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THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995: A REVIEW OF ITS KEY PROVISIONS AND AN ASSESSMENT OF ITS EFFECTS AT THE CLOSE OF 2001

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I. Introduction

On December 22, 1995, the Private Securities Litigation Reform Act (the "Reform Act" or the "Act") was enacted into law over a presidential veto.[1] Congress passed the Reform Act in an effort to rein in "abusive" and "frivolous" private securities litigation.[2] For many years preceding the promulgation of the Reform Act, members of Congress discussed the extent to which these abuses existed in our system of private securities litigation and the best ways to resolve them.[3] The focus of the debate had been on the explosion of meritless class action lawsuits, commonly called "strike suits,"[4] which are filed entirely for their settlement value.[5] These suits typically follow on the

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[1] Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (1995). On December 19, 1995, President William Jefferson Clinton vetoed the Reform Act. 141 CONG. REC. S19,034 (1995); 141 CONG. REC. H15,214-66 (1995). By a vote of 319 to 100, the House of Representatives overrode the veto on December 20, 1995. 141 CONG. REC. H15,214, at H15,223. The Senate overrode the President's veto by a vote of 68 to 30. 141 CONG. REC. S19,180 (1995).

[2] Private Securities Litigation Reform Act; H.R. REP. NO. 104-369, at 38 (1995), *reprinted in* 141 CONG. REC. H13,692, at H13,699-700 (1995). In the Conference Committee report that accompanied the Reform Act, Congress stated that it "ha[d] been prompted by significant evidence of abuse in private securities lawsuits to enact reforms to protect investors and maintain confidence in our capital markets." H.R. REP. NO. 104-369, at 38, *reprinted in* 141 CONG. REC. H13,692, at H13,699.

[3] John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, 338 (1996).

[4] Strike suits are "[s]hareholder derivative action[s] begun with the hope of winning large attorney fees or private settlements, and with no intention of benefiting the corporation on behalf of which suit is theoretically brought." BLACK'S LAW DICTIONARY 1556 (6th ed. 1990).

[5] *Private Litigation Under the Federal Securities Laws: Hearing Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs*, 103d Cong.(1993) (opening statement of Christopher Dodd, Chairman of the subcommittee). According to evidence heard by the House and Senate Committees, "abusive practices" committed in private securities litigation included:

> (1) the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might eventually lead to some plausible cause of action; (2) the targeting of deep pocket defendants, including accountants, underwriters, and individuals who may be covered by insurance, without regard to their actual culpability; (3) the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle; and (4) the manipulation by class action lawyers of the clients whom they purportedly represent.

H.R. REP. NO. 104-369, at 38, *reprinted in* 141 CONG. REC. H13,692, at H13,699.

heels of a dramatic drop in a publicly held company's stock price.[6] The complaints often charge that at the time the investors purchased their securities, company insiders allegedly issued materially misleading statements, causing the stock price to artificially rise at the time of purchase.[7]

The most notable provisions of the Reform Act aimed at the reduction of abusive and frivolous lawsuits include: (1) a statutory "safe harbor" provision which would prevent companies from being sued for forward-looking statements;[8] (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,[9] and an automatic stay of discovery pending a ruling on a motion to dismiss;[10] (3) a provision providing for enhanced Rule 11 sanctions;[11] (4) the elimination of joint and several liability except in a few narrowly defined cases;[12] (5) a provision allowing for appointment of a lead plaintiff in class action suits;[13] and (6) a provision providing for aiding and abetting liability.[14]

This Article will analyze the Reform Act and conclude that it was necessary in order to curb the abusive tactics embraced by securities class action lawyers reaping millions of dollars from unwary shareholders who are hurt more than helped by these strike suits.[15] The circumstances driving the passage of the Reform Act will be discussed

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[6] H.R. REP. NO. 104-50, pt. 1, at 18 (1995). "Using professional plaintiffs, law firms often file complaints within days of a substantial movement in stock price." *Id.* "The leading plaintiffs' law firm reported that 69 percent of the cases it filed over a three-year period were filed within 10 days of the event or disclosure that gave rise to the allegation of fraud." *Id.*

[7] Dow Jones, *Federal Court Sets High Standard for Fraud Suits*, N.Y. TIMES, July 6,1999, at A1. *See, e.g.*, *In re* Silicon Graphics Inc. Securities Litigation v. McCracken, et al., 183 F.3d 970 (9th Cir. 1999) (alleging that Silicon Graphics Inc. and six of its officers were accused by stockholders of hiding bad news about a product).

[8] *See infra notes* 107, 113. Companies will get protection from making forward-looking statements as long as these statements are accompanied by meaningful cautionary language. Avery, *supra* note 3, at 345.

[9] *See infra* note 120.

[10] *See infra* note 129.

[11] *See infra* note 134.

[12] *See infra* note 147.

[13] *See infra* note 159.

[14] *See infra* note 164.

[15] *See infra* Parts I – IV.

in Part II.[16] A history of the legislative initiatives leading up to the passage of the Act will be discussed in Part III.[17] Part IV (A) will analyze some of the most notable provisions of the Reform Act and discuss some of their practical ramifications.[18] Part IV (B) will discuss the impact the Reform Act has had from inception through calendar year 2001.[19] Part V will address whether the legislation has successfully achieved its stated objectives and conclude that it has fallen short of that mark.[20]

II. Background

The overriding purpose of federal securities laws is to protect investors and to maintain confidence in the securities markets so investments may grow for the benefit of all participants.[21] The United States Supreme Court has recognized that section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") is a commonly used and essential antifraud provision of the federal securities laws.[22] Actions brought against corporations are often raised under this provision, alleging misstatements or omissions in prospectuses or other communications to shareholders.[23]

Securities class action lawsuits are typically filed against high-growth and high technology companies whose stock prices are by their nature more volatile.[24] These cases involve investors who purchased their stock at a time when the price was artificially inflated due to the omission of important information or the disclosure of materially

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16 *See infra* Part II.

17 *See infra* Part III.

18 *See infra* Part IV (A).

19 *See infra* Part IV (B).

20 *See infra* Part V.

21 H.R. REP. NO. 104-369, at 38 (1995) (Statement of Managers), *reprinted in* 141 CONG. REC. H13,692, at H13,699 (1995).

22 Basic Inc. v. Levinson, 485 U.S. 224, 230-31 (1988). *See also* Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310 (1985) ("[W]e repeatedly have emphasized that implied private actions provide 'a most effective weapon in the enforcement' of the securities laws and are a necessary supplement to Commission action.") (quoting J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964)).

23 *Bateman*, 472 U.S. at 310.

24 H.R. REP. NO. 104-50, pt. 1, at 17 (1995); *Securities Litigation Reform: Hearing Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs*, 104th Cong. (1995) (testimony of Richard C. Breeden, Chairman, International Financial Services Coopers & Lybrand) [hereinafter *Securities Litigation Reform*].

misleading information to the public.[25] Later, when the company discloses the bad news, investors reduce their expectations about the company's future outlook, causing its stock price to decline significantly.[26] When this happens, securities class action lawyers file a complaint on behalf of the defrauded investors claiming that the company knew or should have known about the bad news and should have disclosed it earlier.[27]

Complaints are often filed within days of a significant drop in a company's market value irrespective of actual proof of wrongdoing by the company.[28] Allegedly defrauded plaintiffs usually hold few shares in the defendant company.[29] However, a small ownership percentage does not preclude standing to sue.[30] These investors, commonly known as "professional plaintiffs," almost certainly have filed such actions before, typically working with the same law firm and receiving extra compensation in the form of bounty payments or bonuses for their services.[31]

After the complaint is served, the defendants file their motions to dismiss, denying all allegations of fraud lodged in the complaint.[32]

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[25] *Securities Litigation Reform*, *supra* note 24 (testimony of Richard C. Breeden, Chairman, International Financial Services Coopers & Lybrand).

[26] *Id.* (testimony of Sen. Pete V. Domenici). Bad news includes news that a company came up short on an earnings projection or will be forced to delay the introduction of a new product. *Id.*

[27] H.R. REP. NO. 104-50, pt. 1, at 17 (citing testimony of Professor Daniel R. Fischel before the House Subcomm. on Telecomm. and Finance, Hearing on H.R. 10, January 19, 1995, p. 3).

[28] H.R. REP. NO. 104-50, pt. 1, at 18. "Firms are able to do this by keeping a stable of professional plaintiffs who hold few shares in a broad range of companies." *Id.* "The leading plaintiff's law firm reported that 69 percent of the cases it filed over a three year period were filed within 10 days of the event or disclosure that gave rise to the allegations of fraud." *Id.* (citing *Securities Litigation Reform: Hearing Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs*, 103rd Cong., 1st Session (1993)).

[29] H.R. REP. NO. 104-50, pt. 1, at 17.

[30] *Id.*

[31] *Id.*

[32] *Id.* at 18. Speaking before the Senate Subcommittee, Charles C. Cox, Senior Vice President of Lexecon Inc., stated:

> One might surmise that the frivolous and nonmeritorious class action suits would be dismissed prior to trial or weeded out at trial when a jury decides if the evidence supports or contradicts the allegations of fraud. In my experience, however, that is not the way private securities litigation works. A few (approximately one percent) class actions suits are dismissed by a court before they get to trial. For the cases that do go to trial, the verdict is often for the defendant. However, most (approximately 96 percent) class actions securities

Typically, these motions are denied and the "financial blood letting" begins with the onset of the discovery process in search of facts that might support the plaintiffs' otherwise unsubstantiated allegations of fraud.[33] Because the discovery rules under the Federal Rules of Evidence are extremely powerful in the hands of a skilled attorney, the pressure to settle mounts as the cost of discovery rises.[34] Regardless of whether a lawsuit is frivolous or not, the corporation must devote an enormous amount of resources to defend itself.[35] Many cases settle for substantial sums before discovery is completed without ever adjudicating the merits of the case.[36] When the dust settles, the lawyers for the plaintiffs take one-third of the settlement award and the rest is distributed among the thousands of members of the class, resulting in pennies for each individual shareholder.[37] This practice has been described by some critics as nothing less than "legal extortion."[38]

> suits settle.

Securities Litigation Reform, *supra* note 24 (testimony of Charles C. Cox).

[33] H.R. REP. NO. 104-50, pt. 1, at 19 (citing *Securities Litigation Reform*, *supra* note 24 (testimony of Dennis W. Bakke, CEO of AES Corp)).

[34] H.R. REP. NO. 104-50, pt. 1, at 19. As Charles C. Cox stated before the Committee:

> Defendants choose to settle rather than litigate through a trial because their costs of litigating are high – millions of dollars – and they face the risk of a multimillion dollar damage payment if the jury finds that there was fraud. Moreover, a settlement usually involves a partial payment from the officers and directors' insurance company while the insurance does not pay if there is a finding of fraud. Individual defendants have a strong incentive to settle because they face the risk of a finding that they personally defrauded investors and violated the federal securities laws.

Securities Litigation Reform, *supra* note 24 (testimony of Charles C. Cox).

[35] H.R. REP. No. 104-50, pt. 1, at 17. "A typical tactic of plaintiff lawyers is to request an extensive list of documents and to schedule an ambitious agenda of depositions that often distract the company CEO and other key officers and directors. Discovery costs comprise eighty percent of the expense of defending a securities class action lawsuit." 141 CONG. REC. S19,146, at S19,151 (1995).

[36] H.R. REP. NO. 104-50, pt. 1, at 19. As James Kimsey, Chairman of America Online, Inc., testified: "Even when a company committed no fraud, indeed no negligence, there is still the remote possibility of huge jury verdicts, not to mention the cost of litigation. In the face of such exposure, defendant companies inevitably settle these suits rather than go to trial." *Id.* (citing *Common Sense Legal Reforms Act: Hearing on H.R. 10 Before the Subcomm. on Telecomm. and Fin. of the House Comm. on Commerce*, 104th Cong. (1995) (testimony of James Kimsey, Chairman, America Online, Inc.)).

[37] H.R. REP. NO. 104-50, pt. 1, at 19. Senator Domenici, testifying before the Senate Subcommittee, stated that "[T]he most generous estimate I have seen indicates that investors recover about eleven cents on the dollar of their losses, while plaintiffs' lawyers rake on average between 30 and 33 percent of the settlement fund." *Securities Litigation Reform*, *supra* note 24 (testimony of Sen. Pete V. Domenici).

[38] H.R. REP. NO. 104-50, pt. 1, at 17.

The provisions of the Reform Act are designed to deter these abusive class actions under the federal securities laws.[39] The Act's primary goal is to protect the integrity of the American capital markets from being undermined by securities class actions lawyers who seek to extort enormous settlements from innocent companies by filing frivolous lawsuits.[40] The Reform Act was specifically designed with Rule 10(b)-5 as its primary target.[41]

III. Legislative History

A. *The Legislative Path*

The broad scope of the Reform Act represents an ambitious effort by Congress to refine the system of private securities litigation under federal law.[42] The legislative initiatives in both Houses were largely prompted by substantial evidence of abuse in private securities lawsuits.[43] The House Conference Report made clear that the intent of the drafters of the Reform Act was to curb the filing of abusive and meritless securities lawsuits.[44]

B. *House Bill Introduced*

One of the earliest initiatives introduced into the House of Representatives to curtail the explosion of private securities litigation was H.R. 10, the "Common Sense Legal Reforms Act of 1995" (the "Bill").[45] The Bill was introduced by Representative Henry Hyde along

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39 H.R. REP. NO. 104-369, at 38 (1995), *reprinted in* 141 CONG. REC. H13,692, at H13,699 (1995).

40 *Id.* As stated in the Joint Conference Report: "The private securities litigation system is too important to the integrity of American capital markets to allow this system to be undermined by those who seek to line their own pockets by bringing abusive and meritless suits." *Id.*

41 David L. Ratner, *The Private Securities Litigation Reform Act of 1995*, SC21 ALI-ABA 27, 29 (1998).

42 *See* Private Securities Litigation Reform Act of 1995, Pub. L. NO. 104-67, 109 Stat. 737 (1995). The Reform Act amended the Securities Act of 1933 and the Securities and Exchange Act of 1934 by adding symmetrical provisions to both of those Acts. *See id.*

43 H.R. REP. NO. 104-369, at 38, *reprinted in* 141 CONG. REC. H13,692, at H13,699. *See also supra* note 5.

44 *See* H.R. REP. NO. 104-369, at 38-39, *reprinted in* 141 CONG. REC. H13,692 at H13,699-700.

45 H.R. 10, 104th Cong. (1995). H.R. 10 embodied two distinct initiatives. *See id.* Title I was the legislative incarnation of a provision in the Republican "Contract with

with over 100 co-sponsors on January 4, 1995.[46] H.R. 10 then underwent several modifications before being reported to the Subcommittee on Telecommunications and Finance of the House Committee on Commerce.[47] The most draconian modification would

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America" calling for an overhaul of the tort liability system in America. *See id.* Title II, on the other hand, addressed securities litigation reform. *See id.*; *See also* H.R. REP. NO. 104-50, pt. 1, at 15 (1995). It was drafted to accomplish three objectives: (1) eliminate abusive practices in private securities actions that foment litigation; (2) provide plaintiffs with greater control over the litigation; and (3) define or modify the legal standards for establishing a claim based on securities fraud. H.R. REP. NO. 104-50, pt. 1, at 15.

H.R. 10 was one of four different initiatives introduced in the House, which were designed to carry out securities litigation reform. The other three bills were: (1) H.R. 555, "Private Securities Litigation Reform Act of 1995," introduced on January 18, 1995 by Rep. Markey (D-MA) as an alternative to H.R. 10. *See* H.R. 555, 104th Cong. (1995); (2) H.R. 675, "Securities Litigation Equity Act of 1995," introduced by Rep. Mineta (D-CA) on January 25, 1995. *See* H.R. 675, 104th Cong. (1995); (3) H.R. 681, "Securities Private Enforcement Act," introduced on January 25, 1995 by Rep. Tauzin (D-LA). *See* H.R. 681, 104th Cong. (1995).

[46] H.R. 10.

[47] *See* H.R. REP. NO. 104-50, pt. 1. As was presented, the Bill would have implemented a "loser pays" provision, which would have amended the Securities Exchange Act of 1934 to require a judge to award attorneys' fees to the prevailing party under prescribed conditions. H.R. 10, §203; *see also* H.R. REP. NO. 104-50, pt. 1, at 34-35. To be awarded fees, the prevailing party would have the burden to prove that: (1) the action brought by the losing party was not "substantially justified"; (2) an award in favor of the prevailing party would be "just" and; (3) the costs incurred to the prevailing party were substantially burdensome or unjust. *Id.*

Furthermore, H.R. 10 would have imposed joint and several liability among *all* defendants regardless of their respective levels of culpability. H.R. REP. NO. 104-50, pt. 1, at 37. The Bill was later amended, however, to impose joint and several liability only where the trier of fact determined that the defendants acted knowingly, as opposed to recklessly, in violating the securities laws. *Id.* Said differently, where the defendant is found to have acted recklessly, liability is limited to the percentage of defendant's responsibility. *Id.*

The safe harbor provision of H.R. 10 was substantially amended since it was introduced to codify the common law "bespeaks caution" doctrine granting immunity to corporate officials who made forward-looking statements. *Id.* at 38.

H.R. 10 also includes the following provisions: (1) a heightened pleading standard, H.R. 10, § 204; (2) a general provision directed at stemming abusive practices that kindle litigation, H.R. 10, § 203. For example, § 203(c) permits an award of reasonable attorneys' fees to the party that prevails in a private action on the basis of a motion for summary judgment, a motion to dismiss, or a trial on the merits. H.R. 10, §203(c); *see also* H.R. REP. NO. 104-50, pt. 1, at 35; and (3) a section requiring the implementation of a "class action steering committee" to prevent lawyer-driven litigation practices. H.R. 10, § 202. One of Congress' concerns motivating it to introduce this provision was rooted in the fact that although nearly ninety-three percent of securities lawsuits are settled, these settlements were typically negotiated by plaintiffs' lawyers with no client involvement. *Securities Litigation Reform*, *supra* note 24 (testimony of James Kimsey, Chairman, America Online, Inc.). This phenomenon has lead William Lerach, a named partner at Milberg Weiss Bershad Hynes & Lerach, to quip: "I have the greatest practice of law in the world. . . I have no clients."

have required plaintiffs to establish actual reliance on a fraudulent misstatement or omission for actions brought under the Exchange Act's general anti-fraud provisions.[48] This would have effectively blocked those actions predicated on a fraud-on-the-market theory of liability from ever entering a courtroom.[49] The final version of H.R. 10, however, permitted reliance to be established using the fraud-on-the-market theory of liability.[50]

The Subcommittee on Telecommunications and Finance held two hearings on Title II of H.R. 10.[51] The first hearing, held on January 19, 1995, focused on the impact that abusive securities litigation imposed on corporations, their shareholders, and on society as a whole.[52]

William P. Barrett, *I Have No Clients*, FORBES, Oct. 11, 1993, at 52.

[48] *See* H.R. 10, §203.

[49] *See infra* note 57.

[50] H.R. 10, §204 (Prevention of "Fishing Expedition" Lawsuits). Section 204 states in relevant part:

> For purposes of paragraph (1), reliance may be proven by establishing that the market as a whole considered the fraudulent statement, that the price at which the security was purchased or sold reflected the markets estimation of the fraudulent statement, and that the plaintiff relied on the market price.

Id.

[51] *Common Sense Legal Reforms Act: Hearing on H.R. 10 Before the Subcomm. on Telecomm. and Fin. of the House Comm. on Commerce*, 104th Cong. (1995) [hereinafter *Common Sense Legal Reforms Act*].

[52] *Id.* For example, James Kimsey outlined six major consequences that the current system of abusive securities litigation imposes on corporate America:

> Abusive law suits restrict the amount of useful and available information that the companies are willing to disclose to the public . . .[out] of fear of being sued if the estimates do not materialize.
>
> Defending against these types of lawsuits detracts management attention from the business at hand and costs the company millions of dollars in attorneys' fees whether the case is tried or settled.
>
> Under the current system, the plaintiff shareholders in the class receive only a portion of the settlement amounts – far too great a portion goes to the attorneys who have represented those plaintiffs in the action.
>
> [E]xperienced and respected members of the corporate community are reluctant to serve on corporate boards . . . primarily because the potential liability from securities litigation – in which they are named defendants – is just too great.
>
> Even when a company committed no fraud, indeed no negligence, there is still the remote possibility of huge jury verdicts, not to mention the costs of litigation. In the face of such exposure, defendant companies inevitably settle these suits rather than go to trial.
>
> Massive settlements are causing D&O insurers to either stop underwriting policies . . . or make such coverage prohibitively expensive.

Id. (testimony of James Kimsey, Chairman, America Online, Inc.).

Witnesses testifying at the hearing included James Kimsey, Chairman of America Online, a staunch supporter of securities litigation reform;[53] Dennis W. Bakke, the president of AES Corporation, who offered anecdotal evidence of the havoc wreaked by the current system on his company; and Professor Daniel R. Fischel, whose testimony evidenced the predatory nature of our current system of securities litigation.[54]

A second hearing was held on February 10, 1995, featuring Arthur Levitt, Chairman of the Securities and Exchange Commission.[55] The Chairman supported legislative efforts to curb meritless securities lawsuits while preserving the vital role that private actions play in maintaining the integrity of our capital markets.[56] Although private litigation is a "necessary supplement" to the enforcement of the federal securities laws, the Chairman emphasized the importance of preserving a proper balance between encouraging meritorious suits and abating frivolous private actions.[57]

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[53] *Id.* Mr. Kimsey advocates a "strong and balanced enforcement system." *Id.* Such a system, he believes, protects investors against fraud while simultaneously ensuring the free flow of capital to the most productive industries of the economy. *Id.* Mr. Kimsey further states that once a "strong and balanced enforcement system" is achieved, United States capital markets will function effectively and efficiently. *Id.*

[54] *Id.* Mr. Fischel notes that:

> [i]t is critical to understand that litigation in general, and private securities litigation in particular, is big business. Plaintiffs' class action counsel file hundreds of lawsuits alleging federal securities law violations and earn hundreds of millions of dollars in fees from prosecuting these cases each year. Existing law creates perverse incentives to file securities class action lawsuits whenever a company experiences any significant change in stock price, no matter what the cause.

Id. (testimony of Professor Danel R. Fischel).

[55] *See id.* Other witnesses testifying at the hearing included Richard Breeden, Partner, Coopers & Lybrand and former SEC Chairman; Saul Cohen, Rosemnan and Colin; Daniel L. Goelzer, Partner, Baker & McKenzie; Mark Griffin, Securities Commissioner for State of Utah; Gregory Joseph, Partner, Fried, Frank, Harris, Shriver & Jacobson; Sheldon Elsen, Partner, Orans, Elsen & Lupert; and Professor Joel Seligman, University of Michigan Law School. *Id.*

[56] *Id.* (testimony of Arthur Levitt, Chairman, Securities and Exchange Commission).

[57] *Id.* In this regard, the Chairman advocated a modified "loser-pays" provision that would grant judges discretionary authority to award fees and costs to the prevailing party when actions are brought without merit. *Id.* Unlike the discretionary fee-shifting scheme advocated by the Commission, H.R. 10, as introduced, would have implemented a mandatory fee-shifting provision. *Id.* "In the Commission's view, a strict 'English Rule' provision of the type contemplated by H.R. 10 would effectively eliminate the private right of action for small investors." *Id.* "Although major corporations might continue to file suits under Exchange Act section 10(b) and Rule 10b-5, individual investors would inevitably be deterred from filing meritorious cases because they could not take the risk of being exposed

On February 14, 1995, the House Subcommittee on

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to a fee award if they failed to prevail." *Id.*

Alternatively, the Chairman supported the imposition of sanctions against plaintiffs or their attorneys who file meritless claims. *Id.* The Commission also supported a measure embodied in H.R. 10 eliminating civil liability under the Racketeer-Influenced and Corrupt Organizations Act (RICO) that are predicated on securities law violations. *Id.* For many years, the SEC has supported legislation to eliminate the overlap between the private remedies under RICO, 18 U.S.C. § 1962 (1994), and under the federal securities laws. *Id.* "Because the securities laws generally provide adequate remedies for those injured by securities fraud, it is both unnecessary and unfair to expose defendants in securities cases to the threat of treble damages and other extraordinary remedies provided by RICO." *Id.* Furthermore, the Chairman supported a system of proportionate liability among co-defendants. *Id.* This departs from the practice which prevailed at the time the securities laws were first enacted, when liability for contribution was apportioned among defendants in equal shares or pro rata. *Id.*

Chairman Levitt stated, however, that the Commission was not amenable to all of the provisions embodied within H.R.10. *Id.* Among the provisions that the Commission opposed included the elimination of the fraud-on-the-market theory of liability. *Id.* One of the reasons that the Commission opposed the elimination of the fraud-on-the-market theory was because:

> [m]uch of the Commission's disclosure regulation. . .is premised on the assumption that the market will absorb all available information and incorporate it into a company's stock price. When someone buys stock at a price affected by misrepresentations, the buyer has in effect bought the misrepresentations, whether or not he or she actually reads the statements in question.

Id. Elimination would require plaintiffs to prove that they actually relied on a misstatement or omission to support a 10(b) cause of action. *Id.* According to the Chairman, this would make it virtually impossible for investors to assert their claims as part of a class action. *Id.* "As the Supreme Court pointed out in *Basic*, 'requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented respondents from proceeding with a class action, since individual issues then would have overwhelmed the common ones.'" *Id.*

The Chairman was also opposed to any provisions that would eliminate recklessness as a basis for liability in both private and SEC enforcement actions. *Id.* The Chairman noted that the Supreme Court explicitly recognized that "in certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act." *Id.* (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193-94, n.12 (1976)). "In part, this rule serves to discourage deliberate ignorance of facts indicating fraud." *Common Sense Legal Reforms Act*, *supra* note 51 (testimony of Arthur Levitt, Chairman, Securities and Exchange Commission). Arthur Levitt stated in relevant part that:

> [t]he commission has consistently supported a recklessness standard because such a standard is needed to protect the integrity of the disclosure process. The law should sanction corporations and individuals who act recklessly when making disclosures, because that is the only way to assure the markets of a continuous stream of accurate information. A higher scienter standard would lessen the incentives for corporations and other issuers to conduct a full inquiry into areas of potential exposure, and thus threaten the process that has made our markets a model for nations around the world.

Id.

Telecommunications and Finance met in an open session to markup H.R. 10.[58] The Bill was reported, as amended, to the full Committee by a vote of 16 to 10.[59] The Subcommittee approved a substitute amendment based on compromise language offered by Rep. Fields to modify several provisions, including the provisions relating to loser pays, the actual knowledge standard, and the actual reliance standard.[60]

On February 16, 1995, two days later, the Commerce Committee met in an open session to markup H.R. 10.[61] The Bill was reported out of the Commerce Committee by a recorded bipartisan vote of 32 to 10.[62] As reported, Title II of H.R. 10 was substantially different from the bill that was introduced.[63] H.R. 10 was subsequently split into two bills, and Title II of H.R. 10 was redesignated H.R. 1058.[64] The Bill was the reported version of H.R. 10 with some minor changes.[65] The House subsequently debated H.R. 1058 on March 7 and 8, 1995.[66] After several amendments were considered on the House floor, the Bill passed by a vote of 325 to 99.[67] Four substantive amendments were adopted during House consideration of the Bill.[68] Several other

58 H.R. REP. NO. 104-50, pt. 1, at 24 (1995).

59 *Id.*

60 *Id.*

61 *Id.*

62 *Id.*

63 *See id.* Several provisions of the Bill that had applied to both the SEC and private actions were restricted to private actions. *See* H.R. 10, 104th Cong. (1995). For example, the fee-shifting provision was modified, the provision eliminating recklessness as a basis for liability was changed to include recklessness (which was defined), and instead of abolishing the fraud-on-the-market theory, a provision was added defining the scope of a limited fraud-on-the-market theory. H.R. 10, §§203, 204. In addition, the safe harbor provision of H.R. 10 was changed substantially to create a statutory safe harbor for forward-looking information if it met certain statutory criteria. H.R. 10, §205.

64 H.R. 1058, 104th Cong. (1995).

65 *See id.*

66 *See* 141 CONG. REC. H2749 (1995); 141 CONG. REC. H2818 (1995).

67 141 CONG. REC. H2818, at H2863-64.

68 141 CONG. REC. H2779-2811 (1995); 141 CONG. REC. H2818, at H2826-64. There were a total of eleven amendments offered between March 8 and 9, 1995. *See* 141 CONG. REC. H2749 (1995); 141 CONG. REC. H2818. Six amendments were adopted and five were rejected. *See id.* The amendments that were adopted included an amendment offered by Rep. Eshoo (D-CA), subsequently modified by an amendment offered by Rep. Cox, to refine the definition of "recklessness." 141 CONG. REC. H2818, at H2820. Rep. Eshoo's amendment, as offered, would strike the following language from the definition of recklessness: "[A] defendant who *genuinely forgot* to disclose, or to whom disclosure did not come to mind, is not reckless." 141 CONG. REC. H2818 (emphasis added). The House later agreed to substitute Rep. Eshoo's amendment by adopting Rep. Cox's amendment,

amendments offered for consideration on the floor of the House by various Representatives were rejected.[69]

C. *Senate Bill Introduced*

On January 18, 1995, Senators Christopher Dodd (D-CT) and Pete Domenici (R-NM) introduced S. 240, the Private Securities Litigation Reform Act of 1995.[70] The Bill was drafted with three stated objectives

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which would modify the definition of "recklessness" by striking the exclusion of "genuine forgetfulness" and substituting language that provided instead that a situation in which an individual "[d]eliberately refrain[ed] from taking steps to discover whether [his or her] statements [were] false or misleading constitutes recklessness, but if the failure to investigate was not deliberate, such conduct shall not be considered to be reckless." 141 CONG. REC. H2818, at H2820. The Cox Amendment was adopted by a recorded vote of 252 yeas and 173 nays with one voting "present." *Id.* at H2826.

The House further agreed to adopt Rep. Cox's Amendment prohibiting the use of the RICO statute for actions filed under federal securities laws. *Id.* The amendment was adopted by a recorded vote of 292 yeas and 124 nays with one voting "present." *Id.* In addition, the House adopted an amendment offered by Reps. Mineta and Tauzin providing an exemption from liability for "forward-looking statements" when accompanied by unambiguous cautionary language. *Id.* at H2840-46. Finally, the House agreed to adopt an amendment offered by Rep. Wyden (D-OR) that codifies certain SEC disclosure requirements as they pertain to the auditing practices of publicly held corporations. *Id.* at H2846-47. According to Rep. Wyden (D-OR), "this amendment stipulates that if there is a major fraud perpetrated at a corporation and corporate management refuses to correct the abuse, the corporation's accountant would be required to report the fraud to government regulators." *Id.* at H2846.

[69] *Id.* at H2831-63. Amendments rejected included the following: An amendment offered by Rep. Markey seeking to exempt securities fraud cases involving the purchase or sale of derivative instruments was rejected by a vote of 162 to 261. *Id.* at H2831. An amendment offered by Rep. Dingell seeking to allow state and local governments to continue filing securities fraud lawsuits under existing laws for three years after enactment was defeated by a vote of 179 to 248. *Id.* at H2839. The House also rejected an amendment offered by Rep. Bryant by a vote of 168 to 255 that sought to strike language in §204 of H.R. 10, a provision to prevent "Fishing Expedition" lawsuits. *Id.* at H2852. The defeated provision would require the plaintiff to specify each statement or omission alleged to be misleading, establish a summary procedure for dismissing deficient pleadings, and grant stays of discovery in the interim. *Id.* The House also rejected an amendment offered by Rep. Manton that sought to replace the "loser pays" provision with one that would require the attorney for the losing party in a private action to pay the prevailing party's legal costs and expenses if the court determined that the losing party's case was brought for an "improper purpose," lacked "evidentiary support," or was "unwarranted" under existing law. *Id.* at H2852-58.

[70] S. 240, 104th Cong. (1995). The Bill was cosponsored by Senators Bennett, Burns, Chafee, Conrad, Faircloth, Gorton, Hatch, Helms, Hutchinson, Johnston, Kyl, Lott, Mack, Mikulski, Moseley-Braun, Murray, Pell, Santorum, and Thomas. *Id.* The Bill contains identical provisions to S. 1976, a bill introduced in the 103d Congress. *See* S. 1976, 103d Cong. (1994). Among other measures, the Bill would have modified certain litigation practices in private securities actions, particularly in the case of class actions. *Id.* In

in mind.[71] First, S. 240 was intended to encourage publicly held corporations to voluntarily disclose all material information as it pertained to their viability.[72] Second, the Bill was designed to empower shareholders, not their lawyers, to exercise meaningful control over private securities litigation.[73] Finally, S. 240 was intended to encourage plaintiffs' bar to pursue valid securities fraud claims and to encourage corporate entities to challenge frivolous claims.[74] The Bill was referred

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addition to S. 240, a second bill, S. 667, "The Securities Enforcement Act of 1995," was introduced on April 4, 1995 by Senators Bryan (D-NV) and Shelby (R-AL), but did not succeed. *See* S. 667, 104th Cong. (1995).

[71] S. REP. NO. 104-98, at 4 (1995).

[72] *Id.* According to the Senate Committee on Banking, Housing, and Urban Affairs:

> The hallmark of our securities laws is broad, timely disclosure to investors of information about the financial condition of publicly traded companies. The mere specter of 10b-5 liability, however, has become more than a deterrent to fraud. Private securities class actions under 10b-5 inhibit free and open communication among management, analysts, and investors. This has caused corporate management to refrain from providing shareholders forward-looking information about companies. According to the SEC: "the threat of mass shareholder litigation, whether real or perceived, has had adverse effects, especially in chilling . . . disclosure of forward-looking information."

Id. at 5. S. 240 contains several provisions to achieve this goal. *Id.* For example, the Bill creates a safe harbor provision for forward-looking statements accompanied by meaningful cautionary language. *Id.*

[73] *Id.* at 4. Under the present system,

> the initiative for filing 10b-5 suits comes almost entirely from the lawyers, not from genuine investors . . . The lawyers can decide when to sue and when to settle, based largely on their own financial interests, not the interest of their purported clients. . .[P]laintiffs' counsel in many instances litigate with a view toward ensuring payment for their services without sufficient regard to whether their clients are receiving adequate compensation in light of the evidence of wrongdoing.

Id. at 6. S. 240 contains several provisions to achieve this goal. *Id.* For example, the Bill creates a rebuttable presumption that the members of a purported class of shareholders with the largest financial stake in the case shall serve as the lead plaintiff. *Id.*

[74] *Id.* Currently:

> [m]any such actions are brought on the basis of their settlement value. The settlement value to defendants turns more on the expected costs of defense than the merits of the underlying claim. . .The incentive to settle stems not only from legal fees incurred but also from the doctrine of joint and several liability, which requires a defendant to pay 100 percent of the damages even if the defendant is only one percent responsible.

Id. at 7. As Chairman D'Amato stated, "the threat of such liability often forces innocent deep pocket defendants to settle frivolous suits." *Id.* To reduce this phenomenon, S. 240 includes several provisions encouraging defendants to fight abusive claims rather than settle them. *Id.* For example, the Bill provides for proportionate liability except in cases involving knowing fraud. *Id.* Defendants who knowingly perpetrate securities fraud will be held jointly and severally liable for their actions. *Id.*

to the Senate Securities Subcommittee (the "Subcommittee"), which held three hearings on securities litigation reform on March 2 and 22, 1995, and April 6, 1995.[75]

On May 25, 1995, the Senate Committee on Banking, Housing, and Urban Affairs (the "Committee") voted to report S. 240 by a vote of 11 to 4.[76] The Bill passed by the Committee contained numerous changes from the original version of S. 240.[77] On June 28, 1995, after

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[75] *See Securities Litigation Reform Proposals: Hearing on S. 240 Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs*, 104th Cong. (1995). The first hearing included witnesses who generally expressed support for the proposed legislation. *See id.* Senator D'Amato, for example, supported granting shareholders greater autonomy in the litigation of class actions, enhanced disclosure of settlement terms to injured investors, and a limitation on joint and several liability. *Id.* (statement of Senator D'Amato). A former SEC Chairman supported reforms that would address the counterproductive incentives that permit lawyers to "extort" payments from corporations and other defendants with impunity. *Id.* (statement of Former SEC Chairman, Carter Beese, Jr.). Other witnesses testifying included: Senator Dodd, Senator Domenici, Marc E. Lackritz, former SEC Commissioner J. Carter Beese, Jr., Nell Minow, James F. Morgan, Christopher J. Murphy, III, and George H. Sollman.

The second hearing occurred on March 22, 1995, and included witnesses who generally spoke against securities reform that would make it difficult for innocent investors to pursue claims against those who commit securities fraud. *Id.* (statement of Mark J. Griffin). Specifically, the North American Securities Administrators Association, Inc., opposed, among other provisions, abandoning the "fraud-on-the-market theory" of liability, establishing an unrealistically high pleading standard, imposing a "loser pays" rule, and requiring plaintiffs to post a security bond. *Id.* Others who opposed the legislation included representatives of the Association of the Bar of the City of New York and the National Association of Securities and Commercial Law Attorneys. *See id.*

The Subcommittee's third hearing took place on April 6, 1995, and featured testimony from then current SEC Chairman Arthur Levitt, former SEC Chairmen Richard Breeden, and Charles C. Cox. All three speakers supported legislation to reform private securities litigation. *Id.* Chairman Levitt described S. 240 as:

> a positive step toward improving the private litigation system but suggested ways in which the bill could be improved with certain modifications, including (i) the adoption of the Second Circuit's requirement, that plaintiffs plead with particularity facts that give rise to a "strong inference" of fraudulent intent by the defendant; (ii) the inclusion of express language confirming the Commission's authority to provide a "safe harbor" for forward-looking information; (iii) the adoption of the *Sundstrand* definition of recklessness; (iv) the adoption of an expanded statute of limitations that is not limited by a "should have been discovered" clause; and (v) the restoration of aiding and abetting liability.

Id. (statement of Arthur Levitt, Chairman, Securities and Exchange Commission).

[76] S. REP. NO. 104-98, at 3 (1995).

[77] *See id.* A provision that would have provided a two and five year statute of limitations for actions under section 10(b) was dropped, but a new provision giving the SEC authority to bring aiding and abetting actions was added. *Id.* While provisions relating to class action reforms and limitations on certain practices in private securities litigation only

seven days of deliberation, the Senate passed S. 240 by a vote of 69 to 30.[78]

D. *Conference Report Considered by Both Houses*

On November 28, 1995, members from both Houses of Congress

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applied to actions brought under the Exchange Act in the original bill, the Committee extended these provisions to actions brought under the Securities Act of 1933, as well. *Id.* Among other changes, the bill reported by the Committee provided a presumption that the lead plaintiff in a securities class action would be the plaintiff with the largest financial stake. *Id.* at 6. It also included a statutory safe harbor for forward-looking statements, with certain specified conditions and exclusions. *Id.* at 5. The proportionate liability provisions of the Bill also were modified. *Id.* at 7. An amendment offered by Sen. Bennett (R-UT) was adopted to amend section 12(2) to permit defendants to show that factors other than misrepresentations in the prospectus caused some or all of a plaintiffs' losses. *Id.* at 3.

[78] 141 CONG. REC. S8885, at S8923 (1995). During the debate, the Senate passed on several motions and amendments. *See* 141 CONG. REC. S8885. Initially, a motion to commit the Bill to the Judiciary Committee was tabled and consideration of the Bill proceeded. *Id.* at S8924. An amendment offered by Sen. Sarbanes establishing proportional liability in securities actions against reckless defendants was rejected by the Senate. 141 CONG. REC. S9032, at S9074 (1995). The Senate also defeated an amendment offered by Senators Shelby and Bryan that would make defendants responsible for the uncollected share of an insolvent codefendant in proportion to its percentage of responsibility. 141 CONG. REC. S8966, at S8975 (1995). An amendment offered by Sen. Boxer directing the SEC to report to Congress on whether senior citizens and retirement plans required enhanced protection was adopted. 141 CONG. REC. S9032, at S9044. The Senate tabled an amendment by Sen. Bryan that would have implemented a statute of limitations for implied private rights of action of two years after the fraud is discovered and five years after the violation occurred. *Id.* at S9073. An amendment offered by Senators Boxer and Bingaman establishing procedures governing the court appointment of lead plaintiff in class actions suits was rejected by a partisan vote. 141 CONG. REC. S9089, at S9116 (1995). The Republicans voted 5 to 48 against the amendment; whereas the democrats voted 36 to 10 in support of the amendment. *Id.* An amendment delegating to the SEC the authority to develop a safe harbor provision was rejected. 141 CONG. REC. S9126, at S9130 (1995). This provision originally appeared in the bill introduced by Senators Domenici and Dodd. *See* S. 240, 104th Cong. (1995). An amendment to substitute an "actual knowledge" standard for the "actual intent" standard in the safe harbor provision was also tabled. 141 CONG. REC. S9133, at S9134 (1995). An amendment providing an early evaluation procedure to screen out frivolous securities class action claims was rejected. 141 CONG. REC. S9150, at S9156 (1995). An amendment offered by Senators Bingaman and Bryan clarifying the application of sanctions under Rule 11 of the Federal Rules of Civil Procedure in private securities actions was adopted. *Id.* at S9164. The Senate adopted an amendment offered by Sen. Specter clarifying the pleading requirements in private securities litigation. 141 CONG. REC. S9199, at S9201 (1995). On the other hand, the members of the Senate rejected Senator Boxer's amendments that would prevent insider traders who benefit from false or misleading forward-looking statements from safe harbor protection. *Id.* at S9202. Finally, the Senate tabled an amendment granting a stay of discovery under certain circumstances and an amendment providing sanctions for abusive litigation. 141 CONG. REC. S9150, at S9164.

met to reconcile the differences between H.R. 1058 and S. 240.[79] The Committee adopted a Conference Report on H.R. 1058, containing the final version of the Bill based principally on S. 240.[80] The Conference Report was accompanied by a "Statement of Managers," describing the purpose and intent of the legislation.[81] The final version of the House bill, accompanied by the "Statement of Managers," was submitted to the two Houses for consideration.[82] On December 5, 1995, the Senate voted on H.R. 1058 and the Bill was adopted by a vote of 65 to 30.[83] The next day, the House passed H.R. 1058 by a 320 to 102 margin.[84]

E. *President Vetoes Conference Report*

On December 19, 1995, President William Jefferson Clinton vetoed H.R. 1058.[85] The President insisted that although he supported the goals of the Reform Act, he opposed any bill that would effectively "clos[e] the courthouse door on investors who have legitimate claims."[86] Specifically, the President objected to three provisions of the legislation.[87] First, he opposed the heightened pleading standard with respect to the defendant's state of mind because it posed an unacceptably high hurdle to meritorious claims.[88] The President stated, however, that he was prepared to support a bill that adopted the Second Circuit's pleading standard.[89] Second, while the President supported the provision granting corporations "safe harbor" protection for forward-looking statements accompanied by cautionary statements, he objected to the language of the "Statement of Managers," which courts would

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79 *See* H.R. REP. NO. 104-369 (1995).

80 *See* 141 CONG. REC. H13,692 (1995).

81 *See id.*

82 *See* H.R. REP. NO. 104-369, *reprinted in* 141 CONG. REC. H13,692.

83 141 CONG. REC. S17,991, at S17,997 (1995).

84 *See id.*

85 141 CONG. REC. H15,214 (1995).

86 *Id.* President Clinton was not alone when he expressed this concern. 141 CONG. REC. S19,146, at S19,147. (citing a letter dated Dec. 19, 1995 from Professor Arthur Miller, Harvard Law School). Others have stated that the heightened 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." *Id.* at S19,148. Opponents point out that Rule 11 of the Federal Rules of Civil Procedure already provides safeguards against frivolous claims, and the Act takes things too far by requiring facts relating to state of mind to be pleaded with particularity. *Id.*

87 141 CONG. REC. H15,214, at H15,215.

88 *Id.*

89 *Id.; See also infra* note 122.

use to determine congressional intent.[90] The Statement of Managers, he insisted, "weaken[ed] the cautionary language that the bill itself requires."[91] Finally, the President opposed the disparate treatment of plaintiffs and defendants under the Bill's provision for sanctions for violations of Rule 11 of the Federal Rules of Civil Procedure.[92] This, he stated, came too close to a "loser pays" standard, which he opposed.[93] In conclusion, the President stated that he was prepared to support a balanced bill that would reduce frivolous securities litigation without closing the courthouse door on victims of intentional fraud.[94]

F. *House and Senate Override of the Presidential Veto*

The following day, the House convened at 10:45 a.m. to reconsider the legislation.[95] Less than two hours later, the House voted 319 to 100 to override the President's veto.[96] On December 21, 1995, the Senate met to take up the same issue.[97] The next day, the Senate voted 68 to 30 to pass the Bill, "the objections of the President of the United States to the contrary notwithstanding."[98] On December 22, 1995, the Private Securities Litigation Reform Act of 1995 became the law of the land.[99]

IV. Analysis

A. *Key Provisions of the Act*

A critical element of the Federal Rules of Civil Procedure is the ability to identify frivolous claims early before any exorbitant expenses associated with protracted litigation are incurred.[100] Various prophylactic devices currently exist that facilitate the dismissal of groundless claims relatively early in the litigation process.[101] Many

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90 141 CONG. REC. H15,214, at H15,215.

91 *Id.*

92 *Id.*

93 *Id.*

94 *Id.*

95 *Id.*

96 141 CONG. REC. H15,214, at H15,223-24 (1995).

97 Avery, *supra* note 3, at 353.

98 141 CONG. REC. S19,180 (1995).

99 Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (1995).

100 *Securities Litigation Reform*, *supra* note 24 (statement of Arthur Levitt, Chairman, Securities and Exchange Commission).

101 Avery, *supra* note 3, at 354. *See, e.g.*, Fed. R. Civ. P. 9(b); Fed. R. Civ. P. 56; Fed.

frivolous claims, for example, are never brought because of the looming threat of Rule 11 sanctions being imposed.[102] Critics of the current system argue, however, that these mechanisms insufficiently screen out nonmeritorious claims because they are not always consistently applied from jurisdiction to jurisdiction.[103]

The Reform Act has attempted to remedy this problem by enacting a uniform system of private securities litigation laws.[104] The following discussion will delve into the most notable provisions of the Reform Act intended to deal with abusive and frivolous litigation.[105]

1. Safe Harbor for Forward-Looking Statements

Civil suits are frequently filed under the antifraud provisions of the securities laws merely because the corporation makes a projection that does not materialize.[106] The safe harbor provision was enacted to codify the common law "bespeaks caution" doctrine,[107] which shields corporate officers from liability for disclosing soft information.[108] The safe harbor

R. Civ. P. 11(c); Securities Act §11(e).

102 Avery, *supra* note 3, at 354.

103 *Id.*

104 *See* Private Securities Litigation Reform Act.

105 *See infra* Part IV, §A 1-7.

106 Avery, *supra* note 3, at 343.

107 *Id.* at 345. "Bespeaks caution" is a common law term. *Id.* at 344. "The essence of the [bespeaks caution] doctrine is that where an offering statement, such as a prospectus, accompanies statements of its future forecasts, projections, and expectations with adequate cautionary language, those statements are not actionable as securities fraud." *In re* Donald Trump Casino, 793 F. Supp. 543, 549 (D.N.J. 1992), *aff'd*, 7 F.3d 357 (3rd Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994). The "safe harbor," incorporating the "bespeaks caution doctrine" adopted by a number of courts, applies to both written and oral statements, but is subject to a number of significant exclusions. *See, e.g.* Securities Act §27A; Securities Exchange Act §21E. Many courts have applied the bespeaks caution doctrine in analyzing forward-looking statements. Avery, *supra* note 3, at 344.

108 Private Securities Litigation Reform Act, § 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:

> 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 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

provision allows corporate officers to announce projections about their company's future and to encourage disclosure with impunity if the predictions are not forthcoming.[109] The safe harbor provision has two "prongs" that operate disjunctively.[110] If either prong is satisfied, the entity making the projection is shielded from private liability, but not from an action brought by the Securities and Exchange Commission ("SEC").[111]

Under the first prong, the entity is sheltered from liability if the plaintiff fails to establish that the statement, written or oral, was made with "actual knowledge" that it was false or misleading.[112] To satisfy this prong, it is not necessary that the forward-looking statement be accompanied by meaningful cautionary language.[113] This prong merely

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> (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
> (I) made by or with approval of an executive officer of that entity, and (II) made or approved by such officer with actual knowledge by that officer that the statement was false or misleading.

Id. at 750.

[109] Avery, *supra* note 3, at 354-55. "The SEC has long recognized the important role played by projections and other forward-looking statements, as well as the potential for abusive litigation when such projections do not come true." *Id.* at 354.

[110] H.R. REP. NO 104-369, at 50 (1995), *reprinted in* 141 CONG. REC. H13,692, at H13,703 (1995). The first prong of the Reform Act provides that any of the listed parties (including issuers and certain persons retained or acting on behalf of an issuer) shall not be liable for making forward-looking statements if either (i) the statement is identified as such 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) the statement is immaterial.

See Private Securities Litigation Reform Act §102(c). The second prong further states that a business entity cannot be held liable for forward-looking statements unless such statement was made by or with the approval of an executive officer of the business entity who had actual knowledge that the statement was false or misleading. *Id.* An individual cannot be held liable for a forward-looking statement unless that person made such statement with actual knowledge that it was false or misleading. *Id.*

[111] H.R. REP. NO. 104-369, at 50, *reprinted in* 141 CONG. REC. H13,692, at H13,703.

[112] Private Securities Litigation Reform Act, §102, 109 Stat. 737, 750-54, (adding §27A(c)(1)(B) to the Securities Act and §21E(c)(1)(B) to the Exchange Act).

[113] *Id.* The following cautionary language is an example of language typically found accompanying a forward-looking statements in documents publicly filed with the Securities and Exchange Commission:

> This annual report, including the documents incorporated by reference into this annual report, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements, other than statements of historical facts,

focuses on the "state of mind" of the person making the forward-looking statement rather than the cautionary language accompanying the statement.[114] Under the second prong, the entity making the statement is insulated from liability if the offending statement is classified as a forward-looking statement and accompanied by meaningful cautionary language identifying important factors that could cause the outcome to vary significantly from those projected in the statement.[115]

Opponents of the provision argue that it grants companies "a license to lie" by masquerading future earnings reports in the form of a forward-looking statement.[116] Rather than encouraging disclosure, opponents fear that the safe harbor provision will actually facilitate

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> included in this annual report, or in documents incorporated by reference into this annual report, regarding our strategy, future operations, financial position, future revenues, projected costs, prospects, plans and objectives of management are forward-looking statements. The words "anticipates," "believes," "estimates," "expects," "predicts," "potential," "intends," "continue," "may," "plans," "projects," "will," "should," "could," "would" and similar expressions are intended to identify forward-looking statements, although not all forward-looking statements contain these identifying words. We cannot guarantee that we actually will achieve the plans, intentions or expectations disclosed in our forward-looking statements, and you should not place undue reliance on our forward-looking statements. Forward-looking statements are inherently subject to risk, uncertainties and assumptions. Actual results or events could differ materially from the plans, intentions and expectations disclosed in the forward-looking statement that we make.

Caminus Corporation, *Annual Report on Form 10-K*, February 12, 2002, *at* http://www.sec.gov/Archives/edgar/data/1095157/000095012302001374/y57092e10-k.htm.

114 H.R. REP. NO. 104-369, at 51, *reprinted in* 141 CONG. REC. H13,692, at H13,703.

115 *See supra* note 109; *See also In re Donald Trump Casino*, 793 F.Supp. at 549. Under this prong:

> boilerplate warnings will not suffice as meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in the statement. The cautionary statements must convey substantive information about factors that realistically could cause results to differ materially from those projected in the forward-looking statement, such as, for example, information about the issuers' business.

H.R. REP. 104-369 at 50, *reprinted in* 141 CONG. REC. H13,692, at H13,703.

116 Speaking in support 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 [sic] 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.

141 CONG. REC. S12,201, at S12,203 (1995).

company efforts to mislead investors.[117] Consequently, it will make investment decisions difficult and discourage some from investing altogether.[118] Proponents of the Reform Act, however, contend that the provision provides a much-needed mechanism to screen out frivolous lawsuits early in the litigation process.[119]

2. Heightened Pleading Requirements[120]

The heightened pleading standard arms judges with another screening mechanism to help ensure that plaintiffs have a valid basis for their claim before it proceeds.[121] Although Rule 9(b) of the Federal Rules of Civil Procedure was designed for this particular task,[122] Congress was not satisfied with Rule 9(b) as a procedural device to curb abusive securities litigation or with the varying interpretations of the rule among the courts of appeal.[123] The Reform Act's heightened

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[117] 141 CONG. REC. S19,146, at S19,148 (1995).

[118] *Id.*

[119] *See* Letter from Arthur Levitt, Chairman, SEC, and Steven Wallman, Commissioner, SEC, to Sen. Alfonse D'Amato, Chairman, Comm. on Banking, Hous., and Urban Affairs (Nov. 15, 1995). 141 CONG. REC. H17,933, at H17,935 (1995). The Bill as it stands, "represents a workable balance . . . [because] it encourage[s] companies to provide valuable forward-looking information to investors while, at the same time, it limits the opportunity for abuse." *Id.*

[120] Private Securities Litigation Reform Act, §101, 109 Stat. 737, 747 (1995) (added to the Securities Exchange Act of 1934 as § 21D(b)(1), (2)). Additionally, the Act states in relevant part:

> . . .the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

Id.

[121] 141 CONG. REC. S19,146, at S19,149-50 (statement of Sen. Bradley).

[122] Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1128 (2d Cir. 1994). Rule 9(b) states that "[m]alice, intent, knowledge, and other conditions of mind of a person may be averred generally." FED. R. CIV. P. 9(b).

[123] H.R. REP. NO. 104-369, at 47 (1995), *reprinted in* 141 CONG. REC. H13,692, at H13702 (1995). The Second Circuit requires that plaintiffs plead facts that give rise to a strong inference of fraudulent intent. *Shields*, 25 F.3d at 1128 (holding that "to serve the purposes of Rule 9(b), we require plaintiffs to allege facts that give rise to a strong inference of fraudulent intent.") On the other hand, the Ninth Circuit has rejected the Second Circuit's pleading standard, and allows plaintiffs to aver scienter generally. *In re* Glenfed Inc. Sec. Litig., 42 F.3d 1541, 1545, 1547 (9th Cir. 1994). The Reform Act "implements needed procedural protections to discourage frivolous litigation." H.R. REP. NO. 104-369, at 38-9, *reprinted in* 141 CONG. REC. H13,692, at H13,699. Congress found that "naming a party in a civil suit for securities fraud is a serious matter [because] [u]nwarranted fraud claims can lead to serious injury to reputation for which our legal system effectively offers

pleading standard was designed to remedy this problem by establishing uniform and more stringent pleading requirements across the board.[124]

First, the Reform Act requires plaintiffs alleging that the defendant misrepresented or omitted a material fact to specify the allegedly misleading statements and the reason the statements are misleading.[125] Where allegations are made based on information and belief, the complaint must state with particularity the facts on which that belief is predicated.[126] Second, where the cause of action requires the plaintiff to prove that the defendant acted with "a particular state of mind," the complaint must state with specificity facts giving rise to a "strong inference" that the defendant acted with the prescribed state of mind.[127] A complaint that fails to satisfy either requirement will be subject to dismissal upon the making of a motion to dismiss by the defendant.[128] In addition, the Reform Act imposes an automatic stay on all discovery requests pending a ruling on the motion to dismiss.[129] The objective of

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no redress." H.R. REP. NO. 104-369, at 47, *reprinted in* 141 CONG. REC. H13,692, at H13,702.

124 H.R. REP. NO. 104-369, at 47, *reprinted in* 141 CONG. REC. H13,692, at H13,702.

125 15 U.S.C.A. § 78u-4(b)(1) (West Supp. 2000); Securities Exchange Act of 1934 §21D(b)(1). This provision states in relevant part:

> 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.

126 *Id.*

127 *Id.*

128 15 U.S.C.A. § 78u-4(b)(3)(A). Despite the sweeping language of the Reform Act, complaints alleging securities fraud are not exempt from Rule 9(b) requirements. *See In re* Advanta Corp. Sec. Litig., 180 F.3d 525 (3d Cir. 1999). Rule 9 states: "In all averments of *fraud* or *mistake*, the circumstances constituting fraud or mistake shall be stated with *particularity*." FED. R. CIV. P. 9(b)(emphasis). Malice, intent, knowledge, and other *condition of mind* of a person may be averred *generally*." Fed. R. Civ. P. 9(b)(emphasis). By its own terms, however, Rule 9(b)'s provision allowing *state of mind* to be averred generally conflicts with the Reform Act's requirement that plaintiffs "state with particularity facts giving rise to a strong inference" of scienter. 15 U.S.C.A. §78u-4(b)(2). "In that sense, [we] believe the Reform Act supersedes Rule 9(b) as it relates to Rule 10b-5 actions." *In re Advanta*, 180 F.3d at 531; *see also* H.R. REP. NO. 104-369, at 48, *reprinted in* 141 CONG. REC. H13,692, at H13,702 (the conference committee explicitly stated that it intended to "strengthen" existing pleading standard).

129 Private Securities Litigation Reform Act, §101, 109 Stat. 737, 741 (1995) (added to the Securities Exchange Act of 1934 as § 21D(b)(3)). Section 101 states in relevant part:

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 this latter provision is to prevent plaintiff's counsel from forcing defendants to settle frivolous claims merely to avoid the exorbitant costs associated with the discovery process.[130] It further permits the judge to determine whether the case has any merit before subjecting defendants to the expense of turning over voluminous documents and subjecting directors, officers, and employees to time consuming depositions.[131]

3. Sanctions for Frivolous Filings

Rule 11 of the Federal Rules of Civil Procedure authorizes federal judges to impose appropriate sanctions on attorneys, law firms, or parties who file frivolous claims.[132] The Conference Committee has recognized, however, that Rule 11 has failed to adequately deter frivolous securities litigation.[133] The Reform Act seeks to give teeth to Rule 11 by mandating that judges make specific findings at the conclusion of the case to determine whether all attorneys and all parties

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motion of any party, that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.

Id.

130 141 CONG. REC. S19,146, at S19,151 (1995).

131 *Id.*

132 FED. R. CIV. P. 11. Rule 11 states in relevant part:

> By presenting to the court . . . a pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances . . .the allegations and other factual contentions have *evidentiary support* or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery . . .If, after notice and a reasonable opportunity to respond, the court determines that subdivision (b) has been violated, the court may, . . . impose an appropriate sanction upon the attorneys, law firms, or parties that have violated subdivision (b) or are responsible for the violation.

FED. R. CIV. P. 11(b), (c)(emphasis added).

133 H.R. REP. NO. 104-369, at 46 (1995), *reprinted in* 141 CONG. REC. H13,692, at H13,702 (1995). The Committee found that:

> Courts often fail to impose Rule 11 sanctions even where such sanctions are warranted. When sanctions are awarded, they are generally insufficient to make whole the victim of a Rule 11 violation: the amount of the sanction is limited to an amount that the court deems sufficient to deter repetition of the sanction conduct, rather than imposing a sanction that equals the costs imposed on the victim by the violation. Finally, courts have been unable to apply Rule 11 to the complaint in such a way that the victim of the ensuing lawsuit is compensated for all attorneys' fees and costs incurred in the entire action.

Id.

have complied with each requirement of Rule 11.[134] Where the court finds that an attorney or party violated any requirement of Rule 11(b) as to the complaint, responsive pleading, or dispositive motion, the court must impose mandatory sanctions on such attorney or party in accordance with Rule 11.[135] The failure of a responsive pleading or a dispositive motion to comply with any requirements of Rule 11(b) mandates an award to the prevailing party of reasonable attorneys' fees and other expenses *directly* incurred as a result of the violation.[136] Where the complaint substantially fails to comply with Rule 11(b) requirements, however, the prevailing party is awarded reasonable attorneys' fees and expenses incurred in the entire action.[137]

Opponents of this provision contend that the enhanced sanction language imposes a "fee shifting" scheme that will discourage even those investors with considerable wealth and a strong case from filing suit due to the rise of unlimited liability created by this provision.[138] President Clinton, for example, stated that the provision "[came] too close to a 'loser pays' standard [that] I oppose."[139] Instead, the President sought the restoration of the Rule 11 language in the Senate version of this measure, which limited the sanctions to reasonable attorneys' fees incurred as a *direct* result of the violation in the responsive pleading, dispositive motion, and the complaint.[140] Proponents of the rule contend that the measure creates incentives against filing frivolous claims by

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134 Securities Act of 1933, § 27(c), Securities Exchange Act of 1934, §21D(c); 15 U.S.C. §§ 77z-1(b)(1) (Supp. 2000), 78u-4(b)(3)(B) (Supp. 2000); Private Securities Litigation Reform Act, Pub. L. No. 014-67, §101, 109 Stat. 737, 742 (1995). Section 101 states, in part:

> [T]he court shall adopt a presumption that the appropriate sanction (i) for failure of any responsive pleading or dispoitive motion to comply with any requirements of Rule 11(b) of the Federal Rules of Civil Procedure is an award to 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.

Private Securities Litigation Reform Act, §101.

135 Private Securities Litigation Reform Act, 109 Stat. at 742, 748; Securities Act §27(c); Exchange Act §21(D)(c).

136 *Id.* (emphasis added). H.R. REP. NO. 104-369, at 46 (1995), *reprinted in* 141 CONG. REC. H13,692, at H13,702 (1995).

137 *See supra* note 135.

138 141 CONG. REC. S19,146, at S19,148 (1995).

139 141 CONG. REC. H15,214, at H15,215 (1995).

140 *Id.* (emphasis added).

bolstering the use of Rule 11 penalties, which impose sanctions for filing nonmeritorious claims.[141]

4. Proportionate Liability

One of the most unjust features of the pre-Reform Act system of securities litigation is the wholesale imposition of liability on a less culpable or innocent defendant for harm caused by another defendant.[142] Prior to the enactment of the Reform Act, a single defendant found to be one percent liable might be forced to pay 100% of the damages regardless of that party's actual culpability.[143] The current system of joint and several liability pressured innocent defendants to settle meritless cases merely to avoid unlimited exposure to grossly disproportionate liability.[144] The Reform Act seeks to remedy this injustice by adopting a "fair share" system of proportionate liability.[145]

Section 201 of the Reform Act imposes joint and several liability only in cases where the trier of fact specifically determines that the defendant knowingly[146] violated the federal securities laws.[147] Defendants who are found liable but have not engaged knowingly in violations are only responsible for the portion of the judgment that corresponds to their percentage of culpability.[148]

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141 *See supra* note 138.

142 *Id.*

143 H.R. CONF. REP. NO. 104-369, at 44 (1995), *reprinted in* 141 CONG. REC. H13,692, at H13,701 (1995).

144 *Id.*

145 *Id.*

146 For purposes of the provision: a defendant knowingly commits a violation of the securities laws if (i) the defendant makes an untrue statement of a material fact, with actual knowledge that the representation is false, or omits to state a fact necessary in order to make the statement made not misleading, with actual knowledge that, as a result of the omission, one of the material representations of the defendant is false, and persons are likely to reasonably rely on that misrepresentation or omission, or (ii) in cases not involving false representations, the defendant engages in conduct with actual knowledge of the facts and circumstances that make such conduct a violation of the securities laws. *See* Litigation Reform Act § 201, 109 Stat. 737, 761 (1995); Securities Exchange Act §21D(g)(10)(A).

147 Securities Exchange Act of 1934 §21D(g), (d); Private Securities Litigation Reform Act § 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 "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.*

148 Securities Exchange Act §21D(g), (d); Private Securities Litigation Reform Act § 201, 109 Stat. 737, 759. The factors to be considered in assessing the percentage of responsibility of each defendant are (i) the nature of the person's conduct and (ii) the nature

Proponents support this measure because it prevents plaintiffs from suing a defendant, such as an accountant, that may only be marginally at fault simply because the defendant has "deep pockets."[149] Opponents contend that as between a defrauded innocent investor and a marginally culpable defendant, the burden should lie with the latter.[150]

5. Appointing Lead Plaintiff

The drafters of the Reform Act sought to curb abusive litigation by discouraging the use of "professional plaintiffs" to facilitate the filing of frivolous securities litigation.[151] The current system permits lawyers to readily file nonmeritorious securities class action lawsuits against an entity whose stock price happens to take an unexpected dive that day.[152] Law firms are able to do this by keeping a stable of professional plaintiffs who hold handfuls of shares in a wide variety of publicly held companies.[153] These hired plaintiffs, as they are sometimes called, are compensated for their services in the form of bonuses on top of receiving a portion of the settlement award.[154]

This problem is further compounded by the "race to the courthouse" phenomenon.[155] Under the current system, lawyers have an enormous monetary incentive to be the first to file the complaint in court.[156] Traditionally, the first lawsuit filed determines the lead plaintiff in the case regardless of who has the biggest stake in the

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and extent of the causal relationship between that conduct and the damages. *See id.* at 759; Securities Exchange Act §21D(g)(3)(C). *See also* H.R. REP. NO. 104-369, at 45 (1995), *reprinted in* 141 CONG. REC. H13,692, at H13,701 (1995).

149 141 CONG. REC. S17,933, at S17,934 (1995) (statement of Sen. D'Amato).

150 Avery, *supra* note 3, at 362, stating:

> [A]lthough the traditional doctrine of joint and several liability may cause accountants and others to bear more than their proportional share of liability in particular cases, this is because the system is based on equitable principles that operate to protect innocent investors. As between defrauded investors and defendants who are found knowingly or recklessly to have participated in a fraud, the risk of loss should fall on the latter.

Id.

151 H.R. REP. NO. 104-369, at 39, *reprinted in* 141 CONG. REC. H13,692, at H13,700 (1995).

152 H.R. REP. NO. 104-369, at 39-40, *reprinted in* 141 CONG. REC. H13,692, at H13,700.

153 *Id.*

154 *Id.* at 39.

155 *Id.* at 40.

156 *Id.*

outcome or who can most adequately represent the class members.[157] Thus, in many instances, plaintiffs who own a nominal amount of stock in several companies appear as lead plaintiffs in a number of class action lawsuits filed by the same attorneys to the exclusion of the largest shareholders.[158]

The Reform Act adopts several new rules to discourage the use of professional plaintiffs and to slow down "the race to the courthouse."[159] The Reform Act requires the court to appoint the shareholder who most adequately represents the class as lead plaintiff.[160] This is a presumption that may be rebutted only by evidence that the selected plaintiff is not in a position to fairly and adequately represent the collective interests of the class.[161] The lead plaintiff may, subject to approval of the court, select and retain counsel to represent the class.[162] In addition, the Reform Act prohibits a person to act as lead plaintiff in more than five securities class actions brought during any three-year period.[163]

6. Aiding and Abetting Liability[164]

The Reform Act also deals with the hotly contested issue

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157 *Id.*

158 *Id.*

159 *See* Private Securities Litigation Reform Act §101, 109 Stat. 737, 738-39 (1995). Section 101 states in relevant part:

> 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. at 739; *See also* Securities Act §27(a); Securities Exchange Act §21D(a).

160 Private Securities Litigation Reform Act §101, 109 Stat. 737, 738-39.

161 *Id.* at 739.

162 *Id.* at 740.

163 *Id.*

164 Private Securities Litigation Reform Act §104, 109 Stat. 737, 757. Section 104 states in relevant part:

> 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.

surrounding the liability of aiders and abettors.[165] In *Central Bank of Denver v. First Interstate Bank of Denver*, the United States Supreme Court held that neither the SEC nor a private investor could pursue a securities fraud claim predicated on aiding and abetting liability.[166] Section 104 of the Reform Act restores the ability of the SEC to file suit against aiders and abettors when they knowingly provide substantial assistance to another person in violation of the federal securities laws.[167] The Reform Act does not, however, restore the authority, which was available before the *Central Bank* decision, of the SEC to pursue aiders and abettors that act recklessly in committing a fraud.[168] Moreover, the Reform Act does not restore the ability of private investors to pursue aiders and abettors in all situations.[169]

7. Statute of Limitations[170]

The Reform Act establishes a statute of limitations that requires private securities actions to be filed within one year after the fraud is discovered or three years after it occurred.[171] Critics argue that the statute of limitations will not permit investors adequate time to discover and pursue a securities violations claim.[172] Proponents argue that by limiting the statute of limitations to one year, lawyers are unable to go

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165 141 CONG. REC. S17,933, at S17,937 (1995) (statement of Sen. Sarbanes).

166 Central Bank of Denver v. First Interstate Bank of Denver, 114 S.Ct. 1439, 1448 (1994).

167 *See supra* note 165.

168 The Seventh Circuit defined a reckless omission as:

> a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standard of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1045 (7th Cir. 1977).

169 *See supra* note 165.

170 141 CONG. REC. S8989 (1995).

171 *Id.* "During the Senate's consideration of the bill, Senator Bryan introduced an amendment which would have increased the applicable statute of limitation to a 'two and five' year statute of limitations." *Id.* at S8990. "The final version of the Act, however, contains no such amendment and as such, holds to the standard set by the *Lampf* case." 141 CONG. REC. S17,933, at S17,936 (1995) (statement of Sen. Sarbanes).

172 141 CONG. REC. S17,933, at S17,936. 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." *Id.* Chairman Breeden pointed out that many times, the facts surrounding the alleged fraud come to light years after the alleged fraud actually occurred. *Id.*

"shopping around for years, looking for any possible violation to allege."[173]

B. *Impact of Key Provisions*

Six years have elapsed since Congress enacted the Reform Act. While vigorous debate continues to surround the exact impact it has had on private securities litigation in this country, clear patterns have emerged suggesting that it has not – save for the first year following promulgation – fulfilled its goal of reducing securities litigation. On the contrary, as will become more evident below, securities litigation seems to have hit an all time high at the close of 2001.[174]

In the year immediately following adoption of the Reform Act, President Clinton wrote to the then Securities and Exchange Commission Chairman, Arthur Levitt, asking the Commission to "advise me and the Congress within a year about the impact of the act on the effectiveness of the securities laws and on investor protection, and on the extent and nature of any litigation under the act."[175] In response, the Commission's Office of General Counsel prepared a report setting forth its observations of the impact, adding the following caveat with respect to its findings: "[I]t is too soon to draw any firm conclusions about the effect of the Reform Act on frivolous securities litigation[.]"[176]

The report indicated that "[t]he number of companies sued in securities class actions in federal court is down for the twelve months following passage of the Reform Act."[177] The report identified 105 companies sued "in federal securities class actions during the first year following passage of the Reform Act."[178] By contrast, the Commission noted that 153 companies were sued for alleged securities violations in

[173] 141 CONG. REC. S8989 (1995) (statement of Sen. D'Amato).

[174] *See* http://securities.stanford.edu/index.html (Internet-based reporting entity maintained by Stanford University that tracks private securities suits filed in federal court).

[175] *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995*, U.S. Securities and Exchange Commission, Office of the General Counsel (April 1997), *available at* http://securities.stanford.edu/research/reports/19970401lreform.html.

[176] *Id.*

[177] *Id.*

[178] *Id.* The report indicated that the leading jurisdictions for federal securities class action suits were California (24), New York (18), Florida (10), Massachusetts (8), and Texas (8). *Cf.* http://securities.stanford.edu/index.html (indicating that in 1996 at least 110 suits were filed alleging federal securities violations as opposed to 105).

1993, 221 in 1994, and 158 in 1995. Accordingly, the Commission concluded that there was a 34% decline in the number of companies sued in 1995, a 52% decline in 1994, and a 31% decline in 1993.[179]

At first blush, the impact of the Reform Act's success immediately following enactment suggested that the provisions of the subject legislation were immediately taking hold and reigning in escalating and abusive litigation practices.[180] This outlook, however, was tempered by the Commission's prophetic warning.[181] The Commission's report explained that "[t]his may be a temporary aberration" inasmuch as "[p]laintiff's lawyers may have been hesitant to test uncharted waters."[182] The Commission's prophecy appears to have become reality. In each of the years following 1996, the Securities Class Action Clearinghouse, a Web-based tracking entity maintained by Stanford Law School, found that the number of lawsuits filed in federal courts nationally exceeded that of calendar year 1996 in which it reported 110 filings.[183] The Clearinghouse reported that as of March 30, 2002, 175 suits were filed in 1997, 233 in 1998, 205 in 1999, and 213 in 2000.[184] At the close of the calendar year 2001, the Clearinghouse reported that as many as 478 class action suits were filed around the country.[185] That figure alone represents a 355% increase in suits filed as compared to the 1996 estimate reported by the SEC's Office of General Counsel. Given current market instability, the outlook for lawsuits filed in calendar year 2002 is not likely to see much, if any, improvement.[186]

V. Conclusion

The Private Securities Litigation Reform Act presented the 104th Congress with the rare opportunity to address a growing epidemic in this country that impacts investors worldwide. The Reform Act's provisions provide a much-needed mechanism to ferret out frivolous lawsuits early in the litigation process. The former system invited attorneys to file abusive class action claims and compelled defendant

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179 *See supra* note 175.
180 *Id.*
181 *Id.*
182 *Id.*
183 *See* http://securities.stanford.edu/index.html.
184 *Id.*
185 *Id.*
186 *Id.*

corporations to settle claims promptly to avoid the attendant cost of litigation. The challenge that Congress faced in enacting the Reform Act was to balance two important social objectives: to curb the abusive filing of meritless class action suits, while at the same time, ensuring that the courthouse gates are not closed to innocent investors with legitimate claims. The Reform Act does not, at least not on any practical level, appear to have achieved the former objective.

Although there may be many theories to explain the explosive increase in federal securities class action lawsuits, such as the increase in the number of inherently volatile high-tech companies that have come on the scene, or the ability of crafty lawyers to circumvent the Reform Act's provisions, the Reform Act does not appear to have achieved the policy objectives that lawmakers envisioned it would achieve. The ensuing years may paint a different picture, but for now, it may be back to the drawing board for Congress.