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The Private Securities Litigation Reform Act of 1995: Friend or Foe of the Investor

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NOTE

THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995: FRIEND OR FOE OF THE INVESTOR?

*Jill N. Willis**

I. INTRODUCTION 841

II. HISTORY OF SECURITIES REGULATIONS 846
  A. *The Securities Act of 1933 and the Securities Exchange Act of 1934* 846
  B. *Recent Supreme Court Decisions Dealing with Securities Fraud* 848

III. THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995—MAJOR ISSUE AREAS 851
  A. *Statute of Limitations* 851
  B. *Aiding and Abetting Liability* 852
  C. *Safe Harbor Provision* 853
  D. *Pleading Standard* 855
  E. *Enhanced Rule 11 Sanctions* 856
  F. *Proportionate Liability* 856
  G. *Appointment of Lead Plaintiff and Cap on Damages* 858

IV. EARLY IMPACTS OF THE ACT—DOES IT WORK AS PROMISED? 858

V. CONCLUSION 862

I. INTRODUCTION

From an office high above New York City, a lawyer waits, keeping a close eye on a handful of large corporations. This lawyer makes a practice of filing lawsuits whenever the board of directors of these

* I wish to thank W. Craig Williams for his friendship and encouragement and to express my admiration of his unending dedication to the learning process.

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corporations increase their compensation.[1] These lawsuits claim that the directors are improperly using the assets of the corporation for their own benefit.[2] Of course, the lawyer knows that the lawsuits are baseless. He also knows that the corporation will never take him to court.[3] Lawsuits are expensive, and discovery is expensive, and the lawyer knows that it is more economical for the corporation to settle than it is for it to take him to court.[4] And the lawyer is right. The corporation does settle; for filing a meritless complaint, the lawyer receives a $100,000 check.[5]

Soon, the lawyer makes a practice of this. He watches corporations and automatically sues companies whenever the compensation of the directors goes up, for whatever reason.[6] He becomes a lawyer without clients who has embarked on an enterprise which exploits corporations, especially those with fluctuating stock prices.[7] It is only after the lawyer decides to sue a company with deep enough pockets, that he is forced to prove the merits of his claim in a court of law and is finally forced to back down.[8]

Senator Bennett relayed this story on the senate floor in an effort to point out one of the many deficiencies in the area of securities litigation.[9] Each year, lawyers file nearly 300 securities class action lawsuits.[10] Often, these lawyers hire plaintiffs to appear in a variety of lawsuits, typically plaintiffs who may own only a few shares of stock.[11] These "professional plaintiffs" become the lawyer's tool with which they collect huge settlements.[12] Over 90% of these cases settle at an average settlement cost of $8.6 million dollars.[13] In 1994, these settlements cost

1. 141 CONG. REC. S19,036 (daily ed. Dec. 21, 1995) (statement of Sen. Bennett).

2. *Id.*

3. *Id.*

4. *Id.*

5. *Id.*

6. *Id.*

7. *See id.* Since many corporations base director compensation on corporate profitability, the director's compensation may increase without direct action by the Board. *See id.*

8. *Id.*

9. *Id.* Senator Bennett remarked that this story was, in fact, based on the experience of his father, a retired Senator who served on several boards of directors. *Id.*

10. 141 CONG. REC. S17,933 (daily ed. Dec. 5, 1995) (statement of Sen. D'Amato). Many of the same lawyers, and sometimes the same plaintiffs, appear repeatedly in the lawsuits. *Id.* Many times, the same "form" complaint is used over and over, and almost any change in the company can bring on such a complaint. *Id.* "A drop in . . . stock price, a failed product development project, or even adverse market conditions that affect earnings, can trigger . . . securities fraud lawsuits." *Id.*

11. *Id.*

12. *See id.* at S17,933-34.

13. *Id.* at S17,934. One member of a company told a securities subcommittee that responding to discovery resulted in the production of over 1500 boxes of documents. *Id.* at

Willis: The Private Securities Litigation Reform Act of 1995: Friend or F

companies and their insurers $1.4 billion dollars.[14] Ironically, after the lawyer collects his fees, the class members receive only about six cents on the dollar.[15]

In an effort to put a stop to frivolous complaints and to curb abusive securities litigation, Congress enacted, over President Clinton's veto, the Private Securities Litigation Reform Act of 1995.[16] The Act, which was in the making for four years before passage on December 22, 1995,[17] contains several notable reforms designed to provide lawyers a strong disincentive to file abusive and frivolous claims.[18] The most notable reforms include: (1) a safe harbor provision which would prevent companies from being sued for forward-looking statements, as long as these statements are accompanied by meaningful cautionary language;[19]

S17,933. The total cost of discovery to the company was $1.4 million. *Id.*

14. *Id.* at 17,934.

15. *Id.* However, the "professional plaintiffs," whose names appear as lead plaintiff in many suits "are paid well for their services, usually in the form of a bounty payment." *Id.* According to news reports, one person was lead plaintiff in over 300 lawsuits. *Id.*

16. Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.); *see* Jeffrey Taylor, *Congress Sends Business a Christmas Gift: Veto Is Overridden on Bill Curbing Securities Lawsuits*, WALL ST. J., Dec. 26, 1995, at A2 [hereinafter Taylor, *Christmas Gift*]. The House voted 319 to 100 to override the veto. *See* Jeffrey Taylor, *House Votes to Override Veto of Securities-Suit Bill*, WALL ST. J., Dec. 21, 1995, at A3 [hereinafter Taylor, *Securities-Suit Bill*]. The law went into effect on December 22, 1995, when the Senate also overrode the veto with a vote of 68 to 30. *See* Taylor, *Christmas Gift, supra*, at A2.

17. 141 CONG. REC. S17,933, at S17,933.

18. *See id.* at S17,934.

19. § 102, 109 Stat. 737, 749-51. Section 102 amends the Securities Act of 1933 by adding a new section. The new section states in relevant portion:

> (c) SAFE HARBOR.—
> (1) IN GENERAL.— Except as provided in subsection (b), in any private action arising under this title that is based on an untrue statement of a material fact or omission of a material fact necessary to make the statement not misleading, a person referred to in subsection (a) shall not be liable with respect to any forward-looking statement, whether written or oral, if and to the extent that —
> (A) the forward-looking statement is —
> (i) identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement; or
> (ii) immaterial; or
> (B) the plaintiff fails to prove that the forward-looking statement—
> (i) if made by a natural person, was made with actual knowledge by that person that the statement was false or misleading; or
> (ii) if made by a business entity; was—
> (iii) made by or with the approval of an executive officer of that entity, with actual knowledge by that officer that the statement was false or misleading.

(2) a heightened pleading standard requiring plaintiffs to state with particularity facts giving rise to a strong inference that the defendant acted with the requisite state of mind[20] and an automatic stay of discovery pending a motion to dismiss;[21] (3) a provision providing for enhanced Rule 11 sanctions;[22] (4) elimination of joint and several liability except in a few narrowly defined cases;[23] (5) a provision

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Id. at 750.

20. § 101, 109 Stat. 737, 747 (1995). Another addition to the Securities Act of 1933 was § 101, which states in relevant part:

> (2) REQUIRED STATE OF MIND.—In any private action arising under this title 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 title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

Id.

21. § 101, 109 Stat. 737, 741 (1995). Section 101 states in relevant part:

> (B) STAY OF DISCOVERY.—In any private action arising under this title, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.

Id.

22. § 101, 109 Stat. 737, 742 (1995). Section 101 states in relevant portion:

> (A) IN GENERAL.— . . . the court shall adopt a presumption that the appropriate sanction—
> (i) for failure of any responsive pleading or dispositive motion to comply with any requirement of Rule 11(b) of the Federal Rules of Civil Procedure is an award to the opposing party of the reasonable attorneys' fees and other expenses incurred as a direct result of the violation; and
> (ii) for substantial failure of any complaint to comply with any requirement of Rule 11(b) of the Federal Rules of Civil Procedure is an award to the opposing party of the reasonable attorneys' fees and other expenses incurred in the action.

Id.

23. § 201, 109 Stat. 737, 758-59 (1995). Section 201 amends the Securities Exchange Act of 1934 by adding a new section. The new section states in relevant portion:

> (B) PROPORTIONATE LIABILITY.—
> (i) IN GENERAL.— . . . a covered person against whom a final judgment is entered in a private action shall be liable solely for the portion of the judgment that corresponds to the percentage of responsibility of that covered person. . . .

Id.

allowing for appointment of a lead plaintiff in class action suits,[24] and (6) a provision providing for a cap on damages.[25]

Perhaps as notable as these reforms, however, are the two areas which the Act did not significantly reform. The act did not fully restore the liability of aiders and abettors in securities fraud cases but instead restored only the ability of the SEC to file suit against aiders and abettors who act knowingly.[26] Also, the Act does not change the current "one and three" statute of limitations, which bars claims brought more than one year after the fraud was discovered or three years after it occurred.[27]

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24. § 101, 109 Stat. 737, 739 (1995). Section 101 states in relevant portion:

> (i) IN GENERAL.—Not later than 90 days after the date on which a notice is published under subparagraph (A)(i), the court shall consider any motion made by a purported class member in response to the notice, including any motion by a class member who is not individually named as a plaintiff in the complaint or complaints, and shall appoint as lead plaintiff the member or members of the purported plaintiff class that the court determines to be most capable of adequately representing the interests of class members . . . in accordance with this subparagraph.

Id.

25. § 101, 109 Stat. 737, 748-49 (1995). Section 101 states in relevant part:

> (e) LIMITATION ON DAMAGES.—
> (1) IN GENERAL.—Except as provided in paragraph (2), in any private action arising under this title in which the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.

Id.

26. § 104, 109 Stat. 737, 757 (1995). Another addition to the Securities Exchange Act of 1934 was § 104, which states in relevant part:

> (f) PROSECUTION OF PERSONS WHO AID AND ABET VIOLATIONS.—For purposes of any action brought by the Commission . . . , any person that knowingly provides substantial assistance to another person in violation of a provision of this title, or of any rule or regulation issued under this title, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.

Id.

27. *See* 141 CONG. REC. S17,936 (daily ed. Dec. 5, 1995) (statement of Sen. Sarbanes).

Although the Act received strong bi-partisan support, those opposed to the Act call it "a scandalous piece of legislation" which "sanctifies the most outrageous kind of fraud and misbehavior imaginable."[28] Opponents claim that the legislation goes too far in protecting companies while at the same time placing undue burdens on potential plaintiffs.[29]

This Note analyzes this new piece of legislation, focusing on the effect it will have in securities litigation. First, Part II looks at the historical development of securities regulation, especially with respect to securities fraud, and examines recent Supreme Court cases dealing with securities fraud.[30] Next, Part III focuses on some of the controversial areas of the Act and examines the arguments of both proponents and opponents of the Act.[31] Finally, Part IV questions whether the Act, now that it has gone into effect, has functioned as expected and assesses whether the legislation was the best solution to the problem of abusive lawsuits.[32]

II. HISTORY OF SECURITIES REGULATION

A. *The Securities Act of 1933 and the Securities Exchange Act of 1934*

After the 1929 stock market crash and amidst reports of the widespread abuses in the securities industry, the 73rd Congress enacted the Securities Act of 1933[33] and the Securities Exchange Act of 1934.[34] The 1933 Act primarily regulates initial distributions of securities, while the 1934 Act regulates the purchase and sale of securities after the initial distribution.[35] The purpose of these Acts is " 'to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*. . . .' "[36] These Acts "create an extensive scheme of civil liability," authorizing the Securities and Exchange Commission (SEC) to "bring administrative actions and injunctive proceedings to enforce

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28. 141 CONG. REC. H14,038, H14,041 (daily ed. Dec. 6, 1995) (statement of Rep. Dingell). Rep. Dingell went on to say that the legislation "would be beloved by Mike Milken, Ivan Boesky, and Charles Keeting. . . . It will permit the skinning of widows and orphans." *Id.*

29. *See id.*

30. *See infra* text accompanying notes 33-73.

31. *See infra* text accompanying notes 74-143.

32. *See infra* text accompanying notes 144-69.

33. 48 Stat. 74, as amended, 15 U.S.C. §§ 77a-bbbb (1933).

34. 48 Stat. 881, 15 U.S.C. §§ 78a-*ll* (1934).

35. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 752 (1975).

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

a variety of statutory prohibitions."[37] Additionally, private plaintiffs may sue under both express private rights of action and under the implied private rights of action contained in sections 10(b) and 14(a).[38] Section 10(b) is the general anti-fraud provision.[39] In 1942, the SEC adopted a similar anti-fraud provision, Rule 10b-5.[40]

In cases dealing with section 10(b) and Rule 10b-5, the Supreme Court has addressed two primary issues.[41] First, the Court has had to determine what kinds of actions are prohibited by section 10(b).[42] Second, "in cases where the defendant has committed a violation of sec. 10(b)," the Court has answered questions regarding the elements that make up the liability scheme of Rule 10b-5.[43] With respect to the

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37. Central Bank v. First Interstate Bank, 114 S. Ct. 1439, 1445 (1994).

38. Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13, n.9 (1971) (finding a private right of action implied in the terms of § 10(b)); J.I. Case Co. v. Borak, 377 U.S. 426, 430-31 (1964) (finding a private right of action implied in the terms of § 14(a)).

39. *Central Bank*, 114 S. Ct. at 1445. Section 10(b) states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe. . . .

15 U.S.C. § 78j (1988).

40. 17 C.F.R. § 240.10b-5 (1993). Rule 10(b)-5 is as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

41. *Central Bank*, 114 S. Ct. at 1445.

42. *Id.* (citing Dirks v. SEC, 463 U.S. 646 (1983); Aaron v. SEC, 446 U.S. 680 (1980); Chiarella v. United States, 445 U.S. 222 (1980); Santa Fe Indus. v. Green, 430 U.S. 462 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)).

43. *Central Bank*, 114 S. Ct. at 445-46 (citing Musick, Peeler & Garrett v. Employers Ins. of Wausau, 508 U.S. 286 (1993); Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501

second issue, the Court has noted that such decisions are difficult "because Congress did not [explicitly] create a private § 10(b) cause of action" and hence did not address what elements would be necessary or appropriate for a private liability scheme.[44] The Court, then, has had " 'to infer how the 1934 Congress would have addressed the issue[s] had the 10b-5 action been included as an express provision in the 1934 Act.' "[45]

B. *Recent Supreme Court Decisions Dealing with Securities Fraud*

In recent years, the Supreme Court has decided several cases which have limited the power of plaintiffs in bringing suits based on securities fraud. In 1991, the Supreme Court heard the case of *Lampf v. Gilbertson*,[46] which raised issues as to the statute of limitations applicable in private securities fraud actions.[47] In that case, respondents purchased units in a limited partnership for the purpose of receiving federal income tax benefits.[48] In late 1982 and early 1983, after the partnerships had failed, respondents were notified that the partnerships were being investigated by the IRS.[49]

Subsequently, the IRS disallowed the tax benefits, and in 1986 and 1987, respondents filed complaints against petitioner for misrepresentation.[50] Respondents claimed that they discovered the alleged misrepresentations only after the IRS disallowed the tax benefits in 1985.[51] The district court granted summary judgment for petitioner, holding that the claims were governed by Oregon's two-year limitations period and that respondents were put on notice of the fraud as early as 1982.[52] The Court of Appeals for the Ninth Circuit reversed, holding that there were unresolved factual issues as to when respondents "discovered or should

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U.S. 350 (1991); Basic Inc. v. Levinson, 485 U.S. 224 (1988); Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299 (1985)).

44. *Central Bank*, 114 S. Ct. at 1446.

45. *Id.* (quoting *Musick, Peeler & Garrett*, 508 U.S. at 294).

46. 501 U.S. 350 (1991).

47. *Id.* at 352.

48. *Id.*

49. *Id.*

50. *Id.* at 352-53. The alleged misrepresentations included promises that investors would receive "substantial tax benefits; that the leasing of the hardware and software packages would generate a profit; that the software was readily marketable; and that [the] equipment appraisals were accurate and reasonable." *Id.* at 353.

51. *Id.* at 353.

52. *Id.* The court found the investors were on "inquiry-notice" based on reports issued to them that showed the financial decline of the partnership "and allegations of misconduct made known to the general partners." *Id.*

have discovered the alleged fraud. . . ."[53] Both courts agreed, however, that the state statute of limitations should apply.[54]

The Supreme Court reversed, holding that a uniform federal statute of limitations should apply.[55] The Court noted that the statute does not expressly provide for private causes of action and therefore contains no statute of limitations.[56] The Court concluded, however, that other sections of the 1934 Act targeted the dangers of section 10(b).[57] These other sections all contained a statute of limitations of one year after the discovery of the fraud or three years after its occurrence.[58] Thus, the Court determined that the one-year statute of limitations combined with the three-year statute of repose would be most appropriate to private actions brought under section 10(b).[59]

The Court further limited the ability of a plaintiff to bring private actions under section 10(b) in *Central Bank v. First Interstate Bank.*[60] In this case, the Colorado Springs-Stetson Hills Public Building Authority (Authority) issued bonds to finance a residential and commercial development.[61] Petitioner Central Bank was indenture trustee for the bond issues.[62] "The bonds were secured by landowner assessment liens, . . . [and] [t]he bond covenants required that the land subject to the liens be worth at least 160% of the bonds' outstanding principal and interest."[63] Central Bank received an annual report from

53. *Id.* at 354 (citing Reitz v. Leasing Consultants Assoc., 895 F.2d 1418 (9th Cir. 1990)).

54. *Id.* In arriving at this conclusion, the court "implicitly rejected petitioner's argument" that Rule 10b-5 should be governed by a federal statute of limitation. *Id.* Petitioner had argued that the court should look "to the '1-and-3' structure applicable to the express causes of action in § 13 of the" 1933 Act and to some of the express actions of the 1934 Act. *Id.* at 354-55. Respondents maintained that § 10(b) limitations should be derived from common-law fraud and that the underlying policies of § 10(b) litigation "do not justify a departure from the traditional practice of 'borrowing' analogous state-law statutes of limitations." *Id.* at 354.

55. *Id.* at 355.

56. *See id.* at 359.

57. *Id.* at 360.

58. *Id.* at 360 n.7.

59. *Id.* at 362. In so doing, the Court rejected the argument of the Solicitor General, who appeared on behalf of the SEC. *See id.* at 355. The Solicitor General agreed that a federal statute of limitations was necessary, but argued that the Court should apply a five-year statute of repose like that applicable in § 20A of the 1934 Act. *Id.* The SEC thought the five-year statute of repose comported with " 'Congress's most recent views on the accommodation of competing interests, provides the closet federal analogy, and promises to yield the best practical and policy results in Rule 10b-5 litigation.' " *Id.* (quoting the Brief for Securities and Exchange Commission as *Amicus Curiae,* at 8).

60. 114 S. Ct. 1439 (1994).

61. *Id.* at 1443.

62. *Id.*

63. *Id.*

the developer showing that this requirement was met.[64] Subsequently, Central Bank received word that the most recent report may not have reflected declining property values and that the 160% test may not have been met.[65] The Authority and Central Bank agreed that Central Bank would have an independent appraisal conducted to review the most recent appraisal, but before the appraisal was complete, the Authority defaulted on the bonds.[66]

Respondents First Interstate and Jack Naber sued the Authority, among others, for violations of section 10(b) of the Securities Exchange Act of 1934.[67] Respondents also claimed that petitioner Central Bank was " 'secondarily liable under § 10(b) for its conduct in aiding and abetting the fraud.' "[68] The United States District for the District of Colorado granted summary judgment for petitioners, and the Tenth Circuit Court of Appeals reversed.[69]

The Supreme Court reversed, holding that there is no private cause of action for aiding and abetting under section 10(b).[70] The Court stated "that the statutory text controls the definition of conduct covered by § 10(b)."[71] The Court rejected the argument that the phrase "directly or indirectly" imposes liability on aiders and abettors, reasoning that "aiding and abetting liability extends beyond persons who engage, even

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64. *Id.*

65. *Id.*

66. *Id.*

67. *Id.*

68. *Id.* (quoting the Appendix at 26).

69. First Interstate Bank v. Pring, 969 F.2d 891, 893, 905 (1992). The court of appeals set forth the elements of a cause of action for aiding and abetting under § 10(b):

> "(1) a primary violation of § 10(b);
> (2) recklessness by the aider and abettor as to the existence of the primary violation; and
> (3) substantial assistance given to the primary violator by the aider and abettor."

Central Bank, 114 S. Ct. at 1443 (citing *Pring*, 969 F.2d at 898-903).

The court of appeals, in applying the above standard, "found that Central Bank was aware of concerns about the accuracy of the 1988 appraisal" and that "Central Bank knew both that the sale of the 1988 bonds was imminent and that purchasers were using the 1988 appraisal to evaluate the collateral for the bonds." *Id.* at 1443-44. The court stated that Central Bank's actions (and inactions) "could support a finding of extreme departure from standards of ordinary care": thus, there was "a genuine issue of material fact regarding the recklessness element of aiding and abetting liability." *Id.* (citing *Pring*, 969 F.2d at 904). The court also found that there was a genuine issue of material fact as to the question of whether Central Bank "rendered substantial assistance by delaying the independent review of the appraisal." *Id.* (citing *Pring*, 969 F.2d at 904).

70. *Id.* at 1455.

71. *Id.* at 1447.

indirectly," in prohibited activities.[72] The Court noted "that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act," and the act of aiding and abetting itself involves neither of those things.[73]

While these recent Supreme Court decisions did limit the ability of plaintiffs to bring private actions under section 10(b) and Rule 10b-5, these decisions had only limited effect. Abusive securities litigation was still widespread. Thus, Congress gave birth to the controversial yet comprehensive piece of legislation called the Private Securities Litigation Reform Act of 1995.

III. THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995—MAJOR ISSUE AREAS

A. *Statute of Limitations*

One area of concern among opponents of the Act and even some supporters is the Act's retention of the "one and three" year statute of limitations set by the Supreme Court in the *Lampf* case. This standard forces plaintiffs bringing private actions under section 10(b) to file claims within one year after the fraud is discovered or three years after it occurred, otherwise the claim is barred.[74] During the Senate's consideration of the bill, Senator Bryan introduced an amendment which would have increased the applicable statute of limitations to a "two and five" year statute of limitations.[75] The final version of the Act, however, contains no such amendment and as such, holds to the standards set by the *Lampf* case.[76]

The main arguments that critics advance is that the statute of limitations will not allow investors adequate time to discover and pursue securities violations.[77] In 1991, then SEC chairman Richard Breeden testified before the Banking Committee that the statute of limitations set out in the *Lampf* case " 'will do undue damage to the ability of private litigants to sue.' "[78] Chairman Breeden pointed out that many times, the

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72. *Id.* The Court noted if Congress had chosen to "impose aiding and abetting liability, . . . it would have used that words 'aid' and 'abet' in the statutory text." *Id.* at 1448. The Court stated that the issue is not whether it would be good public policy to impose liability on aiders and abettors, but whether such liability is addressed by the statute. *Id.*

73. *Id.*

74. *See* 141 CONG. REC. S8,989, S8,990 (June 23, 1995) (statements of Sen. D'Amato and Sen. Sarbanes).

75. *Id.* at S8,990.

76. 141 CONG. REC. S17,933, at S17,936 (statement of Sen. Sarbanes).

77. *Id.*

78. *Id.*

facts surrounding the alleged fraud come to light years after the alleged fraud actually occurred.[79] In a speech on the Senate floor, Senator Sarbanes noted that a provision to extend the statute of limitations and overturn the *Lampf* decision appeared in the original bill introduced by Senators Dodd and Dominici and had disappeared only after the Banking Committee met to consider the bill.[80]

However, while the Act does prohibit potential plaintiffs from bringing a private action more than one year after the discovery of three years after the occurrence of the fraud, it does not prevent the SEC from bringing suit on behalf of wronged investors after the private statute of limitations has run.[81] There is no statute of limitations for the SEC; the SEC can bring an action years after the fraud is discovered.[82] Also, proponents of the *Lampf* statute of limitations point out that by limiting the statute of limitations to one year, lawyers are unable to go "shopping around for years, looking for any possible violation to allege."[83]

B. *Aiding and Abetting Liability*

Another area that has received criticism from opponents of the act deals with the liability of aiders and abettors.[84] After the Supreme Court's decision in *Central Bank*, neither the SEC nor private investors could pursue aiders and abettors of securities fraud.[85] Section 104 of the Act restores the ability of the SEC to file suit against aiders and abettors of violations when the aiders and abettors act knowingly.[86] However, it does not restore the power of the SEC, which was available pre-*Central Bank*, to pursue aiders and abettors who have behaved recklessly toward the fraud, and it does not restore the ability of private investors to pursue aiders and abettors in any situation.[87]

However, proponents of the bill point out that neither the original drafters nor the Supreme Court thought that liability for aiders and abettors should be included in the Exchange Act.[88] Furthermore, as proponents note. investors who are faced with fraud on the part of a

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79. *Id.*

80. *Id.* Senator Sarbanes noted that the FDIC, state securities regulators, and the SEC were all in favor of overturning the *Lampf* decision. *Id.* Additionally, Sen. Sarbanes pointed out that the Banking Committee had actually approved to the provision before it was dropped. *Id.*

81. 141 CONG. REC. S8,989, at S8,989 (statement of Sen. D'Amato).

82. *Id.*

83. *Id.*

84. 141 CONG. REC. S17,933, at S17,937 (statement of Sen. Sarbanes).

85. *Central Bank*, 114 S. Ct. at 1448; *see supra* notes 60-73 and accompanying text.

86. *See supra* note 26 and accompanying text.

87. 141 CONG. REC. S17,933, at S17,937.

88. 141 CONG. REC. H14,039, at H14,040 (statement of Rep. Bliley).

lawyer, broker, or other person who might fall into such a category, can always seek to bring their cause of action through the SEC.[89]

C. *Safe Harbor Provision*

Perhaps the most striking reform accomplished by the Act is the inclusion of a safe harbor provision for forward-looking statements. The safe harbor provision prevents companies from being sued for forward-looking statements as long as the companies include "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."[90] If the company fails to include such cautionary language, the company can be liable for a false forward-looking statement if the plaintiff proves that the defendant had actual knowledge of the falsity of the forward-looking statement.[91] The safe harbor does not cover IPO's, financial statement information, penny stocks, or limited partnerships, all areas where there is a "potential for abuse."[92]

The purpose behind the safe harbor provision is to allow companies to make projections about their future and to encourage disclosure without fear that they will be sued if the predictions do not come to fruition.[93] Speaking in favor of the safe harbor provision, Senator Dominici stated:

> It is neither a license to lie, nor a license to steal. It is an opportunity to disclose for the company and restores the investors['] right-to-know. The bill does recognize that a projection about the future is a prediction, not a promise, or an adequate basis upon which to bring a multimillion dollar lawsuit. The bill does take away the class action lawyers' license to extort a settlement when a prediction about the future doesn't quite materialize.[94]

However, opponents of the Act claim that the safe harbor provision does, in fact, give companies a license to lie.[95] They point out that the bill allows companies to couch phony earnings forecasts in the form of

89. 141 CONG. REC. S8,989, at S8,989 (statement of Sen. D'Amato).

90. 109 Stat. 737, 750 (1995); *see supra* note 19 and accompanying text.

91. 109 Stat. 737, 750 (1995).

92. 141 CONG. REC. S17,933, at S17,934 (statement of Sen. D'Amato).

93. *See* 141 CONG. REC. S12,201, S12,204 (Aug. 10, 1995) (statement of Sen. Domenici).

94. *Id.*

95. Frank Lalli, *Now Only Clinton Can Stop Congress from Hurting Small Investors Like You*, MONEY, Dec. 1995, at 9.

a forward-looking statement by using "boiler-plate language," knowing how difficult it will be for a plaintiff to prove that the company knew the statement was false at the time they issued it.[96] Opponents fear that rather than encouraging disclosure, the safe harbor will actually encourage companies to mislead potential investors.[97] Opponents point out that it will be difficult for investors to rely on such statements in making their investment decisions and will discourage some from investing at all.[98]

Another potential problem with the safe harbor provision is the difficulty in determining what constitutes "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."[99] The Act does not elaborate on how a company should identify which factors are more important than others or how a company should identify forward-looking statements.[100] A professor at Columbia Law School noted that "the wording is ripe for debate."[101] The wording of the Act does not explain whether the company can list some factors that will affect future earnings while omitting other, possibly more important factors, or whether someone who intentionally omits an important factor would still be covered by the safe harbor.[102] A recent article from the *Wall Street Journal* posed this very question:

> Take the case of a pharmaceutical company that learns in testing that a blockbuster drug which it has touted to analysts doesn't work. If it says that the drug has the potential to achieve billions a year in ales but that actual earnings may be reduced by competition and other market factors, is it entitled to the benefit of the safe harbor, even though it knowingly omitted the most important factor?[103]

Proponents of the Act note that the joint conference committee intentionally chose not to include "language that would have required

96. *Id.*

97. 141 CONG. REC. S19,146, S19,148 (Dec. 22, 1995) (citing letter from the National League of Cities, National Association of Counties, National Association of County Treasurers and Finance Offices, U.S. Conferences of Mayors, Government Finance Officers Association, and Municipal Treasurers' Association dated Dec. 21, 1995).

98. *See id.*

99. 109 Stat. 737, 750 (1995).

100. Margaret A. Jacobs & Edward Felsenthal, *Securities Bill May Prompt New Litigation*, WALL ST. J., Dec. 13, 1995, at B2.

101. *Id.* (citing statements by John C. Coffee, Jr.).

102. *Id.*

103. *Id.*

companies to identify the factors most likely to affect future earnings."[104] Instead, the joint conference committee created a legislative history which will aid courts in interpreting the provision.[105]

D. *Pleading Standard*

Another controversial area of the Act involves the pleading standard. Section 101(b) requires the plaintiff to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[106] Additionally, there is an automatic stay of discovery pending the motion to dismiss, so the plaintiff will not have the benefit of discovery to aid in determining what facts give rise to the required state of mind.[107] The stated purpose behind the heightened pleading standard is to ensure that plaintiffs have a basis for their claim before it proceeds.[108] Proponents note that prior to the Act, companies, particularly high-technology and bio-technology companies, often faced frivolous claims of fraud "days or even hours after adverse earnings announcements."[109] For example, Raytheon Co., a large, high-tech firm, made a tender offer of $64 per share for E-Systems, Inc.[110] This amount was "a 41 percent premium over the closing market price."[111] The proposed transaction was viewed as fair to E-Systems shareholders, yet the first of eight class action suits was filed on the same day the transaction was announced, less than 90 minutes after the courthouse opened.[112]

Under the pleading standard set out in the Act, however, " '[y]ou aren't going to see a stock price drop and five hours later have class-action cases filed in New York and San Diego.' "[113] The automatic stay of discovery prevents plaintiffs' lawyers from conducting a "legal fishing expedition" though the defendant's files and keeps defendants from settling meritless claims simply because they wish to avoid the often high costs of discovery.[114] Proponents state that the language was meant to codify the Second Circuit standard in part.[115] The main

104. *Id.*
105. *Id.*
106. 109 Stat. 737, 747 (1995).
107. *Id.*
108. 141 CONG. REC. S19,146, at S19,149 (statement of Sen. Bradley).
109. 141 CONG. REC. S9,320, at S9,321 (statement of Sen. Dodd).
110. *Id.*
111. *Id.*
112. *Id.*
113. Taylor, *Christmas Gift, supra* note 16, at A2 (quoting John C. Coffee, Jr.).
114. 141 CONG. REC. S19,146, at S19,149.
115. *Id.*

difference is the substitution of the words "state with particularity" for the words "specifically allege."[116]

However, opponents strongly urge that the pleading standard will prevent many victims of securities fraud from accessing federal courts and will "effectively discriminat[e] against millions of Americans who entrust their earnings to the securities markets."[117] Opponents point out that Rule 11 of the Federal Rules of Civil Procedure already provides adequate safeguards against frivolous fraud claims, and the Act takes things too far by requiring facts relating to state of mind to be pleaded with particularity.[118] Further, opponents argue that the heightened pleading standard infringes on "notions of privilege and confidence by demanding that allegations on information and belief must be accompanied by a particularization of 'all facts on which that belief is formed.'"[119]

E. *Enhanced Rule 11 Sanctions*

The Reform Act also seeks to curb frivolous lawsuits by providing for heightened Rule 11 sanctions. Originally, the bill as passed by the Senate required the court to include findings in securities class actions as to the parties' and attorneys' compliance with Rule 11.[120] The court was required to impose sanctions if a plaintiff or defendant violated Rule 11.[121] The presumptive sanction was "an award of reasonable attorneys' fees and other expenses incurred as a direct result of the violation."[122] However, the law as passed goes one step further in deterring plaintiffs from filing frivolous lawsuits. Under the law as passed, if a plaintiff substantially violates Rule 11, the plaintiff "pays all attorneys' fees incurred in the action" rather that "just those resulting from the violation."[123]

F. *Proportionate Liability*

Section 201 of the Act eliminates joint and several liability except when "the trier of fact specifically determines that such covered person

116. *Id.*

117. *Id.* at S19,148 (citing a letter from Professor Arthur Miller of Harvard Law School dated Dec. 19, 1995).

118. *Id.*

119. *Id.*

120. 141 CONG. REC. S17,933, at S17,937 (statement of Sen. Sarbanes).

121. *Id.*

122. *Id.*

123. *Id.*

knowingly committed a violation of the securities laws."[124] Previously, a plaintiff could recover the entire judgment from one defendant, but under the Act, each defendant will only be liable for its own share of the damages.[125] The purpose behind the elimination of joint and several liability was to prevent defendants from being liable for the total loss even though they may have been only one or two percent at fault.[126] Additionally, it prevents plaintiffs from suing a defendant that may only be marginally at fault simply because the defendant has "deep pocket[s]."[127] Proponents of the proportional liability scheme point out that in the past, companies have chosen to settle in cases where they knew "they have not committed any tortious acts, but the risk of the jury finding any evidence in the way of negligence, even a small, minute amount, might jeopardize the company with hugh claims[.]"[128] Furthermore, these settlements rarely increase the amount of recovery by plaintiffs, but instead merely add to the fees collected by attorneys.[129] Had the proportionate liability scheme been in force during the savings and loan crisis, it would have saved the "Big Six" accounting firms a substantial portion of the more than $1.6 billion dollars in damages and settlements.[130]

Proponents also point out that the Act retains joint and several liability in cases where the company knowingly or intentionally defrauds the investor.[131] Furthermore, the Act creates an exception for plaintiffs whose net worth is less than $200,000 and who have recoverable damages equal to more than 10% of their net worth.[132] If a plaintiff who does not meet the criteria cannot collect from one or more defendants, the other defendants will be liable for as much as 150% of their proportionate share.[133]

Opponents point out that the proportionate scheme may be unworkable and may in fact disfavor older Americans[134] because the provision specifies that personal residences be included in determining net worth.[135] This provision may disfavor older Americans who have paid

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124. 109 Stat. 737, 758 (1995); *see supra* note 23 and accompanying text.
125. 141 CONG. REC. S19,146, at S19,149.
126. 141 CONG. REC. S17,933, at S17,934 (statement of Sen. D'Amato).
127. *Id.*
128. *Id.* at S17,936.
129. 141 CONG. REC. S9,320, at S9,321 (statement of Sen. Dodd).
130. Taylor, *Christmas Gift*, *supra* note 16, at A2.
131. 141 CONG. REC. S9,320, at S9,322.
132. 109 Stat. 737, 759-60 (1995).
133. *Id.* at 760.
134. 141 CONG. REC. S19,146, at S19,149.
135. 109 Stat. 737, 760 (1995).

for their homes but have relatively low annual incomes.[136] Opponents of the proportionate liability scheme note that these older americans will often fail to qualify under this provision, even though they are often the group most "devastated by fraud" because they live on fixed incomes and proceeds from their investments.[137] Opponents also note that in the past, the rationale behind the scheme of joint and several liability has been that "a fraud cannot succeed without the assistance of each participant, so each wrongdoer is held equally liable."[138]

G. *Appointment of Lead Plaintiff and Cap on Damages*

Another problem that the Act seeks to remedy is the "hired plaintiff" situation in which a plaintiff who owns a relatively small amount of stock in several companies appears as lead plaintiff in a number of class action suits all filed by the same attorney. Under the new provisions in the Act, investors have the power to allow a plaintiff with the largest claim to be the lead plaintiff; the lead plaintiff is then allowed to select counsel.[139] Proponents assert that this insures that the plaintiffs with the most at stake are adequately represented.[140] Moreover, the Act contains a provision which limits the number of class action suits in which any one plaintiff can be named as lead plaintiff during a three-year period.[141] The Act also requires that investors are sent notices of settlement agreements which disclose how much investors are getting or giving up by settling and how much their lawyers are receiving.[142] Furthermore, the Act places a cap on the award of attorneys' fees based on how much is recovered by the investors.[143]

IV. EARLY IMPACTS OF THE ACT—DOES IT WORK AS PROMISED?

While proponents of the Act praise it as the answer to abusive securities litigation, opponents cite the Act as scandalous legislation which essentially gives companies a "license to lie." In reality, however, perhaps both sides are overestimating the impact of this legislation, whether that impact be positive or negative. As securities fraud cases are brought under the Act, proponents may be disappointed to find that the

136. 141 CONG. REC. S19,146, at S19,149.
137. *Id.*
138. 141 CONG. REC. S17,933, at S17,938 (statement of Sen. Sarbanes).
139. 109 Stat. 737, 739-40; *see supra* note 24 and accompanying text.
140. 141 CONG. REC. S17,933, at S17,934 (statement of Sen. D'Amato).
141. 109 Stat. 737, 740 (1995).
142. *Id.* at 740-41.
143. *Id.* at 740.

legislation may not, in fact, result in substantial reduction in litigation. Additionally, opponents of the Act may be surprised to find out that the most controversial and "scandalous" portions of the law are merely codifications of already existing law and may not be applied any differently than the law prior to the Act.

For example, the heightened pleading standard that requires plaintiffs to allege facts giving rise to a "strong inference that the defendant acted with the required state of mind" is merely a codification of the pleading standard adopted by the Second Circuit in *In re Time Warner Inc. Securities Litigation.*[144] This standard already "requires plaintiffs to plead a motive and opportunity for fraud or a strong inference of fraudulent conduct" to survive a motion to dismiss.[145] Yet, as commentators point out, generalized "complaints that allege defendants recklessly disregarded indications of fraud survive motions to dismiss."[146] Thus, there is no reason to think that cases would be treated any differently under the new law, especially when judges feel that the plaintiff's lawyer has done a good job.

Furthermore, as one commentator points out, plaintiffs may resort to creative pleading; since "all facts alleged in a complaint are assumed to be true for purposes of a motion to dismiss," it would be difficult to obtain dismissal.[147] Perhaps the more effective solution would simply be more " 'active case management by district court judges.' "[148] These judges have the ability to test plaintiffs' cases prior to trial and also can control discovery.[149]

As to the safe harbor provision for forward-looking statements, it is essentially a codification of the "be-speaks caution" doctrine, which " 'holds that economic projections, estimates of future performance, and similar optimistic statements in a prospectus are not actionable when precise cautionary language elsewhere in the document adequately discloses the risks involved.' "[150] Nearly every court of appeals that

144. 9 F.3d 259, 268 (2d Cir. 1993); Dennis J. Block & Jonathan M. Hoff, *Legislative Proposals to Reform Securities Laws,* 213 N.Y. L.J. 5 (May 18, 1995).

145. Block & Hoff, *supra* note 144, at 5; *see Time Warner,* 9 F.3d at 268.

146. Block & Hoff, *supra* note 144, at 5 (citations omitted).

147. *Id.*

148. Dennis J. Block et al., *Selected Developments Concerning the Federal Securities Laws and in the Market for Corporate Control* (PLI Corp. Law & Practice Course Handbook Series No. 34-7086, 1995), *available in* WL 907 PLI/Corp *277, *290 (quoting *In re* Glenfed Inc. Sec. Litig., 42 F.3d 1541, 1557 (9th Cir. 1994) (Norris, J., concurring)).

149. *Id.*

150. *Id.* at *303.

has considered this issue has adopted the "bespeaks caution" doctrine.[151]

Proponents of the Act praise the safe harbor provision because they assert that it will encourage companies to provide greater disclosure about projections in the form of annual reports or Form K's;[152] however, before the Act was passed, the "bespeaks caution" doctrine was already "widely applied," and companies were still reluctant to make future projections.[153] Thus, the safe-harbor provision may not provide any greater incentive for companies to make public forecasts about their futures. At the same time, it seems odd that opponents criticize the provision as giving companies a "license to lie," when in reality, the protections afforded under the Act are essentially no greater than those widely applied under the "bespeaks caution" doctrine.

Another reason why the safe-harbor provision may not have as dramatic an effect as proponents had hoped is that if a company moves to dismiss on the ground that its allegedly fraudulent statement is covered by the safe-harbor and the court denies that motion, the company may lose the opportunity to argue at trial that the safe harbor applies.[154] Thus, for the safe harbor "to have its intended effect, one must assume that courts will be inclined to aggressively dismiss complaints, which some may argue is contrary to experience."[155]

With respect to the "lead plaintiff" provision, authorities predict that institutions and large investors will not "be running to court to become lead plaintiffs."[156] Under the old law, institutions could file suit but often chose not to because filing a complaint would "open . . . investment practices to discovery and require that the funds attack the very outlets that offer them the first crack at the best initial public offerings."[157]
Authorities note that under the Act, the "higher pleading standard and risk of sanctions after dismissal" merely "magnify those worries."[158]

As noted earlier, the provisions dealing with the statute of limitations and aiding and abetting liability are merely codifications of *Lampf*[159] and *Central Bank*,[160] respectively. The Act does restore the ability of

151. *Id.*
152. *Id.* at *307.
153. *Id.* at *305.
154. *Id.*
155. *Id.*
156. Karen Donovan, *A Place in the Sun*, NAT'L L.J., Feb. 12, 1996, at A1, A26.
157. *Id.* (citing William S. Lerach of Milberg, Weiss, Bershad, Hynes & Lerach).
158. *Id.* (citing Mr. Lerach).
159. *See supra* notes 46-59 and accompanying text.
160. *See supra* notes 60-73 and accompanying text.

the SEC to file suit against aiders and abettors who act knowingly,[161] but the SEC cannot file suit against aiders and abettors who act recklessly, and private investors cannot pursue aiders and abettors under any circumstances.[162] The limited restoration of power in the SEC, however, hardly overcomes the difficulties present in reaching aiders and abettors in securities fraud cases. The knowledge standard will be difficult to prove, and since actions against aiders and abettors can only be brought by the SEC, private investors are forced to bring their action through the SEC, and they may not exercise that option. Thus, the limited restoration of power in the SEC may exist in theory but will most likely make no difference in practice.

Similarly, the proportionate liability scheme set up by the Act may not be meaningful. Scienter is a required element of an action brought under section 10(b). Prior to the enactment of the Act, federal courts had held that the scienter requirement can be met through a showing of "recklessness."[163] However, the Act does not codify this standard and therefore leaves open the question of how the scienter requirement is satisfied.[164] If courts determine that the requisite scienter standard in securities fraud cases is actual knowledge, the proportionate liability scheme will be meaningless, for the Act retains joint and several liability for defendants who have acted knowingly.[165]

The Act does institute changes in the presumptive sanctions for plaintiffs who have violated Rule 11,[166] but the judge retains a large amount of discretion in determining whether a violation has occurred. Judges will be aware of the heightened sanctions and therefore may be less likely to impose such sanctions on sympathetic plaintiffs. Also, commentators note that while the heightened sanctions will force plaintiffs' lawyers to " 'think and investigate and take Rule 11 seriously[,] . . . careful plaintiffs' law firms have done that anyway. . . .' "[167] Thus, the heightened sanctions may not change the practice of many plaintiffs' lawyers.

Ironically, one of the first cases decided under the new law, a case involving a proxy contest between a corporation and a group of shareholder activists, demonstrates how the Act may not always achieve

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161. 109 Stat. 737, 757 (1995).

162. *Id.*

163. Block & Hoff, *supra* note 144, at 5.

164. *Id.*

165. *Id.*

166. *See* 141 CONG. REC. S17,933, at S17,937 (statement of Sen. Sarbanes).

167. *Litigation Reform: Industry Hails Veto Override, Consumer Groups, Others Opposed*, S.R.L.R., Jan. 5, 1996, at 5 (quoting John Olson of Gibson Dunn & Crutcher in Washington, D.C.).

Florida Law Review, Vol. 47, Iss. 5 [1995], Art. 4

its desired effects.[168] In that case, the corporation sued to enjoin the activists, charging them with fraud.[169] The activists moved to dismiss, and the magistrate denied the corporation's motion for expedited discovery based on the activists' claim that the Act provides for a stay of discovery in private actions alleging securities fraud.[170] The irony of this situation is that Congress intended the stay of discovery provision to protect corporations from "fishing expeditions" by investors seeking to prove fraud. Thus, the company that was supposed to benefit from the provision instead got stung.

V. CONCLUSION

The Private Securities Litigation Reform Act has been four years in the making. Finally, on December 22, the Act became law in what was President Clinton's first veto override. It is clear that Congress felt that this legislation was the answer to the widespread growth of abusive securities litigation. It is equally clear that this Act would continue to be a source of controversy. The Act now has been in force for slightly over two months, and it is still difficult to measure what effect, if any, the new law has had in curbing abusive lawsuits. While proponents claim that frivolous lawsuits are at an end, opponents claim that investors no longer have realistic remedies for fraud. Most of the provisions in the Act, however, are merely codifications of already existing law. Thus, there is a question as to whether this legislation really will impact securities litigation as much as proponents and opponents claim. Perhaps the answer lies not in the Act, but instead in the courts. Courts may interpret the law as providing for few significant changes. The courts have the ability to manage their case load and to determine which suits are meritless. The Act may have no effect at all if the courts choose to loosely interpret its language. In the coming months, both proponents and opponents of the bill should not be surprised to find that very few things have changed.

168. Donovan, *supra*, note 156, at A26.
169. *Id.*
170. *Id.*

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