Introduction: The Implication of the Private Securities Reform Act

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Washington University Law Quarterly

VOLUME 76 NUMBER 2 1998

F. HODGE O'NEAL CORPORATE AND SECURITIES LAW SYMPOSIUM

THE IMPLICATIONS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT

INTRODUCTION

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It is a pleasure to have been here today in such distinguished company to discuss the Private Securities Litigation Reform Act of 1995, and what has turned out to be its unpredictable aftermath. Speaking at the 5 o'clock hour, after all the remarkable panels, I will do my best not to parrot too many of the remarks made earlier in the day. Forces of El Niño notwithstanding, some of my thunder has inevitably been stolen.

At the outset, I must commend Kelly Koenig and the *Quarterly*'s members for their prescience in picking such an "of the moment" topic. By all indications, the latest chapter in the Reform Act's rapidly evolving history—namely, the debate over the need for preemption of state fraud actions—appears likely to come to an imminent conclusion. Senate Bill 1260—known to some as the Senate "*uniform standards*" bill and to others as the Senate "*preemption*" bill (depending on which side of the debate you are on)—is headed for mark-up in a matter of days, thus taking it one step closer to becoming law. There appears to be overwhelming support in Congress to move soon on some version of the bill. Senator Trent Lott has stated his intention of sending the bill to the Senate floor in April. A

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companion bill in the House, House Resolution 1689, introduced by Representatives Anna Eshoo and Rick White also has strong momentum, with over 160 bi-partisan co-sponsors, although it appears that the House will work off the Senate bill rather than the Eshoo-White bill.

The current initiative represents the third major piece of legislation introduced in the last three years by Congress, which has significantly rewritten portions of the securities laws. The first law, the Private Securities Litigation Reform Act of 1995, as you've heard throughout the day, changed the rules governing private securities fraud litigation and established special rules for the securities fraud class action—rules that are not applicable to any other form of class action. Next, in 1996, the process for registering securities for sale underwent a major revamping with passage of the National Securities Markets Improvement Act of 1996 which eliminated state blue sky registration for large categories of securities. And now, just a year and a half later, Congress is back at work seeking to pass a bill that builds upon the concepts underlying both the 1995 and 1996 Acts.

My remarks today, and they are my remarks and do not necessarily represent the views of the Commission or its staff, focus on the events of the last two years that have brought us to the brink of preempting state securities fraud laws—laws which have existed for nearly 90 years and which even predate the federal securities laws. I'll offer my observations about key activities at both the federal and state levels in the wake of the Reform Act. I'll conclude by offering my opinion about whether, on the current record, the case for preemption has been made.

Observations at the Federal Level

The logical starting place for any analysis of current legislative proposals is the Reform Act itself. Passage of the Reform Act over President Clinton's veto marked the culmination of efforts to curb complaints about frivolous litigation in securities class actions. Several studies have been conducted analyzing practice under the Act during the first year, including one by the SEC, which has been distributed to you in the conference materials. I will spare you the details of each study, other than to say that the overarching conclusion of each was that, with just one year's experience under our belts, it was too soon to judge the effectiveness of the Act. I believe that same conclusion holds true for the most part today, a year and a half later. There have been no appellate decisions interpreting the Act. There have been no trials. And there have been only a handful of settlements.

Notwithstanding our inability to draw any significant conclusions about the overall effectiveness of the Act in curbing frivolous litigation, it is not too soon to conclude that the Act is having at least some bite at the federal level, making it tougher for plaintiffs to proceed. While the Act has not chilled plaintiffs from filing suit, it apparently has made early dismissals more commonplace.

In the 280 class actions filed during 1996 and 1997, we are aware of sixty-three in which there have been rulings on a motion to dismiss. In more than half of these cases, fifty-six percent of the motions to dismiss have been granted in some form. By contrast, Congress heard evidence that in 1992, only approximately forty percent of all federal securities class actions were dismissed on a motion prior to trial. Available data shows that in 1990 and 1991, thirty-eight percent of the cases filed by a leading plaintiff law firm were dismissed on motion.[1]

Other than the increased number of pretrial dismissals, there are additional reasons (which are discussed in the SEC Staff Report) why the Act is making it more difficult for plaintiffs to maintain federal securities class actions. In particular, the discovery stay, which is being strictly enforced, and the heightened pleading standards, are creating significant obstacles for plaintiffs.

While the Reform Act has unquestionably raised the bar in maintaining a class action, it has failed to achieve some of the goals that Congress intended. For example, congressional critics charged that plaintiffs' lawyers were filing cookie cutter complaints against companies within days or hours of a substantial drop in the company's stock price. While post-Reform Act complaints appear to be detailed and contain more specific factual allegations, the pressure to file quickly remains. Initially, we found that in 1996 the "race to the courthouse" had slowed. Complaints were being filed an average of seventy-nine days after the release of bad news, as opposed to forty-nine days, on average, before the Act. While we have not finished our analysis for 1997, my sense is that the race is back on. Plaintiff firms now compete to file the first complaint, so they can be the first to publish notice of the suit, which attracts potential clients.

We recently sampled twenty-one of the 1997 class actions; six had been filed within a week of release of the bad news; a few had been filed within forty-eight hours. Of course, the Act does not prohibit the quick filing of a complaint. The Act's heightened pleading standards, however, require detailed factual allegations of wrongdoing which suggest the need for a thorough pre-filing investigation. It will be interesting to see how these

1. In addition, data provided by the Big Six accounting firms shows that between 1990 and 1992, they were successful on motions to dismiss 33%, 24%, and 40% of the time, respectively.

complaints fare on a motion to dismiss pursuant to the new heightened pleading standards.

Another shortcoming of the Act which we first reported in our Staff Report is that institutions have not sought to actively take advantage of the lead plaintiff provision which was designed to encourage them to take command of these lawsuits. I recently read an article by Lowell Sachnoff that aptly analogized the situation to the old saw about the boy scout who helped the old lady cross the street—but she didn't want to go. In the 280 federal securities class actions filed during 1996 and 1997, we are aware of only seventeen (six percent) in which institutions have sought lead plaintiff designation. While I have heard some proclaim that this is a victory given the paucity of institutional involvement in class action litigation before the Reform Act, I believe that Congress hoped for better results.

Observations at the State Level

Since the Reform Act evidently has had some success in making it more difficult to prosecute a federal securities class action, what brings us to the debate over the need for *further* legislation? The most commonly offered response is that, since passage of the Act, we have witnessed a so-called "migration" of cases from federal to state court, where the Act does not apply.

Various authorities have collected data on the quantity of such litigation in state courts before and after the Reform Act in efforts to determine whether there has been a migration. In my view, the data is inconsistent and does not provide a supportable basis for preemption. At least three studies on the issue have been conducted—one by Joe Grundfest and Michael Perino at Stanford, one or two by Price Waterhouse, depending on how you count, and one by the National Economics Research Associates ("NERA"). All of these studies reach differing conclusions. While Grundfest found a large increase in the filing of state cases after the Reform Act, Price Waterhouse did not, at least initially. NERA, by contrast, found a material increase in 1996, but reported that the 1996 increase was "transient," and that the number of filings in 1997 had returned to pre-Reform Act levels. Bolstering the conclusion that the numbers here are too unreliable, Price Waterhouse sent a letter to Senator Al D'Amato on the eve of the most recent Senate hearing on the bill, reporting that its initial count was incorrect. Price Waterhouse reported that its revised figures showed that the average number of state suits filed after passage of the Reform Act was significantly higher than first reported in its initial study.

In any event, whether or not there has been a migration of class actions to state court in the wake of the Reform Act, two things are clear: First, the percentage of such cases in comparison to all cases brought in state court is minute, and second, the bulk of this litigation is highly concentrated in just one state—California. There are approximately fifteen million civil cases annually filed in state court, roughly fifty of which are securities class actions. Arguments in support of broad-based preemption based on an average of less than one suit per week filed in state court fall of their own weight, particularly where approximately sixty-two percent of the cases have been filed in a single state—California. This leads me to question whether the litigation reform debate should be taking place in Sacramento rather than on Capitol Hill.

The actual number of state cases aside, preemption proponents have also argued that preemption is needed because of the *threat* of state court litigation. Most notably, they claim that state court is now a more attractive forum than it was before passage of the Reform Act because the federal safe harbor for forward-looking statements and the automatic discovery stay do not apply in state court.

As to the safe harbor, issuers have informed Congress that they continue to refrain from making disclosure of forward-looking information because they remain exposed to liability for such disclosure at the state level. A recent study by three business school professors, which Bill Lerach referred to this morning, however, casts doubt on these claims. The study analyzed the disclosures made by 547 computer, software, and drug firms, during the year before and after passage of the Reform Act. The main finding of the study is that "there was a significant post-Act increase in both the frequency of firms issuing forecasts and the mean number of forecasts issued." With all due respect to the study's authors, I question whether the data supports the conclusions. The only apparent material change revealed by the data is that twenty-six firms that did not make a forecast in the pre-Act period, only five percent of the sample, did so in the post-Act period. This relatively small increase does not, in my view, qualify the Reform Act's safe harbor as a success. More significant, I believe, is the fact that *more than half* the firms comprising the sample, fifty-one percent, continue to refrain from making any forward-looking disclosure post-Reform Act. This is troubling.

Absence of safe harbor protection in state court poses a real problem and some form of relief is required here. At least in theory, if there is no safe harbor in state court, there is no safe harbor at all. It appears likely that more forward-looking information would be disclosed if the fear of state court causes of action based on failed forecasts was eliminated.

The success that Senate Bill 1260 will have in addressing this concern is uncertain. Even assuming the Senate bill succeeds in substantially reducing the threat of suits based on failed forecasts brought in state courts, concerns will still abound at the federal level as to what is meant by "meaningful" cautionary language, which must accompany forward-looking disclosures for the safe harbor to apply. There has been no judicial guidance to date. And as Steve Rosenfeld properly noted, there has been no authoritative guidance by the SEC. The manner in which courts interpret this term will influence future safe harbor use by issuers far more than preemption of state law causes of action.

The absence of an automatic discovery stay in state court proceedings is the second reason that has been cited as to why we need to preempt state court proceedings. The federal discovery stay may indeed be evaded by the filing of a twin lawsuit in state court. Discovery obtained in the state action may then be used in the federal action. Of the 280 federal securities class actions filed during 1996 and 1997, we have identified fifty-one, or eighteen percent, tied to a parallel state case. This number may swell further in light of a recent ruling by a California state appellate court in the *Oak Technology* case. The court held that the trial judge did not abuse his discretion in allowing discovery to proceed although a stay was in place at the federal level.

Allowance of such dual track litigation, where the purpose is to circumvent the discovery stay, is a problem in need of a fix. I am sympathetic to claims made by defense counsel that the cost of pretrial proceedings has increased by approximately thirty-three percent as a result of having to defend on two fronts.[2]

Senate Bill 1260, however, will *not* cure this problem. Senate Bill 1260 only preempts "class actions," primarily defined as those in which damages are sought on behalf of twenty-five or more persons. The loophole is obvious. If the bill is enacted into law, plaintiffs' lawyers would still be free to bring a federal class action and an identical individual (i.e., non-class) state action where discovery can be pursued.

A bill which has been introduced in the House by Congressman Campbell from California, House Resolution 1653, would solve the problem by preempting both individual as well as class actions brought in state court. Not surprisingly, there has been very little support for this bill, given the breadth of its preemptive provisions in the face of a problem of relatively limited proportion.

Aside from the so-called threat of a migration of cases to state court, the

2. *See* BILL KISLIUK, *Are Two Securities Cases Better Than One?* RECORDER, July 14, 1997, at 1-2 (citing an estimate by defense counsel that the cost of pretrial proceedings has increased by approximately 33% as a result of dual track litigation).

flames of the preemption movement have also been fanned by the issuer community's desire not to see a repeat of Proposition 211, a defeated plaintiff-friendly California ballot initiative. Proposition 211 contained several controversial provisions that would have made California the mecca for securities class actions. These included the extension of the fraud-on-the-market presumption of reliance to common law fraud actions, where punitive damages are available. Both proponents and opponents of Proposition 211 opened their war chests during the campaign, making it the most expensive ballot initiative in California's history. After opposition from President Clinton, Senator Dole, and SEC Chairman Arthur Levitt, the measure was defeated by a vote of three to one. Even before the votes were counted, however, those opposed to the initiative were already considering alternative strategies in the event the initiative passed. One such strategy was the enactment of legislation that would preempt Proposition 211 and any other similar measures adopted in other states. The preemption movement was launched when the opponents of Proposition 211, fresh from their victory, turned their attention to Washington, D.C. to seek federal legislation ensuring that similar initiatives did not resurface in any state.

The fear that measures similar to Proposition 211 would be introduced in other states has so far proved to be unfounded. There have been no efforts made to liberalize the blue sky laws of any state. In fact, three states, Arizona, Montana, and Ohio, have adopted the reforms contained in the Reform Act thereby narrowing, rather than broadening, state court remedies for securities violations. California has also introduced such a bill, although it has gone nowhere.

The Need for Preemption?

In the depths of the Great Depression in 1930, President Roosevelt told the American people, "we have nothing to fear but fear itself." In many respects, fear—fear of future Proposition 211s, fear of what tactics plaintiffs' lawyers may employ, fear of Bill Lerach—has been the driving force behind the push for preemption. To be sure, there are companies that have been saddled with the cost of defending multiple lawsuits in both state and federal courts and who raise real and legitimate concerns. And there are loopholes in the Reform Act which have been exploited. But the record of documented abuses is thin. And the availability of more narrowly targeted fixes to the problems that have been shown do not lead me to the conclusion that preemption of state class action lawsuits is necessary at the present time, at least for the purposes that its proponents nominally assert, to plug gaps in the Reform Act. But the fact that it may not be necessary to address deficiencies in the Reform Act, does not necessarily mean that it's a bad idea altogether.

Wholly apart from the Reform Act, the notion that securities trading over national exchanges without regard to state borders should be governed by a uniform national fraud standard has some appeal. As Chairman Levitt stated during the debate leading up to the 1996 Improvement Act: The current system of dual federal-state regulation is not the system that Congress—or the Commission—would create today if we were designing a new system. An appropriate balance can be attained in the federal-state arena that better allocates responsibilities, reduces compliance costs and facilitates capital formation, while continuing to provide for the protection of investors.

Senator Dodd has stated his belief that although this statement was directed at securities registration, its principles are equally solid for securities fraud litigation. I tend to agree. Issuers of nationally traded securities, such as General Motors or IBM, have nationwide shareholder bases and make disclosures without regard to state boundaries. No doubt, they face material burdens and confusion by being subject to fifty differing sets of procedural and substantive laws.

The adoption of a national liability standard would also have the advantage of providing consistency in a global marketplace. We have been a leader in attracting foreign issuers to our markets, but we cannot rest on our laurels. The European Economic Community has already taken steps to make transnational commerce in Europe more efficient. Competition to attract capital and promote commerce should cause us to pay heed to the example they have set.

The concept a uniform national standard for nationally traded securities therefore makes sense to me. Chairman Levitt and Commissioners Hunt and Unger have also indicated support for such a concept. I want to underscore, however, that what I am talking about is a national standard that only applies to nationally-traded securities, such as those of the companies trading on the major exchanges and the NASD National Market system. Exchange transactions are impersonal and the state in which the buyer or seller resides is a fortuity. Localized transactions taking place off exchanges are another story. I am a firm believer that states have a strong interest in protecting their citizens from frauds within their borders.

If we accept in theory the notion of a uniform national standard, we must be committed to making sure that, in fact, the standard is one that adequately protects defrauded investors and that operates to deter wrongdoing. We cannot have a uniform standard at any cost. The standard must be one that is fair and balances competing interests. In this regard, I am concerned about those federal cases that have held that, in the wake of the Reform Act's heightened pleading standards, recklessness no longer suffices as a basis to plead securities fraud. At last count, I am aware of eleven courts reaching this conclusion; by contrast, sixteen have held that it continues to suffice.

The first court to reject recklessness, the Northern District of California in the *Silicon Graphics* class action, stated that while recklessness would not suffice, it would be willing to accept allegations of "deliberate recklessness"—whatever that means. The issue will soon be addressed in three cases pending in the Ninth and Sixth Circuits. The SEC has filed amicus briefs in three cases urging the courts to uphold recklessness as a basis for liability. The issue is of vital importance to the SEC; we would not be content with a national liability standard unless it afforded injured investors an opportunity to recover damages for reckless misconduct at the hands of others.

Aside from the possible loss of recklessness, I also worry about two other categories of investor protection that are available at the state level but would be lost through broad preemption. First, each state allows for some form of aiding and abetting liability. As we know from the 1994 Supreme Court decision in *Central Bank*, aiding and abetting a securities fraud violation is no longer a valid federal cause of action. In addition, thirty-three states have statutes of limitations longer than the short one-year period imposed at the federal level by the Supreme Court in 1991. It appears that there is no appetite in Congress to include in current legislation provisions that would make aiding and abetting and a lengthened statute of limitations part of any national liability standard.

So where does this all leave us? I have been talking this afternoon in analytical terms, trying to examine whether the reasons advanced in support of preemption make sense or whether there are other supportable bases to enact legislation.

In the real world of legislative policy and politics, of course, there are other factors at work that influence decision making. And those other factors, I believe, have created a climate and an environment where, realistically, the likelihood of additional legislation passing is quite high. Will this bring the clamor for litigation reform to an end? I doubt it. As long as companies continue to be sued, and as long as they feel that such suits are unjustified, there will be calls to end litigation. This is particularly true in an extended bull market. On other hand, if the courts should find that there is no liability for reckless misconduct or otherwise impose restrictions on injured investors that prevent them from recovering damages for real losses, then there will be those, the SEC among them, who will urge that the national standard must be modified to provide greater investor protection. Thank you.