

# PREEMPTING UNINTENDED CONSEQUENCES

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There is something called the “Law of Unintended Consequences.” Who enacted this law, who enforces it, and its exact scope are obscure. However, from time to time it manifests itself, most recently having made an appearance in some of the fallout from the Private Securities Litigation Reform Act of 1995<sup>1</sup> (“the Act”). One unintended or, perhaps more accurately, unforeseen consequence of the Act has been the increasing appearance of the Milberg, Weiss firm as plaintiffs’ counsel in securities class action litigation.<sup>2</sup> This firm, seen by many advocates of reform as the incarnation of all they dislike in class litigation, has become an ever more commanding presence on that scene. Milberg, Weiss has extraordinarily competent and experienced lawyers in class action litigation who have been extremely successful in securing substantial verdicts and procuring huge settlements. Their increased ascendancy and heightened visibility in the class action arena cannot be a source of joy to the promoters of the Act. The reason for the firm’s rise is very simple: One consequence of the Act has been the lengthening of proceedings. Milberg, Weiss, with its deep pockets and vast experience, is better able than most other smaller plaintiffs’ firms to sustain this lengthy process without suffering crippling financial strain.

Another unintended consequence of the Act was the initial migration of securities litigation to the state courts.<sup>3</sup> Most states do not have laws that impose the stringent pleading requirements of the Act, set the hurdles so high in prevailing on fraudulent forecasts, provide for separate and proportionate damages,<sup>4</sup> or place other impediments in the path of success in class actions like those created by the Act. While there initially appeared to be a major move toward state courts, this trend subsequently abated, and at the present writing the pendulum has swung back toward the federal system, both as a proportion of total litigation and in absolute numbers. Not surprisingly, most of the state litigation was initiated in California, largely as a consequence of the fact that

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1. Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C. (Supp. I 1995-96)).

2. See Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year’s Experience* (visited Feb. 27, 1997), available at <[http://securities.stanford.edu/report/pslra\\_yr1/index.html](http://securities.stanford.edu/report/pslra_yr1/index.html)>.

3. See *id.*

4. Many states provide for some form of separate and proportionate damages, mainly as the result of the successful efforts of the accounting profession.

the principal targets of such litigation were technology-oriented companies, many of which are located in Silicon Valley.<sup>5</sup> Currently, in the California Supreme Court, a case is pending in which the defendants have asserted that suits in California courts can reach only transactions that occurred in California, an assertion which if adopted by the court obviously would impede the ability to maintain a nationwide class action in the California courts and thus would make California a much less attractive forum.<sup>6</sup>

As a consequence of the initial migration of litigation to the state courts and a fear that it might recur, many of the original advocates of the Act agitated for preemptive legislation that would preclude the maintenance of securities fraud class actions in state courts. H.R. 1653<sup>7</sup> and H.R. 1689,<sup>8</sup> introduced in the House, and S. 1260,<sup>9</sup> introduced in the Senate, would achieve this. Although they differ as to the details, the thrust of these bills is the same—forcing all securities class actions into federal court, thus subjecting such litigation to the constraints of the Act. The interest in the legislation is huge: H.R. 1689 has 224 co-sponsors; its Senate counterpart has forty co-sponsors.

Critics of this proposed federal legislation quickly emerged. The Securities and Exchange Commission (“SEC”) was one early and vocal critic. In testifying before the Senate Sub-Committee on Securities on October 29, 1997,<sup>10</sup> the SEC sounded several cautions. First, it said that experience under the Act had been so limited that Congress should not leap to conclusions about its consequences, including the likelihood of the continued popularity of state courts.<sup>11</sup> Second, the SEC was concerned that by providing for exclusive federal jurisdiction, investors might be deprived of “important protections,” which they are denied under federal law, such as aiding and abetting civil liability and longer statutes of limitations.<sup>12</sup> Finally, the SEC was concerned that the benefits flowing from the ability of corporations and shareholders to secure quick relief in state courts, particularly the Delaware courts, might be lost in connection with tender offers, proxy contests, and other financial transactions.<sup>13</sup> However, the SEC noted that S. 1260 would preserve a number of actions, such as cases against brokers, actions involving localized fraud, claims involving fraud in penny stocks and microcap securities, and actions by state regulators.<sup>14</sup> The SEC also noted that even if the Senate legislation was adopted it would not

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5. *See id.*

6. *See* Pass v. Diamond Multimedia, No. S058723 (Cal., petition granted Mar. 27, 1997).

7. Securities Litigation Improvement Act of 1997, H.R. 1653, 105th Cong.

8. Securities Litigation Uniform Standards Act of 1997, H.R. 1689, 105th Cong.

9. Securities Litigation Uniform Standards Act of 1997, S. 1260, 105th Cong.

10. *See Securities Litigation Abuses: Testimony of the Securities and Exchange Commission Concerning S. 1260, the “Securities Litigation Uniform Standards Act of 1997” Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., & Urban Aff., 105th Cong. (1997), available in LEXIS, LEGIS Library, CNGTST File.*

11. *See id.*

12. *See id.*

13. *See id.*

14. *See id.*

necessarily preclude the use of the state courts in an individual action to secure discovery otherwise barred in a federal class action.<sup>15</sup> Furthermore, the SEC noted that the bill might discourage institutional investors from seeking to be named as lead plaintiffs in securities fraud class actions because this would prevent them from bringing related state claims unless they opted out of the plaintiff class.<sup>16</sup>

Notwithstanding these misgivings, the SEC has now endorsed the legislation, apparently because the Senate Banking Committee agreed to put into the legislative history of S. 1260 an assurance that when Congress adopted the Act it did not intend to do away with the “recklessness” standard for liability under the Securities Exchange Act of 1934. Several district court cases have construed the Act as requiring *conscious* misconduct.<sup>17</sup> The SEC has been extremely concerned lest this might become the accepted standard. Hence it was apparently willing to put aside its earlier misgivings about preemption to assure the viability of recklessness as a basis for civil liability. The Senate committee has accommodated the SEC by stating in the Committee report:

The Committee emphasizes that the clear intent in 1995 and our continuing intent in this legislation is that neither PSLRA nor S.1260 in any way alters the scienter standard in federal securities fraud suits. It was the intent of Congress, as was expressly stated during the legislative debate on the PSLRA, and particularly during the debate on overriding the President’s veto, that the PSLRA establish a uniform federal standard on pleading requirements by adopting the pleading standard applied by the Second Circuit Court of Appeals.

Thus, the Senate has made it clear that recklessness is sufficient to maintain an action for fraud under the federal securities laws. Some commentators have suggested that this is an unusual process, to use the legislative history of one statute to clarify Congress’ intent in adopting another statute and there have been expressions of doubt as whether such a process will be binding upon the courts. Clearly a better procedure would have been to amend the Act.

This author is among those who believe that relief from the excesses of civil securities litigation has been, and is still, sorely needed, but I believe the Act is seriously flawed. Literally enforced, the requirement for pleading with particularity “facts giving rise to a strong inference that the defendant acted with the required state of mind” before discovery is permitted seriously hampers legitimate plaintiffs. Similarly, the safe harbor for forward-looking statements may constitute not just a “safe harbor” but an impregnable fortress in which

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15. *See id.*

16. *See id.*

17. *See* UNITED STATES SEC. AND EXCHANGE COMM. OFFICE OF GEN. COUNSEL, REPORT TO THE PRESIDENT AND THE CONGRESS ON THE FIRST YEAR PRACTICE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995, at 42-48 (visited Apr. 1997), available at <<http://www.sec.gov/news/studies/lreform.txt>>. The most notable of these cases is *In re Silicon Graphics, Inc. Sec. Litig.*, No. C 96-0393 FMS, 1996 U.S. Dist. LEXIS 16989 (N.D. Cal. Sept. 25, 1996). The court concluded in *Silicon Graphics* that under the Act a plaintiff must plead with particularity facts giving rise to a strong inference that the defendant’s conduct was conscious and not merely reckless. *See id.* at \*16.

18. S. REP. NO. 105-182, at 4 (1998).

wrongdoers might take refuge. To the extent that worthy plaintiffs are hampered in securing an adequate remedy in the federal courts, the obvious and most simple remedy is to amend the Act to eliminate or modify the provisions that operate unfairly against meritorious plaintiffs. However, this is undoubtedly an unrealistic expectation. Even if the balance of power in Congress were to shift, it is doubtful that Congress would revisit the Act so soon. Moreover, the Act passed in the Senate with a margin sufficient to overcome a Presidential veto. Any foreseeable shift in that body undoubtedly would be insufficient to adopt appropriate remedial legislation.

However, that does not close the debate. Despite the relative newness of the Act and the dearth of authoritative interpretations of it, a rush to preemption does seem unwarranted. Apart from the deficiencies in the Act and the argument that preemption is necessary to preserve the meritorious thrust of Congress in enacting it, the question of preemption is a worthy one that should be carefully considered, *but on its merits apart from the Act*.

In its simplest form, the case for preemption is that there is an inherent logic, efficiency, and consistency in having litigation involving nationally traded securities resolved in a single forum, with a single statute of limitations, a single standard of proof, and a single set of substantive requirements. The alternative is fifty-plus definitions of scienter, fifty-plus statutes of limitations, fifty-plus rules on attorneys' fees, fifty-plus rules on what constitutes a class, fifty-plus rules on standing, and conflict questions galore. These considerations underlie the preemptive provisions of the National Securities Markets Improvement Act,<sup>19</sup> which preempted most of the state authority over disclosure by companies with nationally traded securities and a number of other matters.

Of course, there are some meritorious arguments against preemption. First, there is the venerable Brandeisian observation that the states provide laboratories for the nation: Legal theories and approaches to litigation can be tested in the state courts. However, whatever value the states may have had as laboratories for securities regulation, it long since has been realized and it is doubtful whether further state experimentation is necessary or desirable. Also, there is the argument that the states should not be stripped of their power to litigate wrongs committed against their citizens. However, this argument would not justify a nationwide class action being dealt with in a state court, the very issue presently before the California Supreme Court. Furthermore, these considerations did not preclude the enactment of the National Securities Markets Improvement Act, which enjoyed considerable support and significantly circumscribed the power of states to protect their citizens against disclosure wrongs and other securities misdeeds. And, finally, there is the constitutional argu-

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19. Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in scattered sections of 15 U.S.C. §§ 77a-77mm (Supp. I 1995-96)).

ment. I leave that to scholars better able to deal with it than I, such as Manning Warren.<sup>20</sup>

Unfortunately, the realm of environmental law does not provide solace for those opposing preemption. The allocation of responsibility between the states and the federal government in this area was the result of a very carefully considered and nicely defined allocation of responsibility.<sup>21</sup> When the securities acts were adopted in the early 1930s, they specifically reserved broad jurisdiction to the states. I would defer to Dean Seligman on matters of securities law history, but it has always seemed to me that this was done, not because of any burning desire to preserve the states as laboratories or as the result of a carefully considered allocation of responsibility, but rather because of a then-common deference to state authority. At that time, courts were far less willing than they are presently to tolerate the intrusion of federal law into areas that traditionally had been governed by state law. After all, it was only a year after the Securities Exchange Act of 1934 was enacted that the Supreme Court decided *Schechter Poultry Corp. v. United States*,<sup>22</sup> which highlighted the contemporary judicial hesitancy to expand the authority of the federal government. In the Federal Securities Code, which sadly never was enacted, there was a more considered allocation of jurisdiction between federal and state courts, much like that which appears in today's environmental laws.

One of the significant concerns expressed with regard to the pending legislation that would provide for preemption is that it would preempt some desirable state litigation—desirable even in the eyes of the proponents of preemption—principally in Delaware, whose courts, because of the judicial climate and their experience, have facilitated the completion of transactions and the protection of shareholders. For instance, in tender offers and proxy contests involving one or more Delaware corporations, the Delaware courts have provided a speedy and informed forum in which to resolve a variety of questions, some of which parallel the sort of claims that may be asserted under federal securities law. This type of state jurisdiction should be preserved. The Senate bill has been amended to provide, in the words of the section-by-section analysis, “for the preservation of certain law suits brought under State law affecting the conduct of corporate officers with respect to certain corporate actions, including tender offers, exchange offers or the exercise of dissenter’s or appraisal rights.” This summary seems to be somewhat narrower than the text of the bill itself. With the SEC’s and the bar’s (particularly the Delaware bar’s) concerns having been met and given the extent of sponsorship in the Senate, it is not surprising that the legislation passed the Senate by a vote of 79 to 21. The House Subcommittee on Finance and Hazardous Materials of the Committee on Commerce held a hearing on H.R. 1689 on May 19, 1998. With a majority of the

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20. See Manning Warren, *Federalism and Investor Protection: Constitutional Restraints on Preemption of State Remedies for Securities Fraud*, 60 LAW & CONTEMP. PROBS. 169 (Summer 1997).

21. See John P. Dwyer, *The Role of State Law in an Era of Federal Preemption: Lessons from Environmental Regulation*, 60 LAW & CONTEMP. PROBS. 203 (Summer 1997).

22. 295 U.S. 495 (1935).

House as co-sponsors, there is little doubt that this legislation will become law during the current Congress. The administration has evidenced support for it, so a presidential veto is not in the cards.

The legislation will pass for all the wrong reasons and without the principled debate which the importance of the issue demands. This outcome is unfortunate, but the argument for preemption is a compelling one on principle, hence the outcome is not in any sense catastrophic or unduly rending of the constitutional fabric. There is indeed ample logic for focusing private litigation involving nationally traded securities in the federal courts. There is an old Portuguese proverb, "God writes straight with crooked lines." This legislation may be one of the instances in which that is true.