THE NEW SECURITIES CLASS ACTION: FEDERAL OBSTACLES, STATE DETOURS

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INTRODUCTION

The year 1995 will long be remembered as the year in which Congress first tackled the thorny issue of tort reform. Rarely has such an issue so inflamed passions and captured the attention of lawyers, legislators and legal experts alike. While proponents of tort reform have complained of a broad range of claimed abusive practices in tort lawsuits,[1] the debate in 1995 focused on a relatively narrow category of cases—class action lawsuits alleging securities law violations.

The Private Securities Litigation Reform Act of 1995 (the "Reform Act" or the "Act")[2] represents the culmination of extensive lobbying efforts by accountants, securities firms, and the high-technology industry to curtail what they perceived to be abusive securities class action litigation. These entities felt that they had been unjustly victimized by lawsuits alleging "fraud by hindsight." In such suits, a sudden drop in a company's stock price was claimed to be evidence that the issuer and its agents had been covering up the bad news that led to the price drop. A

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As this Article was going to print, the Commission issued a report to both President Clinton and the Congress on litigation under the Private Securities Litigation Reform Act of 1995. The authors helped prepare that report; portions appear in this Article. The conclusions expressed herein, however, are solely those of the authors, not necessarily the Commission.

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1. *See* House Republican Conference, Contract With America, Common Sense Legal Reforms Act, LEGISLATIVE DIGEST, Sept. 27, 1994, at 37 (The Act would have made "a number of legal reforms to, among other things, make sure that expert witness testimony is based on scientifically sound evidence, that product liability laws are uniformly applied, that abusive securities lawsuits are limited, and that opportunities for alternative dispute resolution are expanded.").

2. Pub. L. No. 104–67, 109 Stat. 737 (1995).

central theme of the legislative history is that plaintiffs' lawyers, rather than faithfully representing investors, were acting for their own benefit. Critics of securities class actions alleged that plaintiffs' lawyers were filing suits against "deep pocket" defendants—whether or not there was actual fraud—solely for their settlement value. Moreover, the critics charged, plaintiffs' lawyers were taking an exorbitant share of these settlements for themselves, leaving defrauded investors with only a fraction of the damages that the investors had suffered. Proponents of securities class actions countered that plaintiffs' lawyers serve an essential role in deterring fraud.[3] Putting obstacles in the enforcement of the securities laws by plaintiffs' attorneys would cause investors to lose confidence in the markets.[4]

We do not take sides in the debate and express no views on the accuracy of these competing characterizations of the role of plaintiffs' lawyers.[5] A brief review of the legislative history makes clear, however, that *Congress* did take sides, crediting the arguments of critics who asserted that plaintiffs' lawyers were the central problem with private securities litigation. Thus, the enactment of the Reform Act can be seen as an attempt by Congress to erect obstacles in the path of the plaintiffs' bar.[6]

As with any new legislative initiative, however, Congress must depend on the

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3. *Hearings Before the Subcomm. on Telecomm. and Fin., House Comm. on Commerce on Legislation on Sec. Fraud Litig.*, 104th Cong., 1st Sess. 45 (1995) (statement of William S. Lerach, testifying on behalf of the National Association of Securities and Commercial Law Attorneys (NASCAT)) ("we believe the empirical case for the major changes in the [House bill] has not been made and those proposals would leave those defrauded in the securities markets essentially without a remedy"); *Hearing on Sec. Litig. Reform Proposals: Subcomm. on Sec., Senate Comm. on Banking, Housing, and Urban Affairs*, 104th Cong., 1st Sess. 195 (1995) (statement of Sheldon H. Elsen, representing the New York Bar Association) (predicting that obstacles to securities class actions would lead to "many more violations of the law").

4. *Hearing on Sec. Litig. Reform Proposals, Subcomm. on Sec., Senate Comm. on Banking, Housing, and Urban Affairs*, 104th Cong., 1st Sess. 193 (1995) (statement of David J. Guin, testifying on behalf of NASCAT) (arguing that strengthened securities laws are necessary to maintain investor confidence).

5. The incentives of plaintiffs' lawyers are discussed in John C. Coffee, Jr., *Understanding the Plaintiffs's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669 (1986), and Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991).

We note that the Commission, while opposed to abusive litigation, has consistently stressed that private actions provide additional deterrence against securities law violations, thereby serving as a necessary supplement to the Commission's enforcement activities. *Hearing on Sec. Litig. Reform Proposals: Subcomm. on Sec., Senate Comm. on Banking, Housing, and Urban Affairs*, 104th Cong., 1st Sess. 247 (1995) (statement of Arthur Levitt, Chairman of the Securities and Exchange Commission) ("[T]he Commission has for some time been concerned about abuses in the private litigation system that operate to the detriment of the markets and investors. In most securities law cases, investors are on *both* sides of the cases. None of these investors is well served by a system that is unnecessarily costly to them.... [P]rivate actions are critical to ensure that issuers and those who work with them bear appropriate responsibility for their actions.") (emphasis added); *see also* Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 376 (1991) (Kennedy, J., dissenting).

6. *See* John C. Coffee, Jr., *The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung*, 51 BUS. LAW. 975, 995 (1996) ("the Reform Act seeks to tilt the balance in securities litigation in favor of the defendant at virtually every juncture").

courts to effect its purposes.[7] The courts' interpretation of the Reform Act will determine whether the Reform Act poses a substantial obstacle to the plaintiffs' bar, or a mere bump in the road.[8] The initial data suggests that the Reform Act is having some effect, at least in reducing the number of federal securities class action lawsuits.[9] The Securities and Exchange Commission's Office of the General Counsel has identified 105 companies sued in federal class actions during the first year following passage of the Reform Act. This compares with approximately 153 companies sued in federal securities class actions during 1993, 221 during 1994, and 158 during 1995.[10] Accordingly, there is a 34% drop-off from the number of suits filed in 1995, a 52% drop-off from the number of suits filed in 1994, and a 31% drop-off from the number of suits filed in 1993.[11]

In this Article, we go behind the numbers to analyze the initial decisions under the Reform Act in order to assess its effect on the ability of the plaintiffs' bar to bring—and continue to control—securities class actions in federal court.[12] We conclude that while some provisions of the Reform Act are indeed creating substantial obstacles for the plaintiffs' bar, the Act has not displaced plaintiffs' lawyers from the driver's seat in securities class actions. Moreover, plaintiffs lawyers appear to have found at least one detour around the obstacles erected by the Reform Act in federal court: state court. A new breed of forum shopping has

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7. Donald J. Boudreaux & A.C. Pritchard, *Reassessing the Role of the Independent Judiciary in Enforcing Interest-Group Bargains*, 5 CONST. POL. ECON. 1 (1994).

8. *See* Coffee, *supra* note 6, at 975 ("[T]he Reform Act is more like wet clay that has been shaped into an approximation of a human form by an apprentice craftsmen and has not been turned over to the master sculptor for the details that will spell the difference between high art and merely competent mediocrity. Legislation, like art, requires interpretation, and until that interpretive process is further along, the Reform Act must be regarded as still in its early formative period.").

9. We caution against evaluating the effectiveness of the Reform Act on a purely statistical basis. Data on the number of new filings does not point to any clear conclusions as to whether the Reform Act has been successful in eliminating the practices that it targeted.

10. These statistics have been supplied by *Securities Class Action Alert* ("SCAA").

11. A recent study by the National Economic Research Associates (NERA), however, finds that following an initial decline in cases filed, the number of new filings is now on pace with the number of filings last year. *See* DENISE N. MARTIN ET AL., NATIONAL ECONOMIC RESEARCH ASSOCIATES, RECENT TRENDS IV: WHAT EXPLAINS FILINGS AND SETTLEMENTS IN SHAREHOLDER CLASS ACTIONS? (1996) (hereinafter the "NERA Study"). According to the NERA Study, no significant decline in federal class action filings has occurred since the passage of the Reform Act. *Id.* at 6. NERA arrives at this conclusion by excluding the number of class actions filed during January to March of 1996, the first three months of the Act, and focusing solely on the number of class actions filed between April and October 1996. *Id.* During this time, 81 suits were filed, compared to 81 suits filed during the same period in 1995. *Id.*

The authors agree that the first three months following passage of the Reform Act are not telling. It has been reported that many class actions were rushed in under the wire in December 1995 to avoid the strictures of the Reform Act. *Id.* at 5. Other lawsuits were likely delayed as attorneys were hesitant to test unchartered waters as the first to file under the new Act. Nonetheless, even excluding the first three months from the count, the number of new cases filed in 1996 was less than in prior years. As NERA itself notes, going back to 1994, 135 cases were filed during the period from April to October, 60% more than the 81 filed during the same period in 1996, 97 were filed in 1993 (a 20% increase), and 125 were filed in 1992 (a 54% increase). *Id.* at tbl. 1.

12. We have reviewed the Reform Act decisions through February 20, 1997. While we discuss certain patterns that have begun to emerge, the case law is still in its infancy. As more cases are decided, the patterns may change. Nonetheless, the new securities class action is starting to take shape.

developed resulting in both an increase in stand alone state securities class actions, and parallel federal and state securities class actions.[13] It has been reported that 40% of the securities class actions filed in the first ten months of 1996 were filed in state courts, compared to slightly more than 20% during 1995.[14] Indeed, one source reports that there were sixty-five securities class actions filed in state court between January 2, 1996 and December 26, 1996—64% of the number filed in federal court during this same period.[15] The NERA Study found that seventy-eight cases had been filed in the first ten months of 1996 (for an annualized total of ninety-four), as compared to forty-eight cases for the previous year.[16] This shift to state court—which apparently was not anticipated by Congress—may well spark the next great battle in securities litigation reform. We analyze the incentives that have drawn plaintiffs' attorneys to turn to state courts in filing securities class actions; we then discuss the potential responses to this state court detour.

I. CREATION OF THE NEW SECURITIES CLASS ACTION

The federal securities class action, like other forms of class actions, is subject to both substantive and procedural requirements. The substantive requirements derive from the federal securities laws and the cases interpreting those laws. The procedural requirements governing the securities class action are found in the Federal Rules of Civil Procedure, in particular Rule 23. In the wake of the Reform Act, an entirely new securities class action has emerged. The new securities class action, while retaining nearly all of the substantive and procedural requirements of the old, has an entirely new layer of requirements—requirements not found in Rule 23 of the Federal Rules of Civil Procedure, and not applicable to other forms of class actions—which makes the new securities class action a unique genre. The new requirements were adopted to address the perceived abuses that Congress believed existed under the old order. The requirements are designed to encourage the real parties in interest in securities class actions—investors—to take a greater role in their management and to discourage frivolous suits by placing obstacles in the path of such suits.

A. Perceived Abuses

In the hearings that led to the enactment of the Reform Act, a primary target for congressional critics of securities class actions was the attorneys who represent plaintiffs in those actions.[17] The critics charged that the traditional plaintiff class action law firms dominated the actions brought by the "100 share plaintiff," setting their own fees, making all strategic decisions, and often reaching cosmetic settlements that favored the law firm at the expense of investors. The Senate Report

13. As accurately predicted by Professor Coffee, "[a] period of intense gamesmanship and experimentation seems likely, as new litigation strategies are attempted." Coffee, *supra* note 6, at 976.

14. *See* Walter Hamilton, *Lawyers' End Run Around Legal Reforms*, INVESTOR'S BUS. DAILY, Oct. 21, 1996, at A1.

15. *Securities Class Action Clearinghouse—State Complaints*, at 1–7 (last modified Jan. 8, 1997) <http://securities.stanford.edu>.

16. NERA Study, *supra* note 11, at 7.

17. For a more extensive discussion of the legislative history leading to the adoption of the Reform Act, see John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335 (1996).

states:

> Under the current system, the initiative for filing 10b–5 suits comes almost entirely from the lawyers, not from genuine investors. Lawyers typically rely on repeat, or "professional," plaintiffs who, because they own a token number of shares in many companies, regularly lend their names to lawsuits. Even worse, investors in the class usually have great difficulty exercising any meaningful direction over the case brought on their behalf. The lawyers can decide when to sue and when to settle, based largely on their own financial interests, not the interests of their purported clients.[18]

The Senate Report further charged that plaintiffs' lawyers recruited these malleable "professional plaintiffs" through "the payment of a 'bonus' far in excess of their share of any recovery."[19] With plaintiff in pocket, the Senate Report observed, plaintiffs' lawyers often rushed to the courthouse after spending a "minimal time preparing [the] complaint[]" because "[c]ourts traditionally appoint the lead plaintiff and lead counsel in class action lawsuits on a 'first come, first serve' basis."[20]

Congressional critics also charged that plaintiffs' lawyers were engaged in what was essentially legalized "extortion."[21] According to the House Report, plaintiffs' lawyers were filing suits "citing a laundry list of cookie-cutter complaints" against companies "within hours or days" of a substantial drop in the company's stock price.[22] Once the complaint was filed, plaintiffs' lawyers were free to impose "massive costs" on defendants in the form of discovery requests.[23] The availability of wide-ranging discovery gave plaintiffs' lawyers incentives to "file frivolous lawsuits in order to conduct discovery in the hopes of finding a sustainable claim not alleged in the complaint."[24] Faced with the cost of discovery, defendants found that "the pressure to settle becomes enormous."[25] "The cost of discovery often forces innocent parties to settle frivolous securities class actions."[26] Even if a company were willing to bear the expense of litigation, Congress believed companies inevitably settled rather than face a potentially ruinous jury verdict.[27]

Congress also found abuses in the settlement process, which they again blamed on the plaintiffs' bar. Plaintiffs' lawyers typically received a third of the settlement, with the plaintiffs often receiving pennies on the dollar.[28] Members of the plaintiff class often received inadequate notice of the terms of the settlement.[29] Courts were also subjected to criticism from Congress: judges rubber stamped these abusive settlements on "the premise that a bad settlement is almost always better than a

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18. S. REP. NO. 104–98, at 6 (1995).
19. *Id.* at 10.
20. *Id.*
21. *See, e.g.*, H.R. CONF. REP. NO. 104–369, at 32 (1995) ("Investors always are the ultimate losers when extortionate 'settlements' are extracted from issuers.").
22. H.R. REP. NO. 104–50, at 16 (1995).
23. *Id.*
24. S. REP. NO. 104–98, at 14 (1995).
25. H.R. REP. NO. 104–50, at 17 (1995).
26. H.R. CONF. REP. NO. 104–369, at 37 (1995).
27. H.R. REP. NO. 104–50, at 17.
28. *Id.*
29. H.R. CONF. REP. NO. 104–369, at 36 (1995).

good trial."[30]

In response to these perceived abuses by plaintiffs' lawyers, Congress, over President Clinton's veto,[31] enacted a series of provisions intended to "empower investors so that they—not their lawyers—exercise primary control over private securities litigation."[32] The Reform Act also attempts to make it more difficult for plaintiffs' lawyers to sue a company and force a settlement simply because its stock price dropped.

B. Empowering Investors

The Reform Act endeavors to empower investors vis-á-vis plaintiffs' lawyers in the conduct of securities class actions. One of the more novel reforms directs the court to appoint a "lead plaintiff" from among class members who seek to act as such, with a procedure for national publication of a notice advising class members of the filing of the action.[33] Not later than twenty days after the complaint is filed, the plaintiff filing the complaint must publish "in a widely circulated national business-oriented publication or wire service, a notice advising members of the purported plaintiff class...of the pendency of the action, the claims asserted therein, and the purported class period" and "not later than 60 days after the date on which the notice is published, any member of the purported class may move the court to serve as lead plaintiff of the purported class."[34] There is a rebuttable presumption that the most adequate plaintiff is the class member or group of members that has the largest financial interest in the relief sought in the case.[35] That presumption may be rebutted by proof that the presumptive plaintiff will not fairly and adequately protect the interests of the class or is subject to unique defenses foreclosing adequate representation.[36] Notably, the lead plaintiff selects counsel for the class, subject to court approval.[37]

Congress believed that the new system created by the Reform Act would encourage more responsible control of class actions. The presumption that the most adequate plaintiff is the one with the largest financial stake in the lawsuit is intended to "encourage institutional investors to take a more active role in securities class action lawsuits."[38] The Conference Committee "expect[ed] that the plaintiff will choose counsel rather than, as is true today, counsel choosing the plaintiff."[39]

The Reform Act further attempts to shift control of securities class actions into investors' hands by eliminating the ability of plaintiffs' attorneys to reward favored clients who agreed to serve as class representatives at their lawyers' behest. In

30. H.R. REP. 104–50, at 17.

31. The Presidents veto message appears at 141 CONG. REC. H15214 (daily ed. Dec. 20, 1995). The House voted to override the President's veto on December 20, 1995 by a vote of 319–100. *Id.* at H15223–24. The Senate overrode the veto on December 22, 1995 by a vote of 68–30. 141 CONG. REC. S19180 (daily ed. Dec. 22, 1995).

32. S. REP. No. 104–98, at 4 (1995).

33. 15 U.S.C. § 78u-4(a)(3) (1994 & Supp. I 1995).

34. *Id.* § 78u-4(a)(3)(A)(i).

35. *Id.* § 78u-4(a)(3)(B)(iii).

36. *Id.*

37. *Id.* § 78u-4(a)(3)(B)(v).

38. H.R. CONF. REP. No. 104-369, at 34 (1995).

39. *Id.* at 35.

particular, the Act prohibits bonus payments to class representatives, and limits plaintiffs to five times serving as a class representative during any three-year period.[40] In addition, class representatives are required to certify that they: (1) have reviewed the complaint and authorized its filing; (2) did not purchase the security at the direction of counsel or to participate in the action; and (3) are willing to serve as class representative.[41]

The Reform Act also places substantial restrictions and obligations on plaintiffs' attorneys in connection with settlements of securities class actions. The Act restricts the filing of settlements under seal and limits attorneys' fees to a reasonable percentage of the class recovery.[42] The Act further requires that notice of the settlement be given to class members, listing: (1) the average amount of recoverable damages per share; (2) an explanation of the attorneys' fees and costs sought; (3) the address and telephone number for class counsel; and (4) the reason for the proposed settlement.[43] Finally, the Act prohibits the payment of attorneys' fees from funds obtained in a Commission disgorgement action.[44]

C. Erecting Barriers

The second category of changes brought about by the Reform Act erects barriers to the bringing of securities lawsuits. One of the Reform Act's principal reforms is a strict new pleading standard which requires plaintiffs to state with particularity facts giving rise to a "strong inference" that the defendant acted with the required state of mind.[45] Moreover, where a complaint alleges that the defendant misrepresented or omitted to state a material fact, the plaintiff must specify each statement alleged to have been misleading and the reasons why the statement is misleading.[46] If an allegation is made on information and belief, the plaintiff must state with particularity all facts on which the belief is formed.[47]

In the Conference Report, the managers of the Reform Act expressed the view that the heightened pleading standard was necessary "to establish uniform and more stringent pleading requirements to curtail the filing of meritless lawsuits."[48] The Conference Report indicates that "[b]ecause 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."[49]

In order to put teeth in the heightened pleading standard, Congress mandated that courts make a finding of compliance with Rule 11(b), Federal Rules of Civil Procedure, with respect to any complaint, responsive pleading, or dispositive motion.[50] If the court finds that there has been a violation of Rule 11, it is required to impose a sanction.[51] The Act creates a presumption that the appropriate sanction

40. 15 U.S.C. § 78u–4(a)(3)(B)(vi) (1994 & Supp. I 1995).
41. *Id.* § 78u–4(a)(2)(A).
42. *Id.* § 78u–4(a)(5), (6).
43. *Id.* § 78u–4(a)(7).
44. *Id.* § 78u(d)(4).
45. *Id.* § 78u–4(b)(2).
46. *Id.* § 78u–4(b)(1).
47. *Id.*
48. H.R. CONF. REP. NO. 104–369, at 41 (1995).
49. *Id.* For a discussion of the Second Circuit standard, see text at *infra* notes 202–03.
50. U.S.C. § 78u–4(c)(1) (1994 & Supp. I 1995).
51. *Id.* § 78u–4(c)(2). One court to date has undertaken this mandatory inquiry. On

for a violation is an award of attorneys' fees incurred as a direct result of the violation.[52] If the noncomplying pleading is a complaint, however, the presumption is that the correct sanction is an award of fees incurred in the action.[53] In order to ensure that sanctions are effective, the Act authorizes the court to require, if it deems necessary, an undertaking for the payment of fees and expenses from either plaintiffs or defendants, and/or their respective lawyers.[54] Congress determined that such an undertaking was necessary in certain cases to ensure that "the award of attorneys' fees and costs under Rule 11 will not become, in practice, a one-way mechanism only usable to sanction parties with deep pockets."[55]

Strengthening the barriers to abusive practices, the heightened pleading standards are coupled with a stay of discovery. All discovery is stayed during the pendency of any motion to dismiss, unless the court finds that particularized discovery is necessary to preserve evidence or prevent undue prejudice.[56] Congress was concerned that the expense and time burden created by discovery in securities class actions "often forces innocent parties to settle frivolous securities class actions."[57] The purpose of this provision is to prevent "fishing expedition" lawsuits.[58] Specifically, Congress believed that plaintiffs sometimes filed suit and then immediately proceeded to scour the defendant's books and records and take "endless depositions" in hopes of uncovering "any shred of evidence."[59]

The Reform Act erects further obstacles to the bringing of abusive lawsuits by limiting: (1) the type of statements which can give rise to liability; and (2) the liability of certain "peripheral" defendants. The Act creates a "safe harbor" for forward-looking statements that are identified as forward-looking and accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."[60] In addition, the safe harbor applies to forward-looking statements that

December 24, 1996, in the class action against Hart Brewing, Inc. in the Southern District of California, the court granted Hart's FRCP 12(b)(6) motion to dismiss for failure to state a claim. Order Granting Defendants' Motion to Dismiss, Steckman v. Hart Brewing, Inc., Civil Case No. 96–1077–K (RBB), (S.D. Cal. Dec. 24, 1996). The opinion ends with: "As required by 15 U.S.C. 77(z)–1, the Court finds that no parties violated the pleading requirements of F.R.C.P. Rule 11(b) in this matter. Sanctions are therefore not appropriate in this case." *Id.* at 9. The court offered no explanation.

52. 15 U.S.C. § 78u–4(c)(3)(A)(i) (1994 & Supp. I 1995).

53. 15 U.S.C. § 78u–4(c)(3)(A)(ii).

54. 15 U.S.C. § 78u–4(a)(8) (1994).

55. H.R. CONF. REP. NO. 104–369, at 40 (1995).

56. 15 U.S.C. § 78u–4(b)(3)(B) (1994). The discovery stay barrier has grown even higher in the Northern District of California. Pursuant to a local rule adopted as this Article was going to print, a discovery stay is imposed in securities class actions not just during the pendency of motions to dismiss, but rather until a lead plaintiff is chosen by the court. Proposed N.D. Cal. Civil L.R. 26–6(c).

57. H.R. CONF. REP. NO. 104–369, at 37.

58. *Id.*

59. *Id.*

60. 15 U.S.C. § 78u–5(c)(1)(A)(i) (1994). No court has yet shed any light on what is meant by "meaningful cautionary" language. Chairman Levitt, however, has expressed dissatisfaction with the quality of the safe harbor statements seen to date. He specifically noted that "rather than [take] advantage of the new safe harbor to communicate forecasts more clearly, companies are using even more boilerplate, in the form of cautionary language." Arthur Levitt, Remarks at the 24th Annual Securities Regulation Institute, San Diego, CA (Jan. 23, 1997) (on file with authors).

are made without actual knowledge that the statement is false or misleading.[61]

In creating the safe harbor, Congress worried that liability exposure was chilling issuers from making statements about their business:

> Private securities class actions under 10b–5 inhibit free and open communication among management, analysts, and investors. This has caused corporate management to refrain from providing shareholders forward-looking information about companies.... As a result, investors often receive less, not more, information, which makes investing more risky and increases the cost of raising capital.[62]

Securities and Exchange Commission Chairman Arthur Levitt endorsed the safe harbor provision as enacted, calling it a "workable balance."[63]

Congress also acted to reduce the liability exposure of secondary defendants. According to the Senate Report, "[u]nderwriters, lawyers, accountants, and other professionals are prime targets of abusive securities lawsuits. The deeper the pocket, the greater the likelihood that a marginal party will be named as a defendant in a securities class action."[64] Congress found that the "system of joint and several liability creates coercive pressure for entirely innocent parties to settle meritless claims rather than risk exposing themselves to liability for a grossly disproportionate share of the damages in the case."[65] In response to this threat, the Act adopts proportionate, rather than joint and several, liability for defendants who are not found to have knowingly violated the securities laws.[66]

II. FEDERAL OBSTACLES

Implementation of the Reform Act is still in the formative stages, and it remains to be seen how courts will construe most of its provisions. While there are few reported cases to date, the early returns are instructive. This Section will weigh these early returns—which have primarily addressed the lead plaintiff provision, the discovery stay, and the pleading standards—to assess whether the obstacles put in place by the Reform Act are serving Congress's intentions as expressed in the legislative history.

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61. 15 U.S.C. § 78u–5(c)(1)(B) (1994).

62. S. REP. NO. 104–98, at 5 (1995).

63. Avery, *supra* note 17, at 356.

64. S. REP. NO. 104–98, at 9. *See also id.* at 21–22 ("Accounting firms particularly have been hard hit by securities litigation. The six largest firms face $10 billion in 10b–5 claims. Their gross audit-related litigation costs amounted to $783 million in 1992—more than 14% of their audit revenues for that year. Former SEC Commissioner A.A. Sommer, who heads the Public Oversight Board, the independent body that oversees the accounting profession's self-regulatory efforts, testified that, in view of 'some recent judgments and the amounts being sought in pending cases, it is not beyond the pale to believe, and some responsible people do believe—that one or more major [accounting] firms may ultimately be bankrupted.'") (footnotes omitted).

65. H.R. CONF. REP. NO. 104–369, at 37–38 (1995).

66. 15 U.S.C. § 78u–4(g)(2)(B) (1994). There are two exceptions to this rule of proportionate liability. Defendants are jointly and severally liable to a plaintiff who is entitled to damages exceeding 10% of his net worth, if the plaintiff's net worth is less than $200,000. 15 U.S.C. § 78u–4(g)(4)(A)(i). Defendants also must make up any shortfall due to a codefendant's insolvency, up to 50% of their own liability. 15 U.S.C. § 78u–4(g)(4)(A)(ii).

A. The New Complaints: Better Research, Fewer Deep Pocket Defendants

As noted, the legislative history expresses a desire to put plaintiffs—not their lawyers—in charge of securities class actions. The lead plaintiff should actively represent the class. The Committee believes that the lead plaintiff—not lawyers—should drive the litigation. As one witness testified: "One way of addressing this problem is to restore lawyers and clients to their traditional roles by making it harder for lawyers to invent a suit and then attach a plaintiff."[67]

The early returns post-Reform Act suggest that Congress's efforts to put plaintiffs in charge have not yet born fruit. With few exceptions, traditional plaintiffs' firms continue to run the majority of class actions, representing investors, or groups of investors, with only nominal holdings in the issuer. In the 105 cases filed in the first year after passage of the Reform Act, we have found only eight cases in which institutions have moved to become lead plaintiff.[68] In seven of those eight cases, the institution has been represented by a group of law firms which includes at least one traditional plaintiffs' law firm.[69] In two of these seven cases the lead plaintiff is represented by *thirty* and *thirty-three* law firms respectively, most of which are familiar names in securities class actions.[70] Although an institution's choice of a traditional plaintiffs' firm to represent it does not preclude the institution from exercising control over the litigation, even the most active institutional investor is likely to have difficulty controlling thirty or more law firms.

Even though the reins of power in securities class action lawsuits have not yet been fully transferred to investors, initial research suggests that the "race to the courthouse" has slowed. We were able to identify the date for both the end of the class period and the filing of the first complaint for ninety-six of the 105 securities class actions filed during 1996. The average lag time was seventy-nine days, and the median lag time was thirty-eight days. By comparison, NERA has observed that from January 1991 through December 5, 1995, the average lag time was forty-nine days.[71] We also observed that 11% of the complaints were filed within one week of

67. S. REP. NO. 104–98, at 10 (1995) (testimony of Mark E. Lackritz, on behalf of the Securities Industry Association; *Hearings on Securities Litigation Reform Proposals: Subcomm. on Securities, Senate Comm. on Banking, Housing, and Urban Affairs* (1995)).

68. Gluck v. CellStar Corp., Class Action 396CV1353 (N.D. Tex. filed May 14, 1996) (State of Wisconsin Investment Board); Malin v. IVAX Corp., Case No. 96–1843–CIV–Moreno (S.D. Fla. filed July 15, 1996) (Pennsylvania School Employees Retirement System Pension Fund); Mark v. Fleming Cos., Civil Action No. CIV–96–0506–M (W.D. Okla. filed Apr. 4, 1996) (City of Philadelphia, acting through its Board of Pensions and Retirement); *In re* Summit Technology Sec. Litig., Case No. 96–11589 JLT (D. Mass. filed Aug. 2, 1996) (Teachers' Retirement System of Louisiana); Teachers' Retirement Sys. v. Micro Warehouse, Inc., Case No. 396CV02166 (D. Conn. filed Oct. 25, 1996) (Teachers' Retirement System of Louisiana & Pennsylvania School Employees Retirement System Pension Fund); *In re* Cephalon Inc. Sec. Litig., Civil Action No. 96CV–633 (E.D. Pa. filed Jan. 29, 1996) (Sands Point Partners, L.P.); Sweetwater Invs., Inc. v. Pepsi-Cola Puerto Rico Bottling Co., No. 96–8671 CIV–ZLOCH (S.D. Fla. filed Oct. 15, 1995) (Sweetwater Investments, Inc.); Chan v. OrthoLogic Corp., No. CIV 96–1514 PHX RCB (D. Ariz. filed June 24, 1996) (City of Philadelphia).

69. The only exception is *CellStar*, in which the State of Wisconsin Investment Board is represented by Blank, Rome, Comisky & McCauley.

70. The two cases are, respectively, *IVAX*, Case No. 96–1843–CIV–Moreno (S.D. Fla. filed July 15, 1996) (30) and *Summit*, Case No. 96–11589 JLT (D. Mass. filed Aug. 2, 1996) (33).

71. NERA Study, *supra* note 11, at 6.

the end of the class period, 21% within two weeks, and 33% within three weeks. At the opposite end of the spectrum, 27% of the complaints were filed three months or more after the end of the class period, and 14% were filed after six months. The heightened pleading standards and the lead plaintiff provision are likely responsible for this slowdown.

Members of both the plaintiffs' and defense bar have told us that greater research and investigation is going into the typical class action complaint. Our review of the 105 complaints filed post-Reform Act confirms that greater time is being spent in drafting complaints; few are premised solely on a drop in the stock price. We found no complaints with the type of glaring errors which would suggest that they were the product of a hurried word processing "cut and paste." Moreover, few (12%) are based solely on forecasts that have not proved true. Substantially more are premised on either insider trading (48%) or accounting irregularities (43%).[72] A smaller number contain allegations of restatement of previously reported financial results (18%), government investigations (15%), or outright Ponzi schemes (2%). Fourteen percent contain allegations not fitting into any of the above categories.

Also noteworthy in post-Reform Act complaints is the dearth of peripheral actors—accountants, lawyers, and underwriters—being named as defendants. Our review of complaints in the 105 cases filed under the Act reveals that accounting firms have been named in six cases, corporate counsel in no cases, and underwriters in nineteen cases.[73] By contrast, a report of the Big Six accounting firms concluded that the number of audit-related suits filed against these firms for the years 1990 to 1992, was 192, 172, and 141 respectively.[74] Moreover, this report concludes that during these same years the number of cases either settled or dismissed against the Big Six firms which involved claims under Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") was nineteen, thirty-five, and fifty-eight respectively.[75] The NERA Study reports that during the period 1991 through June 1996, accountants were defendants in fifty-two reported settlements (as opposed to complaints), underwriters were defendants in eighty, and law firms were defendants in seven.[76]

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72. A recent study found that prior to the Reform Act, 20.7% of the securities class actions contained allegations of insider trading and 33% contained allegations of misrepresentations in financial statements. JOSEPH A. GRUNDFEST & MICHAEL A. PERINO, CORNERSTONE RESEARCH, SECURITIES LITIGATION REFORM: THE FIRST YEAR'S EXPERIENCE 15, 18, 21 (1997). The Securities Class Action Clearinghouse reports that, in addition to a material drop in stock price, 61% of post-Reform Act complaints allege accounting fraud and 49% allege insider trading. *Securities Class Action Clearinghouse—Federal Litigation Box Score* (last modified Jan. 22, 1997) <http://securities.stanford.edu>.

73. These numbers could increase as plaintiffs begin to conduct discovery and file amended complaints. Moreover, even though these actors are not being named in securities class actions, they may still face liability exposure. *See, e.g.*, Karen Donovan, *Bean Counters in a Bind: Trade-Off Expands Duties*, NAT'L L.J., Apr. 29, 1996, at B1 (discussing derivative suit filed against Ernst & Young L.L.P. for negligent audit). We note that claims against underwriters typically are based on Securities Act Section 11, which imposes strict liability subject to a due diligence defense upon underwriters for material misstatements or omissions in the prospectus. 15 U.S.C. § 77k(a)(5) (1994).

74. Letter from Mark H. Gitenstein & Andrew J. Pincus, Mayer Brown & Platt, to Walter P. Schuetze, Chief Accountant, Securities and Exchange Commission, at 14, tbl. VIII (June 11, 1993) (on file with the *Arizona Law Review*).

75. *Id.* at 16, tbl. IX.

76. NERA Study, *supra* note 11, at tbl. 17. These numbers, relying on the number of

The decrease in cases against accountants and lawyers is not wholly attributable to the Reform Act. Rather, this decrease may largely stem from the Supreme Court's decision in *Central Bank v. First Interstate Bank*,[77] in which the Court held that a private aiding and abetting action will not lie under Section 10(b) of the Exchange Act. Aiding and abetting was the theory most often charged against these defendants.

In sum, a review of the 1996 complaints suggests that: (1) plaintiffs' firms continue to dominate securities class actions; (2) they are devoting more time and resources to drafting complaints; and (3) secondary defendants are not currently a prime target of securities class action claims. Plaintiffs' lawyers may be encountering new obstacles under the Act, but they have not been displaced from their dominant role in securities class actions.

B. The New Class Notice: Information for Investors or Commercials for Counsel?

The Reform Act also encourages greater investor participation in securities class actions through a series of provisions which require public notice of class action filings and provide an opportunity for large investors to intervene and be appointed lead plaintiff. The lead plaintiff provision of the Reform Act presumes that the most adequate plaintiff is the class member or group of members that has the largest financial interest in the relief sought in the case.[78] That presumption may be rebutted by proof that the presumptive plaintiff will not fairly and adequately protect the interests of the class or is subject to unique defenses foreclosing adequate representation.[79] The lead plaintiff procedure implicates the role of plaintiffs' counsel because the lead plaintiff—subject to court approval—selects counsel for the class.[80] The procedure also reduces the incentives for plaintiffs' attorneys to race to the courthouse to file a complaint, although there are still advantages in being the first to file because it allows the attorney to control the content of the notice. Because "first in time" no longer assures lead plaintiff status, the courthouse race has been replaced by strategies designed: (1) to identify and collect the group of shareholders with the largest stake in the action; and (2) to show that rival groups will not adequately represent the class.

The Reform Act affords parties seeking to be named lead plaintiff the opportunity to intervene by requiring "widely circulated" national publication of a notice advising class members of the filing of the action, "the claims asserted," and their right to move to be lead plaintiff.[81] In drafting the notice provision, Congress left many details to be resolved by the courts. What exactly does "widely circulated" mean? How much detail satisfies Congress's mandate that the notice advise of the "claims asserted" in the action? These inherently imprecise terms give the courts great latitude in deciding how meaningful these notices must be, both in terms of means of publication and content. The limited returns suggest that the notice provision does create an obstacle to securing lead plaintiff status by the first

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settlements, rather than the number of times named in a complaint, understate the litigation burden faced by these defendants.

77. 511 U.S. 164 (1994).
78. 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I) (1994 & Supp. I 1995).
79. *Id.* § 78u-4(a)(3)(B)(iii)(II).
80. *Id.* § 78u-4(a)(3)(B)(v).
81. *Id.* § 78u-4(a)(3)(A)(i).

plaintiff to file, as courts are interpreting the provision strictly. The strict interpretation of the notice provision increases the likelihood that other class members will both receive the notice and inform themselves of the suit's allegations, so that they can make an educated decision whether to seek lead plaintiff status. Moreover, the early returns demonstrate that the notice provision may have created an added obstacle in that defendants, too, may have standing to object to the adequacy of the notice.

1. Means of Publication

The first written opinion ruling on a motion to become lead plaintiff was issued on August 15, 1996, in *Greebel v. FTP Software, Inc.*,[82] addressing several issues relating to the notice provision under the Act. Greebel filed a complaint on March 14, 1996 against FTP Software, Inc. ("FTP") alleging that FTP made material misrepresentations and omissions concerning its business.[83] On March 18, 1996, Greebel issued a press release to *Business Wire* for transmission over its computer database to inform other potential class members of their right to move to be appointed lead plaintiff. The entire text of the notice was picked up by *Bloomberg Business News Wire*.[84] Subsequently, a group of three persons—Greebel, Robinson, and Crane—moved to be appointed lead plaintiff and for the law firm of Milberg, Weiss, Bershad, Hynes & Lerach to be appointed lead counsel.

The Act requires a plaintiff to file with his or her complaint a sworn certificate describing, among other things, the plaintiff's transaction in the security and his or her prior appearances as plaintiff in other securities class actions, and stating that the plaintiff has read the complaint and authorized its filing.[85] This obstacle is intended to slow the race to the courthouse.[86] Here, only Greebel filed the required certificate; Robinson and Crane (who were not named in the caption of the complaint) did not.[87]

Defendant FTP raised three objections to the motion: (1) that it was premature to determine whether Greebel and the others met the class-representation requirements of Rule 23 of the Federal Rules of Civil Procedure; (2) that Greebel's notice over *Business Wire* failed to satisfy the Act's publication requirement; and (3) that Robinson and Crane failed to comply with the certification requirement.[88] The movants responded that FTP did not have standing to oppose a motion for appointment of a lead plaintiff.[89]

The court first held that defendant FTP had standing to object to the adequacy of the notice and certification because these are procedural prerequisites to becoming lead plaintiff. According to the court, "permitting a defendant to object on these grounds enhances effective judicial administration of the case," *i.e.* if notice is defective, the court cannot rely on other class members to proffer

82. 939 F. Supp. 57 (D. Mass. 1996).
83. *Id.* at 59.
84. *Id.*
85. 15 U.S.C. § 78u-4(a)(2)(A).
86. *See Greebel*, 939 F. Supp. at 61.
87. *Id.* at 59.
88. *Id.*
89. *Id.*

opposition.[90] The court further held, however, that FTP could not object to the movants' adequacy to serve as lead plaintiffs at this point in the proceedings. On this issue the court stated, "The text of the [Act] clearly indicates that this issue is one over which only potential plaintiffs may be heard. For example, Congress provided that rebuttal of the lead plaintiff presumption shall be limited to 'proof by a member of the purported plaintiff class.'"[91] The court ruled that FTP could be heard on this issue later when a Rule 23, Federal Rules of Civil Procedure, motion for class certification was made: "[the] determination to appoint a person...as lead plaintiff must be without prejudice to the possibility of revisiting that issue in considering a motion for class certification."[92]

Next, FTP claimed that Greebel's notice over *Business Wire* failed to satisfy the Act's publication requirement, arguing that *Business Wire* did not qualify as a "wire service" and was not "widely circulated."[93] On the first point, the court held that the "mere fact that *Business Wire* arrives at a print publication via an electronic signal, rather that [sic] in the manner of a traditional wire service, does not disqualify it as a 'wire service' within the meaning of the statute."[94] The court also held that *Business Wire* is "widely circulated" as hundreds of print publications and other wire services subscribe to it and individuals can access it directly through on-line services and databases.[95]

The court went on to reject FTP's argument that notice over *Business Wire* was inadequate because receipt by other prospective plaintiffs was "chancy." Here, the court stated, "[i]f Congress had intended to eliminate the contingency of a print medium carrying a wire service story, it would not have allowed publication by means of a wire service."[96] The court implied that notice over *Business Wire* might be more effective than notice via newspapers because spotting the notice in a newspaper is "subject to the happenstance" of purchasing the newspaper that day whereas notice transmitted via computers remains accessible.[97] Finally, the court noted that *Business Wire* is likely to reach institutional investors, the Reform Act's favored class members.[98]

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90. *Id.* at 60.

91. *Id. But see* Order Requiring Further Information for Plaintiff's Motion to be Appointed Lead Plaintiff Pursuant to Section 21D(a)(3)(B) of the Securities Exchange Act, at 6–7, Howard Gunty Profit Sharing v. Quantum Corp., Civil No. 96–20711 SW (N.D. Cal. Feb. 6, 1997) (Creating further obstacles for plaintiffs by holding: "While defendants may not offer evidence or conduct discovery relating to who is the most adequate plaintiff, it is appropriate for defendants to bring to the attention of the court a flaw in the papers of a party moving for the appointment as lead plaintiff," and "defendants [may] make a limited, facial challenge to a plaintiff's motion for appointment as lead plaintiff....").

92. *Greebel,* 939 F. Supp. at 60.

93. *Id.* at 62.

94. *Id.*

95. *Id.*

96. *Id.* at 63.

97. *Id.* Separately, at least one court has held that publication of the notice in a business newspaper with national distribution will satisfy the Reform Act. In an Order Appointing Lead Plaintiff in *In re Silicon Graphics, Inc. Securities Litigation,* Judge Fern Smith of the Northern District of California held that *Investor's Business Daily* constitutes "a widely circulated, national, business-oriented publication." Order Appointing Lead Plaintiff and Lead Plaintiffs' Counsel, *In re* Silicon Graphics, Inc. Sec. Litig., Lead Case No. 96–0393 FMS (N.D. Cal. Apr. 30, 1996) [hereinafter SG Order].

98. *Greebel,* 939 F. Supp. at 64 ("Because publication on Business Wire is reasonably calculated to reach, at the least, sophisticated and institutional investors, the

The court went on to hold that the certification need only be filed by the plaintiff who files the complaint, and not by class members who subsequently file motions to become lead plaintiff. The court relied on the language of Section 21D(a)(2)(A), which requires "each plaintiff seeking to serve as a representative party on behalf of a class...[to] provide a sworn certification, which shall be...*filed with the complaint.*" The court bolstered this conclusion with legislative history which states that parties moving to be named lead plaintiff need not file the certificate.[99] As no other party moved to become lead plaintiff, the court granted Greebel, Robinson and Crane's lead plaintiff motion.

2. Content of Notice

The Reform Act specifies that the notice must advise potential class members of four items: (1) the "pendency of the action;" (2) the "claims asserted therein;" (3) the "purported class period;" and (4) that class members may move to be named lead plaintiff within sixty days of publication of the notice.[100] While the first, third, and fourth items appear non-controversial, Congress did not spell out the level of detail needed to satisfy the second item.

In *SyQuest Technology, Inc.*,[101] Judge Vaughn Walker of the Northern District of California addressed what notice of "claims asserted" required. In that case, a group of plaintiffs ("Group 1"), represented by three firms, moved to be appointed lead plaintiff.[102] Group 1 had published notice, which read as follows:

> TO: All purchaser (sic) of SyQuest Technology, Inc. common stock during the period October 21, 194 (sic) to February 1, 1996
>
> On April 2, 1996, a class action, Ravens, et al. v. Iftikar, et al., C–96–1224–VRW, was filed in the U.S. District Court for the Northern District of California, which asserts claims for violations of §§ 10(b) and 20(a) of the Securities Exchange Act of 1934. Any member of the proposed class may move the Court to serve as lead plaintiff no later than 60 days from the date of this Notice. For more information contact [name and phone number of plaintiffs' counsel].[103]

Sixty days expired, and no prospective class members moved to be named lead plaintiff. Later, a rival group of plaintiffs, also represented by three traditional plaintiff class action firms, opposed Group 1's motion, challenging the adequacy of Group 1's notice.[104]

Judge Walker held that the notice was deficient, reasoning that:

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court cannot find that such publication frustrates the purpose of the [Reform Act].").

99. *Id.* at 62 (The Senate Committee Report explains that it "does not intend for the members of the purported class who seek to serve as lead plaintiff to file with this motion the certification described above." (citation omitted)).

100. 15 U.S.C. § 78u–4(a)(3)(A)(i) (1994 & Supp. I 1995).

101. No. C–96–1224–VRW (N.D. Cal. 1996).

102. Order, Ravens v. Iftikar, No. C–96–1224–VRW (N.D. Cal. Jan. 7, 1997).

103. *Id.* at 8. A more detailed notice of the lawsuit was issued over *Business Wire*. *See Class Action Suit Filed Against SyQuest Technology and Its Officers and Directors Alleging Misrepresentations, False Financial Statements and Insider Trading*, BUS. WIRE, Apr. 10, 1996, *available in* LEXIS, World Library, BWIRE File. This notice was not addressed by Judge Walker.

104. *See* Order, Ravens v. Iftikar, No. C–96–1224–VRW, at 8.

> The notice provisions are only effective...if qualified investors are notified of the nature and character, not just the existence, of the claims asserted. An investor can only make an informed determination whether intervention [is] appropriate to protect his interests if he is provided information describing the legal and factual basis of the claims. A mere recitation of the statute, or statutes, under which the claim is brought is simply inadequate to give an investor the information necessary to make the decision to intervene or not.[105]

In addressing the inadequacies of the notice, Judge Walker observed that the following detail would be required to give notice of the "claims asserted": "[an] explanation of the legal theory underlying plaintiffs' suit; [a] discussion of who violated the Securities Exchange Act of 1934; and [a] description of the alleged wrongdoing that forms the basis of the complaint."[106] As these features were absent from Group 1's notice, he denied Group 1's lead plaintiff motion. Judge Walker also ordered that a case management conference be set up to discuss how the plaintiffs could correct the notice's deficiencies.

By contrast, Judge Fern Smith, also of the Northern District of California, held a virtually identical notice to be adequate.[107] In her order, Judge Smith held that the notice "advised the potential class members of the claims and of the opportunity to file a motion to be lead plaintiff."[108] It appears, however, that the notice at issue, unlike in *SyQuest*, was not challenged by other plaintiffs. Thus, the content required by the notice may only be an obstacle for plaintiffs' attorneys when rival attorneys challenge the notice. When such a challenge is brought, minimalist notice will not suffice.

105. *Id.* at 5–6.

106. *Id.* at 8. In his order, Judge Walker also states that a diligent investor receiving "deficient" notice may be prone to travel to the courthouse to inspect the plaintiffs' complaint. *Id.* at 9. However, Judge Walker notes that these efforts could not be fruitful in this case because, "The complaint filed by [Group 1] contains over fifty-five pages of painstakingly detailed allegations of evidentiary facts. The [Group 2] complaint rings in at just under forty pages of turgidity." *Id.* These statements seem to run counter to both (i) the purposes of specific Reform Act provisions, such as the heightened pleading standards and the lead plaintiff provision, which are designed to lead to better drafted complaints, and (ii) specific statements by Congress in the Reform Act's legislative history. For example, the Conference Committee Report states, "The Conference Committee was also troubled by the plaintiffs' lawyers 'race to the courthouse' to be the first to file a securities class action complaint. This race has caused plaintiffs' attorneys to become fleet of foot and sleight of hand. *Most often speed has replaced diligence in drafting complaints.*" H.R. CONF. REP. No. 104–369, at 33 (1995) (emphasis supplied). Moreover, the principal purpose of a complaint is to alert defendants to the nature of the allegations against them, not to alert potential plaintiffs, in plain English, to the nature of the suit.

107. SG Order, *supra* note 97, at 2–3. The notice read as follows:

> On January 29, 1996, a class action, Brody v. McCraken, et al., C–96–0393–FMS, was filed in the U.S. District Court for the Northern District of California, which asserts claims for violations of §§ 10(b) and 20(a) of the Securities Exchange Act of 1934 and violations of state law. Any member of the proposed class may move the court to serve as lead plaintiff no later than 60 days from the date of this Notice. For more information contact [name and phone number of plaintiffs' counsel].

108. *Id.* at 3.

3. *When Congress Gives You Lemons, Make Lemonade*

While the lead plaintiff provision and its accompanying publication requirement are intended to shift control from plaintiffs' lawyers to the plaintiffs themselves, enterprising attorneys have garnered at least two benefits from the publication of notice. First, the notice may be used as a form of advertising by lawyers representing one or more investors with only a small financial stake in the class action. The Reform Act allows the court to select as lead plaintiff not just individuals but alternatively a "group of persons," whose financial interests in the suit may be aggregated in determining if they have the "largest financial interest in the relief sought by the class."[109] Taking advantage of this provision, lawyers have used the notice to recruit investors as additional clients. Notices are pitched in a way more likely to attract clients, rather than competition from investors (and other law firms) independently vying to be named lead plaintiff. While not required by the Act, notices routinely end with two boilerplate paragraphs consisting of a firm biography and a form of sales pitch to investors. A standard example follows:

> [Plaintiffs' firm] has been actively engaged in commercial litigation emphasizing securities and antitrust class actions, for more than 20 years. The firm has offices [nationwide] and is active in major litigations pending in federal and state courts throughout the United States. The firm's reputation for excellence has been recognized on repeated occasions by courts which have appointed the firm to major positions in complex multi-district or consolidated litigations. [Plaintiffs' firm] has taken a lead role in numerous important actions on behalf of defrauded investors, and has been responsible for a number of outstanding recoveries which, in the aggregate, total approximately $2 billion.
>
> If you are a member of the Class described above, you may, no later than 60 days from today, move the Court to serve as lead plaintiff of the Class, if you so choose. In order to serve as lead plaintiff, however, you must meet certain legal requirements. If you wish to discuss this action or have any questions concerning this notice or your rights or interests, please contact [name of lawyer] at [firm phone number].

The second advantage of publishing notice for plaintiffs' lawyers is that it can help uncover relevant facts. The notice can help attract witnesses, including disgruntled ex-employees and others who may possess useful information. This source of information may be invaluable to the development of a case, especially given the automatic discovery stay imposed by the Act upon a motion to dismiss.

In this regard, the notice provision may be less of an obstacle for plaintiffs' attorneys than it is a device for circumventing some of the other obstacles built into the Reform Act. For this reason, the race to the courthouse, while it has slowed, may not have stopped altogether. Plaintiffs' attorneys who file first can publish their notice first, thereby catching a step on rival plaintiffs' firms in recruiting plaintiffs and potential witnesses.

4. *Need for a Centralized Notice Repository?*

While the Reform Act requires a "widely circulated national business-oriented

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109. 15 U.S.C. § 78u–4(a)(3)(B)(iii)(I)(bb) (1994 & Supp. I 1995).

publication or wire service," it does not mandate a precise location for publication. Representatives of institutional investors have informed us that they are having difficulty spotting notices in timely fashion. A possible solution would be a Reform Act amendment requiring the notice of each class action to be posted on a designated Internet site.[110]

C. The New Lead Plaintiff Provision: King of the Mountain? Plaintiffs Battle Other Plaintiffs for Lead Plaintiff Status

Once notice is published, several parties may come forward and move, either individually or as a group, to be named lead plaintiff. As previously noted, the lead plaintiff is allowed to choose, subject to court approval, counsel for the class.[111] Thus, the first skirmishing in securities class actions is not plaintiff against defendant, but rather, plaintiff against plaintiff, seeking the coveted lead plaintiff position. Members of the plaintiff class may attempt to rebut the presumption that the class member having the largest financial stake in the litigation is the most adequate plaintiff by demonstrating that this plaintiff "will not fairly and adequately protect the interests of the class" or "is subject to unique defenses that render such plaintiff incapable of adequately representing the class."[112] A plaintiff demonstrating a reasonable basis for a finding that the presumptively most adequate plaintiff will not adequately represent the class is entitled to conduct discovery of that plaintiff.[113]

When an institution seeks to become lead plaintiff, other would-be lead plaintiffs do not sit on their hands. Rather, they use the above provisions to challenge the institution in court.[114] While there may be bona fide concerns that the institution will not adequately represent the class, cynics might suggest that such challenges are motivated to obtain better positioning for the individual plaintiff. We take no position on the motivation behind these challenges, other than to note that they will increase cost and result in delays.

1. Micro Warehouse[115]

The post-Reform Act class action pending against Micro Warehouse, Inc. is representative. At least eight plaintiffs filed separate, but related complaints, against Micro Warehouse.[116] Four competing motions for lead plaintiff status were

110. A new Northern District of California local rule requires lawyers in securities class actions to post certain enumerated documents to "Designated Internet Sites ('DIS')". N.D. Cal. Civil L.R. 23-3. The Commission is considering creating links from its web site to each DIS.

111. 15 U.S.C. § 78u-4(a)(3)(B)(v).

112. *Id.* § 78u-4(a)(3)(B)(iii)(II).

113. *Id.* § 78u-4(a)(3)(B)(iv).

114. The authors have been unable to locate any court orders dealing with lead plaintiff challenges between and among individual plaintiffs only. These disputes appear to have been resolved by agreement among the parties. Rather, the challenges have arisen during the first year when institutions have sought to be named lead plaintiff.

115. Case No. 396CV02166 (D. Conn. filed Oct. 25, 1996).

116. *See* Joint Amended Motion of the Micro Warehouse Plaintiffs' Group to be Appointed Lead Plaintiffs at 1, Payne v. Micro Warehouse, Inc., Civil Action No. 3:96 CV 01920 (DJS) (D. Conn. Dec. 20, 1996) (listing the actions). These multiple filings are somewhat curious as the Reform Act allows any plaintiff to simply *move* to be named lead plaintiff after an initial complaint is filed, thereby making the filing of additional (and

subsequently filed.[117] After negotiation, a group was formed (the "Micro Warehouse Group") to represent movants in three of the four motions.[118] This group included two institutional investors, the Teachers' Retirement System of Louisiana ("TRSL") and the Pennsylvania School Employees Retirement System Pension Fund ("PSERS").[119]

The Micro Warehouse Group alleged that TRSL had purchased 141,504 shares of Micro Warehouse during the class period at a market value in excess of $5.4 million, and had suffered a loss of $2.1 million.[120] The papers also alleged that PSERS had purchased 306,900 Micro Warehouse shares during the class period and had suffered a loss of $3.6 million (the largest loss of any movant seeking lead plaintiff status).[121]

In opposition to this formidable group stood two individual plaintiffs, John Turner and John Schultz, who collectively claimed to have lost of over $250,000 during the class period.[122] They moved for the appointment of John Turner as lead plaintiff.[123] To rebut the Reform Act's presumption that the Micro Warehouse Group was the most adequate plaintiff, Turner and Schultz launched an offensive against their fellow class members. Turner and Schultz argued that TRSL would not fairly and adequately represent the interests of the class.[124] Specifically, they objected to the bid by William Reeves, General Counsel of TRSL, to serve as class counsel in an effort to reduce fees. In a certification filed with the court, TRSL declared:

> The General Counsel of the plaintiff [TRSL] is participating as one of the attorneys for the plaintiff in this litigation and, if the present action is successful and results in the creation of a fund for the compensation of Class Members, the plaintiff will apply to this Court for reimbursement of its expenses and said General Counsel will apply to the Court for an award of a reasonable attorney's fee said expenses [sic] with any award of such attorney's fee and expenses being subject to the approval of the Court.[125]

Turner and Schultz argued that, to the extent that Reeves turned over to TRSL any fee he obtained from representing the class, his actions would violate Section 21D(4) of the Reform Act which limits the award to the lead plaintiff to its pro rata share of the final judgment or settlement.[126] They further argued that "the different

costly) complaints unnecessary.

117. *Id.*

118. *Id.*

119. *Id.*

120. Memorandum of Law of the Micro Warehouse Plaintiffs' Group in Support of Their Joint Amended Motion to Be Appointed Lead Plaintiffs at 8, Payne v. Micro Warehouse, Civil Action No. 3:96 CV 09120 (DJS) (D. Conn. 1996).

121. *Id.*

122. *See* Memorandum of Law in Support of Motion of Plaintiff John Turner for Appointment as Lead Plaintiff and to Conduct Certain Discovery Pursuant to Section 21D(a)(3)(B) of the Securities Exchange Act of 1934 at 5, Payne v. Micro Warehouse, Inc., Civil Action No. 3:96 CV 01920 (DJS) (D. Conn. Dec. 2, 1996) [hereinafter Turner Memorandum].

123. *Id.* at 5–6.

124. *Id.* at 12–16.

125. *Id.* at 13.

126. *Id.* In advancing this argument, Turner and Schultz apparently ignored a qualifying sentence found in Section 21D(4). That sentence provides: "Nothing in this

allegiances TRSL's General Counsel will possess as an employee of the class representative and as counsel for the Class will cause a conflict—either in fact or in appearance—between the interests of TRSL and the interests of the Class that may result in the denial of TRSL as the class representative."[127] Turner and Schultz added a motion to conduct discovery of TRSL.[128]

TRSL subsequently withdrew its proposal that Reeves serve as co-lead counsel to resolve the conflict, but the in-fighting did not stop. Rather, Schultz and Turner began opposing PSERS participation as co-lead plaintiff.[129] They made two arguments. First, the decision for PSERS to enter the class action was made by Pennsylvania's then Treasurer, Catherine Baker Knoll.[130] In January 1997, a new Treasurer took office. Schultz and Turner complained that "[t]here has been no proffer by the Commonwealth of their interest in continuing the lawsuit."[131] Second, Schultz and Turner argued that Knoll has not documented her authority from PSERS to commence this litigation, even though as Treasurer, she was custodian for PSERS.[132] Schultz and Turner concluded by asking the court to name Turner co-lead plaintiff with TRSL, or alternatively, to allow discovery of Knoll.[133] The court did not resolve the dispute, however, as an agreement was reached where a new lead plaintiffs' group was formed including Turner and the two institutions.

2. Cephalon[134]

A second example of the battles between plaintiffs, with their attendant cost and delay, is the class action against Cephalon, Inc. On March 27, 1996, one of the plaintiffs, Sands Point Partners, LP. ("Sands Point"), represented by Wolf, Popper moved to be named lead plaintiff.[135] Sands Point, a private fund managing $12 million, claimed to have lost $677,876 trading in Cephalon securities.[136]

A competing group of four individual plaintiffs moved the court to take discovery of Sands Point to determine whether Sands Point had properly

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paragraph shall be construed to limit the award of reasonable costs and expenses (including lost wages) directly relating to the representation of the class to any representative party serving on behalf of a class." 15 U.S.C. § 78u-4(a)(4) (1994 & Supp. I 1995). This provision would arguably allow TRSL to receive fees earned by its General Counsel Reeves.

127. Turner Memorandum, *supra* note 122, at 14.

128. *Id.* at 17–19.

129. *See* Plaintiffs John Turner and John Schultz' Opposition or Statement Relating to the Motions of Catherine Baker Knoll, State Treasurer of the Commonwealth of Pennsylvania as Custodian for the Pennsylvania School Employees Retirement System Pension Fund, the Motion of Teacher's Retirement System of Louisiana and others; and the Motion of Bruce Payne, Roberto Espinosa, Lawrence Bober, Bruce Banker, and Melvin Levine for Appointment as Lead Plaintiffs, *In re* Micro Warehouse Sec. Litig., Civil Action No. 3:96 CV 01920 (DJS) (D. Conn. Dec. 23, 1996).

130. *Id.* at 4.

131. *Id.*

132. *Id.*

133. *Id.* at 6.

134. Civil Action No. 96CV-633 (E.D. Pa. filed Jan. 29, 1996).

135. *See Plaintiffs Vie for Lead Role in PA Securities Suits Against Cephalon Officers*, SEC. & COMMODITIES LITIG. REP., May 6, 1996, at 1, 13.

136. *See* Affidavit of John P. Nicholson, M.D. In Support of Motion of Sands Point Partners L.P. for Appointment as Lead Plaintiff at 3–4, *In re* Cephalon Sec. Litig., Civil Action No. 96CV-633 (E.D. Pa. Filed Jan. 29, 1996).

characterized itself to the court as an "institutional investor."[137] The statutory basis for this request is unclear, as the Reform Act's lead plaintiff provision nowhere mentions the term "institutional investor;" rather, it presumes that the lead plaintiff will be the person or group of persons having "the largest financial interest in the relief sought by the class."[138] Nonetheless, the court granted discovery: "As Sands Point has asserted that it is a uniquely situated institutional investor to which the Act affords preference in appointing the lead plaintiff, and as the [competing group of] plaintiffs ha[s] raised concerns challenging this position, this court finds that discovery on the issue of determining the most adequate plaintiff is appropriate."[139]

The court's order sweeps broadly, providing that "[*a*]*ny* plaintiff in this matter is granted leave to take discovery of *any other* plaintiff in this matter on the appointment of lead plaintiff and lead counsel."[140] In allowing broad-based discovery by any plaintiff of any other plaintiff, the order conflicts with the text of the Reform Act which allows narrow discovery by a moving plaintiff "*only if* the plaintiff *first demonstrates a reasonable basis* for a finding that the presumptively most adequate plaintiff is incapable of adequately representing the class."[141] The issue was later resolved when the two groups of plaintiffs proposed that they be appointed co-lead plaintiffs, which the court accepted.[142]

The *Cephalon* order granting liberal discovery is troubling. If courts follow this precedent and freely allow plaintiffs to take discovery of each other without strictly adhering to the limitations set forth in the Reform Act, smaller plaintiffs may adopt a practice of moving to take time-consuming and expensive discovery of larger plaintiffs in an attempt to gain bargaining leverage.

3. OrthoLogic[143]

In other battles, recycled pre-Reform Act challenges have been made that institutional investors, as sophisticated investors, are subject to unique defenses and are incapable of adequately representing the class. This argument is being made despite the Reform Act's clear bias toward institutional investors as lead plaintiffs. To the extent this argument is successful, the potential effectiveness of the lead plaintiff provision will be eroded if not eliminated. In the two cases to date, the courts have rejected this argument.[144]

In the class action pending against OrthoLogic Corp., a lead plaintiff motion was made by a group including the City of Philadelphia.[145] A group of individuals competing for the lead plaintiff position ("Group B") argued that under Rule 23,

137. *See* Memorandum of Law in Support of Motion for Leave to Take Discovery, *In re* Cephalon Sec. Litig., Civil Action No. 96CV–633 (E.D. Pa. July 12, 1996).

138. 15 U.S.C. § 78u–4(a)(3)(B)(iii)(I)(bb) (1994 & Supp. I 1995).

139. Memorandum and Order, *In re* Cephalon Sec. Litig., Civil Action No. 96CV–633 (E.D. Pa. July 18, 1996).

140. *Id.* at 2. (emphasis supplied).

141. 15 U.S.C. § 78u–4(a)(3)(B)(iv) (emphasis supplied).

142. *In re* Cephalon Sec. Litig., Civil Action No. 96CV–633, 1996 U.S. Dist. LEXIS 13492 (E.D. Pa. Aug. 27, 1996).

143. Chan v. OrthoLogic Corp., No. CIV 96–1514 PHX RCB (D. Ariz. filed June 24, 1996).

144. Aside from *OrthoLogic*, discussed below, another case where these arguments have been raised is *CellStar*, discussed at *infra* notes 150–62.

145. *See* Order, Chan v. OrthoLogic Corp., No. CIV 96–1514 PHX RCB (D. Ariz. Dec. 19, 1996).

Federal Rules of Civil Procedure, the defendants would be able to challenge Philadelphia as a class representative, because as a sophisticated investor, "it operates according to methods and investment criteria which are not typical of those employed by the smaller individual investors...."[146] In making their argument, Group B cited a number of pre-Reform Act cases which held that sophisticated investors are atypical of the class under Rule 23.[147] The court was not persuaded. First, the court found that the pre-Reform Act cases had essentially been superseded: "in light of the [Reform Act], the landscape under which [these prior decisions were made] has clearly shifted in favor of institutional investors."[148] The court also concluded that the fraud-on-the-market theory, essential to the bringing of a securities fraud class action, applies equally to institutional and individual investors. Here, the court held, "[d]ifferences in sophistication, etc., among purchasers have no bearing in the impersonal market fraud context, because dissemination of false information necessarily translates through market mechanisms into price inflation which harms each purchaser identically."[149]

4. Gluck v. CellStar[150]*—The State of Wisconsin Investment Board Becomes the First Institutional Investor to Control a Class Action*

To date, the benefits of institutional investors becoming lead plaintiff can best be seen in the case of *Gluck v. CellStar*, a class action filed against CellStar Corp. Here, the State of Wisconsin Investment Board ("SWIB"), represented by Blank, Rome, Comisky & McCauley, made a motion to be named lead plaintiff.[151] SWIB, which manages $40 billion of investment assets for the Wisconsin Retirement System,[152] purchased one million shares of CellStar during the class period.[153] SWIB alleged that it lost more than $14 million on its investment during the class period, the most significant financial interest in the action, and therefore, it should be named lead plaintiff.[154]

Another group of plaintiffs, represented by a traditional plaintiffs' law firm ("Group 2"), opposed SWIB's motion.[155] Group 2, echoing the arguments made in *OrthoLogic*, claimed that SWIB would not satisfy the requirements of Rule 23, Federal Rules of Civil Procedure, because, as a sophisticated investor, it was subject to defenses atypical of the class.[156] Group 2 argued that it should be named co-lead plaintiff.[157] Following a hearing, the court issued an order, without written opinion, naming SWIB the lead plaintiff, and denying Group 2's motion to be

146. *Id.* at 9.
147. *Id.* at 10–11.
148. *Id.* at 11.
149. *Id.* (citation omitted).
150. Gluck v. CellStar Corp., Class Action 396CV1353 (N.D. Tex. filed May 14, 1996).
151. *See* Brief of the State of Wisconsin Investment Board in Support of Its Motion for Appointment as Lead Plaintiff, Larson v. CellStar Corp., Civil Action No. 3:96–CV–1436 (N.D. Tex. July 22, 1996) [hereinafter SWIB Brief].
152. Declaration of Keith Johnson at 1, Gluck v. CellStar Corp., Civil Action No. 3:96–CV–1353–R (N.D. Tex. July 26, 1996) [hereinafter Johnson Declaration].
153. SWIB Brief, *supra* note 151, at 4.
154. Johnson Declaration, *supra* note 152, at 2.
155. *See* Dean Starkman, *Pension Fund to Test New Securities Law,* WALL ST. J., Aug. 8, 1996, at B7.
156. *Id.*
157. *Id.*

named co-lead plaintiff. The court has not yet ruled on SWIB's selection of Blank, Rome as class counsel.

SWIB's responsible management of the class action may provide a blueprint for future class actions involving institutions.[158] Keith Johnson, Assistant General Counsel for SWIB, describes SWIB's management of the case as follows:

> A committee with internal and external legal expertise and portfolio management representation was established to review SWIB's CellStar claim. Several qualified law firms that had previously expressed an interest in providing securities class action legal advice to SWIB were invited to make presentations to the committee on their evaluation of SWIB's claim. The selected law firms included representation from the traditional plaintiffs' bar. Firms were asked to include in their presentations an evaluation of the case, a plan for pursuing the claim, a review of their expertise, and a proposed fee schedule. At the conclusion of this process, SWIB selected Blank, Rome...to represent it in pursuing lead plaintiff status in the case.
>
> Blank, Rome agreed to represent SWIB, and the class if approved as lead counsel by the court, on a contingent fee basis that *SWIB believes could save the class as much as several million dollars in legal fees from customary fee levels.* The fee arrangement is based on a sliding percentage scale, which increases both as the size of the recovery increases and as the matter progresses through the litigation process. It starts at 12.5 percent of first dollar recoveries and tops out at 25 percent of amounts in excess of $15 million,[159] and includes any post-trial appellate work. SWIB also agreed to support a fee bonus of up to 1.5 percent if the case can be promptly prepared and scheduled for trial within set target dates. The fee structure was designed to align the interests of the law firm with those of its clients.[160]

SWIB's efforts to negotiate attorneys' fees should work to the benefit of investors.[161] The process employed by SWIB is similar to an attorney bidding

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158. *See* Melvin R. Goldman, The Reform Act—One Year Later: The Next Generation, Prepared for the 24th Annual Securities Regulation Institute 31 (Jan. 22–24, 1997) (on file with the authors) ("*CellStar* is significant not only because it represented one of the first judicial applications of the Reform Act's lead plaintiff provisions, but also because SWIB set a precedent for institutional investors in other class actions by taking an active role in the litigation and in the selection of lead counsel.").

159. By contrast, the NERA Study found that the average award of attorney fees in securities class actions, measured as a percentage of settlement, is as follows: 30.38% for settlements ranging from $0.00–$0.99 million; 31.88% for settlements ranging from $1.00–$1.99 million; 32.11% for settlements ranging from $2.00–$9.99 million; 31.72% for settlements ranging from $10.00–$49.99 million; and 31.48% for settlements in excess of $50 million. NERA Study, *supra* note 11, at tbl. 9.

160. Keith Johnson, *Institutional Investors and Securities Class Action Reform: A Report from the Trenches*, CORPORATE GOVERNANCE ADVISOR, Jan.–Feb. 1997, at 3–4 (emphasis and footnote supplied).

161. On a related note, on September 27, 1996, the Commission filed an *amicus curiae* brief in the class action pending against PaineWebber Incorporated Limited Partnerships in the Southern District of New York arguing that the amount of fees sought by class counsel was excessive. Brief of the Securities and Exchange Commission, amicus curiae, *In re* PaineWebber Inc. Ltd. Partnerships Litig., 94 Civ. 8547 (SHS) (S.D.N.Y. Sept. 27, 1996). Class counsel stated an intent to submit a petition for attorneys' fees in the amount of

process ordered by Judge Vaughn Walker of the Northern District of California in pre-Reform Act class actions against California Micro Devices, Wells Fargo, and Oracle Systems.[162]

SWIB's active involvement is a model of the institutional investor involvement that Congress sought in formulating the lead plaintiff provision. The challenges that have been made to institutional investors seeking lead plaintiff designation, while not unexpected, are disappointing. The lead plaintiff provision was intended by Congress to be a means by which shareholders could be put in charge of securities class actions. In practice, however, the lead plaintiff provision could become another obstacle to federal securities class actions. Extended disputes over lead plaintiff status, while creating delay and expense, produce little tangible benefit for the class. In this regard, we note that the Reform Act does not include lead plaintiff motion papers among the pleadings and papers that are subjected to mandatory Rule 11, Federal Rules of Civil Procedure, scrutiny. Absent a meaningful threat of sanctions for meritless objections to lead plaintiff status, plaintiffs and their lawyers have every reason to tie institutional investors up in lead plaintiff battles. Worse yet, if other courts follow the *Cephalon* court's lead in allowing wide-ranging discovery without any showing of a reasonable basis that the institution can not adequately represent the class, institutions could be discouraged from intervening in securities class actions as Congress intended.

The legislative history suggests that Congress believed institutions would readily step forward once they were armed with the new lead plaintiff provision.[163] Our discussions with institutional investors, however, suggest that there are substantial disincentives for institutional investors considering intervention in securities class actions. Those disincentives fall into two categories: cost and exposure.

As the Reform Act allows plaintiffs to conduct discovery of other plaintiffs, institutions may find key personnel being subjected to costly and time-consuming discovery by plaintiffs and then to a second round of discovery by defendants. Moreover, private institutional investors, such as investment companies, may be

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27.5% of the $125 million in immediate cash consideration, plus 27.5% of the cash portion of "Additional Benefits" to be paid under the settlement agreement. *Id.* at 1. The value of the total requested fees, based on Lead Class Counsel's valuation of Additional Benefits at over $75 million, was at least $34.4 million, and may approach $55 million. *Id.*

The Commission's brief argued that the attorneys' fees being sought were excessive because they substantially exceeded those normally awarded in cases involving large settlements and the case did not involve unusually large risks. *Id.* at 2–3. A decision has not yet been rendered. Had a reasonable fee schedule been set up front, as in *CellStar*, the situation would never have arisen.

162. *See* John F. Olson et al., *Pleading Reform, Plaintiff Qualification and Discovery Stays Under the Reform Act*, 51 BUS. LAW. 1101 (1996) ("The Reform Act's new class action procedures may diminish, but will not eliminate, the need for innovative judicially created methods of choosing class counsel such as those employed by Judge Vaughn Walker.") *Id.* at 1147. ("To the extent that [institutional] investors elect not to act as lead plaintiffs, court will still have to determine which individual plaintiffs (and more importantly, their counsel) most adequately represent the interests of the class. In that situation, despite the reluctance of plaintiffs' counsel (and perhaps because of it), courts may begin using competitive bids to select lead counsel more regularly.") *Id.* at 1149.

163. *See* H.R. CONF. REP. NO. 104–369, at 34 (1995) ("The conference committee...intends that [the] lead plaintiff provision will encourage institutional investors to take a more active role in securities class action lawsuits.").

forced to open their books during discovery revealing proprietary information.[164] In addition, many institutions may not want to advance the costs of litigation for the class. Adding to the expense is the time needed to manage the litigation.

Some institutions have also expressed concerns about added liability exposure when acting as lead plaintiff. The fear is that other plaintiffs may sue them for actions such as selecting incompetent counsel, settling for an inadequate amount, or dismissing what the institution deemed to be a meritless suit. Further, institutions can still opt out of the class, proceed separately, and not be faced with this added exposure. Whether or not institutions will look beyond these disincentives remains to be seen.

D. The New Discovery Stay: An Added Incentive for a Motion to Dismiss

Plaintiffs' attorneys who file a complaint and survive the battles over notice and lead plaintiff status can expect to be confronted by at least one, and perhaps several, motions to dismiss. Serving as perhaps the largest obstacle in the path of bringing a class action, the motion to dismiss now triggers a discovery stay. Moreover, the courts have interpreted the discovery stay strictly, allowing no relief therefrom. As a result, plaintiffs' attorneys no longer enjoy the access to evidence that they had pre-Reform Act. Consequently, defendants are now extremely reluctant to settle before a motion to dismiss has been decided.

1. Standards for Granting Relief from the Discovery Stay

All discovery is stayed in a private securities action during the pendency of a motion to dismiss, unless the court finds that particularized discovery is either "necessary to preserve evidence or to prevent undue prejudice."[165] The decisions to date demonstrate that bald assertions of an existing risk of destruction of evidence will not satisfy the first prong, and that under the second prong the relevant standard will be a showing of harm greater than mere prejudice but less than irreparable harm.

a. *Novak v. Kasaks*[166]

In a class action pending against AnnTaylor Stores Corp., *Novak v. Kasaks*, the plaintiffs served nearly thirty subpoenas on various non-parties, including analysts, broker-dealers, and rating agencies, shortly after filing their complaint.[167] Certain defendants asked the court to stay discovery in anticipation of a motion to dismiss. The court denied this request because no motion had yet been filed.[168] Mere anticipation of a motion to dismiss was not enough to trigger the discovery stay provision.

After serving the plaintiffs with a motion to dismiss, defendants renewed their request. Plaintiffs argued that discovery should proceed because there was "'great risk' that highly relevant evidence will be lost or destroyed and that undue

164. Public institutions generally do not share this problem as they are subject to state public record laws which make their books and records available for public inspection.

165. 15 U.S.C. § 78u-4(b)(3)(B) (1994 & Supp. I 1995).

166. 96 Civ. 3073 (AGS), 1996 U.S. Dist. LEXIS 11778 (S.D.N.Y. Aug. 16, 1996).

167. *Id.* at *1.

168. *Id.* at *2.

prejudice will result if discovery is stayed."[169] The court disagreed and granted the requested stay, finding that no evidence supported plaintiffs' "wholly speculative assertions."[170]

Plaintiffs also argued that if the discovery stay was imposed, non-parties would not feel obligated to maintain relevant documents.[171] The court found this concern "easily remedied," and imposed an order directing all non-parties upon whom subpoenas had been served to preserve all potentially relevant evidence.[172] The result of this order is that plaintiffs continue to have every incentive to serve subpoenas on non-parties to the extent permitted by local rules, even if a discovery stay is on the horizon, or perhaps already in place, in order to ensure that relevant evidence is not destroyed.

b. *Medical Imaging Centers of America, Inc. v. Lichtenstein*[173]

On January 10, 1996, Medical Imaging filed a complaint in the Southern District of California seeking injunctive relief and damages against several Medical Imaging shareholders. The case is unusual in that the corporation is suing its shareholders, rather than vice-versa. Medical Imaging alleged that the defendant shareholders violated Section 13(d) of the Exchange Act by filing an incomplete and misleading Schedule 13D and amendments thereto in an ongoing proxy contest for control of the corporation.[174] Medical Imaging asked that the defendants be ordered to correct their Schedule 13D disclosures on matters necessary for an informed vote to take place.

The defendant shareholders filed a motion to dismiss. Medical Imaging argued that it would suffer "undue prejudice" if discovery was stayed as the shareholder vote to replace the board of directors was imminent.[175] The magistrate reviewed the legislative history of the Act and noted that the only example provided on overcoming a discovery stay was "'the terminal illness of an important witness.'"[176] The magistrate went on to conclude that the harm required to establish "undue prejudice" must be essentially irreparable.[177]

Medical Imaging appealed the magistrate's ruling to the district court. On February 2, 1996, the Commission filed an amicus brief urging the district court to

169. *Id.* at *3.
170. *Id.*
171. *Id.* at *4. Section 21D(b)(3)(C)(i) of the Reform Act, entitled "Preservation of Evidence," requires "any party to the action with actual notice of the allegations contained in the complaint" to preserve all potentially relevant evidence in its custody or control. 15 U.S.C. § 78u-4(b)(3)(C)(i) (1994 & Supp. I 1995). The Reform Act imposes no similar mandate on non-parties.
172. Novak v. Kasaks, 96 Civ. 3073 (AGS), 1996 U.S. Dist. LEXIS 11778, at *4 (S.D.N.Y. Aug. 16, 1996). *See also* Order Denying Plaintiff's Motion to Compel Non-Party Cisco Systems, Inc. to Produce Documents, Kane v. Madge Networks N.V., Case No. C96-20652 RMW PVT (N.D. Cal. Jan. 13, 1997) (staying third-party discovery prior to the filing of a motion to dismiss, pursuant to FRCP 26(c), because "[s]uch discovery is unnecessary and burdensome because it may require considerable production prior to an assessment of the viability of the pleadings").
173. 917 F. Supp. 717 (S.D. Cal. 1996).
174. *Id.* at 718.
175. *Id.* at 719.
176. *See* Medical Imaging Ctrs. v. Lichtenstein, Case No. 96-0039 B (AJB), 1996 U.S. Dist. LEXIS 7641, at *5 (S.D. Cal. Jan. 19, 1996).
177. *Id.* at *7.

reject the magistrate's ruling. The Commission contrasted this case, where an event (proxy contest) had not yet occurred, with the type of case envisioned by the Act's legislative history—money damages sought for events occurring in the past.[178] The Commission argued in its brief:

> [T]he "undue prejudice" standard for allowing limited discovery should not be restricted to situations where irreparable harm can be demonstrated. Rather, in a case where, as here, the plaintiff seeks emergency equitable relief with respect to an on-going contest for control of a corporation, it is possible that the time pressure of upcoming events may result in substantial prejudice, although less than irreparable harm, accruing from a stay of discovery. In such cases, a showing of harm, which is greater than mere prejudice but less than irreparable harm, should satisfy the "undue prejudice" criterion.[179]

At a February 7, 1996 hearing, the district court judge stated that he agreed with the analysis of the statutory provision as articulated in the Commission's brief. After hearing evidence from both sides, however, the judge concluded that Medical Imaging had demonstrated insufficient prejudice and left the discovery stay in place pending resolution of the motion to dismiss.[180] The motion to dismiss was eventually denied and Medical Imaging obtained an injunction.

c. *Levy v. United HealthCare Corp.*[181]

The defendants in this case sought to use the discovery stay as both a shield and a sword. After making a motion to dismiss, the defendants sought relief from the discovery stay so they could depose the plaintiff in order to test the veracity of the statements in the certification filed with his complaint.[182] Finding that neither of the exceptions to the discovery stay had been met, the court denied defendants' motion.[183]

2. The Discovery Stay Likely Will Encompass FRCP 26 Disclosure

a. *Hockey v. Medhekar*[184]

In *Hockey*, Judge Patel of the Northern District of California held that the discovery stay does not encompass the disclosures mandated by Rule 26(a), Federal Rules of Civil Procedure.[185] Rule 26(a) requires the "disclosure" of certain information by plaintiffs as well as defendants, including: identification of persons likely to possess discoverable information relevant to disputed facts; identification of all parties expected to be called as expert witnesses at trial; exchange of reports concerning the opinions to be expressed by expert witnesses; and exchange of

178. Brief of the Securities and Exchange Commission, amicus curiae, at 6–7, Medical Imaging Ctrs. v. Lichtenstein, 917 F. Supp. 717 (S.D. Cal. 1996).
179. *Id.* at 2.
180. *Medical Imaging*, 917 F. Supp. at 722–23.
181. Civ. No. 3-96-750 (D. Minn. Sept. 10, 1996).
182. *Id.* at 2.
183. *Id.* at 3.
184. 932 F. Supp. 249 (N.D Cal. 1996), *vacated sub nom.* Medhekar v. United States District Court, 99 F.3d 325 (9th Cir. 1996).
185. *Id.*

witness lists.[186] Judge Patel noted that recent amendments to Rule 26 inserted the term "disclosure," and added that the court "assumes...that Congress is fully cognizant of the difference between the terms 'discovery' and 'disclosure.'"[187]

The Ninth Circuit disagreed.[188] The appellate court noted that "[t]he federal discovery rules contain numerous examples in which disclosures are treated as a subset of discovery."[189] The Ninth Circuit added that "the time and expense involved in the identification and production of documents and other items required by the disclosure rule is exactly the type of burden sought to be eliminated by the Act"[190] and "Congress clearly intended that complaints in these securities actions should stand or fall based on the actual knowledge of the plaintiffs rather than information produced by the defendants after the action has been filed."[191] Accordingly, the court granted the defendants' petition for a writ of mandamus and vacated the district court's decision.[192]

b. *Levy v. United HealthCare Corp.*[193]

When faced with the same issue, the District of Minnesota, in *Levy v. United HealthCare Corp.*, followed the district court decision in *Hockey*.[194] The court in *Levy* stated two reasons for allowing "disclosure" to go forward. First, the court looked to the text of the Reform Act. It stated, "[W]e are confident that had Congress intended to relieve the parties from the disclosures intended by Rule 26(a), it was fully capable of so stating."[195] Next, the court stated that to hold otherwise would run counter to the views of the FRCP's Advisory Committee. In the Notes to the 1993 Amendments to Rule 26(a), Federal Rules of Civil Procedure, the Committee states, "[t]he obligation to participate in the planning process [i.e., a FRCP Rule 26 disclosure conference] is imposed on all parties that have appeared in the case, including defendants who, because of a pending Rule 12 motion, may not have filed an answer in the case."[196] The Eighth Circuit was not given an opportunity to resolve the conflict between *Levy* and the Ninth Circuit's decision in *Hockey* because the *Levy* plaintiffs voluntarily dismissed their complaint.

E. The New Pleading Standard: Judicial Acceptance of the Second Circuit Standard

The Reform Act strengthens securities class action pleading requirements in

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186. FED. R. CIV. P. 26.
187. *Hockey*, 932 F. Supp. at 251.
188. *Medhekar*, 99 F.3d at 325.
189. *Id.* at 328.
190. *Id.*
191. *Id.*
192. On a related issue, the Northern District of California has published a proposed local rule addressing when disclosure may be had in securities class actions. The rule would require the exchange of disclosure information not later than 10 days before a case management conference to be scheduled by the court after its designates a lead plaintiff. Proposed N.D. Cal. Civil L.R. 26-6(b).
193. Civ. No. 3-96-750 (D. Minn. Sept. 10, 1996).
194. *Id.* This decision was handed down before the Ninth Circuit's decision in *Medhekar*.
195. *Id.* at 3-4.
196. *Id.* at 4.

two significant respects. First, plaintiffs must state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.[197] Second, where the complaint alleges that the defendant misrepresented or omitted to state a material fact, the plaintiff must specify each statement alleged to have been misleading and the reasons why the statement is misleading.[198] If an allegation is made on information and belief, the plaintiff must state with particularity all facts on which the belief is formed.[199]

The Reform Act leaves the question of what constitutes a "strong inference" to be decided by the courts.[200] Prior to the Reform Act, the circuits were split on the issue of securities fraud pleading requirements. The Ninth Circuit had the most liberal pleading standard, allowing scienter to be averred generally, i.e. simply by saying it exists.[201] By contrast, the Second Circuit had the strictest pleading standard, requiring that plaintiffs state facts with particularity and that these facts give rise to a "strong inference" of fraudulent intent.[202] Under the Second Circuit test, a plaintiff can adequately plead scienter pursuant to a two prong test by alleging either: (1) a "motive" and an "opportunity" on the part of the defendant to commit fraud; or (2) facts that constitute strong circumstantial evidence of conscious behavior or recklessness.[203]

The Reform Act's heightened pleading standard as construed by the Conference Report was one of the primary reasons offered by President Clinton for his veto of the Act. In his veto message, President Clinton stated:

> I believe that the pleading requirements of the Conference Report with regard to a defendant's state of mind impose an unacceptable procedural hurdle to meritorious claims being heard in Federal courts. I am prepared to support the high pleading standards of the U.S. Court of Appeals for the Second Circuit—the highest pleading standard of any Federal circuit court. But the conferees make crystal clear in the

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197. 15 U.S.C. § 78u–4(b)(2) (1994 & Supp. I 1995).

198. *Id.* § 78u–4(b)(1).

199. *Id.*

200. *See* Goldman, *supra* note 158, at 11 ("While Congress borrowed the 'strong inference' standard from Second Circuit case law, Congress did not say how this standard could be satisfied and it is not at all clear from this language alone that Congress intended to import the Second Circuit's two-part test as the means for satisfying this new standard.").

201. *See In re* Glenfed Inc. Sec. Litig., 42 F.3d 1541, 1547 (9th Cir. 1994) ("We conclude that plaintiffs may aver scienter generally...that is, simply by saying that scienter existed."); Robbins v. Hometown Buffet, Inc., 1995 U.S. Dist. LEXIS 17870, at *2 (S.D. Cal. Mar. 16, 1995) (stating that the *Glenfed* standard is an "easily met pleading requirement"); Securities Investor Protection Corp. v. Vigman, 764 F.2d 1309, 1313 (9th Cir. 1985) ("When considering a Section 10(b) and Rule 10b–5 claim for relief, the court should liberally construe that claim in order to effectuate the policies underlying the federal securities laws.").

202. *See* H.R. CONF. REP. NO. 104–369, at 41 (1995) (describing the Second Circuit test as being "[r]egarded as the most stringent pleading standard").

203. Ross v. A.H. Robins Co., 607 F.2d 545, 558 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); Beck v. Manufacturers Hanover Trust Co., 820 F.2d 46, 50 (2d Cir. 1987); Shields v. Citytrust Bancorp., Inc., 25 F.3d 1124, 1128 (2d Cir. 1994). Motive is defined to include "concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged." *Shields*, 25 F.3d at 1130. Opportunity is defined as "the means and likely prospect of achieving concrete benefits by the means alleged." *Id.*

Statement of Managers their intent to raise the standard even beyond that level. I am not prepared to accept that.[204]

Despite the President's concerns, however, the trend of the cases has been toward adoption of the Second Circuit test. The Reform Act brings pleading standards nationwide in line with the highest pleading standard existing before passage of the Act.

This result will have the greatest impact in the Ninth Circuit—the most popular jurisdiction for securities class actions[205]—as the new standard radically departs from the Ninth Circuit's traditional liberal standard. This sea change in Ninth Circuit pleading standards is already being felt. In 1995, 37% of securities class actions were brought in California federal court.[206] In 1996, by contrast, this number dropped to 22%.[207]

To date, six courts (three in California) have issued opinions construing the Act's heightened pleading standards. Five have adopted the Second Circuit test. Of these five, three denied motions to dismiss, one denied in part and granted in part, and one granted the motion. These decisions make clear that the obstacle presented by the new pleading standard is significant. Notably, both dismissed cases were brought in the Ninth Circuit, where the result may have differed pre-Reform Act. Plaintiffs' lawyers no longer have an incentive to take advantage of forum-shopping opportunities which prompted them to file cases in the Ninth Circuit. The change in Ninth Circuit pleading is a substantial new obstacle facing class action plaintiffs.

1. Post-Reform Act Case Law Adopting the Second Circuit Standard

a. *Marksman Partners, L.P. v. Chantal Pharmaceuticals Corp.*[208]

In *Chantal*, suit was filed against Chantal Pharmaceuticals and its Chairman of the Board and CEO, Chantal Burnison, alleging violations of Exchange Act Section 10(b). The complaint alleged that the company and Burnison engaged in a scheme to boost Chantal's share price prior to a series of private placements by Chantal and open market sales by Burnison. Specifically, the complaint alleged that Chantal violated generally accepted accounting principles ("GAAP") by immediately recognizing millions of dollars in sales revenue on items that were sold on consignment.[209] As Chantal's stock price began to rise, Chantal made a series of private placements, and Burnison sold 300,000 shares of her own personally held stock, netting in excess of $6,300,000.[210]

The defendants moved to dismiss, arguing that Marksman failed to satisfy the Act's heightened pleading standard. Defendants argued that the Act rejected the Second Circuit's "motive and opportunity" test, citing a provision in the

204. H.R. Doc. No. 150, 104th Cong., 1st Sess. 240 (1995).

205. *See* NERA Study, *supra* note 11, at tbl. 11c (finding that from January 1991–December 22, 1995, the Ninth Circuit had 295 filings; by comparison, the Second Circuit, second most on the list, had 169 filings for the same period).

206. The source of this data is SCAA.

207. Of the 105 cases brought during 1996, 23 were brought in California. *Id.*

208. 927 F. Supp. 1297 (C.D. Cal. 1996).

209. *Id.* at 1302.

210. *Id.* at 1303.

Conference Committee Report that states, "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."[211] The *Chantal* court was not persuaded, ultimately concluding that the "'motive and opportunity' test has not been jettisoned."[212] In reaching this conclusion, the court relied on several factors, including the fact that the "strong inference" language of the Reform Act's pleading standard mirrors the Second Circuit standard, and that Congress failed to specifically disapprove of the test in the statute's text.[213]

In finding that motive was adequately pled, the court held that "[a]llegations that a corporate insider either presented materially false information, or delayed disclosing materially adverse information, in order to sell personally-held stock at a huge profit can supply the requisite 'motive' for a scienter allegation."[214] The court qualified this holding, however, by adding that "a plaintiff however, must demonstrate that the insider trading activity was 'unusual.'"[215] Adopting pre-Reform Act case law, the court defined "unusual" as "'amounts dramatically out of line with prior trading practices, at times calculated to maximize personal benefit from undisclosed inside information.'"[216] The court was swayed by the fact that Burnison had not sold any of her Chantal stock during the three prior years but had sold 20% of her holdings during the class period.[217] As Burnison controlled issuance of all accounting and financial statements, the court found the "opportunity" prong satisfied.[218]

The court also found that plaintiffs had pled scienter adequately by alleging facts supporting the inference that defendants consciously attempted to defraud the market or were reckless. The court enunciated a test here that will surely be invoked in future post-Reform Act financial fraud cases: "Although it is true that a violation of GAAP in itself will generally not be sufficient to establish fraud...when combined with other circumstances suggesting fraudulent intent, however, allegations of improper accounting may support a strong inference of scienter."[219] The court found that the test had been satisfied because the complaint coupled the alleged violation of GAAP with the substantial insider sales, the private placements, and revenue overstatements of a large magnitude.[220] Accordingly, the court denied defendants' motion to dismiss.

b. *Zeid v. Kimberley*[221]

In *Zeid*, plaintiffs filed suit against Firefox Communications, Inc., a software company, and three of its officers and directors, alleging that the defendants engaged in a fraudulent scheme to inflate the price of the company's stock prior to a planned merger. The defendants moved to dismiss the complaint for failure to

211. *Id.* at 1311 n.11.
212. *Id.* at 1311.
213. *Id.*
214. *Id.* at 1312.
215. *Id.*
216. *Id.* (citations omitted).
217. *Id.* at 1313.
218. *Id.* at 1312.
219. *Id.* at 1313 (citations omitted).
220. *Id.* at 1314–15.
221. 930 F. Supp. 431 (N.D. Cal. 1996).

meet the pleading requirements. The complaint contained general allegations that Firefox's "sales and marketing expansion plan was failing" and that "demand for Firefox products was weak."[222] The court found that these allegations lacked the necessary specificity: "Plaintiffs have not sufficiently alleged the reason or reasons why the statements [made to the public]...are misleading.... [C]onclusory allegations are insufficient to support a claim of fraud."[223]

In analyzing whether the heightened pleading standards for scienter were satisfied, the *Zeid* court, like the *Chantal* court, applied the Second Circuit standard, and found that the complaint fell short under either prong of the analysis.[224] The "motive and opportunity" prong was found not to be satisfied because the company released disappointing earnings results *prior* to the merger, thus causing its stock price (and the merger price) to plummet. Moreover, plaintiffs failed to allege any facts supporting their contention that the defendants intended to complete the merger prior to announcing the results.[225] Plaintiffs also did not satisfy the "circumstantial evidence" prong because they did "not sufficiently specify any reasons why [d]efendants' statements were misleading when they were made,"[226] and they did "not set forth any contemporaneous facts to support their assertions of knowledge and recklessness."[227] Accordingly, the complaint was dismissed with leave to amend.[228]

In granting leave to amend, the court rejected the defendants' argument that since the complaint did not satisfy the Act's pleading standards, the language and legislative history of the Act compelled that it be dismissed without leave to amend.

> Contrary to Defendants' assertions, there is nothing in [the language of the Act] to indicate that district courts are required to dismiss securities fraud claims without leave to amend. Further, without a clear directive from Congress, this Court refuses to read into the Reform Act any limitation on the ability of trial courts to permit an opportunity to amend.[229]

c. *STI Classic Fund v. Bollinger Industries, Inc.*[230]

On November 12, 1996, Chief Judge Buchmeyer of the Northern District of Texas adopted a magistrate's report and recommendation which refused to dismiss, in large part, an amended class action complaint filed against Bollinger Industries. The complaint alleged that Bollinger engaged in a financial fraud.[231] The magistrate concluded that the Second Circuit's "motive and opportunity" test was the

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222. *Id.* at 436.
223. *Id.*
224. *Id.* at 438.
225. *Id.*
226. *Id.*
227. *Id.*
228. Claims that various boilerplate warnings were themselves false and misleading because they were not specific enough were dismissed without leave to amend.
229. *Zeid*, 930 F. Supp. at 438. *See also* Coffee, *supra* note 6, at 985 (claiming that "[a]t work here seems to be an unsurprising distaste for special procedural rules applicable to a limited context and inconsistent with the Federal Rules of Civil Procedure").
230. CA 3:96-CV-0823-R (N.D. Tex. Nov. 12, 1996).
231. *Id.* at 2.

"persuasive interpretation" of the Reform Act's heightened pleading requirements.[232] The magistrate further concluded that the individual defendants, owning substantial shares in Bollinger, had ample motive to engage in the alleged financial fraud. Specifically, the magistrate stated, "Materially inflated reports concerning Bollinger's financial health...benefited the value of Bollinger's shares and likewise increased the value of the Brothers Bollinger's interest in the Company...."[233]

This means of satisfying the "motive and opportunity" test threatens to erode the effectiveness of the heightened pleading standards, as individual defendants often will be officers and directors holding substantial shares in the company. The magistrate responded, "Defendants argue that these facts would 'indict' any small, family dominated business, were such sufficient to allege a federal securities fraud claim.... The flaw in Defendants' argument is that it seeks to isolate an element of the circumstances alleged in Plaintiffs' amended complaint rather than to consider them in their totality."[234] The magistrate did not specify what other facts were part of this "totality" of circumstances.

d. *Fischler v. AmSouth Bancorporation*[235]

In *Fischler*, the Middle District of Florida also adopted the Second Circuit test and case law as the pleading standard to be used post-Reform Act. The plaintiff class alleged that the defendant bank holding company and certain of its subsidiaries violated the antifraud provisions of the federal securities laws by selling annuities without disclosing certain hidden surrender charges.[236] Defendants moved to dismiss on several grounds, including failure to adequately plead fraud.

The *Fischler* court quickly disposed of defendants' argument. As both the Reform Act and the traditional Second Circuit test both require that a "strong inference" of scienter be pled, the court looked to the Second Circuit for interpretive guidance.[237] The court noted that the motive and opportunity test is a "common method" for establishing this strong inference.[238] Without any discussion of the facts, the court held, "In the present case, Plaintiff alleges facts showing motive and opportunity. Plaintiff's Complaint meets the requirements of § 21D(b)(3)(A)."[239] No indication is given as to what the court found to be an adequate motive. One interpretation of the court's decision would be that a mere profit motive satisfies the motive prong; this sweeps too broadly, as a profit motive would be present in nearly all cases involving the sale of securities. A review of the complaint shows that the pleading standard is more readily satisfied by reference to the other prong of the Second Circuit test, which permits the pleading of facts giving rise to strong circumstantial evidence of at least reckless behavior. Here, the complaint alleges that defendants were the subject of two NASD investigations during the class period, as well as investigations by the Alabama and Florida state

232. *Id.*
233. *Id.* at 2–3.
234. *Id.* at 3.
235. No. 96-1567-CIV-T-17A, 1996 U.S. Dist. LEXIS 17670 (M.D. Fla. Nov. 14, 1996).
236. *Id.* at *3.
237. *Id.* at *7–*8.
238. *Id.* at *8.
239. *Id.*

securities regulators. Moreover, a report by an outside consultant concluded that systematic wrongdoing was occurring. This information should have put the defendants on notice of the fraud.

e. *Rehm v. Eagle Finance Corporation*[240]

In *Rehm*, the Northern District of Illinois became the fifth court post-Reform Act to adopt the Second Circuit pleading standard. Like the *Chantal* court, this court was swayed by the fact that both the Reform Act and the Second Circuit test require that a "strong inference" of fraudulent intent be pled.[241] The court also looked to the legislative history:

> The Committee does not adopt a new and untested pleading standard that would generate additional litigation. Instead, the Committee chose a uniform standard modelled upon the pleading standard of the Second Circuit...[without] intend[ing] to codify the Second Circuit's case law interpreting this pleading standard, although courts may find this body of law instructive.[242]

Finally, the court found that the Second Circuit test strikes an appropriate balance between curtailing abusive securities lawsuits and leaving the courthouse door open for valid lawsuits.[243] The court, while stating that it was not bound by Second Circuit case law, decided to apply that case law after finding that it was "consistent with the language and purpose" of the Reform Act.[244]

The court's opinion, like *Chantal*, sheds light on the motive prong. The lawsuit alleges that Eagle, a financial services company, materially misrepresented Eagle's known credit losses and net income.[245] The court found inadequate general allegations that the company was facing a mounting risk that it would lose access to the capital markets. The court echoed several pre-Act opinions in stating, "[A]llegations of motives that are generally held by similarly positioned executives and companies are insufficient."[246] The court also found it significant that plaintiffs did not allege that Eagle actually attempted to raise capital during the class period.[247] Next, the court held insufficient allegations that the individual defendants owned substantial Eagle stock.[248] Allowing motive to be inferred from stock ownership would mean that "virtually every company in the United States that experiences a downturn in stock price would be forced to defend securities fraud actions" based on the statements of its officers and directors.[249] Finally, the court also deemed insufficient allegations that one of the individual defendants engaged in insider trading during the class period. The court noted that this person's trading—6% of his Eagle holdings—was not "*dramatically* out of line with [his]

240. No. 96 C 2455, 1997 U.S. Dist. LEXIS 767 (N.D. Ill. Jan. 27, 1997).
241. *Id.* at *16.
242. *Id.* at *17 (citing S. REP. NO. 104-98, at 15 (1995)).
243. *Id.*
244. *Id.* at *18.
245. *Id.* at *3.
246. *Id.* at *20-*21.
247. *Id.* Conversely, the conduct of a public offering of securities or a significant private placement during the class period may well satisfy the motive prong.
248. *Id.* at *22.
249. *Id.* at *23 (citation omitted).

prior trading practices...."[250]

The *Rehm* court nonetheless did not dismiss the complaint because it held that plaintiffs had satisfied the second prong of the Second Circuit. The court found that plaintiffs had adequately pled facts demonstrating at least reckless behavior. Again following *Chantal*, the court held that, "in addition to bare allegations of GAAP violations, the complaint must show that defendants recklessly disregarded the deviance [from GAAP] or acted with gross indifference towards the purported material misrepresentations contained in the financial statements."[251] The court also focussed on the "magnitude of [the] reporting errors" and the "optimistic and reassuring 'spin'" the individual defendants put on the matter in public remarks.[252] The court held that the magnitude of the reporting errors combined with these remarks satisfied the heightened pleading standard.

2. *Post-Reform Act Case Law Rejecting the Second Circuit Standard*

a. *In re Silicon Graphics Securities Litigation*[253]

On September 25, District Court Judge Fern Smith of the Northern District of California broke ranks, refusing to look to Second Circuit case law to interpret the heightened pleading standard. The *Silicon Graphics* class action alleged violations of Section 10(b) of the Exchange Act against the company and nine of its officers and directors in connection with both historical and forward-looking statements about the company's growth targets.[254] The plaintiffs alleged that the company and the individual defendants issued false and misleading information after a disappointing first quarter in an effort to inflate the stock price so that the individuals could sell their own stock at a substantial profit.[255] The defendants moved to dismiss.

Primarily based on the language in the Conference Committee Report, the court found that "Congress did not simply codify the Second Circuit standard," but "intended to strengthen it."[256] Because Congress chose not to include language from the Second Circuit relating to motive, opportunity, and recklessness in the statute, the court reasoned, it must have adopted the Conference Committee view and intended that a narrower first prong apply.[257] Therefore, the court held, the plaintiff "must allege specific facts that constitute circumstantial evidence of *conscious* behavior by defendants."[258] Allegations of recklessness would no longer be adequate. The court noted that its opinion conflicted with the holdings in *Chantal* and *Zeid*, but "respectfully disagreed" with those decisions.[259] Determining that the

250. *Id.* at *24–*25. *Compare Chantal,* 927 F. Supp. 1297, 1313 (C.D. Cal. 1996) (sales by Chantal Burnison of 20% of her holdings during the class period deemed "unusual"). The court also found it relevant that the other two individual defendants did not sell stock during the class period, *Rehm,* 1997 U.S. Dist. LEXIS 767, at *23, although this fact seems irrelevant as to the scienter of the insider who actually traded.

251. 1997 U.S. Dist. LEXIS 767, at *28.

252. *Id.* at *29–*30.

253. Fed. Sec. L. Rep. (CCH) ¶ 99,325 (N.D. Cal. 1996).

254. *Id.* at 95,959–95,960.

255. *Id.*

256. *Id.* at 95,961–95,962.

257. *Id.* at 95,962.

258. *Id.* (emphasis supplied).

259. *Id.* at n.4.

plaintiff's allegations were not specific enough to raise a strong inference of fraud, the court dismissed the complaint with leave to amend.[260]

3. *The Commission's Viewpoint*

On February 3, 1997, the Commission filed an *amicus curiae* brief in *Silicon Graphics* urging the district court to reconsider its earlier decision and to hold that recklessness suffices for liability under Section 10(b) of the Exchange Act and Rule 10b–5 thereunder.[261] The Commission argues that the Act made no change in the definition of the state of mind required to be shown in a private action, except in the case of certain forward-looking statements entitled to the protection of the "safe harbor."[262] The Commission's brief further argues that a retreat from the recklessness standard would greatly erode the deterrent effect of Section 10(b) actions.[263]

The brief reviews the Reform Act's legislative history and concludes that the Act does not eliminate recklessness as a scienter standard. The Commission points out that:

> Nowhere did the Conference Committee suggest that it was eliminating recklessness as satisfying the scienter requirement, or, indeed, that it was eliminating evidence of motive and opportunity or circumstantial evidence of fraudulent intent (be it conscious or reckless) as factors that the courts might consider in determining whether the strong inference had been established. Instead, Congress simply elected not to attempt to codify the guidance provided in Second Circuit case law, preferring to leave to the courts the discretion to create their own standards for determining whether a plaintiff has established the required strong inference.[264]

The Commission concluded that, "If plaintiffs can state with particularity facts giving rise to a strong inference that defendants acted recklessly, their complaint is sufficient under Section 21D(b)(2)."[265] A hearing on the motion to dismiss is set for April 1997. Doubtless, plaintiff and defense lawyers will continue to grapple over the appropriate interpretation of the Reform Act's pleading standard.[266]

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260. Following the court's order granting the Motion to Dismiss, the plaintiffs filed a First Amended Complaint on October 17, 1996. The defendants moved to dismiss the Amended Complaint on December 13, 1996. This motion is pending.

261. Brief of the Securities and Exchange Commission, amicus curiae, *In re* Silicon Graphics Sec. Litig., Fed. Sec. L. Rep. ¶ 99, 325 (N.D. Cal. 1996) (No. 96–0393) [hereinafter Brief of the Securities and Exchange Commission].

262. *Id.* at 7–8.

263. *Id.* at 3.

264. *Id.* at 12–13. *See also* Michael A. Perino, *A Strong Inference of Fraud? An Early Interpretation of the 1995 Private Securities Litigation Reform Act*, SEC. REFORM ACT LITIG. REP., June–July 1996, at 397, 403 ("Like the statements in the earlier Senate Report, the language in the Statement of Managers is ambiguous. It does not clarify whether Congress intended to make its standard more stringent than the Second Circuit's standard, whether the Second Circuit standard was meant to be the norm, or whether the Managers were only attempting to formulate a standard that was higher than that used by Circuits other than the Second Circuit.").

265. Brief of the Securities and Exchange Commission, *supra* note 261, at 13.

266. *Compare* Goldman, *supra* note 150, at 12 (a partner at a traditional defendant law firm: "*Silicon Graphics*' reliance on the Statement of Managers' report is plainly the most

III. STATE DETOURS

The strictures of the Reform Act have led some plaintiffs' attorneys to seek a detour around the obstacles in federal court by turning to state forums. As discussed in the introduction, the number of state court class actions has significantly increased.[267] This increase does not appear to have been anticipated by Congress; there is no indication in the legislative history that Congress considered the effect of state court class actions on the reforms that it was implementing. In this section, we explore the implications of the state court detour for the new securities class action.

A. Why Detour?

The Reform Act has made state court newly alluring for plaintiffs' attorneys. While state court has always offered advantages over federal court (depending on the jurisdiction)—such as non-unanimous jury verdicts, punitive damages, and (post-*Central Bank*) aiding and abetting liability—it has not traditionally been the primary forum for securities class actions. The federal obstacles put in place by the Reform Act are now prompting plaintiffs' lawyers to file more securities class actions in the friendlier confines of state court.

The main feature now attracting the plaintiffs' bar is not any particular state blue-sky provision, but rather, the *absence* of the discovery stay found in federal court. The state action provides the potential for an unobstructed path to discovery, whether or not a judgment is ultimately obtained in state court. In the new securities class action, a parallel state proceeding can be used to gain discovery that is unobtainable—but nonetheless usable—in a federal action, thereby negating one of the more daunting obstacles created by the Reform Act. Of the 105 federal actions filed in the year following the passage of the Act, we have identified twenty-six that are tied to a parallel state action. In these actions, defendants are forced to respond on two fronts, thus incurring greater litigation expense than pre-Reform Act, a result surely not intended by Congress.

The remaining state actions—thirty-nine as measured by the Stanford Securities Class Action Clearinghouse[268]—are stand-alone state court actions. Some of these cases may migrate to federal court after discovery has taken place. Some may be forced into federal court if a national class cannot be certified at the state level.[269] Others, however, may proceed to the merits in state court. Of the thirty-nine stand alone state actions, twenty-four are in California.

Three factors make state court a viable alternative for many cases, two of which come together only in California. The first, which applies to all state court actions, is the Supreme Court's recent ruling in *Matsushita Electric Industrial Co. v. Epstein*,[270] which held that a state court judgment dismissing a state class action

appropriate way to resolve the ambiguity in this statute") *with* William S. Lerach & Eric Alan Isaacson, *Pleading Requirements Under Section 21D(b) of the Securities Exchange Act of 1934*, 34 SAN DIEGO L. REV. (forthcoming 1997) (partners at a traditional plaintiffs' law firm: "The *Silicon Graphics* interpretation of Section 21D(b) is untenable.").

267. *See supra* notes 13–16 and accompanying text.

268. *Securities Class Action Clearinghouse Litigation—State Complaints* at 1–7 (last modified Jan. 8, 1997) <http://securities.standford.edu>.

269. On class certification, see *infra* notes 287–96 and accompanying text.

270. 116 S. Ct. 873 (1996).

suit pursuant to a settlement agreement could include a provision barring federal securities fraud class actions arising out of the same transaction. The Court concluded that the state court judgment would be entitled to res judicata effect, despite the exclusive federal court jurisdiction over cases brought under the Exchange Act, including Section 10(b) and Rule 10b–5 claims.[271] By allowing defendants to obtain a global settlement in state court, *Matsushita* provided plaintiffs' lawyers with significant leverage and incentive to file class actions in state courts.

The confluence of the second and third factors is unique to California. The second factor is the absence of an individualized reliance requirement. In *Mirkin v. Wasserman*, the California Supreme Court, while rejecting the fraud-on-the-market theory in common law fraud actions, said in dicta that plaintiffs need not plead or prove actual reliance in an action under the state's blue-sky law.[272] Eliminating the requirement of reliance makes possible a class action for securities suits.[273] The third factor is the availability of jurisdiction over a favorite target of plaintiffs' lawyers, high-technology firms.[274] The largest concentration of high-technology firms in the United States is, of course, located in Silicon Valley. High-technology firms tend to have a volatile share price, plus officers and directors who receive a large portion of their compensation in company stock and stock options, which means they will be more likely to be selling shares during a period of volatility. Volatility and insider sales are frequently relied upon by plaintiffs' attorneys in pleading their cases. Thus, California provides a convenient detour around the obstacles found in federal court.

It is noteworthy that it appears state court detours are not being taken to circumvent the federal court obstacles to suing peripheral deep pocket defendants. These obstacles were created both by the Reform Act's proportionate liability provision and by the Supreme Court's *Central Bank* decision holding that there is no private right of action for aiding and abetting under Section 10(b) of the Exchange Act. A review of forty-one post-Reform Act state securities class action complaints discloses only one naming accountants, none naming corporate counsel, and nine naming underwriters.

For the most part, the allegations in state court complaints are similar to those found in the federal complaints. We reviewed a sample of state court complaints—ten complaints for which there is a parallel federal action and sixteen complaints for stand-alone state actions.[275] The results are as follows:

- 15% of the state court complaints are based soley on failed forecasts (as

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271. *Id.*

272. 858 P.2d 568, 580 (Cal. 1993). Three other states do not require reliance for common-law fraud actions: Rosenthal v. Dean Witter Reynolds, Inc., 908 P.2d 1095, 1106 (Colo. 1996); State v. Superior Court of Maricopa Cty., 599 P.2d 777 (Ariz. 1979); Weatherly v. Deloitte & Touche, 905 S.W.2d 642, 648–49 (Tex. Ct. App. 1995), while one state trial court has adopted the fraud-on-the-market doctrine under that state's blue-sky law: Bierman v. Thompson, No. DV–96–124A (Mont. 11th Jud. Ct. Oct. 15, 1996).

273. Basic Inc. v. Levinson, 485 U.S. 224, 241–47 (1988).

274. NERA Study, *supra* note 11, at tbl. 10c (finding that suits naming high-technology firms as defendants comprised 22.85% of all securities class actions between 1991 and October 1996, and 26.92% of all filings between January and October 1996).

275. This sample was selected to mirror the overall percentage (40%) of parallel (26 out of 65) versus stand-alone (39 out of 65) state actions, as reported by the *Securities Class Action Clearinghouse.*

compared to 12% at the federal level);

- 38% contain allegations of accouting irregularities (as compared to 43% at the federal level);
- 15% contain allegations of an earnings restatement (as compared to 18% at the federal level);
- 46% contain insider trading allegations (as compared to 48% at the federal level);
- 8% contain allegations of a concurrent government investigation (as compared to 15% at the federal level); and
- 15% contain none of the above allegations (as compared to 14% at the federal level).

These numbers suggest that weaker complaints are not migrating to state court. Further analysis, however, casts a slightly different light. The parallel complaints should be no weaker on average because those state complaints presumably mirror closely their federal counterpart. But the stand-alone complaints have no federal counterpart to be subjected to the heightened federal pleading standards. In the sixteen stand-alone state complaints that we reviewed, the numbers are as follows:

- 25% of these complaints are based solely on failed forecasts (as compared to 12% at the federal level);
- 31% contain allegations of accouting irregularities (as compared to 43% at the federal level);
- 13% contain allegations of an earnings restatement (as compared to 18% at the federal level);
- 25% contain insider trading allegations (as compared to 48% at the federal level);
- 6% contain allegations of a concurrent government investigation (as compared to 15% at the federal level); and
- 25% contain none of the above allegations (as compared to 14% at the federal level).

B. State Obstacles

Class action plaintiffs who have taken state court detours have found that the road has some potholes of its own. First, a discovery stay may be available. Four cases have addressed the issue: two have granted the stay, two have denied it. Second, institutions may seek to intervene. Third, state securities actions raise difficult constitutional issues when plaintiffs seek to certify a national class. Thus, the long term viability of the state court detour remains to be determined.

1. State Discovery Stay Cases

a. Cases Imposing a Discovery Stay

In *Milano v. Auhll*,[276] the plaintiff filed a complaint in California state court alleging violations of both state and federal securities laws.[277] The defendants demurred and moved for a discovery stay pursuant to the Reform Act. Milano responded that the Reform Act's discovery stay does not apply to cases pending in state courts. Milano's primary argument rested on the Act's plain language. First, the Act states that a "motion to dismiss" triggers the discovery stay, and Milano contended that this term is unknown to California civil procedure, which instead uses the term "demurrer." Second, Section 27(a) states that it shall apply "to each private action arising under this title that is brought as a plaintiff class action pursuant to the *Federal Rules of Civil Procedure*."[278] Milano argued that the reference to the Federal Rules meant that the Act's provisions were not meant to apply in state court actions.

The court rejected these arguments and imposed the discovery stay. The court reasoned that Section 27(b), which contains the discovery stay provision, applies by its terms to "any private action arising under this title."[279] The court concluded that "title" referred to the Securities Act. The court accordingly held that the discovery stay applies "if at least one cause of action is within [the Reform Act] amendments."[280] Because Milano had alleged a Securities Act Section 11 violation, his complaint was controlled by the Reform Act.

In response to *Milano*, state class action complaints are likely to omit Securities Act Section 11 claims, and instead rely exclusively on state law claims.[281] This strategy, however, may not evade the discovery stay. In a class action filed against Brooktree Corporation in California,[282] a discovery stay was imposed, despite the fact that plaintiffs had alleged no federal securities claims. Notwithstanding the exclusively state claims, the court granted Brooktree's motion to stay all discovery, including third-party discovery. While no opinion accompanied the court's order, the oral argument transcript discloses that the court was "looking at the spirit of the new federal legislation...in the nature of guidance"

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276. No. SB 213 476 (Cal. Super. Ct. Santa Barbara Cty. Oct. 2, 1996).

277. Milano's state court claim for violations of federal securities laws is authorized by Section 22 of the Securities Act which provides state courts with concurrent jurisdiction to enforce any liability or duty created by that Act. 15 U.S.C. § 77v(a) (1994). Section 22 further provides that cases brought in state court may not be removed to federal district courts. *Id. Compare* Section 27 of the Exchange Act, 15 U.S.C. § 78aa (1994) (providing federal courts with exclusive jurisdiction to enforce any liability or duty created by the Exchange Act).

278. No. SB 213 476, at 4.

279. *Id.*

280. *Id.* at 5.

281. This is not to say that a Securities Act Section 11 claim may not be added in an amended complaint after discovery is had. *See* Alpern v. UtiliCorp United, Inc., 84 F.3d 1525 (8th Cir. 1996) (holding that a Section 11 claim added to an amended complaint relates back to the date the original complaint was filed for purposes of the statute of limitations and calculation of damages, if based on the same transactions, occurrences, and conduct alleged in the original complaint).

282. Sperber v. Bixby, Case No. 699812 (Cal. Super. Ct. San Diego Cty. Oct. 18, 1996).

and that imposing a stay was "a function of judicial discretion."[283]

b. Cases Denying a Discovery Stay

In two state class actions, *Nutrition for Life* and *IMP, Inc.* (both parallel to federal actions), state courts have denied the discovery stay.[284] While the *Nutrition for Life* court does not explain its ruling, the *IMP* court, in allowing discovery and denying a motion to stay the proceedings in favor of the federal action, held:

> The motion to stay the consolidated state actions is denied. This action was filed after the related federal actions. California law affords plaintiffs broader and more effective relief on their state law claims than on their federal claims, which involve different issues. Under the circumstances, this court can best determine the rights of the parties. There are no "unseemly conflicts" if this case proceeds. And this action is not harassing, vexatious or oppressive.[285]

Thus, plaintiffs who seek to evade the federal discovery stay may find the state detour attractive, but the path is still uncertain.

2. You Can Run (to State Court) but You Cannot Hide (from Institutional Investors)

Filing suit in state court does not necessarily give individual class action plaintiffs refuge from institutional intervention. A recent New York state court decision, not involving the Reform Act, raises issues of control similar to those being litigated under the lead plaintiff provision of the Act. On September 3, 1996, in New York, a trial judge granted a motion made by the California Public Employees Retirement System ("CALPERS") to become co-lead counsel during settlement talks in a shareholder action against W.R. Grace & Co.[286] The suit centered on the departure of Grace's CEO, J.P. Bolduc, who received severance pay in excess of $20 million. CALPERS, one of W.R. Grace & Co.'s largest shareholders, was displeased with a previously proposed settlement that would have required the company to change certain policies, but not return any funds to shareholders. If institutions continue to intervene in this manner, the influence of the Reform Act will be felt at the state level as well.

3. National Certification

For the state court actions which are not being used only as discovery vehicles for parallel federal actions, certification of a national class is critical. If a national class cannot be certified, potential recovery is greatly diminished.

California, as the main battleground for state class actions, provides the most relevant body of law to assess the availability of a nationwide class. In

283. Transcript of Defendants' Motion to Stay at 2–3, Sperber v. Bixby, Case No. 699812.

284. David S. Gilfand, Ltd. Profit Sharing Plan v. Nutrition for Life Int'l, Inc., (Harris Cty., Tex. Dec. 11, 1996); Lee v. IMP, Inc., CV 760793 (Cal. Super. Ct. Santa Clara Cty. Dec. 11, 1996).

285. Lee v. IMP, Inc., CV 760793, at 1.

286. Weiser v. Grace, Index No. 106285/95 (N.Y. Sup. Ct., N.Y. Cty. Sept. 3, 1996).

Clothesrigger, Inc. v. GTE Corp.,[287] the California Court of Appeals set forth the procedure for California courts to follow when deciding whether to certify a national class. First, a determination must be made as to whether California law may apply to the claims of proposed class members not resident of California. In order to apply its law to non-residents, California must satisfy both the Due Process Clause of the Fourteenth Amendment and the Full Faith and Credit Clause of Article IV. As those provisions have been construed by the United States Supreme Court in *Phillips Petroleum Co. v. Shutts*, California "must have a 'significant contact or significant aggregation of contacts' to the claims asserted by each member of the plaintiff class, contacts 'creating state interest,' in order to ensure that the choice of [California] law is not arbitrary or unfair."[288] When conducting this analysis, "an important element is the expectation of the parties."[289] The court, however, need only find a significant contact that "appl[ies] generally to every class member's claims," and the court "need not articulate how the contacts apply in each class member's case."[290]

California law will likely apply to the entire class if the defendant is incorporated or maintains its principal place of business in California.[291] A state also has a "significant contact" if the plaintiff resides in that state[292] or the alleged fraudulent conduct occurred in that state.[293] Moreover, one California Court has held that "significant contacts" exist where the defendant does "extensive business" in California.[294]

If the court determines that application of California law would be constitutional, *Clothesrigger* next dictates that the court perform a traditional choice-of-law analysis to determine whether to apply California law.[295] If the court determines California law will apply, the nationwide class should be certified, assuming all other requirements for certification are satisfied.[296]

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287. 191 Cal. App. 3d 605 (Ct. App. 1987).

288. 472 U.S. 797, 821–22 (1985) (citation omitted).

289. *Id.* at 822.

290. *In re* Computer Memories Sec. Litig., 111 F.R.D. 675, 687 (N.D. Cal. 1986). *See also* Roberts v. Heim, 670 F. Supp. 1466, 1495 (N.D. Cal. 1987) ("*Shutts* does not require the court to undertake an individual choice-of-law inquiry into the claims of each and every plaintif.... *Shutts* requires only that a threshold due process inquiry be made into whether the application of a given state's law to the claims of all class members would be arbitrary or unfair.").

291. Havlicek v. Coast-to-Coast Analytical Servs., Inc., 39 Cal. App. 4th 1844, 1855 (Ct. App. 1995) (principal place of business is a "significant contact").

292. *Phillips Petroleum*, 472 U.S. at 819.

293. *Id. See also In re* Victor Techs. Sec. Litig., 102 F.R.D. 53, 60 (N.D. Cal. 1984) (certifying national class where the misstatement "emanated" from California), *aff'd*, 792 F.2d 862 (9th Cir. 1986).

294. Nicolet, Inc. v. Superior Court, 224 Cal. Rptr. 408 (Ct. App. 1986) (holding that California law constitutionally applied to a suit involving a Pennsylvania asbestos manufacturer against a Pennsylvania insurance company which refused to indemnify claims, where the insurance company elected to do business nationwide).

295. 191 Cal. App. 3d 605, 618 (Ct. App. 1987). Analysis of a choice of law question involves three steps: "(1) determination of whether the potentially concerned states have differ[ing] laws; (2) consideration of whether each of the states has an interest in having its law applied...; and (3) [if the first two prongs are answered in the affirmative,] selection of which state's law to apply by determining which state's interests would be more impaired if its policy were subordinated to the policy of the other state." *Id.* at 614.

296. The *Clothesrigger* decision is also noteworthy for its instructions in the event that the trial court determines California law may not be constitutionally applied to all

To summarize, California may not apply its substantive law to plaintiff claims which do not at least have a "significant contact" with California. All plaintiffs will likely be able to avail themselves of California law if the defendant corporation is (i) incorporated in California, (ii) has its principal place of business in California, (iii) does extensive business in California, or (iv) the alleged fraudulent conduct occurred in California. It is uncertain if the *Phillips Petroleum* test is satisfied when the defendant does business in California, but not on an extensive level. As migration continues to California state courts, the California Supreme Court will likely be called upon to resolve these class certification issues.

C. The Future of the State Detour

The migration to state court has resulted in disparate responses by the plaintiffs' bar and the issuer community. Class action proponents unsuccessfully sought to rewrite California blue-sky laws through a ballot initiative known as Proposition 211 that would have made the state a haven for future class actions. Proposition 211 advocates spent $15 million in support of the measure, while issuers spent over $35 million in opposition,[297] thereby making Proposition 211 the most expensive initiative campaign in California history.[298] In response to the threat of greater exposure at the state level, issuers and other traditional defendants have begun a push for federal preemption of state securities class actions. Obviously, passage of either a Proposition 211-type measure or preemptive legislation would again shift the battle lines of the securities class action.[299]

1. Proposition 211

Proposition 211, officially known as the "Attorney-Client Fee Arrangements, Securities Fraud, Initiative Statute" appeared on the ballot in California in November, 1996. The measure would have, among other things, created an Exchange Act Section 10(b) type action at the state level expressly allowing: private rights of action, aiding and abetting, punitive damages, the fraud-on-the-market theory, no indemnification of officers and directors, joint and several liability for all defendants, and no caps on attorney's fees. Proponents of Proposition 211 argued that the Reform Act's obstacles left investors in need of better protection from fraud. After opposition by President Clinton, Senator Dole,

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nationwide class members. It states:

> [T]he court should consider the degree of complexity arising from the need to apply other states' laws. The court may decline to certify the nationwide class if it determines such complexity results in common legal questions not predominating or makes nationwide class litigation unmanageable. The court may certify the nationwide class despite such complexity if it determines the legal questions are sufficiently similar to be manageable and all other requirements for certification are satisfied.

Id. at 619.

297. Peter Schrag, *Initiative Process Has Been Hijacked*, SAN DIEGO UNION-TRIB., Nov. 14, 1996, at B13.

298. Tom Abate, *Prop. 211 Opponents to Push On*, S.F. EXAMINER, Nov. 6, 1996, at A25.

299. Legislators in California have taken action which may also affect the future of the state detour. *See Legislative Briefs, State News Briefs*, Sec. Reg. & L. Rep. (BNA) No. 48, at 1523 (Dec. 13, 1996) (reporting that California State Senators John Vasconcellos and Jim Brulte introduced Senate Bill No. 35, a bill that would incorporate the Reform Act into California state law).

and Commission Chairman Levitt, the measure was defeated by a vote of 3 to 1. In voicing his opposition, Chairman Levitt stated Proposition 211 "may skew [the] balance" between investor protection and capital formation and that "the Litigation Reform Act should be given a chance to work before other measures are taken."[300]

2. The Preemption Movement

The concern over the post-Reform Act increase in state court securities class actions and a desire to avoid a repeat of the Proposition 211 battle in some other venue has triggered a push for federal preemption. On November 9, 1996, at their annual industry convention, top Wall Street officials, including NYSE Chairman Richard Grasso, announced they would push for federal legislation during this upcoming congressional session to preempt state blue-sky laws.[301] Further, Silicon Valley executives have banded together to form the California Technology Alliance, with passage of preemption legislation one of its top priorities.[302] It has also been reported that California Republicans Christopher Cox and Tom Campbell are considering drafting preemption legislation.[303] In fact, Representative Joseph P. Kennedy II of Massachusetts sent a letter to his congressional colleagues on November 20, 1996 asking for support of preemption legislation which he intends to introduce "in the early days" of the 105th Congress. As expected, opposition to preemption is beginning to form.[304]

CONCLUSION

The new securities class action has not yet taken its final shape. Several obstacles erected by the Reform Act, including the safe-harbor for forward looking statements, the mandatory Rule 11 inquiry, and the proportionate liability standard, have received virtually no judicial attention. Other provisions, such as the pleading standards, the discovery stay, and the lead plaintiff provision, have been the subject of a number of district court decisions, but have yet to be authoritatively interpreted by the courts of appeals. Notwithstanding the limited returns to date, certain patterns have begun to emerge.

The new pleading standards have made it more difficult to sue issuers in federal court. While most courts have adopted the Second Circuit standard, the adoption of that standard marks a sea change for the Ninth Circuit, perhaps the most important jurisdiction for securities class actions. Plaintiffs' attorneys have responded by investing more time and effort in the drafting of complaints, which have more detailed allegations and are less likely to be premised solely on a drop in stock price. Plaintiffs who are unable to meet the Second Circuit standard at the

300. Letter from SEC Chairman Arthur Levitt Jr. to the Honorable Anna G. Eshoo, Congresswoman, 14th Dist., California (Oct. 17, 1996) (on file with *Arizona Law Review*).

301. *See* Jill Dutt, *Brokers Pledge to Fight Anti-Securities Initiatives*, WASH. POST, Nov. 10, 1996, at A7.

302. *See House Members Ready Preemptive Securities Litigation Reform Bill*, CORP. FINANCING WK., Dec. 16, 1996, at 13.

303. *See* Lynn Stevens Hume, *SEC Chairman: Federal Securities Law Reform Should Get Time to Work*, BOND BUYER, Nov. 8, 1996, at 4.

304. *See* Rachel Witmer, *Industry Groups Seek New Legislation to Preserve Securities Litigation Reform*, Sec. Reg. & L. Rep. (BNA) No. 6, at 152–53 (Feb. 7, 1997) (listing Public Citizen, Government Finance Officers Association, and Consumer Federation of America as potential opponents).

outset are unlikely to prevail, as the discovery stay is being applied strictly, thus preventing the use of discovery to bolster a sketchy complaint. The difficulty in obtaining discovery may have had its most significant effect on secondary defendants such as accountants, who are much less likely to be sued than they were pre-Reform Act.

The lead plaintiff provision has changed the nature of the battles among plaintiffs' lawyers, but it has not displaced them from control of securities class actions. Plaintiffs' lawyers now compete amongst each other to get the largest plaintiff group, instead of entering the pure race to the courthouse that went on before the Reform Act. The lead plaintiff provision has not yet induced a significant number of institutional investors to step forward and take control of securities class actions. In short, plaintiffs' lawyers still run the show.

Going forward, perhaps the most significant development in securities class actions is the state court detour. This is the boldest strategem by plaintiffs' attorneys seeking to evade the obstacles that they now find in federal court. Many of the state-court actions are parallel to federal actions, presumably brought to evade the discovery stay. A larger number, however, are stand-alone actions. Those cases raise difficult questions about the role of state law in the regulation of the securities markets, which operate on a national basis. It remains to be seen, however, whether the detour to state court is a temporary phenomena or a long-term trend. If the state court detour does prove to be a long-term trend, the battle over securities class actions may return to Congress in the form of a contentious battle over preemption.