

Private Securities Litigation Reform Failure: How Scierter Has Prevented The Private Securities Litigation Reform Act of 1995 from Achieving Its Goals*

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I. INTRODUCTION

In passing the Private Securities Litigation Reform Act of 1995 (PSLRA or the Act) Congress attempted to further two goals: creating a uniform scienter requirement for private securities litigation and bringing about a reduction in the filing of frivolous securities lawsuits. A controversial circuit split over the meaning of the PSLRA’s scienter requirement has prevented the Act from achieving either of its goals.

Congressional intent to minimize abusive securities litigation practices is clear in both the Act’s legislative history and the probable effect of its main provisions (the “core provisions”). The core provisions have the clear purpose and the ability to reduce the filing of frivolous lawsuits by reducing plaintiff’s¹ bargaining leverage. The PSLRA could have furthered the stated congressional goal of discouraging the filing of meritless securities lawsuits by reducing the attractiveness of bringing private securities claims. However, the courts and commentators have mostly interpreted the PSLRA’s ambiguous scienter provision in a manner that undermines the dominant purpose of the Act.

In this Comment, “bargaining leverage” refers to a party’s ability to gain an advantageous settlement. The more bargaining leverage a party has, the better are the chances it will receive a favorable settlement. Thus, a plaintiff with superior bargaining power will presumably be able to attain a larger settlement. Conversely, a defendant with superior bargaining power will have the increased chances of arriving at a smaller settlement or avoiding settlement altogether. Numerous factors can influence a party’s bargaining leverage. For example, plaintiff’s bargaining leverage in a negligence action will improve significantly if she discovers that the

1. In the interest of simplicity, this article commonly refers to the parties of a class or derivative action as simply “plaintiff.”

defendant was intoxicated while operating a vehicle that collided with the plaintiff's car. Other types of information can also have substantial impact on the parties' respective bargaining positions, including changes in the applicable law, extra-legal ramifications,² and the amount of resources necessary to pursue litigation. This Comment depends largely on the assumption that there will be some positive correlation between the strength of a party's bargaining leverage and the quality of settlement she will be able to attain.

This Comment advocates a purposivist reading of the scienter requirement in private securities litigation. Section II.A of this comment provides an overview of securities litigation and the relevant laws, including the PSLRA. Section II.B illustrates how the core provisions of the PSLRA advantage defendants by comparing the core provisions of the Act to the law as it stood before the PSLRA and to other alternatives available to Congress. Section II.C describes the importance of purposivism in interpreting securities laws. Section II.C concludes that any reading of the ambiguous scienter requirement that favors securities litigation plaintiffs is inconsistent with the crux of the Act and the policy of federal securities laws. Section III.A describes the pre-PSLRA circuit split, whereas section III.B describes the post-PSLRA circuit split and describes why the Ninth Circuit's interpretation of scienter is the sole interpretation that is consistent with the crux of Act. Section IV concludes with a recommendation that the United States Supreme Court grant certiorari and adopt the Ninth Circuit's articulated scienter requirement should the issue present itself for appellate review.

II. THE CORE PROVISIONS OF THE PSLRA PLACE THE PLAINTIFF IN A DISADVANTAGEOUS POSITION

A. History

1. Overview of Securities Litigation

There are two distinct classes of securities litigation, public securities litigation and private securities litigation.³ Public securities litigation

2. Extra-legal ramifications for a corporation include injury to brand image that might result from litigation. In considering whether to settle or litigate, a corporation must weigh both the costs of settlement and potential brand injury against expected results at trial.

3. For a discussion of the history of the definition of "security" see Marc I. Steinberg & William E. Kaulbach, *The Supreme Court and the Definition of "Security"*:

comprises those suits prosecuted by the Securities and Exchange Commission (SEC) and the Department of Justice. Private securities litigation comprises those suits brought by investors. The SEC is the government agency responsible for regulating the sale of securities in both initial offerings and subsequent transactions.⁴ Due to limited resources, the SEC is unable to investigate and ultimately prosecute every possible case of fraud.⁵ Private securities litigation is a means to

The "Context" Clause, "Investment Contract" Analysis, and Their Ramifications, 40 VAND. L. REV. 489, 493–98 (1987); Theresa A. Gabaldon, *A Sense of a Security: An Empirical Study*, 25 J. CORP. L. 307, 309–10 & nn.14–15 (2000). See also William J. Carney, *Defining a Security: The Addition of a Market-Oriented Contextual Approach to Investment Contract Analysis*, 33 EMORY L.J. 311, 356 (1984) (arguing that the subject matter of one-on-one transactions should not be classified as a security because the Securities Acts' disclosure requirements are only applicable to instruments whose valuation is affected by economies of scale).

4. The U.S. Securities and Exchange Commission has the responsibility of administering and enforcing the federal securities laws. . . . The Commission enforces the federal securities laws by conducting investigations in large part through its regional and branch offices which may lead to criminal prosecutions, civil actions for injunctive relief, or to administrative proceedings to impose remedial sanctions on broker-dealers and investment advisers and to issue cease and desist orders.

HAROLD S. BLOOMENTHAL, *SECURITIES LAW HANDBOOK* § 1:1 (2003) [hereinafter *SECURITIES HANDBOOK*]. The SEC's regulatory and enforcement roles are supplemented by several other types of organizations. See *id.* at §§ 1:2–1:8. Self-regulatory organizations, including the NYSE and the National Association of Securities Dealers, possess self-regulatory responsibilities. *Id.* at § 1:2.

The rules of such self-regulatory authorities must provide for the disciplining of their members, and persons associated with their members, for violations of the rules of the exchange, and for violations of the Exchange Act and rules adopted thereunder. Such rules must provide a fair procedure for determining violations and imposing sanctions.

Id. The Comptroller of the Currency for national banks, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation regulate banks to the extent to which they are subject to securities laws. *Id.* at § 1:3. These regulatory bodies typically require the filing of periodic reports exhibiting compliance with securities laws. *Id.* Each of the fifty-three districts has some form of securities regulation laws, dating back to Kansas' enactment of the Blue Sky laws in 1911. *Id.* at § 1:5. The Securities Investor Protection Corporation protects investors against the risks associated with their broker-dealers becoming insolvent. *Id.* at § 1:7. The Public Accounting Oversight Board (PCAOB), created by the Sarbanes-Oxley Act, makes it illegal for any public accounting firm that is not registered with PCAOB to participate in part of the securities issuance process. *Id.* at § 1:8.

5. The SEC enforcement division employs only 935 individuals to prosecute fraudulent transactions. See 2003 SEC ANN. REP. 15, available at <http://www.sec.gov/about/annrep03.shtml> (last visited May 7, 2005). This small group of professionals is charged with enforcing rules violations on two of the world's largest exchanges. The New York Stock Exchange sees in excess of \$11,000,000,000,000 in transactions per fiscal year and the NASDAQ lists securities from well over 4000 companies. Nell Ingals & Laura Johnson, *Stocks and How They are Traded*, at <http://www.sls.lib.il.us/reference/workshop/business/stocks.html> (Nov. 18, 2002). It is clear that the SEC alone does not create a sufficient threat of prosecution to act as an effective deterrent.

supplement the SEC's limited enforcement resources, which the SEC advocates.⁶

Proponents of private securities litigation note that it is a valuable tool, essential to furthering the goal of directorial accountability.⁷ Private securities litigation offers a means for shareholders and their lawyers to monitor the behaviors of a corporate board in the interest of reducing agency costs.⁸ These justifications of private security litigation have done little to dispel the negative stereotypes associated with the attorneys who represent securities plaintiffs.⁹

Opponents of private securities litigation argue that excessive private securities litigation places unfair burdens on corporations, the typical defendants in private securities litigation.¹⁰ These burdens include the cost of defending against frequent prosecution and monitoring costs. Insuring against fraud by managers and employees imposes substantial agency costs on corporations.¹¹

6. Frank v. Cooper Indus., SEC Litigation Release No. 14356, 58 SEC Docket 807, 807 (Dec. 15, 1994) (“The [SEC] has consistently stressed the importance of . . . private rights of action . . .”).

Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs.

H.R. CONF. REP. NO. 104-369, at 31 (1995), reprinted in 1995 U.S.C.A.N. 730.

7. JEFFREY D. BAUMAN ET AL., CORPORATIONS LAW AND POLICY: MATERIALS AND PROBLEMS 904 (5th ed. 2003) (“[S]hareholder lawsuits constitute a very important . . . corporate accountability mechanism because they alone target specific instances of managerial misconduct and can be initiated without collective action by a corporation’s shareholders.”).

8. *Id.* at 904–10.

9. 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, 1007 (1996) (“The bar, as a whole, has an image today of the securities plaintiffs’ lawyer as both overzealous and self-regarding.”).

10. See H.R. CONF. REP. NO. 104-369, at 31–32 (implying that the state of private securities litigation prior to the passage of the PSLRA did not live up to the “high standard[s]” to which it should aspire). The commentary further notes “significant evidence of abuse in private securities lawsuits” and thus a need “to enact reforms to protect investors and maintain confidence in our capital markets.” *Id.* These abusive practices included “the targeting of deep pocket defendants . . . [and] the abuse of the discovery process to impose costs so burdensome that it is often [economically rational] for the [corporation] to settle.” *Id.*

11. See REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 21–31 (2004) (discussing the three most prominent agency costs in the corporate setting, including the innate conflict between shareholders and managers, and further discussing the most effective strategies for limiting agency costs).

Private securities litigation accounts for a substantial portion of securities litigation, as rational self-interested individuals pursue suits against corporations or boards of directors when they feel they have been the victims of fraud.¹² One result of allowing securities fraud suits to be brought by private parties is an environment where committing securities fraud is less attractive, as private party litigation greatly increases the number of individuals who have an incentive to bring suit. Thus, private securities litigation serves an important deterrent function by increasing the chances that corporate defendants will be subject to civil suit for engaging in fraudulent activities.

The Securities Exchange Act of 1934 (the Exchange Act) and the rules promulgated thereunder are among the laws under which the SEC operates. The Exchange Act was adopted during the Great Depression to “promote investor confidence in the United States securities markets and thereby to encourage the investment necessary for capital formation, economic growth, and job creation.”¹³ The Exchange Act protects investors from manipulated stock prices and imposes reporting requirements on publicly traded corporations.¹⁴

12. The SEC brings a relatively limited number of actions per year. For example, the SEC brought 271 and 270 civil injunctive actions in fiscal year 2003 and 2002, respectively. 2003 SEC ANN. REP., *supra* note 5, at 17. In these same years the SEC brought 365 and 281 additional administrative actions. *Id.* It should be noted that these numbers refer to prosecutions against both natural and artificial entities. It is very common for a single case of fraud to result in filing of actions against multiple individuals. *See, e.g.*, SEC v. Morris Weissman, SEC Litigation Release No. 17068, 75 SEC Docket 1288, 1288–1293 (July 18, 2001). This litigation release shows that several civil actions arose from a single fraudulent scheme: Civil Action No. 01 CV 6449 (JSR) (S.D.N.Y. July 18, 2001); SEC v. Am. Banknote Corp., Civil Action No. 01 CV 6450 (JSR) (S.D.N.Y. July 18, 2001); SEC v. Am. Bank Note Holographics, Inc., Civil Action No. 01 CV 6453 (JSR) (S.D.N.Y. July 18, 2001); SEC v. Richard Macchiarulo, Civil Action No. 01 CV 6454 (JSR) (S.D.N.Y. July 18, 2001); SEC v. Anotonio Accornero and Russell McGrane, Civil Action No. 01 CV 6452 (JSR) (S.D.N.Y. July 18, 2001); In the Matter of Am. Bank Note Holographics, Inc.; In the Matter of Mark Goldberg, CPA; In the Matter of John Lerlo. *Id.* In addition, the SEC brought three administrative proceedings in regard to the same fraudulent scheme: Administrative Proceeding File Nos. 3-10532, 3-10534, and 3-10533. *Id.*

13. S. REP. NO. 104-98, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683 (1995); H.R. CONF. REP. NO. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730 (“The overriding purpose of our Nation’s securities laws is to protect investors and to maintain confidence in the securities markets, so that our national savings, capital formation and investment may grow for the benefit of all Americans.”).

14. *Business Accounting and Foreign Trade Simplification Act: Joint Hearings on S. 414 Before the Subcomm. on Int’l Finance and Monetary Policy and the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 98th Cong., 1st Sess. 48, 52 (1983) (statement of John Shad, Chairman, SEC) (noting that the primary purpose of forced corporate disclosure is the protection of investors, not the prevention of bribery).

Section 10(b) of the Exchange Act makes it illegal to “employ . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe. . . .”¹⁵ Subsequently, the SEC promulgated Rule 10b-5 under section 10(b) of the Exchange Act. Rule 10b-5 provides that securities fraud occurs when it can be proven that the defendant (1) made a misstatement or omission,¹⁶ (2) of a material fact,¹⁷ (3) with scienter,¹⁸ (4) on which the plaintiff justifiably relied,¹⁹ (5) that proximately caused plaintiff’s injury.²⁰ The courts have found that Congress implicitly provided for a private cause of action under section 10(b) when passing the Exchange Act.²¹ Plaintiffs bringing this private cause of action must prove the same five elements as their government counterparts.

A plaintiff bringing a securities action is required to include particular factual allegations because the heightened pleading standard of Federal Rule of Civil Procedure (FRCP) 9(b)²² applies to securities fraud claims.²³ To state a claim under the default federal pleading system of

15. 15 U.S.C. § 78j(b) (Supp. 2000).

16. *In re Comshare, Inc.*, 183 F.3d 542, 548 (6th Cir. 1999).

17. *Id.*

18. *Id.* This is the most controversial element of a 10b-5 cause of action. See BLACK’S LAW DICTIONARY 1373 (8th ed. 2004) (defining scienter as “[a] degree of knowledge that makes a person legally responsible for the consequences of his or her act or omission; the fact of an act’s being done knowingly, esp. as a ground for civil damages A mental state consisting in an intent to deceive, manipulate, or defraud.”).

19. *Comshare*, 183 F.3d at 548. For an analysis of the role of reliance in securities litigations, see Gregory S. Meece, *Class Actions, Typicality, and Rule 10B-5: Will the Typical Representative Please Stand Up?*, 36 EMORY L.J. 649, 660–61 (1987).

20. *Comshare*, 183 F.3d at 548.

21. While other sections of the Securities Exchange Act, in proscribing the practices described therein, specifically make a civil cause of action available, § 10 does not expressly provide for a civil remedy. The question to be discussed at this point is whether, notwithstanding the absence in § 10 of a specific provision for a civil cause of action, such a cause of action exists in favor of a private person.

While the question has never been decided by the Supreme Court of the United States, the lower federal courts have unanimously held that a civil cause of action may be brought by a private person to enforce §10 (b) of the Securities Exchange Act
37 A.L.R. 2d 649, 650 (1954). The article goes on to state that courts unanimously rejected the *expressio unius est exclusio alterius* argument in favor of not making a private cause of action available. *Id.* at 651–52.

22. See FED. R. CIV. P. 9(b) (addressing pleading special matters).

23. FED. R. CIV. P. 9(b) (“In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity.”). Securities fraud claims constitute a substantial portion of private securities litigation, as the business judgment

notice pleading imposed by FRCP 8(a), the pleader need only state “a short and plain statement of the claim showing that the pleader is entitled to relief.”²⁴ Under notice pleading, motions for summary judgment rarely succeed, as the pleader can easily state a claim under the permissive standard.²⁵ Heightened pleading standards, which require that a claim be plead “with particularity,” are in opposition to the otherwise liberal federal system of notice pleading.²⁶ The application of a heightened pleading standard presents a challenge to the plaintiff and substantially reduces her bargaining leverage.²⁷

rule protects directors from liability for most business decisions. The business judgment rule is a rebuttable presumption that protects disinterested corporate decisions made on an informed basis and in good faith, provided they are made in the corporation’s best interest. BLACK’S LAW DICTIONARY 212 (8th ed. 2004). If not for the business judgment rule, private securities litigation would increase dramatically, because shareholders would be able to sue the corporation for poor business decisions. The exception to the business judgment rule is that it is not applicable to decisions where a director is guilty of self-dealing to the detriment of the corporation.

The “business judgment rule”, however, yields to the rule of undivided loyalty. . . . The dealings of a director with the corporation for which he is the fiduciary are therefore viewed “with jealousy by the courts.” . . . Such personal transactions of directors with their corporations, such transactions as may tend to produce a conflict between self-interest and fiduciary obligation, are, when challenged, examined with the most scrupulous care, and if there is any evidence of improvidence or oppression, any indication of unfairness or undue advantage, the transactions will be voided.

Bayer v. Beran, 49 N.Y.S.2d 2, 6–7 (1944).

24. See FED. R. CIV. P. 8(a) (addressing general rules of pleading).

25. See *Dioguardi v. Durning*, 139 F.2d 774, 775 (2d Cir. 1944) (holding that a complaint can survive a Rule 12(b)(6) motion “however inartistically [it] may be stated” provided plaintiff shows that defendant has done some legally correctable harm to plaintiff). The implicit holding of *Dioguardi* is that courts will be extremely reluctant to dismiss actions on motions to dismiss absent a glaring factual or procedural deficiency.

26. See FED. R. CIV. P. 8(a); Cf. FED. R. CIV. P. 9(b). *Gompper v. VISX, Inc.*, 298 F.3d 893, 896 (9th Cir. 2002). (“[A]n inevitable tension arises between the customary latitude granted the plaintiff on a motion to dismiss under Fed. R. Civ. P. 12(b)(6), and the heightened pleading standard set forth under the PSLRA.”). Heightened pleading standards are only allowed as provided for under FRCP 9(b) or where otherwise authorized by statute and cannot be created absent explicit authorization. See *Leatherman v. Tarrant County Narcotics Intelligence and Coordination Unit*, 507 U.S. 163, 164 (1993) (representing the holding of the United States Supreme Court that a federal court was not entitled to apply a heightened pleading standard to a 42 U.S.C. § 1983 civil rights action alleging municipal liability). This holding was in response to municipal assertions that municipalities were entitled to qualified immunity based on the good faith actions of their officers.

27. A heightened pleading standard increases the probability that a defendant will win at summary judgment. This increased ability to dismiss cases at the summary judgment stage was the motivating factor behind courts implementing heightened pleading standards for disfavored lawsuits. For example, courts have attempted to interject heightened pleading standards for § 1983 actions against public officials. *Owen v. City of Independence*, 445 U.S. 622, 650 (1980) (reasoning that legislative history and public policy weigh against the imposition of qualified immunity for acts done in good faith under color of law). Defendants have a very difficult time prevailing on motions for

One difficulty associated with heightened pleading standards is that they often require a plaintiff to plead facts that he may not yet possess. As one commentator astutely observed, “[y]ou can’t get discovery unless you have strong evidence of fraud, and you can’t get strong evidence of fraud without discovery.”²⁸ The PSLRA’s stay provision²⁹ worsens this conflict by delaying discovery until after the complaint survives a motion to dismiss.

2. Legislative History of the PSLRA

On December 22, 1995, Congress enacted the PSLRA over President Clinton’s veto.³⁰ One commentator described the PSLRA as “the most momentous event in the history of securities regulation since the adoption of the [Securities Act and the Exchange Act].”³¹ The PSLRA introduced major revisions to the Exchange Act and the rules of private securities litigation. Among the most significant changes were the incorporation of a safe harbor provision,³² replacement of joint and

summary judgment absent a heightened pleading standard. *See Dioguardi*, 139 F.2d at 775.

28. Charles F. Hart, *Interpreting the Heightened Pleading of the Scierter Requirement in Private Securities Fraud Litigation: The Tenth Circuit Takes the Middle Ground*, 80 DENV. U. L. REV. 577, 577 (2003) (quoting Columbia University law professor Jack Coffee).

29. 15 U.S.C. § 78u-4(b)(3)(B) (2004).

30. SECURITIES HANDBOOK, *supra* note 4, at § 1:15; *See* Michael B. Dunn, Note, *Pleading Scierter After the Private Securities Litigation Reform Act: Or, a Textualist Revenge*, 84 CORNELL L. REV. 193, 220 (1998) (discussing the varied responses to President Clinton’s veto, including the House of Representatives override of the veto with minimal discussion of heightened pleading standards and a thorough response from the Senate). Senators Arlen Specter, Republican from Pennsylvania and the author of the unsuccessful Specter Amendment to the PSLRA, and Paul Sarbanes, Democrat from Maryland and coauthor of the Sarbanes-Oxley Act, supported the presidential veto and argued that dropping the Specter Amendment would result in a new pleading standard which was higher than the prevailing Second Circuit standard. *Id.* Other Senators disagreed with the position of Senators Specter and Sarbanes and President Clinton, and argued that the law would not result in a heightening of the Second Circuit pleading standard. *Id.*

31. HAROLD S. BLOOMENTHAL ET AL., PRIVATE SECURITIES LITIGATION REFORM ACT: SPECIAL UPDATE, 1–2 (1996) [hereinafter PSLRA UPDATE].

32. THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 12.9[8] (4th ed. 2002). Forward looking statements are projections or statements relating to anticipated future performance. JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS, 591–92 (4th ed. 2004). The PSLRA’s safe harbor protects a qualified person from liability in private action where the statements are accompanied by “meaningful cautionary” language, or where plaintiff cannot adequately establish that the statements were made “with actual knowledge.” *Id.* at 591.

several liability with comparative liability for most defendants,³³ and the creation of a cap on damages.³⁴

Congress's stated aim in passing the PSLRA was to discourage the filing of unnecessary securities fraud claims, including the following: (1) the practice of filing lawsuits in response to a significant drop in price without evidence of fraud,³⁵ (2) targeting of financially resourceful defendants,³⁶ (3) use of excessive discovery to encourage settlement,³⁷ and (4) the manipulation of plaintiffs by class action attorneys.³⁸ The Conference Committee stated that it was their intent to strengthen the pre-Reform Act pleading standard, and not to codify the prevailing Second Circuit standard.³⁹ Advocates of the Second Circuit standard largely dismiss this statement.⁴⁰

The Ninth Circuit relied on express statements of congressional intent when the court read the legislative history of the PSLRA to mean that Congress intended to "raise the standard above all existing requirements."⁴¹ President Clinton stated that his reason for vetoing the bill was his disapproval of any attempt to heighten the standard beyond that applied in the Second Circuit, which then applied the highest pleading standard.⁴² Commentators have heavily criticized President Clinton's objections based on subsequent statements by the proponents of the bill that expressed their disagreement with the President's reading of its impact.⁴³

3. Enter Stage Right: The PSLRA

The PSLRA represents an attempt by Congress to strike the optimal balance between protecting investors from fraud and preventing

33. Leslie M. Kelleher, *Taking "Substantive Rights" (in the Rules Enabling Act) More Seriously*, 74 NOTRE DAME L. REV. 47, 52 (1998).

34. 15 U.S.C. § 78u-4(e) (2004).

35. H.R. CONF. REP. NO. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.A.N. 730.

36. *Id.*

37. *Id.*

38. *Id.*

39. *Id.* at 41 ("Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard.").

40. *See, e.g.*, Laura R. Smith, *The Battle Between Plain Meaning and Legislative History: Which Will Decide the Standard for Pleading Scienter After the Private Securities Litigation Reform Act of 1995?*, 39 SANTA CLARA L. REV. 577, 603-04 (1999) (discussing the flaw in the logic used in *Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1252 (N.D. Ill. 1997), where the court stated that congressional failure to codify the Second Circuit test does not equate to congressional disapproval).

41. *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 978 (9th Cir. 1999).

42. 141 CONG. REC. H15,214 (daily ed. Dec. 20, 1995).

43. Janine C. Guido, Note, *Seeking Enlightenment from Above: Circuit Courts Split on the Interpretation of the Reform Act's Heightened Pleading Requirement*, 66 BROOKLYN L. REV. 501, 541 (2000).

opportunistic plaintiffs from bringing frivolous suits. Among the stated goals of the PSLRA was to help deter plaintiff's attorneys from bringing "strike suits."⁴⁴ Typically filed in response to significant drop in share value, strike suits rarely contain specific allegations of fraud or impropriety.⁴⁵ By definition, these suits represent bad faith efforts to reach excessive settlements and accompanying attorneys' fees.⁴⁶

Congressional proponents of the PSLRA argued that strike suits benefit only the attorneys involved and are detrimental to the corporation and the shareholders.⁴⁷ As will be explained below, a sufficiently low pleading standard places a corporation in a situation where they will be willing to pay several million dollars to settle a suit that is largely without merit.

Strike suits can place corporate defendants in a situation where it is better to settle a frivolous suit for millions of dollars than risk litigation.⁴⁸ The following example illustrates a situation in which a corporation would rather settle for \$10,000,000 than proceed with litigation, despite having a very strong case.

44. S. REP. NO. 104-98, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683 ("The Committee heard substantial testimony that today certain lawyers file frivolous 'strike' suits alleging violations of the Federal securities laws in the hope that defendants will quickly settle to avoid the expense of litigation."); *see also* BLACK'S LAW DICTIONARY 1475 (8th ed. 2004) (defining a strike suit as "[a] suit (esp. a derivative action), often based on no valid claim, brought either for nuisance value or as leverage to obtain a favorable or inflated settlement.").

45. S. REP. NO. 104-98, at 4 ("These suits, which unnecessarily increase the cost of raising capital and chill corporate disclosure, are often based on nothing more than a company's announcement of bad news, not evidence of fraud."). This chilling effect is a result of public officers' fears that disclosure will naturally result in an increase in suits brought against them.

46. *See* H.R. REP. NO. 104-50 (1995), *reprinted in* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 724-26 (2d ed. 1997). The complaints are usually based on minimum investigation, perhaps even so lacking as to warrant Rule 11 sanctions, and plead general allegations. *See id.* at 725. The problem is "compounded by the reluctance of many judges to impose sanctions under Federal Rule of Civil Procedure 11, except in those cases involving truly outrageous misconduct." H.R. CONF. REP. NO. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730. The attorney often engages in abusive settlement tactics, which induce inefficient settlements. *See* COX, *supra*, at 725; H.R. CONF. REP. NO. 104-369, 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.").

47. COX, *supra* note 46, at 725.

48. *See* Stanford Law School, *Securities Class Action Clearinghouse*, at <http://securities.stanford.edu> (last updated May 20, 2005) (observing that since the passage of the PSLRA, "[t]he dollar magnitude of settlement has increased noticeably").

Huge Corporation (Huge), on the heels of three quarters of consistent financial gains, faces expectations that they are unable to meet. In order to remain in compliance with SEC regulations, Huge releases news of the disappointing earnings via a press release. Shortly thereafter, Huge receives notice of a shareholders' derivative action. Huge, and all parties involved, are aware that the suit is largely without merit. The members of the class claim that Huge knew that the projections were overly optimistic and failed to correct them sooner in an effort to artificially inflate stock prices. The negative earnings resulted in a 20% decrease in the value of Huge common stock (the stock went from \$10 per share to \$8 per share). Huge currently has 100,000,000 shares of common stock outstanding. Thus the resulting loss in market capitalization equals \$200,000,000.⁴⁹

Assume the cost of discovery for Huge would be \$1,000,000. Huge, knowing the suit is largely without merit, can expect a high probability of success. Assume the probability of success is 95%.⁵⁰ In such a case, Huge can expect that, on average, the corporation will lose \$10,000,000 if it litigates the case, plus the \$1,000,000 cost of discovery.⁵¹ The total cost of the litigation to the corporation would exceed the easily calculable costs of discovery and expected payout. However, it would be difficult to measure. The costs would also include damage to the corporation's image and opportunity costs associated with the time employees spent defending the lawsuit (being deposed, answering interrogatories, etc.). This lost time would be a significant cost when one considers the types of employees who would be involved in defending against an accusation of securities fraud.⁵²

49. Calculated as follows: *number of shares outstanding * reduction in value per share*. In this example the loss in market capitalization would be 100,000,000 multiplied by 2, which equals a reduction in market capitalization of \$200,000,000. The reader should note that this example uses the relatively conservative assumption of 100,000,000 outstanding shares for a major corporation. Compare this figure with the number of shares real life corporations would be likely to have outstanding—IBM and Microsoft have 1.73 billion and 10.68 billion, respectively. Losses of 20% in the shares of either of these companies could result in exposure to astronomical liability. *Market Capitalization Defined*, at <http://www.investopedia.com/articles/basics/03/031703.asp> (March 17, 2003).

50. The likelihood of success in this example is deliberately high. The example is designed to illustrate why a company will spend relatively large sums to settle strike suits.

51. This figure represents the loss in market capitalization, \$200,000,000, multiplied by the probability that Huge will lose, 5%.

52. In all likelihood the defendants would be members of the board of directors, high-ranking managers and corporate officers. Where losing a hundred hours of janitorial time would not be financially damaging to most corporations, losing the same amount of Chief Executive Officer's time could be a damaging blow.

Huge, as a rational entity, would be willing to pay up to \$11,000,000 in settlement based on the easily calculable costs alone. This is a costly settlement when one considers that the plaintiff class has a weak case against the corporation. This example presents a bleak, but plausible, example of how a plaintiff with little evidence can successfully attain a sizeable settlement.

Abusive litigation tactics have the power to hurt not only the corporation, but also the corporation's shareholders. Strike suits can hurt shareholders in several ways. Settlements that result in large disbursements of corporate assets can represent inefficient allocation of corporate assets. In addition, corporations expend significant resources defending against charges of securities fraud. A typical expenditure in the context of a derivative action is the formation of a special litigation committee (SLC).⁵³ An SLC is a board subcommittee charged with the responsibility of recommending how to address the litigation. Money or other consideration paid from the corporation to the shareholders as a term of settlement can also be detrimental to the shareholders' interests where that consideration would create more shareholder value if retained by the corporation.⁵⁴

Perhaps the most substantial threat meritless suits can pose to shareholders' interests is the threat that an attorney representing a class of shareholders with a frivolous state law claim can reach a settlement agreement with the defendant that precludes a meritorious federal claim. In *Epstein v. MCA, Inc.*,⁵⁵ the Ninth Circuit was obliged to give full faith and credit to a prior settlement involving a state law claim arising out of the same transaction.⁵⁶ The state law claim involved was unlikely to succeed, but gave a second plaintiff's firm a chance to get in on the litigation.⁵⁷ The result was that the settlement of a meritless claim

53. BAUMAN, *supra* note 7, at 947–53 (discussing the degree of deference courts give to the decisions of an SLC, including whether the SLC's decisions are entitled to the benefits of the business judgment rule).

54. *Id.* at 286–87 (arguing that earning should only be retained, as opposed to paid out as dividends, by the corporation where each dollar retained results in at least a one dollar increase in the market value of the corporation).

55. 179 F.3d 641 (9th Cir. 1999), *cert. denied*, 528 U.S. 1004 (1999). Matsushita made a successful tender offer from MCA which “precipitated two lawsuits.” *Id.* at 643. First, a Delaware class brought suit, alleging directoral breach of fiduciary duties. *Id.* Second, a federal class brought suit, alleging violations of SEC rules. *Id.*

56. *Id.* at 650 (“[T]he Delaware judgment was not constitutionally infirm and must be accorded full faith and credit.”).

57. BAUMAN, *supra* note 7, at 906.

prevented a corporate defendant from having to litigate or settle a potentially meritorious claim, or both. Whether one views the tactics of the attorneys representing the state law class as ingenious or opportunistic, it is clear that the result is not fair to the class of plaintiffs with the meritorious federal claim.

B. How the Core Provisions of the PSLRA Disadvantage Plaintiffs

This section will survey the core provisions of the PSLRA and argue that the impact of each provision disadvantages the plaintiff. Specifically, this section will address the following provisions of the Act: replacement of joint and several liability with proportionate liability,⁵⁸ limitations placed on damages,⁵⁹ the certification to be filed with plaintiff's complaint,⁶⁰ and an increased emphasis on the use of sanctions.⁶¹ The trend where specific provisions reduce plaintiff class bargaining position, can be seen throughout the PSLRA; it is present in each phase of any private securities litigation, from appointment of lead plaintiff⁶² to calculation of damages.⁶³

1. Proportionate Liability Versus Joint and Several Liability

The PSLRA narrowly limits the situations in which joint and several liability will apply to defendants found liable of securities fraud.⁶⁴ Under the new rule, a defendant subject to a final judgment will only be held jointly and severally liable upon findings that said defendant "knowingly committed a violation of the securities laws."⁶⁵ A knowing violation occurs when a defendant "makes an untrue statement of a

58. 15 U.S.C. § 78u-4(f) (2004).

59. 15 U.S.C. § 78u-4(e) (2004).

60. 15 U.S.C. § 78u-4(a)(2)(A) (2004).

61. 15 U.S.C. § 78u-4(c) (2004).

62. 15 U.S.C. § 78u-4(a)(3) (2004). This Comment does not discuss the implications of lead plaintiff appointments on bargaining leverage. However, it is worth noting that the provision probably benefits defendants. In creating a system where the lead plaintiff will usually be an institutional shareholder, the PSLRA attempts to place control of the litigation with investors, rather than with attorneys. In theory, this would prevent filings where the attorney's sole ambition was collecting fees, as institutional investors would hire firms whose intent was to pursue the litigation in the investors' best interest.

63. 15 U.S.C. § 78u-4(e) (2004).

64. PSLRA UPDATE, *supra* note 31, at 55–56 (noting the confusing legislative history of the damages provision. Specifically, how one version of the PSLRA made joint and several liability available only in the case of knowing violation of the Exchange Act was abandoned in favor of a version which provided that joint and several liability can be available for a "knowingly committed a violation of the securities laws," which would include not only the Exchange Act, but also the Securities Act, the Investment Company Act, and the Investment Advisers Act).

65. 15 U.S.C. § 78u-4(f)(2)(A) (2004).

material fact, with actual knowledge that the representation is false⁶⁶ or fails to disclose a fact “with actual knowledge that, as a result of the omission, one of the material representations . . . is false.”⁶⁷ The Exchange Act expressly states that reckless conduct does not constitute a knowing violation and therefore does not trigger the application of joint and several liability.⁶⁸

Joint and several liability favors plaintiffs.⁶⁹ A plaintiff successful against multiple defendants under joint and several liability can recover her entire judgment from any defendant.⁷⁰ Conversely, a plaintiff successful against multiple defendants under pure comparative liability can only recover from each defendant according to that defendant’s relative fault. Joint and several liability has been widely discarded in favor of proportionate liability.⁷¹ However, joint and several liability remains intact where the plaintiff(s) suffers an indivisible injury caused by multiple defendants.⁷² The nature of the injury in securities litigation

66. 15 U.S.C. § 78u-4(f)(10)(A)(i)(I) (2004).

67. *Id.*

68. 15 U.S.C. § 78u-4(f)(10)(B) (2004). The PSLRA requires that the jury answer special interrogatories, or in a bench trial, that the judge make specific findings as to whether each defendant has knowingly violated securities laws. 15 U.S.C. § 78u-4(f)(3)(A) (2004). In jurisdictions that allow liability to be based on recklessness, one can anticipate that joint and several liability will be used less frequently, as proportionately fewer liable defendants will have acted intentionally. *Cf.* 15 U.S.C. § 78t(a) (providing joint and several liability for controlling persons, unless said persons acted in good faith and did not directly or indirectly induce the tortious acts).

69. *See Developments in the Law: Toxic Waste Litigation* (pt. 5), 99 HARV. L. REV. 1511, 1534 (1986) (arguing that joint and several liability encourages minimally culpable parties to ensure that more culpable parties comply with the law). These minimally parties, acting rationally in their own self interest, will effectively act an additional monitoring device, protecting innocent third parties from harm in the interest of limiting their own exposure to liability. The article then notes that in the absence of joint and several liability these less culpable parties have no incentive to monitor other potentially culpable parties.

70. BLACK’S LAW DICTIONARY 933 (8th ed. 2004) (“[E]ach liable party is individually responsible for the entire obligation . . .”).

71. Mark M. Hager, *What’s (Not!) in a Restatement? ALI Issue-Dodging on Liability Apportionment*, 33 CONN. L. REV. 77, 98–99 (2000) (“Abandonment or modification of joint and several liability is arguably the chief fruit of states’ tort reform campaigns over the past two decades, despite the fact that joint and several liability is a longstanding and traditional common law doctrine . . .”).

72. *Am. Motorcycle Ass’n v. Super. Ct. of Los Angeles County*, 578 P.2d 899 (Cal. 1978); *Jenson v. Eveleth Taconite Co.*, 130 F.3d 1287, 1293 n.9 (8th Cir. 1997) (“The single *indivisible injury* rule imposes joint and several liability when two or more persons acting independently cause harm to a third person through consecutive acts . . . related in point of time. If the harm is indivisible, each actor is liable for the entire harm.”) (emphasis added).

seems to justify the application of joint and several liability.⁷³

Maintaining joint and several liability for defendants in securities litigation actions would have the definite effect of increasing shareholder advantage in negotiating settlements. Proportionate liability's most salient problem is that a successful plaintiff may be unable to collect the entire share owed to her due to the insolvency of one or more defendants.⁷⁴ Joint and several liability frees the plaintiff from the risk associated with defendant insolvency by allowing plaintiff to recover the entire damages award from a single solvent defendant. Thus, plaintiffs prefer joint and several liability because the insolvency of either defendant is not a potential bar to recovery.⁷⁵

While critics question joint and several liability's fairness towards the defendant,⁷⁶ it certainly represents the most advantageous system of liability for the plaintiff. The regime also pragmatically recognizes that tort law is unable to deter insolvent defendants. Joint and several liability is desirable in that it forces a culpable defendant, rather than a comparatively innocent plaintiff, to internalize the risk associated with an insolvent defendant's inability to pay.

The PSLRA attempts to lessen the potential harshness of pure proportionate liability through its "Uncollectible Share" provision,⁷⁷ which creates a system of modified comparative liability.⁷⁸ The PSLRA

73. Securities litigation plaintiffs suffer an indivisible injury (reduction in the market price of the securities they own), caused by multiple defendants. Thus, securities litigation plaintiffs satisfy the requirements for the application of joint and several liability.

74. For example, assume the plaintiff is entitled to a judgment of \$1,000,000 from two defendants ("D1" and "D2" respectively). D1 is a corporation worth several million dollars and D2 is an insolvent individual. If the applicable liability regime is one of joint and several liability, plaintiff can attain the entire judgment from D1. D1 would then be entitled to receive a contribution from D2, equaling D2's relative fault.

75. Under a proportionate liability system, plaintiff is entitled to recover from D1 only the proportion of the damages for which the fact finder determined D1 was responsible. Plaintiff would bear the risk of loss associated with any given defendant being unable to pay his own share of the damages. In situations where proportionate liability applies, a plaintiff may be placed in the dangerous position of being undercompensated for his injuries. This is particularly troublesome where the damage award consists entirely of compensatory damages. For example, a personal injury plaintiff in such a situation might be forced to pay his own medical bills or simply absorb a loss incurred from missing work.

76. See Nancy L. Manzer, *1986 Tort Reform Legislation: A Systematic Evaluation of Caps on Damages and Limitations in Joint and Several Liability*, 73 CORNELL L. REV. 628, 636 (1988); Craig N. Johnston, *Current Landowner Liability Under CERCLA: Restoring the Need for Due Diligence*, 9 FORDHAM ENVTL. L.J. 401, 424 (1998) (discussing Congress's refusal to adopt joint and several liability in regard to the Comprehensive Environmental Response, Compensation and Liability Act due to concerns over the doctrine's unfairness to certain defendants).

77. 15 U.S.C. § 78u-4(f)(4) (2004).

78. The PSLRA's liability apportionment regime is one of modified comparative

allows plaintiff to recover an uncollectible share⁷⁹ from the solvent defendant in two situations.⁸⁰ The *poverty provision* allows the plaintiff to hold each culpable defendant liable for the entire sum of the damages provided plaintiff has limited economic means.⁸¹ Specifically, plaintiff must prove that the recoverable damages are at least 10% of the plaintiff's net worth, and that the plaintiff's net worth is less than \$200,000.⁸² This limitation eliminates the vast majority of shareholders and makes the provision largely useless.⁸³

Where plaintiff's financial status removes him from the poverty provision, a solvent defendant may still have to cover all or part of another defendant's liability.⁸⁴ However, the solvent defendant's additional liability may not exceed one-half of his proportionate share.⁸⁵ Thus, where one of two equally culpable defendants becomes insolvent, plaintiff will be able to recover 75% of the total damages from the solvent defendant.⁸⁶ In a situation where the solvent defendant was more than twice as liable as the insolvent defendant, the plaintiff would be able to recover the complete damage award from the solvent

liability because it has the power to force a party to pay a higher share of the damages than the jury determines she is liable. *See* 15 U.S.C. § 78u-4(f)(4) (2004).

79. An uncollectible share is the amount of a given defendant's share of the damages that she is unable to pay due to insolvency.

80. 15 U.S.C. § 78u-4(f)(4)(A) (2004) ("[If] the court determines that all or part of the share of the judgment of the covered person is not collectible against that covered person, and is also not collectible against [a person described in the joint and several liability section], each covered person . . . shall be liable for the uncollectible share . . .").

81. 15 U.S.C. § 78u-4(f)(4)(A)(i) (2004) (providing that "[e]ach covered person shall be jointly and severally liable for the uncollectible share").

82. *Id.*

83. It should be remembered that the size of a shareholder's financial stake in a company influences lead plaintiffs selection. 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(bb) (2004) (establishing a rebuttable presumption that the lead plaintiff should be a person who "has the largest financial interest in the relief sought by the class"). It is very unlikely that the lead plaintiff will be worth less than \$200,000. *See* 15 U.S.C. 78u-4(f)(4)(A)(iii) (2004) (establishing that calculation of net worth, which is established prior to the sale of purchase of the question security, includes all personal assets, including investments in real and personal property). In fact, the shareholders with the largest vested interest are likely to be institutional shareholders, whose net worth will easily exceed the \$200,000 maximum allowable for the imposition of joint and several liability.

84. 15 U.S.C. § 78u-4(f)(4)(A)(ii) (2004).

85. *Id.*

86. Assume P is entitled to \$100 and D1 and D2 were each 50% liable. D1 is solvent. D2 is insolvent. D1 will be forced to pay \$75, which represents D1's personal liability plus an additional one-half of D1's liability that will be used to cover D2's uncollectible share.

defendant.⁸⁷ While each of these situations is roughly palatable for both plaintiff and the solvent defendant, as plaintiff receives the majority of the damages and defendant pays an amount that is arguably within the limits of his actual culpability,⁸⁸ other plausible situations are gravely unjust to the plaintiff.⁸⁹

Regardless of the fairness of joint and several liability to the parties, it is clear that its impact is to reduce the probability that plaintiff will be able to recover the full amount of damages awarded to her. The possibility that plaintiff will not be able to recover the entire damages award will naturally be contemplated by the parties in settlement negotiations. There is a direct correlation between plaintiff's chance of full recovery and the plaintiff's bargaining leverage.⁹⁰ A plaintiff could not rightly calculate an appropriate settlement figure without first considering the probability that either defendant will become insolvent and will not be able to pay his share. Instead, the plaintiff's estimation of what she is entitled to must include the portion of the damages that she will be likely to recover.

Assume that plaintiff would be entitled to \$10,000,000 in damages if successful at trial, and that there is a 90% chance of success. A plaintiff who is certain to recover the entire sum of the damages, if successful at trial, possibly because of the applicability of joint and several liability, may be able to expect a settlement of around \$9,000,000.⁹¹ Conversely, a plaintiff with the same chances of success at trial and the same expected

87. Assuming D1's is at least 66.67% liable, P will be able to recover 100% of the damages from D1. This is true because any number greater than or equal to 66.67% times 1.5 equals a number greater than 1. As 1 represents the total of the damages award, P will be able to recover the entire award from D1.

88. See Neil Vidmar, *The Performance of the American Civil Jury: An Empirical Perspective*, 40 ARIZ. L. REV. 849, 849 (1998) ("Juries have been said, variously, to be incompetent, capricious, unreliable, biased, sympathy-prone, confused, hostile to corporate defendants and doctors, gullible, excessively generous in awarding compensatory damages, and out of control when awarding punitive damages.").

89. An example would be a situation where the solvent defendant, D1, is responsible for 5% of the damages and the insolvent defendant, D2, is responsible for 95% of the damages. In this situation the most P can hope to recover from the solvent defendant is 7.5% of the total damages. D1's liability (5%) times statutory maximum which D1 could be forced to pay (1.5) equals 7.5%. Such an apportionment of liability is not improbable. For instance, suppose that D2 is an independent contractor, working in concert with a brokerage house, and D1 is a large corporation or the brokerage house that hired D2. In this situation, we can easily imagine D2 having relatively limited financial resources, especially in view of the potentially astronomical damages in a shareholder's derivative suit, while D1 had the power to absorb the damages without going bankrupt.

90. Or, in the alternative, there is an inverse correlation between the probability that the plaintiff will be denied full recovery and the plaintiff's bargaining leverage.

91. This figure represents what plaintiff expects to win at trial, multiplied by the plaintiff's chance of succeeding at trial (\$10,000,000 * 90%).

judgment might have to settle for a lower figure if there is an increased chance that the plaintiff will be unable to recover due to insolvency of either defendant.

Assume, for example, that plaintiff estimates that each defendant is equally culpable,⁹² and that there is a 90% chance that one defendant will go bankrupt. Plaintiff will estimate the expected value of two possible outcomes—each defendant is solvent, or one defendant becomes insolvent—as follows. In possible outcome number one, each defendant is able to pay his or her own share, and the expected value equals \$9,000,000.⁹³ In possible outcome number two, one of the defendants becomes insolvent and is unable to pay any of his share of the damages. In such a case, the expected value equals \$6,750,000.⁹⁴ These two figures represent the complete range of outcomes based on the noted assumptions.

Plaintiff must then consider the probability of each of the two possible outcomes occurring. In this example, possible outcome number one has a probability of 10% and possibility number two has a probability of 90%. Plaintiff can expect that she will be able to recover \$6,975,000.⁹⁵ This figure represents an adequate, but comparatively unsatisfactory, settlement figure for the plaintiff.⁹⁶

In adopting a system of modified comparative liability, the PSLRA forces the parties to anticipate lower damages than they would under a system of joint and several liability. The application of comparative liability reduces the amount a rational plaintiff can expect to recover in pretrial settlement negotiations. Accordingly, should the parties attempt to negotiate a settlement before the litigation, the plaintiff will be placed in a disadvantaged position where she can expect a lower settlement price. The PSLRA's liability apportionment regime is consistent with the Act's overall purpose of discouraging the filing of frivolous securities suits by placing plaintiffs in a disadvantaged position.

92. Thus, each defendant would be responsible for \$4,500,000 in damages.

93. This figure represents plaintiff recovering \$4,500,000 from each defendant.

94. Calculate as follows: *(DI's share of the judgment) + (Amount of uncollectible share that DI will be forced to pay)*. In this example: $(\$4,500,000) + (\$4,500,000 * 0.5)$. This hypothetical assumes that a defendant has the resources to pay either all of his share of the debt or becomes insolvent and is unable to pay any of his share of the debt.

95. Calculated as: *(Probability of outcome 1) * (Expected value of outcome 1) + (Probability of outcome 2) * (Expected value of outcome 2)*. In this example: $(10%) * (\$9,000,000) + (90%) * \$6,750,000$.

96. In the preceding example plaintiff would anticipate being able to collect \$9,000,000 under joint and several liability and only \$6,975,000 under modified comparative liability.

2. Cap on Damages

Calculating damages is among the most confusing and controversial areas of securities litigation.⁹⁷ In general, damages sought in securities litigation can be divided into two classes: direct damages, where the plaintiff sues the party from whom he bought the securities at issue, and indirect damages, where the plaintiff is suing anyone not involved in his purchase of the securities at issue.⁹⁸ Direct damages for misstatements are the simplest type of damages to calculate and allow the plaintiff to recover his entire loss from the culpable party.⁹⁹ In the PSLRA's legislative history, the House Conference Report alludes to direct damages as the typical measure of damages in securities fraud litigation.¹⁰⁰ Adopting direct damages would have substantially advantaged plaintiffs by increasing the amount of damages they were likely to recover if victorious at trial.

Instead, the PSLRA adopted a cap on damages.¹⁰¹ The damage limitation provision creates the possibility of undercompensation for plaintiffs who sell their shares during a period of market overreaction following the disclosure of information that causes a decrease in the price of the security.¹⁰² While this limitation creates a controversy as to what it implies for congressional economic policy,¹⁰³ its implications for private

97. DAVID L. RATNER, *SECURITIES REGULATION IN A NUTSHELL* 281 (6th ed. 1998) (“Because of the great variety of situations giving rise to liability, it is difficult to generalize about the computation of damages.”); H.R. CONF. REP. NO. 104-369, at 42 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 741 (“The current method of calculating damages in 1934 Act securities fraud cases is complex and uncertain.”).

98. RATNER, *supra* note 97, at 281–83.

99. *Id.* at 281–82 (noting that the measure of damages paid to a plaintiff-purchaser by a defendant-seller is typically the price the plaintiff paid for the securities minus the price of the security when sold by plaintiff or the price at the time of initiation of the suit).

100. H.R. CONF. REP. NO. 104-369, at 42 (“Typically, in an action involving a fraudulent misstatement or omission, the investor’s damages are presumed to be the difference between the price the investor paid for the security and the price of the security on the day the corrective information gets disseminated to the market.”).

101. “[I]n any private action . . . in which the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.

15 U.S.C. § 78u-4(e)(1) (2004).

102. See Nathaniel Carden, *Implications of the Private Securities Litigation Reform Act of 1995 for Judicial Presumptions of Market Efficiency*, 65 U. CHI. L. REV. 879, 894–95 (1998).

103. *Id.* at 894–98. Carden argues that Congress implicitly rejected the efficient capital market hypothesis, as the damages limitation presupposes that investors could “beat the market” if they invested immediately after the release of damaging news and held a security until the market returned to a rational level. *Id.* at 895.

securities plaintiffs are clear.¹⁰⁴ The damage limitation provision of the PSLRA reaffirms congressional intent to discourage the filing of frivolous lawsuits by reducing plaintiff's bargaining leverage.

Under the damages provision, a plaintiff is only entitled to recover the difference between the sale price of the security and the security's mean price over a ninety-day period following disclosure of the withheld information.¹⁰⁵ This limitation derives from the assumption that markets will overreact to certain types of news.

The following example shows how the damage limitation works. Party A purchases 10,000 shares of common stock in X Corporation at \$10 per share on day one.¹⁰⁶ X Corporation's common stock was somewhat overvalued on day one based on pervasive accounting irregularities. When the news of these irregularities becomes public on day two, the market for X common stock drastically weakens. A, afraid that the news of irregularities and subsequent legal action will render the stock worthless, sell all of his shares of X at \$5 per share on day three.¹⁰⁷ The easiest way to calculate A's damages based on the fraud is by reference to the market price of the security. One must simply subtract the sale price he received for the stock on day three from the purchase price he paid on day one.¹⁰⁸ This method of calculation creates total damages of \$50,000, which accurately represents the losses A incurred.¹⁰⁹

104. *See id.* at 896.

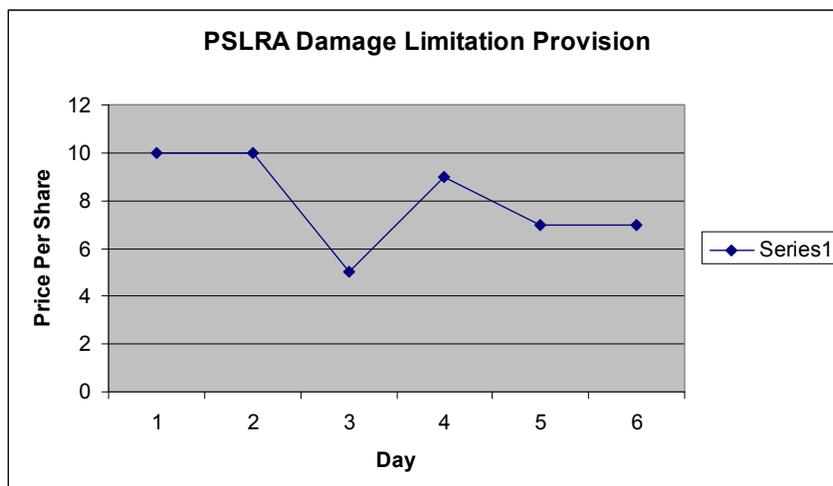
105. 15 U.S.C. § 78u-4(e)(1) (2004).

106. Thus, A has invested \$100,000 in X. *See* PSLRA Damages Limitation Provision Chart, *infra* p.22.

107. Thus, A received \$50,000 from the sale of X securities. *See* PSLRA Damages Limitation Chart, *infra* p.22.

108. (10,000 shares * \$10/share) - (10,000 shares * \$5/share), or simply \$100,000 - \$50,000 = \$50,000.

109. A could arguably also seek incidental costs associated with the transactions, however, these will be omitted in the interest of maintaining simplicity. Incidental costs could be significant, depending on the method of trading A engages in. If A manages his own trades via an online broker, incidental costs would be minor. However, if A trades through a traditional broker, it is likely that he paid a substantial amount of money in brokers' fees.



Under the damage calculation method adopted by the PSLRA, A might collect far lower damages. Assume further that the price of X common stock rebounded from the low of \$5, the price at which A sold, to \$9, and then to a more rational \$7, resulting in an average price of \$7 for the ninety days following disclosure of the irregularities.¹¹⁰ In this scenario the plaintiff's recoverable damages per share, as measured under the PSLRA damage provision,¹¹¹ would be limited to \$3 per share, with total damages equaling only \$30,000.¹¹² Thus, the PSLRA damages limitation provision would undercompensate A by \$20,000.¹¹³

Limiting the damages available to a plaintiff class is the simplest, and arguably the most effective, means to ensure that the class will be less likely to establish an advantageous settlement, short of blatantly barring the cause of action. Thus, the damages limitation provision is consistent with the core provisions of the PSLRA in discouraging the filing of frivolous lawsuits by reducing the attractiveness of securities fraud claims.

110. See PSLRA Damages Limitation Provision Chart, *infra*.

111. 15 U.S.C. § 78u-4(e)(1) (2004).

112. $(10,000 \text{ shares} * \$10/\text{share}) - (10,000 \text{ shares} * \$7/\text{share}) = \$30,000$.

113. This is found by subtracting A's recoverable loss (\$30,000) from his actual loss (\$50,000). Again, bear in mind that this example assumes that transaction costs are zero.

3. Increased Emphasis on the Imposition of Sanctions

Federal Rule of Civil Procedure 11 (Rule 11) governs the imposition of sanctions for abusive pleading practices in litigation.¹¹⁴ The PSLRA departs from the common application of Rule 11 by placing an increased emphasis on the use of sanctions as a means to deter frivolous pleadings. The Act forces the court to review the pleadings for Rule 11 violations,¹¹⁵ to impose sanctions where violations are found,¹¹⁶ and creates a presumption that attorneys' fees and costs are proper when one party fails to comply with Rule 11(b).¹¹⁷ These sanction rules reduce plaintiff's bargaining position by increasing the likelihood that the plaintiff and plaintiff's counsel will face sanctions.¹¹⁸

114. See FED. R. CIV. P. 11(c).

115. 15 U.S.C. § 78u-4(c)(1) (2004) (“[U]pon final adjudication of the action, the court shall include in the record specific findings regarding compliance by each party and each attorney representing any party with each requirement of Rule 11(b) of the Federal Rules of Civil Procedure as to any complaint, responsive pleading, or dispositive motion.”) (emphasis added).

116. 15 U.S.C. § 78u-4(c)(2) (“If the court makes a finding under paragraph (1) that a party or attorney violated any requirement of Rule 11(b) of the Federal Rules of Civil Procedure as to any complaint, responsive pleading, or dispositive motion, the court shall impose sanctions on such party or attorney”); See also Gurary v. Nu-Tech Bio-Med, Inc., 303 F.3d 212, 220 (2d Cir. 2002) (attributing the rule change to “[congressional concern] that under existing Rule 11 practice, when a court did award Rule 11 sanctions, the award was ‘generally insufficient to make whole the victim of the Rule 11 violation’”) (quoting H.R. CONF. REP. NO. 104-369, at 39 (1995), reprinted in 1995 U.S.C.C.A.N. 738). Cf. Cooter & Gell v. Hartmarx Corp., 496 U.S. 384, 393 (1990) (noting that the central goal of Rule 11 is deterrence and streamlining the judicial process, not punishment).

117. 15 U.S.C. § 78u-4(c)(3). (“[There is a rebuttable presumption that the appropriate sanction] for failure of any responsive pleading or dispositive motion to comply with any requirement of Rule 11(b) of the Federal Rules of Civil Procedure is an award to the opposing party of the reasonable attorneys’ fees and other expenses incurred as a direct result of the violation”). *Id.* Federal Rule of Civil Procedure 11(b) requires that any representation before the court not be for an improper purpose, be based on existing law and evidentiary support, and that denials of allegations are warranted. FED. R. CIV. P. 11(b).

118. The plain language of [Rule 11] again provides the answer. It speaks of attorneys and parties in a single breath and applies to them a single standard: “The signature of an attorney or party constitutes a certificate by the signer that the signer has read the pleading, motion, or other paper; that to the best of the signer’s knowledge, information, and belief formed after reasonable inquiry it is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law, and that it is not interposed for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation.” *Bus. Guides, Inc. v. Chromatic Communications Enters.*, 498 U.S. 533, 541–42 (1991).

The PSLRA's requirement that the court make specific findings as to potential Rule 11 violations is not present in the course of ordinary litigation.¹¹⁹ Instead, Rule 11 gives courts the right, but not the obligation, to make specific findings concerning Rule 11(b) violations.¹²⁰ In increasing the level of Rule 11 review, the PSLRA actually contradicts the purpose of the 1993 amendments to the Rule. The amendments' goal was to minimize the frequency with which courts made Rule 11 findings.¹²¹

When considered in conjunction with other applicable provisions, in particular the PSLRA stay provision,¹²² and the requirement that plaintiff pleads with particularity,¹²³ mandatory sanctions for filing overly prolix pleadings place the plaintiff in a very precarious position. While the plaintiff wants to include as many claims as possible, he must be very careful when doing so, as the PSLRA increases the probability that plaintiff and plaintiff's attorney will face sanctions.¹²⁴ Thus, one can logically anticipate situations where plaintiffs will fail to include certain allegations because of uncertainty about their validity and the fear of sanctions. Such plaintiffs run the risk of losing said claims, and place themselves in a disadvantaged situation, when compared to plaintiffs who do not face heightened Rule 11 requirements. The PSLRA's increased emphasis on the use of sanctions is consistent with the core purpose of the PSLRA—disadvantaging plaintiffs and discouraging the filing of frivolous lawsuits by reducing the attractiveness of bringing securities suits.

4. Certification to be Filed with Complaint and Appointment of Lead Plaintiff

An individual seeking to serve as a lead plaintiff in securities fraud class action must first overcome several barriers, including filing a certification with her complaint.¹²⁵ While certain requirements offer no

119. See FED. R. CIV. P. 11(c)(1)(A)–(B).

120. *Id.* (stating that a motion for Rule 11 findings may be made by the opposing party, or “the court *may* enter an order describing the specific conduct that appears to violate subdivision (b)”) (emphasis added).

121. FED. R. CIV. P. 11 (1993 advisory committee notes) (“The revision . . . should reduce the number of motions for sanctions . . .”); see also *Ridder v. City of Springfield*, 109 F.3d 288, 293–94 (6th Cir. 1997) (noting that the 1993 revisions to Rule 11 “place[] greater constraints on the imposition of sanctions,” and that “Rule 11’s ultimate goal [is] deterrence, rather than compensation”).

122. 15 U.S.C. § 78u-4(b)(3) (2004).

123. See discussion *supra* Section II.A.1.

124. See *Bus. Guides, Inc. v. Chromatic Communications Enters.*, 498 U.S. 533, 541 (1991) (noting that plain language imposes the same standard for both parties and attorneys, that of a “reasonable inquiry” under the circumstances).

125. See 15 U.S.C. § 78u-4(a)(2)(A) (2004).

genuine challenge to the plaintiff,¹²⁶ others create substantive burdens that may pose legitimate challenges.¹²⁷ The certification also requires the potential plaintiff to state facts under oath regarding transactions involving the security, or securities, in question.¹²⁸ It may be difficult for plaintiff to plead such detail without the aid of discovery.

The new lead plaintiff procedure instructs the court to adopt a presumption that the “most adequate plaintiff” is the investor who makes a motion to serve as lead plaintiff,¹²⁹ has the largest financial interest in the relief sought,¹³⁰ and satisfies the requirements of FRCP 23.¹³¹ The

126. See 15 U.S.C. §§ 78u-4(a)(2)(A)(i), (iii) (2004) (requiring the plaintiff to certify that she has read the complaint, authorize its filing, and be willing to serve as lead plaintiff, including a willingness to provide testimony).

127. See H.R. CONF. REP. NO. 104-369, at 32–33 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 731–32 (“Professional plaintiffs who own a nominal number of shares in a wide array of public companies permit lawyers readily to file abusive securities class action lawsuits. . . . The Conference Committee believes that several new rules will effectively discourage the use of professional plaintiffs.”); H.R. CONF. REP. NO. 104-369, at 33 (“To further deter the use of professional plaintiffs . . .”); see 15 U.S.C. § 78u-4(a)(2)(A)(v) (2004) (requiring the certification to “identify[] any other action under [15 U.S.C. §§ 78a et seq.], filed during the 3-year period preceding the date on which the certification is signed by the plaintiff, in which the plaintiff has sought to serve as a representative party on behalf of a class . . .”); see also 15 U.S.C. § 78u-4(a)(2)(A)(vi) (2004) (providing that plaintiff may not accept any payment for acting as lead plaintiff, except for his pro rata share and any other compensation ordered or approved by the court); see also 15 U.S.C. § 78u-4(a)(4) (2004) (stating that lead plaintiff is entitled to only his pro rata share and “reasonable costs and expenses (including lost wages) directly relating to the representation of the class . . .”).

128. See 15 U.S.C. § 78u-4(a)(2)(A)(ii) (2004) (requiring that the certification “states that the plaintiff did not purchase the security that is the subject of the complaint at the direction of plaintiff’s counsel or in order to participate in any private action . . .”); see also 15 U.S.C. § 78u-4(a)(2)(A)(iv) (2004) (providing that certification must list all transactions the plaintiff made in the security during the class period).

129. 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(aa) (2004). See also H.R. CONF. REP. NO. 104-369, at 32–33 (noting that the “most adequate plaintiff” provision was drafted in response to the Conference Committee’s concerns caused by the “race to the courthouse” among several plaintiff’s lawyers, each of whom wanted to be the first to file). The result of this desire to file first is that complaints are increasingly filed without proper diligence. This race was encouraged by the traditional “first come, first serve” method used for appointment of lead plaintiff, wherein courts tended to consider the promptness with which a complaint was filed, rather than the diligence employed in drafting the complaint. *Id.* at 33. The Conference Committee sought to rid securities litigation of the negative results of the race to the courthouse by making “the selection of the lead plaintiff and lead counsel [dependent] on considerations other than how quickly a plaintiff has filed its complaint.” *Id.*

130. 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(bb) (2004); H.R. CONF. REP. NO. 104-369, at 34. The previous system for appointment of lead plaintiff discouraged institutional investors, who hold over half of the equity in domestic markets, from acting as lead plaintiffs. The Conference Committee went on to explain:

PSLRA provides that the presumption of the “most adequate plaintiff” is rebuttable,¹³² but it does not address when it is possible to challenge the presumption.¹³³ Nor does it address the issue of whether defendants have standing to challenge the “most adequate plaintiff” presumption.¹³⁴

Certain courts have held that a defendant in a securities class action has standing to object to lead plaintiff appointment.¹³⁵ These courts justify their rule as being “consistent with the goal of alleviating the

[We believe] that increasing the role of institutional investors in class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions. . . .

. . . Institutional investors and other class members with large amounts at stake will represent the interests of the plaintiff class more effectively than class members with small amounts at stake.

Id. The PSLRA further encourages institutional shareholders to act as lead plaintiffs by creating extensive notice obligations on the individual seeking to serve as lead plaintiff. 15 U.S.C. § 78u-4(a)(3)(A) (2004). Specifically, said individual is responsible for filing, within twenty days of filing the complaint, a notice which informs potential class members of the action, its claims, and the purported class period. 15 U.S.C. § 78u-4(a)(3)(A)(i)(I) (2004). Federal common law holds that a plaintiff generally bears the entire cost of notice. *Oppenheimer Fund, Inc. v. Sanders*, 437 U.S. 340, 349, 356–59 (1978). This partially justifies the most adequate plaintiff presumption, as the defendant with the largest financial stake is more likely to be able to bear the costs of litigation. The most adequate plaintiff presumption is the most substantial improvement to private securities litigation caused by the PSLRA. It stands as somewhat of an outlier in the PSLRA as a provision that benefits plaintiffs. The presumption benefits plaintiffs because a plaintiff with a substantial financial interest in the litigation is likely to be an institutional investor. Institutional investors have more resources than a typical investor and are able to expend more time and money monitoring the course of the litigation. Since all plaintiffs recover a pro rata share of the damages, each plaintiff benefits from the most zealous representation possible.

131. 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(cc) (2004). For a class to be maintainable it must first meet the following requirements of Federal Rule of Civil Procedure 23(a): numerosity, commonality, typicality, and adequate representation of the class. FED. R. CIV. P. 23(a). In a shareholder derivative suit the lead plaintiff will usually satisfy these four requirements. Numerosity is satisfied because corporations typically have enough shareholders to make joinder impracticable, commonality is satisfied because all shareholders are suing based on common issues of law and fact, typicality is satisfied because each shareholder’s injury arise from the ownership of stock, only their pro rata share differs, and finally, adequate representation should be satisfied because any rational self-interested individual or entity will prosecute the claim to the best of their ability, because their personal recovery is contingent upon the group’s recovery.

132. 15 U.S.C. § 78u-4(a)(3)(B)(iii)(II) (2004).

133. *Id.* However, the Conference Committee report alludes to “potential conflicts” that may arise from institutional investors acting as lead plaintiff, which may imply that the presumption can be properly rebutted when conflicts arise from institutional investors acting as lead plaintiffs. H.R. CONF. REP. NO. 104-369, at 34.

134. Tiffany M. Wong, Comment, *Defendants’ Standing to Oppose Lead Plaintiff Appointment Under the Private Securities Litigation Reform Act of 1995*, 2003 U. CHI. LEGAL F. 833, 836.

135. *King v. Livent, Inc.*, 36 F. Supp. 2d 187, 190 (S.D.N.Y. 1999) (concluding that “nothing in the text of the Reform Act precludes or limits the right of defendants to be heard on [the appointment of lead plaintiff and class counsel].”).

abuses of the class action device in securities litigation.”¹³⁶ Here, the courts exhibit what this Comment repeatedly asserts: any ambiguous provision must be read in accord with the PSLRA’s core purpose of deterring frivolous lawsuits. This principle of statutory construction, known as purposivism, instructs judges to consider congressional purpose or policy behind the statute’s enactment when interpreting its meaning.¹³⁷ “Instead of attempting to reconstruct how the legislature would have likely addressed a particular issue, purposivism calls on judges to identify the statute’s purpose and resolve the dispute at issue in light of that purpose.”¹³⁸

C. Purposivism in Securities Litigation Jurisprudence

The Supreme Court employed a purposivist reading of the Exchange Act in a recent private securities litigation case.¹³⁹ In *United States v. O’Hagan*, the Court validated misappropriation theory as the basis for insider trading liability because the theory was “well tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence.”¹⁴⁰ Richard Walker and David Levine, former senior officials at the SEC, support the reasoning employed in *O’Hagan* and have since suggested that “[a] strict textual reading of section 10(b) would not only invalidate the misappropriation theory, but would eviscerate insider trading liability altogether.”¹⁴¹ *O’Hagan* suggests that the Court prefers purposivism to strict textual construction in determining section 10(b) liability.¹⁴² Thus, purposivist statutory construction has been crucial in establishing the current body of private securities litigation jurisprudence.¹⁴³

136. *Id.* (quoting *Howard Gunty Profit Sharing v. Quantum Corp.*, No. 96 Civ. 20711 SW, slip op. at 7 (N.D. Cal. Aug. 14, 1997)).

137. Ediberto Román, *Statutory Interpretation in Securities Jurisprudence: A Failure of Textualism*, 75 NEB. L. REV. 377, 389 (1996).

138. *Id.* (citing Martin H. Redish & Theodore T. Chung, *Democratic Theory and the Legislative Process: Mourning the Death of Originalism in Statutory Interpretation*, 68 TUL. L. REV. 803, 815 (1994)).

139. *See* *United States v. O’Hagan*, 521 U.S. 642 (1997).

140. *Id.* at 658.

141. Richard H. Walker & David M. Levine, *The Limits of Central Bank’s Textualist Approach—Attempts to Overdraw the Bank Prove Unsuccessful*, 26 HOFSTRA L. REV. 1, 19 (1997).

142. *See id.* at 21–22 (“As long as defendant’s conduct reasonably comes within the flexible language of section 10(b) [textualist precedent] will not shield that defendant from liability simply because the conduct has historically been described in specific language not found in the statute.”).

143. *Cf.* Amy E. Fahey, Note, *United States v. O’Hagan: The Supreme Court*

Because the scienter requirement is an ambiguous term,¹⁴⁴ it should be read consistently with its surrounding provisions and the purpose of the PSLRA. This section has established that the core provisions of the PSLRA disadvantage securities plaintiffs consistently with the Act's purpose. Thus, the scienter requirement should be interpreted in a manner that furthers the congressional goal of discouraging frivolous lawsuits by reducing plaintiff's bargaining leverage.

III. SCIENTER

A. *The Scienter Requirement Before the PSLRA*

1. *Second Circuit's Pre-PSLRA Standard*

Prior to the enactment of PSLRA, plaintiffs in the Second Circuit faced the nation's highest pleading standard. In the Second Circuit, scienter was a necessary element of each 10b-5 action, but there was no requirement that plaintiff go so far as to plead scienter with "great specificity."¹⁴⁵ Second Circuit case law required that the facts alleged in the plaintiff's complaint "give[] rise to a 'strong inference' of fraudulent intent."¹⁴⁶

Plaintiff could fulfill her burden and give rise to the strong inference by alleging either (1) motive to commit securities fraud and an opportunity to do so, or (2) facts constituting sufficient evidence of reckless or conscious behavior.¹⁴⁷ At the time, this was the most difficult standard for plaintiffs to satisfy.

2. *Ninth Circuit's Pre-PSLRA Scienter Standard*

In the Ninth Circuit, conclusory allegations of scienter were sufficient to survive a motion to dismiss.¹⁴⁸ Alternatively, a plaintiff could allege

Abandons Textualism to Adopt the Misappropriation Theory, 25 *FORDHAM URB. L.J.* 507, 532–34 (1998) (arguing that purposivism should not be used in interpreting section 10(b)).

144. The PSLRA refers to the "[r]equired state of mind" without providing a description of the required state of mind. *See* 15 U.S.C. § 78u-4(b)(2) (2004).

145. *Conn. Nat'l Bank v. Fluor Corp.*, 808 F.2d 957, 962 (2d Cir. 1987) (quoting *Goldman v. Belden*, 754 F.2d 1059, 1070 (2d Cir. 1985)).

146. *O'Brien v. Nat'l Prop. Analysts Partners*, 936 F.2d 674, 676 (2d Cir. 1991) (quoting *Wexner v. First Manhattan Co.*, 902 F.2d 169, 172 (2d Cir. 1990)). *See also* Eugene P. Caiola, Comment, *Retroactive Legislative History: Scienter Under the Uniform Securities Litigation Standards Act of 1998*, 64 *ALB. L. REV.* 309, 324–25 (2000).

147. *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 269 (2d Cir. 1993).

148. *Fecht v. Price Co.*, 70 F.3d 1078, 1082 n.4 (9th Cir. 1995) (stating that under the applicable standard the plaintiff "need 'simply . . . say[] that scienter existed' to satisfy the requirements of Rule 9(b)." (alteration in original) (quoting *In re Glenfed, Inc.*

facts constituting circumstantial evidence of fraudulent behavior, provided the allegations describe how defendant's behavior was fraudulent.¹⁴⁹ For example, a plaintiff could allege that defendant disregarded a substantial and unjustified risk that projected earnings were far in excess of likely earnings. This standard, as first established by *In re Glenfed*, was admittedly lenient.¹⁵⁰ However, the court adhered to the lower standard, which the justices read as the appropriate construction of the law, while implying that the effect of a lower standard may bring about undesirable results.¹⁵¹

The split encouraged forum shopping.¹⁵² A typical shareholder's derivative suit will have plaintiffs in numerous states. In fact, it would be unusual for the initiators of such a suit to be unable to find a potential plaintiff in the Ninth Circuit, the most populous of the Federal Circuit Courts,¹⁵³ or the Second Circuit, where the New York Stock Exchange (NYSE) and many of the world's largest institutional investors are located. Defendants, due to their national characteristics, can also be subject to service of process and proper jurisdiction in multiple circuits.¹⁵⁴ Thus, plaintiffs are free to sue in a jurisdiction that applies law more conducive to their cause. This trend of forum shopping continues under the post-PSLRA standards.¹⁵⁵

Sec. Litig., 42 F.3d 1541, 1547 (9th Cir. 1994)).

149. *Id.* at 1083.

150. *See In re Glenfed, Inc. Sec. Litig.*, 42 F.3d 1541, 1546–47 (noting that the court might “like the effects” of heightening the applicable pleading standard). The *Glenfed* court appeared to be implying that they would prefer a heightened pleading standard because such a standard would be better able to deter frivolous lawsuits. *Id.* at 1546.

151. *Id.*

152. Laurae Rossi, *Choosing the Best Standard of Pleading Under the 1995 Private Securities Litigation Reform Act, And Why The Ninth Circuit's Standard Under In Re Silicon Graphics Conquers the Battle of the Circuits*, 31 SW. U. L. REV. 263, 265 (2002).

153. Office of the Circuit Executive, *United States Courts for the Ninth Circuit: History & Guide to the U.S. Courts*, at <http://www.ce9.uscourts.gov/> (last visited Apr. 16, 2005).

154. *See Wiwa v. Royal Dutch Petroleum Co.*, 226 F.3d 88, 93–99 (2d Cir. 2000) (holding that defendants, despite not having extensive contacts with New York, were properly subjected to personal jurisdiction in the Southern District of New York based on their having securities listed on the NYSE and an investor relations office in New York City).

155. *See Stanford Law School*, *supra* note 48 (noting that the Second Circuit's Southern District Court in New York, which currently imposes a lower standard than the Ninth, is the most active district for private securities litigation). U.S. courts have consistently discouraged forum shopping. *See McCarthy v. Olin Corp.*, 119 F.3d 148, 157 (2d Cir. 1997) (Calabresi, J., dissenting) (noting that certification in diversity cases serves to avoid the evil “of forum shopping that *Erie R.R. Co. v. Tompkins*, 304 U.S. 64,

B. The Post-PSLRA Circuit Split

The PSLRA was unsuccessful in resolving the circuit split over the meaning of scienter because Congress failed to define scienter in the Act. If the language of the PSLRA was less ambiguous, the circuit split could have been resolved.¹⁵⁶ Unfortunately, the language of the Act leaves ample room for interpretation. Within a year of the PSLRA's passage Professor John Coffee compared it to "wet clay," arguing that the ultimate reading of the PSLRA lies with the federal courts, "the master sculptor . . . that will spell the difference between high art and merely competent mediocrity."¹⁵⁷ Professor Coffee's metaphor has proven accurate, as the various circuits have molded the PSLRA into their respective visions of what the law should be. The Fourth Circuit may have been wise to avoid this controversial circuit split in a recent decision.¹⁵⁸

1. Second Circuit's Post-PSLRA Standard

Second Circuit case law holds that the PSLRA did not change the basic pleading requirements for private securities litigation.¹⁵⁹ Plaintiff may plead scienter by alleging specific facts that either (1) establish

73–77 (1938), was intended to prevent") (citations omitted).

156. When a statute's meaning is clear from the language alone, judicial inquiry as to meaning is unnecessary. *See* *Conn. Nat'l Bank v. Germain*, 503 U.S. 249, 253–54 (1992).

[I]n interpreting a statute a court should always turn to one, cardinal canon before all others. . . . [C]ourts must presume that a legislature says in a statute what it means and means in a statute what it says there. . . . When the words of a statute are unambiguous, then, this first canon is also the last: "judicial inquiry is complete."

Id. However, when a statute's meaning is not apparent from its language, varying judicial interpretation seems inevitable. Numerous circuit splits revolve around the interpretation of ambiguous statutory language. *See, e.g., InvesSys, Inc. v. McGraw-Hill Cos.*, 369 F.3d 16, 22–23 & n.3 (1st Cir. 2004) (demonstrating that the First Circuit agreed with the Seventh Circuit, but disagreed with the Eight Circuit, over whether § 505 of the Copyright Act provides that attorneys should be reimbursed for computer-assisted research); *United States v. Brisbane*, 367 F.3d 910, 912–14 (D.C. Cir. 2004) (demonstrating that the D.C. Circuit disagreed with four other circuits over whether "cocaine base," as used in 21 U.S.C. §841(b)(1)(B)(iii), applied only to crack and other smokeable versions of cocaine, or to all base forms of cocaine).

157. Coffee, Jr., *supra* note 9, at 975.

158. *See Svezzese v. Duratek, Inc.*, No. 02-1587, 2003 WL 21357313, at *5 (4th Cir. June 12, 2003) (representing plaintiffs' allegations that defendants engaged in a scheme designed to inflate the price of Duratek stock). The court avoided taking a position on the controversial circuit split by noting that the facts alleged by the plaintiff class were insufficient to meet even the most lenient pleading standard. *Id.* Thus, the Fourth Circuit managed to stay out of the fray.

159. *Novak v. Kasaks*, 216 F.3d 300, 310 (2d Cir. 2000) ("[T]he PSLRA effectively raised the nationwide pleading standard to that previously existing in this circuit and no higher . . .").

“both motive and opportunity to commit fraud,” or (2) constitute “strong circumstantial evidence of conscious misbehavior or recklessness.”¹⁶⁰ The Second Circuit’s position is the overwhelming favorite among commentators.¹⁶¹

Second Circuit courts have defended the motive and opportunity test by holding that “[m]otives that are generally possessed by most corporate directors and officers do not suffice; instead, plaintiffs must assert a concrete and personal benefit to the individual defendants resulting from the fraud.”¹⁶² A sufficient motive may be established where defendant liquidates his holdings following misrepresentations, which artificially inflate stock price.¹⁶³ While the facts necessary to establish a sufficient motive, those of a “concrete and personal” benefit,¹⁶⁴ may initially seem like a rare occurrence, they occur frequently in insider trading cases.¹⁶⁵ A plaintiff can satisfy the second means of pleading scienter by alleging positive misstatements.¹⁶⁶ Unsubstantiated allegations of misstatement do not suffice in the Ninth Circuit.¹⁶⁷

160. *Kalnit v. Eichler*, 264 F.3d 131, 138–39 (2d Cir. 2001). This test is identical to that used in the Second Circuit before the PSLRA’s passage. The Second Circuit seems to view the PSLRA’s scienter requirement as nothing more than a codification of pre-PSLRA Second Circuit case law. In fact, in explaining the ways in which a plaintiff may meet her scienter requirement, the *Kalnit* court cited pre-PSLRA Second Circuit case law. *Id.* (citing *Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 52 (2d Cir. 1995) (quoting *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994))).

161. *See* Guido, *supra* note 43, at 534 (arguing that the PSLRA did not change the substantive standard for scienter); Dunn, *supra* note 30, at 248–50 (arguing that textual reading, legislative history, and policy goals favor reading scienter as unchanged under the PSLRA); Erin Brady, Comment, *Determining the Proper Pleading Standard Under the Private Securities Litigation Reform Act of 1995 After In re Silicon Graphics*, 28 PEPP. L. REV. 471 (2001) (relying on a textual reading to support the argument that the Second Circuit’s standard is reflective of congressional intent).

162. *Kalnit*, 264 F.3d at 139.

163. *Novak*, 216 F.3d at 307–08.

164. *Id.* at 307.

165. *See* SEC v. Weissman, Litigation Release No. 17,068, 75 SEC Docket 1288 (July 18, 2001); SEC v. Schiffer, Litigation Release No. 17,191, 76 SEC Docket 237 (Oct. 16, 2001); SEC v. Iacovelli, Litigation Release No. 17,280, 76 SEC Docket 1526 (Dec. 19, 2001); SEC v. Thatcher, Litigation Release No. 17,353, 76 SEC Docket 2602 (Feb. 5, 2002); *United States v. King*, Litigation Release No. 17,398, 77 S.E.C. Docket 194 (Mar. 6, 2002).

166. *Kalnit*, 264 F.3d at 143–44.

167. *Nursing Home Pension Fund, Local 144 v. Oracle Corp.* 380 F.3d 1226, 1231 (9th Cir. 2004) (requiring plaintiff be able to point to “hard numbers and make specific allegations” to call into question the validity of public representations).

2. Ninth Circuit's Post-PSLRA Standard

a. *Silicon Graphics I and II*

In re Silicon Graphics, Inc. Securities Litigation (“*Silicon Graphics I*”) was the first case to decide that the PSLRA eliminated recklessness as a basis for liability in securities fraud.¹⁶⁸ In *Silicon Graphics I*, the United States District Court for the Northern District of California held that Congress intended to abrogate the Second Circuit motive and opportunity test as a sufficient basis for liability and “strengthen” the pre-PSLRA scienter standard.¹⁶⁹ The *Silicon Graphics I* court relied heavily on the Conference Committee Report,¹⁷⁰ a means of statutory construction supported by even the staunchest of textualists.¹⁷¹

The Ninth Circuit expanded on the *Silicon Graphics I* standard in *In re Silicon Graphics, Inc. Securities Litigation* (“*Silicon Graphics II*”).¹⁷² The *Silicon Graphics II* court held that the PSLRA requires a plaintiff to plead “particular facts giving rise to a strong inference of *deliberate recklessness*.”¹⁷³ Where ordinary recklessness is essentially heightened negligence, and therefore can occur absent intentional conduct, deliberate recklessness requires intentional action.¹⁷⁴ Thus, the Ninth Circuit’s post-PSLRA scienter requirement differs from all pre-PSLRA rulings in that it is the first to require intentional misconduct.¹⁷⁵ This is, without debate, the higher of the various standards.

The Ninth Circuit scienter standard as articulated in *Silicon Graphics II* does not function as an absolute bar to plaintiff recovery. Instead, it represents the most successful attempt to “eliminate frivolous or sham actions, but not actions of substance.”¹⁷⁶ Recent Ninth Circuit cases

168. 970 F. Supp. 746, 757 (N.D. Cal. 1997).

169. *Id.* (“Motive, opportunity, and non-deliberate recklessness may provide some evidence of intentional wrongdoing, but are not alone sufficient to support scienter unless the totality of the evidence creates a strong inference of fraud.”)

170. *See id.* (“In light of the confusion revealed in individual legislators’ statements, the Court finds the Conference Committee Report and the ultimate adoption of the Conference’s version of the bill even more persuasive.”).

171. *See Garcia v. United States*, 469 U.S. 70, 76 (1984) (Rehnquist, J.) (“[T]he authoritative source for finding the Legislature’s intent lies in the Committee Reports on the bill, which ‘represen[t] the considered and collective understanding of those Congressmen involved in drafting and studying proposed legislation.’”) (quoting *Zuber v. Allen*, 396 U.S. 168, 186 (1969)).

172. 183 F.3d 970 (9th Cir. 1999).

173. *Id.* at 974 (emphasis added).

174. *Id.* at 975–77.

175. *Cf. Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529, 538 (2d Cir. 1999) (implying that recklessness is not a form of intentional conduct); *see also Caiola*, *supra* note 146, at 332.

176. *Nursing Home Pension Fund, Local 144 v. Oracle Corp.* 380 F.3d 1226, 1235 (9th Cir. 2004).

illustrate the balance that the circuit has struck between sustaining meritorious claims and dismissing frivolous claims.

b. Oracle and the Specificity With Which Plaintiff Must Plead

In *Nursing Home Pension Fund v. Oracle (Oracle)*,¹⁷⁷ allegations that a business had constructive knowledge that it was not going to meet financial expectations, when combined with allegations of insider trading and accounting irregularities, were sufficient to plead scienter under the PSLRA.¹⁷⁸ The complaint's specific factual allegations were essential to the court's findings. For example, a plaintiff may show that a corporation made purposefully false representations by reference to internal corporate data that contradicts public representations.¹⁷⁹ However, plaintiff can only rely on the presence of such internal records by pleading "hard numbers or other specific information."¹⁸⁰ The requirement that plaintiff plead specific facts in his complaint allows the Ninth Circuit to distinguish between meritorious and meritless claims.¹⁸¹

In *Oracle*, the corporate defendant repeatedly asserted that it would meet its earnings predictions of twelve cents per share and revenue predictions of \$2.9 billion for the fiscal quarter, despite a slowing economy and the disappointing performance of one of the company's most important products.¹⁸² Statements made by Oracle's Chief Executive Officer (CEO),¹⁸³ Chief Financial Officer,¹⁸⁴ Executive Vice President,¹⁸⁵

177. *Id.*

178. *Id.* at 1235.

179. *See id.* at 1230–31. "The most direct way to show both that a statement was false when made and that the party making the statement knew that it was false is via contemporaneous reports or data, available to the party, which contradict the statement." *Id.* at 1230.

180. *Id.* at 1231; *See also* *In re Silicon Graphics Sec. Litig.*, 183 F.3d at 985 ("[A] proper complaint which purports to rely on the existence of internal reports would contain at least some specifics from those reports as well as such facts as may indicate their reliability."). *Cf.* *Lipton v. Pathogenesis Corp.*, 284 F.3d 1027, 1036 (9th Cir. 2002) (noting that conclusory allegations that defendant had access to internal reports, which were inconsistent with public representations, did not give rise to an inference that defendant was deliberately reckless in making errant public representations).

181. *Cf. Lipton*, 284 F.3d at 1036.

182. *Oracle*, 380 F.3d at 1228.

183. *Id.* ("The economic slowdown isn't hurting Oracle . . . because the company has spent the past three years updating its product line to focus on software that helps companies use the internet to cut costs and boost efficiency.").

184. *Id.* ("[T]he economy right now even though it's slowing doesn't seem to be affecting us. We see no difference in demand for our upcoming third fiscal quarter.").

185. *Id.* ("[Oracle is experiencing] robust demand for both its database and applications

and spokeswomen¹⁸⁶ indicated that the corporation was making a concerted effort to project the message that profits would not be down for the quarter. Plaintiffs were able to allege that these statements were intentionally misleading by relying on statements of former Oracle insiders, each of whom testified to a “major slowdown in sales.”¹⁸⁷

Absent insider statements indicating that the public representations were false, plaintiffs would not have been able to challenge the legitimacy of the public representations.¹⁸⁸ This rule prevents plaintiffs from suing based on many public representations that ultimately prove false, thus encouraging corporate disclosure. A rule that allows suits to proceed on the inaccuracy of public statements, absent specific factual allegations that suggest fraud, would chill corporate disclosure.

Suspicious insider trades indicate scienter by suggesting that corporate insiders had knowledge that the company was withholding crucial information from the market.¹⁸⁹ The Ninth Circuit evaluates the suspiciousness of insider trades by considering “(1) the amount and percentage of shares sold; (2) timing of the sales; and (3) consistency with prior trading history.”¹⁹⁰ The *Oracle* court found that Larry Ellison, Oracle’s CEO, engaged in suspicious insider trading by selling a substantial block of shares prior to the announcement that Oracle failed to meet earnings.¹⁹¹ Ellison’s behavior was particularly suspicious because he had not sold Oracle shares during the previous five years.¹⁹² The test employed in determining the suspiciousness of insider trades furthers the goal of requiring plaintiff to plead with specificity.

businesses . . . Oracle says it is also seeing sustained demand for its database product, despite industry-wide concern over contracting [information technology] budgets.”).

186. “Oracle has yet to see any sign that its business is being hurt by the economic slowdown or reported cuts to information-technology budgets’ . . . ‘[The] slowdown is going to provide new opportunities for Oracle as companies need to streamline and be more strategic about the technology they buy.’” *Id.* (quoting Oracle spokeswomen Stephanie Aas and Jennifer Glass, respectively).

187. *Id.* at 1231 (“For example, an account manager for the western United States said that ‘by the summer 2000, the telephones in General Business West ‘went dead.’”).

188. *Cf.* *Kalnit v. Eichler*, 264 F.3d 131, 138–39 (2d Cir. 2001) (implying that scienter can be established in the Second Circuit absent specific misstatements) and *Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529, 538 (2d Cir. 1999) (“The Second Circuit has been lenient in allowing scienter issues to withstand summary judgment based on fairly tenuous inferences.”).

189. *See In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 986 (9th Cir. 1999).

190. *Oracle*, 380 F.3d at 1232 (citing *Silicon Graphics II*, 183 F.3d at 986). The first consideration places reduced emphasis on the percentage of shares sold where “stock sales result in a truly astronomical figure.” *Oracle*, 380 F.3d at 1232.

191. *Id.*

192. *Id.*

Misleading or improper accounting practices also indicate that a defendant possesses the requisite scienter to commit securities fraud.¹⁹³ In *Oracle*, plaintiffs presented an expert witness who argued that questionable accounting practices resulted in Oracle improperly recording \$230 million as revenue.¹⁹⁴ The assertions of the expert witness were sufficient to give rise to an inference that Oracle engaged in misleading accounting practices.¹⁹⁵

Specific allegations that corporate officers had at least constructive knowledge of corporate fraud are crucial to pleading scienter in the Ninth Circuit.¹⁹⁶ For example, where a CEO is personally involved in several failed negotiations, it is inferred that he has constructive knowledge of the impact the failed negotiations will have on the company's ability to meet its financial goals.¹⁹⁷ Further, corporate officers who admittedly engage in micromanagement are more likely to have constructive knowledge of financial shortcomings.¹⁹⁸

Oracle illustrates two essential principles of Ninth Circuit scienter jurisprudence: (1) pleading scienter requires specific allegations of fraud, and (2) specific allegations that corporate officers had reason to know of the company's fraudulent operations.¹⁹⁹ By requiring securities plaintiffs to make specific factual allegations regarding both the substance of fraud and management's knowledge of the fraud, the Ninth Circuit effectively discourages the filing of frivolous lawsuits without preventing meritorious claims from surviving a motion to dismiss.

193. Oracle maintained a debit account containing money that customers had inadvertently overpaid to Oracle. On November 17, 2000, Oracle created more than 46,000 invoices ("debit memos") in an effort to "clean up" the account. Plaintiffs allege that Oracle credited the amount of the debit memos as revenue, thereby artificially inflating the amount of revenue reported on December 14 at the end of the second quarter.

See id. at 1233.

194. *Id.*

195. *Id.* at 1234.

196. *See id.* at 1231–34.

197. *Id.* at 1231–32.

198. *See id.* at 1234 (describing specific admissions by corporate officers that they engage in "hands on" management, which suggest that said managers had knowledge of fraudulent activity).

199. *See id.* ("It is reasonable to infer that the Oracle executives' detail-oriented management style led them to become aware of the allegedly improper revenue recognition of such significant magnitude that the company would have missed its quarterly earnings projection but for the adjustments.").

c. Advantages of the Ninth Circuit Rule

Adoption of the Ninth Circuit rule decreases the chances that plaintiffs will be successful when pursuing fraud claims. Plaintiffs and plaintiffs' attorneys will be less likely to bring securities suits if they contemplate reduced chances of success. Reducing the number of securities fraud claims pursued against issuers will cause an increase in the value of securities. This increase will result from both issuers allocating fewer resources to monitoring its agents, and issuers being subjected to fewer lawsuits.

The prevailing standards have not effectively reduced the number private fraud filings.²⁰⁰ The Stanford Law School Security Class Action Clearinghouse noted this nonreduction as a pattern in the five years following the passage of the PSLRA.²⁰¹ The easiest way to bring about a reduction in filings is to interpret the scienter standard as being more conducive to granting defendants' motions for summary judgment, which is exactly what the Ninth Circuit standard achieves.

3. Tenth Circuit's Middle Ground

The Tenth Circuit adopted a position in between the extremes that are the Second and Ninth Circuits. The Tenth Circuit test instructs the court to consider the "totality of the pleadings," and considers motive and opportunity to be indicative of scienter.²⁰² The test requires that plaintiff's allegation in their entirety "give rise to a strong inference of scienter."²⁰³ This approach has become increasingly popular and resembles the tests used by the First, Fifth, Sixth, and Eleventh Circuits.²⁰⁴

200. See Stanford Law School, *supra* note 48 (noting that the number of suits filed in the three years before the passage of the PSLRA, 1993–1995, averaged 194 per year). In the four years after the passage of the bill, 1997–2000, the number rose to 207 per year. *Id.* This second number would be substantially higher if it included the number of suits filed in 2001, when the collapse of the internet boom in part contributed to the filing of an astounding 493 suits. *Id.*

201. *Id.*

202. *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245, 1262–63 (10th Cir. 2001); Hart, *supra* note 28, at 578 (referring to the Tenth Circuit's position as aligning itself with the "middle ground" circuits).

203. *Fleming*, 264 F.3d, at 1263.

204. *Id.* at 1261–62. "These circuits have determined that courts must look to the totality of the pleadings Allegations of motive and opportunity may be important to that totality, but are typically not sufficient in themselves to establish a 'strong inference' of scienter." *Id.* at 1262. The Tenth Circuit went on to note that the Eleventh Circuit's standard was "arguably" in line with the position adopted by the Tenth Circuit. *Id.* at 1261.

IV. NINTH CIRCUIT'S ARTICULATED STANDARD SHOULD BE ADOPTED ON CERTIORARI

A. Second Circuit Standard is Not Consistent with the Core Provisions

As established in section II.B, the core provisions of the PSLRA discourage the filing of marginal securities suits by decreasing plaintiff's bargaining leverage. When combined with the Act's legislative history, the effect of the core provisions gives rise to a logical inference that the purpose of the PSLRA was to advantage securities litigation defendants. When interpreting the scienter requirement, courts should act consistently with the Act's overall purpose.

The Second Circuit's interpretation of scienter prevents the PSLRA from effectively furthering its goal of discouraging the filing of frivolous lawsuits. By adopting ordinary recklessness as the requisite scienter requirement, the Second Circuit undermined the PSLRA's dominant purpose. Where the core provisions of the Act work to the defendants' advantage, the Second Circuit's scienter requirement favors securities litigation plaintiffs and contravenes the intent expressed in the Act's legislative history.

The degree of intent required to find liability for a given claim relates directly to the parties' bargaining positions. The basic standards of culpability include, from easiest to most difficult to establish, the following standards: negligent,²⁰⁵ reckless,²⁰⁶ intentional,²⁰⁷ and purposeful.²⁰⁸ A defendant liable under a heightened standard of culpability will also be liable under all lower standards. For example, a defendant acting purposely is also, by definition, acting intentionally.

The imposition of recklessness, as opposed to a higher standard, as the required state of mind to hold a defendant liable for securities fraud violations increases plaintiff's chances of success at trial. Any factor

205. BLACK'S LAW DICTIONARY 1061 (8th ed. 2004) ("[F]ailure to exercise the standard of care that a reasonably prudent person would have exercised in a similar situation; any conduct that falls below the legal standard established to protect others against unreasonable risk of harm . . . culpable carelessness.").

206. *Id.* at 1298 ("Conduct whereby the actor does not desire harmful consequence but nonetheless foresees the possibility and consciously takes the risk.").

207. *Id.* at 826 ("Done with the aim of carrying out the act.").

208. *Id.* at 1272 ("Done with a specific purpose in mind . . ."). Purpose is defined in part as "[a]n objective, goal, or end." *Id.* at 1271.

that increases the chance that a party will succeed at trial increases that party's bargaining leverage. Thus, the Second Circuit scienter requirement gives plaintiff more bargaining leverage than does the Ninth Circuit scienter requirement. This interpretation conflicts with the effect of the core provisions of PSLRA, which is to increase defendant's bargaining leverage.²⁰⁹

Several arguments support abandoning recklessness as the standard for liability in favor of a higher standard. First, the Second Circuit holding that the PSLRA did not modify the scienter requirement²¹⁰ ignores statements of congressional intent.²¹¹ Second, the PSLRA, as currently interpreted, has been largely ineffective in discouraging the filing of frivolous lawsuits. Third, it can be inferred from the effect of the core provisions of the PSLRA that the desired goal of the Act was to discourage plaintiffs from filing frivolous suits by reducing their chances of surviving a motion to dismiss.²¹²

B. Ninth Circuit Standard is Consistent as Articulated, However its Application is Questionable

The Ninth Circuit's decision in *In re Silicon Graphics II*²¹³ established that the PSLRA's scienter requirement could only be satisfied by pleading deliberately reckless or conscious misconduct.²¹⁴ The *Silicon Graphics* courts expressly rejected motive and opportunity to commit fraud as a means to establish the requisite scienter.²¹⁵ This scienter requirement was generally viewed as a substantial change from the level of proof required before the PSLRA.²¹⁶ This standard, if applied as articulated, would be consistent with the effect of the core provisions of the PSLRA. However, a recent trend suggests that the Ninth Circuit's

209. See section II.B, *supra* (discussing the effect of the core provisions).

210. *Kalnit v. Eichler*, 264 F.3d 131, 138–39 (2d Cir. 2001).

211. H.R. CONF. REP. NO. 104-369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740 (“Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit’s case law interpreting this pleading standard.”).

212. See *King v. Livent, Inc.*, 36 F. Supp. 2d 187, 190 (S.D.N.Y. 1999); *In re First Union Corp. Sec. Litig.*, 157 F. Supp. 2d 638, 641 (W.D.N.C. 2000).

213. *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999) (requiring plaintiff to plead “in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct.”).

214. *Id.*

215. *Id.*

216. Scott H. Moss, Comment, *The Private Securities Litigation Reform Act: The Scienter Debacle*, 30 SETON HALL L. REV. 1279, 1318 (2000) (“In addition to forming a new and uncertain standard of scienter under the PSLRA, the Ninth Circuit established a *seemingly impossible barrier* to private individuals bringing a securities fraud claim”) (emphasis added).

application of the rule established in *Silicon Graphics I* and *II* blurs the differences between deliberate recklessness and ordinary recklessness.²¹⁷

It has been argued that the Ninth Circuit has “retreated” from its once “extreme interpretation” of the PSLRA and has applied a more relaxed standard in recent cases.²¹⁸ Charles F. Hart argues that the “deliberate recklessness” standard, as applied by the Ninth Circuit, is “essentially the same as the Sixth Circuit’s ‘akin to conscious disregard,’ which both the First and Eleventh Circuits have adopted.”²¹⁹ Mr. Hart bases this argument on two Ninth Circuit cases, one of which directs district courts to view complaints in their “entirety” and to consider an allegation “together with any reasonable inferences.”²²⁰

In *Gompper v. VISX*, the Ninth Circuit emphasized the importance of viewing a complaint in its entirety, including drawing all logical inferences, in order to ensure that a heightened pleading standard is applied.²²¹ To do otherwise, and to accept “only inferences favorable to [the plaintiff] would be to eviscerate the PSLRA’s strong inference requirement by allowing plaintiffs to plead in a vacuum.”²²² The *Gompper* court expressly rejected plaintiff’s argument that the court must accept any reasonable and warranted inference favorable to the plaintiff and reject all other inferences.²²³ This approach, considering all possible inferences, is consistent with the Ninth Circuit precedent, but creates the possibility of a functional lowering of the articulated standard.²²⁴

217. See Hart, *supra* note 28, at 601 (“Interestingly, in both *Lipton v. PathoGenesis Corp.*, and in another Ninth Circuit case, *Gompper v. VISX, Inc.*, the Ninth Circuit appeared to downplay any differences between its interpretation of the PSLRA and that of its sister circuits.”).

218. *Id.*

219. *Id.* Hart goes on to argue that the Tenth Circuit’s “extreme departure from the standards of ordinary care . . . known to the defendant” will usually lead to the same result as the supposedly extreme Ninth Circuit test. *Id.*

220. *Id.* at 601 (citing *Gompper v. VISX, Inc.*, 298 F.3d 893, 897 (9th Cir. 2002)).

221. *Gompper*, 298 F.3d at 896.

222. *Id.*

223. *Id.* Plaintiff argued that the fact that defendant, VISX, vigorously litigated against others, who VISX felt were infringing on their patent rights, gave rise to the inference that VISX knew their patent was invalid and were attempting to protect their business through intimidation. *Id.* at 896–97. The court then noted that they could not rightly exclude the inference which cut against plaintiffs’ argument that VISX was litigating against potential patent infringers because VISX believed the patent was valid. *Id.*

224. *Id.* at 897 (citing *Yourish v. Cal. Amplifier*, 191 F.3d 983, 996 (9th Cir. 1999)). Plaintiff argued that defendant knew it was not going to have strong sales based on defendant’s knowledge that defendant was expecting a reduction in total shipment. *Id.* The court rejected plaintiff’s argument because of the possibility of other inferences,

A recent district court case applying the Ninth Circuit standard illustrates the possibility that the lofty scienter requirement can be applied in a lenient fashion through the adoption of permissive presumptions. In *Johnson v. Aljian (Aljian)*,²²⁵ the Central District of California adopted a permissive presumption that a civil defendant who trades while in possession of material nonpublic information (MNPI) is trading based on the MNPI.²²⁶ The court instructed that this presumption is proper where defendants' trading in the security at issue was suspiciously inconsistent with defendants' prior trades.²²⁷ The court held that the circumstantial evidence was sufficient to give rise to a strong inference of scienter.²²⁸

Allowing the permissive inference in *Johnson* to constitute sufficient evidence of scienter conflicts with Ninth Circuit precedent. An earlier Ninth Circuit decision held that "[t]he existence of a 'reasonable inference' . . . does not satisfy the PSLRA's requirement that Plaintiffs allege particular facts that give rise to a 'strong inference' of scienter."²²⁹ Regardless of the reasonableness of the inference in *Aljian*, its certain affect is to improve plaintiff's chance of surviving a motion for summary judgment. Liberal adoption of permissive presumptions based on minimal hard evidence undermines the PSLRA's goals and effectively lowers the Ninth Circuit's heightened pleading standard.

V. CONCLUSION: COURTS SHOULD INTERPRET THE SCIENTER REQUIREMENT CONSISTENTLY WITH THE CORE PROVISIONS

The PSLRA's drafters wrote a piece of legislation whose clear goal was to shift the advantage in private securities litigation from plaintiff to defendant. This intent is evident in the probable effect of numerous PSLRA provisions. This Comment cites several examples of how the PSLRA reduces the plaintiff class' bargaining leverage and decreases the likelihood that the plaintiff class will reach a favorable settlement. The goal of reducing bargaining leverage can also be gleaned from the legislative history of the Act, including an admission that the existing

including that there might not be a correlation between shipments and sales. *Id.*

225. No. 03-5986 FMC (PJWx), 2004 U.S. Dist. LEXIS 14986 (C.D. Cal. July 30, 2004).

226. *Id.* at 40 ("[A]lthough knowing possession of insider information is not a per se violation, when an insider trades while in possession of [NMPI], a strong inference arises that such information was used in the insider trading.") The same presumption was rejected by the Ninth Circuit in a criminal case as it would force the accused to prove her own innocence. *Id.* at 40-41.

227. *Id.* at 42.

228. *Id.* at 41.

229. *In re Read-Rite Corp. Sec. Litig.*, 335 F.3d 843, 848-49 (9th Cir. 2003).

law was not a sufficient means to limit the number of frivolous lawsuits filed.

The PSLRA's ambiguous and controversial scienter requirement is inconsistent with the rest of the Act if read as reducing or maintaining the pre-PSLRA scienter requirement. Only a reading which views the PSLRA's intent requirement as heightened beyond the pre-PSLRA standards would be consistent with the balance of the provision in the PSLRA. The United States Supreme Court should remedy the flawed interpretation of the PSLRA by adopting the Ninth Circuit's articulated scienter requirement and clarifying that there is a substantive difference between the adopted standard and that employed by the Second Circuit and the "middle ground" circuits.

SHAUN MULREED

