NO. 105-182, at 6 (1998) (“It was the intent of Congress, as was expressly stated during the legislative debate on the PSLRA, and particularly during the debate on overriding the President’s veto, that the PSLRA establish a uniform federal standard on pleading requirements by adopting the pleading standard applied by the Second Circuit Court of Appeals.”). A colloquy on the Senate floor between Senators Dodd and D’Amato (both sponsors of the Reform Act) made the same point, and explained that footnote 23 should not be interpreted to the contrary. See 144 CONG. REC. S4,798-99 (daily ed. May 13, 1998) (colloquy between Sen. Dodd and Sen. D’Amato) (reiterating that neither sponsor intended the Reform Act to raise the bar above the Second Circuit level and confirming that footnote 23 was intended merely to account for the omission of the Specter amendment). On the House side, Representatives Eshoo and Cox (both sponsors of the Reform Act) engaged in a parallel colloquy, which concluded with Representative Cox’s statement that “[i]t is my clear understanding that Congress did not, in adopting the Reform Act, intend to alter standards of liability under the Exchange Act.” 144 CONG. REC. H6,061 (daily ed. July 21, 1998) (colloquy between Rep. Eshoo and Rep. Cox).

86. See *supra* note 59.

C. *The Policy Rationales Underlying the Reform Act Require Retention of the Second Circuit's Tests*

Protection of investors and investor confidence is "the overriding purpose of our Nation's securities laws," and the purpose of the Reform Act.⁸⁷ Investors (and by extension, investor confidence) are protected by the deterrent value of private enforcement of the securities laws. If the scienter pleading standard were raised to circumstantial evidence of conscious wrongdoing, that deterrent value would diminish:

Ensuring that the scienter standard includes reckless misconduct is critical to investor protection. Creating a higher scienter standard would lessen the incentives for issuers of securities to conduct a full inquiry into potentially troublesome areas and could therefore damage the disclosure process that has made our markets a model for other nations. The U.S. securities markets are the envy of the world precisely because investors at home and abroad have enormous confidence in the way our markets operate. Altering the scienter standard in the way envisioned by some of these district court decisions could be very damaging to that confidence.⁸⁸

While the Reform Act focuses on decreasing securities lawsuits, that is only because Congress believed that the pendulum had swung too far toward securities fraud plaintiffs.⁸⁹ An interpretation of the Reform Act that raised the bar too high would be inconsistent with the balance that Congress intended the Reform Act to strike. Complete prohibition of motive and opportunity pleadings would be inconsistent in precisely this fashion, because it would almost certainly preclude some legitimate complaints.⁹⁰ Permitting recklessness and motive and opportunity to play some role in securities fraud litigation helps protect investors and maintain confidence by exposing fraudulent schemes that might withstand scrutiny under a more defense-oriented test.

* * *

Therefore, just as the Reform Act does not codify the Second Circuit's tests, it also does not prohibit their use. Put differently, the Reform Act rejects both per se approaches, *Marksman* and *Silicon Graphics*. Under the Reform Act, recklessness is neither per se sufficient nor per se insufficient (lest the rule thwart the consensus of every Circuit Court of Appeals that recklessness generally

87. Statement of Managers, *supra* note 4, at 31.

88. 144 CONG. REC. S4,798 (daily ed. May 13, 1998) (statement of Sen. Dodd).

89. Statement of Managers, *supra* note 4, at 31 ("Congress has been prompted by significant evidence of abuse in private securities lawsuits to enact reforms to protect investors and maintain confidence in our capital markets.")

90. See Clinton Veto Message, *supra* note 50, at 2210.

suffices to establish liability under Rule 10b-5).⁹¹ Subsequent legislative history has made clear that Congress did not intend to change the substantive law of scienter: in other words, they did not intend to overturn the consensus of the circuits. The treatment of motive and opportunity tracks the treatment of recklessness — pleading motive and opportunity is neither *per se* sufficient nor *per se* insufficient. The need to maintain confidence in the securities market also supports the availability of the Second Circuit's tests.

III. CONGRESS LEFT COURTS TO DECIDE ON A CASE-BY-CASE BASIS WHETHER PARTICULAR SHOWINGS OF MOTIVE AND OPPORTUNITY OR CIRCUMSTANTIAL EVIDENCE OF RECKLESSNESS GIVE RISE TO A STRONG INFERENCE OF SCIENTER

A small cadre of federal district courts has consistently held that the Reform Act codified the Second Circuit's pleading standard, a result that is logical given the plain text of section 21D(b)(2), but not the Second Circuit's tests interpreting that standard.⁹² This Part argues that these courts, led by *In re Baesa Securities Litigation*, are correct. The Reform Act essentially shifts the locus of uncertainty in federal securities fraud lawsuits. In the pre-Reform Act Second Circuit, and in post-Reform Act *Marksman* courts, the courts compare a plaintiff's pleading with an ideal motive and opportunity pleading or an ideal recklessness pleading. The question becomes "is this allegation of motive and opportunity or recklessness sufficiently specific and particular to give the test any teeth?" The Reform Act shifts the locus of uncertainty from the test itself to the antecedent and ultimately terminal question "has the plaintiff raised a strong inference of scienter?" Section III.A contends that the plain language of the statute and the legislative history dictate this interpretation. Section III.B demonstrates that the *Baesa* rule also best effectuates the policy goals of the Reform Act.

91. If recklessness is sufficient to establish *liability*, recklessness must also be a sufficient *pleading*. See *supra* note 59 and accompanying text. The alternative, requiring a higher standard for pleading than for a showing of liability, requires one to believe that Congress intended covertly to change the liability standard, a conclusion that courts should not accept. See text accompanying *supra* notes 60-61.

92. See *Malin v. IVAX Corp.*, 17 F. Supp. 2d 1345, 1357 (S.D. Fla. 1998); *Queen Uno Ltd. Partnership v. Coeur D'Alene Mines Corp.*, 2 F. Supp. 2d 1345, 1359 (D. Colo. 1998); *In re Stratosphere Corp. Sec. Litig.*, 1 F. Supp. 2d 1096, 1107-08 (D. Nev. 1998); *In re Health Management, Inc. Sec. Litig.*, 970 F. Supp. 192, 200-01 (E.D.N.Y. 1997); *In re Baesa Sec. Litig.*, 969 F. Supp. 238, 242 (S.D.N.Y. 1997).

A. *The Baesa Rule Flows Directly from the Plain Language of the Reform Act, and Is Supported by the Legislative History*

The *Baesa* rule is relatively simple: courts must conduct a fresh examination of each plaintiff's allegations, without regard to "formalistic categor[ies]" such as recklessness or motive and opportunity, to determine whether a strong inference of scienter is raised.⁹³ The *Baesa* court observed that section 21D(b)(2) merely adopts the strong inference standard but stops short of endorsing any particular method of raising a strong inference.⁹⁴ The court then explained that:

The conclusion follows from the plain language of the statute that the mere pleading of motive and opportunity does not, of itself, automatically suffice to raise a strong inference of scienter.

This, of course, does not mean that particulars regarding motive and opportunity may not be relevant to pleading circumstances from which a strong inference of fraudulent scienter may be inferred. In some cases, they may even be sufficient by themselves to do so. But, under the Reform Act, and in contrast to prior Second Circuit precedent, they are not presumed sufficient to do so. Rather, under the Reform Act formulation, the pleadings must set forth sufficient particulars, of whatever kind, to raise a strong inference of the required scienter.⁹⁵

The key to the *Baesa* rule is its refusal to determine the outcome of a motion to dismiss based on "formalistic categor[ies] such as motive and opportunity."⁹⁶ Under the *Baesa* rule, recklessness or motive and opportunity are presumed neither sufficient nor insufficient. Further, those categories do not exhaust a plaintiff's potential options: just as a plaintiff might make a recklessness showing or a motive and opportunity showing that was sufficient to raise a strong inference of scienter, a plaintiff could also "impress[] upon the court a novel legal theory."⁹⁷ The sole inquiry under this approach is the strong inference standard, and the court declines to take shortcuts by presuming either recklessness or motive and opportunity to be per se sufficient or per se necessary.⁹⁸

The *Baesa* rule follows from the language of the Reform Act. Congress codified the Second Circuit's pleading standard, but expressly refrained from codifying the Second Circuit's tests interpreting the standard. The inevitable conclusion is that courts must

93. *Queen Uno*, 2 F. Supp. 2d at 1359.

94. *See In re Baesa*, 969 F. Supp. at 242.

95. 969 F. Supp. at 242 (footnotes omitted).

96. *Queen Uno*, 2 F. Supp. 2d at 1359.

97. *In re Health Management*, 970 F. Supp. at 201.

98. *See Queen Uno*, 2 F. Supp. 2d at 1359; *see also* *Malin v. IVAX Corp.*, 17 F. Supp. 2d 1345, 1356-57 (S.D. Fla. 1998).

examine a plaintiff's showings to determine if they meet the strong inference standard.⁹⁹ The Reform Act, "while adopting the 'strong inference' requirement, makes no mention whatever of 'motive and opportunity,' nor singles out any other special kind of particulars as presumptively sufficient."¹⁰⁰ The Reform Act also does not single out any "special kind of particulars" as presumptively insufficient. Thus, the *Baesa* rule merely asks courts to "appl[y] the statute as written," under which "allegations of motive, opportunity, or reckless behavior may still be relevant."¹⁰¹

The *Baesa* rule is consistent with the key elements from the legislative history that the *Silicon Graphics* court relied on. These elements all demonstrate that the Second Circuit's tests were deliberately omitted from the legislation.¹⁰² The *Baesa* rule is consistent with this point, because it does not give either recklessness or motive and opportunity presumptive weight. The *Silicon Graphics* rule also relies on citations to the legislative history tending to demonstrate that Congress intended to raise the overall bar for pleading scienter nationally, which would require raising the bar in the Second Circuit.¹⁰³ The *Baesa* rule is consistent with this point as well: under the *Baesa* rule, courts in the Second Circuit may no longer permit a pleading to survive *as a matter of law* merely because it contains allegations of recklessness or motive and opportunity. Instead, they must find that those allegations are sufficient to raise a strong inference of scienter *on those facts*. This raises the

99. *In re Advanta Sec. Litig.*, No. 98-1846, 1999 WL 395997, at *7 (3d Cir. June 17, 1999) ("[I]f Congress had desired to eliminate motive and opportunity or recklessness as a basis for scienter, it could have done so expressly in the text of the Reform Act. In our view, the fact that Congress considered inserting language directly addressing this line of cases, but ultimately chose not to, suggests that it intended to leave the matter to judicial interpretation."); *In re Silicon Graphics Inc. Sec. Litig.* Nos. 97-16204 & 97-16240, 1999 WL 446521, at *20 (9th Cir. July 2, 1999) (Browning, J., concurring and dissenting) (citing *Advanta* for the same point).

100. *In re Baesa*, 969 F. Supp. 238, 242 (S.D.N.Y. 1997).

101. *OnBank & Trust Co. v. FDIC*, 967 F. Supp. 81, 89 n.4 (W.D.N.Y. 1997); *accord Myles v. Midcom Communications, Inc.*, No. C96-614D (W.D. Wash. Nov. 19, 1996) ("The statute itself defines the standard and the statute is clear."), *discussed in SEC REPORT*, *supra* note 3, at 44.

102. *See, e.g., In re Silicon Graphics, Inc. Sec. Litig.*, 970 F. Supp. 746, 756 (N.D. Cal. 1997) (citing the Statement of Managers for the proposition that the Conference Committee deliberately chose not to include references to recklessness or motive and opportunity in the pleading standard).

103. *See, e.g., Silicon Graphics* 1996 WL 664639, at *6 n.4 ("The Court finds that the legislative history, the most definitive part of which is the Conference Committee Report, establishes the SRA standard as stricter than the Second Circuit standard.").

Judge Smith drafted two opinions in *Silicon Graphics*. The first, 1996 WL 664639, at *1, was the original hearing. The second, 970 F. Supp. at 746, responded to a renewed motion to dismiss and a motion for summary judgment following plaintiffs' submission of an amended complaint. For purposes of this Note, the two are functionally interchangeable, because Judge Smith incorporated her prior holding as to the pleading standard in her second opinion. *See Silicon Graphics*, 970 F. Supp. at 754 ("After reviewing the arguments and the legal authorities, the Court believes that its original interpretation was correct.").

bar even in the Second Circuit,¹⁰⁴ without demanding a showing of conscious wrongdoing — the hurdle President Clinton rejected as excessively prodefendant.

B. *The Baesa Rule Is Consistent with the Policies Underlying the Reform Act*

The *Baesa* rule effectuates the Reform Act's policy goals better than either the *Marksman* rule or the *Silicon Graphics* rule. Section III.B.1 argues that the case-by-case element of the *Baesa* rule prevents the kind of generic, "cookie-cutter" pleadings Congress sought to avoid. Section III.B.2 concludes that the *Baesa* rule avoids the *Marksman* problem of risking nonmeritorious litigation, while also avoiding the *Silicon Graphics* problem of setting the bar too high.

1. *The Baesa Rule Prevents "Cookie-Cutter" Complaints*

The *Baesa* court's case-by-case approach prevents abusive cookie-cutter complaints. Boilerplate litigation filed without investigation into specific facts was one of Congress's central objections. The House Report used the phrase "cookie-cutter complaints" to refer to boilerplate claims filed within hours of a significant stock movement.¹⁰⁵ The Report cited the example of Philip Morris:

On April 2, 1993, Philip Morris announced that it would reduce the average price of its cigarettes, and therefore, that it expected earnings in the future to decline. Less than five hours later, the first of [ten] lawsuits [in two days] were filed . . . Two of the complaints contained identical allegations "that the defendants . . . engaged in conduct to create and prolong the illusion of Philip Morris' success in the toy industry." Apparently, these complaints are lodged in some computer bank of fraud complaints, available for quick access but without much regard to accuracy.¹⁰⁶

The case-by-case approach of the *Baesa* rule would control this problem better than a *per se* rule. While judges will certainly scrutinize complaints carefully under any rule, a generic complaint is surely easier to draft under a *per se* rule that has endorsed one or another formalistic test. A rule that mandates case-by-case analysis should result in more detailed scrutiny of a plaintiff's allegations,

104. See *In re Stratosphere Corp. Sec. Litig.*, 1 F. Supp. 2d 1096, 1107-08 (D. Nev. 1998).

105. H.R. REP. NO. 104-50, pt. 1, at 16 (1995) (commenting that plaintiff's lawyers would "file suit within hours or days" of a stock drop "citing a laundry list of cookie-cutter complaints"); see also 141 CONG. REC. S19,064 (daily ed. Dec 21, 1995) (statement of Sen. Faircloth) ("One law firm files a securities suit every 5 working days, one a week. They are just churning them out, whether there is any validity or not. That is how much it takes to meet the payroll, so they churn out one a week.").

106. H.R. REP. NO. 104-50, pt. 1, at 16 (1995) (second omission in original) (emphasis in original) (footnote omitted).

compelling the plaintiff to put more detail and care into complaints, with an attendant decrease in cookie-cutter complaints.¹⁰⁷

Many Members of Congress regarded these boilerplate complaints as paradigm cases of abuse of the litigation process.¹⁰⁸ Plaintiffs' lawyers designed the cookie-cutter complaint to track language from the case law — the so-called magic words, in order to survive a motion to dismiss with minimal actual evidence of wrongdoing. Because 12(b)(6) motions must argue exclusively from the pleadings, such complaints often permitted plaintiffs to get to discovery. Once the plaintiffs got to discovery, they were able to extract the coercive results Congress sought to avoid. By depriving litigants of the "magic words" and thereby reducing boilerplate complaints, the *Baesa* rule should check generic litigation before it can develop into coercive settlements.

2. *The Baesa Rule Properly Balances the Competing Goals of Minimizing Frivolous Litigation and Protecting Investors*

The *Baesa* rule properly reconciles the need for recklessness-based liability in some cases with Congress's expressed intention to shelter forward-looking statements. A rule that treats recklessness as per se insufficient would undercut the Reform Act's goal of "protect[ing] investors and [maintaining] confidence in the securities markets."¹⁰⁹ In an efficient market, misinformation directly

107. Complaints filed immediately subsequent to the Reform Act provide some support for this claim. The SEC's *Report to the President and the Congress* found that, in the first year after the Reform Act, "[m]ost securities class action complaints filed in federal court . . . appear to contain detailed allegations specific to the action. Few appear to be cookie-cutter complaints and a substantial majority include allegations beyond a mere failed forecast." SEC REPORT, *supra* note 3, at 4; *see also id.* at 22 ("[M]ost complaints [filed post-Reform Act] do not have the type of glaring errors which would suggest that they were the product of a hurried word processing 'cut-and-paste.'"). It is reasonable to suspect that the Reform Act's disruption of previously per se acceptable standards contributed to this increased specificity.

108. *See, e.g.*, 141 CONG. REC. S8,897 (daily ed. June 22, 1995) (statement of Sen. Domenici) ("All the allegations are the same, case after case. . . . [T]hey always use the same allegations and the same words. The lawyers just change the name of the company being sued — it pops out of the computer."); 141 CONG. REC. S8,894 (daily ed. June 22, 1995) (statement of Sen. Dodd) ("No one lawyer could possibly have investigated the facts this quickly."); 141 CONG. REC. S8,911 (daily ed. June 22, 1995) (statement of Sen. Faircloth) (describing cookie-cutter complaints as "not lawsuits" but "legalized blackmail"); 141 CONG. REC. S8,935 (daily ed. June 22, 1995) (statement of Sen. Grams) (complaining that cookie-cutter complaints "are rarely filed with any evidence of fraud or wrongdoing — in fact, they are often filed simply with the knowledge that the value of a stock has dropped").

109. Statement of Managers, *supra* note 4, at 31; *see also The Securities Litigation Uniform Standards Act of 1997 — S. 1260: Hearing Before the Subcomm. on Sec. of the Sen. Comm. on Banking, Hous., and Urban Affairs*, 105th Cong. 45 (1997) [hereinafter *S. 1260 Hearing*] (statement of Arthur Levitt, Jr., SEC Chairman and Isaac C. Hunt, Jr., SEC Commissioner) ("The Commission strongly believes that recklessness must be preserved as the standard for liability because it is essential to investor protection. . . . [Failing to] include recklessness as a basis for liability would jeopardize the integrity of the securities markets, and would deal a crippling blow to defrauded investors with meritorious claims.").

and immediately distorts the market, regardless of the intentions of the disseminator of the misinformation.¹¹⁰ Therefore, reckless dissemination of misinformation undercuts the protection of investors and the maintenance of confidence in the securities markets every bit as much as conscious dissemination of misinformation. Civil liability for recklessness encourages corporate officials to verify proactively the information they disseminate, while abolishing such liability would create a perverse incentive for corporate officials to “remain purposely ignorant.”¹¹¹

Enforcing the motive and opportunity test as a *per se* sufficient showing would undercut the Reform Act's goal of preventing frivolous and abusive litigation.¹¹² Pleading motive and opportunity is often too easy — one merely names the corporate officers (who have opportunity by definition) and asserts a motive generally applicable to most or all corporate officials — for example, “[m]aintaining the prestige of a company and the value of its stock, preventing hostile takeovers, retaining executive positions or obtaining performance based bonuses, [or] increasing the value of an officer's stock options or stock sales.”¹¹³ A *per se* rule accepting motive and opportunity pleadings would therefore invite exactly the sort of “fraud by hindsight” complaints Congress sought to prevent.¹¹⁴

Eliminating any possibility of pleading motive and opportunity, however, sets the bar so high as to risk excluding plaintiffs with legitimate complaints.¹¹⁵ The *Baesa* rule effectively splits the difference by giving courts license to take notice of motive and opportunity when the facts are such that motive and opportunity genuinely raise strong suspicion without compelling courts to accept specious motive and opportunity showings that fail to invoke genuine suspicion. Eliminating the presumption that pleading motive

110. See COX ET AL., *supra* note 4, at 36-37 (reporting empirical research demonstrating that the U.S. securities market is efficient, i.e., that it rapidly incorporates information presented and adjusts prices accordingly).

111. *Malin v. IVAX Corp.*, 17 F. Supp. 2d 1345, 1357 (S.D. Fla. 1998); see also *S. 1260 Hearing*, *supra* note 109, at 45 (statement of Arthur Levitt, Jr., SEC Chairman and Isaac C. Hunt, Jr., SEC Commissioner) (“A higher scienter standard would lessen the incentives for corporations to conduct a full inquiry into potentially troublesome or embarrassing areas, and thus would threaten the disclosure process that has made our markets a model for nations around the world.”).

112. See Statement of Managers, *supra* note 4, at 31-32.

113. *Malin*, 17 F. Supp. 2d at 1358.

114. See *supra* note 3 and accompanying text.

115. See Clinton Veto Message, *supra* note 50, at 2210; see also *Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1252 (N.D. Ill. 1997) (“To impose a higher pleading standard would make it extremely difficult to sufficiently plead a 10b-5 claim — an outcome which would certainly be contrary to the broad remedial purposes of the federal securities laws.”).

and opportunity is per se sufficient accomplishes Congress's goal of strengthening existing pleading requirements.¹¹⁶

One potential problem with the *Baesa* rule is the fact that Congress hoped that the Reform Act would reduce forum shopping by creating a nationally uniform pleading standard. The legislative history reflects such a goal,¹¹⁷ as does the subsequent passage of the Uniform Standards Act.¹¹⁸ The SEC rejected the *Baesa* rule precisely because "such a test is likely to produce varying applications of the pleading standards, a result contrary to Congress's goal of uniformity."¹¹⁹

Substantial uniformity is generated, however, merely by the act of codifying the Second Circuit's pleading standard.¹²⁰ While dif-

116. See *Queen Uno Ltd. Partnership v. Coeur D'Alene Mines Corp.*, 2 F. Supp. 2d 1345, 1359 (D. Colo. 1998); *In re Stratosphere Corp. Sec. Litig.*, 1 F. Supp. 2d 1096, 1107-08 (D. Nev. 1998). This argument is highly significant because it accounts for a key element in the legislative history that many courts have relied upon to strike down the "motive and opportunity" test entirely. The Conference Report states that "[b]ecause the Conference Committee intends to *strengthen existing pleading requirements*, it does not intend to codify the Second Circuit's case law interpreting this pleading standard." Statement of Managers, *supra* note 4, at 41. Numerous courts have relied upon this language to strike down the "motive and opportunity" test. See, e.g., *In re Silicon Graphics, Inc. Sec. Litig.*, No. C 96-0393, 1996 WL 664639, at *5 (N.D. Cal. Sept. 25, 1996). The *Stratosphere* court's reasoning — that eliminating "the ability to rely solely on motive and opportunity" strengthens the Second Circuit's standard, 1 F. Supp. 2d at 1107-08, accounts for this language in a way that does not require courts to disregard the plain language of the statute, ignore significant threads in both the contemporaneous and subsequent legislative history, or dismiss the considered opinion of the administrative agency charged by Congress with interpreting the Reform Act.

117. See Statement of Managers, *supra* note 4, at 41 ("The House and Senate hearings on securities litigation reform included testimony on the need to establish uniform . . . pleading requirements . . .").

118. See S. REP. NO. 105-182, at 4 (1998) ("A number of witnesses at the July 1997 hearing advocated legislation to establish uniform standards for private securities class action litigation. This legislation is an outgrowth of the July 1997 hearings and subsequent investigation and oversight by the Committee." (footnote omitted)).

119. SEC Brief, *supra* note 57, at 25 n.51. While arguing for the *Marksman* rule, the SEC makes the predicate arguments upon which the *Baesa* approach is based in an alternative argument — "[w]hether or not [adoption of the Second Circuit tests] is compelled as a matter of legislative intent, Congress certainly did not foreclose the possibility of the use of the Second Circuit tests in applying the Reform Act's pleading standard. *Id.* at 16. At a minimum, therefore, this Court has the discretion to adopt the Second Circuit's tests as its own under the Reform Act." *Id.* The fact that the Second Circuit's tests are neither mandated nor forbidden by the Reform Act is the underlying rationale for the *Baesa* approach. In its *amicus* brief at the district court level, the Commission more directly approved the *Baesa* reasoning: "Congress simply elected not to attempt to codify the guidance provided in Second Circuit case law, preferring to leave to the courts the discretion to create their own standards for determining whether a plaintiff has established the required strong inference." Brief of the SEC, *Amicus Curiae, In re Silicon Graphics Sec. Litig.*, Fed. Sec. L. Rep. ¶ 99, 325 (N.D. Cal. 1996) quoted in SEC REPORT, *supra* note 3, at 42.

120. Professor Grundfest has stated that codification of the Second Circuit's pleading standard, even absent codification of the tests, achieves adequate uniformity. See Grundfest memorandum, *supra* note 40, at S19,068 ("As I read the securities litigation conference report, the pleading standard is faithful to the Second Circuit's test. Indeed, I concur with the decision to eliminate the Specter amendment language, which was an incomplete and inaccurate codification of case law in the circuit. . . . [C]odification of a uniform pleading standard in 10b-5 cases would eliminate the current confusion among circuits. The Second Circuit

ferent courts will surely see different showings as sufficient or not sufficient under the *Baesa* standard, thus giving rise to some incentive to forum-shop, the result would be no different under the *Marksman* rule, as empirically demonstrated by inconsistent rulings within the Second Circuit.¹²¹ If the Second Circuit can have significant internal variance in its interpretation of the motive and opportunity test, it would be naïve to assume that there will not be even more variance as the other eleven circuits interpret and apply it. Further, the *Silicon Graphics* rule would also risk this same incentive to forum shop, since it would replace the tested and interpreted Second Circuit's standards with an untested and uninterpreted "circumstantial evidence of conscious wrongdoing" standard. Faced with the specter of allowing probable fraud to go unpunished, one can easily imagine district court judges reaching widely varying conclusions as to precisely what constitutes circumstantial evidence of conscious wrongdoing.

The *Baesa* rule is a direct application of the plain language of the statute. To reject it based on the uniformity issue is to ignore the language Congress actually codified in favor of a collage of snippets from the legislative history. Courts should generally decline to do this,¹²² especially when the relative uniformity to be gained is so minimal.

* * *

The *Baesa* rule properly charts a course between two extreme alternatives. The *Marksman* approach, treating recklessness and motive and opportunity as codified, undoes too much of the Reform Act. It would permit coercive, cookie-cutter complaints and would allow generic litigation without actual evidence of wrongdoing. The *Silicon Graphics* approach, rejecting both recklessness and motive and opportunity, takes the Reform Act too far. It would block complaints with genuine merit and would encourage corporate officials to remain purposefully ignorant of securities

standard is among the most thoroughly tested, and it also balances deterrence of unjustified claims with the need to retain a strong private right of action. . . . In short, I support the pleading provision of the conference report.").

121. *Compare In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 270 (2d Cir. 1993) (holding that where defendant offered stock to raise capital for debt repayment purposes, plaintiff adequately alleged motive by alleging that defendant intended to artificially enhance the price of stock and thereby decrease dilutive effect of sale) *with* *San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos.*, 75 F.3d 801, 813-14 (2d Cir. 1996) (holding that, where defendant issued \$700 million in debt securities, plaintiff did not adequately allege motive by alleging that defendant intended to maintain the company's bond or credit ratings to secure favorable debt terms).

122. While it is always relevant, legislative history cannot override a clear statutory mandate. *See United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241, (1989) (holding that the clear meaning of the statute trumps contrary legislative history); *Blum v. Stenson*, 465 U.S. 886, 896 (1984) (same). The legislative history relied on by the *Baesa* rule is not excluded by these cases because it is consistent with a plain reading of the statute.

fraud. The *Baesa* rule finds an effective middle ground by denying litigants the ability to withstand 12(b)(6) motions merely by complying with a set formula, but still permitting litigants to plead recklessness or motive and opportunity when they have genuine reason to do so.

CONCLUSION

The plain language of the Reform Act simply requires that plaintiffs in federal securities fraud cases plead facts giving rise to a strong inference of scienter. Conspicuously absent, however, from the plain language of the Reform Act is any mention of tests such as motive and opportunity or circumstantial evidence of recklessness. District courts under the Reform Act must therefore scrutinize the factual allegations in each securities fraud case to determine whether or not those allegations give rise to a strong inference of scienter. In that regard, the Second Circuit's case law may, in Senator Dodd's words, be "instructive"¹²³ — if particular Second Circuit opinions evaluate facts similar to those of a contemporary case, those opinions would be persuasive authority. To whatever extent a Second Circuit opinion gives compelling reasons for its conclusion that a particular motive and opportunity or recklessness showing raised a strong inference of scienter, those reasons would continue to be persuasive and relevant in the contemporary case.

The *Baesa* rule admits ambiguity, but only because it is balancing the conflicting demands of discouraging securities fraud and discouraging frivolous lawsuits. As the case history in the Second Circuit amply demonstrates, phrases like "motive and opportunity" or "circumstantial evidence of conscious or reckless wrongdoing" are far from precise formulations that judges may apply to reach clear and unambiguous results. The Reform Act shifts the locus of uncertainty from questions such as "is this allegation of motive sufficiently specific to give the test any teeth?" to the dispositive question "has the plaintiff raised a strong inference of scienter?" Courts may be guided by Second Circuit case law in answering that question, but they may not regard it as determinative.

Judge Brimmer's explanation in *Queen Uno* precisely captures the point of the Reform Act:

In short, the Reform Act requires that a court examine a plaintiff's allegations in their entirety, without regard to whether those allegations fall within a formalistic category such as motive and opportunity, to determine if the allegations permit a strong inference of fraudulent intent. If the facts alleged permit such an inference then a

123. 141 CONG. REC. S17,960 (daily ed. Dec. 5, 1995) (statement of Sen. Dodd).

10b-5 claim will by the Reform Act's plain language survive a motion to dismiss.¹²⁴

Although formalistic categories are convenient, the Reform Act sacrifices that convenience for greater analytical rigor in each individual case. The heuristic function of the *Baesa* rule is to remind litigants of the Reform Act's mandate for individualized pleadings, without crippling necessary private enforcement of the securities laws.

124. *Queen Uno Ltd. Partnership v. Coeur D'Alene Mines Corp.*, 2 F. Supp. 2d 1345, 1359 (D. Colo. 1998).