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RESPONDING TO A FALSE ALARM: FEDERAL PREEMPTION OF STATE SECURITIES FRAUD CAUSES OF ACTION

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Introduction

Congress has passed the Securities Litigation Uniform Standards Act of 1998 ("Uniform Standards Act"),[1] preempting securities fraud class actions under the common law and statutes of all fifty states.[2] As a result, defrauded investors, with the exception of state and local governments and their pension funds,[3] will be barred from bringing class

1 Pub. L. No. 105-353, 112 Stat. 3227 (to be codified in scattered sections of 15 U.S.C.).

2 A bill that would have preempted all private rights of action for securities fraud under state law was introduced in the House of Representatives, but it did not proceed further. *See* Securities Litigation Improvement Act of 1997, H.R. 1653, 105th Cong. § 16 (1997). Congressman Tom Campbell (R-Cal.), a Stanford Law School Professor, proposed House Bill 1653 and Professor Joseph Grundfest of Stanford Law School had drafted it. *See The Securities Litigation Uniform Standards Act of 1997: Hearing on H.R. 1689 Before the Subcomm. on Fin. and Hazardous Materials of the House Comm. on Commerce*, 105th Cong. 15-17 (1998) [hereinafter *May 19, 1998, House Uniform Standards Act Hearing*] (statement of Rep. Tom Campbell).

3 *See* S. 1260, 105th Cong. § 3(f) (1998), *reprinted in* 144 Cong. Rec. S4811 (May 13, 1998) (agreeing to Amendment No. 2397 exempting suits brought by "a State or political subdivision thereof or a State pension plan" on its own behalf or as a member of a class comprised solely of similar entities); H.R. 1689, 105th Cong. § 16(d)(2) (1998), *reprinted in* 144 Cong. Rec. H6053 (July 21, 1998) (same, except providing that exempted class members must have "authorized participation[ ] in such action"). The Uniform Standards Act incorporated the House language.

actions in state court or under state law. Because most plaintiffs find litigation outside of a class action impractical and uneconomical,[4] the vast majority of investors will be left with only federal remedies—the express remedies created by the Securities Act of 1933 ("1933 Act")[5] and the remedies that the federal courts have implied under the Securities Exchange Act of 1934 ("1934 Act").[6] Preemption now occurs even though the 1933 and 1934 Acts expressly preserved state causes of action,[7] and the courts that subsequently interpreted federal remedies under these statutes assumed that alternative state remedies were available.[8] Ironically, the Congress that now preempts these state remedies has been committed to federalism in almost every other area of legislation.[9]

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4 For a discussion of the economics of class action litigation, see *infra* Part V.A.

5 Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb (1994 & Supp. II 1996).

6 Securities Exchange Act of 1934, 15 U.S.C. §§ 78e-78mm. The 1934 Act contains express remedies in section 9 for market manipulation, *see id.* § 78i (1994), and in section 18 for false statements in filings with the SEC. *See id.* § 78r. Section 9, however, is limited to enumerated acts of market manipulation and does not generally reach misrepresentations made to purchasers of securities. *See id.* § 78i. Section 18 requires a showing that each plaintiff relied on the defendant's misrepresentations in its SEC filings. *See id.* § 78r(a). Because reliance turns on different questions of fact for each plaintiff (many of whom never read SEC filings), class actions under section 18 are virtually impossible. Most plaintiffs instead use the implied private right of action under section 10(b) of the 1934 Act, *see id.* § 78(j). This implied right of action is discussed more fully below. *See infra* note 47; *infra* text accompanying notes 410-27.

7 *See* Securities Act of 1933, ch. 38, § 16, 48 Stat. 74, 84 (codified at 15 U.S.C. § 77p (1994)) ("The rights and remedies provided by this [Act] shall be in addition to any and all other rights and remedies that may exist at law or in equity."); Securities Exchange Act of 1934, ch. 404, § 28(a), 48 Stat. 881, 903 (codified as amended at 15 U.S.C. § 78bb(a) (Supp. II 1996)) ("The rights and remedies provided by this [Act] shall be in addition to any and all other rights and remedies that may exist at law or in equity. . . .").

8 For example, the Supreme Court stated in *Marine Bank v. Weaver*: "[W]e are satisfied that Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud." 455 U.S. 551, 556 (1982) (holding that a privately negotiated arrangement promising a share of a borrower's profits in return for a loan guarantee was not a security for purposes of section 10(b)); *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 738 n.9 (1975) (holding that a plaintiff has no standing to sue under section 10(b) of the 1934 Act unless the plaintiff was an actual purchaser or seller of securities, and pointing out that disadvantages imposed on investors by this seemingly arbitrary restriction are "attenuated to the extent that remedies are available to nonpurchasers and nonsellers under state law"). *Blue Chip* and other holdings narrowly construing federal private rights of action are discussed *infra* text accompanying notes 410-37.

9 Welfare reform, health care, and environmental regulation are a few examples of areas in which the 104th and the 105th Congresses preferred to leave power with the states. *See infra* notes 444-49 and accompanying text. A notable exception was tort reform. *See* Common Sense Product Liability Reform Act of 1996, H.R. 956, 104th Cong. (1996). This Act would have limited punitive damage claims in most product liability cases. *See id.* § 201. However, President Clinton vetoed House Bill 956. *See* Message to the House of Representatives Returning Without Approval Product Liability Legislation, PUB. PAPERS 681 (May 2, 1996) (William J. Clinton). Congress failed to override the veto by a vote of 258 to 163. *See* 142 CONG. REC. H4764 (daily ed. May 9, 1996).

In 1998 bills were introduced in the House and the Senate that would have expanded federal courts' jurisdiction over class action litigation. Representative Henry Hyde (R-Ill.)

The reasons why this sweeping preemption of state law succeeded in the 105th Congress are rooted in a seminal piece of legislation of the 104th Congress: the Private Securities Litigation Reform Act of 1995 ("1995 Reform Act").[10] The 1995 Reform Act, which sought to curb frivolous class action litigation in the federal courts,[11] amended federal law to implement among other measures: heightened pleading requirements, a stay of discovery pending motions to dismiss, a safe harbor for forward-looking statements, provisions for the judicial appointment of a lead plaintiff that has a significant economic interest in the litigation, and heightened judicial scrutiny of settlement terms.[12]

Soon after Congress enacted the 1995 Reform Act, however, many of its supporters discovered that a "loophole" in the legislation allowed plaintiffs' lawyers to avoid the new restrictions by filing suits under state law.[13] Professors Joseph Grundfest and Michael Perino of Stanford Law School compiled statistics suggesting that, following the 1995 Reform Act, state court litigation increased during 1996, mostly in California.[14] In turn, the high technology companies of Silicon Val-

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introduced House Bill 3789 on May 5, 1998, *see* H.R. 3789, 105th Cong. (1998), and Senators Charles Grassley (R-Iowa) and Herb Kohl (D-Wis.) introduced Senate Bill 2083 on May 14, 1998, *see* S. 2083, 105th Cong. (1998). The bills sought to amend 28 U.S.C. § 1332 (providing for federal jurisdiction in cases where there is diversity of citizenship) to provide for federal jurisdiction wherever any member of a plaintiff class is a citizen of a state different from any defendant. *See* H.R. 3789 §2(a); S. 2083 § 3. Neither bill progressed beyond committee in 1998.

10 Pub. L. No. 104-67, 109 Stat. 737 (codified in 15 U.S.C. §§ 77k-l, 77z-1 to z-2, 78u-4 to u-5, 78j-1 (Supp. II 1996)).

11 *See* Joint Explanatory Statement of the Committee of Conference, H.R. CONF. REP. No. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730 [hereinafter 1995 Reform Act Joint Explanatory Statement] ("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.").

12 *See* 15 U.S.C. § 78u-4(b) (pleading requirements); *id.* §§ 77z-1(b), 78u-4(b)(3)(B) (stay of discovery); *id.* §§ 77z-2, 78u-5 (safe harbor for forward-looking statements); *id.* §§ 77z-1(a)(3), 78u-4(a)(3) (lead plaintiff provisions); *id.* §§ 77z-1(a)(7), 78u-4(a)(7) (judicial scrutiny of settlement terms). *See infra* Part III.A.

13 *See* 144 CONG. REC. S4781 (daily ed. May 13, 1998) (statement of Sen. D'Amato on Senate Bill 1260) ("The problem to which I refer is a loophole that strike lawyers have found in the 1995 [Reform Act] . . . ."); *see also The Securities Litigation Uniform Standards Act of 1997—S. 1260: Hearings on S. 1260 Before the Subcomm. on Sec. of the Senate Comm. on Banking, Housing, and Urban Affairs*, 105th Cong. (July 24, 1997) (forthcomimg) (transcript at 23) [hereinafter *July 24, 1997, Senate Uniform Standards Act Hearing*] (prepared statement of Joseph Polizzotto, representative of the Securities Industry Association) (discussing how plaintiffs and their lawyers are exploiting the state court "loophole."); Kenneth J. Blackwell, *Securities Loophole in Need of Repair*, WASH. TIMES, Aug. 25, 1997, at A13 ("Closing a loophole is exactly what Congress must do to make sure its 1995 bid to protect investors from abusive securities lawsuits works as intended.").

14 *See The Securities Litigation Uniform Standards Act of 1997—S. 1260: Hearings on S. 1260 Before the Subcomm. on Sec. of the Senate Comm. on Banking, Housing, and Urban Affairs*, 105th Cong. 24-26 (1997) [hereinafter *October 29, 1997, Senate Uniform Standards Act Hearing*] (testimony of Michael A. Perino, Professor of Law); *Implementation of the Private Securi-*

ley, one of the largest defendant groups in securities fraud class actions,[15] made substantial political contributions and lobbied for preemption.[16] Consumer groups, public finance officials, and plain-

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ties Litigation Reform Act of 1995: Hearings, Serial No. 105-59 Before the Subcomm. on Fin. and Hazardous Materials of the House Comm. on Commerce, 105th Cong. 40-44 (1998) [hereinafter *Oct. 21, 1997, House 1995 Reform Act Implementation Hearing*] (testimony and prepared statement of Michael A. Perino, Professor of Law); *July 24, 1997, Senate Uniform Standards Act Hearing*, *supra* note 13 (transcript at 44) (prepared testimony of Joseph A. Grundfest and Michael A. Perino, Professors of Law); Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 302-14 (1998) (reciting statistics showing an increase in state court filings after the 1995 Reform Act); JOSEPH A. GRUNDFEST & MICHAEL A. PERINO, SECURITIES LITIGATION REFORM: THE FIRST YEAR'S EXPERIENCE 3 (John M. Olin Program in Law and Econ. Working Paper No. 140, 1997) (same).

Many of the statistics cited by Professors Grundfest and Perino are from Stanford Law School's Securities Class Action Clearinghouse, a World Wide Web site launched in December 1996 that publishes court papers in class action lawsuits. The Stanford Web site is funded in part by private industry. *See Securities Class Action Clearing House* (visited Sept. 10, 1998) <http://securities.stanford.edu/about/caveat.html> [hereinafter *Securities Class Action Website*]. According to the Clearinghouse's homepage:

> George Roberts [a founding partner of Kohlberg, Kravis, Roberts and Co.] provided the 'seed capital' for this venture; the National Center for Automated Information Research . . . provides the largest source of . . . sustaining support; Netscape Communications . . . donated the software for the site; and Sun Microsystems and Apple Computer . . . donated the hardware for this site.

Id. Several of these sponsors are not entirely disinterested in securities litigation.

The same month that Stanford launched this Website, the United States District Court for the Northern District of California proposed Rule 23.3, requiring complaints, settlements, and other filings in securities fraud class actions to be posted on a designated Website. The San Francisco Bar Association's board of directors voted to oppose the proposed rule. *See* Todd Woody, *Not the Year in Review, but Some Year-End Stars*, LEGAL TIMES, Jan. 13, 1997, at 45. The Statement of Managers for the Uniform Standards Act noted the utility of Stanford's database and urged other federal district courts to adopt rules similar to those of the Northern District of California. *See* H.R. CONF. REP. No. 105-803 (1998), *reprinted in* 144 CONG. REC. 11,021 (daily ed. Oct. 15, 1998).

15 According to a survey by National Economics Research Associates, roughly 23% of all securities class action suits filed in federal court from January 1991 through October 1996 were filed against high technology firms. *See* DENISE N. MARTIN ET AL., NAT'L ECON. RESEARCH ASSOC., RECENT TRENDS IV: WHAT EXPLAINS FILINGS AND SETTLEMENTS IN SHAREHOLDER CLASS ACTIONS? iii, tbl.10c (1996) [hereinafter NERA 1996 STUDY]. Data recorded by Professors Grundfest and Perino found that high technology companies represented roughly 34% of all issuers named as defendants in federal actions both before and after the 1995 Reform Act. *See* GRUNDFEST & PERINO, *supra* note 14, at 23 & tbl.8.

16 The Technology Network, a newly formed political action committee in Palo Alto, California, amply demonstrates Silicon Valley's political influence:

> Spurred by John Doerr, a Menlo Park venture capitalist credited with raising $40 million against Proposition 211, TechNet was formed as a full-fledged political action committee in July. Jim Barksdale, CEO of Netscape Communications Corp. in Mountain View, was named co-chairman with Doerr.
>
> . . . .
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> TechNet has been host of nine fund-raising events for leading Democrats, including an $800,000 dinner for the DNC in San Francisco that featured President Clinton.

tiffs' lawyers stood on the opposing side.[17] Over two dozen securities law professors also urged Congress not to preempt state causes of action.[18]

In 1997 Arthur Levitt, Chairman of the Securities and Exchange Commission ("SEC"), asked Congress to postpone preemption of state causes of action until more was known about the impact of the 1995 Reform Act on litigation in state and federal courts.[19] However, in 1998, as the proponents of preemption gained the upper hand, Chairman Levitt and two other SEC commissioners decided to endorse the Uniform Standards Act in return for certain assurances with respect to federal law. They wanted both the legislative history and the Senate floor debate to reflect that Congress had not intended the 1995 Reform Act to preclude suits for reckless misrepresentation in the sale of securities,[20] an issue that has been a source of confusion in

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> TechNet also has organized monthly meetings with Vice President Al Gore—known as 'Gore-Techs'—and two dozen issues briefings with state and federal Democratic legislators, including Clinton.
>
> The Republican side of TechNet has held a dozen issues briefings and been host of four fund-raising events.
>
> In a week-long trip to Washington, industry leaders met privately with the cream of Republican congressional leadership, including House Speaker Newt Gingrich and Senate Majority Leader Trent Lott.
>
> In all, TechNet has raised more than $2 million in campaign funds—roughly $1 million each for Democrats and Republicans.

Mark Simon, *How Tech Leaders Talk Politics: Silicon Valley Approach Confuses Washington*, S.F. CHRON., Nov. 13, 1997, at A19.

17 Consumer groups and public finance officials wrote Congress in opposition to preemption of state securities fraud causes of action. *See infra* notes 279-83 and accompanying text. Securities plaintiffs' lawyers also opposed preemption, and like other plaintiffs' lawyers, made suhstantial political contributions. *See infra* notes 161-63.

18 *See* 144 CONG. REC. S4784 (daily ed. May 13, 1998) (letter from Ian Ayres et al., Securities Law Professors, to Senators and Members of Congress (Jan. 23, 1998)). Additionally, 23 professors signed another, longer letter to Senators and Members of Congress, also dated January 23, 1998, that specified in more detail the reasons the signatories opposed preemption of state securities fraud causes of action: Ian Ayres, Stephen M. Bainbridge, Douglas M. Branson, William W. Bratton, John C. Coffee, Jr., James D. Cox, Charles M. Elson, Theresa A. Gabaldon, Nicholas L. Georgakopoulos, James J. Hanks, Jr., Fred S. McChesney, Lawrence E. Mitchell, Donna M. Nagy, Jennifer O'Hare, Richard W. Painter, William H. Painter, Margaret V. Sachs, Joel Seligman, D. Gordon Smith, Marc I. Steinberg, Robert B. Thompson, Manning G. Warren III, and Cynthia A. Williams. *See* Letter from Ian Ayres et al., Securities Law Professors, to Senators and Members of Congress (Jan. 23, 1998) (on file with author). The author of this Article wrote both of these letters.

19 *See July 24, 1997 Senate Uniform Standards Act Hearing*, *supra* note 13 (transcript at 15) (prepared statement of Arthur Levitt, Chairman, SEC); *see also Oct. 21, 1997, House 1995 Reform Act Implementation Hearing*, *supra* note 14, at 31 (testimony of Arthur Levitt, Chairman, SEC) (responding to questions concerning the 1995 Reform Act's efficacy by stating that more time is needed to get a "clearer picture," and concluding that Congress should postpone preemption of state causes of action).

20 *See May 19, 1998, House Uniform Standards Act Hearings*, *supra* note 2, at 21 (prepared statement of Arthur Levitt, Chairman, SEC) (stating that "[t]he Commission was able to support S. 1260 only upon receiving assurances that legislative history would be

the federal district courts.[21] One commissioner, Norman Johnson, dissented, stating that preemption was unnecessary.[22] The Clinton Administration followed the majority of the SEC commissioners and promised to support the legislation, provided members of Congress made the requisite statements concerning suits for reckless misrepresentation under federal law.[23] Clarifying statements regarding the recklessness issue were made in the Senate Floor debate on May 13, 1998.[24] The text of the Uniform Standards Act, however, does not address the issue of recklessness under federal law.[25]

Although Congress thus has abolished most securities fraud class actions under state law, a subsequent Congress could reinstate the right to bring such suits. Meanwhile, state law continues to provide remedies for plaintiffs suing in an individual capacity and in class actions brought by state and local governmental entities and their pension funds.[26] Thus, state private rights of action for securities fraud will continue to play a significant, albeit much reduced, role in U.S. securities regulation.

This Article evaluates, from both an economic and a political perspective, the arguments for and against preemption of state securities fraud causes of action. This Article also develops, for the benefit of scholars and future Congresses, a methodology for determining

inserted into the record making clear that the [1995] Reform Act was not meant to define or alter the state of mind requirements for securities fraud liability [under federal law]").

21 The current state of the recklessness standard under federal law is discussed further *infra* note 181. *See also* Michael B. Dunn, Note, *Pleading Scienter After the Private Securities Litigation Reform Act: Or, a Textualist Revenge*, 84 CORNELL L. REV. 193, 221-37 (1998) (analyzing thirty-one district court cases and highlighting their varied interpretations of the 1995 Reform Act's heightened pleading standard).

22 *See* 144 CONG. REC. S4786 (daily ed. May 13, 1998) (letter from Norman S. Johnson, SEC Commissioner, to Sen. Alfonse M. D'Amato, Sen. Phil Gramm, and Sen. Christopher J. Dodd (Mar. 24, 1998)) ("I share in the views of 27 of this country's most respected securities and corporate law scholars who have urged you and your colleagues not to support S. 1260 or any other legislation that would deny investors their right to sue for securities fraud under state law."). Commissioner Carey did not participate in the Commission's decision concerning endorsement of the preemption legislation.

23 *See id.* at S4781 (letter from Bruce Lindsey, Assistant to the President and Deputy Counsel, and Gene Sperling, Assistant to the President for Economic Policy, to Chairman D'Amato, Chairman Gramm, and Sen. Dodd (Apr. 28, 1998)) ("[I]t is particularly important to the President that you be clear that the federal law to be applied includes recklessness as a basis for pleading and liability in securities fraud class actions.").

24 The prearranged colloquy on the recklessness issue took place between Senators Dodd and D'Amato. *See id.* at S4798-99 (floor debate on Senate Bill 1260); *infra* text accompanying notes 308-23 (discussing the colloquy itself and the exchange of letters between the SEC and the sponsors of S.1260 that led to this arrangement).

25 *See infra* text accompanying notes 314-25 (discussing the Uniform Standards Act in its final form).

26 *See* H.R. 1689, 105th Cong. § 16(d)(2) (1998), *reprinted in* 144 CONG. REC. H6053 (July 21, 1998) (exempting suits by state and local governments and their pension funds); S. 1260, 105th Cong. § 3(f) (1998), *reprinted in* 144 CONG. REC. S4811 (May 13, 1998) (same).

under what circumstances, and in what manner, state causes of action for securities fraud should be preempted.

First, do the benefits of preempting state causes of action outweigh the costs? In answering this question, this Article assumes that *both* state laws and federal laws strike an "efficient" balance between the interests of plaintiff investors and defendant issuers.[27] This Article concludes that the purported benefits of requiring securities fraud claims to be litigated under federal law are ephemeral, in part because plaintiffs will continue to litigate fiduciary breach claims under state corporate law. Although Congress could create a more efficient litigation system by requiring plaintiffs to litigate *both* securities and corporate law claims under federal law,[28] the Uniform Standards Act does not establish a federal corporate law, and convincing arguments favor leaving corporate law to the states.[29] Congress could have taken the opposite approach and abolished federal securities causes of action that have counterparts under state law. Absent such a step, which presents its own difficulties,[30] preemption does little to enhance the efficiency of the litigation system and instead reinforces, with jurisdictional barriers, the already cumbersome distinction between corporate and securities law.

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27 Professor Stout described this balancing of interests in the litigation system in terms of two types of error: Type I error (the "false positive," in which an innocent defendant is found liable in, or forced to settle, a suit for securities fraud), and Type II error (the "false negative," in which a guilty defendant escapes liability). *See* Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 ARIZ. L. REV. 711 (1996). *See infra* notes 359-68.

28 Many of the efficiencies that could be realized by making corporate and securities issues subject to the law of a single jurisdiction can be described under the rubric of "network externalities." *See infra* text accompanying notes 82, 347-58. For example, in cases against issuers incorporated in the same state in which they sell most of their securities, state causes of action allow a plaintiff to bring corporate and securities law claims under the law of one jurisdiction. Federal preemption of state securities law removes this option and instead requires plaintiffs to litigate these two interconnected causes of action under the laws of two separate jurisdictions.

29 *See* Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985); *infra* text accompanying notes 61-66. *But see* Lucian Ayre Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992) (arguing that manager opportunism and externalities may lead states to enact socially undesirable corporation laws that reduce shareholder value). *See generally* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991) (discussing various facets of corporate law in which state law promotes efficiency).

30 Whether replacing federal causes of action with state causes of action would be beneficial overall depends in part upon whether the states would have sufficiently strong private rights of action to provide the optimal level of deterrence of securities fraud. In its political analysis, this Article asserts that the federal government may be more prone to bias in favor of issuers and other defendants than to bias in favor of plaintiffs. *See infra* Part V.B.2. Preserving both federal and state causes of action may be the best way to reduce the impact of pro-defendant bias and provide optimal deterrence of fraud.

Second, this Article analyzes an important political question: whether the foregoing assumption that state and federal law strike an efficient balance between the interests of plaintiffs and defendants is true, or whether federal or state law is likely to embody an inefficient bias in favor of one interest or the other. To date, state law has not demonstrated significantly more bias in favor of plaintiffs than has federal law. The statistical evidence that plaintiffs fled to state courts following the 1995 Reform Act is at best ambiguous. Other statistical evidence, including studies prepared by National Economics Research Associates[31] and Price Waterhouse L.L.P.,[32] suggests that the 1996 increase in state court litigation was temporary and that the number of state court securities class actions filed in 1997 returned to pre-1995 levels.[33]

Developments in California, the site of the majority of securities fraud class action suits brought under state law,[34] also do not indicate a state-law bias in favor of plaintiffs. California voters rejected ballot initiatives proposed by both sides of the securities litigation debate,[35] and the California Supreme Court has yet to decide whether litigation on behalf of a nationwide class of plaintiffs can proceed under California law.[36] Developments in other states further demonstrate that state law governing class action securities litigation was moving in the same, decidedly pro-defendant direction that the 1995 Reform Act had taken federal law, even before preemption became an issue on Capitol Hill.[37] Finally, a

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31 *See* DENISE N. MARTIN ET AL., NAT'L ECON. RESEARCH ASSOC., FEDERAL SHAREHOLDER CLASS ACTION FILINGS RISE TO PRE-REFORM ACT LEVELS AS STATE FILINGS FALL 1-2, tbl.2 (1997) [hereinafter NERA 1997 STUDY] (reporting 23 state court securities class action filings in the first five months of 1995, 53 in the first five months of 1996, and 21 in the first five months of 1997).

32 *See* PRICE WATERHOUSE L.L.P., PRICE WATERHOUSE SECURITIES LITIGATION STUDY 1 (1998) [hereinafter PRICE WATERHOUSE STUDY] (reporting 67 securities class actions filed in state court in 1994, 52 in 1995, 66 in 1996, and 44 in 1997). The Price Waterhouse Study was discussed extensively in the February 1998 Senate hearing on Senate Bill 1260. *See* Appendix A (discussing the Price Waterhouse Study in detail).

33 In addition to state court filings returning to pre–1995 Reform Act levels, the number of federal filings in 1997 approached pre–1995 Reform Act levels. *See* NERA 1997 STUDY, *supra* note 31, at tbl.1 (reporting 69 federal court securities class action filings in the first five months of 1995, 47 in the first five months of 1996, and 78 in the first five months of 1997); PRICE WATERHOUSE STUDY, *supra* note 32, at 1 (reporting 219 securities class actions filed in federal court in 1994, 164 in 1995, 112 in 1996, and 171 in 1997).

34 *See infra* note 183 and accompanying text.

35 *See* Retirement Savings and Consumer Protection Act, Prop. 211, 1995-96 Reg. Sess., 1996 Cal. Legis. Serv. No. 10, at A-20 (West) (defeated in general election of November 5, 1996); Shareholder Litigation Reform Act, Prop. 201, 1995-96 Reg. Sess., 1996 Cal. Legis. Serv. No. 2, at A-22 (West) (defeated in general election of March 26, 1996); *infra* Part III.B.1.

36 *See, e.g.*, Diamond Multimedia, Inc. v. Superior Court, No. H016376 (Cal. Ct. App. Jan. 17, 1997), *review granted*, No. S058723 (Cal Mar. 27, 1997); *infra* Part III.B.2.

37 *See Oct. 21, 1997, House 1995 Reform Act Implementation Hearings*, *supra* note 14, at 25 & n.27 (prepared statement of Arthur Levitt, Chairman, SEC) (noting that states other

public choice theory analysis of trends in state law predicts that most states would continue to favor issuers that base operations or sell securities within their state, although pro-plaintiff interests could dominate a few smaller states.[38]

By contrast, there is some reason for concern that the federal system could embody too much bias in favor of defendants, particularly if efforts to limit plaintiffs' causes of action go further than they already have gone.[39] Much substantive federal securities law is based on a narrow judicial construction of implied rights of action, which Congress never expressly bestowed in the 1934 Act,[40] and much procedural federal securities law is rooted in the pro-defendant 1995 Reform Act.[41] Moreover, voting patterns in Congress indicate that legislators casting "swing votes" are pursuing a strategy of maximizing political support from both trial lawyers and businesses. They have voted against legislation that would hurt plaintiffs in consumer product litigation, while they have supported legislation that limits plaintiffs' right to sue for securities fraud.[42] Preserving state private rights of action becomes particularly important in light of this possibility that political factors could create an inefficient bias in the federal system by favoring defendants.

Part I of this Article begins with an analogous debate, which culminated in the late 1970s, over proposals to enact a federal corporate law in place of the existing "federalist" system in which states enact laws and businesses choose where to incorporate. Proponents of a federal corporate law observed a "race to the bottom" in which corporate managers, with the aid of lawyers, induce state legislatures to impose minimal fiduciary duties on managers in an effort to attract corporate charters.[43] Proponents of the federalist system responded that market forces steer capital toward businesses incorporated in states that efficiently balance shareholder and manager interests.[44] Part I briefly reviews the literature evaluating these arguments and discusses the insights that public choice theory provides into the reasons why Congress declined to federalize corporate law.

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than California have enacted provisions similar to those of the 1995 Reform Act and citing ARIZ. REV. STAT. §§ 44-2081-2087; 1997 MONT. LAWS 468; OHIO REV. CODE ANN. §§ 1707.432-438)).

38 *See infra* notes 389-92 and accompanying text.

39 *See* Stout, *supra* note 27, at 714-15; *infra* Part V.B.2.

40 *See infra* text accompanying notes 410-27.

41 *See infra* Part III.A.

42 *Compare infra* notes 177-78 and accompanying text (discussing Congress's successful override of President Clinton's veto of the 1995 Reform Act), *with infra* notes 447-48 and accompanying text (discussing Congress's failure to override President Clinton's veto of the Common Sense Product Liability Legal Reform Act of 1996, which would have imposed limits on punitive damages in product liability cases).

43 *See* discussion *infra* text accompanying notes 55-60.

44 *See* discussion *infra* text accompanying notes 61-66.

Part II explains how the law governing the purchase and sale of securities has developed along a very different evolutionary path than did corporate law. This Part discusses common law remedies for securities fraud, the origins of state blue sky laws, the introduction of federal regulation in 1933 and 1934, and the reasons Congress allowed dual federal and state regulation of securities sales and dual forum litigation of securities law claims. Part II then turns to an explanation of how changing conditions in more recent years led to dissatisfaction with the dual-regulation framework and to 1996 legislation preempting state "merit review" of most securities offerings.

Part III introduces the battle over class action securities litigation, in which two colossal interest groups have injected rhetoric and money into the political process. The plaintiffs' bar has urged an expansion of liability, and issuers, underwriters, and accountants have urged contraction of private rights of action. At stake is the mechanism by which plaintiffs' attorneys act as "private attorneys general" and represent defrauded investors in suits brought under: (1) the express remedies in Sections 11[45] and 12[46] of the 1933 Act; (2) the implied remedies in Sections 10(b)[47]

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45 Securities Act of 1933 § 11, 15 U.S.C. § 77(k) (1994 & Supp. II 1996).

46 Securities Act of 1933 § 12, 15 U.S.C. § 77(*l*) (Supp. II 1996).

47 Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78(j) (1994). Section 10(b) provides, in relevant part:

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

Id.

Promulgated under section 10(b) of the 1934 Act, SEC Rule 10b-5 states:

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

17 C.F.R. § 240.10b-5 (1998). An implied private right of action under section 10(b) and SEC Rule 10b-5 was first recognized in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513-14 (E.D. Pa. 1946), but was not explicitly acknowledged by the Supreme Court until 1970. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12-14 (1971); *see also* Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983) (declaring that the private right of action under Rule 10b-5 is "simply beyond peradventure"); SEC v. National Sec.,

and 14[48] of the 1934 Act; and (3) state common law and blue sky laws.[49] The 1995 Reform Act amended both the 1933 and 1934 Acts to curtail meritless federal suits, but it did nothing to preempt litigation under state law. State causes of action thus became the object of new battles over securities litigation reform, and Part III focuses on developments in California, the state that became the most important battleground.

Part IV turns to the debate over preemption. Part IV begins with an evaluation of the empirical data used to support claims that securities litigation migrated from federal courts to state courts when plaintiffs' attorneys sought to avoid the strictures of the 1995 Reform Act. Part IV next discusses the bills that became the Uniform Standards Act and the hearings on these bills before the House of Representatives and Senate in 1997 and 1998.

Part V contains much of this Article's economic and political analysis of the relationship between federal and state causes of action. Proponents of preemption essentially made a race-to-the-bottom argument all over again, but this time they described the mirror image of the scenario that proponents of federal corporate law had described in the 1970s. This time they asserted that special interests—in this case plaintiffs' lawyers—will induce state legislatures to create havens for frivolous suits that expose corporate managers to unmeritorious claims by disgruntled shareholders. Part V concludes that this argument is unpersuasive and that Congress should have postponed preemption of state causes of action until more information about developments at both the federal and state levels became available.

Part VI suggests steps that Congress could have taken to preempt state law more narrowly, thereby only affecting circumstances in which securities litigation is most likely to be abusive. For example, Congress could have provided that class actions can only be filed under state law against issuers that are incorporated or do substantial business in the state or that sell a substantial portion of their securities (e.g., 20%) within the state. If necessary, Congress also could have preempted state law that conflicts with the 1995 Reform Act's safe harbor for forward-looking statements, and it could have enacted measures to prevent plaintiffs from using state court discovery proceedings to circumvent the fed-

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Inc., 393 U.S. 453, 465 (1969) (stating that section 10(b) and Rule 10b-5 "may well be the most litigated provisions in the federal securities laws").

48 *See* Securities Exchange Act of 1934 § 14(a), 15 U.S.C. § 78n(a) (1994); SEC Rule 14a-9, 17 C.F.R. § 240.14a-9 (1998). *See generally* J. I. Case Co. v. Borak, 377 U.S. 426, 431-33 (1964) (approving of a shareholder's private right of action for false or misleading proxy statements under section 14(a) even though Congress did not create an express private right of action).

49 Section 410 of the Uniform Securities Act and the express private rights of action under the laws of various states are discussed *infra* note 369-72 and accompanying text. Express private rights of action under California law are discussed *infra* text accompanying notes 186-226.

eral discovery stay.[50] Part VI also addresses a critical question that the Supreme Court raised in *Matsushita Electric Industrial Co. v. Epstein*,[51] but that the Uniform Standards Act neglected: when is it appropriate for representative parties to settle federal securities claims on behalf of a class as part of a global settlement of corporate law claims brought in a state court? The *Matsushita* holding could undermine the ability of federal courts to scrutinize state court settlements for inadequate representation and possible collusion between plaintiffs' counsel and defendants. As Professor Coffee has suggested, a solution to this problem is overdue,[52] and the Uniform Standards Act should have addressed it.

This Article concludes that for two main reasons, Congress should have taken the initial advice offered by Chairman Levitt in 1997[53] and refrained from preempting state law in this area. First, many of the arguments in favor of preemption did not rest on proven statistical evidence or a complete evaluation of political developments likely to occur at the state level. Second, it is still unclear how federal courts will interpret the 1995 Reform Act. Instead of enacting sweeping legislation that closes the doors of state courts to almost all class action plaintiffs, Congress should have drafted a more narrow statute designed to address the problems that dual-forum class action litigation does create.

By making the federal remedy for securities fraud the only remedy available to so many plaintiffs, Congress has imposed on itself the burden of protecting investors in the future. If the federal regime—much of which is based on judicial interpretation of private rights of action that Congress never expressly bestowed[54]—becomes too hostile to defrauded investors, Congress either will have to rewrite the federal cause of action or will have to reevaluate the flawed logic behind federal preemption.

I
The Federalism Debate in Corporate Law

Justice Brandeis first described the competition among states for corporate charters as a "race to the bottom" toward laxity in enforce-

50 The Uniform Standards Act does contain a provision authorizing federal courts to enjoin discovery in state court suits that are not preempted. *See infra* text accompanying note 317.

51 516 U.S. 367 (1996).

52 *See* John C. Coffee, Jr., *Class Actions: Interjurisdictional Warfare*, N.Y.L.J., Sept. 25, 1997, at 5, 35 [hereinafter Coffee, *Class Actions*] (suggesting that state courts' power to approve settlements of federal claims should be curtailed); John C. Coffee, Jr., *State Securities Preemption: The Hidden Issues*, N.Y.L.J., May 28, 1998, at 2 [hereinafter Coffee, *Securities Preemption*] (suggesting that preemption of state securities class actions could be designed to "solve the '*Matsushita* problem'").

53 *See supra* note 19 and accompanying text.

54 *See supra* text accompanying notes 405-27.

ment of fiduciary duties.[55] Professor and former SEC Chairman William Cary, Professor Richard Jennings, and consumer activist Ralph Nader expressed this concern again in the 1970s.[56] Professor Cary posited that corporate managers choose where to incorporate and will select a jurisdiction with rules favorable to themselves and detrimental to shareholders.[57] The states, in turn, will compete among themselves to attract corporate charters and revenue from corporate franchise taxes by enacting corporation codes that please the corporate managers.[58] Professor Cary observed that Delaware was winning this race toward laxity, and he argued that Delaware's lawyers and judges helped shape law that allowed managers to extract value from shareholders.[59] To solve this problem, Cary suggested Congress enact federal "minimum corporation law provisions" that would "remove much of the incentive to organize in Delaware or its rival states."[60]

The "corporate federalists" rejected the race-to-the-bottom theory. They believed that Delaware had "'achieved its prominent position because its permissive corporation law maximizes, rather than minimizes, shareholders' welfare.'"[61] Frank Easterbrook,[62] Ralph Winter,[63] Daniel Fischel,[64] and Roberta Romano,[65] among others, ar-

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55 *See* Louis K. Liggett Co. v. Lee, 288 U.S. 517, 559 (1933) (Brandeis, J., dissenting) ("The race [is] one not of diligence but of laxity.").

56 *See* RALPH NADER ET AL., TAMING THE GIANT CORPORATION 60 (1976) ("The entire function of state corporate law has been reduced to reflecting the preferences of the managers of the largest corporations."); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 666 (1974) (suggesting that lax regulation enables corporate managers to "operate with minimum interference"); Richard W. Jennings, *Federalization of Corporation Law: Part Way or All the Way*, 31 BUS. LAW. 991, 992-93 (1976) (suggesting Delaware's laws that are highly beneficial to corporations have prompted more corporations to incorporate in Delaware than in states with less favorable laws).

57 *See* Cary, *supra* note 56, at 664-70, 696.

58 *See id.* at 664-66.

59 *See id.* at 668-70 (describing the primacy of Delaware); *id.* at 690-92 (describing links between Delaware's legislature, judiciary, and bar).

60 *Id.* at 702.

61 *See* Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 476 (1987) (quoting Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 919-20 (1982)).

62 *See* EASTERBROOK & FISCHEL, *supra* note 29; Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540 (1984); *see also* Fred S. McChesney, *Positive Economics and All That*, 61 GEO. WASH. L. REV. 272 (1992) (reviewing EASTERBROOK & FISCHEL, *supra* note 29).

63 *See* Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

64 *See* EASTERBROOK & FISCHEL, *supra* note 29; Fischel, *supra* note 61.

65 *See* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 14 (1993) (characterizing the competition among states for corporate charters as a race for the top); Romano, *supra* note 29, at 227-32 (same); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 710-17 (1987) (reviewing the literature on state competition for corporate chartering).

gued that markets for capital, executive compensation, and corporate control, "limit managers' ability to pursue their own wishes at the expense of their shareholders."[66]

The corporate federalists won in the political arena, and the initiative to enact a federal corporate law failed.[67] Congress never enacted, nor even seriously considered enacting, a federal corporate law. Congress's regulation of tender offers under the Williams Act[68] represents the closest that it has come to encroaching on substantive corporate law, and to this day the Act continues to have an uneasy coexistence with the state corporation laws that govern voting rights of shareholders, fiduciary responsibilities of corporate managers, and other internal corporate affairs.[69] In 1984 the SEC proposed a bill that would have expanded the reach of the Williams Act by federalizing much of the substantive law governing poison pills, golden parachutes, and other antitakeover devices used to entrench corporate management.[70] Although the SEC insisted that the bill would not make an unwarranted intrusion into state law,[71] the Reagan Administration disagreed,[72] and the bill never reached a vote. Congress con-

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66 Macey & Miller, *supra* note 61, at 477; *see also* CHARLES R. O'KELLEY, JR. & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 155 (1992) ("[E]conomic theory suggests that shareholders would demand a premium to invest in corporations with laws that allowed management excessive room to act opportunistically."); Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179 (1985) (arguing that "state corporation laws . . . should differ and that firms will select their state of incorporation adaptively").

67 Nonetheless, the academic debate continues. *See, e.g.*, Bebchuk, *supra* note 29, at 1499-1507 (discussing reasons why federal corporate law should be expanded to limit state chartering competition).

68 Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (codified as amended in 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1994)). The Williams Act requires certain disclosures in connection with a tender offer and that shareholders be given adequate time to consider an offer. *See id.*

69 *See* CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 86-87, 94 (1987) (holding that Indiana's Control Shares Acquisition Act, which limited the voting rights of shareholders acquiring in excess of a stated percentage of an Indiana corporation's stock, was constitutional under the Commerce Clause and was not preempted by the Williams Act); Edgar v. Mite Corp., 457 U.S. 624, 626-27, 646 (1982) (holding that Illinois's Business Takeover Act, which imposed a 20-day "precommencement period" after announcement of a tender offer and required a tender offer for a corporation with a significant number of Illinois stockholders to undergo a "substantive fairness" hearing before the Secretary of State, imposed an unacceptable burden on interstate commerce and therefore violated the Commerce Clause).

70 *See* Tender Offer Reform Act of 1984, H.R. 5693, 98th Cong. (1984).

71 *See* Letter of SEC Chairman John S.R. Shad to Congressman Timothy E. Wirth, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,630, at 86,879 (May 21, 1984) (stating that House Bill 5693 would "enhance shareholder protection without unduly intruding into state corporate law").

72 *See* Katherine B. Raup, Note, *Has Ohio Avoided the Wake of* MITE*? An Analysis of the Constitutionality of the Ohio Control Share Acquisition Act*, 46 OHIO ST. L.J. 203, 222 n.204 (1985) (quoting Letter from Donald T. Regan to John D. Dingell, Chairman of the Committee on Energy and Commerce (Sept. 25, 1984) which stated that House Bill 5693 would

sidered similar legislation in 1987,[73] but it thus far has declined to enact any such proposal.

Why has corporate federalism prevailed? First, the corporate federalist argument has merit. Judicial rulings have limited the race to the bottom to the extent that it does occur. With regard to hostile tender offers, for example, the Delaware Supreme Court has balanced the interests of stockholders against the discretion of directors.[74] The Delaware Supreme Court's holding in *Smith v. Van Gorkum*[75]—that directors can be held liable for gross negligence event absent a conflict of interest[76]—also demonstrates its willinguess to hold managers accountable. The Delaware Supreme Court's decision in *Zapata Corp. v. Maldonado*[77] gives Delaware courts more latitude in scrutinizing board-appointed "special litigation committees" than courts in other important jurisdictions such as New York have.[78] Furthermore, though changes in Delaware law occasionally have been pro-management, they have been, for the most part, less pro-management than

"'intrude unnecessarily into State law, and constitute an unwarranted step toward imposition of a substantive federal corporation law'").

73 *See* Tender Offer Reform Act of 1987, H.R. 2172, 100th Cong. (1987). The Tender Offer Reform Act would have barred "greenmail" payments, mandated a one-share, one-vote rule for certain publicly traded securities, restricted "golden parachutes," and required shareholder approval of certain takeover defenses. *See generally* Robert A. Prentice, *The Role of States in Tender Offers: An Analysis of* CTS, 1988 COLUM. BUS. REV. L. 1, 83-86 (1988) (describing features of House Bill 2172 and predicting its effect on corporate law); Bruce Ingersoll, *Dingell, Markey Seek To Limit Raids Via Open Market*, WALL ST. J., Apr. 27, 1987, at 2 (describing features of House Bill 2172).

74 *See, e.g.*, Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 42-48 (Del. 1994) (holding that *Revlon*-auction duties were triggered when Paramount's directors agreed to a transaction which had the effect of shifting control from public stockholders to a controlling entity, Viacom); Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1142 (Del. 1989) (holding that directors satisfied *Unocal* test when Paramount's tender offer arguably threatened Time's corporate culture and a preexisting plan to form a business combination with Warner); Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 182, 185 (Del. 1986) (holding that once a corporation is up for sale, directors have a fiduciary duty not to obstruct sale to the highest bidder); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 958 (Del. 1985) (holding that before directors adopt measures to oppose a hostile tender offer they must undertake a reasonable investigation, reasonably perceive a threat to the corporation, and pursue a reasonable plan in relation to the threat posed).

75 488 A.2d 858 (Del. 1985).

76 *See Van Gorkum*, 488 A.2d at 873, 893. *But see* DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1996) (permitting provision in a corporation's certificate of incorporation exculpating directors from liability to the corporation in certain circumstances).

77 430 A.2d 779 (Del. 1981).

78 *Compare id.* at 789 (holding that a reviewing court should exercise its own business judgment in deciding whether to overrule a special litigation committee's recommendation that a derivative suit against a corporation be dismissed), *with* Auerbach v. Bennett, 393 N.E.2d 994, 1002-03 (N.Y. 1979) (holding that the reviewing court may only inquire into the independence and procedures of the committee).

similar changes made to the ABA's *Model Business Corporation Act*.[79] This trend suggests that pro-management bias in corporate law is attributable in part to a political dynamic other than competition among states to attract corporate charters.[80] The 1995 Reform Act and the federal courts' securities law decisions also demonstrate that the creation of rules favoring managers can have nothing to do with competition for corporate charters. In fact, passage of the 1995 Reform Act and the Uniform Standards Act suggests that shareholders might fare better if Congress continues to stay away from corporate law.[81]

Furthermore, both managers and shareholders find Delaware corporate law attractive because it is extensive and because Delaware courts have developed a thorough understanding of corporate governance. As Professor Klausner observed, valuable "network externali-

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79 MODEL BUS. CORP. ACT (1991). For example, section 102(b)(7) of Delaware's General Corporation Law permits a corporation to include in its certificate:

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders . . . for breach of fiduciary duty[, except] liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) [for unlawful payment of dividends, stock purchase, or stock redemption]; or (iv) for any transaction from which the director derived an improper personal benefit.

DEL. CODE ANN. tit. 8, § 102(b)(7).

This provision is a decidedly pro-management rule, as it allows corporations to exculpate their directors for negligence, but the exculpation rule in the ABA's *Model Business Corporation Act* goes even further. The ABA rule allows a corporation's articles of incorporation to include

> a provision eliminating or limiting the liability of a director to the corporation or its shareholders for money damages for any action taken, or any failure to take any action, as a director, except liability for (A) the amount of a financial benefit received by a director to which he is not entitled; (B) an *intentional infliction of harm* on the corporation or the shareholders; (C) a violation of section 8.33 [concerning dividends and share repurchases]; or (D) *an intentional violation of criminal law.*

MODEL BUS. CORP. ACT § 2.02(b)(4) (emphasis added).

Both the Delaware statute and the Model Act allow corporations to exculpate directors from liability, arguably at the expense of shareholders, but the ABA, which has no interest in tax revenues from corporate charters, clearly outran Delaware in this particular race to the bottom.

80 The American Law Institute's ("ALI") work in some instances has been shaped by participating lawyers who, consciously or unconsciously, incorporate the views of corporate clients in drafting and in voting on proposed drafts. On at least one occasion the ALI's President objected to this practice, stating that the ALI should not be a "forum for power plays by clients," and that "the precept of leaving one's client at the door must be honored if we are to preserve our integrity as an organization." 68 A.L.I. PROC. 10 (1991) (remarks of Roswell B. Perkins, President). "Any member who [does] not have the stomach for voting in a way that an important client would not like, simply should not vote." *Id.*

81 *See infra* Part III.A (describing the 1995 Reform Act). *But see* Bebchuk, *supra* note 29, at 1500-07 (discussing several reasons why federal corporate law would eliminate biases that afflict state laws and would not be worse than that of the states).

ties" have developed around Delaware law, including interpretive case law, common business practices, cost effective legal services, and the heightened marketability of securities that results from the depth and specifity of Delaware law.[82] These network externalities may assure the dominance of Delaware's rules, even in situations in which the rules are not inherently more efficient than an alternative, but untested, set of rules.[83]

Public choice theory suggests other reasons for federal deference to state regulation entirely apart from the corporate federalists' arguments centered around the merits of efficient rules and network externalities. Professor Jonathan Macey identified three conditions in which Congress will "franchise" the right to regulate in a particular area to the states:

> (1) when a particular state has developed a body of regulation that comprises a valuable capital asset and federal regulation would dissipate the value of that asset; (2) when the political-support-maximizing outcome varies markedly from area to area due to the existence of spatial monopolies, variegated local political optima, and variations in voter preferences across regions; and (3) [when] Congress can avoid potentially damaging political opposition from special-interest groups by putting the responsibility for a particularly controversial issue on state and local governments.[84]

Describing the first of these conditions, Professor Macey observed that Delaware corporate law represents a valuable capital asset, as it generates professional fees and tax revenues for the state.[85] Indeed, the Delaware bar has appropriated much of the value of Delaware cor-

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82 *See* Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 772-79 (1995) (discussing how, apart from the "efficient" contract terms identified by the contractarian paradigm, network externalities cause businesses to prefer to incorporate in Delaware). For a general discussion of network externalities, see Michael L. Katz & Carl Shapiro, *Technology Adoption in the Presence of Network Externalities*, 94 J. POL. ECON. 822 (1986); Michael L. Katz & Carl Shapiro, *Network Externalities, Competition, and Compatibility*, 75 AM. ECON. REV. 424 (1985). "Path dependence" is a term sometimes used to describe a similar phenomenon. *See* Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641 (1996). As Professor Roe explains, if a fur trader built a curved road to circumvent a wolves' den, or other dangers, and developments are later created alongside the road, the road is not likely to be straightened once the initial obstacles that induced the fur trader to choose a curved road disappear. *See id.* at 643-44. Roe goes on to note that "society, having invested in the path itself and in the resources alongside the path, is better off keeping the winding road on its current path than paying to build another[; however,] occasionally the path-dependent road becomes so costly that a society rips it up and builds a new one." *Id.*

83 *See* Klausner, *supra* note 82, at 815 ("The danger of [a locked-in] equilibrium is greatest if a [legal] term with high network benefits has a long history during which time its value may have declined relative to that of alternative terms.").

84 Jonathan R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public-Choice Explanation of Federalism*, 76 VA. L. REV. 265, 268-69 (1990).

85 *See id.* at 277-80.

porate law in the form of profits from the litigation that flourishes in Delaware courts.[86] Notwithstanding this appropriation by lawyers, the value inherent in Delaware's corporate law remains significant, and the federalization of corporate law would dissipate this value and thus would face formidable opposition.

Professor Macey's discussion of the second condition builds on previous observations of Professor Cary: local interest groups, spearheaded by the Delaware bar, have established what amounts to a "spatial monopoly" over Delaware corporate law.[87] Elsewhere, the political-support-maximizing solution to corporate law issues—whether related to fiduciary duties or procedures for handling derivative litigation—will vary from state to state, depending on the relative political strength of interest groups such as lawyers, investment bankers, corporate managers, or shareholders.

Finally, corporate law satisfies a third condition under which Congress would rather defer to the states: the "national political-support-maximizing course is not apparent."[88] Corporate managers often give important support to politicians, but legislation favoring managers over shareholders risks incurring the wrath of voters.[89] It is more convenient for Congress to delegate corporate law issues to the states, where at least one of these constituencies—the shareholders—has little direct impact on the political process. (Most shareholders of Delaware corporations do not live or vote in Delaware, though many of the lawyers who represent them in derivative suits do.)

However, putting aside Professor Macey's arguments, perhaps the most important "political" reason for Congress's avoidance of a federal role in corporate governance has been the resurgence of concern about states' rights and the concomitant antipathy to federal regnlation. The election of President Ronald Reagan made Professor Cary's proposal for some federalization of corporate law[90] a dead letter.[91] Even after President Clinton's election in 1992, political winds contin-

86 Macey & Miller, *supra* note 61, at 502-06 (discussing the interests of the Delaware bar with respect to Delaware corporation law). Some developments in Delaware corporate law can even be explained by a desire to create just enough ambiguity to foster litigation and increase the profits of Delaware lawyers. *See id.* at 505-06. Delaware law, however, can only go so far in shifting wealth from managers and shareholders to lawyers without undermining Delaware's ability to attract the corporate charters that give Delaware law so much significance in the first place. *See id.*

87 *See id.* at 506-09 (explaining why the Delaware bar interest group is the most likely to remain galvanized in their efforts and why other interest groups struggle to compete against the bar). *See also* Cary, *supra* note 56, at 690-92 (discussing the influence of the Delaware bar over Delaware corporate law).

88 Macey, *supra* note 84, at 286.

89 *See id.* at 284-85.

90 *See supra* text accompanying notes 58-60.

91 Even the ALI's proposed Federal Securities Code, which would have clarified the law in an already heavily regulated area failed to pass Congress in the 1980s. For a discus-

ued to favor federalism in areas as far reaching as welfare, health care, and environmental regulation.[92] Furthermore, to the extent that Congress has shown more sympathy for corporate managers than for investors,[93] shareholder advocates have little reason to promote a federal corporate law. Indeed, recent academic criticism has been aimed not at a race to the bottom among the states, but instead at a perceived race in Congress to accommodate corporate managers.[94] Lawyers participating in the work of the American Bar Association and American Law Institute—the same organizations that would advise Congress if it were to enact a federal corporations statute—also have been accused of racing to accommodate corporate clients.[95]

II
Federalism in Securities Law

A. Sales of Securities Under Common Law and State Blue Sky Laws

Private rights of action, at common law and in equity, for persons injured in securities transactions preceded state statutes regulating the sale of securities, and many of those remedies still exist. Contract remedies include breach of warranty[96] and rescission,[97] and the latter

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sion of the Code and its political fate, see 1 Louis Loss & Joel Seligman, Securities Regulation 278-85 (3d ed. 1989).

92 *See infra* notes 445-46 and accompanying text.

93 *See infra* notes 398-99 and accompanying text.

94 *See* sources cited *infra* note 179.

95 *See, e.g., supra* note 80. Professor Cary once observed that "[b]ecause the Model Act has been endorsed by leaders of the corporate bar and is itself an American Bar Association committee product, it too accelerated the trend toward permissiveness." Cary, *supra* note 56, at 665.

96 "Breach of warranty is the most limited of all nonstatutory remedies in the securities field." 9 Loss & Seligman, *supra* note 91, at 4124. As stated in the U.C.C.:

> A person who transfers a certificated security to a purchaser . . . warrants . . . that:
>
> (1) the certificate is genuine and has not been materially altered;
>
> (2) the transferor . . . does not know of any fact that might impair the validity of the security;
>
> (3) there is no adverse claim to the security;
>
> (4) the transfer does not violate any restrictions on transfer;
>
> . . . .
>
> (6) the transfer is otherwise effective and rightful.

U.C.C. § 8-108(a) (1995). Thus, a plaintiff can base a breach claim upon only a few warranties. Moreover, oral promises and representations made in connection with the security sale will usually be subject to the parol evidence rule. *See* 9 Loss & Seligman, *supra* note 91, at 4125.

97 "The elements of rescission, in a nutshell, are 'misrepresentation' of 'material' 'fact' on which the buyer justifiably 'relied.'" 9 Loss & Seligman, *supra* note 91, at 4126. The knowledge, or intent, of a seller is irrelevant, except that a plaintiff often does not have to show materiality when the underlying misrepresentation was fraudulent rather than negligent or unintentional. *See id.* at 4126 n.9. A causal connection between the seller's misrepresentation and damage to the buyer need not be shown, but suit for rescis-

can be stated in an affirmative action for restitution or as a defense to a suit on a contract.[98] The principal tort remedy is the cause of action for deceit.[99] Some states also recognize a cause of action for equitable fraud, which does not require proof of the defendant's scienter.[100]

Kansas passed the first blue sky law, a state statute regnlating the sale of securities, in 1911.[101] By 1933 every state but Nevada had enacted a statute regulating securities sales.[102] Most of these statutes preserved common law remedies,[103] and with the notable exception of New York's Martin Act,[104] a majority also contained civil liability provisions.[105] Many of these liability provisions have been expanded in more recent times.[106]

The modern class action suit also has its genesis in actions brought under the common law, the corporate law, and later the securities law of the states. As Professor Abram Chayes pointed out, "[i]n the United States in the 19th and early 20th centuries, class actions were used mostly as a vehicle for adjudicating relationships among unincorporated associations and rights of security-holders

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sion is inappropriate if the buyer is unable to restore the seller to the status quo by returning the securities. *See id.* at 4126-27.

98 *See id.* at 4123.

99 A suit in tort for deceit, like a suit for rescission of a contract, must establish both the materiality of the defendant's misrepresentation and the plaintiff's reliance thereon, but in tort a plaintiff must additionally establish the defendant's scienter (intent or knowledge of the misrepresentation) and causation (that the plaintiff suffered damages as a result of the misrepresentation). *See id.* at 4128. Also unlike a suit for rescission, a suit for deceit does not require privity of contract, although the defendant must have made his misrepresentation either to the plaintiff or with the intent of influencing the plaintiff. *See id.* at 4128.

100 At equity, a "defendant d[oes] not have to know or believe that his statement was false or to have proceeded in reckless disregard of the truth." Stephenson v. Capano Dev., Inc., 462 A.2d 1069, 1074 (Del. 1983).

101 *See* LOUIS LOSS & EDWARD M. COWETT, BLUE SKY LAW 5-7 (1958).

102 *See* 1 LOSS & SELIGMAN, *supra* note 91, at 194-99 & n.58. For a history of the emergence of these statutes, see VINCENT P. CAROSSO, INVESTMENT BANKING IN AMERICA 156-64 (Ralph W. Hidy ed., 1970); LOSS & COWETT, *supra* note 101, at 10-13.

103 *See* 9 LOSS & SELIGMAN, *supra* note 91, at 4121 & n.1 (citing UNIFORM SECURITIES ACT § 410(h) (1956) and 43 state and territorial statutes).

104 *See id.* at 4134-35.

105 *See* HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS AND PROCEEDINGS OF THE THIRTY-NINTH ANNUAL CONFERENCE 200 (1929) (reprinting the liability provision, section 16, of the *Uniform Sale of Securities Act* adopted in 1929 by the National Conference of Commissioners on Uniform State Laws); *see also* LOSS & COWETT, *supra* note 101, at 129-61 (outlining and discussing various provisions of the blue sky laws, including civil liability provisions). *See generally* LEONARD L. COWAN, MANUAL OF SECURITIES LAWS OF THE UNITED STATES (1923) (compiling all states' blue sky laws); JOHN M. ELLIOTT, THE ANNOTATED BLUE SKY LAWS OF THE UNITED STATES (1919) (reproducing several state securities statutes).

106 Most state statutes are now based on the *Uniform Securities Act*, which this Article discusses in comparison to federal civil liability provisions *infra* notes 369-72 and accompanying text.

against corporate managers or in corporate reorganizations."[107] For example, in 1924 New York permitted joinder of common law fraud claims that 193 investors had brought against promoters who sold stock by use of a misleading prospectus.[108] Today, many class actions filed in state court allege similar claims, either under common law fraud or more frequently, under statutes prohibiting false statements intended to induce the purchase of securities.[109] Plaintiffs also can bring class action suits under corporate law when they allege that directors or controlling shareholders breached their fiduciary duties, including the duty of disclosure, owed to minority shareholders.[110]

These state laws purported to protect investors from fraud, but the blue sky statutes resulted in part from pressure by banks, farmers, and small businessmen to limit competition for capital by restricting securities sales.[111] Arguably, these laws were also ineffective. For ex-

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107 Abram Chayes, *The Supreme Court, 1981 Term—Foreword: Public Law Litigation and the Burger Court*, 96 HARV. L. REV. 4, 26 n.130 (1982); *see also* Harry Kalven, Jr. & Maurice Rosenfield, *The Contemporary Function of the Class Suit*, 8 U. CHI. L. REV. 684, 687-88 (1941) (discussing the advantages of class action suits over joinders).

108 *See* Akely v. Kinnicutt, 144 N.E. 682 (N.Y. 1924) (finding that New York civil procedure statute permitted joinder because common questions of law and fact predominated among the plaintiffs).

109 *See, e.g.*, Diamond Multimedia, Inc. v. Superior Court, H016376 (Cal. Ct. App. Jan. 17, 1997), *review granted*, No. S058723 (Cal. 1997). The plaintiffs in *Diamond Multimedia* sued in part under Section 25400 of the California Corporations Code, which creates a cause of action for misrepresentations made in selling securities. *See id.* This case is discussed *infra* Part III.B.2.

110 *See, e.g.*, Zirn v. VLI Corp., 681 A.2d 1050, 1053 (Del. 1996) (discussing how plaintiff brought suit for breach of fiduciary duties, "on behalf of a class of similarly situated stockholders," against VLI Corporation and its directors claiming that disclosures disseminated hy VLI in connection with American Home Products Corporation's tender offer for VLI's outstanding shares "were materially misleading absent further, related disclosures," and that the misleading statements "impeded the stockholders' ability to make an informed decision as to the merits of the VLI-AHP transaction"); *In re* Tri-Star Pictures, Inc., 634 A.2d 319, 331-32 (Del. 1993) (discussing class action brought on behalf of former minority stockholders of Tri-Star against defendants, including Tri-Star's directors and controlling shareholder, Coca-Cola, that alleged breach of fiduciary duty, including the duty of disclosure, for conduct including dissemination of misleading proxy materials in order to gain approval of a business combination between Tri-Star and Coca-Cola Company). The *Tri-Star* court concluded: "[h]ad plaintiffs heen fully informed of all material facts relating to this transaction, the required number of votes may not have been obtained. . . . Thus, by its alleged breaches of the duty of disclosure, Coca-Cola materially and adversely affected the minority class' right to cast an informed vote." *Id.*

Earlier versions of the Uniform Standards Act would have preempted, in addition to state securities fraud causes of action, these types of actions brought under state corporate law. *See infra* text accompanying notes 262 and 314.

111 *See* Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 364-70 (1991) (analyzing anti-competitive rationale for enactment of state blue sky laws). Macey and Miller ohserved that

> while frequent complaints ahout 'fraudulent' securities sales persisted in the first decade of the twentieth century, it appears that many of the securities offerings objected to were not so much fraudulent as merely highly speculative. The rhetoric of the times did not distinguish between a secur-

ample, because state securities commissioners could not extend their authority across state lines, state securities laws could not control two major waves of securities frauds, which took place from 1917 to 1920 and in the late 1920s.[112]

B. The Federal Securities Laws

1. *The Legislation of 1933 and 1934*

Shortly after taking office in March of 1933 President Franklin Roosevelt sent a message to Congress proposing that the federal government regulate securities sales in light of state laws' inability to deter fraud.[113] Although the 1933 Act itself does not contain a general statement of legislative purpose, the legislative history of the Act clearly expresses dissatisfaction with the then-existing system in which the states alone regulated securities sales.[114] The 1934 Act, by contrast, specifically enumerates the reasons Congress chose to regulate securities transactions.[115] The 1934 Act includes among these reasons the fact that securities transactions are carried out across state boundaries, are an important part of interstate commerce, involve issuers engaged in interstate commerce, and affect the financing of activities in interstate commerce.[116] Although the 1934 Act does not state that blue sky laws inadequately address these concerns, the legislative his-

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ity sold through actual fraud and one so highly speculative as to be of questionable value.

Id. at 350.

112 *See* 1 Loss & Seligman, *supra* note 91, at 199.

113 *See* S. Rep. No. 73-47, at 6-7 (1933) (message of the President, Mar. 29, 1933); H.R. Rep. No. 73-85, at 1-2 (1933) (same). President Roosevelt's letter stated that "[i]n spite of many State statutes [,] the public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities." *Id.* at 1.

114 *See* 1 Loss & Seligman, *supra* note 91, at 148-52 (discussing the inadequacy of state regulation and citing *Federal Securities Act: Hearings on H.R. 4314, Before House Comm. on Interstate & Foreign Commerce*, 73d Cong. 87, 100 (1933)). Put simply, "the basic reason for the inadequacy of state legislation is the increasingly interstate nature of modern business." *Id.* at 149; *see also* Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. Corp. L. 1, 20-24 (1983) (discussing the securities fraud waves that precipitated federal intervention).

115 *See* Securities Exchange Act of 1934 § 2, 15 U.S.C. § 78b (1994) ("For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto . . . .").

116 *See* § 2(1), 15 U.S.C. § 78b(1). Congress also stated that national regulation was necessary for the following reasons: prices established and offered in securities transactions are quoted throughout the United States and form the basis for computing income tax liability and collateral for bank loans, *see* § 2(2), 15 U.S.C. § 78b(2), fluctuations in securities prices due to market manipulation affect the volume of credit available, *see* § 2(3), 15 U.S.C. § 78b(3), and economic downturns are "precipitated, intensified and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets." § 2(4), 15 U.S.C. § 78b(4).

tory indicates that, in fact, Congress was concerned about the effectiveness of state regulation. In particular, Congress worried about the possibility that listing requirements of exchanges would deteriorate in a race to the bottom if the exchanges were governed by only their own rules and state law.[117]

However, as enacted, both the 1933 Act and the 1934 Act explicitly allowed for concurrent securities regulation by the states. Section 18 of the 1933 Act provided that "[n]othing in this title shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person."[118] Furthermore, the 1933 Act bestowed concurrent jurisdiction on state and federal courts and even prohibited the removal of state cases to federal court.[119]

The 1934 Act also contained specific language protecting state blue sky laws from federal preemption.[120] Although section 27 of the 1934 Act departed from the concurrent jurisdiction approach of the 1933 Act and gave federal courts exclusive jurisdiction over 1934 Act claims,[121] section 28 specifically stated that "[t]he rights and remedies

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117 The following passage is indicative of the legislative sentiment in 1934:

> "Although the exchanges have endeavored to bring about an improvement in the type of financial reports filed by corporations, they have been hampered by the terms of the listing contracts made with issuers, which they have not considered themselves entitled to modify without the consent of such issuers. Progress in this direction has been further retarded by the unwillingness of issuers to furnish adequate information, supported by the threat of withdrawal of their listings, and by the potential competition of exchanges having more lenient standards. Such impediments could not exist so far as a Federal regulatory body is concerned."

Dennis S. Corgill, *Insider Trading, Price Signals, and Noisy Information*, 71 IND. L.J. 355, 363 n.26 (1996) (quoting S. REP. No. 73-792, at 5 (1934)); *see also* H.R. REP. No. 73-1383, at 11 (1934) (reporting that "responsible officials of the leading exchanges" recognized the importance of accurate corporate reporting but remained "handicapped by [a] lack of legal power" to effect change).

118 Securities Act of 1933, ch. 38, § 18, 48 Stat. 74, 85 (codified as amended in 15 U.S.C. § 77r (Supp. II 1996)). Congress amended section 18 of the 1933 Act when it enacted the National Securities Improvement Act of 1996. *See infra* notes 150-55 and accompanying text. The 1933 Act also stated: "The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity." Ch. 38, § 16, 48 Stat. 74, 84 (codified as amended in 15 U.S.C. § 77p (1994)).

119 *See* Securities Act of 1933 § 22, 15 U.S.C. § 77v (1996).

120 *See* Securities Exchange Act of 1934, ch. 404, § 28(a), 48 Stat. 881, 903 (codified as amended in 15 U.S.C. § 78bb(a) (Supp. II 1996)). Section 28(a) of the 1934 Act stated that, except as otherwise specifically provided, "[n]othing in this title shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this title or the rules and regulations thereunder."

121 *See* Securities Exchange Act of 1934, ch. 404, § 27, 48 Stat. 881, 902 (codified as amended in 15 U.S.C. § 78aa (1994)). This provision has been much criticized. *See, e.g.*, FEDERAL SECURITIES CODE § 1822 (1980) (providing for concurrent jurisdiction, but without the 1933 Act's nonremoval provisions); 9 LOSS & SELIGMAN, *supra* note 91, at 4186 n.7

provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity."[122] As the Supreme Court recognized in 1979, this provision sought "to protect, rather than to limit, state authority."[123] The only limitation on state actions in the 1934 Act was a bar to double recovery.[124]

Congress thus chose not to preempt state law with respect to either the registration of securities or private suits for securities fraud. However, as the ABA correctly discerned in 1986, over fifty years later, it is unclear whether either the 1933 or 1934 Congress "had any systematic understanding of what the relations of state and federal securities regulations should be, how regnlatory responsibilities should be allocated, or how federal disclosure regulation and state merit regulation should be accommodated to each other."[125]

2. *Why Not Preemption?*

Dean Seligman has suggested three reasons why state blue sky laws survived the enactment of federal legislation.[126] First, in 1933 and 1934 "political sentiment favored retention of a state role."[127]

(noting that concurrent jurisdiction is bestowed by "all the SEC statutes except the 1934 Act (which has given rise to most of the private actions)"); *see also* AMERICAN LAW INSTITUTE, STUDY OF THE DIVISION OF JURISDICTION BETWEEN STATE AND FEDERAL COURTS § 1311(b), at 183-84 (1969) (noting that there is no compelling reason for section 27's grant of exclusive jurisdiction); Matthew J. Press, Note, *Arbitration of Claims Under the Securities Exchange Act of 1934: Is Exclusive Jurisdiction Still Justified?*, 77 B.U. L. REV. 629, 630-31 (1997) (recommending repeal of exclusive jurisdiction).

122 Securities Excbange Act of 1934, ch. 404, § 28(a), 48 Stat. 881, 903 (codified as amended in 15 U.S.C. § 78bb(a) (1994)).

123 Leroy v. Great Western United Corp., 443 U.S. 173, 182 (1979).

124 *See* Securities Exchange Act of 1934, ch. 404, § 28(a), 48 Stat. 881, 903 (codified as amended in 15 U.S.C. § 78bb(a) (1994)) ("[N]o person permitted to maintain a suit for damages under the provisions of this title shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of."). According to the legislative history of the 1934 Act, section 28(a) "reserves rights and remedies existing outside of those provided in the act, but limits the total amount recoverable to the amount of actual damages." H.R. REP. NO. 73-1383, at 28 (1934).

125 Ad Hoc Subcommittee on Merit Regulation of the State Regulation of Securities Committee, *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785, 793 (1986) [hereinafter *ABA Report*].

126 *See* Joel Seligman, *The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation*, 93 MICH. L. REV. 649, 675-77 (1995).

127 *Id.* at 675. As Dean Seligman observes:

> Far from preempting a field when interstate commerce is involved, Congress in this case affirmatively yielded to local regulation by inserting a number of intrastate exemptions even when the mails or facilities of interstate commerce are used and more broadly adopted provisions generally "preserving the jurisdiction of the state securities commissions."

Id. (footuote omitted) (quoting I LOSS & SELIGMAN, *supra* note 91, at 272).

Dean Seligman states further that "[t]he states' enthusiasm for these laws can in part be traced to the fact that blue sky laws, like corporation statutes, are implicitly tax statutes" that raise revenues for the states through filing fees. *Id.*

Second, the state-law burden imposed on issuers has been reduced in the years after passage of the federal legislation because the "state statutes have generally been rewritten to reduce compliance burdens at the state level when a securities issuance is registered at the federal level."[128] Third, several states actively have maintained their securities laws and "have performed a significant enforcement role with respect to fraud in local securities offerings."[129] However, Dean Seligman notes that today "the most significant augmentative aspect of the state blue sky laws may well be [that they provide] broader private relief in many instances than do the federal securities laws."[130] In the two years since Dean Seligman made this observation, preemption proponents have made this "augmentative aspect" of state blue sky laws the target of their federal preemption initiative. These efforts culminated in the Uniform Standards Act.

Public choice theory also provides some insights into why Congress initially chose to retain a system of dual regulation. The relevant inquiry resembles Professor Macey's identification of the circumstances in which Congress will "franchise" an area of regulation to the states by avoiding federal involvement entirely, as Congress has done in corporate law.[131] First, a strong case can be made for the proposition that by the 1930s several states had developed in their blue sky laws a body of regulation that comprised a valuable capital asset.[132] Indeed, Congress appropriated part of this asset's value when it used state blue sky laws as a model for drafting the 1933 and 1934 Acts.[133] In particular, New York's Martin Act "was repeatedly called to Congress' attention as an example for federal legislation to follow."[134] One draft of the 1933 Act passed by the House directly sought to in-

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128 *Id.* at 675-76; *see also* UNIFORM SECURITIES ACT § 303 (amended 1985), 7B U.L.A. 559 (1985) (providing for registration by coordination with federal filings when securities are registered under the 1933 Act).

129 Seligman, *supra* note 126, at 677. Dean Seligman also points out that California has been responsible for a substantial number of the criminal convictions for securities fraud. *See id.* However, Dean Seligman clarifies that "results vary significantly from state to state. In many jurisdictions, parsimonious state budgets have meant understaffing of state securities law programs." *Id.*

130 *Id.* at 678.

131 *See* Macey, *supra* note 84, at 268-69.

132 *See id.* at 268 (discussing a states' development of "a body of regulation that comprises a valuable capital asset" as a condition in which Congress will "franchise" the right to regulate to the states).

133 *See* Aaron v. SEC, 446 U.S. 680, 711 (1980) (Blackmun, J., concurring in part, dissenting in part) (discussing how state blue sky alws were used in drafting the federal securities laws).

134 *Id.* at 711 (Blackmun, J., concurring in part, dissenting in part); *see also* Harry Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 243 (1933) (stating that the liability provision in section 12(1) of the 1933 Act "for the sale of unregistered securities or for the use of nonconforming prospectuses is merely that commonly imposed by state Blue Sky laws for similar violations").

corporate state regulations by prohibiting the sale of securities in any state if the sale violated that state's blue sky laws.[135] Because the ongoing development of state securities law would inform federal courts and the SEC in interpreting the new federal legislation, immediate preemption of state blue sky laws would have diminished the value of this important body of regulation.[136]

Second, differing "political-support-maximizing" outcomes in different regions[137] may explain the varying approaches to merit regulation—the process by which some states preclude the sale of "worthless" or "unmeritorious" securities within their borders—in the blue sky laws of different states. Early drafts of the 1933 Act included a "merit review" process,[138] but perhaps because legislators had difficulty determining a political-support-maximizing position on federal merit review, they abandoned this merit-based approach.[139] As Professor Lowenstein observed, Congress "may have decided to keep the

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135 *See* H.R. REP. No. 73-85, at 25 (1933); *Federal Securities Act: Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce*, 73rd Cong. 117 (1993) [hereinafter *House Federal Securities Act Hearings*] (statement of Oliver M. Butler, Foreign Service Div., Dept. of Commerce) (stating that the purpose of this provision was "to assure the States that [the 1933 Act] was not an attempt to supplant their laws, but an attempt to supplement their laws and to assist them in enforcing their laws in those cases where they have no control"). As Professor Karmel points out, the Senate later deleted this clause and replaced it with section 18 of the Act. *See* Roberta S. Karmel, *Blue-Sky Merit Regulation: Benefit to Investors or Burden on Commerce?*, 53 BROOK. L. REV. 105, 108-09 (1987).

136 For example, until 1991 most federal courts determined statutes of limitations for implied federal private rights of action for securities fraud by borrowing limitation periods from analogous state statutes. The Supreme Court, however, finally imposed a uniform statute of limitations borrowed from express rights of action elsewhere in the federal securities laws. *See* Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 362-64 (1991). For further discussion of *Lampf*, see *infra* text accompanying notes 416-18.

137 *See* Macey, *supra* note 84, at 268 (stating that a second condition in which Congress will "franchise" the right to regulate to the states is when the "political-support-maximizing outcome varies markedly from area to area due to the existence of spatial monopolies, variegated local political optima, and variations in voter preferences across regions").

138 *See* James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30-32 (1959). *See generally House Federal Securities Act Hearings*, *supra* note 135, at 21-23, 42-51, 133-45, 240-43 (debating the need for a form of federal merit review); JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 39-72 (1982) (reviewing the testimony on the 1933 Act and recounting events taking place while Congress was considering the legislation).

139 President Roosevelt was skeptical of the merit-based approach. *See* H.R. REP. No. 73-85, at 1-2 (1933) (message of the President, Mar. 29, 1933). President Roosevelt stated: "Of course, the Federal Goverument cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit." *Id.* at 2; *see also House Federal Securities Act Hearings*, *supra* note 135, at 52-55, 140-44 (discussing merit review). Then-professor William O. Douglas criticized the abandonment of merit review in the federal legislation. *See* William O. Douglas, *Protecting the Investor*, 23 YALE REV. 521, 524 (1934) (noting that most investors have neither "the time, money, nor intelligence to assimilate the mass of information in the registration statement").

1933 Act as a disclosure statute precisely because the state blue sky laws were already in place."[140]

Lastly, by establishing a disclosure-oriented regime that benefitted Wall Street professionals[141] and leaving the politically charged issue of merit review to the states, Congress could "avoid potentially damaging political opposition from special-interest groups by putting the responsibility for a particularly controversial issue on state and local governments."[142] More importantly, by enacting only a limited number of express private rights of action and leaving state private rights of action intact, Congress also could avoid some of the blame for having created civil liability.

All three of these conditions steering Congress away from preemption of state law were salient in 1933 and 1934. However, the first condition—that state blue sky laws provide a valuable capital asset—has become far less compelling with the development of a wide body of case law interpreting the federal securities laws. Moreover, the second condition—that state blue sky laws allow for varying political-support-maximizing outcomes—has become less important with the declining importance of merit review to the state regulation of securities sales.[143] Finally, the third condition—that Congress could escape damaging political opposition from special interest groups by allowing the states to take the lead in particularly controversial areas of securities regulation—is now outweighed by the vast benefits that federal

140 Louis Lowenstein, *Shareholder Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson*, 89 COLUM. L. REV. 979, 991 (1989).

141 Professor Roberta Romano observes that

> [t]he targets of the SEC's disclosure policy are primarily corporate issuers, and most corporations oppose the regulation. However, foes of the SEC, applying the insight of the capture theory, perceive the regulatory scheme to benefit security analysts, lawyers, and accountants, and neither investors nor firms. In this regard, the private institutions that bridge the information gap could be the principal beneficiaries and supporters of the disclosure laws.

Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923, 1003 (1984) (footuote omitted).

142 *See* Macey, *supra* note 84, at 268-69 (discussing this as a third condition in which Congress will "franchise" an area of regulation to the states). With responsibility for merit regulation, however, state and local governments of course get the opportunity to reap political support. *See* Fred S. McChesney, *Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 J. LEGAL STUD. 101, 101-03 (1987) (positing that political actors can extract "rents" from the private sector because they have the power to impose burdensome regulation unless they receive payments from regulated entities). Federal preemption legislation, such as the Uniform Standards Act, should have the opposite effect of steering political support toward federal actors. Today, this political support is manifested mostly clearly in campaign contributions. *See supra* note 16.

143 *See* Therese H. Maynard, *Commentary: The Future of California's Blue Sky Law*, 30 LOY. L.A. L. REV. 1573, 1589 (1997) (arguing that "piecemeal regulatory reform efforts over the last fifteen years by [California Department of Corporations] commissioners, both past and current, do implicitly recognize that merit review is of *declining* importance").

legislators who monopolize a field of regulation can reap in campaign contributions when they take sides in politically charged debates between special interest groups. The dual regulation framework that made political sense in 1933 and 1934 thus become increasingly outdated in later years.

3. *The Federalism Debate Revisited*

The debate over state blue sky laws,[144] particularly state merit regulation, resulted in few legislative changes prior to 1996. The Small Business Investment Incentive Act of 1980[145] recognized the burdens that the dual-registration regime imposed on small businesses, yet stopped short of preempting state registration requirements. The Act added section 19(c)(3)(C) to the 1933 Act,[146] which allows for "a uniform exemption from registration for small issuers which can be agreed upon among several States or between the States and the Federal Government" and provides that the SEC "shall have the authority to adopt such an exemption as agreed upon for Federal purposes."[147] However, the next sentence explicitly provides that "[n]othing in this [Act] shall be construed as authorizing preemption of State law."[148] In 1984 Congress preempted state regulation of mortgage-backed securities when it enacted the Secondary Mortgage Market Enhancement Act of 1984.[149] These Acts constituted Congress's only encroachments on the dual-registration regime prior to 1996.

However, in 1996 much of the dual-registration regime was dismantled by a Republican controlled Congress committed to reducing the regulatory burden on business. Pursuant to the National Securi-

144 Opponents of state merit regulation included Harold Bloomenthal, Rutheford Campbell, Jr., and Roberta Karmel. *See* Harold S. Bloomenthal, *Blue Sky Regulation and the Theory of Overkill*, 15 WAYNE L. REV. 1447 (1969); Rutheford B. Campbell, Jr., *An Open Attack on the Nonsense of Blue Sky Regulation*, 10 J. CORP. L. 553 (1985); Karmel, *supra* note 135, at 107 ("State merit regulation is a burden on interstate commerce and stands as an obstacle to the achievement of the SEC's statutory goals of facilitating capital formation and the establishment of a national market system.") Supporters of merit regulation included Conrad Goodkind, Hugh H. Makens, and Manning Warren. *See* Conrad G. Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements?*, 1976 WIS. L. REV. 79; Hugh H. Makens, *Who Speaks for the Investor? An Evaluation of the Assault on Merit Regulation*, 13 U. BALT. L. REV. 435 (1984); Manning G. Warren III, *Reflections on Dual Regulation of Securities: A Case Against Preemption*, 25 B.C. L. REV. 495 (1984).

145 Pub. L. No. 96-477, 94 Stat. 2275 (codified in scattered sections of 15 U.S.C.).

146 *See* Securities Act of 1933 § 19(c)(3)(C), 15 U.S.C. § 77s(c)(3)(C) (1994).

147 *Id.*

148 *Id.*

149 Secondary Mortgage Market Enbancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689 (codified as amended in scattered sections of 15 U.S.C.). For a further discussion of section 106, 15 U.S.C. § 77c-1 (1994 & Supp. II 1996), which is the preemption provision, see 1 LOSS & SELIGMAN, *supra* note 91, at 40 n.36.

ties Markets Improvement Act of 1996 ("1996 Act"),[150] state blue sky laws requiring registration or merit qualification no longer apply to "covered securities" or securities that will become "covered securities," upon completion of a transaction. The 1996 Act defines the term "covered securities" to include nationally traded securities,[151] securities of investment companies,[152] securities sold to certain qualified purchasers,[153] and securities sold pursuant to certain exempt offerings.[154] Although the 1996 Act places "covered securities" beyond the

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150 Pub. L. 104-290, 110 Stat. 3416 (codified in scattered sections of 15 U.S.C.). For a discussion of various provisions of the 1996 Act, see JAMES HAMILTON, SECURITIES REFORM: NATIONAL SECURITIES MARKETS IMPROVEMENT ACT OF 1996—LAW & EXPLANATION (1996); Rutheford B. Campbell, Jr., *Blue Sky Laws and the Recent Congressional Preemption Failure*, 22 J. CORP. L. 175 (1997).

151 *See* Securities Act of 1933 § 18(b)(1), 15 U.S.C. § 77r(b)(1) (Supp. II 1996). This section of the 1933 Act as amended by the 1996 Act provides:

> A security is a covered security if such security is—
>
> (A) listed, or authorized for listing, on the New York Stock Exchange or the American Stock Exchange, or listed on the National Market System of the Nasdaq Stock Market (or any successor to such entities);
>
> (B) listed, or authorized for listing, on a national securities exchange (or tier or segment thereof) that has listing standards that the Commission determines by rule (on its own initiative or on the basis of a petition) are substantially similar to the listing standards applicable to securities described in subparagraph (A); or
>
> (C) is a security of the same issuer that is equal in seniority or that is a senior security to a security described in subparagraph (A) or (B).

Id.

152 *See* § 18(b)(2), 15 U.S.C. § 77r(b)(2). This section provides:

> A security is a covered security if such security is a security issued by an investment company that is registered, or that has filed a registration statement, under the Investment Company Act of 1940.

Id.

153 *See* § 18(b)(3), 15 U.S.C. § 77r(b)(3). This section provides:

> A security is a covered security with respect to the offer or sale of the security to qualified purchasers, as defined by the Commission by rule. In prescribing such rule, the Commission may define the term "qualified purchaser" differently with respect to different categories of securities, consistent with the public interest and the protection of investors.

Id.

154 *See* § 18(b)(4), 15 U.S.C. § 77r(b)(4). This section provides:

> A security is a covered security with respect to a transaction that is exempt from registration under [the 1933 Act] pursuant to—
>
> (A) paragraph (1) or (3) of section 77d of this title, and the issuer of such security files reports with the Commission pursuant to section 78m or 78o(d) of this title;
>
> (B) section 77d(4) of this title;
>
> (C) section 77(c)(a) of this title, other than the offer or sale of a security that is exempt from such registration pursuant to paragraph (4) or (11) of such section, except that a municipal security that is exempt from such registration pursuant to paragraph (2) of such section is not a covered security with respect to the offer or sale of such security in the State in which the issuer of such security is located; or
>
> (D) Commission rules or regulations issued under section 78(d)(2) of this title, except that this subparagraph does not prohibit a State from imposing notice filing requirements that are substantially similar to those re-

reach of state blue sky laws, it specifically preserves states' rights to prosecute fraud and to collect filing fees,[155] and furthermore, it does nothing to impair private rights of action for fraud under state law.

Congress also has amended the 1934 Act on occasion to preempt state laws that interfere with the uniform regulation of securities trading. For example, in 1982 Congress amended section 28 of the 1934 Act to preempt state regulation of options contracts under state antigambling laws,[156] and in 1990 Congress added section 17A(f), which gives the SEC the authority to preempt state laws that impede uniform settlement procedures.[157] Despite these isolated changes, Congress's 1934 scheme for parallel federal and state regulation of the purchase and sale of securities generally remained intact prior to the Uniform Standards Act.

III
THE BATTLE OVER SECURITIES LITIGATION

The debate over state law registration requirements, like the debate over mandatory disclosure in general,[158] was part of a broader debate over the proper role of government regulators in the market-

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> quired by rule or regulation under section 4(2) that are in effect on September 1, 1996.

Id.

155 *See* National Securities Markets Improvement Act of 1996 § 102(a), 15 U.S.C. § 77r(c)(1)-(2) (Supp. II 1996) (amending Securities Act of 1933 §§ 18(c)(1), (2)).

156 Securities Exchange Act of 1934 § 28(a), 15 U.S.C. § 78bb(a) (Supp. II 1996). Section 28 states that state laws on wagering or gaming, or the operation of "bucket shops," shall not invalidate, or regulate activity connected with, any put, call, straddle, option, privilege, or other security that is traded pursuant to the rules of a self-regulatory organization registered with the SEC. *See id.* Bucket shop laws generally are not intended to regulate the trading of bona fide securities, but rather to prohibit contracts based on security prices when the parties do not actually intend to purchase or sell the underlying security, but instead plan to "gamble" on securities' prices by using market quotations. Congress believed that "options contracts approved for trading by the SEC pursuant to the rules of national securities exchanges . . . should not be prevented from trading by state laws which were historically desigued to prevent unregulated gambling activities." H.R. REP. No. 97-626, at 9 (1982), *reprinted in* 1982 U.S.C.C.A.N. 2780, 2787.

157 *See* Market Reform Act of 1990 § 5, 15 U.S.C. § 78q-1(f). This Act gave the SEC authority to preempt state investor-protection statutes governing clearance and settlement of securities transactions when the SEC finds that "in the absence of a uniform rule, the safe and efficient operation of the national system for clearance and settlement of securities transactions will be, or is, substantially impeded." Securities Exchange Act of 1934 § 17A(f)(2)(A)(ii), 15 U.S.C. § 78q-1(f)(2)(A)(ii).

158 *Compare* EASTERBROOK & FISCHEL, *supra* note 29, at 280-83 (arguing that disclosure rules do not need to be mandatory), *with* John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 737-51 (1984) (critiquing Easterbrook and Fishel's theory and arguing in favor of mandatory disclosure), *and* Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1048 (1995) (presenting an "alternative efficiency justification for mandatory disclosure").

place.[159] By contrast, the debate over federal and state securities litigation is part of a broader debate over the proper role of courts in adjudicating relationships between private parties in the marketplace, whether buyers and sellers of consumer products[160] or issuers and investors. In the securities arena, this debate often escalates into a "battle," as plaintiffs' lawyers accuse issuers, underwriters, and accountants of pervasive fraud, and they, in turn, charge plaintiffs' lawyers with greed and opportunism.[161] In support of their diametrically opposed viewpoints, these colossal interest groups direct their influence,[162] and with it large amounts of money,[163] at the legislative process.

A. The 1995 Securities Litigation Reform Act

Following the 1994 congressional elections, securities issuers, underwriters, and accounting firms clearly had gained the upper hand in Congress. Within a year Congress enacted the 1995 Reform Act,[164] which imposed fundamental changes on federal securities fraud litiga-

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159 *Compare* RALPH NADER ET AL., *supra* note 56 (arguing for more extensive regulation in the context of corporate chartering), *with* PHILIP K. HOWARD, THE DEATH OF COMMON SENSE (1994) (arguing for repeal of excessively detailed and burdensome regulation).

160 See, for example, *supra* note 9 for a discussion of Congress's passage, and President Clinton's veto, of the Common Sense Product Liability Legal Reform Act of 1996, H.R. 956, 104th Cong. (1996), which would have limited punitive damages in product liability cases.

161 For a discussion of the economic factors motivating the plaintiffs' attorney in securities class action, see John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669 (1986); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991).

162 One very influential plaintiffs' lawyer is William Lerach of Milberg, Weiss, "a securities lawyer who is widely viewed as the king of shareholder litigation." Dan Morain, *Meet the Attorney That Proposition 201 Backers Love To Hate; Election: Securities Lawyer Bill Lerach Says the Initiative Is One More Attempt by Corporate Bosses To Have Their Own Way*, L.A. TIMES (Orange County ed.), Mar. 24, 1996, at A42, *available in* LEXIS, News Library, U.S. News Combined File. "As the [1995 Reform Act] awaited the president's siguature, Lerach spoke to Clinton at a White House dinner. Four days later, Clinton vetoed it." *Id.*

163 Plaintiffs' lawyers have long made substantial political contributions. *See July 24, 1997, Senate Uniform Standards Act Hearing*, *supra* note 13 (transcript at 22) (prepared statement of Joseph Polizzotto, representative of the Securities Industry Association). By contrast, defense lawyers, for whom more litigation means more billable hours, usually remain neutral toward litigation reform, although the battle over Proposition 211 in California, *see infra* Part III.B.1, prompted their involvement. *See* Bill Ainsworth, *Firms Chip in $500,000 To Beat 211: Securities Measure Prods Defense Attorneys to Rare Display of Political Activism*, RECORDER, Oct. 4, 1996, at 1. Harvey Schloss, Vice President of Finance for Wilson Sonsini Goodrich & Rosati, a Palo Alto-based law firm, reported that the firm donated $150,000 to oppose Proposition 211 and that "individual attorneys will probably be making additional contributions." *Id.* Political contributions made by the Technology Network, a political action committee based in Palo Alto, California, amply demonstrate the influence of Wilson Sonsini's Silicon Valley clients. *See supra* note 16.

164 Pub. L. No. 104-67, 109 Stat. 737 (codified in 15 U.S.C. §§ 77k-l, 77z-1 to z-2, 78u-4 to u-5, 78j-1 (Supp. II 1996)).

tion. The more significant provisions include the following: a "safe harbor" provision, which precludes suits alleging that certain forward-looking statements are materially misleading;[165] a provision that erects heightened pleading standards by requiring plaintiffs to plead specific facts in support of fraud allegations;[166] a provision that stays discovery while courts decide motions to dismiss;[167] a provision that requires courts to presume that the "lead plaintiff" (i.e., the plaintiff controlling the class action) will be the issuer's largest shareholder, rather than the first shareholder to file suit;[168] a provision, useful for accountants and other collateral participants in securities transactions, under which defendants found not to have knowingly committed fraud are proportionately liable, rather than jointly and severally liable for plaintiffs' damages;[169] a provision that requires heightened judicial scrutiny of settlement terms to ensure that lawyers' fees are not excessive in proportion to damages awarded to a plaintiff class;[170] a provision that instructs courts to make a written determination of whether parties have complied with Rule 11 of the *Federal Rules of Civil Procedure* and to impose sanctions on parties and their counsel if they violate Rule 11;[171] and a "90-day bounce back" provision that reduces damages if the issuer's stock recovers in the period following disclosure.[172] In enacting these changes, Congress made clear its belief that

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165 *See* Private Securities Litigation Reform Act of 1995 § 102, 15 U.S.C. §§ 77z-2, 78u-5 (Supp. II 1996) (amending 1933 and 1934 Acts to include safe harbor provisions for forward-looking statements). There is some debate over whether the federal safe harbor has induced issuers to make forward-looking statements. The most recent study, conducted by business school professors at Stanford University and the University of Michigan, concludes that in 1996 the number of forward-looking statements by issuers in the high technology sector increased. *See* Marilyn Johnson et al., The Impact of Securities Litigation Reform on the Disclosure of Forward-Looking Information by High Technology Firms 23 (Jan. 2, 1998) (unpublished manuscript on file with author) (surveying issuers in the computer, software, and drug industries and finding, with respect to the first two industries, "that there was a significant post-[1995 Reform] Act increase in both the frequency of firms issuing forecasts and the mean number of forecasts issued").

166 *See* § 101(b), 15 U.S.C. § 78u-4(b) (amending 1934 Act section 21D).

167 *See* § 101, 15 U.S.C. §§ 77z-1(b), 78u-4(b)(3)(B) (amending 1933 Act section 27(b) and 1934 Act section 21D(b)).

168 *See* § 101, 15 U.S.C. §§ 77z-1(a)(3), 78u-4(a)(3) (amending 1933 Act section 27(a) and 1934 Act section 21D(a)).

169 *See* § 201, 15 U.S.C. §§ 77k(f), 78u-4(g) (amending 1933 Act section 11(f) and 1934 Act section 21D). Another provision of the 1995 Reform Act, which Congress inserted in return for this reduced liability exposure, requires auditors to disclose illegal acts by an issuer to the SEC. *See* § 301(a), 15 U.S.C. § 78j-1 (amending 1934 Act to include § 10A).

170 *See* § 101, 15 U.S.C. §§ 77z-1(a)(4)-(7), 78u-4(4)-(7) (amending 1933 Act section 27(a) and 1934 Act section 21D).

171 *See* § 101, 15 U.S.C. §§ 77z-1(c), 78u-4(c) (amending 1933 Act section 27(c) and 1934 Act section 21D).

172 *See* § 101(b), 15 U.S.C. § 78u-4(e) (amending 1934 Act section 21D). This provision is unlikely to reduce damages in more than a handful of cases. *See* Jonathan C. Dickey & Marcia Kramer Mayer, *Effect on Rule 10b-5 Damages of the 1995 Private Securities Litigation Reform Act: A Forward-Looking Assessment*, 51 BUS. LAW. 1203, 1214-19 (1996).

opportunistic trial lawyers were undermining the securities litigation system and were the primary target of the legislation.[173]

Many of the issues that the 1995 Reform Act addressed, such as appointment of lead plaintiffs in class actions and sanctions against counsel and parties for meritless claims, previously had fallen within the discretion of the courts.[174] Congress also explicitly encroached on an area previously delegated to the SEC when it created the statutory safe harbor for forward-looking statements by issuers.[175] The SEC nonetheless supported the final version of the bill,[176] albeit reluctantly, which Congress, despite President Clinton's veto,[177] enacted into law in a rare override.[178]

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173 *See* 1995 Reform Act Joint Explanatory Statement, *supra* note 11, at 31 ("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.").

174 *See, e.g.*, FED. R. CIV. P. 11(b) (authorizing, but not requiring, a federal court to impose sanctions on lawyers and parties who file pleadings without basis in law or fact); Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2062 & n.41 (1995) (describing how, before the 1995 Reform Act, courts usually appointed as lead counsel the first lawyer to file a class action complaint claiming open-market fraud).

175 *See* Rule 175, 17 C.F.R. § 230.175 (1998). The House-Senate Conference Report for the 1995 Reform Act specifically stated that the SEC's Rule 175 "has not provided companies meaningful protection from litigation." 1995 Reform Act Joint Explanatory Statement, *supra* note 11, at 49 n.29.

176 The SEC's support "appeared to be a change in direction for an agency that in the past had zealously defended the utility of private litigation as an aid to enforcement." Edward A. Fallone, *Section 10(b) and the Vagaries of Federal Common Law: The Merits of Codifying the Private Cause of Action Under a Structuralist Approach*, 1997 U. ILL. L. REV. 71, 79.

177 *See* Message to the House of Representatives Returning Without Approval the Private Securities Litigation Reform Act of 1995, PUB. PAPERS 1912 (Dec. 19, 1995) (William J. Clinton). In his veto message the President stated:

> I made clear my willingness to support the bill passed by the Senate with appropriate "safe harbor" langnage, even though it did not include certain provisions that I favor—such as enhanced provisions with respect to joint and several liability, aider and abettor liability, and statute of limitations.
>
> ....
>
> Specifically, I object to the following elements of this bill. First, I believe that the pleading requirements of the Conference Report with regard to a defendant's state of mind impose an unacceptable procedural hurdle to meritorious claims being heard in Federal courts. I am prepared to support the high pleading standard of the . . . Second Circuit . . . . [but] I am not prepared to [go beyond that].
>
> ....
>
> Second, remove the langnage in the Statement of Managers that waters down the nature of the cautionary langnage that must be included to make the safe harbor safe. Third, restore the Rule 11 language to that of the Senate bill.

Id.

178 On December 20, 1995, the House voted to override the veto by a vote of 319 to 100, *see* 141 CONG. REC. H15,223-24 (daily ed. Dec. 20, 1995), and two days later, on December 22, the Senate voted to override by a vote of 68 to 30, *see* 141 CONG. REC. S19,180 (daily ed. Dec. 22, 1995).

The 1995 Reform Act deters the filing of some frivolous suits in federal court, but it also makes litigation on behalf of defrauded investors more difficult.[179] The Act's full impact on securities litigation also remains uncertain, in part due to the lack of case law interpreting the legislative language.[180] For example, how federal courts will interpret the 1995 Reform Act's heightened pleading standards remains uncertain.[181] District courts also have disagreed over whether the 1995 Reform Act changed the scienter standard under section 10(b) of the 1934 Act by precluding suits for recklessness absent an intent to defraud.[182]

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179 *See* John C. Coffee, Jr., *The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung*, 51 Bus. Law. 975, 995 (1996) (observing that the 1995 Reform Act favors defendants "at virtually every juncture"). In 1997 the SEC prepared a Staff Report on the impact of the 1995 Reform Act on securities litigation. *See Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995* [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,931 (Apr. 30, 1997) [hereinafter *Staff Report*]. For further discussion of the Staff Report, see *infra* text accompanying notes 255-57. A series of *Arizona Law Review* articles extensively discussed the projected impact of the 1995 Reform Act on securities litigation. *See* Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 Ariz. L. Rev. 533 (1997); Symposium, *Securities Litigation: The Fundamental Issues*, 38 Ariz. L. Rev. 473 (1996); Richard H. Walker et al., *The New Securities Class Action: Federal Obstacles, State Detours*, 39 Ariz. L. Rev. 641 (1997); Elliott J. Weiss, *Comment: The Impact to Date of the Lead Plaintiff Provisions of the Private Securities Litigation Reform Act*, 39 Ariz. L. Rev. 561 (1997).

180 As SEC Chairman Arthur Levitt observed:

> there has been only limited experience with the Act's key provisions in the short time since its passage. In particular, the appellate courts have had virtually no opportunity to interpret the Act. No case has made its way to a jury, relatively few motions to dismiss have been decided, and there have been even fewer reported settlements.

Oct. 21, 1997, House 1995 Reform Act Implementation Hearing, *supra* note 14, at 19 (prepared statement of Arthur Levitt, Chairman, SEC).

181 Some district courts have held that plaintiffs may meet the scienter standard by pleading facts supporting a strong inference that the defendants had both a motive and an opportunity to commit fraud. *See In re* Wellcare Mgmt. Group, Inc. Sec. Litig., 964 F. Supp. 632, 638-39 (N.D.N.Y. 1997) (applying the "motive and opportunity" standard); Rehm v. Eagle Fin. Corp., 954 F. Supp. 1246, 1253-55 (N.D. Ill. 1997) (same); Zeid v. Kimberley, 930 F. Supp. 431, 438 (N.D. Cal. 1996) (same); Marksman Partners, L.P. v. Chantal Pharm. Corp., 927 F. Supp. 1297, 1310 (C.D. Cal. 1996) (holding "that the 'motive and opportnnity' test has not been discarded [by the 1995 Reform Act]"). Other courts have held that pleading motive and opportunity to commit fraud is insufficient, and that plaintiffs must plead specific facts showing either conscious misrepresentations or omissions, or deliberate recklessness. *See In re* Silicon Graphics, Inc. Sec. Litig., 970 F. Supp. 746, 757 (N.D. Cal. 1997) (holding that motive and opportunity "may provide some evidence of intentional wrongdoing, but are not alone sufficient to support scienter"); Norwood Venture Corp. v. Converse Inc., 959 F. Supp. 205, 208-09 (S.D.N.Y. 1997) (rejecting "the motive and opportunity" standard); Friedberg v. Discreet Logic Inc., 959 F. Supp. 42, 48-49 (D. Mass. 1997) (observing that Congress considered and rejected language that would have codified the "motive and opportunity" standard).

182 Some confusion exists as to whether the changes in the pleading standards preclude liability premised on recklessness alone. *Compare In re* Baesa Sec. Litig., 969 F. Supp. 238, 241 (S.D.N.Y. 1997) (including recklessness as a sufficient basis for liability), *with Silicon Graphies*, 970 F. Supp. at 757 (holding that knowing or intentional misconduct includes deliberate recklessness), *Discreet Logic*, 959 F. Supp. at 49 (suggesting that pleading

B. The Battle in California

The enactment of the 1995 Reform Act shifted the battle over securities litigation to the states, and both issuers and trial lawyers have devoted most of their attention to the developments in one state: California. California has been the site of an overwhelming majority (probably more than two-thirds) of class action suits for securities fraud that plaintiffs have brought under state blue sky laws.[183] High technology companies, many based in California's Silicon Valley, make up a substantial portion of the defendants named in these suits and in securities suits generally.[184] Although developments in other states are important, particularly to the extent that they allow "strike suits" by relatively small plaintiff classes,[185] California predictably became the crucial battleground over state securities fraud litigation after the 1995 Reform Act.

California law governing private suits for securities fraud is not remarkably different from federal law as it existed prior to the 1995 Reform Act. California's most significant departure from federal law occurred in *Mirkin v. Wasserman.*[186] In *Wasserman,* the California Supreme Court held that plaintiffs in a tort action for deceit could not use the "fraud-on-the-market doctrine,"[187] approved of by the United States Supreme Court in *Basic Inc. v. Levinson,*[188] as a substitute for showing each class member's actual reliance on a defendant's misrepresentations. However, the *Wasserman* court specifically recognized

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recklessness may not be sufficient), *and Norwood Venture,* 959 F. Supp. at 208-09 (same). As Judge Rakoff recognized in *Baesa,* the law in this area is murky indeed:

> While some of the language in these cases suggests that Congress rejected "recklessness" as sufficient to satisfy the scienter requirement, the cases may also be read as simply reinforcing the requirement that recklessness in this context include a conscious component. Other cases, addressing the same legislative history, have concluded that Congress in no way disavowed "recklessness."

Baesa, 969 F. Supp. at 241 n.1. As for the SEC, it filed an *amicus* brief in *Silicon Graphics* protesting the district court's departure from the recklessness standard. *See* Brief of the Securities and Exchange Commission, *Amicus Curiae,* Concerning Defendants' Motion to Dismiss the Amended Complaint at 13-14, 970 F. Supp. 746 (N.D. Cal. 1997) (C96-0930 FMS).

183 The Staff Report noted that the SEC's staff obtained and reviewed 55 complaints filed in securities class actions under state law since passage of the 1995 Reform Act. Of these cases, 43 (or 78%) had been filed in California. *See Oct. 21, 1997 House 1995 Reform Act Implementation Hearing, supra* note 14, at 23 (prepared statement of Arthur Levitt, Chairman, SEC).

184 *See supra* note 15.

185 *See infra* text accompanying notes 460-63.

186 858 P.2d 568 (Cal. 1993).

187 *Id.* at 584.

188 *See* 485 U.S. 224, 241-47 (1988).

that actions brought against the sellers of securities under California's Corporations Code do not require reliance.[189]

Since the passage of the 1995 Reform Act, the differences between California law and federal law have become more significant. Most of the key provisions of the 1995 Reform Act, including the statutory safe harbor for forward-looking statements, the heightened pleading standards, the lead plaintiff provision, and the limitation on damages under the "90-day bounce back" rule,[190] have no counterpart under California law. However, California law arguably applies only to securities transactions that take place in California,[191] which makes it very difficult for a plaintiff's attorney to assemble a nationwide class of plaintiffs in a California state court.[192]

Perhaps most importantly, California does not automatically impose a stay of discovery while motions to dismiss are pending. This difference might allow information obtained from discovery proceedings in a California action to be used in a parallel federal action. Despite this possibility, some California courts have imposed stays on discovery in circumstances where federal courts also would have imposed stays. For example, in *Milano v. Auhll*,[193] in which the plaintiff brought both state and federal claims, the court stayed discovery pending a motion to dismiss.[194] Similarly, in *Sperber v. Bixby*,[195] in

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189 *See Wasserman*, 858 P.2d at 580. The Court observed that the law does not require reliance in an action brought under California Corporations Code §§ 25,400 and 25,500 (the relevant text of these provisions appears *infra* notes 191 and 214). *See id.*; *see also* Christopher Boffey, Mirkin v. Wasserman: *The Supreme Court of California Rejects the Fraud-on-the-Market Theory in State Law Deceit Actions*, 49 BUS. LAW. 715, 735 (1994) (arguing that the California Supreme Court incorrectly applied California law in *Wasserman*).

190 *See supra* notes 165-72 and accompanying text.

191 *See* CAL. CORP. CODE § 25,400(d) (West 1977). Most securities fraud class actions filed in California are brought under this section, which provides the following:

> It is unlawful for any person, directly or indirectly, *in this state*
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> . . . .
>
> (d) If such person is a broker-dealer or other person selling or offering for sale or purchasing or offering to purchase the security, to make, for the purpose of inducing the purchase or sale of such security by others, any statement which was, at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or which omitted to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, and which he knew or had reasonable ground to believe was so false or misleading.

Id. (emphasis added) Arguably, the "in this state" language requires that the securities transaction, as well as the false or misleading statement, occur in California. *See infra* Part III.B.2.

192 *See infra* notes 224-25 and accompanying text.

193 No. SB 213476 (Cal. Super. Ct. Oct. 2, 1996).

194 *See Milano*, No. SB 213476, slip op. at 8 (rnling on motion to stay discovery pending decision on demurrers); GRUNDFEST & PERINO, *supra* note 14, at 40 (discussing *Milano v. Auhll*).

195 No. 699812 (Cal. Super. Ct. Oct. 25, 1996).

which the plaintiff brought only state claims, the defendants successfully argued that the court should look to federal law as persuasive authority for deciding whether to impose a stay.[196] In *Marinaro v. Superior Court*,[197] the California Supreme Court ordered an appellate court to reconsider a motion for a stay of discovery because the plaintiffs apparently sought discovery to gain an advantage in parallel actions in federal court.[198] Although these decisions do not bode well for plaintiffs seeking to use California courts to evade the discovery stay mandated by the 1995 Reform Act, other decisions have demonstrated a more liberal attitude.[199] Ultimately, the California Supreme Court will have to resolve this issue.[200]

1. *Propositions 201 and 211*

The battle of the California ballot initiatives began in March 1996 with Proposition 201.[201] This measure, sponsored by industry groups in and around Silicon Valley, would have instituted a "loser pays" system for securities litigation and required plaintiffs to post a bond for expenses.[202] California voters defeated the measure by a margin of 59.5% to 40.5%.[203] Several California state legislators responded by proposing bills that would enact various provisions of the 1995 Reform Act into California's blue sky laws.[204] Thus far, none of these proposed bills have become law.

The plaintiffs' bar responded in November 1996 with Proposition 211, which would have revised California's blue sky laws to accommodate a broad range of class actions that had theretofore been unsuccessful.[205] Proponents of Proposition 211 spent $15 million to

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196 *See Sperber*, No. 699812, slip op. at 2 (granting defendants' motion for a protective order staying all discovery); GRUNDFEST & PERINO, *supra* note 14, at 40 (discussing *Sperber v. Bixby*).

197 1996 Cal. LEXIS 6105 (Oct. 30, 1996).

198 *See Marinaro*, 1996 Cal. LEXIS 6105, at *1; GRUNDFEST & PERINO, *supra* note 14, at 40 (discussing *Marinaro*).

199 *See* Oak Tech. v. Superior Court, No. H016141, slip op. at 2 (Cal. Ct. App. Aug. 14, 1997) (denying stay of discovery in three separate class actions).

200 *See* StorMedia, Inc. v. Superior Court, H016376 (Cal. Ct. App. June 24, 1997), *review granted*, No. S062661 (Cal. Aug. 20, 1997).

201 Shareholder Litigation Reform Act, Prop. 201, 1995-96 Reg. Sess., 1996 Cal. Legis. Serv. No. 2, at A-22 (West) (defeated in general election of March 26, 1996).

202 *See id.* § 3(c)-(e).

203 *See* Dan Bernstein, *More Legal Reform Votes?: Defeats of Three Measures Likely to Slow Campaigns*, SACRAMENTO BEE, Mar. 28, 1996, at A16.

204 For example, California State Senate Bill No. 35, introduced by California State Senators John Vasconcellos (D) and Jim Brulte (R) on December 2, 1996, would have incorporated 1995 Reform Act provisions into California law. *See Legislative Briefs*, 28 Sec. Reg. & L. Rep. (BNA) 1523 (Dec. 13, 1996).

205 *See* Retirement Savings and Consumer Protection Act, Prop. 211, 1995-96 Reg. Sess., 1996 Cal. Legis. Serv. No. 10, at A-20 (West) (defeated in general election of November 5, 1996). In sum,

support the measure, and opponents spent over $35 million in their campaign to defeat it.[206] These huge sums of money made Proposition 211 the most expensive campaign over a ballot initiative in California history.[207] In the end, both the SEC[208] and President Clinton[209] opposed Proposition 211, and California voters rejected the measure by a three-to-one margin.[210]

2. Diamond Multimedia *and* StorMedia

In *Pass v. Hyung Hwe Huh*,[211] Joanne Pass filed a class action in California state court alleging that insiders at Diamond Multimedia Systems, Inc. purposely had inflated the price of Diamond Multimedia's stock and then profited by selling four million of their own shares before the stock price dropped sharply.[212] The plaintiffs sued under the California Corporations Code sections 25,400[213] and 25,500,[214] which impose liability for misrepresentations in securities sales, and under the antifraud provisions in California Civil Code sections 1709[215] and 1710.[216] The defendants demurred, claiming that

> [t]he measure would have, among other things, created an Exchange Act Section 10(b) type action at the state level expressly allowing: private rights of action, aiding and abetting, punitive damages, the fraud-on-the-market theory, no indemnification of officers and directors, joint and several liability for all defendants, and no caps on attorney's fees.

Walker et al., *supra* note 179, at 683.

206 *See* Walker et al., *supra* note 179, at 683.

207 *See id.*

208 *See July 24, 1997 Senate Uniform Standards Act Hearing*, *supra* note 13 (transcript at 9, on file with author) (statement of Arthur Levitt, Chairman, SEC) (criticizing the proposition as an effort to "undo the federal law.").

209 *See* Glenn Burkins, *Clinton Opposes Measure To Make It Easier for Shareholders To Sue*, WALL ST. J., Aug. 9, 1996, at B2.

210 *See Intel up on Bullish Outlook*, U.P.I., Nov. 7, 1996, *available in* LEXIS, News Library, Wires File.

211 No. CV758927 (Cal. Super. Ct. June 26, 1996). The facts of this case are discussed in *Oak Technology v. Superior Court*, No. H016186 (Cal. Ct. App. Aug. 14, 1997), which consolidates three cases including *Diamond Multimedia* on a discovery issue.

212 *See Oak Tech.*, No. H016186, slip op. at 4 (Cal. Ct. App. Aug. 14, 1997).

213 CAL. CORP. CODE § 25,400 (West 1977). For relevant portions of this statute, see *supra* note 191.

214 *Id.* § 25,500. This section of the statute provides that:

> Any person who willfully participates in any act or transaction in violation of Section 25400 shall be liable to any other person who purchases or sells any security at a price which was affected by such act or transaction for the damages sustained by the latter as a result of such act or transaction. Such damages shall be the difference between the price at which such other person purchased or sold securities and the market value which such securities would have had at the time of his purchase or sale in the absence of such act or transaction, plus interest at the legal rate.

Id.

215 This section provides that "[o]ne who willfully deceives another with intent to induce him to alter his position to his injury or risk, is liable for any damage which he thereby suffers." CAL. CIV. CODE § 1709 (West 1998).

216 This section provides that:

the plaintiffs had not alleged transactions occurring "in this state" of California, as required by sections 25,400 and 25,500.[217] The trial court overruled the defendants' demurrer,[218] and the defendants then appealed the case to the California Supreme Court in *Diamond Multimedia, Inc. v. Superior Court.*[219] The California Supreme Court has not yet decided this case.

Another important case also awaits a decision from the California Supreme Court. In *StorMedia v. Superior Court,*[220] plaintiffs in a class action similar to *Diamond Multimedia* alleged that corporate officers of StorMedia, a manufacturer of computer hard drive parts, sold their own shares in the company to unsuspecting investors based on false projections. The trial court overruled the defendants' demurrer on the grounds that the defendants could not be sued for securities transactions that had not taken place in California.[221] The California Supreme Court granted a petition for review in August 1997.[222]

These pending cases raise two critical issues: who can sue, and who can be sued, for securities fraud under the California Corporations Code.[223] A ruling against the plaintiffs may make it virtually impossible for plaintiffs to form a nationwide class in a securities suit brought under California law, even when the defendant is a California-based company.[224] This result would make class action litigation

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> A deceit, within the meaning of the last section, is either:
>
> 1. The suggestion, as a fact, of that which is not true, by one who does not believe it to be true;
>
> 2. The assertion, as a fact, of that which is not true, by one who has no reasonable ground for believing it to be true;
>
> 3. The suppression of a fact, by one who is bound to disclose it, or who gives information of other facts which are likely to mislead for want of communication of that fact; or
>
> 4. A promise, made without any intention of performing it.

Id. § 1710.

217 *See Hyung Hwe Huh,* No. CV758927 (order of Dec. 26, 1996). Section 25,500 incorporates section 25,400 by reference. *See* text of section 25,400 in *supra* note 191.

218 *See id.* (overruling defendants' demurrer to cause of action for violation of California Corporations Code §§ 25,400 and 25,500).

219 Diamond Multimedia, Inc. v. Superior Court, No. H016376 (Cal. Ct. App. Jan. 17, 1997), *review granted,* No. S058723 (Cal. Mar. 27, 1997).

220 Werczberger v. StorMedia, Inc., No. CV760825, slip op. at 1 (Cal. Super. Ct. Mar. 21, 1997).

221 *See id.* (order of Mar. 21, 1997).

222 *See* StorMedia, Inc. v. Superior Court, No. H016376 (Cal. Ct. App. June 24, 1997), *review granted,* S062661 (Cal. Aug. 20, 1997).

223 On September 5, 1997, Chief Justice Ronald George signed an order in *StorMedia* requesting the parties to "assist the court in deciding whether this case and/or *Diamond Multimedia* should be treated as the lead case for the issues presented." *StorMedia,* No. S062661 (order of Sept. 5, 1997). *See also* Bill Kisliuk, *Alright Now, Which Case Is More Precedential?*, RECORDER, Sept. 16, 1997, at 4 (discussing the two cases).

224 Even if the California Supreme Court does rule in favor of the plaintiffs in these cases, the Due Process Clause and the Full Faith and Credit Clause of the United States Constitution might impede formation of nationwide classes in state court, particularly

under state law far less profitable for lawyers[225] and steer most securities fraud class actions into federal court, irrespective of whether they are preempted by the Uniform Standards Act. Even without the Uniform Standards Act, wholesale migration of litigation from federal to state court would be far less probable if the California Supreme Court finds that nationwide classes of plaintiffs cannot be assembled in California courts.[226]

IV
The Preemption Debate

In October 1997 Senator Chris Dodd (D-Conn.) explained the rationale for preemption of state securities fraud causes of action:

> In general, I believe that the 1995 Reform Act . . . is working pretty well. In fact, . . . it's working so well on the Federal level that weaker claims have migrated from Federal courts to State courts. . . . —a development that threatens . . . the success that we have achieved to date in this general area.
>
> Moreover, without a national standard for liability, the potential threat is always there that one State will change its laws in such a way as to become the haven for litigation. This almost happened in California last year with Proposition 211. The potential remains it could successfully happen elsewhere in the future.[227]

Senator Dodd and other supporters of the Uniform Standards Act[228] thus premised their argument for preemption on two assertions. First, their argument relied on an empirical claim that weaker securities claims migrated to state court after the 1995 Reform Act. Second, their argument projected that one or more states will enact laws decidedly more favorable to plaintiffs than federal law. The first section of

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against out-of-state defendants. *See* Phillips Petroleum Co. v. Shutts, 472 U.S. 797, 821-22 (1985) (holding that a forum state "must have a 'significant contact or significant aggregation of contacts' to the claims asserted by each member of the plaintiff class, contacts 'creating state interests,' in order to ensure that the choice of [the forum state's] law is not arbitrary or unfair" (quoting Allstate Ins. Co. v. Hague, 449 U.S. 302, 312-13 (1981))). The fact that a defendant's principal place of business was in California would probably be sufficient to satisfy this standard, even if the defendant was incorporated elsewhere.

225 Attorneys' fees are tied to the dollar amount of recovery which is tied to the size of the plaintiff class. *See* Macey & Miller, *supra* note 161, at 22-27 (describing the increasing popularity of the percentage-of-recovery method of calculating attorneys' fees in common funds cases and comparing that method with the lodestar method based on attorney hours expended, hourly rate, and risk).

226 With the stakes so high, particularly before the Uniform Standards Act, it is not surprising that, in both *StorMedia* and *Diamond Multimedia,* the country's most prominent plaintiffs' law firm, Milberg, Weiss, Bershad, Hynes & Lerach LLP, represents the plaintiffs and Silicon Valley's largest and most prominent law firm, Wilson, Sonsini, Goodrich & Rosati, represents the defendants.

227 *Oct. 29, 1997, Senate Uniform Standards Act Hearing, supra* note 14, at 15 (opening statement of Sen. Christopher J. Dodd).

228 *See, e.g.*, Perino, *supra* note 14, at 321-22, 338.

this Part addresses the first of these assertions by examining the statistical data available through late 1997.[229] Section V.B.1 later will address the likelihood that, absent federal preemption, one or more states would have become the haven for litigation that Senator Dodd predicted, and if this prediction was correct, whether large or small states would have been the most likely candidates.

A. Migration of Litigation to State Court

Proponents of preemption have echoed Senator Dodd's assertion that, after the 1995 Reform Act, plaintiffs increasingly resorted to state court to avoid the 1995 Reform Act's requirements.[230] First, statistical data purportedly show that plaintiffs filed claims in state court that the 1995 Reform Act made difficult to litigate in federal court (the "substitution effect").[231] Second, proponents of preemption argue that other groups of plaintiffs filed suits simultaneously in state and federal court ("parallel claims") in order to evade the 1995 Reform Act's discovery stay.[232]

The statistical data, however, do not provide strong evidence of either a lasting substitution effect or a substantial increase in the number of parallel claims filed after 1995. The data compiled at Stanford Law School's Securities Class Action Clearinghouse, show that plaintiffs sued 110 companies in federal court in all of 1996, and eighty-three companies in the first six months of 1997 (an *increase* on an annual basis).[233] Another study (the "Grundfest-Perino study") reports that plaintiffs sued seventy companies in state court in all of 1996, and twenty-four companies in the first six months of 1997 (a *decrease* on an annual basis).[234] The Stanford database does not include pre-1996 state court filings. Nonetheless, the Grundfest-Perino study compared the 1996 and 1997 figures with the number of filings before 1996 and "speculated that these figures represented an *increase*

229 Although data for early 1998 were available at the time of this Article's publication, those data are not used because levels of state filings in 1998 were almost certainly influenced by the impending passage of the Uniform Standards Act.

230 *See July 24, 1997, Senate Uniform Standards Act Hearing, supra* note 13 (transcript at 44) (prepared statement of Joseph A. Grundfest and Michael A. Perino, Professors of Law); *Oct. 29, 1997, Senate Uniform Standards Act Hearing, supra* note 14, at 68-69, 77-79 (prepared statement of Michael A. Perino, Professor of Law); GRUNDFEST & PERINO, *supra* note 14, at ii, 7-9; Perino, *supra* note 14, at 302-14.

231 *See Oct. 29, 1997, Senate Uniform Standards Act Hearing, supra* note 14, at 69 (prepared statement of Michael A. Perino, Professor of Law); GRUNDFEST & PERINO, *supra* note 14, at ii, 7.

232 *See Oct. 29, 1997, Senate Uniform Standard Act Hearing, supra* note 14, at 69 (prepared statement of Michael A. Perino, Professor of Law).

233 *See* Perino, *supra* note 14, at 302 tbl.1.

234 *See id.* at 310 tbl.IV. The post-Reform Act data also "may not reflect all activity at the state court a level, due to the difficulty in compiling data on state class actions, but the extent of this problem remains unclear." *Id.* at 302.

in state court filings, based on anecdotal reports that securities class action litigation was rarely filed in state court prior to the [1995] Reform Act."[235] The speculative nature of this conclusion did not keep it from taking on a life of its own and eventually making its way into the Findings section of the Uniform Standards Act[236] as well as the House-Senate Conference Committee's Joint Explanatory Statement of the Committee of Conference ("Statement of Managers") for that legislation.[237]

National Economics Research Associates, Inc. ("NERA"), a New York-based economics consulting firm, conducted a separate study in November 1996.[238] This study showed that class action securities suits filed in federal court decreased between 1994 and 1996, with 185 suits filed in the first ten months of 1994, 127 in the first ten months of 1995, and only 104 in the first ten months of 1996.[239] However, the NERA study indicated that state court filings increased during this same time period, rising from fifty-two and forty-eight suits filed in the first ten months of 1994 and 1995 respectively, to seventy-eight suits filed in the first ten months of 1996.[240] In a July 1997 Report,[241] however, NERA concentrated on the first five months of each year and found that this trend had reversed itself, and by mid-1997 both federal and state filings had returned to pre-1995 Reform Act levels. While

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235 *Id.* at 303 (emphasis added); *see also* GRUNDFEST & PERINO, *supra* note 14, at 5-6 (discussing the difficulties in obtaining accurate pre-1995 Reform Act state court filing data).

236 Securities Litigation Uniform Standards Act of 1998, § 2(2), 112 Stat. 3227, 3227 (to be codified at 15 U.S.C. § 78a) ("The Congress finds that . . . (2) since enactment of [the 1995 Reform Act], considerable evidence has been presented to Congress that a number of securities class action lawsuits have shifted from Federal to State courts. . . ."). A close reading of this sentence, however, suggests an awareness on the part of Congress that the statistical evidence was tenuous. Congress only refers to "a number" of suits having shifted from federal to state court and fails to state whether this "number" was substantial or even significant.

237 *See* H.R. CONF. REP. No. 105-803, at 14, *reprinted in* 144 CONG. REC. H11,021 (daily ed. Oct. 15, 1998) (noting a shift of securities litigation from federal to state court and an increase in parallel filings, and observing that "[p]rior to the passage of the [1995] Reform Act, there was essentially no significant securities class action litigation brought in State court." (citing GRUNDFEST & PERINO, *supra* note 14)).

238 NERA 1996 STUDY, *supra* note 15.

239 *See id.* at 34 tbl.1. The filing data consisted of all cases compiled by *Securities Class Action Alert (SCAA)*, a monthly newsletter published by Investors Research Bureau, Inc. in Cresskill, New Jersey. NERA then supplemented the data with filings reported in Stanford's Securities Class Action Clearinghouse and, for October 1996, with filings reported in a database compiled by Bloomberg L.P. *See id.* at n.1.

240 *See id.* at 37 tbl.4. The filing data consisted of all cases compiled by *SCAA*, Stanford's Securities Class Action Clearinghouse, and for September and October of 1996, Bloomberg L.P. *See id.* at n.4. Professor Perino points out that the NERA study "likely overcounts the amount of state court activity" prior to the 1995 Reform Act, in part because it includes "actions alleging breaches of officers' and directors' duties of loyalty, care, or candor." *See* Perino, *supra* note 14, at 302 n.128.

241 NERA 1997 STUDY, *supra* note 31.

there had been sixty-nine federal court filings in the first five months of 1995 and only forty-seven in the first five months of 1996, the number of federal court filings increased to seventy-eight in the first five months of 1997.[242] The NERA study further revealed that while the number of state court filings increased from twenty-three in the first five months of 1995 to fifty-three in the first five months of 1996, it decreased to twenty-one for the first five months of 1997.[243] A 1998 Study by Price Waterhouse reached similar conclusions.[244] (The Price Waterhouse study is discussed in Appendix A.)

The upswing in class actions filed in state court in 1996 might suggest that some plaintiffs found state court more hospitable after passage of the 1995 Reform Act. However, this increase may also be attributable both to temporary disenchantment with the federal forum and to incentives to file in state court created by the Supreme Court's 1996 holding in *Matsushita Electrical Industrial Co. v. Epstein*[245] that parties can settle federal class action claims as part of state class actions.[246] Even if, as preemption proponents argue, the 1996 increase properly can be attributed to plaintiffs attempting to avoid the strictures of the 1995 Reform Act, NERA's 1997 statistics suggest two reasons why it would be a mistake to rely solely on 1996 statistics: first, plaintiffs' lawyers may have found state court litigation more cumbersome than they expected; and second, they may have found the 1995

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242 *See id.* at tbl.1. The NERA study reported that the number of federal filings for 1996 totalled 123, down from 163 for 1995, and an annual average from 1991 to 1995 of 179. *See id.* Most of the drop in 1996, however, was attributable to an acceleration of federal filings in December 1995, followed by a lull for the first three months of 1996. The difference between filings in the next six months of 1996, and filings in prior years, is statistically insignificant. *See id.*

243 *See id.* at tbl.2. The NERA study reported that the number of state court filings in 1996 totalled 110, more than double the annual average from 1991 to 1995 of 52. *See id.* However, the 19 state court filings for the first four months of 1997 "project to a total of 57 filings for this year, approximating the 1991 to 1995 average." *See id.* at 2.

244 *See* PRICE WATERHOUSE STUDY, *supra* note 32, at 1 (reporting 67 securities class actions filed in state court in 1994, 52 in 1995, 66 in 1996, and 44 in 1997 from data supplied by *SCAA*). Preemption opponents cited the Price Waterhouse Study along with the NERA 1997 Study in the February 23, 1998 Hearing. *See, e.g.*, *Hearing on S. 1260, The Securities Litigation Uniform Standards Act of 1997 Before the Subcomm. on Sec. of the Senate Comm. on Banking, Housing, and Urban Affairs*, 105th Cong. (forthcoming) (transcript at 9) (1998) [hereinafter *Feb. 23, 1998 Senate Uniform Standards Act Hearings*] (prepared statement of Richard W. Painter, Professor of Law); *id.* (transcript at 49-50) (colloquy between Sen. Phil Gramm and Prof. Painter).

245 516 U.S. 367 (1996).

246 *See Matsushita*, 516 U.S. at 369; Perino, *supra* note 14, at 310 (acknowledging that the *Matsushita* holding is one of the "reasons unrelated to attempts to avoid the provisions of the [1995] Reform Act" that may make a state forum "appear to be more desirable than a federal forum"). The *Matsushita* holding is discussed in detail *infra* text accompanying notes 485-503.

Reform Act to be less onerous than they expected.[247] Whether the 1997 trend toward lower levels of state court litigation would have continued absent preemption by the Uniform Standards Act would have depended, in part, on the federal courts' interpretation of the 1995 Reform Act.[248] Conflicting case law interpreting the 1995 Reform Act's new pleading standards[249] and inconclusive statistics on the success of post-1995 Reform Act motions to dismiss[250] suggest that it may be some time before plaintiffs have a clear understanding of the legal landscape awaiting them in federal court.

At the time that Congress passed the Uniform Standards Act, it also remained to be seen how hospitable state courts would have been to discovery requests made in order to circumvent the 1995 Reform Act.[251] Some state courts had imposed stays on discovery in circumstances when federal courts would do likewise, thus frustrating plaintiffs who filed parallel claims in order to use state discovery proceedings to their advantage.[252] Furthermore, as previously discussed, the California Supreme Court has not yet decided this issue. Nor has it decided an even more critical issue that will shape the future of class action litigation in California: the scope of the permissible plaintiff class in suits against California-based issuers.[253]

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247 *See* NERA 1997 STUDY, *supra* note 31, at 1 ("'These results are consistent with anecdotal evidence reported by plaintiffs' attorneys who recently have been more upbeat in their response to the Act, believing that they are bringing stronger cases resulting in larger recoveries.'" (quoting Dr. Frederick Dunbar, NERA Senior Vice President)).

248 There has thus far been little chance for appellate review of the 1995 Reform Act's provisions. *See supra* notes 180-82 and accompanying text.

249 *See supra* note 181.

250 *See* Joe Niedzielski, *State Class-Action Securities Suits Down*, NAT'L UNDERWRITER, Sept. 15, 1997, at 11, 80. This article pointed out that

> according to figures available from the Palo Alto, Calif.-based law firm of Wilson Sonsini Goodrich & Rosati, in 23 decisions since passage of the reform act, eight motions to dismiss were granted with prejudice and two were granted in part, while six motions were granted with leave to amend (meaning that plaintiffs were able to refile the case with more information), and the remaining seven denied the main defendants' motion.

Id.

251 This problem is partially solved by provisions of the Uniform Standards Act that give federal courts authority to stay discovery in state court proceedings in aid of their jurisdiction in federal cases, *see* H.R. 1689, 105th Cong. § 101(a)(2) (1998), *reprinted in* 144 CONG. REC. H6053 (daily ed. July 21, 1998) (amending section 27(b) of the 1933 Act and section 21D(b)(3) of the 1934 Act). Plaintiffs, however, can still file suit individually, or as part of a class consisting solely of state and local governments and pension funds, and obtain discovery in state court before a federal suit is filed.

252 *See supra* notes 193-200 and accompanying text.

253 *See supra* Part III.B.2 (discussing *Diamond Multimedia* and *StorMedia*). Even after the Uniform Standards Act, a decision for the plaintiffs in these cases would open the door to nationwide classes of state and local governments and pension funds in California courts.

B. State Court Litigation and the Federal Safe Harbor

Preemption proponents also argued that issuers would be unwilling to use the 1995 Reform Act's safe harbor for forward-looking statements so long as they remained exposed to suits under state laws lacking a similar safe harbor.[254] A 1997 SEC staff report mentioned anecdotal evidence that many companies were not taking advantage of the safe harbor and disclosing forward-looking statements,[255] but the report failed to explain why. Little empirical work has been done to ascertain whether these anecdotal reports are true, and in any event, no study has established an empirical link between the failure to use the federal safe harbor and litigation in state courts. Indeed, the failure to use the safe harbor more likely results from continuing uncertainty about how the federal courts eventually will interpret the 1995 Reform Act's safe harbor provision.[256] Because the exact scope of the safe harbor remains unclear, many corporate managers may prefer to "signal" information about their company's projected performance through indirect mechanisms, such as dividend increases, stock splits, and stock repurchases.[257]

Furthermore, some evidence exists that issuers have used the federal safe harbor in the 1995 Reform Act. A 1998 study of companies in the high technology industry, conducted by business school professors from Stanford University and the University of Michigan, found an "increase in both the frequency of firms issuing forecasts and the mean number of forecasts issued" following enactment of the 1995 Reform Act.[258] Wilson, Sonsini, Goodrich & Rosati ("Wilson Sonsini"), the law firm that advises many issuers in the Silicon Valley, apparently continued to advise its clients throughout 1997 to use the

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254 *See, e.g.*, 144 Cong. Rec. S4781-82 (daily ed. May 13, 1998) (comments of Sen. D'Amato in floor debate on S. 1260) ("In addition, these lawsuits have a chilling, a chilling effect on one of the most important provisions in the 1995 [Reform] Act and that is called the safe harbor provision. Until this loophole is closed, no company can safely risk issuing any forecast, even though the market desperately wants it.").

This exposure is reduced, but not eliminated, by the Uniform Standards Act, which preempts most class actions, but not individual suits. *See infra* Part IV.C.

255 *See Oct. 29, 1997 Senate Uniform Standards Act Hearing*, *supra* note 14, at 43 (prepared statement of Arthur Levitt, Chairman, SEC) ("The Staff Report indicated that it appears that companies are not using the safe harbor to make more forward-looking information.").

256 As late as mid-1997, Arthur Levitt observed that the safe harbor's "'meaningful cautionary language' requirement . . . ha[d] yet to be addressed at any stage of the litigation process." *July 24, 1997, Senate Uniform Standards Act Hearing*, *supra* note 13 (transcript at 14) (testimony of Arthur Levitt, Chairman, SEC).

257 *See* Robert M. Lawless et al., *The Influence of Legal Liability on Corporate Financial Signaling*, 23 J. Corp. Law 209, 218-24 (1998) (arguing that potential liability under securities laws causes managers to prefer signaling activity to direct disclosure of predictions about future economic performance).

258 Johnson et al., *supra* note 165, at 23.

federal safe harbor for forward-looking statements.[259] Although even more issuers possibly would use the federal safe harbor absent the threat of state court litigation, at least some issuers were using the safe harbor prior to the enactment of the Uniform Standards Act.

C. The Preemption Legislation

In 1997 Representatives Rick White (R-Wash.) and Anna Eshoo (D-Cal.)[260] introduced the Securities Litigation Uniform Standards Act of 1997 ("White-Eshoo bill") in the House of Representatives,[261] which amended section 16 of the 1933 Act to provide:

> No class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—
>
> (1) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or
>
> (2) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.[262]

The White-Eshoo bill made an almost identical amendment to section 28 of the 1934 Act.[263] For purposes of both amendments, the bill defined a "class action" very broadly:

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259 *See* Boris Feldman, *Financial Fraud in the Era of Securities Reform* (visited Feb. 12, 1998) <http://www.wsgr.com/resource/sec_lit/recent/finfraud.htm> ("The safe harbor will go far toward eliminating the classic fraud-by-hindsight suit filed when a company fails to satisfy quarterly earnings expectations."); Boris Feldman, *Navigating the Safe Harbor for Foward-Looking Statements* (visited Feb. 12, 1998), <http://www.wsgr.com/resource/sec_lit/recent/navigate.htm>. Feldman states that:

> [t]he safe harbor seeks to encourage public companies to disclose forward-looking information by protecting them from suit if that information does not come to pass. Corporate counsel and investor relations personnel will want to review their companies' disclosure practices to ensure thorough implementation of the safe harbor's requirements. The statute's protection is worth the effort.

Id.

All of the articles appearing on Wilson Sonsini's Web page were followed by a statement that they are "not legal advice." Despite this disclaimer, the firm obviously intended for the articles to be read by an audience comprised mainly of clients, potential clients, and lawyers advising the firm's clients.

260 *Money* magazine reports that Congresswoman Eshoo "with Silicon Valley in her district has received $78,296 from accounting, high-tech and securities firms." Ann Reilly Dowd, *Look Who's Cashing in on Congress*, MONEY, Dec. 1997, at 128, 136.

261 *See* 143 CONG. REC. E1007 (daily ed. May 21, 1997) (statement of Rep. Anna G. Eshoo) (introducing H.R. 1689, 105th Cong. (1997)).

262 H.R. 1689, 105th Cong. § 2(a)(1) (1997) (amending Securities Act of 1933 § 16(b)).

263 *See id.* § 2(b)(2) (amending Securities Exchange Act of 1934 § 28). This provision of the bill inserted into the 1934 Act a new subsection (f) entitled "Limitations on Remedies."

> [A]ny single lawsuit, or any group of lawsuits filed in or pending in the same court involving common questions of law or fact, in which—
>
> (A) damages are sought on behalf of more than 25 persons;
>
> (B) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated; or
>
> (C) one or more of the parties seeking to recover damages did not personally authorize the filing of the lawsuit.[264]

A security was a "covered security" for purposes of the White-Eshoo bill "if the issuer of the security had outstanding any security that satisfied the standard for a covered security specified in section 18(b)(1) of [the 1933 Act]."[265] Section 18 of the 1933 Act, which was amended by the 1996 Act to preempt state registration requirements for four categories of "covered securities,"[266] defines the first category of covered securities as securities listed for trading on a national exchange or on the NASDAQ system.[267] Although the White-Eshoo bill referred to only the first of the four categories of covered securities specified in the 1996 Act, a security was a "covered security" for purposes of the bill if the issuer had outstanding *any security* falling into this category. The White-Eshoo bill, furthermore, provided for the removal to federal court of "[a]ny class action brought in any State court involving a covered security."[268] Hearings on this bill were held in October 1997 and May 1998 before the House Commerce Committee's Subcommittee on Finance and Hazardous Materials ("House Subcommittee") (sometimes referred to as the "Cash and Trash Committee").[269]

Representatives Tom Campbell (R-Cal.), Scott Klug (R-Wis.) and Calvin Dooley (D-Cal.) introduced a bill that would have gone even further than the White-Eshoo bill and preempted state law for almost all suits involving nationally traded securities—not just class action suits.[270] Stanford Law School Professors Joseph Grundfest and Michael Perino assisted Representative Campbell in drafting this legis-

264 *Id.* § 2(a)(1) (amending Securities Act of 1933 § 16(d)(1)); *id.* § 2(b)(2) (amending Securities Exchange Act of 1934 § 28 to add subsection (f)(3)(A)).

265 *Id.* § 2(a)(1) (amending Securities Act of 1933 § 16(d)(2)); *id.* § 2(b)(2) (amending Securities Exchange Act of 1934 § 28 to add subsection (f)(3)(B)).

266 *See* Securities Act of 1933 § 18(b)(1)-(4), 15 U.S.C. § 77r(b)(1)(4) (Supp. II 1996); *supra* text accompanying notes 150-54.

267 *See* Securities Act of 1933 § 18(b)(1), 15 U.S.C. § 77r(b)(1); *supra* note 151 (setting forth the first category of "covered security" in § 18(b)(1) of the 1933 Act).

268 H.R. 1689, 105th Cong. § 2(a)(1) (1997) (amending Securities Act of 1933 § 16(c)); *id.* § 2(b)(2) (amending Securities Exchange Act of 1934 § 28 to add subsection (f)(2)).

269 *See Oct. 21, 1997, House 1995 Reform Act Implementation Hearing, supra* note 14; *May 19, 1998, House Uniform Standards Act Hearing, supra* note 2.

270 *See* H.R. 1653, 105th Cong. § 2(a)(1) (1997). This bill was called the Securities Litigation Improvement Act of 1997. *See id.* § 1.

lation.[271] However, the bill failed to make significant headway in the House.

In the Senate, Senators Phil Gramm (R-Tex.), Christopher Dodd (D-Conn.), Peter V. Domenici (R-N.M.), and eleven co-sponsors introduced their own version of the Securities Litigation Uniform Standards Act of 1997 ("Gramm-Dodd bill").[272] This bill mirrored the White-Eshoo bill except that it applied only to class action suits concerning nationally traded securities and securities of investment companies.[273] The fact that an issuer has other securities outstanding that fit the definition of "covered securities" was irrelevant under the Gramm-Dodd bill. The Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs ("Senate Subcommittee" or "Senate Banking Committee") held hearings on the Gramm-Dodd bill in July 1997, October 1997, and February 1998.[274]

A number of different interest groups lobbied for and against the White-Eshoo and Gramm-Dodd bills. In July 1997 the President of the National Venture Capital Association testified before the Senate Subcommittee in support of both bills.[275] The general counsel of the American Institute of Certified Public Accountants ("AICPA") also testified in support of the legislation.[276] Perhaps more importantly, the Technology Network, a new bipartisan political action committee based in Palo Alto, California,[277] strongly supported the proposed preemption legislation.[278] A variety of consumer groups opposed the

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271 *See Oct. 29, 1997, Senate Uniform Standards Act Hearing, supra* note 14, at 77 n.65 (prepared statement of Michael A. Perino).

272 *See* S. 1260, 105th Cong. (1997).

273 *See id.* § 2(a)(1) (amending Securities Act of 1933 § 16(d)(2) to read: "A security is a 'covered security' if it satisfies the standard for a covered security specified in paragraph (1) or (2) of section 18(b) of [the 1933 Act]"); *id.* § 2(b)(2) (amending, with identical language, Securities Exchange Act of 1934 to add subsection (f)(3)(B)). The first paragraph of 1933 Act section 18(b) defines a "covered security" as any security listed for trading on a national exchange or on the NASDAQ system. *See* Securities Act of 1933 § 18(b)(1), 15 U.S.C. 77(r)(b)(1) (Supp. II 1996). The second paragraph defines a "covered security" as any security of an investment company registered under the Investment Company Act of 1940. *See id.* § 18(b)(2), 15 U.S.C. 77(r)(b)(2).

274 *See July 24, 1997, Senate Uniform Standards Act Hearing, supra* note 13; *Oct. 19, 1997, Senate Uniform Standards Act Hearings, supra* note 14; *Feb. 23, 1998, Senate Uniform Standards Act Hearings, supra* note 244.

275 *See July 24, 1997, Senate Uniform Standards Act Hearing, supra* note 13 (transcript at 28) (prepared testimony of Brian Dovey, President of the National Venture Capital Association).

276 *See id.* (transcript at 25) (prepared Testimony of Richard I. Miller, General Counsel and Secretary of the American Institute of Certified Public Accountants) ("The most important step that Congress could take to fully implement its reforms would be to pass uniform standards legislation, ensuring that nationwide securities class actions replicating federal 10b-5 lawsuits are brought and tried in federal court.").

277 *See supra* note 16.

278 *See Technology Network Applauds U.S. Senate Introduction of The Securities Litigation Uniform Standards Act of 1997*, BUS. WIRE, Oct. 7, 1997, *available in*, LEXIS, News Library, Wires

preemption bills, including the Consumer Federation of America,[279] the American Association of Retired Persons,[280] and the Gray Panthers.[281] Organizations representing state and local governments also opposed the legislation,[282] and the Government Finance Officers Association, a group of New York state and local public finance officials, urged Senate Banking Committee Chair Alfonse D'Amato to oppose the bills.[283] One notable organization, the North American Securities Administrators Association ("NASAA"), did not take a position, stating that "[t]here is no consensus in the states because [the pending bills] would not affect their direct regulatory authority."[284]

File; David Braun, *Hill Support for Securities Litigation Law Snowballs*, CMP TECHWIRE, Oct. 27, 1997, *available in* 1997 WL 18041555.

279 *See* Letter from Citizen Action, Consumer Federation of America, Consumers Union, and Public Citizen's Congress Watch to Members of the U.S. House of Representatives (Jan. 31, 1997) (on file with author) (expressing concern that "Representatives Tom Campbell and Joseph Kennedy already have announced their intention to introduce bills that would deprive many defrauded investors of their right to challenge securities fraud in state court."); Letter from Citizen Action, Consumer Federation of America, Consumers Union, and Public Citizen's Congress Watch to William J. Clinton, President of the United States (Feb. 4, 1997) (on file with author) (same).

280 *See* Letter from American Association of Retired Persons, Citizen Action, Consumer Federation of America, Consumers Union, Public Citizen's Congress Watch, and U.S. Public Interest Research Group to Members of Congress (June 23, 1997) (on file with author) (asking members to refrain from signing as a co-sponsor House Bill 1689 or House Bill 1653).

281 The Gray Panthers opposed the 1995 Reform Act and, "[g]iven the fact that older people are disproportionately victims of securities fraud," implored President Clinton to oppose "H.R. 1689, H.R. 1653 and any similar Senate bill" that would preempt "proven state laws." Letter from Tim Fuller, Executive Director, Gray Panthers, to William J. Clinton, President of the United States (Sept. 11, 1997) [hereinafter Gray Panther letter] (on file with author).

282 *See, e.g.*, Letter from the National League of Cities, U.S. Conference of Mayors, National Association of Counties, National Association of County Treasurers and Finance Officers, Government Finance Officers Association, and Municipal Treasurers' Association to Thomas J. Bliley, Jr., Chairman of the House Committee on Commerce (Mar. 28, 1997) (on file with author) ("We urge you to oppose any efforts to interfere with the ability of states to protect their public investors through the preemption of private securities fraud actions under state law . . . .").

283 *See* Letter from the Government Finance Officers Association to Alfonse D'Amato, Chairman of the Senate Committee on Banking, Housing, and Urban Affairs 1-2 (Oct. 3, 1997) (on file with author). This letter read, in part:

> In many cases, state private rights of action now remain the only method of obtaining recovery for defrauded investors by permitting liability for aiding and abetting wrongdoing, joint and several liability, and reasonable statutes of limitations for the filing of claims. . . .
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> . . . .
>
> . . . We urge you to resist all efforts to interfere with the ability of states to protect their public investors and their citizens through the preemption of private rights of action under state law.

Id.

284 *See* Lynn Stevens Hume, *NASAA Declines To Take Position on Planned Securities Litigation Reform*, BOND BUYER, Aug. 1, 1997, at 5, *available in* LEXIS, News Library, US File.

SEC Chairman Arthur Levitt testified in 1997 before both Senate and House subcommittees, urging Congress to delay enacting preemption legislation until it could clearly evaluate the impact of the 1995 Reform Act, as interpreted in the federal courts:

> I do not oppose reform—only reform that is too sweeping and reform that is too hasty. Let us not replace the race to the courthouse with a race to the Capitol. It will take more time to gauge the effectiveness of the [1995] Reform Act. But on an important issue like this, the study is well worth the effort.[285]

Professor Joseph Grundfest responded by observing that "delay can only cause a proliferation of litigation" and will promote inconsistency rather than clarity in state law.[286] Professors Grundfest and Perino also listed specific ways in which plaintiffs could use state securities suits "to evade key provisions of federal law."[287] Congress could eliminate such strategic uses of state court litigation, they argued, by preempting state law causes of action for securities fraud.[288]

In the February 1998 hearing, the author of this Article testified before the Senate Subcommittee that preemption was unnecessary because no substantial and sustained increase in state court litigation had occurred, and in any event, California, the state where most state suits were filed, was not treating plaintiffs more favorably than the federal law.[289] Several other witnesses, however, told the Senate Subcommittee that litigation in state courts threatened to undermine the 1995 Reform Act. These witnesses included Michael Morris, the general

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285 *July 24, 1997, Senate Uniform Standards Act Hearing, supra* note 13 (transcript at 29) (prepared statement of Arthur Levitt, Chairman, SEC); *Oct. 21, 1997, House 1995 Reform Act Implementation Hearing, supra* note 14 (testimony of Arthur Levitt, Chairman, SEC).

286 *July 24, 1997, Senate Uniform Standards Act Hearing, supra* note 13 (transcript at 19) (testimony of Joseph Grundfest, Professor of Law).

287 *Id.* (transcript at 19) (testimony of Joseph A. Grundfest, Professor of Law); *Oct. 21, 1997, House 1995 Reform Act Implementation Hearing, supra* note 14, at 52 (prepared statement of Michael A. Perino, Professor of Law). Plaintiffs could take advantage of state court litigation to,

> (1) take discovery that would be prohibited by a federal stay;
> (2) avoid defenses available pursuant to the federal forward-looking safe harbor;
> (3) plead cases where the facts alleged would be insufficient to avoid dismissal in a federal court;
> (4) avoid the need for the designation of a lead plaintiff; [and]
> (5) avoid heightened scrutiny of settlement terms.

July 24, 1997, Senate Uniform Standards Act Hearing, supra note 13 (transcript at 52) (prepared statement of Joseph A. Grundfest and Michael A. Perino, Professors of Law); *Oct. 21, 1997, House 1995 Reform Act Implementation Hearing, supra* note 14, at 53 (prepared statement of Michael A. Perino, Professor of Law).

288 *See July 24, 1997 Senate Uniform Standards Act Hearing, supra* note 13 (transcript at 53) (prepared statement of Joseph A. Grundfest and Michael A. Perino, Professors of Law).

289 *Feb. 23, 1998, Senate Uniform Standards Act Hearing, supra* note 244 (transcript at 9-12) (prepared statement of Richard W. Painter, Professor of Law).

counsel of Sun Microsystems,[290] and Boris Feldman, a prominent securities litigator at Wilson Sonsini, the law firm that defends many class action securities suits.[291] Feldman told the Senate Subcommittee that "[s]ince the [1995] Reform Act was passed, securities class actions—particularly cases premised on failed forecasts—have been migrating to state courts. This appears to be a strategic response by the plaintiffs' bar to the [1995] Reform Act, and it threatens to undermine that Act."[292] Nonetheless, a short article by Feldman posted on Wilson Sonsini's internet site for the benefit of the firm's attorneys and clients, entitled *The Securities Class Action Battlefield Circa 1998*,[293] had painted a decidedly more optimistic picture:

> In my opinion, plaintiffs' state court gambit has been a failure and is over. . . . I base that conclusion on three factors. First, plaintiffs' attempts to broaden dramatically state laws that have been on the books for years have not worked. . . .
>
> Second, I believe that plaintiffs have come to realize that they will not be permitted to use courts in a particular state (i.e. California) to litigate the claims of shareholders around the country. . . .
>
> Finally, plaintiffs have not had much success milking the state cases for discovery that they can then use to file a federal complaint.[294]

The Senate Subcommittee did not explore the reasons for Feldman's two, very different views of the litigation landscape in California.[295] However, Senator Gramm, the Senate Subcommittee Chair, did distribute to the witnesses a letter sent the previous Friday by Price Waterhouse to Senator D'Amato that restated the statistics in the Price

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290 *See id.* (transcript at 13) (testimony of Michael Morris, Vice President and General Counsel, Sun Microsystems).

291 *See id.* (transcript at 4) (written testimony of Boris Feldman, partner, Wilson Sonsini).

292 *Id.* at 3. Feldman also stated that "this strategic maneuver is especially acute in California, where Silicon Valley's high-technology companies have borne the brunt of the state court actions." *Id.* He added that "[his] firm's experience over the last eighteen months confirms this strategic shift from federal to state court, albeit, with ebbs and flows, as the plaintiffs' bar has adjusted its tactics." *Id.* at 4.

293 Boris Feldman, *The Securities Class Battlefield Circa 1998* (visited Feb. 12, 1998) <http://www.wsgr.com/resources/sec_lit/recent/battle.htm>.

294 *Id.*; *see also Feb. 23, 1998, Senate Uniform Standards Act Hearings*, *supra* note 244 (transcript at 10) (prepared statement of Richard W. Painter, Professor of Law) (quoting the Feldman article). After the February 1998 Senate hearing, Feldman explained to Painter that this article had been posted on Wilson Sonsini's Web page several months before the hearing.

295 *See id.* (transcript at 49-50) (Gramm-Painter Senate colloquy). The exchange was as follows:

> Mr. Painter: . . . . And if Mr. Feldman wants to discuss what the difference is between his article on Wilson Sonsini's Web page and anything he said here . . . . Senator Gramm: Well, now, Mr. Feldman is not on trial here. (Laughter) And he seems like a pretty good attorney if he were on trial.

Id.

Waterhouse Study to show precisely what proponents of preemption wanted to show: an apparent increase in state court litigation in 1997.[296] (Appendix A discusses the Price Waterhouse Study.)

In March 1998, Chairman Levitt changed course and, along with SEC Commissioners Isaac C. Hunt, Jr. and Laura S. Unger, endorsed the preemption legislation in return for one principal condition: insertion in both the legislative history and the Senate floor debate of statements that Congress had not intended the 1995 Reform Act to preclude recklessness suits under federal law. Accordingly, on March 24, 1998, Senators D'Amato, Gramm, and Dodd wrote a letter to the SEC specifically stating that:

> [O]ur clear intent in 1995—and our understanding today—was that the [1995 Reform Act] did not in any way alter the scienter standard in federal securities fraud suits. . . . We intend to restate these facts about the [1995 Reform] Act in both the legislative history and the floor debate that will accompany S. 1260, should it be favorably reported by the Banking Committee.[297]

Chairman Levitt, and Commissioners Hunt and Unger, responded the same day with a letter stating that they would endorse the preemption legislation provided that the Senators followed through with these assurances.[298] Only Commissioner Norman Johnson dissented from his colleagues' decision. He stated that the preemption legislation was unnecessary.[299]

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296 *See* Letter from Daniel V. Dooley, Partner, Price Waterhouse LLP, to Senator Alphonse [sic] M. D'Amato (Feb. 20, 1998) [hereinafter Price Waterhouse Letter] (on file with author) (explaining that the Price Waterhouse Study did not measure "parallel filings" in both state and federal court, but other studies that did measure these filings noted that parallel filings in state courts increased in 1996, and then fell by a smaller amount in 1997). The letter reported six state parallel cases were filed in 1994, five in 1995, 46 in 1996, and 22 in 1997. *See id.*; *see also Feb. 23, 1998, Senate Uniform Standards Act Hearings*, *supra* note 244 (transcript at 41-43) (Gramm-Painter Senate colloquy) (discussing the importance of parallel filings relative to other state court filings and the credibility of Price Waterhouse's statistics in view of the obvious haste with which Dooley prepared his letter).

297 Letter from Sen. Alfonse M. D'Amato, Sen. Phil Gramm, and Sen. Christopher J. Dodd to Arthur Levitt, Chairman, SEG (Mar. 24, 1998).

298 *See* Letter from Arthur Levitt, Chairman, Isaac C. Hunt, Jr., Commissioner, and Laura S. Unger, Commissioner, to Sen. Alfonse M. D'Amato, Sen. Phil Gramm, and Sen. Christopher J. Dodd (Mar. 24, 1998), *reprinted in* 144 CONG. REC. S4780 (daily ed. May 13, 1998) (endorsing Senate Bill 1260 and specifically stating "we were gratified by the language in your letter of today agreeing to restate in S. 1260's legislative history, and in the expected debate on the Senate floor, that the [1995 Reform Act] did not, and was not intended to, alter the well-recognized and critically important scienter standard.").

299 *See* Letter from Norman S. Johnson, Commissioner, to Sen. Alfonse M. D'Amato, Sen. Phil Gramm, and Sen. Christopher J. Dodd (Mar. 24, 1998), *reprinted in* 144 CONG. REC. S4786 (daily ed. May 13, 1998) ("I share in the views of 27 of this country's most respected securities and corporate law scholars who have urged you and your colleagues not to support S. 1260 or any other legislation that would deny investors their right to sue for securities fraud under state law."). Commissioner Carey did not participate in the SEC's decision concerning endorsement of the preemption legislation.

The House of Representatives held its final hearing on the White-Eshoo bill on May 19, 1998. Chairman Levitt again testified before the House Subcommittee. This time he stated that the SEC supported preemption, but "only upon receiving assurances that legislative history would be inserted into the record making clear that the [1995] Reform Act was not meant to define or alter the state of mind requirements for securities fraud liability [under federal law]."[300] Professor Jack Coffee also testified that day, and he told the House Subcommittee of a glaring problem with both the White-Eshoo bill and the Gramm-Dodd bill: the bills could preempt class actions brought under state common law by bond holders on negotiated contractual covenants in their bond indentures.[301] Such covenants are often specifically designed to allow bondholders to sue for misrepresentations contained in offering materials without meeting 1934 Act section 10(b)'s scienter requirement and the other elements of the federal cause of action for fraud.[302] Fortunately, the House Subcommittee took Professor Coffee's suggestion and included in its final draft of the bill a provision exempting from preemption any class action "that seeks to enforce a contractual agreement between an issuer and an indenture trustee."[303] Without this change, the Uniform Standards Act could have obstructed the enforcement of contractual rights under state law.

President Clinton, who had vetoed the 1995 Reform Act at the urging of the plaintiffs' bar and consumer groups,[304] revealed as early

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300 *May 19, 1998 House Uniform Standards Act Hearings*, *supra* note 2, at 21 (prepared statement of Arthur Levitt, Chairman, SEC). Other "necessary changes" Chairman Levitt listed in his testimony included a carve-out to preserve state jurisdiction over corporate law claims in situations in which misleading statements are made to obtain shareholder approval of a transaction (the "Delaware carve-out"), changes in the definition of "class action" (including increasing the 25 person threshold to 50), and use of the definition of a "covered security" in Senate Bill 1260 rather than the broader definition in House Bill 1689. *See id.* at 20-24. These changes were incorporated into the final version of the Uniform Standards Act passed by both the House and Senate. *See infra* text accompanying notes 314-25.

301 *See id.* at 59-61 (statement of Jack Coffee, Professor of Law).

302 *See id.* at 65 ("The point I'm trying to make is, they probably can sue under 10(b)(5) if they can prove scienter, but the reason these documents were negotiated, for maybe weeks or months at a time is they wanted contractual protections that eliminated the need to have to prove fraud."). The author of this Article testified after Professor Coffee and reiterated the arguments made in two letters written by him and sigued by 27 and 23 securities law professors, respectively, that federal preemption was unnecessary and potentially harmful for investors. *See id.* at 73-82 (prepared statement of Richard W. Painter, Professor of Law). In addition, this author expressed support for an amendment proposed by Senator Sarbanes that exempted state and local governments and their pension funds from the bill's preemption provisions. *See id.* at 73, 78.

303 H.R. 1689, 105th Cong. § 101(a)(1), (b)(1)(B) (1998), *reprinted in* 144 CONG. REC. H6053 (daily ed. July 21, 1998) (amending Securities Act of 1933 section 16(d)(3) and adding subsection (f) to section 28 of the Securities Exchange Act of 1934).

304 *See supra* notes 162, 177 and accompanying text.

as July 1997 that he might support preemption legislation.[305] Specifically, the President stated:

> [T]he possibility of changes in one or more states' securities laws similar to those proposed in California's Proposition 211 suggests that there may be a need to reconsider the appropriate balance of federal and state roles in securities law. As I said when I opposed Proposition 211 last August, the proliferation of multiple and inconsistent standards could undermine national law.[306]

This statement no doubt pleased the political action committees of Silicon Valley,[307] but it also effectively dissipated the negotiating leverage that the President could have used to improve the Uniform Standards Act. By early 1998, the Clinton Administration restated its support for the legislation, provided the statements agreed upon with the SEC concerning suits for recklessness under federal law appeared in the legislative history and Senate floor debate.[308] "[I]t is particularly important to the President," the White House told the bill's sponsors, "that you be clear that the federal law to be applied includes recklessness as a basis for pleading and liability in securities fraud class actions."[309]

The prearranged colloquy between Senators Dodd and D'Amato on the recklessness issue went as planned.[310] Also as planned by the bill's sponsors, the Senate did not amend the text of the bill to address the issue of recklessness under federal law.[311] Given the

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305 *See President Clinton Supports High-Tech's Call To Curb State Securities Litigation Suits; President Opposes Multiple and Inconsistent Standards for Growth Companies*, Bus. Wire, July 24, 1997, *available in* LEXIS, News Library, Wires File.

306 *Id.* Vice President Al Gore's staff were assigned the task of evaluating the pending preemption legislation, and at least one member of the Vice President's staff, Lisa Brown, suggested limiting Senate Bill 1260 to leave state causes of action intact for face-to-face frauds. *See* Memorandum from Charles Rothfeld to Lisa Brown (Jan. 21, 1998) (on file with author) (evaluating this and other proposed changes to the bill).

307 Vice President Gore, in particular, is known to have significant support among Silicon Valley business interests. *See* Simon, *supra* note 16, at A23 (stating that TechNet, a Silicon Valley political group, is "so closely tied to Gore that Washington insiders call it a Gore connection").

308 *See* Letter from Bruce Lindsey, Assistant to the President and Deputy Counsel, and Gene Sperling, Assistant to the President for Economic Policy, to Chairman D'Amato, Chairman Gramm, and Sen. Dodd (Apr. 28, 1998), *reprinted in* 144 Cong. Rec. S4781 (daily ed. May 13, 1998).

309 *Id.*

310 *See* 144 Cong. Rec. S4798 (daily ed. May 13, 1998) (floor debate on S. 1260) The colloquy progressed as follows:

> Mr. D'Amato: . . . My clear intent in 1995, and my understanding today, is that the [1995 Reform Act] did not in any way alter the scienter standard in federal securities fraud lawsuits. . . .
>
> Mr. Dodd: I agree with the comments of my colleague from New York. I too, did not intend for the [1995 Reform Act] to alter the state of mind requirement in securities fraud lawsuits . . . .

311 No amendment was introduced in either house of Congress that would have amended 1934 Act section 10(b) to allow suits for recklessness. Proponents of the reckless-

Supreme Court's hostility toward using subsequent legislative history in interpreting section 10(b) of the 1934 Act,[312] this colloquy and the entire "quid pro quo" given by the supporters of preemption in return for the support of the SEC and the Administration may be meaningless.[313]

The final version of the legislation passed by both Houses incorporated several changes to the original versions of the White-Eshoo and Gramm-Dodd bills. These changes included the following: a carve-out provision that preserves state jurisdiction over corporate law claims in situations when plaintiffs allege that corporate managers made misleading statements in order to obtain shareholder approval of a transaction (the so-called "Delaware carve-out");[314] changes to the

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ness standard, including the SEC, no doubt knew that such an amendment would have failed and thus would have complicated the floor colloquy and legislative history on the issue. Likewise, opponents of the recklessness standard, including political allies of the Silicon Valley business interests defending the *Silicon Graphics* litigation, knew that they did not possess the votes to remove recklessness from the federal scienter standard. They also realized that the SEC and the Administration would withdraw support for preemption legislation if they tried, and that their best hope lay in the courts, which would probably ignore 1998 legislative history in interpreting statutes passed in 1934 and 1995. *See infra* note 312.

312 The Supreme Court is unlikely to be receptive to arguments based on subsequent legislative history in interpreting section 10(b) of the 1934 Act, which has not been amended since its original enactment. *See* United States v. O'Hagan, 117 S. Ct. 2199, 2214 n.11 (1997) (declining to address the government's argument that the legislative history in a 1988 amendment to other 1934 Act provisions properly approved of the misappropriation theory of insider trading under section 10(b)); *see also* Central Bank v. First Interstate Bank, 511 U.S. 164, 185 (1994) (noting that "Congress has not reenacted the langnage of § 10(b) since 1934" and therefore refusing to apply the reenactnient doctrine under which the Court adheres to consistent judicial construction of statutory language that is reenacted).

313 On the other hand, the argument that Congress intended the 1995 Reform Act to alter the scienter standard to preclude suits for recklessness under federal law is also a weak one. *See* Dunn, *supra* note 21, at 239-47.

314 *See* S. 1260, 105th Cong. § 101(a)(1) (1998), *reprinted in* 144 Cong. Rec. S4779 (daily ed. May 13, 1998) (amending section 16(d) of the 1933 Act). Senate Bill 1260 read:

> (d)(1) Preservation of Certain Actions.—
>
> (1) In General.—Notwithstanding subsection (b), a class action descrihed in paragraph (2) of this subsection that is based upon the statutory or common law of the State in which the issuer is incorporated (in the case of a corporation) or organized (in the case of any other entity) may be maintained in a State or Federal court by a private party.
>
> (2) Permissible Actions—A class action is descrihed in this paragraph if it involves—
>
> (A) the purchase or sale of securities by the issuer or an affiliate of the issuer exclusively from or to holders of equity securities of the issuer; or
>
> (B) any recommendation, position, or other communication with respect to the sale of securities of the issuer that—
>
> (i) is made by or on behalf of the issuer or an affiliate of the issuer to holders of equity securities of the issuer; and
>
> (ii) concerns decisions of those equity holders with respect to voting their securities, acting in response to a tender or exchange offer, or exercising dissenters' or appraisal rights.

definition of a "class action," including an increase in the threshold number of individual suits by named parties that could be treated in the aggregate as a class action from twenty-five to fifty (the definition of a "class action" still includes a suit on behalf of any number of unnamed parties);[315] and adoption of the Senate bill's definition of a "covered security" rather than the broader definition in House Bill 1689.[316] Congress also included in the final version of the Uniform Standards Act a provision, added as an amendment to House Bill 1689, that enables federal courts to stay discovery in any private action in state court while a federal action is pending.[317] Perhaps the most important, and controversial, change to the legislation was an exemption added to the Senate bill in a floor amendment proposed by Senator Sarbanes. This amendment exempted from preemption suits brought by states, their political subdivisions, and state pension plans, either individually or as class actions comprised solely of such entities.[318] The House included a similar provision in its bill, although the House added a requirement that class members affirmatively authorize participation in an exempted class action.[319]

Id. Except for section renumbering, this section of the Uniform Standards Act is virtually identical. *See* Appendix B.

315 *See* S. 1260, 105th Cong. § 101(a)(1) (1998), *reprinted in* 144 CONG. REC. S4779 (daily ed. May 13, 1998) (amending section 16(f)(2) of the 1933 Act).

316 *See id.*, *reprinted in* 144 CONG. REC. S4779 (daily ed. May 13, 1998) (amending section 16(f)(3) of the 1933 Act). The SEC had strongly urged all of these changes. *See May 19, 1998, House Uniform Standards Act Hearings*, *supra* note 2, at 20-24 (prepared statement of Arthur Levitt, Chairman, SEC).

The Uniform Standards Act, however, apparently will not reach securities sold in initial public offerings if those securities are not traded on a national exchange on the date that the alleged misrepresentation or omission occurred. Thus, the definition of a "covered security" may not include issuers accused of engaging in fraudulent misrepresentation in order to create a national trading market in their securities. The Act also excludes debt securities sold in private placement from the definition of covered security.

317 *See* H.R. 1689, 105th Cong. § 101(a)(2) (1998), *reprinted in* 144 CONG. REC. H6053 (daily ed. July 21, 1998) (amending section 27(b) of the 1933 Act and section 21D(b)(3) of the 1934 Act) ("CIRCUMVENTION OF STAY OF DISCOVERY—Upon a proper showing, a court may stay discovery proceedings in any private action in a State court as necessary in aid of its jurisdiction, or to protect or effectuate its judgments, in an action subject to a stay of discovery pursuant to this subsection.").

318 *See* 144 CONG. REC. S4811 (daily ed. May 13, 1998) (statement of Sen. Sarbanes) (seeking adoption of Amendment No. 2397 exempting suits brought by "a State or political subdivision thereof or a State pension plan on its own behalf . . . or as a member of a class comprised solely of [similar entities]"); *see also* Letter from Arthur Levitt, Chairman, and Isaac C. Hunt, Jr., Commissioner, and Laura S. Unger, Commissioner, to Rep. W.J. (Billy) Tauzin, Rep. Anna G. Eshoo, and Rep. Rick White (June 4, 1998), *reprinted in May 19, 1998, House Uniform Standards Act Hearings*, *supra* note 2, at 31-33 (expressing the SEC's general support for the amendment and noting that states, political subdivisions thereof, and their pension plans, may be more likely than other institutional investors to trigger the "grouping" provisions of the Uniform Standards Act under which individual suits filed by more than 50 investors can be treated as a single class action).

319 *See* H.R. 1689, 105th Cong. § 101(a)(1) (1998), *reprinted in* 144 CONG. REC. H6053 (daily ed. July 21, 1998) (amending section 16(d)(2)(B) of the 1933 Act) (exempting suits

The Senate approved its version of the bill on May 13, 1998, by a vote of seventy-nine to twenty-one.[320] The House then approved its version of the bill on July 22, 1998, by a vote of 340 to eighty-three.[321]

The House-Senate Conference Committee adopted the legislation as Senate Bill 1260 on October 9, 1998.[322] In keeping with the deal that the bill's sponsors had struck with the SEC and the Administration, the Statement of Managers stated that "[i]t is the clear understanding of the managers that Congress did not, in adopting the [1995] Reform Act, intend to alter the standards of liability under the Exchange Act."[323] On October 13, 1998, Senate Bill 1260 was passed

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brought by "a State or political subdivision thereof or a State pension plan on its own behalf . . . or as a member of a class comprised solely [of similar entities] . . . that have *authorized participation, in such action*" (emphasis added)). This provision, which was incorporated into the Uniform Standards Act, could narrow the scope of a class action considerably in situations in which class members have no knowledge of the action and plaintiffs' lawyers have no means of discovering who the class members are in order to seek their consent.

320 *See* 144 CONG. REC. S4815 (daily ed. May 13, 1998) (Senate Rollcall Vote No. 135).

321 *See* 144 CONG. REC. H6119-20 (daily ed. July 22, 1998) (House Rollcall Vote No. 318).

322 *See* H.R. CONF. REP. No. 105-803 (1998), *reprinted in* 144 CONG. REC. H11,020-21 (daily ed. Oct. 15, 1998).

323 *Id.* at 15, *reprinted in* 144 CONG. REC. 11,021 (daily ed. Oct. 15, 1998). In the Statement of Managers, a three paragraph discussion of the scienter issue follows this one sentence statement. These paragraphs were erroneously dropped from at least one printed version of the Statement of Managers, *see* Statement of Managers (Oct. 9, 1998) (on file with author), and when the Statement of Managers was first inserted into the *Congressional Record*. *See* 144 CONG. REC. H10,270 (daily ed. Oct. 9, 1998). On October 15, on the motion of Congressman Bliley (R-Va.), one of the bill's sponsors, the House inserted a complete version of the entire Statement of Managers into the *Congressional Record*. The three paragraphs dropped from the misprinted version read in part as follows:

> The managers understand, however, that certain Federal district courts have interpreted the [1995] Reform Act as having altered the scienter requirement. In that regard, the managers again emphasize that the clear intent in 1995 and our continuing intent in this legislation is that neither the Reform Act nor S. 1260 in any way alters the scienter standard in Federal securities fraud suits.
>
> Additionally, it was the intent of Congress, as was expressly stated during the legislative debate on the Reform Act, and particularly during the debate on overriding the President's veto, that the Reform Act establish a heightened uniform Federal Standard on pleading requirements based upon the pleading standard applied by the Second Circuit Court of Appeals. Indeed, the express language of the Reform Act itself carefully provides that plaintiffs must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." The [m]anagers emphasize that neither the Reform Act nor S. 1260 makes any attempt to define that state of mind.
>
> The managers note that in Ernst and Ernst v. Hochfelder, the Supreme Court left open the question of whether conduct that was not intentional was sufficient for liability under the Federal securities laws. The Supreme Court has never answered that question. . . .

144 CONG. REC. H11,021 (daily ed. Oct. 15, 1998) (footnote omitted).

Immediately following the Statement of Managers, however, the *Congressional Record* reproduces a well-footnoted speech by Mr. Bliley, stating that "[a]s Chairman of the Conby unanimous consent in the Senate and by a vote of 319-82 in the House.[324] President Clinton signed the bill into law on election day, November 3, 1998.[325]

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ference Committee that considered the [1995] Reform Act and as the bill's author, respectively, it is *our* view that non-intentional conduct can never be sufficient for liability under section 10(b) of the Exchange Act." *Id.* (emphasis added). What Mr. Bliley meant by his reference to "our view" is unclear as (1) he does not cite specifically the views of other members of Congress, and (2) his speech was not a part the Statement of Managers for the Uniform Standards Act. Clearly, he was expressing his own views (and perhaps those of Professor Grundfest and Ms. Susan French of Stanford University who Mr. Bliley thanks in a footnote for their guidance). *See id.* at H11,022 n.4. Despite the deal that the Uniform Standards Act sponsors had struck with the SEC and the Administration on the scienter issue, at least some individual members of Congress clearly intended that the legislative history be as confusing as possible on the question of whether Congress had believed that recklessness should give rise to a cause of action under Section 10(b) when it passed the 1995 Reform Act.

324 *See* 144 CONG. REC. S12,450, H10,800-01 (daily ed. Oct. 13, 1998).

325 *See* Statement by the President, U.S. Newswire, Nov. 3, 1998, *available in* 1998 WL 13607107. In his Statement, the President both stated his view of the legislative history of the 1995 Reform Act (a curious step in view of the fact that he had vetoed that legislation) and made it clear that he now signed the Uniform Standards Act "with the understanding" that the 1995 Reform Act had not precluded suits for recklessness under federal law:

> Although I supported the [1995] Reform Act's goals, I vetoed the Act because I was concerned that it would erect procedural barriers and keep wrongly injured persons from having their day in court. In particular, I objected to certain statements in the 1995 Conference Report's Statement of Managers that created ambiguity with respect to whether the bill was adopting the pleading standard in private securities fraud cases of the U.S. Court of Appeals for the Second Circuit—the highest pleading standard of any Federal circuit court and a standard that I support. When the bill returned to the House and Senate floors after my veto, the bill's supporters made clear that they did in fact intend to codify the Second Circuit standard. After this important assurance, the bill passed over my veto.
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> . . . .
>
> In signing the Uniform Standards Act, I do so with the understanding, as reflected in the Statement of Managers for this legislation and numerous judicial decisions under the Reform Act adopting the pleading standard of the Second Circuit, that investors with legitimate complaints meeting the Second Circuit pleading standard will have access to our Nation's courts. This point was critical to my veto of the Reform Act in 1995; it was reaffirmed before ultimate passage of the 1995 Act over my veto; and its assurance was a prerequisite to my signing this legislation today, as indicated in the April 28, 1998, letter from my staff to Chairman D'Amato, Senator Gramm, and Senator Dodd. Since the uniform standards provided by this legislation state that class actions generally can be brought only in Federal court, where they will be governed by Federal law, clarity on the Federal law to be applied is particularly important. The Statement of Managers confirms that the Second Circuit pleading standard will be the uniform standard for pleading securities fraud. Thus, the uniform national standards contained in this bill will permit investors to continue to recover losses fairly attributable to reckless misconduct. I am aware of and agree with the expert views on this issue of the Securities and Exchange Commission (SEC), which, along with my staff, worked hard in shaping this legislation.
>
> With these assurances in the Statement of Managers that reckless conduct will continue to be actionable and that complaints meeting the Second Circuit pleading standard will permit investors access to our Nation's courts, I believe that the uniform national standards created by this bill will

V
SHOULD CONGRESS HAVE PREEMPTED STATE CLASS ACTION SECURITIES LITIGATION?

A. The "Economic" Equation: Is a Dual-Forum Class Action Framework Cost Effective?

1. *Costs of a Dual-Forum Class Action Framework*

In their testimony before the Senate, Professors Grundfest and Perino identified the costs to both issuers and investors of litigating securities fraud suits in state and federal courts under different bodies of law.[326] In their view, "[n]eutral principles that apply whether or not one supports the provisions of the [1995] Reform Act"[327] led to the conclusion that:

> (1) National markets should, for reasons wholly unrelated to the debate over the merits of the [1995] Reform Act, be governed by uniform national standards;
>
> (2) Under the doctrine of implied conflict preemption, many provisions of the federal securities laws—including large portions of the [1995] Reform act—can and should be interpreted as preempting conflicting provisions of state law; and
>
> (3) In order to promote certainty and efficiency in federal and state courts, and in our national securities market, Congress should enact legislation that makes it clear that federal antifraud standards prevail in national markets.[328]

The first conclusion, that national markets should be governed by uniform national standards, resembled the arguments made in support of the 1996 Act's preemption of state registration requirements for certain "covered securities" sold in national markets.[329] This uniform standards argument was compelling in the registration context because issuers incurred substantial costs complying with both the SEC rules under the 1933 Act and the states' highly technical and often dissimilar registration, exemption, disclosure, and (in some states) merit review regulations. By contrast, issuers, underwriters, and their counsel can understand federal and state antifraud statutes far easier because conduct that constitutes fraud under federal law is likely to constitute fraud under state law, and vice versa. Most of the

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> generate meaningful information for investors and further reduce frivolous litigation without jeopardizing the critically important right of defrauded investors to obtain relief.

Id.

326 *See July 24, 1997, Senate Uniform Standards Act Hearing, supra* note 13 (transcript at 45) (prepared statement of Joseph A. Grundfest and Michael A. Perino, Professor of Law).

327 *Id.*

328 *July 24, 1997, Senate Uniform Standards Act Hearing, supra* note 13 (transcript at 53) (prepared testimony of Joseph A. Grundfest and Michael A. Perino, Professors of Law).

329 *See generally supra* notes 150-55 and accompanying text (discussing the 1996 Act).

differences between federal and state law concern remedies, burdens of proof, and procedure, and not substantive definitions of prohibited conduct. The most significant exception to the overall uniformity of substantive antifraud law is the new federal safe harbor for forward-looking statements, which issuers may be unwilling to use if states do not incorporate a similar safe harbor into their laws.[330] If Congress wants a national market standard protecting statements that fall within the federal safe harbor, state antifraud laws may interfere.

Professors Grundfest and Perino's second conclusion was, in fact, an opinion about the law preexisting the Uniform Standards Act: that the 1995 Reform Act, and other provisions of the federal securities laws, *impliedly* preempted conflicting provisions of state law. This argument asserts a policy reason why Congress *explicitly* should have preempted state law if the law was uncertain and resources would be spent litigating over whether Congress had implied preemption. However, prior to the enactment of the Uniform Standards Act, there was little if any support for this argument that the 1995 Reform Act preempted state antifraud statutes.[331]

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330 *See* Private Securities Litigation Reform Act of 1995 § 102, 15 U.S.C. §§ 77z-2, 78u-5 (Supp. II 1996). For a brief discussion of the safe harbor provision's efficacy, see *supra* note 165.

331 The New York Court of Appeals decision in *Guice v. Charles Schwab and Co.*, 674 N.E.2d 282 (N.Y. 1996), provides some insight into how courts approach preemption arguments:

> The pre-emption question is ultimately one of congressional intent. As recapitulated most recently in *Barnett Bank*, congressional preemptive intent may be shown from express language in the Federal statute; it may also be established implicitly because the Federal legislation is so comprehensive in its scope that it is inferable that Congress wished fully to occupy the field of its subject matter ("field preemption"), or because State law conflicts with the Federal law. Implied conflict preemption may be found when it is impossible for one to act in compliance with both the Federal and State laws, or when "the state law . . . 'stan[ds] as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'"

Id. at 285 (citations omitted) (quoting Barnett Bank of Marion County v. Nelson, 116 S.Ct. 1103, 1108 (1997) (quoting Hines v. Davidowitz, 312 U.S. 52, 67 (1941))) (alterations in original). The *Guice* opinion, however, does not support the claim that the 1995 Reform Act preempted state law. First, *Guice* specifically recognized that "[t]he pre-emption question is ultimately one of congressional intent," *id.*, and there is no evidence that Congress intended to preempt state law in 1995. Furthermore, *Guice* addressed a much narrower issue: whether a state law requiring a broker to make "full and frank disclosure" to his customer was partially preempted by 1975 amendments to the 1934 Act and by the SEC implementing regulations. *See id.* at 284-87. The *Guice* court held that the federal statute and regnlations preempted state law to the extent that the state law *interfered with the SEC's ability to regulate the securities markets*:

> When, thus, a State's regulation, through the imposition of common-law tort liability or otherwise, adversely affects the ability of a Federal administrative agency to regulate comprehensively and with uniformity in accordance with the objectives of Congress, then the state law may be preempted even though collision between the state and federal regulation may not be an inevitable consequence.

Professors Grundfest and Perino's third conclusion restated their first, which they had made from the perspective of increasing efficiency in the securities markets, from the perspective of increasing efficiency in federal and state courts. Although state court litigation against an issuer usually occurs in a single state,[332] a claimant may still file a parallel federal suit. Accordingly, this third conclusion posits that it would be cheaper, other things being equal, for a claim to be heard in either state or federal court, but not in both. As discussed below, however, other things often are not equal—significant overall benefits can be realized from the dual-forum class action framework.[333]

Moreover, even to the extent that state and federal class actions need to be more efficiently coordinated procedurally, the sweeping preemption of the Uniform Standards Act was drastic and unnecessary. Professor Geoffrey Miller has suggested several specific ways in which federal courts can facilitate litigation of state and federal causes of action in a single forum that afford substantially similar relief.[334] With minor adjustments, many of Professor Miller's suggestions could be implemented to facilitate litigation of federal and state causes of action for securities fraud either in a single forum or in two fora that maintain respect for each other's procedures.

First, Professor Miller suggested that federal courts should have removal power authorizing them "to take over overlapping state class

Id. at 290 (internal quotation marks omitted). By contrast, the causes of action for securities fraud that have existed in the states for well over 100 years do not interfere with the SEC's ability to regulate the securities markets. Indeed, in 1997 the Chairman of the SEC opposed preemption of state cause of action. *See supra* note 285 and accompanying text. Finally, although state courts have imposed stays on discovery in deference to the congressional purpose evidenced in the 1995 Reform Act, no reported holdings have found that the 1995 Reform Act preempts state causes of action for securities fraud. Of course, the Uniform Standards Act does preempt state law, but the argument that without its enactment federal courts would have held that the 1995 Reform Act preempted state class actions is not well-founded.

332 The economics of class action litigation—the class size must justify expenditures on litigation—make commencing a class action in every state in which securities are sold impractical. In fact, the overwhelming majority of state class actions have been filed in California, the state in which the high technology companies often named as defendants base their operations. *See supra* text accompanying notes 183-84.

333 *See infra* Part V.A.2. Costs of duplicate litigation could be reduced if the law required plaintiffs to elect between federal and state remedies, a less drastic approach than complete preemption of state law. Requiring plaintiffs to choose between federal and state remedies, however, would not end duplicate litigation (separate federal and state classes could still be formed), and it might prejudice plaintiffs who lack the sophistication to evaluate competing "sales pitches" from lawyers soliciting them to join one class or the other. Furthermore, the 1934 Act already discourages simultaneous litigation in state and federal courts by limiting combined recovery to a plaintiff's actual damages. *See* Securities Exchange Act of 1934 § 28(a), 15 U.S.C. § 78bb(a) (Supp. II 1996).

334 *See* Geoffrey P. Miller, *Overlapping Class Actions*, 71 N.Y.U. L. Rev. 514, 540-46 (1996).

action cases when the federal-court litigation offers the opportunity for the complete and adequate resolution of the claims asserted in state court."[335] Prior to the Uniform Standards Act, if a plaintiff chose to file a 1933 Act claim in state court, it could not be removed to federal court.[336] Amendment of the 1933 Act to permit, but not require, removal of such a claim,[337] might have been enough to facilitate removal not only of the 1933 Act claim, but also of any related state law claims as well.[338] Although 1934 Act claims, which must be filed in federal court,[339] did not present removal issues, Congress could give federal courts the authority to take over state securities fraud actions in which a plaintiff files an overlapping federal class action under the 1934 Act.

Second, Professor Miller suggested that federal courts can "interpret the Anti-Injunction Act to permit anti-suit injunctions against overlapping state class actions" in situations when there is "a substantial probability that the federal litigation will result in a fair and adequate settlement or judgment that affords relief to the members of the plaintiff class."[340] In the context of securities litigation in which state court proceedings have not yet commenced, federal courts may derive even broader authority from the All Writs Act.[341] The Uniform

335 *Id.* at 542.

336 *See* Securities Act of 1933 § 22(a), 15 U.S.C. § 77v(a) (1994) (allowing a plaintiff to bring an action in either federal or state court but prohibiting removal to federal court of a case brought in a "State court of competent jurisdiction").

337 The Uniform Standards Act amends 1933 Act section 22(a), 15 U.S.C. § 77v(a), by inserting an exception into the provision that prohibited the removal of cases from state court. *See* H.R. 1689, 105th Cong. § 101(a)(3) (1998), *reprinted in* 144 CONG. REC. H6053 (daily ed. July 21, 1998) (amending section 22(a) of the 1933 Act). The exception refers to section 16 in the 1933 Act which the Uniform Standards Act amends to read as follows: "Any covered class action brought in any State court involving a covered security, as set forth in subsection (b), *shall be* removable to the Federal district court for the district in which the action is pending." *Id.* at § 101(a)(1) (emphasis added) (amending section 16(c) of the 1933 Act). Subsection (b), however, refers only to claims brought under the statutory or common law of any state, meaning that an action based exclusively on 1933 Act claims presumably still cannot be removed.

338 *See* 28 U.S.C. § 1441(a) (1994) (granting removal jurisdiction over "civil action[s] brought in a State court of which the district courts of the United States have original jurisdiction"); 28 U.S.C. § 1441(c) (authorizing removal from a state court to a federal court of normally nonremovable state claims if joined with a removable federal claim).

339 *See* Securities Exchange Act of 1934 § 27, 15 U.S.C. § 78aa (1994).

340 Miller, *supra* note 334, at 543. The Anti-Injunction Act, 28 U.S.C. § 2283 (1996), provides that "[a] court of the United States may not grant an injunction to stay proceedings in a State court except as expressly authorized by Act of Congress, or where necessary in aid of its jurisdiction, or to protect or effectuate its judgments."

341 The All Writs Act, 28 U.S.C. § 1651(a) (1994), states: "The Supreme Court and all courts established by Act of Congress may issue all writs necessary or appropriate in aid of their respective jurisdictions and agreeable to the usages and principles of law." Courts have applied the All Writs Act in varied circumstances. *See, e.g.*, United States v. New York Tel. Co., 434 U.S. 159, 174 (1977) (finding that the All Writs Act "extends, under appropriate circumstances, to persons who, though not parties to the original action or engaged in

Standards Act reinforces this point by specifically providing that a federal court may stay discovery in any state court suit while a federal suit is pending.[342]

Third, Professor Miller reiterated a suggestion that he and Professor Macey had made in 1991: that federal courts can "auction off" class action claims to the highest bidder, who would then pay the class members and prosecute the claim.[343] Several federal district court judges already have experimented with auctioning off the lead counsel position.[344] Auctions provide "an additional consideration favoring the centralization of overlapping class action cases in a single federal forum,"[345] and even absent preemption by the Uniform Standards Act, federal courts could have facilitated this centralization by using lead counsel auctions to favor lawyers who present a workable proposal to litigate federal and state claims together in federal court.[346]

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wrongdoing, are in a position to frustrate the implementation of a court order or the proper administration of justice"); *In re* Baldwin-United Corp., 770 F.2d 328, 335-40 (2d Cir. 1985) (upholding, under the All Writs Act, a federal district court's injunction barring attorneys general in all fifty states from bringing lawsuits seeking restitution on behalf of citizens because the same transactions were already the subject matter of over 100 federal securities lawsuits that had been transferred and consolidated in a single federal district court). As Professor Coffee observed, "federal courts have used this power sparingly, principally because of the counterbalancing instruction of the Anti-Injunction Act that federal courts may not (except in extraordinary cases) enjoin state court proceedings." Coffee, *Class Action*, *supra* note 52, at 35.

342 *See* H.R. 1689, 105th Cong. § 101(a)(2), *reprinted in* 144 CONG. REC. H6053 (daily ed. July 21, 1998).

343 *See* Miller, supra note 334, at 543-46 (citing Macey & Miller, *supra* note 161). Professor Miller describes the proposed auction process as follows:

> Upon the filing of a class action complaint, the judge would conduct an initial investigation to determine whether the case would be appropriate for auction. If the judge decided to go forward, he or she would conduct an auction of the claim. Anyone, including the defendant, could bid for the litigation; if the defendant made the high bid, the case would settle. The judge would award the claim to the highest bidder, deduct expenses, and distribute the remaining funds to the class members upon filing of proper proofs of claim. Meanwhile, the winning bidder would prosecute the case (unless the defendant submits the high bid) much like a standard class action case.

Id. at 544 (footnotes omitted). For a critique of this proposal, see Randall S. Thomas & Robert G. Hansen, *Auctioning Class Action and Derivative Lawsuits: A Critical Analysis*, 87 Nw. U. L. REV. 423, 426 (1993) (pointing out that auctions are not always economical and that in the "class of cases where bidders' costs in determining the value of the claim are low, we believe that the benefits of eliminating agency costs exceed the costs of the auction process").

344 United States District Court Judge Vaughn Walker has experimented with an auction approach in several class actions. *See, e.g.*, *In re* California Micro Devices Sec. Litig., No. C-94-2817-VRW, 1995 WL 476625 (N.D. Cal. Aug. 4, 1995); *In re* Oracle Sec. Litig., 131 F.R.D. 688, 697 (N.D. Cal. 1990), *modified by* 132 F.R.D. 538, 539 (N.D. Cal. 1990).

345 Miller, *supra* note 334, at 543.

346 Federal courts may assume supplemental jurisdiction over related state claims. *See* 28 U.S.C. § 1367(a) (1994) ("[I]n any civil action of which the district courts have original

2. *Benefits of a Dual-Forum Class Action Framework*

A dual-forum class action framework has some benefits. Most of these benefits result from the fact that the dual-forum framework allows litigants the option, in appropriate circumstances, of having corporate law and securities law questions resolved together under the law of a single state. The source of these benefits, or "network externalities,"[347] derives from the inherent connectedness of the law of corporate fiduciary duties and securities law, despite a longstanding effort by the federal courts to separate the two.

Many incidents of securities fraud also involve a breach of fiduciary duty by corporate managers. Yet as discussed in Part I of this Article, Congress has declined to enact a federal corporate law. Furthermore, the federal courts have not developed a common law of corporate fiduciary duty after *Santa Fe Industries v. Green*,[348] in which the Supreme Court held that breach of fiduciary duty does not constitute "deception" under section 10(b) of the 1934 Act.[349] Therefore, breach of fiduciary duty, standing alone, must be litigated under state corporate law or possibly state securities law, while claims involving "deception" of security holders also may be litigated under federal securities law. Federal courts have struggled with *Santa Fe's* distinction between fiduciary breach and deception in the context of both securi-

jurisdiction, the district courts shall have supplemental jurisdiction over all other claims that are so related to claims in the action within such original jurisdiction that they form part of the same case or controversy . . . .").

347 *See supra* note 82. Professor Klausner and others have recognized that "[o]ne justification for mandatory disclosure in securities law is to promote standardization in the disclosure format to facilitate comparisons across companies. This is essentially a network externality argument." Klausner, *supra* note 82, at 836 n.240. Similar network externality arguments could be made to justify standardization of the rules governing securities fraud litigation and perhaps for preemption of state rules that differ markedly from federal rules. Nonetheless, as the following discussion demonstrates, other network externalities besides standardization of legal rules have become important to the effective functioning of our system for pleading, litigating, and settling suits under corporate and securities law.

348 430 U.S. 462 (1977).

349 In *Santa Fe Industries*, the minority shareholders of Kirby Lumber Corporation sued under section 10(b) and SEC Rule 10b-5, alleging that (1) Kirby's stock had been undervalued in a short-form merger of Kirby into its parent corporation Santa Fe Industries, and (2) there was no business purpose for the merger. *See id.* at 466-67. The Second Circuit held that a breach of fiduciary duty in connection with the purchase or sale of a security would violate section 10(b), *see id.* at 470, but the Supreme Court reversed, holding that the words "manipulative or deceptive device or contrivance" in section 10(b) require a showing that the defendants manipulated the market, misrepresented a material fact, or failed to disclose a material fact which they had a duty to disclose. *See id.* at 476 (noting that there is no authority for "the proposition . . . that a breach of fiduciary duty by majority stockholders, without any deception, misinterpretation, or nondisclosure, violates the statute and the Rule").

ties sales[350] and proxy solicitations.[351] As Professor Henry Hart once observed, "legal problems repeatedly fail to come wrapped up in neat packages marked 'all-federal' or 'all-state.'"[352]

Under the dual-forum class action framework that preceded the Uniform Standards Act, plaintiffs could sometimes opt into the network externalities inherent in using a single body of law by filing class actions for securities fraud under state corporate law and possibly also by filing related securities law claims in the state of the issuer's incorporation. In those cases, courts were not forced to make sharp distinctions between "fiduciary" and "disclosure" claims and thus avoided having to struggle with the fluid border that separates these two areas of the law. This state law option would be particularly attractive in cases involving securities fraud alleged to have been perpetrated against existing stockholders, issuers that sold most of their securities within their states of incorporation, and situations where economizing on litigation costs is of particular importance.

Although early versions of the White-Eshoo and Gramm-Dodd bills[353] would have obliterated these network externalities by forcing all claims of misrepresentation connected to securities transactions into federal court, the Uniform Standards Act incorporates a "Dela-

350 Some courts distinguish *Santa Fe Industries* and find a fiduciary liable under section 10(b) for failing to disclose her breach of duty if the plaintiff, as a result of the nondisclosure, fails to pursue a remedy available under state law. *See, e.g.*, Estate of Soler v. Rodríguez, 63 F.3d 45, 54 (1st Cir. 1995); Goldberg v. Meridor, 567 F.2d 209, 211-12, 214-15 (2d Cir. 1977). Other courts reject this reasoning. *See, e.g.*, Harris Trust and Sav. Bank v. Ellis, 810 F.2d 700, 704 (7th Cir. 1987) (stating that *Goldberg* and similar holdings "use the securities laws to redress substantive violations of state law").

351 *See* Howing Co. v. Nationwide Corp., 972 F.2d 700, 707-10 (6th Cir. 1992) (holding that although minority shareholders did not have votes sufficient to stop a cash-out merger, they could meet the causation requirement for suit under 1934 Act section 13(e) by showing that a deceptive proxy statement induced them to forego an appraisal remedy under state law); Wilson v. Great Am. Indus., 979 F.2d 924, 931 (2d Cir. 1992). The *Wilson* court stated the following:

> Here loss causation may be established when a proxy statement prompts a shareholder to accept an unfair exchange ratio for his shares rather than recoup a greater value through a state appraisal. And transaction causation may be shown when a proxy statement, because of material misrepresentations, causes a shareholder to forfeit his appraisal rights by voting in favor of the proposed corporate merger.

Id. The Supreme Court specifically left this issue unresolved in Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1107 (1991) ("[T]here is no indication in the law or facts before us that the proxy solicitation resulted in any . . . loss [of a state remedy]."). *See generally* Marc I. Steinberg, *The Emergence of State Securities Laws: Partly Sunny Skies for Investors*, 62 U. CIN. L. REV. 395, 415-16 (1993) (discussing the more recent case law in light of the Supreme Court's ruling in *Virginia Bankshares*).

352 Henry M. Hart, Jr., *The Relations Between State and Federal Law*, 54 COLUM. L. REV. 489, 498 (1954).

353 *See supra* notes 260-74 and accompanying text.

ware carve-out."[354] The carve-out seeks to preserve certain, specified state law fiduciary duty claims in which misrepresentation may be an issue—principally suits over statements made to obtain shareholder approval of mergers and other transactions.[355] However, plaintiffs must file suits involving misrepresentation in transactions that fall outside of this carve-out in federal court under federal law. This requirement forces plaintiffs to litigate securities claims and fiduciary duty claims, which will remain in state court, under separate bodies of law, even if they would have preferred to file securities claims only in the state of incorporation.

Most importantly, the Uniform Standards Act does not replace these network externalities with the potentially more valuable network externalities that would result from *both* securities and corporate law being developed in the same jurisdiction. Congress could have considered Professor Cary's proposal that it establish a federal corporate law erecting minimum standards that would make it less attractive for corporations to organize in any one particular state.[356] Alternatively, Congress could have explored Professor Romano's suggestion that the arguments in favor of leaving corporate law to the states[357] also apply to securities law and that issuers therefore should be allowed to opt into the securities laws of a particular state (including their state of incorporation).[358] Admittedly, each of these proposals could create new costs and benefits for issuers and investors (an issue beyond the scope of this Article). However, as it stands, the Uniform Standards Act does not establish a uniform body of law governing the rights of investors holding securities in a corporation or other business organization.

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354 *See* S. 1260, 105th Cong. § 101(a)(1) (1998). The text of the Delaware carve-out provision is quoted *supra* note 314.

355 The Delaware carve-out was adopted because of concerns expressed by SEC Chairman Arthur Levitt, *see May 19, 1998, House Uniform Standards Act Hearings*, *supra* note 2, at 21-22 (prepared statement of Arthur Levitt, Chairman, SEC), and others, that earlier drafts of the bills in both the House and the Senate threatened to dismember state corporate law by forcing claims involving breach of the fiduciary duty of disclosure to be filed in federal court. For example, earlier versions of the bills probably would have preempted a class action, under Delaware law, against corporate directors for breach of the fiduciary duty of disclosure to shareholders in connection with a merger or other change-in-control transaction. *See, e.g.*, Zirn v. VLI Corp., 681 A.2d 1050, 1062 (Del. 1996) (accepting plaintiffs' argument that breach of fiduciary duty occurred because disclosures made in a Schedule 14D-9, disseminated in connection with a tender offer, were materially misleading).

356 *See* Cary, *supra* note 56, at 701-02.

357 *See supra* notes 61-66 and accompanying text.

358 *See* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 108 YALE L.J. 2359, 2361 (1998) (suggesting that mandatory federal securities regulation be replaced with competing state law regimes and that competitive federalism would be as viable an alternative in securities regulation as it is in corporate law).

B. The Political Equation: Will a Dual-Forum Class Action Framework Achieve the Right Balance Between Issuers and Investors?

Even after passage of the 1995 Reform Act and the Uniform Standards Act, debate will continue over whether the securities litigation system strikes the correct balance between investors' interest in facilitating meritorious lawsuits and deterring fraud and issuers' interest in discouraging frivolous lawsuits and lawsuits that benefit lawyers more than shareholders. Professor Lynn Stout has summarized this debate as one in which two types of error are possible:

> [S]cholars generally divide error into two categories. The first category of legal error is called Type I error, or the "false positive." In securities litigation, an example of a Type I false positive would be a judicial finding that a defendant had fraudulently misrepresented something, when in fact no fraud occurred. The second type of error is called Type II error, or the "false negative." A Type II false negative occurs when a court trying to decide whether the defendant has committed fraud mistakenly finds there has been no fraud, even though fraud actually occurred.[359]

Professor Stout observed that in drafting the 1995 Reform Act, Congress "was particularly concerned about a form of Type I error: the so-called 'strike suit.'"[360]

Plaintiffs' advocates argue that the 1995 Reform Act went too far in favoring defendants,[361] and they point to statistical[362] and anecdotal[363] evidence that securities fraud is on the rise. Such an upswing, if it does in fact exist, might be explained by the recent bull market or by the proliferation of exemptions from both the registration and the prospectus delivery requirements of the 1933 Act, which create opportunities for fraud. Providing further support for this side of the debate, Professor Stout argues that the aggregate cost of Type I error is disproportionately low (in the millions of dollars) relative to the im-

359 Stout, *supra* note 27, at 711.

360 *Id.*

361 *See* sources cited *supra* note 179.

362 *See, e.g.*, William S. Lerach, *Prevalence and Economic Impact of Securities Class Actions: Is Reform Necessary?*, *in* AVOIDING AND MANAGING SECURITIES LITIGATION AND SEC ENFORCEMENT INQUIRIES FOR IN-HOUSE COUNSEL (PLI Corp. L. & Practice Course Handbook Series No. B-888, 1995) (discussing statistical data regarding fraud and class action litigation).

363 *See, e.g.*, David Barboza, *On the Shady Side of the Bull Market: Large Returns Are Now Bringing in Stock Promoters with Rap Sheets*, N.Y. TIMES, May 10, 1997, at 33 ("[T]he tangled tale of [the Genesis fraud episode] suggests that the money to be made in the soaring stock market has begun to attract a more dangerous kind of criminal to businesses that end up fleecing investors"); Paul Beckett, *Bull Market Adds to Regulators' Woes*, WALL ST. J., March 3, 1997, at B7B ("Federal regulators note that stock market's recent bullishness has led to a sharp rise in securities sales fraud. . . .").

pact of Type II error on U.S. capital markets (in which trillions of dollars of securities are outstanding).[364]

However, those who support restricting private rights of action point to statistical evidence of their own: courts eventually dismiss a large number of class action suits;[365] the volume of filings correlates with fluctuations in the market;[366] issuers which use prestigious under-

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364 Professor Stout writes:

> Let us first talk about Type I error: the strike suit. If you listen to the rhetoric coming from Capitol Hill, you will swiftly reach the conclusion that the problem of strike suits is endemic and horribly costly. Indeed, it is draining the life out of American enterprise.
>
> When the proponents of securities litigation reform start to talk dollars and cents, however, you very quickly get a better idea of the magnitude of the social losses supposedly flowing from strike suits. Most often, corporate losses from defending against meritless strike suits are described as running in the millions or tens of millions of dollars. When the proponents of securities litigation reform get really ambitious, they will sometimes mention figures in the hundreds of millions. . . .
>
> Now I want to talk about the cost of an increase in Type II error. . . .
>
> . . . In lay terms, fraud is bad for securities markets because it erodes investor confidence. This occurs because fraud makes it difficult for investors to detect differences in the quality of the securities they buy. Companies issuing bad securities—poorly run firms that throw away money and do a poor job for their investors—can sell their securities at about the same price as well-managed firms, because fraud makes it impossible for investors to easily distinguish between high-quality and low-quality firms.
>
> . . . .
>
> Although the figure is constantly rising, the market value of publicly-held equities issued by United States corporations presently exceeds $ 8 *trillion.* That's just stocks, of course. According to federal Flow of Funds accounts, the market value of corporate bonds currently outstanding is another $ 2 or $ 3 trillion. Throw in commercial paper, and some of the non-bond debt forms corporations issue, and I think it safe and fair to say that the market value of United States corporate securities outstanding today significantly exceeds $ 10 *trillion.* That's $ 10,000,000,000,000.00.
>
> . . . .
>
> When I look at Congress worrying about firms losing hundreds of millions of dollars from strike suits, I cannot help but think about the foolishness of trading in hundreds of *millions* of dollars of Type I error costs for, potentially, hundreds of *billions* of dollars of Type II costs. . . .

Stout, *supra* note 27, at 712-14 (footnotes omitted). Professor Stout's point is clear, although she does not give empirical support for the numbers she uses by way of illustration. Others might argue that Type I costs are significantly higher if one takes into account issuers which never go to market out of fear of strike suits.

365 *See* NERA 1996 Study, *supra* note 15, at tbl.10b (showing dismissals as 17.84% of the 998 total dispositions occurring during the sample period).

366 *See id.* at tbl.3 & fig.1. The average number of cases filed in a given month is negatively correlated with the prior two months return on the Wilshire 5000 index. *See id.* The study begins with the hypothesis that "if it is indeed fraud in the price of individual stocks that determines whether a suit is filed, market movements would not be expected to significantly affect the number of suits filed in a given month." *See id.* at 7. This correlation of class action suits with market fluctuations, however, could be due to the fact that critical elements of a fraud claim, such as loss causation and damages, are difficult to prove in situations in which plaintiffs only suffered minimal losses from buying the issuer's stock in a sustained bull market. The damages provision of section 11 of the 1933 Act also specifically precludes liability if the price of the issuer's stock has gone up between the purchase

writers with "deep pockets" are more likely to be sued;[367] and a significant number of suits settle for "nuisance value."[368] Type I error, issuers and their allies will argue, far outweighs Type II error in a society that has become obsessed with litigation.

Whether a dual-forum litigation framework creates or corrects imbalance between these two types of error depends upon whether bias in favor of one or the other exists in the state or federal political systems. For example, states could be biased in favor of plaintiffs, thereby upsetting the balance established by federal law. Such a bias might result where state legislators or judges either have a naive understanding of what is good for shareholders or simply want to encourage litigation to generate fees for in-state lawyers (thereby causing other states to bear principally the costs of Type I error). However, if the federal regime incurs too much Type II error by precluding legitimate claims for securities fraud, state lawsuits could help restore an efficient trade-off between the two types of error. Indeed, the congresses and courts that have constructed the federal securities regime over the past sixty years have assumed that the federal trade-off between the two types of error was not the final word.

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date and the date plaintiff filed suit. *See* Securities Act of 1933 § 11(e), 15 U.S.C. § 77k(e) (1994).

367 *See* James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 952-55 (1996) (suggesting that IPO's handled by high-reputation underwriters may be more likely to be the subject of class action securities fraud suits than IPO's handled by lower-reputation underwriters). *But see* James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 507 (1997) ("[C]ontrary to [Bohn & Choi's] conclusion that the strike-suit thesis is suggested by their finding that the higher underwriter quality, the higher the likelihood of suit, their overall data merely confirms [sic] that larger offerings attract not only higher quality underwriters but also cost-conscious class action lawyers.")

368 *See* Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727, 743 (1995) (assuming that settlements of less than $2 million generally involve "nuisance" suits, and citing three studies suggesting "that from 22% to 60% of observed settlements are sufficiently low that the merits may not have mattered at all in the resolution of the litigation"). The 1996 NERA Study tests Grundfest's hypothesis. *See* 1996 NERA STUDY, *supra* note 15, at 11-12; *id.* tbl.8a (showing that nine out of 46, or 20%, of cases in the sample settled for less than $2 million); *id.* tbl.8b (showing that 86 out of 331, or 26%, of cases in another sample settled for less than $2 million). By comparing each of these low settlement amounts to the total losses incurred by investors during the class period, and identifying those cases that "settle for an amount that is a much smaller fraction of total investor losses than the average for the whole sample," NERA estimated "that at least 21 percent, and possibly 42 percent of these low-value settlements may well be nuisance suits, and are likely settling for nuisance value." *Id.* at 12. *But see* Cox, *supra* note 367, at 512 (citing Willard T. Carleton et al., *Securities Class Action Lawsuits: A Descriptive Study*, 38 ARIZ. L. REV. 491, 494-99 & tbl.2 (1996) and arguing that, with reasonable assumptions about investor behavior and reliable data, 83% of settlements occur within the range of expected damages); Joel Seligman, *The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority,"* 108 HARV. L. REV. 438, 450-53 (1994) (critiquing these types of studies as based on unreliable estimates of plaintiffs' potential damage recoveries).

1. *Type I Error: Will the States Be Biased in Favor of Plaintiffs?*

Might the states go too far in favoring plaintiffs over defendants, thus making it impossible for Congress and the federal courts to maintain the right balance between the two? Some evidence suggests that state blue sky laws treat plaintiffs more favorably than does the federal civil liability regime. Some states have weaker scienter requirements,[369] and most allow suits against aiders and abettors.[370] A few states allow punitive damages for securities fraud,[371] and others allow for recovery of attorneys' fees.[372]

Professor Perino correctly has pointed out that the forces shaping state securities laws differ sharply from those shaping corporate law.[373] Corporate law is shaped by the market for corporate charters, in which states compete with one another by offering laws with features attractive to corporate management: predictability, efficient rules, and other network externalities constructed around a comprehensive

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369 *See* 9 Loss & SELIGMAN, *supra* note 91, at 4133 n.3 (noting that "there is a possibility of a weaker scienter requirement at common law than under Rule 10b-5, or perhaps none at all," and citing several cases in support of this proposition); *see also* Campbell, *supra* note 150, at 201 n.141 (citing five state antifraud statutes applying a simple negligence standard: IOWA CODE § 502.502 (1991); KAN. STAT. ANN. § 17-1268 (1995); KY. REV. STAT. ANN. § 292.480 (Banks-Baldwin 1996); LA. REV. STAT. ANN. § 51:712 (West 1987); ME. REV. STAT. ANN. tit. 32, § 10,605 (West 1988)).

370 Section 410(b) of the *Uniform Securities Act* imposes joint and several liability on, among others, every broker-dealer or agent "who materially aids in the sale" of securities in violation of section 410(a). UNIF. SEC. ACT § 410(b) (1985). Section 410(a) contains language substantially similar to that in section 12(2) of the 1933 Act, except that section 410(a) is not limited to statements made "by means of a prospectus," Securities Act of 1933 § 12(2), 15 U.S.C. § 77(l)(2) (Supp. II 1996). *See* Gustafson v. Alloyd Co., 513 U.S. 561, 584 (1995) (stating that the words "by means of a prospectus" in section 12(2) require that there be "a document that describes a public offering of securities by an issuer or controlling shareholder"). Sections 12(1) and 12(2) of the 1933 Act also impose liability only on a person who "offers or sells" securities, § 12, 15 U.S.C. § 77(*l*). *See* Pinter v. Dahl, 486 U.S. 622, 642-55 (1988) (finding no support in the language of section 12(1) for imposition of primary liability on persons who do not offer securities for sale, solicit offers, or transfer title to securities). Sections 12(1) and 12(2) thus contain no equivalent to section 410(b) of the *Uniform Securities Act* reaching collateral participants. Similarly, private suits under section 10(b) of the 1934 Act may be brought only against primary violators, not aiders and abettors. *See* Central Bank v. First Interstate Bank, 511 U.S. 164, 175-78 (1994).

371 Punitive damages are unavailable under the 1934 Act because section 28 limits recovery to actual loss. *See* Securities Exchange Act of 1934 § 28(a), 15 U.S.C. § 77bb(a) (1994). Although the Proposition 211 proposal to introduce punitive damages in California failed, *see supra* notes 205-10 and accompanying text, a few state courts have allowed punitive damages in suits under state blue sky laws. *See* 9 Loss & SELIGMAN, *supra* note 91, at 4133 n.3 (noting that *Voskamp v. Arnoldy*, 749 S.W.2d 113 (Tex. App. 1988), allowed punitive damages of $3,750,000 when actual damages from securities fraud were $1,001,850). Furthermore, federal courts have permitted plaintiffs to claim punitive damages in a pendent state law claim joined to a suit under the 1934 Act. *See* Flaks v. Koegel, 504 F.2d 702, 707 (2d Cir. 1974); Young v. Taylor 466 F.2d 1329, 1337-38 (10th Cir. 1972).

372 *See* 9 Loss & SELIGMAN, *supra* note 91, at 4133 n.3.

373 *See* Perino, *supra* note 14, at 324-26.

body of interpretive case law.[374] Securities fraud law, by contrast, is determined by the geographic location of the transaction in question, not by the incorporators' voluntary forum selection: "Unlike the corporate charter market, the securities fraud market has nothing equivalent to the corporate internal affairs doctrine, which preserves mobility by giving corporations the ability to opt in to one state's regulatory scheme simply by reincorporating there."[375] Unlike corporate law, state securities law also serves as a backdrop for a parallel federal law, which plaintiffs can use at their option. Thus, once a cause of action arises, the plaintiffs' counsel, not the issuer, chooses the jurisdiction or jurisdictions in which to sue, depending upon the size of the plaintiff class that can be assembled and the substantive and procedural law of each jurisdiction.[376] The issuer, on the other hand, has a very limited range of options. For the most part, the issuer must make its jurisdictional choice during the time period before a cause of action arises, by either avoiding securities sales in states where antifraud laws are too onerous[377] or moving operations out of a state that allows a nationwide class of plaintiffs to sue in its courts.

Nonetheless, competitive forces among states do shape the development of state securities law. States compete to attract capital, and states in which issuers choose to conduct business operations likely favor those issuers over investors, particularly when most of the investors are out-of-state. Pro-plaintiff interests are likely to prevail only in smaller, less industrialized states where issuers are few in number and have relatively little political influence. Second, an issuer can, as a practical matter, choose with a high degree of certainty the state in which it is amenable to securities fraud class actions by choosing where to base its operations and where to incorporate. For example, out of the fifty-five state securities class action complaints that the SEC reviewed in 1996, seventy-eight percent (forty-three complaints) were filed in California, and only seven percent (four complaints) were

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374 *See supra* notes 74-83 and accompanying text.

375 Perino, *supra* note 14, at 325 (footnote omitted). The internal affairs doctrine "provides that most questions involving the operation of the corporation will be resolved under the laws of the state of incorporation, regardless of where the corporation is headquartered or doing business." *Id.* at 325 n.215.

376 Economies of scale, however, would favor federal court if the class can be considerably larger in a federal than a state action. *See supra* text accompanying notes 225-26.

377 However, "a corporation going public could not prevent leakage into other jurisdictions in aftermarket trading. Thus, if companies want to avail themselves of the public equity markets, they must at the same time forego any opportunity to choose the set of state securities regulations that will apply to aftermarket securities fraud claims lodged against them." Perino, *supra* note 14, at 325-26.

filed in states in which the issuer was not incorporated or did not have its principal place of business.[378]

California's securities bar may have dreamed of making Sacramento the Wilmington, Delaware of securities litigation, but such efforts most likely would have failed even without the Uniform Standards Act. States whose laws favor plaintiffs at the expense of issuers will either drive capital formation efforts to other states or drive down the rate of return that is offered to in-state investors. If state courts expand the reach of their laws to include the sale of securities by in-state businesses to plaintiffs in other states,[379] users of capital may respond by taking their businesses elsewhere.[380] Indeed, the Silicon Valley high technology companies that have complained the most about California's blue sky laws can take both the jobs and tax revenues they generate to another state with more ease than most issuers. If California's voters, judges, or legislators choose a liability regime too biased against issuers, then Route 128 outside of Boston, the high-tech community spinning off from Microsoft in Seattle, and the network of companies developing around the University of Texas in Austin, are all attractive places to relocate.[381]

A similar fate awaits any state choosing to supplant the federal securities litigation scheme through measures similar to Proposition 211, particularly if coupled with the expansive jurisdictional reach urged by the plaintiffs in *Diamond Multimedia* and *StorMedia*.[382] Based upon the market for corporate charters, the corporate federalists predicted that Delaware would not abandon shareholders in a race to the bottom.[383] Likewise, one can predict that the even more powerful

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378 *See Oct. 21, 1997, House 1995 Reform Act Implementation Hearing, supra* note 14, at 23-24 (prepared statement of Arthur Levitt, Chariman, SEC).

379 One argument for allowing nationwide plaintiff classes is that otherwise in-state shareholders might benefit from litigation carried out at the expense of all of the shareholders, which in turn might encourage states to facilitate frivolous lawsuits filed by their own residents. Single-state plaintiff classes, however, would make state law class actions more expensive relative to potential attorneys' fees, presumably making weaker claims less likely to be filed.

380 As Professor Perino has pointed out, issuers cannot entirely escape a state's securities laws by moving away, *see* Perino, *supra* note 14, at 325-26. However, the plaintiff class will be much smaller in a state where the issuer does not conduct most of its operations, and in fact such suits against out-of-state issuers are rare.

381 *But see id.* at 327 (observing that there are other costs of moving that an issuer would have to take into consideration: "[I]nefficient rules might survive if the jurisdiction provides a significant number of other benefits that limit the opportunity for citizens to vote with their feet"). However, demonstrating California's ability to impose inefficient rules on its citizens, who may stay nonetheless, does not refute the assertion that California has political and economic incentives not to impose such inefficient rules. Finally, even if a state were to impose inefficient pro-plaintiff rules, it is entirely possible that the federal government could choose even more inefficient pro-defendant rules.

382 See discussion *supra* Part III.B.2.

383 *See supra* text accompanying notes 61-66.

market for capital will strongly discourage states from expanding the jurisdictional reach of their securities laws, particularly if those laws favor plaintiffs significantly more than do the federal laws. Anyone hoping to create a new Wilmington, Delaware in Sacramento, or any other state capital, by encouraging frivolous lawsuits against issuers would be disappointed, regardless of whether federal law preempts state class actions.[384]

Indeed, recent events in California and elsewhere reinforce the conclusion that the alarm over securities fraud suits in state court has been a false alarm. Although concerns persist that the plaintiffs' bar could promote ballot measures similar to Proposition 211 once again, it should be remembered that voters rejected that measure by a wide margin. In retrospect, the $15 million spent to support Proposition 211 was a colossal waste of money, particularly in light of the fact that issuers were willing to spend significantly more to defeat the measure.[385] Efforts to sway California's judiciary have been equally unsuccessful so far. Many California courts have not given plaintiffs one of the strategic advantages that proponents of federal preemption fear most: expanded discovery allowing plaintiffs to avoid the 1995 Reform Act's heightened pleading and stay of discovery provisions.[386] The California Supreme Court has yet to rule on this issue and has yet to approve a nationwide class of investors suing in California for fraud in the sale of securities by a California-based issuer.[387] Although the California legislature thus far has not amended the state's securities laws, the legislatures of three other states—Arizona, Montana, and Ohio—all have enacted reforms that limit private rights of action in much the same manner as the 1995 Reform Act.[388]

There is, however, one problem that Congress ultimately might have had to contend with if it had not passed the Uniform Standards Act: the rogue state that prospers from a decidedly pro-plaintiff slant in substantive law, particularly if the state's procedural law allowed for nationwide classes to be formed in its courts. In most states, especially large ones, the potential for generating revenue by attracting business to the state outweighs the revenue potential from becoming a haven

384 *But see* Perino, *supra* note 14, at 326 ("[T]here can be little or no competition in any meaningful sense and states have little or no incentive to adopt efficient rules.").

385 For a discussion of the campaign surrounding Proposition 211, see *supra* text accompanying notes 205-10.

386 *See supra* text accompanying notes 193-200.

387 *See* Diamond Multimedia, Inc. v. Superior Court, H016376 (Cal. Ct. App. Jan. 17, 1997), *review granted*, No. S058723 (Cal. 1997). For a discussion of this case, see *supra* text accompanying notes 211-19.

388 *See Oct. 21, 1997, House 1995 Reform Act Implementation Hearing*, *supra* note 14, at 25 & n.27 (prepared statement of Arthur Levitt, Chairman, SEC) (citing ARIZ. REV. STAT. §§ 44-2081 to -2087 (Supp. 1997); 1997 MONT. LAWS §§ 30-10-315 to -323 (1997); OHIO REV. CODE ANN. §§ [1707.43.2]-[.43.8] (Anderson 1997)).

for litigation. However in a few states, such as Alabama,[389] litigation on behalf of nationwide classes against out-of-state companies selling life insurance, tobacco, and other consumer products has become a cottage industry.[390] Congress unsuccessfully sought to deal with this problem by preempting portions of state law in the area of product liability.[391] If the same problem had developed in securities litigation, Congress might justifiably have narrowly preempted state private rights of action or imposed limitations on nationwide classes. However, at the time Congress passed the Uniform Standards Act, this problem was more theoretical than real—plaintiffs had filed almost all state class actions for securities fraud in the defendant issuers' state of incorporation or principal place of business.[392]

2. *Type II Error: Will the Federal System Be Biased in Favor of Defendants?*

What about the concern that Congress or the federal courts will incur too much Type II error because of bias in favor of defendants? If this occurs, private causes of action for securities fraud under state law could play an invaluable role in preserving both balance to the system and confidence in U.S. securities markets.

a. *Type II Error in the Legislative Branch*

There are several reasons to believe that the federal government will not favor defendant issuers over plaintiff shareholders to an excessive degree. First, regardless of the influence that issuers, underwrit-

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389 *See* Adams v. Robertson, 676 So. 2d 1265, 1268, 1270-74 (Ala. 1995) (holding that under Alabama rules, the certification and settlement of a nationwide class action does not allow for objectors to opt out of the settlement).

390 *See generally* Coffee, *Class Actions, supra* note 52, *passim* (discussing new methods by which defense attorueys are fighting class action suits); Perino, *supra* note 14, at 318 (citing *Castano v. American Tobacco Co.*, 84 F.3d 734 (5th Cir. 1996), and claiming that "[s]ecurities litigation could begin to look more like tobacco litigation and other mass tort cases").

391 *See* The Common Sense Product Liability Legal Reform Act of 1996, H.R. 956, 104th Cong. (1996). This Act would have limited punitive damage claims in most product liability cases to $250,000, or two times the compensatory damages, whichever is larger. *See id.* § 108. However, President Clinton vetoed this bill. *See* Message to the House of Representatives Returning Without Approval Product Liability Legislation, PUB. PAPERS 681 (May 2, 1996) (William J. Clinton). Congress then failed to override the veto. *See* 142 CONG. REC. H4764 (daily ed. May 9, 1996) (noting Congress's failure to override the veto by a vote of 258-163).

392 *See supra* note 378 and accompanying text. After the 1995 Reform Act, the plaintiffs' bar invested its resources in efforts to change California's securities laws. *See supra* text accompanying notes 205-10. Because it is so impractical to sue only on behalf of in-state plaintiffs, even in large states like California, the plaintiffs' bar has sought, through the *Diamond Multimedia* and *StorMedia* cases, to expand the scope of the allowed class to include out-of-state investors. *See supra* Part III.B.2. By contrast, the securities laws of smaller states, such as Alabama and Mississippi, have received little attention from the plaintiffs' bar.

ers, and accountants have over the political process,[393] proposals that favor issuers too much are likely to suffer the same fate as California's Proposition 201—rejection at the voting booth.[394] Second, there are powerful interest groups on both sides of this debate, and pro-plaintiff interest groups have strong support in at least one of the major political parties.[395] Third, a legal framework that protects investors increases the size and breadth of a country's capital markets.[396] Assuming Congress understands this point, it is unlikely that it would risk diminishing the scope of U.S. capital markets by repealing laws against fraud.

Nonetheless, there are reasons to be concerned that Congress will be biased too much in favor the defendants. Expanding shareholder rights is not a compelling populist issue, whereas issuers and other participants in securities offerings care passionately about reducing the amount of litigation.[397] Furthermore, because there are no national referenda voters have no opportunity to speak out directly on federal securities law. Elected representatives make these decisions, which makes it easier for politicians to sacrifice investor interests when it is expedient for them to do so. An examination of voting records for both the successful override of President Clinton's veto of the 1995 Reform Act and the unsuccessful override of the President's veto of the Common Sense Product Liability Legal Reform Act of 1996 (limiting punitive damages in product liability cases) illustrates this point. These voting records show that some members of Congress, mostly Democrats, maximize their aggregate political support from business interests *and* trial lawyers by favoring defendants in in-

393 *See supra* text accompanying notes 16, 163.

394 *See supra* text accompanying notes 201-04

395 *See* Glenn R. Simpson, *Trial Lawyers, After Flirting with GOP in 1995, Are Sitting at Democratic Party's Table Again*, WALL ST. J., July 16, 1996, at A12; *see also* Douglas Frantz, *Trial Lawyers, Their Money and Their Influence Have Become Issues in the Campaign*, N.Y. TIMES, Oct. 13, 1996, at 18 ("While the White House says that the President has done nothing just to please the lawyers, he and the Democratic Party have clearly benefitted from the political largess of lawyers, receiving far more in contributions from them than have Mr. Dole and the Republicans.").

396 *See* RAFAEL LA PORTA, LEGAL DETERMINANTS OF EXTERNAL FINANCE 1, 5 (Nat'l Bureau of Econ. Research Working Paper No. 5879, 1997). This study demonstrates "that countries with poorer investor protections, measured by both the character of legal rules and the quality of law enforcement, have smaller and narrower capital markets." *Id.* at 1. Additionally, in studying how legal rules protecting investors affect the capital markets in various countries, the authors assert that "because a good legal environment protects the potential financiers against expropriation by entrepreneurs, it raises their willingness to surrender funds in exchange for securities, and hence expands the scope of capital markets." *Id.* at 19. Leonard B. Simon of Milberg, Weiss, Bershad, Hynes & Lerach LLP discussed this study in his testimony before the House. *See Oct. 21, 1997, House 1995 Reform Act Implementation Hearing*, *supra* note 14, at 76 (prepared statement of Leonard B. Simon, securities litigator).

397 *See supra* note 16.

vestor lawsuits and plaintiffs in tort litigation.[398] This vote splitting is a logical byproduct of the sheer volume of product liability and other tort litigation in comparison to securities litigation.[399] If the plaintiffs' bar must choose to give up either tort or securities litigation, it will sacrifice securities litigation. Similarly, a politician who votes in favor of narrowing federal private rights of action for securities fraud will unlikely lose political support from plaintiffs' lawyers, if she stands beside them in the tort reform arena.[400]

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398 Sixty-five members of the House of Representatives (61 Democrats and four Republicans) voted to override President Clinton's veto of the 1995 Reform Act, but also voted to sustain the President's veto of the Common Sense Product Liability Legal Reform Act. *Compare* CONGRESSIONAL QUARTERLY INC., CONGRESSIONAL ROLL CALL 1995, at H-252 to -253 (1996) [hereinafter 1995 ROLL CALL] (House Roll No. 870) (listing votes for the successful override of President Clinton's veto of the 1995 Reform Act), *with* CONGRESSIONAL QUARTERLY INC., CONGRESSIONAL ROLL CALL 1996, at H-54 to -55 (1997) [hereinafter 1996 ROLL CALL] (House Roll No. 162) (listing votes for unsuccessful override of President Clinton's veto of the Common Sense Product Liability Legal Reform Act of 1996). Fifteen Senators (12 Democrats and three Republicans), in like manner, took different sides in securities litigation than in tort litigation, when they voted to pass the 1995 Reform Act but against passage of the Common Sense Product Liability Legal Reform Act. *Compare* 1995 ROLL CALL, *supra*, at S-49 (Senate Vote No. 295) (listing votes in favor of the 1995 Reform Act), *with* 1996 ROLL CALL, *supra*, at S-10 (Senate Vote No. 44) (listing votes against the Common Sense Product Liability Legal Reform Act). One good example of this phenomenon is Senator Ron Wyden (D-Or.). Senator Wyden, after graduating from law school, began his political career by founding the Grey Panthers, a group dedicated to protecting social security and Medicare benefits for the elderly. *See* Russell Sadler, *Wyden and Smith/Senators Trade Politics for Statesmanship*, BULLETIN (Bend, Or.), Sept. 15, 1997, at A6. The Grey Panthers opposed the 1995 Reform Act and opposed the Uniform Standards Act. *See Gray Panthers Letter*, *supra* note 281. In 1995, however, then-Congressman Wyden (D-Or.) voted to override President Clinton's veto of the 1995 Reform Act. *See* 1995 ROLL CALL, *supra*, at H-252. Senator Wyden was also one of eight Democrats and seven Republicans that cosponsored the Gramm-Dodd bill. Senator Wyden, by contrast, opposed the Common Sense Product Liability Legal Reform Act of 1996. *See* 142 CONG. REC. S2590 (daily ed. Mar. 21, 1996) (recording Senator Wyden's "no" vote on the Conference Report on House Bill 956).

399 Between January 1991 and June 1996, approximately $3.9 billion was paid in settlements for 475 federal class action securities suits. *See* NERA 1996 STUDY, *supra* note 15, at ii. This represents "roughly 60% of all settlements, suggesting as much as $6.5 billion has been paid out overall. On average, plaintiffs' attorneys have received one-third of the settlement awards in each year." *Id.* These fees are substantial, but are dwarfed by the amount of money that lawyers can make in product liability litigation. Attorneys' fees in Texas's planned settlement with the tobacco industry alone could exceed $2 billion (15% of the total settlement). *See Texas Tobacco Settlement Questioned*, UPI, Jan. 21, 1998, *available in* LEXIS News Library, Wires File. The fees charged under Florida's retainer contract with its tobacco litigation attorneys were also astronomical. *See* Stephen Gillers, *Florida Backs Out on a Deal*, N.Y. TIMES, Oct. 10, 1997, at A23 ("Five of the 11 lawyers have demanded payment under the terms of the contract, which would amount to about $100 million *per lawyer*. That may sound like a lot for legal fees, but Florida should honor the contract." (emphasis added)).

400 Another example is Congress's passage of the Uniform Standards Act while two bills that would preempt state court mass tort litigation remain delayed in committee. *See supra* note 9 (discussing House Bill 3789 and Senate Bill 2083). This is particularly ironic given the fact that the arguments in favor of preemption are more compelling in tort

Finally, while academics and perhaps the SEC may be concerned with the eventual size and breadth of U.S. capital markets, entrepreneurs and politicians are concerned much more about developments likely to occur in the next few fiscal years or before the next election. Only a disaster such as the 1929 stock market crash likely would focus attention on the broader structural problems of U.S. capital markets, and even then, legislation would not necessarily respond to the underlying problems.[401]

Setting aside predictions about the future, it is obvious that Washington is not presently taking a pro-plaintiff stance in securities litigation. The 1995 Reform Act was controversial precisely because it significantly altered the legal landscape of securities class actions in favor of defendants.[402] It remains to be seen how the federal courts will interpret the 1995 Reform Act's pleading requirements[403] and its other critical provisions and whether these provisions will deny an unacceptably large number of persons with legitimate claims their day in court. If this occurs, Congress will need to amend the 1933 and 1934 Acts yet again to correct resulting imbalances, and until it can pass new national legislation (*if* it can pass new national legislation), state securities laws could provide an important remedy for these imbalances. Indeed, the 1995 Reforms Act's legislative history contains at least some discussion concerning the availability of state law remedies as a safety net in the event that the 1995 Reform Act worked to preclude plaintiffs from federal court.[404]

b. *The Supreme Court's Scaling Back of Private Rights of Action*

In the judicial branch, twenty years of Supreme Court decisions cutting back on the federal private right of action for securities fraud preceded the 1995 Reform Act. These holdings are rooted in the Supreme Court's hostility, beginning in the mid-1970s, to an implied private right of action under section 10(b) of the 1934 Act—a right of action that Congress never expressly bestowed[405] and that has little

litigation, in which plaintiffs' lawyers have brought suits on behalf of nationwide classes in state court against defendants having minimal contacts with the forum state.

401 *See* Mahoney, *supra* note 158, at 1052-54 (arguing that Congress's objective in passing the 1933 Act was to curtail fraudulent conduct by promoters of new issues).

402 *See, e.g.*, sources cited *supra* note 179.

403 *See* sources cited *supra* notes 181-82.

404 *See Common Sense Legal Reform Act: Hearings Before the Subcomm. on Telecomm. and Fin. of the House Comm. on Commerce*, 104th Cong. 109-10 (1995) (colloquy between Rep. Christopher Cox and Prof. Daniel Fischel) (discussing how changing the federal law would create more options for plaintiffs who would have a choice of forum between federal and state court); *see also Oct. 21, 1997, House 1995 Reform Act Implementation Hearing*, *supra* note 14, at 82 (prepared statement of Leonard B. Simon) (discussing the aforementioned colloquy and additional debates during the consideration of the 1995 Reform Act).

405 Neither the 1934 Act's section 10(b) nor Rule 10b-5 promulgated thereunder, mention a private right of action. *See supra* note 47 (quoting the relevant text of section

support in the legislative history.[406] Ironically, one reason the 1934 Congress did not think to include this private right of action in the 1934 Act may have been because Congress specifically preserved state causes of action in section 28 of the Act.[407] As the Supreme Court stated in *Marine Bank v. Weaver*,[408] "[w]e are satisfied that Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud."[409] Thus, both Congress, by declining to create an express private right of action under section 10(b), and the Court, by interpreting the provision narrowly, made their decisions against the backdrop of section 28. Until passage of the Uniform Standards Act, section 28 gave states an unrestricted opportunity to correct for limitations imposed upon private lawsuits under federal law, and federal courts were well aware of this.

The Supreme Court's contraction of the private right of action under section 10(b) began with *Blue Chip Stamps v. Manor Drug Stores*,[410] which held that a plaintiff must be a person who actually bought or sold the security in question.[411] The Court pointed out

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10(b) and Rule 10b-5); *see also* Central Bank v. First Interstate Bank, 511 U.S. 164, 170-80 (1994) (discussing section 10(b) and Rule 10b-5). The *Central Bank* Court noted:

> In *Blue Chip Stamps*, we noted that it would be "anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action." Here, it would be just as anomalous to impute to Congress an intention in effect to expand the defendant class for 10b-5 actions. . . .

Id. at 180 (citations omitted) (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 736 (1975)). The *Blue Chip* Court had previously pointed out that: "When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn." *Blue Chip*, 421 U.S. at 737.

406 *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976) (finding that "the extensive legislative history of the 1934 Act is bereft of any explicit explanation of Congress' intent" with respect to a private right of action under section 10(b)); Milton V. Freeman, *Administrative Procedures*, 22 BUS. LAW. 891, 922 (1967) (asserting that the SEC, in drafting Rule 10b-5, never contemplated that the Rule would be used in private lawsuits); David S. Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U. L. REV. 627, 685 (1963) ("Congress did not intend to create an implied right of action for violation of a Rule promulgated under Section 10(b). . . ."); Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 432 n.209 (1990) (quoting Ruder, *supra*).

407 *See supra* notes 120-24.

408 455 U.S. 551 (1982) (holding that a privately negotiated arrangement promising a share of a borrower's profits in return for a loan guarantee was not a security for purposes of 1934 Act section 10(b)).

409 *Id.* at 556.

410 421 U.S. 723 (1975).

411 *See id.* at 749-55. *Blue Chip* adopted the rule set forth in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir,. 1952), that a person who is neither a purchaser nor a seller of securities may not bring an action under 1934 Act section 10(b) or Rule 10b-5. *See id.* The *Blue Chip* Court recognized that:

> A great majority of the many commentators on the issue before us have taken the view that the *Birnbaum* limitation on the plaintiff class in a Rule

that plaintiffs who refrain from buying or selling a security because of fraudulent conduct can pursue state law remedies preserved under section 28.[412] Two years later, in *Santa Fe Industries v. Green*,[413] the Court held that section 10(b) does not encompass suits for breach of fiduciary duty.[414] Once again, the Court emphasized that adequate remedies for breach of fiduciary duty existed under state law.[415] Finally, in the 1991 case of *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*,[416] the Supreme Court held that federal courts hearing cases brought under section 10(b) cannot borrow statutes of limitations from analogous state laws in the relevant jurisdiction.[417] The Court instead applied a limitations period borrowed from express private rights of action elsewhere in the federal securities laws: one year from the date the plaintiff discovered the alleged fraud and, regardless of that date, three years from the date of the fraud itself.[418] The Court thus ruled that fraud occurring more than three years before the plaintiff discovered it cannot be the basis for suits under section 10(b). However, the Court made this seemingly harsh decision knowing that plaintiffs could still resort to private rights of action under the typically longer state statutes of limitations.

Other cases interpreting section 10(b) have not specifically referred to state law remedies but nonetheless have chosen narrower

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> 10b-5 action for damages is an arbitrary restriction which unreasonably prevents some deserving plaintiffs from recovering damages which have in fact been caused by violations of Rule 10b-5.

Id. at 738.

412 The Court responded to criticisms of the *Birnbaum* rule by pointing out that:

> Obviously this disadvantage is attenuated to the extent that remedies are available to nonpurchasers and nonsellers under state law. Thus, for example, in *Birnbaum* itself, while the plaintiffs found themselves without federal remedies, the conduct alleged as the gravamen of the federal complaint later provided the basis for recovery in a cause of action based on state law. And in the immediate case, respondent has filed a state-court class action held in abeyance pending the outcome of this suit.

Id. at 738 n.9.

413 430 U.S. 462 (1977).

414 *See id.* at 477-80.

415 *See id.* at 478 ("Of course, the existence of a particular state-law remedy is not dispositive of the question whether Congress meant to provide a similar federal remedy, but . . . we conclude that 'it is entirely appropriate in this instance to relegate respondent and others in his situation to whatever remedy is created by state law.'" (quoting Cort v. Ash, 422 U.S. 66, 84 (1975))).

416 501 U.S. 350 (1991).

417 *See id.* at 361-62.

418 *See id.* at 364. The Court applied this holding retroactively to require dismissal of plaintiffs' suits that were believed to be timely before the decision. In 1991 Congress responded by amending the 1934 Act to reinstate these claims that *Lampf* had barred. *See* Securities Exchange Act of 1934 §27A, 15 U.S.C. § 78aa-1 (1994). In 1995 the Supreme Court then responded by holding in *Plaut v. Spendthrift Farm, Inc.*, 514 U.S. 211 (1995), that "[s]ection 27A(b) is unconstitutional to the extent that it requires federal courts to reopen final judgments entered before its enactment." *Id.* at 240.

remedies than those that exist under state law. In *Ernst & Ernst v. Hochfelder*,[419] the Court held that a plaintiff asserting a cause of action under section 10(b) must show that the defendant acted with scienter.[420] Additionally, in the 1994 case of *Central Bank v. First Interstate Bank*,[421] the Supreme Court refused to allow private suits against aiders and abettors of securities fraud under section 10(b).[422] Therefore, a plaintiff cannot name as defendants in federal suits, accountants, lawyers, and other collateral participants in a securities offering, unless the plaintiff can establish that they were in fact primary participants in the alleged fraud, as opposed to aiders and abettors—an ambiguous distinction at best.[423] In circumstances in which plaintiffs would have difficulty showing that a collateral participant was in fact a primary participant, *Central Bank* substantially reduces the settlement value of a securities class action brought under the 1934 Act.[424]

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419 425 U.S. 185 (1976).

420 *See id.* at 193. The courts of appeals uniformly have held that a showing of recklessness suffices to meet this scienter requirement, although there is some uncertainty as to whether the 1995 Reform Act now precludes a plaintiff from pleading mere recklessness. *See supra* notes 181-82 and accompanying text.

421 511 U.S. 164 (1994).

422 *See id.* at 176-77.

423 *See, e.g, In re* Software Toolworks Inc. Sec. Litig., 50 F.3d 615, 628 n.3 (9th Cir. 1994) (discussing evidence that an accounting firm "played a significant role in drafting and editing" issuer's misleading letters to the SEC and how this evidence supported a claim of primary liability); SEC v. United States Envtl., Inc., 897 F. Supp. 117, 119 (S.D.N.Y. 1995) (holding that conspiring to violate the Securities Acts is not a valid theory of liability after *Central Bank*); *In re* Kendall Square Research Corp. Sec. Litig., 868 F. Supp. 26, 28 (D. Mass. 1994) (finding that accountant's "review and approval" of quarterly reports did not constitute primary liability); Vosgerichian v. Commodore Int'l, 862 F. Supp. 1371, 1378 (E.D. Pa. 1994) (asserting that plaintiff's allegation that a defendant accounting firm "advised" and "guided" a client issuer in making fraudulent misrepresentations did not state a claim for primary liability).

Several law review articles have focused on the confusing case law that has emerged in this area since *Central Bank*. *See generally* Robert A. Prentice, *Locating that "Indistinct" and "Virtually Nonexistent" Line Between Primary and Secondary Liability Under Section 10(b)*, 75 N.C. L. REV. 691 (1997) (arguing that *Central Bank* should not significantly affect professionals' liability in securities fraud cases and that collateral participants should be held liable); Ameena Y. Majid, *Diminishing the Expected Impact of* Central Bank of Denver v. First Interstate Bank of Denver: *Secondary Liability Masquerading as Primary Liability Under Section 10(b)*, 28 LOY. U. CHI. L.J. 551 (1997) (examining federal court interpretations of *Central Bank*); Broady R. Hodder, Central Bank v. First Interstate Bank *and Its Aftermath: Securities Professionals' Ever-Changing Liabilities*, 39 ARIZ. L. REV. 343 (1997) (discussing *Central Bank*'s effect on claims against secondary parties); Manning Gilbert Warren III, *The Primary Liability of Securities Lawyers*, 50 SMU L. REV. 383 (1996) (concluding that attorneys whose behavior deviates from applicable standards for preparing documents are primary violators of Rule 10b-5); David J. Baum, Comment, *The Aftermath of* Central Bank of Denver: *Private Aiding and Abetting Liability Under Section 10(b) and Rule 10b-5*, 44 AM. U. L. REV. 1817 (1995) (analyzing the changes to compensation for injured private investors and the accountability of secondary participants in fraud cases as established by *Central Bank*).

424 *See* NERA 1996 STUDY, *supra* note 15, at iii-iv, 24-25, tbl.20. This study explains that "[i]nclusion of accounting firms as codefendant adds over 70 percent to the expected settlement value of a shareholder class action for the period January 1991 to June 1996.

By refusing to analogize the 1934 Act to causes of action for fraud against aiders and abettors that exist at common law, the *Central Bank* Court's narrow interpretation of section 10(b) also rejected overwhelming precedent in the courts of appeals.[425] Although many state securities fraud statutes permit actions against aiders and abettors,[426] *Central Bank* reaffirms that federal courts must interpret federal securities laws with a view to the text of the federal statute, not to common law fraud.[427] Plaintiffs in search of common law remedies for securities fraud or the remedies afforded by state statutes must sue under state law.

The Court also has scaled back on private rights of action under provisions of the federal securities statutes other than section 10(b). For example, in *Piper v. Chris-Craft Industries*,[428] the Court held that a tender offeror does not have a private right of action against a competing offeror for fraudulent or deceptive practices under section 14(e) of the 1934 Act.[429] The Court referred to its prior decision in *Cort v. Ash*,[430] which held that one factor in determining whether Congress intended to create a private cause of action is whether "the cause

This finding is again consistent with the notion that available assets, especially insurance, are a major factor in explaining settlement amounts." *Id.* at iii-iv. The 1995 Reform Act's proportionate liability provisions, *see* Private Securities Litigation Reform Act of 1995 § 201, 15 U.S.C. §§ 77k(f), 78u-4(g) (Supp. II 1996), may have led to a decrease in this "advisor effect" for cases settled in early 1996. *See* 1996 NERA STUDY, *supra* note 15, at 26.

425 As the Court explained:

> Aiding and abetting is an ancient criminal law doctrine. . . .
>
> The Restatement of Torts, under a concert of action principle, accepts a doctrine with rough similarity to criminal aiding and abetting. An actor is liable for harm resulting to a third person from the tortious conduct of another "if he . . . knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other . . . ."
>
> The doctrine has been at hest uncertain in application, however. . . .
>
> More to the point, Congress has not enacted a general civil aiding and abetting statute—either for suits by the Government (when the Government sues for civil penalties or injunctive relief) or for suits by private parties. Thus, when Congress enacts a statute under which a person may sue and recover damages from a private defendant for the defendant's violation of some statutory norm, there is no general presumption that the plaintiff may also sue aiders and abettors.

Central Bank, 511 U.S. at 181-82 (citations omitted) (quoting RESTATEMENT (SECOND) OF TORTS § 876(b) (1977)).

426 *See supra* note 370 and accompanying text.

427 *See Central Bank*, 511 U.S. at 182; *see also* Montana-Dakota Utils. Co. v. Northwestern Publ. Serv. Co., 341 U.S. 246, 250 (1951) ("If [Petitioner's] cause of action arises from fraud and deceit, it is a common-law action of which a federal court has no jurisdiction . . . .").

428 430 U.S. I (1977).

429 *See id.* at 41-42. *See also* Schreiber v. Burlington Northern, Inc., 472 U.S. 1 (1985) (holding that misrepresentation or nondisclosure is a necessary element of a violation of § 14(e) of the 1934 Act).

430 422 U.S. 66 (1975). The Court in *Cort* noted that "[c]orporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with

of action [is] one traditionally relegated to state law."[431] In *Virginia Bankshares, Inc. v. Sandberg*,[432] the Court held that minority shareholders cannot sue for a misleading proxy statement under section 14(a) of the 1934 Act if their vote was not needed to consummate the underlying transaction.[433] In *Gustafson v. Alloyd Co.*,[434] the Court surprised most of the securities bar by holding that the express private right of action in section 12(a)(2) of the 1933 Act only extends to securities sold in public offerings.[435] Lower federal courts, taking the signal from the Supreme Court, also have narrowly construed even the express private rights of action in the federal securities laws.[436]

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respect to stockholders, state law will govern the internal affairs of the corporation." *Id.* at 84.

431 *Id.* at 78, *quoted in Piper*, 430 U.S. at 40. The Court impliedly has abrogated much of *Cort*'s holding. In *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979), the Court noted that when assessing whether a statute implies a private remedy even though it does not expressly provide for one, the four factors it used in *Cort* do not end the inquiry. *See id.* at 575. Instead, the "central inquiry remains whether Congress intended to create, either expressly or by implication, a private cause of action." *Id.* *Cort* simply lays out some factors that can help discern congressional intent. *See id.* at 575-76; *see also* Asch v. Philips, Appel & Walden, Inc., 867 F.2d 776, 777 (2d Cir. 1989) ("Since *Cort*, the Supreme Court has focused upon congressional intent and stated that *Cort*'s first three factors elucidate that intent.").

432 501 U.S. 1083 (1991).

433 *See id.* at 1107-08. The *Virginia Bankshares* Court expressed discomfort with the implied private right of action under 1934 Act section 14(a) for misleading proxy statements that *J.I. Case Co. v. Borak* had created, *see* 377 U.S. 426, 431 (1964), and observed that:

> *Borak's* probe of the congressional mind, however, never focused squarely on private rights of action, as distinct from the substantive objects of the legislation, and one Member of the *Borak* Court later characterized the "implication" of the private right of action as resting modestly on the Act's "exclusively procedural provision affording access to a federal forum."

Virginia Bankshares, 501 U.S. at 1103 (quoting Bivens v. Six Unknown Fed. Narcotics Agents, 403 U.S. 388, 403 n.4 (1971) (Harlan, J., concurring in judgment)); *see also Virginia Bankshares*, 501 U.S. at 1110 (Scalia, J., concurring in part and concurring in the judgment) ("[T]he federal cause of action at issue here was never enacted by Congress and hence the more narrow we make it (within the bounds of rationality) the more faithful we are to our task." (citation omitted)). Although Professor Louis Loss agreed with the result in *Borak*, even he criticized the Court which, as he puts it, "reached the right result not for the wrong reason but for no reason at all." LOUIS LOSS, 5 SECURITIES REGULATION 2882 (2d ed. Supp. 1969). Congress's neglect of express private rights of action in much of the 1934 Act thus did not deter the relatively liberal Court of the 1960's from implying a private right of action. However, the Court's logic was vulnerable to criticism and eventually to attack by the more conservative Court of the 1980's and 1990's.

434 513 U.S. 561 (1995).

435 *See id.* at 584 (construing the term "prospectus" in section 12(a)(2) to be a "term of art referring to a document that describes a public offering of securities by an issuer or controlling shareholder").

436 *See, e.g.*, Versyss Inc. v. Coopers & Lybrand, 982 F.2d 653 (1st Cir. 1992) (narrowly construing section 11 of the 1933 Act while making specific reference to broader remedies possibly available under state law). In *Versyss*, Continental Telecom, Inc. ("Contel") acquired Northern Data Systems, Inc. ("NDS") in a merger and then sued NDS's accountants and others under section 11, alleging that Contel had agreed to the terms of the merger on the basis of misleading statements in a registration statement filed eleven months earlier for a public offering of NDS stock. *See id.* at 654-55. In holding that Contel received

Regardless of whether these decisions reflect genuine concern over substantive notions of federalism or merely a desire to reduce the amount of litigation in federal courts,[437] courts have rendered these decisions against a backdrop in which Congress expressly preserved state statutory and common law remedies for securities fraud. By now preempting state causes of action, the Uniform Standards Act leaves investors with substantially less protection than they might have had if the Congresses of 1933 and 1934, and the courts since then, had known that the federal law would become the sole remedy for securities fraud.

c. *Proposals To Scale Back Private Rights of Action Even Further*

Furthermore, some proponents of litigation reform believe that the courts have not done enough to cut back on private rights of action, and accordingly have asked the SEC to use its authority under section 10(b) to reduce the scope of the implied private right of action under Rule 10b-5. Before passage of the 1995 Reform Act, Professor Grundfest urged the SEC to use its powers to abolish (or "disimply") critical elements of the implied private right of action under section 10(b) that the courts had created. Ironically, he explicitly mentioned state private rights of action as a limit on the SEC's power to reduce private remedies for securities fraud:

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the assets and liabilities of NDS in the merger and did not receive "securities" within the meaning of section 11, the First Circuit specifically mentioned state remedies for securities fraud:

> As the Supreme Court has reminded us, the federal securities laws were not designed to provide "a broad federal remedy for all fraud," let alone for all negligence. If Coopers & Lybrand has been careless in certifying the registration statement and Contel relied on that statement in setting the terms of the merger, then state law might or might not provide a remedy, depending on how the state court approached issues of negligence, foreseeability, and standing. Section 11, by contrast, is remarkably stringent where it applies, readily imposing liability on ancillary parties to the registration statement (like accountants) for the benefit even of purchasers after the original offering. Its very stringency suggests that, whatever the usual rule about construing remedial securities legislation broadly . . . , some care should be taken before section 11 is extended beyond its normal reading.

Id. at 657 (quoting Marine Bank v. Weaver, 455 U.S. 551, 556 (1982)).

[437] *See* Alison Grey Anderson, *The Meaning of Federalism: Interpreting the Securities Exchange Act of 1934*, 70 VA. L. REV. 813 (1984). According to Anderson:

> [A]lthough the Supreme Court, as well as other courts and commentators, has appeared to rely in part on substantive notions of federalism in deciding whether to imply private rights of action under the securities laws, it has not in fact provided any coherent view of the appropriate relationship between federal and state law. Instead, courts and commentators frequently use the language of federalism to justify decisions based on unarticulated policy choices or a general political preference for less federal regulation and adjudication.

Id. at 814.

> Although the Commission's authority to disimply may be substantial, it cannot be used to rework the entire securities law landscape. As described below, state law, express federal remedies, and limits on the scope of the Section 10(b) delegation itself, place material limitations on the changes that can be wrought through administrative disimplication. . . .
>
> As an initial matter, whatever decision the Commission may reach regarding disimplication under Rule 10b-5, the federal securities laws specifically provide for concurrent state regulation. Commission rulemaking therefore cannot affect the remedies available to private parties under state "blue sky" laws, state common law, or other state statutory regimes. However, none of the securities litigation reforms now pending before Congress would preempt state causes of action, and no amendment to the federal securities laws since their enactment in 1933 has limited the states' authority to regulate securities transactions. Thus, although Congress certainly has the power to oust state regulation from the field, that power has not been exercised, and Congress has given no indication that it intends to exercise it.[438]

Three years after publishing this observation, Professor Grundfest helped draft legislation that would have preempted *all* state private rights of action for securities fraud had Congress passed it instead of the more narrowly drafted Uniform Standards Act.[439]

So far, the SEC has not taken Professor Grundfest's disimplication suggestion. Nonetheless, the SEC is under substantial political pressure to lighten the impact of the securities laws on issuers.[440] The 1933 Act registration and prospectus delivery requirements are riddled with new exceptions,[441] some of which have increased the oppor-

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438 Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 963, 1008-09 (1994) [hereinafter Grundfest, *Commission's Authority*]; *see also* Grundfest, *supra* note 368, at 744 (responding to Seligman's critique of Grundfest's previous article, *see supra*, Grundfest notes "[t]he Second Circuit . . . called for guidance from Congress or the Commission, implying that the SEC might make a more detailed attempt at rule making than [it did with] Rule 10b-5 . . . [—this] is precisely what disimplication is all about").

439 *See supra* note 2. The Uniform Standards Act instead only preempts class actions. Professor Grundfest also assisted Representative Bliley with preparation of a thoroughly researched and well footnoted speech stating that unintentional conduct is not sufficient for liability under section 10(b). *See supra* note 323. This speech appears in the Congressional Record immediately following the Statement of Managers for the Uniform Standards Act. *See supra* note 323.

440 *See* Michael Schroeder, *Guess Who's Gunning for the SEC*, BUS. WK., Aug. 14, 1995, at 40 (describing congressional attacks on the SEC).

441 These exceptions include the 1990 exemption for offshore offerings under Regulation S, *see* 17 C.F.R. § 230.901-.904 (1998); the 1992 "testing the waters" exception to Regulation A's prohibition on offers to sell securities before an offering statement is filed, *see* 17 C.F.R. § 230.254(d); the 1997 amendment of Rule 144 to shorten the holding period before resale of restricted securities, *see* 17 C.F.R. § 230.144(d); the allowance of an institutional market in unregistered securities that has developed since 1990 under Rule 144A, *see*

tunity for fraud.[442] The SEC has now made proposals to ease further the burden of the 1933 Act's registration requirements.[443] If the SEC later turns to the 1934 Act and decides to narrow the private right of action under Rule 10b-5, or some later Congress chooses to eliminate the section 10(b) private right of action altogether, state securities fraud statutes would be the only correcting mechanism available to address potentially massive Type II error in the federal system.

C. Federalism Concerns

Congress has shown a strong commitment to federalism in a wide range of areas, including abolition of unfunded mandates[444] and welfare reform.[445] Meanwhile, in areas in which either the President or

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17 C.F.R. § 230.144A, and the SEC's abandonment in 1992 of solicitation restrictions under Rule 504 of Regulation D, *see* 17 C.F.R. §§ 230.502(c), 230.504.

442 *See How to Avoid Fraud*, AM. BANKER-BOND BUYER, July 1, 1996, at 1, *available in* LEXIS, News Library, American Banker-Bond Buyer Newsletters File ("Moreover, the instances of fraud and alleged fraud have recently increased as structures developed for large, established issuers have, in some cases, been misapplied to smaller less experienced issuers, particularly in private and Rule 144A transactions."); Jaye Scholl, *Easy Money: How Foreign Investors Profit at the Expense of Americans. An Invitation to Scamsters?*, BARRON'S, Apr. 29, 1996, at 31, 31 ("Reg. S created a shady source of cash for hundreds of questionable companies. It also allowed company insiders to sell their shares without informing the public, and it gave rise to a trove of opportunities for scamsters."); Michael Schroeder, *Despite Reforms, Penny-Stock Fraud Is Roaring Back*, WALL ST. J., Sept. 4, 1997, at A12 (reporting use of Rule 504 exemption under Regulation D by a promoter, who has been charged three times in the past two years with civil and criminal fraud, to sell unregistered stock in a failing company to more than 200 investors in 26 states).

443 *See* SEC Releases 33-7606 and 34-40,632 (Oct. 15, 1998) (setting forth a package of proposed rules, commonly dubbed the "aircraft carrier" proposal, that would modernize the regulatory system for securities offerings and waive, for some issuers, mandatory prospectus delivery requirements); *see also Report of the Task Force on Disclosure Simplification* (last modified Mar. 5, 1996) <http://www.sec.gov/news/studies/smpl.htm> [hereinafter *Task Force Report*]. The SEC appointed this Task Force under the leadership of Philip Howard, a New York lawyer whom SEC Chairman Arthur Levitt described as "an outspoken advocate of regulatory common sense." Letter of Arthur Levitt (Mar. 5, 1996), *available in Task Force Report, supra*. The SEC made the Task Force Report public in March 1996, three months after passage of the 1995 Reform Act, and the SEC has implemented some of the Task Force's recommendations. *See* Phase One Recommendations of Task Force on Disclosure Simplification, Exchange Act Release Nos. 33-7271 & 34-36,922, 61 Fed. Reg. 9848 (1996) (proposing elimination and simplification of various 1933 and 1934 Act rules); Phase One Recommendations of Task Force on Disclosure Simpliciation, Exchange Act Release Nos. 33-7300 & 34-37,262, 61 Fed. Reg. 30,397, 30,397 (1996) (eliminating various rules and forms deemed "no longer necessary or appropriate"); Phase Two Recommendations of Task Force on Disclosure Simplification, Exchange Act Release Nos. 33-7301 & 34-37,263, 61 Fed. Reg. 30,405 (1996) (proposing elimination of two forms and one rule).

444 *See* Unfunded Mandates Reform Act of 1995, Pub. L. No. 104-4, 109 Stat. 48 (1995) (codified in scattered sections of 2 U.S.C.) (prohibiting new unfunded mandates from Congress to the states).

445 *See* Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub. L. No. 104-193, 110 Stat. 2105 (1996) (codified as amended in scattered sections of 8 U.S.C. and 42 U.S.C.); *see also* Hon. Terry E. Branstad, *Balancing the Budget: What Washington Can Learn from the States*, HERITAGE FOUNDATION REPORTS 4 (1997) ("In just a little over two years, this Republican Congress has shifted the discussion in Washington, D.C., toward

Congress has sought to expand the reach of federal power, the other almost always has successfully resisted the initiative. For example, President Clinton's proposal to restructure the nation's health care system through federal legislation[446] was a colossal political failure. In contradistinction, when Congress departed from federalist principles in 1996 and passed a bill seeking to curtail product liability lawsuits under state law, supporters of the legislation were unable to garner enough votes to override President Clinton's veto.[447] In his veto message, the President specifically referred to federalism concerns raised by preempting state law.[448] Thus, both the President and Congress have cited federalism successfully in recent years as a powerful rationale for refusing to enact federal legislation that interferes with local autonomy. Texas Governor George W. Bush summed up this rationale quite well in his popular campaign slogan: "Let Texans run Texas."[449]

The Supreme Court also has moved toward favoring state and local autonomy, although often on narrow grounds. The Court recently struck down a portion of the Brady gun control law that required local

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a balanced budget—something what [sic] was a rarity during the years of Democrat control. Furthermore, a debate over federalism and returning power to the states was unheard of in the past.").

446 *See* Health Security Act, S. 1757, 103d Cong. (1993); H.R. 3600, 103d Cong. (1993).

447 *See* Common Sense Product Liability Legal Reform Act of 1996, H.R. 956, 104th Cong. (1996). This Act would have limited punitive damage claims in most product liability cases to $250,000 or two times the compensatory damages, whichever is larger. *See id.* § 108. For a discussion of the President's veto and Congress's unsuccessful attempt to override the veto, *see supra* notes 9 and 398. For commentary on the various other 1995 and 1996 tort reform bills that would have preempted state law, see Betsy J. Grey, *Make Congress Speak Clearly: Federal Preemption of State Tort Remedies*, 77 B.U. L. REV. 559, 588-603 (1997); Linda S. Mullenix, *Mass Tort Litigation and the Dilemma of Federalization*, 44 DEPAUL L. REV. 755, 763-79 (1995). Limited federalization of tort litigation was accomplished with the General Aviation Revitalization Act, 49 U.S.C. § 40101 (1994) (restricting lawsuits involving airplanes used in general aviation).

448 The President stated:

> This bill inappropriately intrudes on State authority, and does so in a way that tilts the legal playing field against consumers. While some Federal action in this area is proper because no one State can alleviate nationwide problems in the tort system, the States should have, as they always have had, primary responsibility for tort law. The States traditionally have handled this job well, serving as laboratories for new ideas and making needed reforms. This bill unduly interferes with that process in products cases; moreover, it does so in a way that peculiarly disadvantages consumers. As a rule, this bill displaces State law only when that law is more favorable to consumers; it defers to State law when that law is more helpful to manufacturers and sellers. I cannot accept, absent compelling reasons, such a one-way street of federalism.

Message to the House of Representatives Returning Without Approval Product Liability Legislation, PUB. PAPERS 681 (May 2, 1996) (William J. Clinton).

449 Margaret Kriz, *Feuding With the Feds*, 29 NAT'L J. 1598, 1601 (1997) ("Nothing said it better than Texas Gov. George W. Bush's popular campaign slogan: Let Texans run Texas.").

authorities to make background checks on gun purchasers,[450] unanimously upheld a state's right to regulate physician assisted suicide,[451] allowed states to confine violent sex offenders in mental institutions following completion of their sentences,[452] and struck down an act of Congress that forbade state and local governments from interfering with religious observances.[453] Although the Court will probably not strike down the Uniform Standards Act, some critics have raised constitutional objections.[454]

An account of the jurisprudential merits and demerits of federalism in areas other than securities fraud litigation is beyond the scope of this Article. However, aside from the political posturing that surrounds many discussions of federalism, normative values underlie the deep appeal that federalist arguments have for courts, legislators, and voters. In their treatise on federal jurisdiction, Hart and Wechsler observed that:

> Federal law is generally interstitial in its nature. . . . Federal legislation, on the whole, has been conceived and drafted on an *ad hoc* basis to accomplish limited objectives. It builds upon legal relationships established by the states, altering or supplanting them only so far as necessary for the special purpose. Congress acts, in short, against the background of the total *corpus juris* of the states in much the way that a state legislature acts against the background of the common law. . . .[455]

The history of the enactment and subsequent judicial interpretation of the federal securities laws illustrates this point profoundly.[456] Furthermore, to the extent that California issuers' hostility to lawsuits

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450 *See* Printz v. United States, 117 S. Ct. 2365, 2383-84 (1997).

451 *See* Washington v. Glucksberg, 117 S. Ct. 2258, 2275 (1997).

452 *See* Kansas v. Hendricks, 117 S. Ct. 2073, 2086 (1997).

453 *See* City of Boerne v. Flores, 117 S. Ct. 2157, 2172 (1997).

454 Professor Manning Warren wrote an intriguing paper exploring the constitutionality of preempting state causes of action for securities fraud. *See* Manning Warren, Congressional Disregard of Corporate Misconduct Through Preemption and the Necessity for Constitutional Restraint (unpublished manuscript, on file with author). Professor Warren observed that a majority of the Supreme Court has "focused not on preemption under the supremacy clause, but rather, on the limitations federalism imposes on Congressional power under the Commerce Clause." *Id.* at [3]. Professor Warren further argued that "predominant federalism postulates should foreclose . . . intrusion into investors' remedies in tort traditionally afforded by the states." *Id.* Finally, Professor Warren proposed "supplementation of the traditional 'rational basis' scope of review of commerce power legislation with a 'strict scrutiny' review where federal legislation, like the uniform standards legislation, seeks to veto or significantly abrogate regulation in areas of traditional state concern." *Id.* Because the federal courts have yet to apply such a strict scrutiny test for preemption, at this point it appears unlikely that legislation preempting state securities fraud causes of action will be declared unconstitutional. For this reason, the subject is not explored further in this Article.

455 PAUL M. BATOR ET AL., HART AND WECHSLER'S, THE FEDERAL COURTS AND THE FEDERAL SYSTEM 470-471 (2d ed. 1973).

456 *See supra* Part II.B and Part V.B.2(b).

brought by California lawyers under California law motivated the Uniform Standards Act—as testimony before the House and Senate Subcommittees amply illustrates[457]—Congress has gone to great lengths to take sides in a political dispute among Californians. Although class action litigation on behalf of state and local governments and pension funds can still be brought under California law, the debate in California over Propositions 201 and 211, and the California Supreme Court's impending decisions in *Diamond Multimedia* and *StorMedia*, are of substantially less importance than before.[458] Sweeping federal preemption of state law has thus eroded representative democracy and civic republicanism[459] by devaluing debate among Californians concerning problems created by California state law.

VI
HOW SHOULD CONGRESS HAVE PREEMPTED STATE SECURITIES LITIGATION?

A. Tailored Preemption

The foregoing discussion suggests that Congress should have preempted state securities fraud causes of action, if at all, far more narrowly than it did in the Uniform Standards Act. Most of the problems that a dual-forum class action framework presents are surmountable, and the drastic step that Congress took by mandating sweeping preemption under the Uniform Standards Act was simply unnecessary.

More appropriately, Congress should have addressed the rare circumstance in which a small number of in-state investors sue an out-of-state issuer.[460] Take, for example, an issuer incorporated in Delaware, headquartered in California, and which sells only a small fraction of its securities in Oregon. A private cause of action in Oregon would only benefit the relatively small number of shareholders allowed to sue in Oregon's courts, and even then, only to the extent that Oregon

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457 *See July 24, 1997, Senate Uniform Standards Act Hearing, supra* note 13, at III (witness list) (revealing that of the six witnesses called to testify, three out of the four testifying in support of preemption were from California); *Oct. 21, 1997, House 1995 Reform Act Implementation Hearing, supra* note 14, at III (witness list) (revealing that of the five witnesses called to testify, both of the two testifying in support of preemption—Michael A. Perino, Stanford University School of Law, and Bruce G. Vanyo, Wilson, Sonsini, Goodrich and Rosati—were from California).

458 *See supra* Part III.B.

459 *See* S. Candice Hoke, *Preemption Pathologies and Civic Republican Values*, 71 B.U. L. Rev. 685 (1991). As Hoke observes:

> Civic republicanism, at its core, emphasizes individuals' direct voice and participation in political processes. The normative good in civic republican theory rests in an active community of citizens debating issues and forming solutions to problems. Preemption of state and local law severs the connection between citizens and their value choices.

Id. at 690 n.18.

460 *See supra* text accompanying notes 389-92.

law provides substantially more relief than federal law.[461] Indeed, the economics of class action litigation usually would dictate against suing in Oregon in such circumstances, and plaintiffs' lawyers in fact filed very few such suits even prior to the Uniform Standards Act.[462] Furthermore, in the rare case in which plaintiffs' lawyers would try to use the Oregon forum to extract a quick settlement of a meritless suit, the Oregon cause of action would be costly to issuers and investors alike. Because in such a case the Oregon cause of action would combine relatively little legitimate purpose with a high potential for mischief, federal preemption of this type of suit may be justified. If Oregon, or some other state, decided to allow plaintiffs to form nationwide classes in its courts in suits against out-of-state issuers, plaintiffs certainly would find a state securities fraud cause of action more useful than if the state only allowed class actions by in-state investors. However, the potential for abuse would increase correspondingly, particularly if the forum has little incentive to treat the issuer fairly.[463]

Therefore, Congress should have considered preempting state securities class actions in a narrow range of circumstances. For example, Congress could have preempted class actions in states where *none* of the following three connections exists: (1) The issuer is incorporated in the state; (2) The issuer has its principal place of business or more than fifty percent of its operations in the state; and (3) Twenty percent or more of the securities purchased or sold by the issuer or other named defendants during the class period were purchased or sold within the state. Alternatively, Congress could have provided that shareholders who file a class action suit against an issuer having none of the above three connections with the state in which they file also may not sue that issuer in a federal cause of action arising out of the same transaction or occurrence, and further, must be excluded from

461 For example, it is easier to sue collateral participants such as lawyers and accountants under Oregon law than under federal law. *Compare* Prince v. Brydon, 764 P.2d 1370, 1371-72 (Or. 1988) (holding that a lawyer who assisted an issuer by drafting legal documentation materially participates in the security offering and can be liable under Oregon law unless he establishes lack of knowledge as an affirmative defense), *with* Pinter v. Dahl, 486 U.S. 622 (1988) (finding no support in 1933 Act's section 12(1) for imposition of primary liability on persons who do not pass title to a security, offer the security for sale, or solicit offers to buy the security).

462 *See supra* text accompanying notes 378, 392 (observing that plaintiffs file very few class actions in jurisdictions where the defendant issuer is neither incorporated nor has a principal place of business). Indeed, the Oregon plaintiffs would probably be better off joining other plaintiffs in federal court. Such a combined class would be large enough in number to prosecute the litigation fully, because litigation expenses would be spread over a larger class.

463 The Due Process Clause and the Full Faith and Credit Clause of the Constitution would probably impede formation of nationwide classes in cases in which the defendant has minimum contacts with the forum state. *See supra* note 224 (discussing *Phillips Petroleum v. Shutts*, 472 U.S. 797 (1985)).

any class that brings such a federal cause of action against that issuer. Unlike preempting state law, employing such an election of remedies as an instrument for discouraging undesirable state suits preserves state causes of action for those circumstances in which investors would truly benefit from them.

If studies could show that state securities litigation undermined the federal safe harbor for forward-looking statements (an argument often made but hardly proven in the hearings preceding the Uniform Standards Act),[464] Congress could have preempted substantive state law that conflicts with the safe harbor. Narrowly crafted measures thus could have provided that a forward-looking statement that complies with the federal safe harbor would not be grounds for civil liability in any suit under state law. This approach would have done far more to establish the federal safe harbor as a national standard than does the Uniform Standards Act, which leaves state law standards entirely intact for suits not falling within the definition of a "class action" or filed by exempt state and local governments and pension funds.[465]

At least some California courts have prevented plaintiffs from using state suits to circumvent the 1995 Reform Act's discovery stay.[466] Nonetheless, Congress was probably right to enact the provision of the Uniform Standards Act that gives federal courts authority to stay discovery in state proceedings to protect their jurisdiction in a federal case.[467] This provision, standing alone, addresses one of the most compelling arguments against the dual-forum class action litigation framework.

Most importantly, Congress should have postponed enacting *any* legislation preempting state securities fraud causes of action until it knew more about how the 1995 Reform Act altered the securities litigation landscape. First, Congress enacted the Uniform Standards Act without knowing whether a significant number of suits had migrated from federal to state courts after the 1995 Reform Act.[468] The data presented on this point were inconclusive.[469]

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464 *See supra* Part IV.B.

465 An unsatisfactory alternative would be for Congress to preempt all state causes of action. Congressman Campbell actually proposed this option in House Bill 1653. *See supra* notes 270-71 and accompanying text.

466 *See supra* text accompanying notes 193-200.

467 *But cf.* text accompanying *supra* notes 340-41 (suggesting that federal courts may have been able to protect their jurisdiction in securities class actions under the All Writs Act and the Anti-Injunction Act).

468 *See supra* text accompanying notes 230-44.

469 Although Stanford's Class Action Clearinghouse has kept detailed records only of post–1995 Reform Act litigation in state court, "[t]he Grundfest-Perino Study *speculated* that these figures represented an increase in state court filings, based on anecdotal reports that securities class action litigation was rarely filed in state court prior to the [1995] Reform Act." Perino, *supra* note 14, at 303 (emphasis added).

Second, Congress's underlying concern was presumably frivolous state court suits that a federal court would have dismissed, not legitimate claims for securities fraud that plaintiffs choose to bring in state court. If frivolous state suits were indeed Congress's concern, the question of whether suits filed in state court have less merit than suits filed in federal court should have been of primary importance. Professor Perino has observed that "[s]tate court litigation is associated with a lower frequency of allegations of misrepresentations or omissions in financial statements and with smaller price drops around the end of the class period,"[470] and has argued that "[t]hese data are consistent with the hypothesis that plaintiffs are filing 'weaker' cases in state court."[471] However, plaintiffs who allege misrepresentations or omissions outside of financial statements are not necessarily asserting frivolous claims, regardless of their possible preference for state courts.[472] Furthermore, although a correlation may exist between small price drops toward the end of a class period and meritless claims, small price drops also may correlate with meritorious claims involving relatively small damages, and it also may make economic sense to file these claims in state court. Data on judgment and settlement amounts as a percentage of damages claimed in post–1995 Reform Act state court suits would provide a more reliable indicator of whether such suits were frivolous—though such data would only be meaningful if compared to similar data for pre–1995 Reform Act state court suits and post–1995 Reform Act federal court suits.[473] Congress did not undertake such an evaluation of the merits of state court litigation.

Third, Congress should have waited to learn how state and federal judges would respond to plaintiffs' use of parallel state court litigation to circumvent the procedural strictures of the 1995 Reform

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470 *Id.* at 278. However, with respect to the incidence of pleading fraud in financial statements "[t]he Grundfest-Perino Study did not analyze complaints against companies sued in state court proceedings." *Id.* at 304. The SEC Staff Report, however, did find that complaints filed solely in state court allege irregularities with financial reports less frequently than federal complaints. *See id.* at 304 & n.144 (citing *Staff Report, supra* note 179, at 73-74).

471 *Id.* at 278.

472 As Professor Perino observes:

> A number of pre-Reform Act [federal] cases found a strong inference of fraud when the complaint alleged either some sort of misrepresentation or omission in the issuer's financial statements, or unusual or suspicious trading by officers or directors while the fraud was alive in the market. All things being equal, it is reasonable to expect that cases with these kinds of facts are more likely to be filed in federal court after the [1995] Reform Act and that plaintiffs might have increased incentives to pursue state court litigation in cases without these facts.

Id. at 295 (footnote omitted).

473 *See supra* note 368 (discussing similar studies comparing judgments and settlements as a percentage of claimed damages).

Act. Will state courts allow plaintiffs to obtain discovery that is unobtainable in federal court? Alternatively, state courts may choose to stay discovery while parallel litigation is pending in federal court, or federal courts may enjoin state court litigation directed at obtaining discovery for use in a pending federal action (even prior to the Uniform Standards Act, the All Writs Act arguably authorized such an injunction in aid of a federal court's jurisdiction[474]). Thus, at the time Congress rushed to pass the Uniform Standards Act, important procedural developments at the federal and state levels had not yet been discerned.

Fourth, Congress should have watched for substantive law developments at the state level. The plaintiffs' bar had proposed ballot initiatives and other measures to accommodate plaintiffs under state law, but without success.[475] Moreover, the three states that have significantly changed their securities fraud statutes since passage of the 1995 Reform Act have followed the decidedly pro-defendant direction of the federal system.[476] Would these trends have continued, or would the plaintiffs' bar have succeeded in steering state laws toward the race to the bottom that preemption proponents feared? Congress should have waited to find out.

Fifth, Congress did not know whether state courts or legislatures will allow plaintiffs' lawyers to bring nationwide classes of plaintiffs into state court and under what circumstances. If one or more states do permit nationwide classes, then class action litigation in state court could become far more profitable than it is today.[477] On the other hand, issuers sued in such actions presumably would have substantial operations in the state in question, making it unlikely that the state's political process would tolerate a judicial system allowing plaintiffs to extract value from these issuers through frivolous litigation.

None of these factors is alone determinative of whether preemption of state law is appropriate, nor of how far preemption should go. Rather, certain combinations of factors could cause state securities fraud litigation to take an unproductive turn that benefits lawyers at the expense of both issuers and investors. Alternatively, state law actions could reduce Type II error, and with it the incidence of fraud, by providing a useful supplement to federal rights of action. Before Congress set out to fix the dual-forum litigation framework, it should have identified exactly what, if anything, was wrong with it.

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474 *See supra* notes 340-41 and accompanying text.

475 *See, e.g., supra* notes 205-10 and accompanying text (discussing plaintiffs' bar attempt to pass Proposition 211).

476 *See supra* text accompanying note 388.

477 Nationwide classes in state court presumably are still a viable option for suits brought by state and local governments, and their pension funds, which are exempted from the Uniform Standards Act.

Finally, the Uniform Standards Act could foreclose alternatives that Congress may want to consider in the future: further restricting, or "disimplying,"[478] the federal private right of action for securities fraud under section 10(b) of the 1934 Act; devoting federal resources that would otherwise be spent on litigation to increase the enforcement budget of the SEC; and allowing most securities fraud litigation to be carried out in state courts under state law.[479] An analysis of these proposals involves a set of issues entirely different from those raised in this Article[480] and depends upon both the effectiveness of state law remedies for securities fraud and the ability of the SEC to deter fraud without plaintiffs acting as private attorneys general in the federal forum. Nonetheless, such a bifurcation of federal and state responsibilities might make sense for several reasons. For example, as discussed previously, state fiduciary duty claims and securities claims are often not easy to distinguish.[481] Furthermore, federal courts are not necessarily better equipped than state courts to hear securities fraud claims, and the law created by Congress and the federal courts is not necessarily preferable.

By abolishing most state law class actions, and thereby forcing almost all securities litigation to federal court, Congress has eroded the valuable network externalities that have developed around state law causes of action.[482] Stunting the growth of state securities law will make it difficult, if not impossible, for state courts to take over if Congress decides to abolish implied causes of action in the federal system. Congress should not have foreclosed its future options by preempting state law and turning securities fraud class actions over to the exclusive jurisdiction of the federal courts.

B. Preempting Settlement of Federal Claims in State Court

Because the vast majority, approximately eighty percent, of shareholder class actions settle,[483] the manner in which they are settled is

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478 *See* Grundfest, *Commission's Authority*, *supra* note 438.

479 *See* Romano, *supra* note 358, at 2361 (suggesting that mandatory federal securities regulation be replaced with competing state law regimes and that competitive federalism would be as viable an alternative in securities regulation as it is in corporate law).

480 Whether replacing federal causes of action with state causes of action would provide a net benefit depends in part upon whether the states would provide sufficiently strong private rights of action to assure the optimal level of deterrence of securities fraud. Part V.B.1 of this Article asked whether state law would be biased in favor of plaintiffs. The converse question, whether the states would be biased in favor of defendants, must be asked, and answered in the negative, before Congress should consider abolishing federal private rights of action.

481 *See supra* text accompanying notes 347-52.

482 *See supra* text accompanying notes 347-58.

483 In NERA's sample of 998 shareholder class actions that were dismissed, settled, or resolved by a jury verdict from January 1991 to June 1996, 80% were resolved through settlement. *See* NERA 1996 STUDY, *supra* note 15, at ii. This study further noted that

probably more important to capital markets than the manner in which they are litigated. Furthermore, related federal and state causes of action, whether filed in the same or in separate courts,[484] often go through the settlement process together. Thus, two issues are relevant to evaluating the effects of the dual-forum class action framework on settlements. First, is the unified settlement of federal and state claims in a single forum desirable? Second, what impact, if any, will preemption of state securities class actions have on existing mechanisms for settling state corporate law claims and federal securities claims together in a single forum?

1. Matsushita *and Unified Settlements*

In 1996, the United States Supreme Court expedited the settlement process by holding, in *Matsushita Electric Industrial Co. v. Epstein*,[485] that federal courts must extend full faith and credit to state court settlements, including settlements that affect securities law claims over which the federal courts have exclusive jurisdiction.[486] As Chairman Levitt noted, *Matsushita* "allow[s] defendants to obtain a global settlement in state court, [and it thereby] made state court class actions more advantageous for plaintiffs."[487] The holding thus arguably creates strategic incentives for plaintiffs to file parallel claims in state and federal court to obtain advantages in settlement.[488] *Matsushita*, however, also makes state court class actions advantageous for defendants who can settle state fiduciary duty and federal securities claims together in state court.

In *Matsushita*, the plaintiffs were former shareholders of MCA, Inc. who surrendered their stock to Matsushita in a tender offer.[489] In a suit brought in California Federal District Court, the plaintiffs alleged that Matsushita's offer violated 1934 Act Rule 14d-10[490]—a claim over which federal courts have exclusive jurisdiction. The federal district court awarded summary judgment to the defendants, and the plaintiffs appealed to the Ninth Circuit.[491] Meanwhile, the plain-

"[e]ven cases that were dismissed, reached trial or received a jury verdict often settled before an appeal was resolved." *Id.*

484 The federal court may hear the state claims by way of supplemental jurisdiction. *See* 28 U.S.C. § 1441(c) (1994).

485 516 U.S. 367 (1996).

486 *See id.* at 386-87. For an excellent discussion and critique of the *Matsushita* holding, see Marcel Kahan & Linda Silberman, Matsushita *and Beyond: The Role of State Courts in Class Actions Involving Exclusive Federal Claims*, 1996 SUP. CT. REV. 219.

487 *Oct. 21, 1997, House 1995 Reform Act Implementation Hearing, supra* note 14, at 24 (prepared statement of Arthur Levitt, Chairman, SEC).

488 *See* GRUNDFEST & PERINO, *supra* note 14, at 4.

489 *See Matsushita*, 516 U.S. at 369-70.

490 *See id.* at 370.

491 *See id.*

tiffs filed a separate class action against MCA and its directors in the Delaware Court of Chancery alleging breach of fiduciary duty under state law for failing to maximize shareholder value and wasting corporate assets.[492] The plaintiffs later added Matsushita as a defendant in the Delaware action on the grounds that it had conspired with MCA's directors to violate their fiduciary duties to shareholders.[493] Perhaps most important to the present analysis, the plaintiffs based their Delaware action solely on fiduciary duty claims, and that action contained no claims under state securities law.

While the federal suit was on appeal to the Ninth Circuit, the parties settled the Delaware suit on terms that included a release of the federal securities claims by all persons who had not opted out of the Delaware plaintiff class.[494] The Ninth Circuit refused to give full faith and credit to the Delaware settlement, in part because section 27 of the 1934 Act gives federal courts exclusive jurisdiction over 1934 Act claims.[495] The Supreme Court reversed the Ninth Circuit's decision. The Court held that the 1934 Act's grant of exclusive jurisdiction did not create an exception to the general rule that state court judgments, including judgments that preclude further litigation of federal claims, are entitled to full faith and credit under the Full Faith and Credit Act.[496] Although the Delaware complaint did not contain state securities law claims, Justice Thomas, writing for the majority, observed that the 1934 Congress had left state causes of action for securities transactions intact. He went on to explain that this parallel framework of federal-state litigation, preserved in section 28(a) of the 1934 Act, provided support for the Court's interpretation of section 27:

> Furthermore, other provisions of the Exchange Act suggest that Congress did not intend to create an exception to [the Full Faith and Credit Act] for suits alleging violations of the Act. *Congress plainly contemplated the possibility of dual litigation in state and federal courts relating to securities transactions.*[497]

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492 *See id.*

493 *See id.*

494 *See id.* at 370-71.

495 *See id.* at 386. For a brief discussion of the criticism surrounding the 1934 Act's exclusive jurisdiction provision, see *supra* note 121.

496 *See Matshushita*, 516 U.S. at 380-86. The Full Faith and Credit Act provides:

> Such Acts, records and judicial proceedings [of any State court] or copies thereof, so authenticated, shall have the same full faith and credit in every court within the United States and its Territories and Possessions as they have by law or usage in the courts of such State, Territory or Possession from which they are taken.

28 U.S.C. § 1738(c) (1994).

497 *Matsushita*, 516 U.S. at 383 (emphasis added) (citing 15 U.S.C § 77bb(a) which preserves "all other rights and remedies that may exist at law or in equity").

Having concluded that the Full Faith and Credit Act applies to state court settlements of 1934 Act claims, the Supreme Court remanded the case to the Ninth Circuit for a determination as to whether the class members had received constitutionally adequate representation from Delaware class counsel.[498]

After a detailed scrutiny of the settlement negotiations, the Ninth Circuit on remand recognized that adequate representation would be extremely difficult when no common issues of fact exist between the state fiduciary duty claims and the federal securities claims.[499] The Supreme Court's ruling notwithstanding, the Ninth Circuit insisted it had properly rejected the settlement:

> The Supreme Court accepted Matsushita's statement of the question presented even though that statement mischaracterized our holding. We did not withhold full faith and credit "simply" because the Delaware judgment released exclusively federal claims. Rather, we withheld full faith and credit because the great disparity between the state and federal claims—there were no overlapping issues of fact whatsoever—meant that a judgment based upon an adjudication of the state claims could have no issue preclusive effect on the federal claims.[500]

The Ninth Circuit recognized on remand that the lack of common issues of fact between the federal and state claims also could affect the Delaware class counsel's ability to properly represent the Delaware plaintiff class. The Delaware class counsel's lack of knowledge about the federal claims had handicapped negotiations with Matsushita from the very beginning: "[I]ndeed, the Delaware plaintiffs probably were unable to conduct any discovery on the federal claims because the facts relevant to those claims had no apparent relevance to the subject matter of the state law claim that the MCA directors had breached their fiduciary duties."[501] This dearth of knowledge not only made the overall negotiations difficult but also rendered the federal claims relatively worthless as a bargaining chip in state court. Thus, absent common issues of fact underlying the state and federal

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498 *See id.* at 386-87.

499 *See* Epstein v. MCA, Inc., 126 F.3d 1235, 1238 n.4, 1249-50 (9th Cir. 1997).

500 *Id.* at 1238 n.4 (citation omitted).

501 *See id.* at 1249 (emphasis omitted). Although plaintiffs' Delaware counsel assured class members that they had conducted an extensive investigation of the federal claims, the Ninth Circuit did not believe this claim:

> It is hard to imagine what Delaware counsel meant by an "extensive investigation," since the record shows no discovery at all on the facts underlying the federal claims. Indeed, this lack of discovery is hardly surprising. . . . Delaware counsel were probably disabled from developing the federal claims through traditional discovery, since discovery in state court was limited to matters relevant to the subject matter of the state claims—that the MCA directors had violated their fiduciary duty. . . .

Id. at 1251-52.

claims, it is difficult to imagine how plaintiffs' counsel could have provided, with respect to the federal claims, the thorough investigation and aggressive negotiation that was required for their representation of the class to be adequate.

The Supreme Court's holding in *Matsushita* thus legitimatized a process for settling federal and state claims in a single forum—state court. Nonetheless, this process is vulnerable to abuse,[502] as recognized by the Ninth Circuit's holding on remand that Delaware class counsel had inadequately represented the plaintiff class with respect to the federal claims.[503] Federal securities claims rarely touch on the same issues as state fiduciary duty claims, although they do share many of the same issues as state securities law claims. When a plaintiff class files only fiduciary duty claims in state court, class counsel's discovery opportunities and negotiating leverage with respect to the federal securities claims rarely will be adequate. In sum, there are several reasons to believe that the unified settlement of federal and state claims within state court is very problematic for the class members who may not be adequately represented, as well as for the lawyers who represent them.

2. *The Uniform Standards Act's Impact on Unified Settlements*

The Uniform Standards Act could exacerbate the problem of inadequate settlements of federal securities claims in state courts.[504] First, because plaintiffs cannot file preempted securities law claims in state court, state courts will rarely have an opportunity to review issues in a case remotely similar to those raised by the federal securities law claims that parties can propose to settle as part of state court proceedings. Although Justice Thomas observed in *Matsushita* that "Congress plainly contemplated" dual litigation of securities claims in state and federal courts,[505] after the Uniform Standards Act, class action litigation of securities claims in state court will be rare. Courts contemplating *Matsushita*-style settlements will almost always confront the

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502 *See* Coffee, *Class Actions*, *supra* note 52, at 5 (discussing a strategy whereby class action defendants encourage a different group of plaintiffs' attorneys to file an overlapping class action in a second jurisdiction and then cheaply dispose of all of the pending claims through a global settlement in the second jurisdiction).

503 *See Epstein*, 126 F.3d at 1255.

504 *Matsushita* type state court claims probably would not be preempted even if they allege misrepresentations of material fact in connection with a securities transaction. The "Delaware carve out" in the Uniform Standards Act applies to any litigation that "involves" a recommendation, position, or other communication by the issuer to its equity shareholders. *See supra* note 314 and accompanying text (discussing and quoting the carve-out provision). Suits brought against third persons who aid and abet a misrepresentation by the issuer, as well as suits against the issuer itself, would thus presumably be saved by the carve out. *See* Coffee, *State Securities Preemption*, *supra* note 52, at 7.

505 *Matshushita*, 516 U.S. at 383.

situation that led the Ninth Circuit to reject the *Matsushita* settlement on remand: a state court proceeding in which the plaintiffs only allege corporate law claims, but within which the parties intend to settle federal securities claims as well. Second, the effectiveness of the settlement mechanism approved of in *Matsushita* depends upon the general knowledge and appreciation state court judges have of securities law (in addition to corporate fiduciary duty law). Preemption of state securities fraud class actions will make state courts even more ill-equipped to evaluate the settlement value of federal claims for misrepresentation in connection with the purchase or sale of securities.[506]

The Uniform Standards Act could, and perhaps should, have prohibited *Matsushita*-type settlements. At a minimum, Congress should have addressed the fact that the *Matsushita* holding, as it now stands, makes it more difficult for federal courts to block state court settlements in which plaintiffs' counsel collude with defendants in order to appropriate the value of federal securities claims from the federal plaintiff class.[507] The Supreme Court's decision could allow plaintiffs' lawyers with no real interest in the federal claims of the class members, and who have obtained no discovery with respect to such claims, to trade in those claims in a binding settlement in state court. This possibility is indeed a glaring loophole in the dual-forum litigation framework and one that the Uniform Standards Act ignores. Entirely apart from the preemption issue, Congress should either bar federal securities law claims filed in federal court from being settled in parallel state court proceedings, or at the very least, make it clear that federal judges should carefully review such settlements for adequate representation of the parties concerned.

Conclusion

Congress should not have passed the Uniform Standards Act until it knew more about critical developments that would have determined whether preemption was truly necessary. Furthermore, having decided to preempt state law, Congress should have considered the precise method of preemption more carefully. Before eradicating state private rights of action that have existed for almost a century, Congress should have known, and simply did not know: (1) whether the 1995 Reform Act had in fact caused a significant number of suits to migrate from federal to state courts; (2) whether these state suits had less merit than suits filed in federal court; (3) whether state courts will allow plaintiffs to use parallel state court litigation to circumvent

506 Conversely, settlements along the lines contemplated in *Matsushita* would be more effective if Congress allowed state courts to hear 1934 Act claims by repealing its grant of exclusive jurisdiction over 1934 Act claims to the federal courts.

507 *See* Coffee, *Class Actions*, *supra* note 52, at 5.

limitations on discovery in federal court; (4) whether federal courts will temporarily enjoin state suits that unduly interfere with the federal stay on discovery; (5) whether pro-plaintiff ballot initiatives and other initiatives would succeed, or whether most states would continue the trend of conforming state law to the pro-defendant changes that have been made to federal law; and (6) whether state courts or legislatures will endorse efforts to create nationwide classes of plaintiffs in state court, and if so, whether the defendants in these suits will be required to have significant contacts with the state in question. Finally, Congress should have addressed one problem that thus far it has completely ignored: inadequate disposition of federal securities claims in settlements of corporate law claims in state court.

The federal securities laws that Congress enacted in 1933 and 1934, and amended in 1995, were part of a framework that included state private rights of action. The federal courts have interpreted the federal securities laws knowing, and sometimes specifically relying on the fact, that state law provided alternative remedies for fraud. Defrauded investors have been told that if they found federal procedural or substantive rules unfavorable, they can turn to state court. Absent pervasive abuses of state causes of action that the states refuse to remedy themselves, Congress should not have foreclosed this well-established source of relief by changing the rules of the game.

Appendix A

The Price Waterhouse Study

In January 1998 Price Waterhouse L.L.P. released a quantitative study of federal and state securities litigation ("Price Waterhouse Study"). This study showed "little to no change" in the average combined number of federal and state class action suits filed after the 1995 Reform Act and only a small increase in state court suits in 1996 followed by a decline in 1997.[508]

Table A1
Filing Trends of Securities Class Action Lawsuits

Year filed	Federal cases	State cases	Federal & state cases
Pre–1995 Reform Act			
1991	156	46	202
1992	194	31	225
1993	154	47	201
1994	219	67	286
1995	164	52	216
Post–1995 Reform Act			
1996	112	66	178
1997	171	44	215

Source: Price Waterhouse L.L.P., Price Waterhouse Securities Litigation Study (1998).

Price Waterhouse later revised this study in a letter, dated February 20, 1998, to Senator D'Amato ("February 20 Letter").[509] Senator Phil Graham distributed the February 20 Letter to witnesses at the February 23, 1998 hearing before the Senate's Subcommittee on Securities shortly after the author of this Article recited statistics from the Price Waterhouse Study in his testimony.[510] The February 20 Letter sought to recast the data used in the Price Waterhouse Study to show a more significant increase in state court securities litigation after the 1995 Reform Act. Price Waterhouse accomplished this revision by focusing on two specific categories of state court suits: (1) cases filed in tandem in both state and federal court ("parallel filings"); and (2) cases filed only in state court in which the plaintiffs

508 Price Waterhouse Study, *supra* note 32, at 1.

509 *See* Price Waterhouse Letter, *supra* note 296.

510 *See supra* note 296 and accompanying text.

raised claims equivalent to those that they could have brought in federal court ("state-federal equivalent claims").[511]

TABLE A2
THE EFFECT OF PARALLEL FILINGS AND STATE-FED EQUIVALENT CLAIMS ON ANALYSIS OF SECURITIES CLASS ACTION LAWSUITS

Year filed	Parallel filings	State-Fed equivalent claims	Total
PRE-1995 REFORM ACT			
1991	3	13	16
1992	4	8	12
1993	5	12	17
1994	6	15	21
1995	5	7	12
POST-1995 REFORM ACT			
1996	46	25	71
1997	22	17	39

SOURCE: Letter from Daniel V. Dooley, Partner, Price Waterhouse L.L.P. to Senator Alphonse [sic] M. D'Amato (Feb. 20, 1998) (on file with author).

State court suits not falling into one of these two categories presumably contained primarily fiduciary duty claims. Therefore, Price Waterhouse reasoned that they should not be counted as state securities suits for purposes of evaluating whether claims filed only in federal court before the 1995 Reform Act were now being filed in state court.

The discrepancy between the totals reported in the Price Waterhouse Study and in the February 20 Letter can be attributed to two factors. First, the February 20 Letter explained that the data used for the Price Waterhouse Study, compiled by Securities Class Action Alert ("SCAA"), counted only the number of defendants sued, and thus did not "report on parallel filings."[512] Thus, the Price Waterhouse Study could have counted a small number of parallel filings as federal cases.[513] If so, the number of state filings reported in

511 *See* Price Waterhouse Letter, *supra* note 296. Parallel filings are only a portion of the state court filings that proponents of preemption legislation claim plaintiffs filed to avoid the strictures of the 1995 Reform Act. Proponents of preemption also premise their arguments on statistical data purportedly showing that plaintiffs filed, in state court, claims that the 1995 Reform Act made difficult to litigate in federal court (the "substitution effect"). *See* GRUNDFEST & PERINO, *supra* note 14, at ii, 3. These apparently come under Price Waterhouse's definition of "state-fed equivalent" claims.

512 Price Waterhouse Letter, *supra* note 296 (emphasis omitted).

513 In many parallel filings (approximately 90%), the state suit is filed first. When the state suit is filed first the SCAA data bank accounts for it as a state filing. If, however, the

the Price Waterhouse Study could be too low for some years, although this apparently was the case only with the 1996 data. Second, and more significantly, the February 20 Letter suggested that the Price Waterhouse Study overreported the number of state cases in other years.[514] Cases filed *only* in state court should not have been counted as state securities cases unless they raised claims equivalent to claims that could have been brought in federal court. Otherwise, these state cases more closely resembled fiduciary duty claims under state corporate law.[515] Taking into account both factors, as shown in the above charts, the February 20 Letter showed an increase in the total number of state court class actions after 1995, whereas the Price Waterhouse Study did not.

However, the February 20 Letter did not address a number of suspicious characteristics of the data it used. In the Price Waterhouse Study, the overcounting of state cases (those that were neither parallel cases nor state-federal equivalent cases) disproportionately affected the years before the 1995 Reform Act. Most (about two-thirds on average) of the state cases reported in the Price Waterhouse Study from 1991 to 1995 were not included in the totals reported in the February 20 Letter, presumably because they were filed only in state court and principally contained fiduciary duty claims. The February 20 Letter, however, reported five *more* state cases in 1996 (seventy-one) than did the Price Waterhouse Study in the same year (sixty-six) and only five fewer for 1997 (thirty-nine as compared to forty-four). The February 20 Letter gave no explanation for why so many state fiduciary duty claims were accounted for as state suits in the Price Waterhouse Study in the years before the 1995 Reform Act and so few in the years afterwards. Additionally, the SCAA data, and consequently the Price Waterhouse Study, most likely only incorrectly counted as federal suits a small portion of parallel filings.[516] It is curious that 1996 (the year immediately following the 1995 Reform Act) is the only year for which this purported undercounting of state suits in the Price Waterhouse Study outweighed the purported overcounting of fiduciary duty suits as state suits, causing the total reported in the Price Waterhouse Study to be less than that reported in the February 20 Letter.[517]

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federal suit is filed first, the SCAA data bank accounts for the suit only as a federal filing. *See* Telephone Interview with James M. Newman, Publisher and Editor, SCAA (March 5, 1998).

514 *See* Price Waterhouse Letter, *supra* note 296.

515 *See id.* at exhibit A n.2.

516 *See supra* note 513 (explaining that a parallel filing is only counted by SCAA as a federal filing if the federal action is filed first, which only happens in 10% of the cases).

517 There is also incongruity between the 1996 parallel filings reported in the February 20 Letter and the 1996 filings reported by Professors Grundfest and Perino, who also use the SCAA data. *Compare* Perino, *supra* note 14, at 302 tbl.1 (reporting that 30 companies

Even accepting the statistics reported in the February 20 Letter at face value, Price Waterhouse does not make a particularly strong case that there was a significant and sustained increase in state court litigation following the 1995 Reform Act. Comparing the years 1994, 1996, and 1997,[518] it is clear that almost all of the significant increase is in "parallel filings" (six in 1994, forty-six in 1996, and twenty-two in 1997). These statistics appear to tell us that in 1996, immediately after Congress passed the 1995 Reform Act, plaintiffs rushed to file parallel cases in state court, but in 1997 some found that their "state court gambit" had failed.[519] By 1997 a substantial number of plaintiffs had abandoned parallel filings, causing the number to drop to less than half of its 1996 level. Whether this drop would have continued absent federal preemption would have depended, in part, on how the California Supreme Court defined the parameters of discovery in state actions when a parallel federal action is pending. In short, one would have to wait and see.

By contrast, the "state-federal equivalent" statistic (fifteen in 1994, twenty-five in 1996, and seventeen in 1997) essentially returned to 1994 levels by 1997. The so-called "substitution effect," whereby plaintiffs file in state court instead of federal court believing the state forum to be better, seems to have disappeared.

In summary, the February 20 Letter, prepared in haste to characterize the Price Waterhouse Study in a light more favorable for preemption proponents,[520] does not suggest a substantial and sustained increase in state court litigation after the 1995 Reform Act. The combined total number of parallel claims and state-federal equivalent claims was thirty-nine in 1997, making the number of state lawsuits in that year less than the number of state statutes that Congress preempted in 1998.[521]

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were sued in both federal and state court in 1996), *with* Price Waterhouse Letter, *supra* note 296 (reporting 46 parallel cases in 1996).

518 It is not helpful to use 1995 data in comparison to other years. In the year Congress passed the 1995 Reform Act, aberrations, including a rush by plaintiffs to file in federal court before the new law took effect, may have influenced both state and federal filings. Similar distortions have occurred in 1998 after it became clear that the Uniform Standards Act would become law.

519 *See* Feldman, *supra* note 259.

520 Perhaps indicative of the carelessness underlying many of the empirical arguments that have been made about state court litigation, the February 20 Letter, written on the letterhead of Price Waterhouse's New York City office, was addressed to "Senator Alphonse M. D'Amato." *See* Price Waterhouse Letter, *supra* note 296. This misspelling of the Committee Chairman's name is best attributed not to lack of knowledge, but to the haste with which Price Waterhouse prepared the February 20 Letter—Price Waterhouse prepared it on a Friday so it would be ready in time for the following Monday's hearing.

521 *See May 19, 1998, House Uniform Standards Act Hearings*, *supra* note 2, at 72 (statement of Richard W. Painter, Professor of Law) ("We are pre-empting the law in 50 States over 39 lawsuits. I don't think that's what federalism is all about. I don't think that's what the Contract with America was all about.").

APPENDIX B

SELECTED PROVISIONS OF THE UNIFORM STANDARDS ACT AS ENACTED ON NOVEMBER 3, 1998

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE

This Act may be cited as the "Securities Litigation Uniform Standards Act of 1998".

SECTION 2. FINDINGS

The Congress finds that–

(1) the Private Securities Litigation Reform Act of 1995 sought to prevent abuses in private securities fraud lawsuits;

(2) since enactment of that legislation, considerable evidence has been presented to Congress that a number of securities class action lawsuits have shifted from Federal to State courts;

(3) this shift has prevented that Act from fully achieving its objectives;

(4) State securities regulation is of continuing importance, together with Federal regulation of securities, to protect investors and promote strong financial markets; and

(5) in order to prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the Private Securities Litigation Reform Act of 1995, it is appropriate to enact national standards for securities class action lawsuits involving nationally traded securities, while preserving the appropriate enforcement powers of State securities regulators and not changing the current treatment of individual lawsuits.

TITLE I– SECURITIES LITIGATION UNIFORM STANDARDS

SECTION 101. LIMITATION ON REMEDIES

(a) *AMENDMENTS TO THE SECURITIES ACT OF 1933.–*

(1) Amendment.–Section 16 of the Securities Act of 1933 (15 U.S.C. 77p) is amended to read as follows:

"SEC. 16. ADDITIONAL REMEDIES; LIMITATION ON REMEDIES.

"(a) Remedies Additional.–Except as provided in subsection (b), the rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity.

"(b) Class Action Limitations.–No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging–

"(1) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or

"(2) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

"(c) Removal of Covered Class Actions.–Any covered class action brought in any State court involving a covered security, as set forth in subsection (b), shall be removable to the Federal district court for the district in which the action is pending, and shall be subject to subsection (b).

"(d) Preservation of Certain Actions.–

"(1) Actions under state law of state of incorporation.–

"(A) Actions preserved.–Notwithstanding subsection (b) or (c), a covered class action described in subparagraph (B) of this paragraph that is based upon the statutory or common law of the State in which the issuer is incorporated (in the case of a corporation) or organized (in the case of any other entity) may be maintained in a State or Federal court by a private party.

"(B) Permissible actions.–A covered class action is described in this subparagraph if it involves–

"(i) the purchase or sale of securities by the issuer or an affiliate of the issuer exclusively from or to holders of equity securities of the issuer; or

"(ii) any recommendation, position, or other communication with respect to the sale of securities of the issuer that–

"(I) is made by or on behalf of the issuer or an affiliate of the issuer to holders of equity securities of the issuer; and

"(II) concerns decisions of those equity holders with respect to voting their securities, acting in response to a tender or exchange offer, or exercising dissenters' or appraisal rights.

"(2) State actions.–

"(A) In general.–Notwithstanding any other provision of this section, nothing in this section may be construed to preclude a State or political subdivision thereof or a State pension plan from bringing an action involving a covered security on its own behalf, or as a member of a class comprised solely of other States, political subdivisions, or State pension plans that are named plaintiffs, and that have authorized participation, in such action.

"(B) State pension plan defined.–For purposes of this paragraph, the term 'State pension plan' means a pension plan established and maintained for its employees by the government of the State or political subdivision thereof, or by any agency or instrumentality thereof.

"(3) Actions under contractual agreements between issuers and indenture trustees.–Notwithstanding subsection (b) or (c), a covered class action that seeks to enforce a contractual agreement between an issuer and an indenture trustee may be maintained in a State or Federal court by a party to the agreement or a successor to such party.

"(4) Remand of removed actions.–In an action that has been removed from a State court pursuant to subsection (c), if the Federal court determines that the action may be maintained in State court pursuant to this subsection, the Federal court shall remand such action to such State court.

"(e) Preservation of State Jurisdiction.–The securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions.

"(f) Definitions.–For purposes of this section, the following definitions shall apply:

"(1) Affiliate of the issuer.–The term 'affiliate of the issuer' means a person that directly or indirectly, through one or more intermediaries, controls or is controlled by or is under common control with, the issuer.

"(2) Covered class action.–

"(A) In general.–The term 'covered class action' means–

"(i) any single lawsuit in which–

"(I) damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of individualized reliance on an alleged misstatement or omission, predominate over any questions affecting only individual persons or members; or

"(II) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated, and questions of law or fact common to those persons or members of the prospective class predominate over any questions affecting only individual persons or members; or

"(ii) any group of lawsuits filed in or pending in the same court and involving common questions of law or fact, in which–

"(I) damages are sought on behalf of more than 50 persons; and

"(II) the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose.

"(B) Exception for derivative actions.–Notwithstanding subparagraph (A), the term 'covered class action' does not include an exclusively derivative action brought by one or more shareholders on behalf of a corporation.

"(C) Counting of certain class members.–For purposes of this paragraph, a corporation, investment company, pension plan, partnership, or other entity, shall be treated as one person or prospective class member, but only if the entity is not established for the purpose of participating in the action.

"(D) Rule of construction.–Nothing in this paragraph shall be construed to affect the discretion of a State court in determining whether actions filed in such court should be joined, consolidated, or otherwise allowed to proceed as a single action.

"(3) Covered security.–The term 'covered security' means a security that satisfies the standards for a covered security specified in paragraph (1) or (2) of section 18(b) at the time during which it is alleged that the misrepresentation, omission, or manipulative or deceptive conduct occurred, except that such term shall not include any debt security that is exempt from registration under this title pursuant to rules issued by the Commission under section 4(2)."

(2) Circumvention of stay of discovery.–Section 27(b) of the Securities Act of 1933 (15 U.S.C. 77z-1(b)) is amended by inserting after paragraph (3) the following new paragraph:

"(4) Circumvention of stay of discovery.— Upon a proper showing, a court may stay discovery proceedings in any private action in a State court as necessary in aid of its jurisdiction, or to protect or effectuate its judgments, in an action subject to a stay of discovery pursuant to this subsection."

(3) Conforming amendments.–Section 22(a) of the Securities Act of 1933 (15 U.S.C. 77v(a)) is amended–

(A) by inserting "except as provided in section 16 with respect to covered class actions," after "Territorial courts,"; and

(B) by striking "No case" and inserting "Except as provided in section 16(c), no case".

(b) *Amendments to the Securities Exchange Act of 1934.*–

[This section substantially mirrors the amendments to the 1933 Act]