RECENT JUDICIAL AND LEGISLATIVE DEVELOPMENTS AFFECTING THE PRIVATE SECURITIES FRAUD CLASS ACTION

Richard H. Walker* & J. Gordon Seymour**

The Securities and Exchange Commission has repeatedly stressed the importance of, and supported, private actions under the securities laws. Private actions serve several important roles. Due to the Commission's limited resources, they are a necessary supplement to the Commission's enforcement efforts. Private actions under the antifraud provisions of the securities laws also serve as a deterrent to securities frauds and provide perhaps the quickest way for defrauded investors to attempt to recoup their losses.[1]

Over the course of the last decade, the substantive and procedural law governing private securities fraud actions has undergone significant changes that could affect the ability of such actions to continue to serve their roles under the federal securities laws. And these changes are still ongoing. As this article is written, the 105th Congress is considering legislation that would preempt state securities fraud class actions involving nationally-traded securities.

This Article provides a brief overview of four developments in the last seven years—two judicial and two legislative—that each either have had or could have a profound effect on the conduct of private securities fraud class actions. The Article has three parts. Part I briefly discusses the role of private enforcement

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* Mr. Walker is the Director of the Division of Enforcement, United States Securities and Exchange Commission.

** Mr. Seymour is an attorney in the Office of the General Counsel, United States Securities and Exchange Commission. The Commission, as a matter of policy, disclaims responsibility for any private publication or statement of any of its employees. The views expressed herein are those of the authors and do not necessarily reflect the views of the Commission or the authors' colleagues on the staff of the Commission. In addition, certain matters discussed in this article may be issues in litigation in which the Commission appears, as a party or otherwise, and no statement in this article should be considered indicative of the views or positions that might be taken by the Commission in any such litigation. The date of this article is May 26, 1998.

1. *See* 58 S.E.C. Docket 697 (Dec. 15, 1994) ("Private actions are a necessary supplement to the Commission's own enforcement efforts, act as a deterrent against securities fraud, and provide a mechanism for defrauded investors to obtain damages.").

under the federal securities laws and the creation of the securities fraud class action. Part II then discusses two important Supreme Court decisions from the 1990s—*Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*[2] and *Central Bank of Denver v. First Interstate Bank of Denver*[3]—and the continuing efforts of the lower federal courts to apply these two decisions. Part III discusses Congress's two recent forays into securities litigation reform—the 1995 Private Securities Litigation Reform Act ("Reform Act") and the current efforts to preempt state securities fraud class actions. In addition to describing these pieces of legislation, Part III surveys some of the current and anticipated issues the courts will have to address to implement Congress's work.

Notably, each of the developments discussed in this article has narrowed the scope of the private securities fraud class action. While this article does not debate the legal merits of the Supreme Court's decisions or the wisdom of Congress's recent efforts to reform securities litigation, it does analyze some of the current issues in the lower courts concerning the interpretation of the *Lampf* and *Central Bank* decisions, the pleading standards adopted in the Reform Act, and some potential issues raised by the state preemption legislation Congress is currently considering. How these issues are resolved in the courts over the next few years may determine how well the private securities class action can continue to serve as a meaningful deterrent to securities fraud and an effective means for defrauded investors to seek recovery of their losses.

I. THE SECURITIES FRAUD CLASS ACTION

The courts—no less than the Commission[4] and Congress[5]—have recognized the importance of private rights of action under the federal securities laws. In *Basic, Inc. v. Levinson*, the Supreme Court noted that private actions under § 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), probably the most well-known and commonly used of the antifraud provisions of the federal securities laws, "constitute[] an essential tool for enforcement of the 1934 Act's requirements."[6]

2. 501 U.S. 350 (1991).

3. 511 U.S. 164 (1994).

4. *See* 58 S.E.C. Docket 697 (Dec. 15, 1994) ("The Commission has consistently stressed the importance of and supported private rights of action under the antifraud provisions of the securities laws."); Securities Exchange Act Rel. No. 34-25893, at n.16 (July 7, 1988).

5. *See* Statement of Managers—The "Private Securities Litigation Reform Act of 1995," 141 Cong. Rec. H13691-08 ("Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs.").

6. 485 U.S. 224, 231 (1988). *See also* Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310 (1985) ("[W]e repeatedly have emphasized that implied private actions provide 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.'") (quoting J. I. Case Co. v. Borak, 377

For defrauded investors, however, the costs of bringing an individual private action are often prohibitive; an investor's loss may not even exceed the expected costs of filing and pursuing a lawsuit. For this reason, courts have long noted that the "ultimate effectiveness of the federal [securities fraud] remedies...may depend in large measure on the applicability of the class action device."[7] This is particularly true in the common situation in which current or former shareholders of a publicly-held issuer allege violations of the antifraud provisions based on misrepresentations by the issuer in its public filings. In this situation, "a class action may well be the appropriate means for expeditious litigation of the issues, because a large number of individuals may have been injured, although no one person may have been damaged to a degree which would have induced him to institute litigation solely on his own behalf."[8]

The federal class action device, as it has developed over the years, is well suited to these types of claims. Courts today note that "[c]laims under the federal securities laws are particularly susceptible to class action treatment."[9] Two developments have contributed to the growth in securities class actions. First, in 1966, Rule 23 of the Federal Rules of Civil Procedure was substantially modified. Prior to 1966, Rule 23 divided class actions into three types: "true," "hybrid," and "spurious" class actions.[10] Under this system, if federal securities claims were maintainable as class actions at all, it was only as a "spurious" class action.[11] A "spurious" class action, however, was binding only on the class members who were original parties and intervenors to the case; the judgment did not bind class members who did not appear before the court.[12] The revised Rule 23, among other things, made the judgment in a class action binding on all class members who do not opt out of the class.[13] This change to Rule 23 therefore enabled a class member to maintain a class action on behalf of a class of defrauded investors and obtain a judgment for class members who did not appear in the action. This made the prosecution of class actions economically feasible.

The second development contributing to the increased use of the class action in federal securities cases was the Supreme Court's decision in *Basic, Inc. v.*

U.S. 426, 432 (1964)).

7. Green v. Wolf Corp., 406 F.2d 291, 295 (2d Cir. 1968) (quoting 3 LOSS, SECURITIES REGULATION 1819 (2d ed. 1961)); Esplin v. Hirschi, 402 F.2d 94, 101 (10th Cir. 1968); LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 4605 (3d ed. Supp. 1996) (listing cases).

8. *Green*, 406 F.2d at 296.

9. LOSS & SELIGMAN, *supra* note 7, at 4606-07 (citing Hudson v. Capital Management Int'l, Inc., 565 F. Supp. 615, 628 (N.D. Cal. 1983)).

10. FED. R. CIV. P. 23, advisory committee's note. "True" class actions were defined as including "joint, common, or secondary rights." *Id.* "Hybrid" class actions were defined as those involving "several" rights to "specific property." *Id.*

11. LOSS & SELIGMAN, *supra* note 7, at 4607, n.320.

12. FED. R. CIV. P. 23 advisory committee's note. *See also Green*, 406 F.2d at 297. Unlike "spurious" class actions, "true" and "hybrid" class actions resulted in judgments that would extend to the entire class. FED. R. CIV. P. 23, advisory committee's note.

13. FED. R. CIV. P. 23, advisory committee's note.

Levinson,[14] in which the Supreme Court endorsed the "fraud-on-the-market" theory. The fraud-on-the market theory is based on the principle that, in an efficient market, the price of a security reflects publicly available information about the security's issuer.[15] Material, misleading statements therefore will affect a security's price and act to defraud an investor whether or not that investor can show that she individually relied on the misleading statements.[16] Based on this reasoning, the fraud-on-the-market theory creates, in appropriate circumstances, a rebuttable presumption of reliance based on misrepresentations to the market.[17]

The fraud-on-the-market theory provides two related benefits to plaintiffs in a securities fraud class action. First, by minimizing the role of individual reliance in a case, the theory makes the requirements of Rule 23(b)(3) (including the requirement that the questions of law or fact common to the members of the class predominate over individual questions) more likely to be met.[18] In *Basic*, the Supreme Court expressly noted the district court's observation that the fraud-on-the-market theory provides "a practical resolution to the problem of balancing the substantive requirement of proof of reliance in securities cases against the procedural requisites of [Federal Rule of Civil Procedure] 23."[19] Second, and of equal importance, the theory provides a means for a class of defrauded investors to show reliance for the absent class members. These benefits have led to widespread use of the theory. Today, the typical federal securities class action involving alleged misrepresentations by an issuer of a publicly-traded security is based on the fraud-on-the-market theory.

In recent years, the securities fraud class action has also attracted its critics. Commentators have contended that frivolous securities fraud class actions have been filed and that the costs issuers incur to defend such cases may be passed on to current shareholders of the issuer. The Commission has itself expressed concern over the costs associated with such litigation.[20] More broadly, some have criticized the current system for not preventing so-called strike suits—securities class actions with a low chance of success that are brought primarily for their anticipated settlement value. According to some commentators, because of the

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14. 485 U.S. 224 (1988).
15. *Id.* at 241.
16. *Id.* at 241-42.
17. *Id.* at 242. The presumption of reliance created by the fraud-on-the-market theory can be rebutted by a "showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price." *Id.* at 248.
18. *Id.* at 242.
19. *Id.*
20. *See* Testimony of Chairman Arthur Levitt, U.S. Securities and Exchange Commission, concerning the impact of the Private Securities Litigation Reform Act of 1995 before the Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, United States Senate, 1994 WL 416650 (F.D.C.H) (July 24, 1997) ("Investors are not well served [] by frivolous lawsuits, which raise the cost of capital and in no way deter fraud."); *see also* 58 S.E.C. Docket 697 (Dec. 15, 1994) ("[T]he Commission recognizes that meritless cases should be discouraged because meritless litigation can impose unnecessary costs and adverse consequences on investors and others.").

asymmetric costs imposed in such cases, defendants have a rational incentive to settle such cases even when the plaintiffs' chances of success at trial are minimal. One oft-cited study concluded that securities fraud class actions typically settle for roughly between twenty and twenty-five percent of the amount at stake in the case.[21] The conclusion suggested by the study was that the merits of the cases did not matter and that defendants were settling such cases to avoid the costs and uncertainty of litigation.[22]

II. RECENT JUDICIAL DEVELOPMENTS

Although this decade has seen a number of important Supreme Court decisions construing the federal securities laws,[23] this article focuses on two cases that have had a particular impact on the conduct of federal securities class actions and that are continuing to generate controversy in the lower federal courts—*Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*[24] and *Central Bank of Denver v. First Interstate Bank.*[25]

The two cases have much in common. Both came as surprises to the securities bar. *Lampf* ended the lower courts' almost thirty-year old practice of borrowing analogous state statutes of limitation in private § 10(b) cases. Likewise, *Central Bank* was the first case to hold that the Exchange Act did not provide for aiding-and-abetting liability in a private §10(b) action. In so holding, the Supreme Court addressed a question not even raised by the certiorari petition.[26] The two cases have also been perceived as reflecting an undercurrent of judicial dissatisfaction with the conduct of private securities fraud litigation. Both cases restricted the circumstances in which a private § 10(b) cause of action may be maintained, and in *Central Bank*, the Supreme Court voiced concerns about the nature of securities fraud class action litigation in general. Finally, the Court's decisions in *Lampf* and *Central Bank* share complicated subsequent histories. Today, some four years after the *Central Bank* decision and seven years after *Lampf*, important questions about the scope and consequences of the two decisions are currently being decided by the courts and will significantly affect what the decisions' final impact will be.

A. Lampf *and Progeny*

In *Lampf*, the Supreme Court held that the statute of limitations found in § 9(e) of the Exchange Act applies to private actions brought under Exchange Act §

21. Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 516-17 (1991).

22. *Id.* at 524.

23. In addition to the cases discussed in this article, see also *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995) (holding that § 12(2) of the Securities Act is limited to public offerings), and *United States v. O'Hagan*, 117 S. Ct. 2199 (1997) (upholding the misappropriation theory of insider trading).

24. 501 U.S. 350 (1991).

25. 511 U.S. 164 (1994).

26. *Id.* at 194–95 (Stevens, J., dissenting).

10(b).[27] The Court did not address, however, the question of how the § 9(e) statute of limitations should be applied. The lack of express Supreme Court guidance on this question has left the door open for the lower courts to interpret *Lampf* in ways that may not have been anticipated or intended by the Court.

1. The Lampf *Decision*

In *Lampf*, the plaintiffs were investors in limited partnerships formed to purchase and lease computer equipment. The plaintiffs invested in the limited partnerships between 1979 and 1981 with the expectation of receiving tax benefits for their investments. The investments failed. In late 1982 and early 1983, plaintiffs received notice that the Internal Revenue Service was investigating the limited partnerships. The IRS subsequently disallowed the tax benefits claimed by the plaintiffs.

Plaintiffs filed suit in November 1986 and June 1987, claiming that they were misled into investing in the partnerships by misrepresentations in the partnerships' offering documents, including misrepresentations concerning the tax benefits of the investments. Among the defendants named was Lampf, Pleva, Lipkind, Prupis & Petigrow, a law firm that had helped form the partnerships and had prepared opinion letters concerning the tax consequences of the investments. Plaintiffs alleged that they became aware of the misrepresentations only in 1985 when the IRS disallowed the tax benefits they had claimed.

The district court dismissed the plaintiffs' claims based on the statute of limitations. Following precedent of the Ninth Circuit, where the case was filed, the district court applied the state limitations period for the "most analogous" state cause of action—in this case, the two year statute of limitations applicable to fraud claims under Oregon law. The court then found that the plaintiffs were put on "inquiry notice" of the fraud in 1982 and accordingly granted the defendants summary judgment on the plaintiffs' claims. The Ninth Circuit reversed, finding that disputed issues concerning when the plaintiffs discovered or should have learned of the fraud precluded summary judgment.[28] In so holding, however, the Ninth Circuit, at least implicitly, rejected the plaintiffs' argument that a uniform federal statute of limitations should apply to § 10(b) claims. The Supreme Court granted certiorari on this question.

After reviewing its prior decisions on borrowing statutes of limitation, the Court decided that "where, as here, the claim asserted is one implied under a statute that also contains an express cause of action with its own time limitation, a court should look first to the statute of origin to ascertain the proper limitation

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27. *Lampf*, 501 U.S. at 359-62. Section 9(e) imposes a short limitations period—one year after discovery of the facts constituting the violation and within three years of the violation.

The statute of limitations created in *Lampf* does not apply in SEC actions. *See* SEC v. Rind, 991 F.2d 1486, 1489–90 (9th Cir. 1992), *cert. denied*, 510 U.S. 963 (1993). As the court noted in *Rind*, the Commission is granted express statutory authority to sue to enforce § 10(b) of the Exchange Act by § 21 of the Exchange Act. *Id.* at 1490.

28. *Lampf*, 501 U.S. at 354.

period."[29] The Court therefore concluded that the statutes of limitations applicable to the express causes of action in the Securities Exchange Act of 1934, and specifically § 9(e) of that Act, apply to § 10(b) claims. Paraphrasing the requirements of § 9(e), the Court concluded that "[l]itigation instituted pursuant to § 10(b) and Rule 10b–5 therefore must be commenced within one year after the discovery of the facts constituting the violation and within three years after such violation."[30]

2. *The Aftermath of* Lampf

Perhaps the most frequently-litigated statute of limitations issue in private securities fraud cases subsequent to *Lampf* is what triggers the running of the one-year prong of the statute of limitations. Specifically, courts have had to decide whether the concepts of "inquiry notice" and "constructive notice" apply to start the one-year period running.[31] Surprisingly, courts have almost unanimously concluded that these concepts do apply. The result has been that many courts have found the one-year prong of the § 9(e) limitations period begins to run when an investor becomes aware *or should have become* aware of the *possibility* (*or probability*) of fraud, not when the investor gains actual knowledge of the fraud itself.[32] As a result, some plaintiffs who file suit within one year of learning of the basis of their cause of action are being deprived of a federal remedy.

This result seems to be inconsistent with the Court's reasoning in *Lampf* for several reasons. On the most basic level, it is inconsistent with how the Court itself described its holding in *Lampf*. In straightforward terms, the Court announced that "[l]itigation instituted pursuant to § 10(b) and Rule 10b–5 [] must be commenced within *one year after the discovery of the facts constituting the violation* and within three years after such violation."[33]

In addition, the Court in *Lampf* seemed to anticipate this issue and resolve it in favor of requiring actual notice when it adopted § 9(e) as the applicable statute of limitations for § 10(b) claims, rather than a different standard that would have provided for inquiry notice. The Court first concluded that the statutes of limitations applicable to the express causes of action in the Securities Act of 1933 and the Securities Exchange Act of 1934 apply to § 10(b) claims. The Court

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29. *Id.* at 359.

30. *Id.* at 364.

31. Courts have found persons on "inquiry notice" from the time that they "became aware of facts that would have led a reasonable person to investigate whether he might have a claim." Tregenza v. Great Am. Comm. Co., 12 F.3d 717, 718 (7th Cir. 1993). While some courts have used different definitions of "constructive notice," this article uses the terms "inquiry notice" and "constructive notice" interchangeably to indicate concepts courts have applied to trigger running of the one-year limitations period before an investor gains actual knowledge of the facts constituting the violation. This article also does not discuss the concept of "equitable estoppel," which some courts have suggested could still apply to the § 9(e) statute of limitations despite the Supreme Court's apparent rejection of "equitable tolling" in *Lampf*. *See, e.g.*, *Tregenza*, 12 F.3d at 720–21.

32. *See infra* text accompanying notes 42–47.

33. *Lampf*, 501 U.S. at 364 (emphasis added).

recognized, however, as the SEC had pointed out in its amicus brief, that the language in the statutes of limitations provided for in § 9(e) of the Exchange Act and § 13 of the Securities Act differed. Faced with these two different provisions, the Court made a clear choice: "To the extent that these distinctions in the future might prove significant, we select as the governing standard for an action under § 10(b) the language of § 9(e) of the 1934 Act."[34]

The distinction between § 9(e) and § 13's language is significant in deciding when the one-year prong of the applicable limitations period begins to run. Section 9(e) of the Exchange Act provides that suit must be brought "within one year after the discovery of the facts constituting the violation and within three years after such violation."[35] Unlike § 9(e), § 13 creates different one-year limitations periods for different claims under the Securities Act. Thus, a claim under § 12(a)(1) of the Securities Act must be brought "within one year after the violation upon which it is based."[36] Significantly, however, an action under § 11 or § 12(a)(2) of the Securities Act must be brought "within one year after the discovery of the untrue statement or the omission, *or after such discovery should have been made by the exercise of reasonable diligence....*"[37] In light of the difference between § 9(e)'s actual notice standard and § 13's reasonable diligence standard, the Supreme Court's choice of § 9(e) of the Exchange Act as the governing statute of limitations in private § 10(b) actions seems to point clearly to endorsement of an actual notice standard.

Finally, the *Lampf* Court's reasoning in declining to apply the doctrine of equitable tolling to the statute of limitations also appears to point to an actual notice standard. The *Lampf* plaintiffs argued that the doctrine of equitable tolling should apply to whatever statute of limitations the Court chose. The Court summarized the doctrine of equitable tolling as follows:

> [W]here the party injured by the fraud remains in ignorance of it without any fault or want of diligence or care on his part, the bar of the statute does not begin to run until the fraud is discovered, though there be no special circumstances or efforts on the part of

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34. *Id.* at 364 n.9.

35. 15 U.S.C. § 78i(e) (1988).

36. 15 U.S.C. § 77m (1988).

37. *Id.* (emphasis added). Section 13, as amended, provides in full:

> No action shall be maintained to enforce any liability created under section 77k or section 77*l*(2) of this title unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence, or, if the action is to enforce a liability created under section 77*l*(1) of this title, unless brought within one year after the violation upon which it is based. In no event shall any such action be brought to enforce a liability created under section 77k or 77*l*(1) of this title more than three years after the security was bona fide offered to the public, or under section 77*l*(2) of this title more than three years after the sale.

Id.

> the party committing the fraud to conceal it from the knowledge of the other party.[38]

The Court rejected the plaintiffs' attempt to apply the doctrine to the statute of limitations it adopted, however, concluding that "it is evident that the equitable tolling doctrine is fundamentally inconsistent with the 1-and-3-year structure. The 1-year period, by its terms, begins after discovery of the facts constituting the violation, making tolling unnecessary. The 3-year limit is a period of repose inconsistent with tolling."[39]

The Court's reasoning on this point is difficult to reconcile with the notion that the one-year limitations period may begin to run before an investor has actual knowledge of the basis of her claim. The Court found equitable tolling "unnecessary" because the one-year prong does not begin to run until "discovery of the facts constituting the violation."[40] If the Court meant for inquiry or constructive notice to sometimes trigger the running of the one-year limitations period before the plaintiff gained actual knowledge of the fraud, it would not seem logical for the Court to have found equitable tolling unnecessary.[41]

Nonetheless, the lower court decisions subsequent to *Lampf* have almost unanimously applied "inquiry notice" concepts to substantially restrict the one-year-after-discovery prong of the statute of limitations established in *Lampf*.[42] As several district courts have recently noted, "every appellate court which has addressed this issue since the Supreme Court's ruling in *Lampf* has held that inquiry notice applies."[43] Specifically, the Second, Fourth, Seventh, and Tenth Circuits seem to have reached this conclusion.[44]

The Seventh Circuit's decision in *Tregenza v. Great American*

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38. *Lampf*, 501 U.S. at 363 (quoting Bailey v. Glover, 21 Wall. 342, 348 (1875)).

39. *Id.*

40. *Id.*

41. *Cf.* Hauman v. Illinois Power Co., 1991 WL 354887 at *8 (C.D. Ill. 1991) (The *Lampf* Court's rationale for not applying equitable tolling "would not apply if diligence and inquiry notice were relevant considerations.").

42. For scholarly criticism of this trend, *see* 3B HAROLD S. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 9A.08 (1993); Roy M. Van Cleave, *The Federal Securities Acts' One-Year Inquiry Notice Statute of Limitations: Are the Scales Tipped Against Fraud Claimants?*, 22 J. CORP. L. 79 (1996); Lewis D. Lowenfels and Alan R. Bromberg, *SEC Rule 10b–5 and Its New Statute of Limitations: The Circuits Defy the Supreme Court*, 51 BUS. LAW. 309 (1996).

43. *In re* Valence Technology, Inc. Securities Litigation, 987 F. Supp. 796, 801 (N.D. Cal. 1997) (listing cases). *See also* Reisman v. KPMG Peat Marwick LLP, 965 F. Supp. 165, 170 (D. Mass. 1997) ("[e]very circuit court of appeals that has addressed the issue has interpreted *Lampf* to require only 'inquiry' or 'constructive notice'") (listing cases).

44. *See, e.g.*, Menowitz v. Brown, 991 F.2d 36, 41–42 (2d Cir. 1993); Brumbaugh v. Princeton Partners, 985 F.2d 157, 162 (4th Cir. 1993); Tregenza v. Great American Communications Co., 12 F.3d 717, 722 (7th Cir. 1993); Anixter v. Home-Stake Production Co., 947 F.2d 897, 898–99 (10th Cir. 1991). *See also In re* Stac Elec. Sec. Litig., 89 F.3d 1399, 1411 (9th Cir. 1996) (dicta).

Communications[45] may be the case most often cited on this issue. In *Tregenza*, the plaintiffs filed § 10(b) claims against defendants Great American Communications and Shearson Lehman Brothers, Inc., based on the defendants' involvement in making allegedly fraudulent statements about an October 1989 offering of Great American common stock. The plaintiffs filed suit in September 1992, within a year of the time they alleged that they gained actual knowledge of the basis of their fraud allegations. The district court, however, found that inquiry notice applied and dismissed the plaintiffs' claims on the grounds that plaintiffs were on inquiry notice of their claims by October 1990, well more than a year before filing suit.[46]

The Seventh Circuit affirmed. The court began by acknowledging that:

> Section 9(e), read literally, requires actual knowledge to set the statute of limitations running. The plaintiff must know "the facts constituting the violation," not merely enough facts to make a reasonable person suspicious and start looking for the facts constituting the violation.[47]

Rather than ending its analysis after finding that the applicable statute requires actual knowledge, the court proceeded to examine the legislative history of Exchange Act § 9(e) and Securities Act § 13. Based on its review of the legislative history, the court concluded that, for actions alleging fraud, Congress would have chosen a statute of limitations with inquiry notice. The court did not attempt to reconcile this conclusion with the Supreme Court's decision in *Lampf* to select Exchange Act § 9(e)—not Securities Act § 13—as the governing statute of limitations.

In fact, the *Tregenza* court's entire analysis of *Lampf* was to note its holding and then conclude that the issue of inquiry notice "was not addressed in *Lampf*, and as the opinion contains dicta pointing both ways, compare 501 U.S. at __ n.2, 111 S. Ct. at 2777 n.2 with *id.*, 501 U.S. at __ n.9, 111 S. Ct. at 2782 n.9, not much help can be got from it."[48] Faced with the decision whether to apply what it called "the judge-made doctrine of inquiry notice" to § 9(e), the *Tregenza* court concluded that "[n]othing in the language, history, or purpose of section 9(e) forecloses so modest and traditional an exercise in judicial creativity."[49] Finally,

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45. 12 F.3d 717 (7th Cir. 1993).

46. *Id.* at 718.

47. *Id.* at 721.

48. *Id.* at 718. The court's brief treatment of *Lampf* is subject to question. While not discussed in terms of "inquiry" or "constructive" notice, *Lampf* does appear to address this issue in choosing § 9(e)'s statute of limitations over the one provided for in § 13. The allegedly conflicting dicta pointed to by the *Tregenza* court bears closer scrutiny. Footnote 2 of the Court's opinion simply describes the statutes of limitation found in Securities Act § 13, and Exchange Act §§ 9(e), 18(c) and 29(b): "Although not identical in language, all these relate to one year after discovery and to three years after violation." Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 355 n.2 (1991). In contrast, footnote 9 of the Court's opinion, as noted above, specifically chose § 9(e) as the governing statute of limitations "[t]o the extent [its differences with § 13] in the future might prove significant." *Id.* at 364 n.9.

49. *Tregenza*, 12 F.3d at 722.

the court concluded that inquiry notice furthered the policy goal of preventing what it called "the opportunistic use of federal securities law to protect investors against market risk."[50]

In contrast to *Tregenza*, the other appellate court decisions and the numerous district court decisions applying inquiry and constructive notice concepts to private § 10(b) claims after *Lampf*, only a few district court decisions appear to have squarely rejected the use of inquiry notice in private § 10(b) cases.[51] Most of these decisions, however, appear to have been implicitly overruled by subsequent decisions from the district courts' courts of appeals.[52]

B. Central Bank *and Progeny*

The second recent Supreme Court decision restricting the ability of investors to bring securities fraud actions is *Central Bank of Denver v. First Interstate Bank.*[53] In *Central Bank*, the Supreme Court significantly altered the law of secondary liability by holding that a private plaintiff may not maintain an aiding-and-abetting claim under Exchange Act § 10(b). *Central Bank* is a decision as noteworthy for its method of analysis as its precise holding. Breaking sharply with prior decisions interpreting the securities laws, the Court abandoned the traditional notion that the securities laws should be interpreted liberally to effectuate their purposes and instead adopted a strict "plain meaning" approach to § 10(b)'s language.

Commentators and courts alike have recognized that the *Central Bank* decision significantly alters the law of secondary liability under § 10(b) of the Exchange Act.[54] *How* the law has been changed, however, remains a matter of dispute. In the wake of *Central Bank*, courts have been called upon to determine the precise contours of the Court's holding—that is, what the decision means for the other types of secondary liability that courts have traditionally recognized in § 10(b) cases, including conspiracy and common law theories such as respondeat superior. Courts have also been faced with the closely related question of where to draw the line between primary and secondary liability under § 10(b). Courts have also been confronted with the efforts of creative defense counsel to import the

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50. *Id.*

51. *See, e.g.*, Slavin v. Morgan Stanley & Co., Inc., 791 F. Supp. 327, 332 (D. Mass. 1992) (the "defendants' attempt to employ the 'reasonable diligence' standard to toll the limitation period is contrary to the specific guidance issued by the Court in *Lampf*: 'The 1-year period, by its terms, begins after discovery of the facts constituting the violation, making tolling unnecessary.'") (quoting *Lampf*, 501 U.S. at 363).

52. *Compare* Werner v. Satterlee, Stephens, Burke & Burke, 797 F. Supp. 1196, 1204 (S.D.N.Y. 1992), *and* Hauman v. Illinois Power Co., No. 89-1130, 1991 WL 354887 at *2-4 (C.D. Ill. Aug. 29, 1991), *with* Menowitz v. Brown, 991 F.2d 36, 41-42 (2d Cir. 1993), and *Tregenza*, 12 F.3d at 722.

53. 511 U.S. 164 (1994).

54. *See* Joel Seligman, *The Implications of* Central Bank, 49 BUS. LAW 1429, 1430 (1994) (the "Supreme Court's *Central Bank* decision is the most important federal securities law decision in several years"); *In re* Leslie Fay Companies, Inc., 871 F. Supp. 686, 689 (S.D.N.Y. 1995) (recognizing *Central Bank* as a "landmark decision").

reasoning of *Central Bank* into other areas of the securities laws. Defendants have argued—with little success to date—that *Central Bank's* method of analysis should be applied in a variety of securities law contexts far afield from secondary liability under § 10(b). Only after these issues are gradually resolved through continued litigation and judicial decisions will the impact of *Central Bank* be fully known.[55]

1. The Central Bank *Decision*

The plaintiffs in *Central Bank* were purchasers of bonds issued by the Colorado Springs public building authority. When the building authority defaulted on the bonds, plaintiffs brought a § 10(b) and Rule 10b–5 action not only against the building authority and certain underwriters that had made representations concerning the bonds, but also against the Central Bank of Denver, N.A., which had served as indenture trustee for the bond issues. The plaintiffs' complaint alleged that Central Bank knew of questions concerning the issuer's valuation of the land securing the bonds but failed to timely investigate them. Accordingly, the complaint did not allege that Central Bank itself made any misrepresentations, but instead only that Central Bank was "secondarily liable under § 10(b) for its conduct in aiding and abetting the fraud."[56]

The Supreme Court, overruling the decisions of a number of Circuits, held that there is no cause of action for aiding-and-abetting liability in a private § 10(b) case. Emphasizing that "the statutory text controls the definition of conduct covered by §10(b),"[57] the Court concluded that the statute did not make liable those who aid and abet, but do not themselves commit, a primary violation of § 10(b).

While noting that "[p]olicy considerations cannot override our interpretation of the text and structure of the Act,"[58] the Court supplemented its textual analysis with a discussion of the policy arguments that weigh in favor of not recognizing private aiding-and-abetting liability. According to the Court, "litigation under Rule 10b–5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."[59] The Court also cited one Senator's estimates of the costs born by accounting firms in securities litigation and

55. For a thorough analysis of the different contexts in which defense counsel have contended that *Central Bank* changed the law, see Richard H. Walker and David M. Levine, *The Limits of* Central Bank's *Textualist Approach—Attempts to Overdraw the Bank Prove Unsuccessful*, 26 HOFSTRA L. REV. 1 (1997).

56. *Central Bank*, 511 U.S. at 168.

57. *Id.* at 175. The Court drew a distinction between "the scope of conduct prohibited by section 10(b)" and "the elements of the 10b–5 private liability scheme." *Id.* at 172. As to the first category, "the text of the statute controls our decision." *Id.* at 173. As to the latter category, however, "[w]e [] have had 'to infer how the 1934 Congress would have addressed the issue[s] had the 10b–5 action been included as an express provision in the 1934 Act.'" *Id.* (quoting Musick, Peeler & Garrett v. Employers Ins. of Wausau, 508 U.S. 286, 294 (1993)).

58. *Id.* at 188.

59. *Id.* at 189 (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739 (1975)).

noted the "ripple effects" of such litigation on small businesses and shareholders.[60]

The Court also found its conclusion bolstered by a review of other sections of the statute. The Court maintained that, "Congress did not overlook secondary liability when it created the private rights of action in the 1934 Act."[61] The express creation of "control person" liability in § 20 of the Exchange Act "suggests that '[w]hen Congress wished to create such [secondary] liability, it had little trouble doing so.'"[62]

The Court also rejected the argument that aiding-and-abetting tort liability formed part of the background upon which Congress legislated in 1934. Aiding-and-abetting liability, according to the Court, began as a criminal law doctrine. The Court also noted that Congress had never enacted a general civil aiding-and-abetting statute that would make all who aid and abet violations of statutes civilly liable.[63]

The Court therefore concluded that § 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act."[64] Accordingly, only a "person or entity...who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b–5, assuming all of the requirements for primary liability under Rule 10b–5 are met."[65] Because the complaint did not allege that Central Bank in fact employed a manipulative device or made a misstatement—but instead asserted that Central Bank was only "secondarily liable" for another entity's having done so—the Court affirmed the district court's granting of summary judgment in favor of Central Bank.[66]

At the same time, however, the Court expressly left the door open for secondary actors in § 10(b) cases to be held liable as primary violators:

> The absence of section 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b–5, assuming all of the requirements for primary liability under Rule 10b–5 are met.... In any complex securities fraud, moreover, there are likely to be multiple violators;

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60. *Id.*

61. *Id.* at 184.

62. *Id.* (quoting Pinter v. Dahl, 486 U.S. 622, 650 (1988)) (brackets in original). *See also id.* ("The fact that Congress chose to impose some forms of secondary liability, but not others, indicates a deliberate congressional choice with which the courts should not interfere.").

63. *Id.* at 182.

64. *Id.* at 177.

65. *Id.* at 191.

66. *Id.*

in this case, for example, respondents named four defendants as primary violators.[67]

2. *The Aftermath of* Central Bank

Supreme Court cases often spawn subsequent litigation. The Court's *Central Bank* decision has distinguished itself even among these cases for the amount of litigation it has generated. This appears to have occurred for at least three reasons. First, the decision's emphasis on § 10(b)'s text and the Court's evident readiness to disregard the long-settled decisions of the lower courts have encouraged defense attorneys to try to apply *Central Bank* to a variety of securities law issues. Second, while the Court's holding was strictly limited to aiding-and-abetting liability in cases brought under § 10(b) by private plaintiffs, some of the Court's reasoning—such as its discussion of "control person" liability under § 20(a) of the Exchange Act—arguably suggests its holding could be applied to other types of secondary liability not explicitly mentioned in the Exchange Act. Third, and finally, how to apply *Central Bank* has remained uncertain because of the atypical fact scenario the Court analyzed in *Central Bank*—that of a bank serving as indenture trustee. As commentators have noted, "*Central Bank* did not involve the most common secondary actors in securities matters—underwriters, accountants, and lawyers—who are involved in preparing offering documents and disclosures.... Although the Court identified applicable legal standards, it did not apply them in the factual context courts most frequently encounter in this area."[68]

Not surprisingly, commentators have diverged widely on what *Central Bank* means for secondary liability under § 10(b) of the Exchange Act.[69] While this article does not purport to provide a comprehensive review of the post-*Central Bank* caselaw, several of the most extensively litigated issues—and several important recent decisions on these issues—are discussed below.

a. Conspiracy

Perhaps the most extensively litigated issue after *Central Bank* has been whether conspiracy survives as a basis for secondary liability. Virtually every court to have considered the issue has agreed that conspiracy is not a valid basis for secondary liability after *Central Bank.* Most recently, in *Dinsmore v. Squadron,*

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67. *Id.*

68. Gareth T. Evans & Daniel S. Floyd, *Secondary Liability Under Rule 10b-5: Still Alive and Well After* Central Bank?, 52 BUS. LAW 13, 15 (1996).

69. *Compare* Lisa Klein Wager and John E. Failla, Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.—*The Beginning of an End, Or Will Less Lead to More?*, 49 BUS. LAW. 1451, 1462 (1994) ("The viability of any precedent applying such common law principles to expand the scope of a section 10(b) cause of action certainly must be questioned, if not rejected out of hand, after the decision in Central Bank"), *with* Simon M. Lorne, Central Bank of Denver v. SEC, 49 BUS. LAW. 1467, 1467 (1994) ("A decision reached by the Supreme Court by a decision of 5 justices against 4 justices cannot 'clearly' or 'obviously' or 'unquestionably' stand for any proposition that is not explicitly covered in the 5-vote majority opinion.").

Ellenoff, Plesent, Sheinfeld & Sorkin,[70] the Second Circuit held that *Central Bank* foreclosed a cause of action for conspiracy in a private action brought under § 10(b).

In *Dinsmore*, the plaintiffs were holders of promissory notes issued by Towers Financial Corporation, the operator of an alleged Ponzi scheme. The plaintiffs named a number of defendants, including Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin ("Squadron, Ellenoff"), a law firm that represented Towers and two of its executives during an SEC investigation. The gravamen of the plaintiffs' claims against Squadron, Ellenoff was that the firm prolonged Towers's fraudulent scheme by, among other things, making material misrepresentations to the SEC during its investigation. The plaintiffs originally sought to hold Squadron, Ellenoff liable as an aider and abettor of Towers's fraud. Following the Supreme Court's decision in *Central Bank*, the plaintiffs amended their complaint to seek to hold the firm liable as a primary violator of § 10(b). The district court dismissed this claim, but in an opinion suggested that *Central Bank* had not precluded the use of conspiracy as a basis of secondary liability under § 10(b) and permitted the plaintiffs to amend their complaint to plead the conspiracy claim. After the amendment, the district court denied defendants' motion to dismiss and certified its ruling for interlocutory appeal.[71]

On interlocutory appeal, the Second Circuit reversed. Drawing entirely on the Supreme Court's reasoning in *Central Bank*, the court concluded that the principles articulated in that decision precluded the use of conspiracy as a basis of secondary liability under § 10(b). The court began by noting that every decision to consider the issue—save the court below and a district court decision that had been effectively overruled by a subsequent Ninth Circuit decision—had concluded that conspiracy did not survive *Central Bank*.[72] The court then relied on three factors. First, the court noted that—as with aiding-and-abetting liability—the text of § 10(b) does not mention conspiracy liability.[73] Second, the court maintained that recognizing a conspiracy cause of action would "render irrelevant the question whether plaintiffs relied on any misstatements or omissions by the defendant being sued."[74] Finally, the court rejected the distinction between aiding-and-abetting

70. 135 F.3d 837 (2d Cir. 1998).

71. *Id.*

72. *Id.* at 841 (citing *In re* GlenFed, Inc., Sec. Litig., 60 F.3d 591, 592 (9th Cir. 1995); Kidder Peabody & Co. v. Unigestion Int'l, Ltd., 903 F. Supp. 479, 496–98 (S.D.N.Y. 1995); *In re* MTC Elec. Techs. Shareholders Litig., 898 F. Supp. 974, 982 (E.D.N.Y. 1995); *In re* College Bound Consol. Litig., Nos. 93 Civ. 2348 & 94 Civ. 3033, 1995 WL 450486, at *8 (S.D.N.Y. July 31, 1995); Van De Velde v. Coopers & Lybrand, 899 F. Supp. 731, 738 (D. Mass. 1995); Upton v. McKerrow, 887 F. Supp. 1573, 1580 (N.D. Ga. 1995); *In re* Medimmune, Inc. Sec. Litig., 873 F. Supp. 953, 964 n.8 (D. Md. 1995); Otto v. Variable Annuity Life Ins. Co., No. 82 Civ. 4762, 1995 WL 121519, at *1 (N.D. Ill. Mar. 17, 1995); *In re* Syntex Corp. Sec. Litig., 855 F. Supp. 1086, 1098 (N.D. Cal. 1994), *aff'd*, 95 F.3d 922 (9th Cir. 1996)).

73. *Id.* at 842.

74. *Id.* at 843. In so reasoning, the court also expressed concern that permitting claims for conspiracy under § 10(b) "would go a long way toward subverting not only the reasoning of *Central Bank*, but the practical impact of that decision." *Id.* at 843 n.7. *See*

liability and conspiracy drawn by the district court. The district court had reasoned that conspiracy liability—unlike aiding and abetting—required intent. The Second Circuit, however, concluded that "[t]he statutory text, not the level of scienter, was the determinative issue in *Central Bank*, and it controls here as well."[75]

b. Scope of Primary Liability: Direct vs. Indirect After *Central Bank*

Another frequently litigated issue in the wake of *Central Bank* is the line between primary and secondary liability. Section 10(b) and Rule 10b–5 explicitly forbid any person from committing a fraudulent act "directly or indirectly."[76] The SEC's amicus brief in *Central Bank* argued in part that § 10(b)'s "directly or indirectly" language demonstrates that "Congress...intended to reach all persons who engage, even if only indirectly, in proscribed activities connected with securities transactions."[77] The Court did not disagree with this statement, but apparently found it irrelevant to the issue it was considering. According to the Court, the "basic flaw" with this argument is that "aiding and abetting liability extends beyond persons who engage, even indirectly, in a proscribed activity; aiding and abetting liability reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do."[78]

The Court's decision therefore rests in part on a distinction between indirect participation in a proscribed activity and merely aiding a proscribed activity. Not surprisingly, the lower courts have reached different conclusions on how to apply this subtle distinction to the variety of contexts in which secondary actors may be sought to be held liable for a securities fraud. Courts have found little guidance in their prior caselaw because before *Central Bank* courts had little, if any, practical reason to draw the distinction between primary and aiding-and-abetting liability under § 10(b).[79] Currently, only a few federal appellate courts have decided cases raising the issue of what constitutes primary liability under *Central Bank*. The decisions reach different conclusions on the issue.

In *Anixter v. Home-Stake Productions Co.*,[80] the plaintiffs sought to hold the defendant issuer's outside auditor liable as both a primary violator of § 10(b) and as an aider and abettor of the securities fraud. After reviewing the *Central Bank* decision

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also id. at 843.

75. *Id.* at 844.

76. 15 U.S.C. § 78j (Supp. 1996); 17 C.F.R. § 240.10b–5.

77. Brief for the Securities and Exchange Commission as Amicus Curiae in Support of Respondents at 8, Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994) (No. 92–854.

78. *Id.*

79. *See, e.g.*, LOSS & SELIGMAN, *supra* note 7, 11.D.4 (Supp. 1996) ("*Central Bank* should cause the lower courts to sharpen the often murky distinction between primary and derivative liability under § 10(b)"); Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1230 (10th Cir. 1996) ("Prior to *Central Bank* the distinction was academic. Now it is pivotal."); *id.* at 1224 n.8 ("Commentators have long recognized vagaries in the borders between primary and secondary liability.... *Central Bank of Denver* requires courts to delineate primary liability much more clearly.").

80. 77 F.3d 1215 (10th Cir. 1996).

and the elements of a primary and aiding-and-abetting claim, the court concluded that "the critical element separating primary from aiding-and-abetting violations is the existence of a representation, either by statement or omission, made by the defendant, that is relied upon by the plaintiff."[81] The court therefore concluded that to be primarily liable accountants "must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors."[82]

The defendant in *Anixter* was appealing from a jury verdict after a three-week trial in the late 1980s.[83] The plaintiffs had introduced evidence at trial that would support a finding that the auditor was liable for a primary violation, such as his certification of the issuer's financial statements, opinion letters on the issuer's balance sheet, and the reproduction of his certifications and opinion letters in certain of the issuer's prospectuses, annual reports, registration statements, and promotional materials.[84] The court noted that this evidence was sufficient to hold the auditor liable for a primary violation of § 10(b).[85] The court also noted, however, that the plaintiffs had introduced evidence—such as the auditor's assistance in preparing the issuer's prospectuses—that could be interpreted as an aiding-and-abetting violation under its reading of *Central Bank*.[86] Since the jury received both an aiding-and-abetting and primary violation instructions and only returned a general verdict, the court felt constrained by Tenth Circuit precedent to reverse the judgment and remand for a new trial.

In *In re Software Toolworks, Inc.*,[87] plaintiff investors in Toolworks appealed the trial court's grant of summary judgment in favor of Toolworks's auditors and underwriters. Among other claims, the plaintiffs sought to hold the auditors liable under § 10(b) and Rule 10b–5 for "participating in drafting" two allegedly misleading letters Toolworks sent to the SEC.[88] The plaintiffs' complaint, filed before *Central Bank* was decided, alleged that Toolworks's auditors were liable both as primary violators and as aiders-and-abettors of Toolworks's fraud.

The Ninth Circuit reversed the district court's grant of summary judgment to Toolworks's auditors. Although it recognized that the claim of aiding and abetting a §

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81. *Id.* at 1225.

82. *Id.* at 1226. Several district courts have taken similar approaches to *Anixter*. *See In re* MTC Electronic Technologies Shareholders Litigation, 898 F. Supp. 974, 987 (E.D.N.Y. 1995) ("If *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b)."); *In re* Kendall Square Research Corp. Sec. Litig., 868 F. Supp. 26, 28 n.2 (D. Mass. 1994) (dismissing secondary liability claim based "on the Supreme Court's emphatic conclusion in *Central Bank* that 'Section 10(b) prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act'") (quoting *Central Bank*, 511 U.S. 164, 177). *See also* Shapiro v. Cantor, 123 F.3d 717, 720 (2d Cir. 1997).

83. *Id.* at 1219, 1221. Incredibly, the plaintiffs' claimed losses were from investments made in 1969 and 1970, and the plaintiffs filed their first complaint in 1973.

84. *Id.* at 1227.

85. *Id.*

86. *Id.* at 1225–30.

87. 50 F.3d 615 (9th Cir. 1995).

88. *Id.* at 628.

10(b) violation was not viable after *Central Bank*, the Ninth Circuit decided there was sufficient evidence to support plaintiffs' primary liability theory. The court cited two pieces of evidence in support of its conclusion. First, the court noted that one of the letters to the SEC stated that it "was prepared after extensive review and discussions" with the auditors.[89] Second, the court mentioned evidence that the auditors "played a significant role in drafting and editing the other letter to the SEC."[90] Because there was sufficient evidence "to sustain a primary cause of action under section 10(b)...*Central Bank* does not absolve [the auditors] on these issues."[91]

The scope of primary liability promises to remain controversial. Recently, a panel of the Third Circuit issued a decision addressing this issue in the context of a law firm that had prepared, but did not sign, fraudulent disclosure documents for an issuer.[92] In *Klein v. Boyd*, the panel concluded that "lawyers and other secondary actors who significantly participate in the creation of the client's misrepresentations, to such a degree that they may fairly be deemed authors or co-authors of those misrepresentations, should be held accountable as primary violators under section 10(b) and Rule 10b–5...."[93] The panel's opinion therefore reversed the district court's grant of summary judgment for the law firm.

On March 9, 1998, the Third Circuit granted a petition for rehearing *en banc* in the case and vacated the panel's opinion. In April 1998, the SEC submitted an amicus brief presenting its views on the following issue presented by the case:

> Is a person who makes a material misrepresentation, while acting with the requisite scienter, but who does not himself disseminate the misrepresentation to investors, and whose name is not made known to them, only an aider and abettor of the fraud, or is that person a primary violator subject to liability?[94]

The Commission's brief takes the position that such a person is a primary violator. The law firm appellee in *Klein* argued that *Central Bank's* conclusion that a primary violator of § 10(b) must "'make[] a material misstatement (or omission)' means that a law firm or other secondary actor can be primarily liable only if it signs the document containing the misrepresentation or is otherwise identified to investors."[95] The Commission's brief explains why this statement is incorrect. Nothing in *Central Bank* indicated that when the Supreme Court used the word "makes," it meant to apply that term only to those who sign disclosure documents or are otherwise identified to investors. In fact, such an interpretation of *Central*

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89. *Id.* at 628 n.3 (quoting the letter).

90. *Id.*

91. *Id.* Several lower courts have taken similar approaches to *Software Toolworks*. *See, e.g.*, *In re* ZZZZ Best Sec. Lit., 864 F. Supp. 960, 970 (C.D. Cal. 1994) (accountants that were "intricately involved" in creating client's false documents liable as a primary violator).

92. Klein v. Boyd, 1998 WL 55245 (3d Cir. Feb. 12, 1998), *vacated on grant of rehearing en banc*, 1998 WL 55245 (Mar. 9, 1998).

93. *Id.*

94. *See* Brief of the Securities and Exchange Commission, Amicus Curiae, in Klein v. Boyd, Nos. 97–1143, 97–1261 (3d Cir. 1997), available at <http://www.sec.gov>.

95. *Id.* at 9–10 (quoting *Central Bank*, 511 U.S. at 191).

Bank would be inconsistent with § 10(b)'s language, which makes it unlawful "for any person, directly or indirectly...[t]o use or employ...any manipulative or deceptive device or contrivance." The law firm's proposed interpretation of *Central Bank* would also have the "unfortunate and unwarranted consequence of providing a safe harbor from liability for everyone except those identified with misrepresentations by name."[96]

For these reasons and others, the Commission's amicus curiae brief rejects the law firm's proposed restriction of *Central Bank* to only those instances in which a defendant signs a document or is otherwise identified to investors. Instead, the Commission's brief explains why, based on the language of § 10(b) and the Supreme Court's decision in *Central Bank*, the proper test is

> that a person who has the requisite scienter can be liable as a primary violator of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b–5 thereunder when he or she, acting alone or with others, creates a misrepresentation, whether or not the person is identified with the misrepresentation by name.[97]

As this article is written, the case of *Klein v. Boyd* has not yet been reheard *en banc*.

c. Impact of *Central Bank*

The ultimate impact of *Central Bank* will remain uncertain until the decision has been more definitively interpreted. Preliminary results have been mixed. Conspiracy claims have almost universally failed. Claims for other types of secondary liability, however, have received mixed reactions.[98] On the other hand, attempts to apply *Central Bank* to other areas of the securities laws—such as insider trading, § 10(b)'s "in connection with" requirement, and the scienter standard under § 10(b)—have failed.[99] More generally, any attempt to read *Central Bank* to create an overarching strict textualist canon for the interpretation of the securities laws was dealt a severe setback in the Supreme Court's decision last term in *United States v. O'Hagan*,[100] in which the Supreme Court relied extensively on the purposes of the securities laws in upholding the misappropriation theory of insider trading.

The decision's impact on the deterrence of securities fraud by the secondary actors most frequently sought to be held liable as aiders and abettors—lawyers, accountants, and underwriters—also remains to be seen. Recent press reports have noted several substantial verdicts and settlements against accounting firms in cases apparently brought in state court under state law for the accountants'

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96. *Id.*

97. *Id.* at 17.

98. Another important *Central Bank* issue currently working its way through the courts is whether common law agency theories of secondary liability—most notably respondeat superior—are still viable. So far, courts seem divided on this issue. *See* Walker & Levine, *supra* note 55, at 36–40.

99. *Id.* at 23.

100. 117 S. Ct. 2199 (1997).

participation in an issuer's fraudulent conduct.[101] Whether the threat of such liability remains a deterrent to secondary actors depends on issues of state law. Moreover, the proposed legislation preempting state securities fraud class actions discussed later in this article may affect the future viability of such cases. Finally, it must be remembered that § 10(b) does not provide the sole basis under the federal securities laws to impose liability on participants in securities frauds. Most notably, secondary actors may also be sought to be held liable under § 12 of the Securities Act or, in some instances, as a "control person" of an Exchange Act violator.

III. RECENT LEGISLATIVE DEVELOPMENTS

Although *Lampf* and *Central Bank* may prove to be the most significant recent judicial developments for securities class actions, developments in Congress in the last three years may exceed the combined impact of these two decisions. Acting out of concerns over reports of frivolous litigation similar to those hinted at in the Supreme Court's *Central Bank* decision, Congress has recently undertaken two significant efforts to reform the conduct of private securities fraud litigation. First, the 104th Congress passed the Private Securities Litigation Reform Act of 1995 ("Reform Act"), which added a number of substantive and procedural provisions designed to redress perceived abuses in private federal securities fraud litigation. More recently, the 105th Congress has also tackled litigation reform. As this article is written, the Senate has passed S. 1260, the Securities Litigation Uniform Standards Act, which would generally preempt state law securities fraud class actions involving nationally-traded securities. Two similar bills introduced in the House await congressional action.

The Reform Act and the state preemption bills are noteworthy not only for the substantive and procedural changes they could work in the law of securities regulation, but also for their breadth. Both are unlike earlier, narrower forms of preemption under the securities laws designed to preempt causes of action based on a specific type of conduct.[102] Instead, the Reform Act and the state preemption bills are, to a large extent, designed to address perceived problems common to an entire genre of litigation—securities fraud class actions. The results are somewhat atypical pieces of legislation. The Reform Act adds procedural hurdles to a substantive body of law; the state preemption bills would eliminate state causes of action, but only for one type of case (securities fraud "class actions" involving certain securities). The Reform Act, and the state preemption legislation if enacted, can be expected to generate litigation for years to come as the courts interpret and apply their provisions.

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101. *See* Daniel Wise, *DeLorean Verdict May Herald New Legal Theory*, N.Y. L.J., Mar. 9, 1998, at 1 (noting state court jury's $46.2 million verdict against an accounting firm in a case brought by the firm's client's bankruptcy trustee); Itzhak Sharav, *Accountant, Heal Thyself: For Auditors, Consulting Is a Professional Disease*, BARRON'S, Apr. 13, 1998, at 63 (noting accounting firm's settlement of state court class action arising out of failed investments in limited partnerships).

102. *See, e.g.*, Exchange Act § 28(e), 15 U.S.C. § 78bb(e) (Supp. 1996) (preempting federal and state lawsuits against investment advisers for certain soft dollar arrangements).

A. *The Private Securities Litigation Reform Act of 1995*

In the most ambitious overhaul of the private securities litigation system ever undertaken, the 104th Congress enacted the Private Securities Litigation Reform Act of 1995 ("Reform Act"). The Reform Act added a broad array of substantive and procedural provisions designed to prevent abuses of federal securities class action lawsuits. While a full discussion of the Reform Act is beyond the scope of this article, some of the Reform Act's principal features are: (1) heightened pleading standards for the state of mind requirement in private actions under the Exchange Act;[103] (2) heightened pleading standards for pleading facts relating to the state of mind requirement and allegedly misleading statements;[104] (3) a safe harbor for certain forward-looking statements;[105] (4) a discovery stay while a motion to dismiss is pending;[106] (5) a lead plaintiff provision and notice requirements;[107] (6) limitations on the imposition of joint and several liability;[108] (7) limitations on damages in fraud-on-the-market cases;[109] (8) elimination of securities fraud as a predicate act under RICO; (9) mandatory sanctions for violations of Rule 11;[110] and (10) substantive and procedural requirements for securities class action settlements.[111]

A number of these important changes to the law have already generated, litigation and can be expected to continue to generate, litigation over their meaning. This article discusses perhaps the most important issue under the Reform Act and the one that has been the most extensively litigated since the Act's passage—what pleading standards apply under the Reform Act.

B. *The Aftermath of the Reform Act: The Pleading Standards Issue in the Courts*

As of March 1998, the federal district courts have issued thirty-one written opinions interpreting the Reform Act's pleading standards. No court of appeals has yet issued an interpretation, although pleading standards issues are raised in three appeals pending in two Courts of Appeals.[112] Of the district court decisions, eighteen have held that the Reform Act adopted the Second Circuit's pleading standard under

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103. Exchange Act § 21D(b)(2), 15 U.S.C. § 78u-4(b)(2)(Supp. 1996).
104. Exchange Act § 21D(b)(1), 15 U.S.C. § 78u-4(b)(1) (Supp. 1996).
105. Exchange Act § 21E, 15 U.S.C. § 78u-5(c) (Supp. 1996).
106. Exchange Act § 21D(b)(3)(B), 15 U.S.C. § 78u-4(b)(3)(B) (Supp. 1996).
107. Exchange Act § 21D(a)(3), 15 U.S.C. § 78u-4(a)(3) (Supp. 1996).
108. Exchange Act § 21D(g)(2)(A), 15 U.S.C. § 78u-4(g)(2)(A) (Supp. 1996).
109. Exchange Act § 21D(e), 15 U.S.C. § 78u-4(e) (Supp. 1996).
110. Exchange Act § 21D(c)(1), 15 U.S.C. § 78u-4(c) (Supp. 1996).
111. Exchange Act § 21D(a)(5), (7), 15 U.S.C. § 78u-4(a)(5), (7) (Supp. 1996).
112. *See* Hoffman v. Comshare, Inc., No. 97–2098 (6th Cir.); Zeid v. Kimberley, No. 97–16070 (9th Cir.); *In re* Silicon Graphics Sec. Litig., No. 97–16240 (9th Cir.). The Commission has filed amicus briefs in each of the three cases. The Ninth Circuit recently announced that oral argument in the *Silicon Graphics* case will be heard later this year. A third appeals court has stated in dicta and with little analysis that the Reform Act adopted the Second Circuit standard. *See* Williams v. WMX Tech., 112 F.3d 175, 177–78 (5th Cir. 1997).

which allegations of recklessness suffice to state a claim for securities fraud. Thirteen district court decisions have held that the Reform Act adopted a stricter pleading standard than the Second Circuit's. In addition, a few cases have commented on whether recklessness remains sufficient to meet the scienter standard for liability.

1. Legislative History[113]

Under the Reform Act, a plaintiff's complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[114] The Reform Act's pleading standard is based on the Second Circuit's, which requires "plaintiffs to allege facts that give rise to a strong inference of fraudulent intent."[115] In the Second Circuit, a plaintiff can meet this pleading standard: "(a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious behavior or recklessness."[116]

The Senate passed a version of the Reform Act that included an amendment offered on the floor by Senator Specter attempting to track the language of the Second Circuit's test. The Conference Committee, however, deleted this amendment. The Conference Committee's Statement of Managers explained: "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."[117] A footnote to this sentence further explained: "For this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness."[118]

The possible suggestion in the Statement of Managers that the Reform Act may have raised the pleading standard beyond the Second Circuit standard was one of the reasons offered by President Clinton for his veto of the Reform 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

113. For a more detailed review of the Act's legislative history, see U.S. SEC. AND EXCHANGE COMM., OFFICE OF THE GEN. COUNSEL, REPORT TO THE PRESIDENT AND THE CONGRESS ON THE FIRST YEAR OF PRACTICE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995, at 5–10, 27–30 (Apr. 1997).

114. Exchange Act § 21D(b)(2), 15 U.S.C. § 78u-4(b)(2) (Supp. 1996).

115. Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1128 (2d Cir. 1994).

116. *Id.* at 1128.

117. *Statement of Managers—The Private Securities Litigation Reform Act of 1995*, H.R. REP. NO. 104-369, at 41 (1995).

118. *Id.* at 41 n.23.

clear in the Statement of Managers their intent to raise the standard even beyond that level. I am not prepared to accept that.[119]

Following the President's veto, a number of legislators reaffirmed their earlier statements that the Reform Act codified the Second Circuit standard.[120] Several legislators made the point that any contrary language in the Statement of Managers "has no effect on the bill."[121]

In amicus briefs filed in several cases currently pending before the appeals courts, the Commission has explained its position on the meaning of the Reform Act's legislative history. In these briefs, the Commission explains that the Reform Act's legislative history, read as a whole, indicates that Congress intended to adopt the Second Circuit's pleading standards. As Senator Dodd explained on the Senate floor, the Conference Committee did not adopt the Specter amendment because it "did not really follow the guidance of the second circuit."[122] Moreover, the Specter amendment's codification of a specific test for pleading scienter would not be consistent with the Reform Act as a whole, which requires a different state of mind in one instance. Under the Reform Act's safe harbor provision, a plaintiff must prove that a forward-looking statement was made with actual knowledge that it was false or misleading.[123] A recklessness standard for pleading that would apply in all cases, such as that proposed in the Specter amendment, would be inconsistent with the safe harbor's requirement that the plaintiff prove actual knowledge.

2. Cases Following the Second Circuit Standard

The majority of the district courts that have decided the issue so far have adopted the Second Circuit standard. [124] These courts have generally found that

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119. 141 CONG. REC. H15214 (daily ed. Dec. 20, 1995).

120. *See, e.g.*, 141 CONG. REC. S19060–02, S19067 (Dec. 21, 1995) (remarks of Sen. Dodd) (the "pleading standard is faithful to the Second Circuit's test") (quoting from memorandum); *id.* at S19150 (remarks of Sen. Domenici) (Conference Committee language "is the Second Circuit's pleading standard"); *id.* at S19149 (remarks of Sen. Bradley) (the Conference Committee "does not substantially modify the language as passed by the Senate").

121. 141 CONG. REC. H15220 (Dec. 20, 1995) (remarks of Rep. Deutsch). *See also id.* at H15218 (remarks of Rep. Moran).

122. 141 CONG. REC. S19068 (1995).

123. *See* Exchange Act § 21E(c)(1)(B), 15 U.S.C. § 78u–5(c)(1)(B) (1995).

124. For a list of all cases on this issue, see City of Painesville v. First Montauk Financial, Corp., 178 F.R.D. 180, 194 (N.D. Ohio 1998); Epstein v. Itron, Inc., 993 F. Supp. 1314, 1324 (E.D. Wash. Jan. 22, 1998); *In re* Wellcare Mgmt. Group, Inc. Sec. Lit., 964 F. Supp. 632 (N.D.N.Y. 1997); Page v. Derrickson, No. 96–842–CIV–T–17C, 1997 U.S. Dist. LEXIS 3673 (M.D. Fla. Mar. 25, 1997); Weikel v. Tower Semiconductor Ltd., No. 96–3711, 1997 U.S. Dist. LEXIS 22229 (D. N.J. Oct. 2, 1997); Gilford Ptnrs. L.P. v. Sensormatic Elec. Corp., 1997 U.S. Dist. LEXIS 13724 (N.D. Ill. Sept. 10, 1997); Galaxy Inv. Fund, Ltd. v. Fenchurch Capital Management, Ltd., 1997 U.S. Dist. LEXIS 13207 (N.D. Ill. Aug. 29, 1997); Pilarczyk v. Morrison Knudsen Corp., 965 F. Supp. 311, (N.D.N.Y. 1997); OnBank & Trust Co. v. FDIC, 967 F. Supp. 81, 88 & n.4 (W.D.N.Y. 1997); Page v. Derrickson, 1997 WL 148558, at *9 (M.D. Fla. 1997); Fugman v. Aprogenex, Inc., 961 F. Supp. 1190, 1195 (N.D. Ill. 1997); Shahzad v. H.J. Meyers & Co., Inc., No. 95 Civ. 6196 (DAB), 1997 U.S. Dist. LEXIS 1128 (S.D.N.Y. Feb. 6, 1997); Rehm v. Eagle Fin. Co., 954 F. Supp. 1246, 1252 (N.D.

allegations of (1) circumstantial evidence of conscious misbehavior or recklessness, or (2) motive and opportunity to commit fraud, are sufficient to meet the Reform Act's heightened pleading standards.

For example, in *Marksman Partners, L.P. v. Chantal Pharmaceutical Corp*,[125] the defendants moved to dismiss the plaintiffs' complaint, arguing that the Reform Act had rejected the "motive and opportunity" prong of the Second Circuit's test and had eliminated recklessness as a basis of liability. The defendants based these arguments in large part on the Reform Act's legislative history and, specifically, the Statement of Managers' remark about not codifying Second Circuit caselaw. The *Marksman* court, however, rejected the defendants' arguments. In concluding that pleading "motive and opportunity" still sufficed, the court relied on the fact that the "strong inference" language of the Reform Act mirrors the Second Circuit test and that Congress failed to disavow this test in the text of the statute—as opposed to a footnote in the legislative history.[126] Likewise, in rejecting the defendant's argument that liability for reckless conduct had been eliminated by the Reform Act, the court noted that both the legislative history and the statutory text (which did not expressly eliminate liability for reckless conduct) indicate that "Congress did not intend to change the state of mind requirements of existing law."[127]

3. Cases Applying a Stricter Standard than the Second Circuit

A number of other district courts have decided that the Reform Act adopted a more stringent standard than the Second Circuit's test for pleading scienter. These cases can be roughly divided into two categories.

First, a few decisions have held that motive and opportunity do not necessarily suffice to create a strong inference of fraud for the purposes of the Reform Act.[128] These decisions stop short, however, of holding that recklessness no longer suffices as a pleading standard or basis of liability. For example, in *In re Baesa Securities Litigation*,[129] the court concluded that since the Reform Act did not specify what the "required state of mind" is, that standard must be found in existing caselaw. The court noted that all Circuits that have considered the issue have held that recklessness suffices and therefore concluded that it remains sufficient.[130] The court

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Ill. 1997); *In re* Health Management Inc., 970 F. Supp. 192, 201 (E.D.N.Y. 1997); STI Classic Fund v. Bollinger Indus., Inc., 1996 WL 885802 (N.D. Tex. Oct. 25, 1996); Zeid v. Kimberley, 930 F. Supp. 431 (N.D. Cal. 1996); Marksman Partners, L.P. v. Chantal Pharmaceutical Corp., 927 F. Supp. 1297, 1309 n.9 (C.D. Cal. 1996); Fischler v. AmSouth Bancorporation, No. 96-1567-CIV-T-17A, 1996 U.S. Dist. LEXIS 17670 (Nov. 14, 1996).

125. 927 F. Supp. 1297 (C.D. Cal. 1996).

126. *Id.* at 1310–11.

127. *Id.* at 1309 n.9.

128. *See* Baffa v. Donaldson, Lufkin & Jenrette Sec. Corp., 1998 WL 164918 (S.D.N.Y. 1998); Novak v. Kasaks, 997 F. Supp. 425 (S.D.N.Y. 1998); *In re* Baesa Sec. Litig., 969 F. Supp. 238 (S.D.N.Y. 1997); Press v. Quick & Reilly Group, Inc., No. 96 Civ. 4278 (RPP), 1997 U.S. Dist. LEXIS 11609, at *4 (S.D.N.Y. Aug. 8, 1997); Myles v. MidCom Comm., Inc., No. C96-614D (W.D. Wash. Nov. 19, 1996).

129. 969 F. Supp. 238.

130. *Id.* at 241.

went on to hold that the Reform Act's failure to incorporate the "motive and opportunity" language of the Second Circuit's test meant that, in contrast to prior Second Circuit law, allegations of motive and opportunity are no longer presumed sufficient to state a strong inference of fraudulent scienter.[131] The court recognized, however, that "in some cases" allegations of motive and opportunity by themselves remain sufficient.[132]

Second, a number of decisions have held that allegations of motive and opportunity and recklessness (at least as it has been traditionally understood) are no longer sufficient to meet the pleading standards of the Reform Act.[133] For example, in *Friedberg v. Discreet Logic Inc.*,[134] the defendants moved to dismiss the plaintiffs' complaint based on, among other things, the Reform Act's heightened pleading standard. The court concluded that "the PSLRA pleading standard was intended to be even stronger than the existing Second Circuit pleading standard."[135]

The *Friedberg* based its decision on two reasons. First, the court relied on the Statement of Managers' language about not codifying Second Circuit caselaw and therefore not including language relating to motive, opportunity or recklessness.[136] Second, the court noted the Conference Committee's decision not to adopt the Specter amendment to the Senate bill.[137] The court therefore rejected the motive, opportunity, and recklessness portions of the Second Circuit's pleading standard. Instead, the court adopted an approach requiring plaintiffs to plead "facts that constitute strong circumstantial evidence of conscious behavior by defendants."[138]

As noted above,[139] the Commission has filed amicus briefs in several of these cases that are now pending before the Courts of Appeals. In its amicus brief in the *Silicon Graphics* litigation, the Commission explains that the Reform Act's new pleading standard does not eliminate recklessness as a basis for pleading scienter in private actions. In short, the Commission's brief argues that it would make no sense to eliminate recklessness as a basis for pleading scienter if, as all courts of appeals that have considered the issue have held, recklessness suffices to establish liability. Further, neither the Reform Act nor its legislative history reflects any intention to

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131. *Id.* at 242.

132. *Id.*

133. *See, e.g.*, Chan v. Orthologic Corp., No. CIV–96–1514–PHX–RCB (D. Ariz. Feb. 5, 1998) (dicta); *In re* Silicon Graphics Sec. Litig., 970 F. Supp. 746 (N.D. Cal. 1997); *In re* Comshare, Inc. Sec. Litig., No. 96–73711–DT, 1997 U.S. Dist. LEXIS 17262 (E.D. Mich. Sept. 18, 1997); Voit v. Wonderware Corp., No. 96–CV. 7883, 1997 U.S. Dist. LEXIS 13856 (E.D. Pa. Sept. 8, 1997); Powers v. Eichen, No. 96–1431–B (AJB), 1997 U.S. Dist. LEXIS 11074 (S.D. Cal. Mar. 13, 1997); Norwood Venture Corp. v. Converse, Inc., 959 F. Supp. 205, 208 (S.D.N.Y. 1997); Friedberg v. Discreet Logic, Inc., 959 F. Supp. 42, 48–49 (D. Mass. 1997); *In re* Glenayre Tech., Inc., 1997 WL 691425 (S.D.N.Y. Nov. 5, 1997); Havenick v. Network Express, Inc., 1997 WL 626539 (E.D. Mich. Sep. 30, 1997).

134. 959 F. Supp. 42 (D.Mass. 1997).

135. *Id.* at 48.

136. *Id.*

137. *Id.* at 48–49.

138. *Id.* at 50.

139. *See supra* note 112.

eliminate recklessness as a basis of liability. The recklessness standard has long been recognized by the federal courts and is essential to investor protection.

C. Proposed Preemption of State Securities Fraud Class Actions

Scarcely had the ink dried on the Reform Act when new congressional proposals for litigation reform began to emerge. In November 1996—some eleven months after the Reform Act went into effect—proposals to preempt state securities fraud lawsuits began to emerge.[140] Early in the 105th Congress, bills were introduced in the House and Senate on this issue.

Three developments primarily contributed to the current movement to preempt state securities fraud class actions. First, and foremost, was Proposition 211, a plaintiff-friendly California ballot initiative that led to the most expensive initiative campaign ever in California. After the initiative was opposed by, among others, President Clinton and Chairman Arthur Levitt of the SEC, it was defeated by California voters by a substantial margin. Fear that similar initiatives may resurface in California or other states has often been cited as a reason for state preemption legislation.[141]

The second impetus for the preemption movement was the perception that securities fraud lawsuits were migrating to state court. Based on, at times, questionable statistical evidence, supporters of preemption spoke of dramatic increases in state court securities litigation.[142] The supposed increase in state court litigation was described as presenting two related problems. First, according to preemption supporters, plaintiffs were evading the pleading requirements of the Reform Act by bringing suit only in state court, where the Reform Act's heightened pleading standards do not apply. As Senator Dodd, co-sponsor of the Senate preemption bill, stated in prepared remarks at a Senate oversight hearing on securities litigation:

> I am deeply concerned over the increase in state filings.... My fear is that the state court filings represent those suits that aren't strong enough to stand up in Federal court. Securities class actions were

140. *See* Richard H. Walker et al., *The New Securities Class Action: Federal Obstacles, State Detours*, 39 ARIZ L. REV. 641, 684 & nn. 301–04 (1997) (discussing early sentiment in favor of state preemption).

141. *See* Letter from President Clinton to Senator Christopher Dodd at 1 (July 23, 1997) ("The possibility of changes in one or more states' securities laws similar to those proposed in California's Proposition 211 suggests that there may be a need to reconsider the appropriate balance of federal and state roles in securities law. As I said when I opposed Proposition 211 last August, the proliferation of multiple and inconsistent standards could undermine national law.").
<http://www.senate.gov/~banking/97_07hrg/072497/members/whthous.htm>.

142. *See Securities Litigation Act, Hearing on S.1260 Before the Subcomm. on Sec. of the Senate Committee on Banking, Hous. and Urb. Aff.*, at 4–5, 105th Cong. (Feb. 23, 1998) *available in* 1998 WL 96488 (F.D.C.H.) (testimony of John F. Olson, Gibson, Dunn, and Crutcher) ("[O]ne crucial goal of the PSLRA has not been achieved. The PSLRA was intended to stem the tide of frivolous nationwide class action lawsuits. Instead, it has had the undesirable effect of channeling more of that litigation into the state court system.").

> almost unheard of in State court prior to 1995. It is reasonable, then, to attribute the increase in both 96 and 97, to weaker and frequently abusive claims finding a more comfortable home in state court than in Federal courts.[143]

Second, preemption proponents contended that plaintiffs were filing parallel state and federal court lawsuits in order to circumvent the Reform Act's discovery stay. According to these proponents, plaintiffs were filing state court lawsuits only to enable them to continue to conduct discovery in parallel federal cases where the Reform Act's stay of discovery had already been imposed pending the federal court's ruling on a motion to dismiss.[144]

Finally, preemption supporters contended that issuers remained reluctant to make use of the Reform Act's safe harbor for forward-looking statements for fear of being held liable in state court where the safe harbor's protections are unavailable. As Senator Gramm, Chairman of the Senate Banking Committee's Subcommittee on Securities and a sponsor of one of the pending preemption bills, noted in an oversight hearing on securities litigation:

> I think it is clear now that what we did to try to make it easier for companies to share information with would-be investors was not successful. I think it is totally clear, when you look at [the annual, quarterly, and other] reports that companies are putting out [subsequent to the Reform Act], that while we were trying through our safe-harbor provision to make it possible for companies to communicate to would-be investors, that we clearly did not do enough or at least those who are concerned about litigation didn't believe we did enough.[145]

While not as frequently cited as a reason for state preemption, some have also maintained that preemption would prevent plaintiffs from choosing the state forum to evade the Reform Act's lead plaintiff and settlement scrutiny provisions.[146]

1. The Preemption Bills

To date, three bills preempting state securities fraud actions have been introduced in the 105th Congress. While they are similar, the bills contain

143. *Hearing on Sec. Litig. Abuses Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous. and Urb. Aff.*, at *11 (July 24, 1997) *available in* 1997 WL 419178 (F.D.C.H.) (testimony of Sen. Dodd) (F.D.C.H.).

144. *See, e.g., Hearing on S. 1260 Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous. and Urb. Aff.*, at *7–8 (Feb. 23, 1998) *available in* 1998 WL 965488 (F.D.C.H.) (prepared testimony of John F. Olson, of Gibson, Dunn and Crutcher).

145. *Hearing on Sec. Litig. Abuses Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous. and Urb. Aff.*, at *5 (July 24, 1997) *available in* 1997 WL 419178 (F.D.C.H.) (prepared testimony of Subcommittee Chairman Phil Gramm).

146. *See, e.g., Hearing on Sec. Litig. Abuses Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous. and Urb. Aff.*, at *47–48 (July 24, 1997) *available in* 1997 WL 419178 (F.D.C.H.). at (prepared testimony of Joseph A. Grundfest) [hereinafter Grundfest testimony].

important differences.

a. The "Securities Litigation Improvement Act of 1997" (H.R. 1653)

On May 16, 1997, Representative Tom Campbell introduced H.R. 1653, the "Securities Litigation Improvement Act of 1997."[147] The first preemption bill introduced, it has also attracted the least attention to date. The bill is noteworthy for its scope. It would preempt all private civil actions based upon the statutory or common law of any state alleging a material misrepresentation or omission or the use of a manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security. The bill's definition of "covered security" is drawn from the definition NSMIA added to § 18(b)(1) of the Securities Act. That definition essentially covers securities that are eligible for listing on a national exchange or the Nasdaq National Market System ("NMS") and securities of the same issuer that are equal or senior to such securities. H.R. 1653 has been referred to the Commerce Committee's Subcommittee on Finance and Hazardous Materials.

b. The "Securities Litigation Uniform Standards Act of 1997" (H.R. 1689)

Shortly after H.R. 1653's introduction, Representatives Anna Eshoo and Rick White introduced H.R. 1689, the "Securities Litigation Uniform Standards Act of 1997."[148] The Eshoo-White bill, introduced on May 21, 1997, is somewhat similar to Rep. Campbell's bill. Like H.R. 1653, the Eshoo-White bill preempts state court lawsuits based on the statutory or common law of any state in which the plaintiff alleges a material misrepresentation or omission or the use of a manipulative or deceptive device or contrivance in connection with the purchase of a covered security.[149] Such actions would be removable to the federal district court for the district in which the action is pending.[150] The bill, however, does have two important differences from the Campbell bill.

First, the bill's definition of "covered security" is broader than the definition of "covered security" in H.R. 1653. The Eshoo-White bill includes as covered securities any security of an issuer that at the time has any security that meets the definition of "covered security" in § 18(b)(1) of the Securities Act.[151] In other words, a junior security of an issuer whose shares trade on the New York Stock Exchange would qualify as a covered security under the Eshoo-White bill but not under the Campbell bill.

Second, and most importantly, the Eshoo-White bill only preempts "class actions" based on state securities fraud laws, rather than all private actions. "Class action" is defined in the bill to generally include lawsuits in which damages are

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147. Securities Litigation Improvement Act of 1997, H.R. 1653, 105th Cong. (1997).

148. Securities Litigation Uniform Standards Act of 1997, H.R. 1689, 105th Cong. (1997).

149. *Id.* § 2.

150. *Id.*

151. *Id.*

sought on behalf of more than twenty-five persons and suits in which one or more parties seek to recover damages on a representative basis on behalf of themselves and others similarly situated.[152] Thus, the Eshoo-White bill—in contrast to the Campbell bill—is not intended to preempt suits brought by individuals in state court. As discussed later in this article in connection with the Senate bill, however, "class action" in the Eshoo-White bill is given a broad definition encompassing much more than has traditionally been thought of as a class action.

As of early March 1998, the Eshoo-White bill had gained a remarkable 186 co-sponsors, including a majority of both the Republicans and Democrats on the House Commerce Committee. On May 29, 1997, the Eshoo-White bill was referred to the Commerce Committee's Subcommittee on Finance and Hazardous Materials. On May 19, 1998, the Finance and Hazardous Materials Subcommittee held a hearing on H.R. 1689.

c. The "Securities Litigation Uniform Standards Act" (S.1260)

The last bill introduced, S. 1260—the "Securities Litigation Uniform Standards Act"—has to date proved to be the uniform standards bill with the most momentum.[153] Following hearings in the Senate Banking Committee, S. 1260 was introduced by Senator Phil Gramm on October 7, 1997. The bill amends both the Securities Act and the Exchange Act to preempt state class actions based on the statutory or common law of any state in which the plaintiff alleges a material misrepresentation or omission or the use of a manipulative or deceptive device or contrivance in connection with the purchase of a covered security.[154]

The bill, as introduced, was similar to the Eshoo-White bill with one important difference—S. 1260 defines "covered security" somewhat more broadly than the Campbell bill and differently than the Eshoo-White bill. Specifically, S. 1260 incorporates the definition of "covered security" NSMIA added to § 18(b)(1) and (2) of the Securities Act.[155] By including § 18(b)(2) in addition to § 18(b)(1), S. 1260 covers shares of registered investment companies in addition to the securities covered in the Campbell bill.

As of early March 1998, S. 1260 had gained thirty co-sponsors and been referred to the Senate Subcommittee on Securities, which held hearings on the bill on October 29, 1997, and February 23, 1998. Recent legislative action on S. 1260 is discussed below.[156]

2. The SEC Position on the Preemption Bills

During the 105th Congress, the Commission was called to testify twice concerning the impact and implementation of the Reform Act generally, once

152. *Id.*

153. Securities Litigation Uniform Standards Act, S. 1260, 105th Cong. (1997).

154. *Id.* § 2. The bill does this through amendments to existing § 16 of the Securities Act and existing § 28 of the Exchange Act.

155. Securities Act § 18(b)(1), (2), 15 U.S.C. § 77r(b)(1), (2) (1988).

156. *See infra* text accompanyiny notes 167–70.

concerning S. 1260, and once concerning H.R. 1689. While some of the Commissioners expressed their support for uniform standards in principle, the Commission's testimony emphasized that uniformity is only desirable if the uniform standard is one that ensures adequate investor protection. Chairman Levitt, appearing before the Senate Subcommittee on Securities before S. 1260's introduction, concluded as follows:

> [V]arious proposals have been put forward that would broadly preempt private state anti-fraud actions. While we are sensitive to the concerns raised by the high technology community and others that frivolous litigation continues to burden capital formation, we counsel caution in responding to these concerns in order to avoid impairing the rights of investors. To this end, any proposals that restrict investors' rights to recover for injuries they have suffered should be narrowly tailored to address documented abuses.[157]

Some of the Commissioners expressed particular concern about preempting state lawsuits at a time when the pleading standard for scienter applied to securities fraud actions in federal courts is not certain.[158] The Commission's testimony also raised a concern that S. 1260, as originally drafted, could have preempted important state corporate law claims, most notably claims alleging breaches of the "fiduciary duty of disclosure" under Delaware law.[159] Finally, the Commission expressed concern that S. 1260's definition of "class action" was drafted too broadly, threatening to preempt actions that would not qualify as a class action under Federal Rule of Civil Procedure 23 and that do not present the types of concerns the legislation was meant to address.[160]

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157. *Hearing on Sec. Litig. Abuses Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous. and Urb. Aff.*, at *36 (July 24, 1997), *available in* 1997 WL 419178 (F.D.C.H.) (testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, concerning the Impact of the Private Securities Litigation Reform Act of 1995).

158. *See Securities Litigation Act, Hearing on S. 1260 Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs* (Oct. 29, 1997) *available in* 1997 WL 6878076 (F.D.C.H.) (testimony of Isaac C. Hunt, Jr., Commissioner, U.S. Securities and Exchange Commission,).

159. *See Securities Litigation Act, Hearing on S. 1260 Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs* (Oct. 29, 1997) *available in* 1997 WL 6878076 (F.D.C.H.) (testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, concerning the impact of the Private Securities Litigation Reform Act of 1995).

160. *See Securities Litigation Act, Hearing on S. 1260 Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs* (Oct. 29, 1997) *available in* 1997 WL 6878076, at *15 (F.D.C.H.) (testimony of Isaac C. Hunt, Jr., Commissioner, U.S. Securities and Exchange Commission). *See also* November 21, 1997 Letter from Commissioner Isaac C. Hunt, Jr. to Chief Clerk, Committee on Banking, Housing, and Urban Affairs, responding to question submitted by Senator Wayne Allard.

Commissioner Johnson has stated that there has been inadequate time to determine the effect of the Reform Act and, accordingly, that any preemption of state remedies or causes of action at this time is unwarranted. Given the possible adverse effect on investor confidence, as well as the long history of effective and concurrent federal and

On March 24, 1998, Senators Alfonse D'Amato, Phil Gramm and Christopher Dodd wrote to Chairman Levitt and the members of the Commission requesting the Commission's views on S. 1260.[161] The Senators' letter also made two significant points. First, the letter addressed the current judicial dispute over the interpretation of the Reform Act's pleading standards as follows:

> [W]e emphasize that our clear intent in 1995—and our understanding today—was that the PSLRA did not in any way alter the scienter standard in federal securities fraud suits. It was our intent, as we expressly stated during the legislative debate in 1995, particularly during the debate on overriding the President's veto, that the PSLRA adopt the *pleading* standard applied in the Second Circuit. Indeed, the express language of the statute itself carefully provides that plaintiffs must "state with particularity facts giving rise to a strong inference that the defendant acted *with the required state of mind*"; the law makes no attempt to define that state of mind. We intend to restate these facts about the '95 Act in both the legislative history and the floor debate that will accompany S. 1260, should it be favorably reported by the Banking Committee.[162]

The Senators' letter also agreed that certain amendments to S. 1260, designed to address the Commission's concerns about the bill's potential preemption of certain state law corporate governance claims and the overbreadth of the bill's definition of "class action," would be offered at the bill's mark-up.[163]

The Commission's letter in response noted its concern that any uniform standard for securities class actions permit recovery for losses attributable to reckless misconduct.[164] The Commission also explained that it was "gratified by the language in [the Senators' letter] and agreed to restate in S. 1260's legislative history, and in the expected debate on the Senate floor, that the Private Securities Litigation Reform Act of 1995 did not, and was not intended to, alter the well-recognized and critically important scienter standard."[165] The Commission's letter also noted the proposed amendments to be offered at the bill's mark-up addressing

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state securities regulation, and the strong federalism concerns raised by preemption, Commissioner Johnson believes that extreme caution should be exercised before state courthouse doors are closed to small investors through the preclusion of state class actions for securities fraud. *See Securities Litigation Act, Hearing on S. 1260 Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs*, at *23 n.35 (Oct. 29, 1997) *available in* 1997 WL 6878076 (F.D.C.H.) (statement of Commissioner Johnson).

161. *See* Mar. 24, 1998 Letter from Senators Alfonse M. D'Amato, Phil Gramm and Christopher J. Dodd to Chairman Levitt and Members of the Commission (on file with author).

162. *Id.*

163. *Id.*

164. *See* Mar. 24, 1998 Letter from Chairman Arthur Levitt, Commissioner Isaac C. Hunt, Jr. and Commissioner Laura S. Unger to Senators Alfonse M. D'Amato, Phil Gramm and Christopher J. Dodd. Commissioner Carey did not participate. Commissioner Johnson wrote a separate letter to reiterate his opinion that uniform standards legislation was premature (on file with author).

165. *Id.*

the Commission's concerns about preempting certain state corporate governance claims and defining "class action" in an overly broad manner. The Commission concluded that "[w]e support enactment of S. 1260 with these changes and with this important legislative history."[166]

3. Recent Legislative Developments

On March 25, 1998, the Chairman of the Senate Banking Committee, Senator D'Amato, announced that S. 1260 would move to mark-up in the Banking Committee on April 29, 1998, with amendments referred to in his March 24, 1998 correspondence.[167] On April 29, 1998, the Senate Banking Committee met in Executive Session to adopt a substitute amendment offered by Chairman D'Amato and Senators Dodd and Gramm and then conducted a legislative mark-up of S. 1260. The substitute amendment principally consisted of amendments to the bill's definition of "class action" and other changes designed to address concerns expressed by the SEC staff. Another amendment, containing findings explaining the purpose of the bill, was passed by a voice vote. The legislation was then ordered reported from the Committee by a 14–4 vote. Senators Shelby, Sarbanes, Bryan, and Johnson voted against the bill.

On May 4, 1998, the Senate Banking Committee submitted the Senate Report on S. 1260.[168] On May 13, 1998, S. 1260 was considered by the full Senate. Following debate on the Senate floor, S. 1260 passed the Senate by a vote of 79–21.[169] The Senate also voted to add an amendment offered by Senator Sarbanes that would permit securities fraud class actions brought by classes consisting solely of states, political subdivisions thereof, and state pension plans to continue to be brought in state court.[170]

4. Uniform Standards Legislation: The Aftermath?

While the fate of uniform standards legislation in the 105th Congress remains uncertain, the effects of such a bill, if passed, can already be predicted to a certain degree. The rest of this article discusses some of the issues that—whether intended or not—the adoption of uniform standards legislation may raise.

a. Circumvention of the Discovery Stay

Proponents of uniform standards legislation have argued that reform is needed to prevent circumvention of the Reform Act's discovery stay. Plaintiffs' lawyers, it is argued, have filed parallel state lawsuits to federal securities class

166. *Id.*

167. *See* Senate Banking Committee News Release, *Prepared Statement of Chairman Alfonse M. D'Amato, Hearing on the Renomination of Arthur Levitt as Chairman of the Securities and Exchange Commission*, (Mar. 25, 1998). <http://www.senate.gov/~banking/pressrel/0325lev.htm>.

168. *See* S. REP. NO. 105–182 (1998).

169. *See* 144 CONG. REC. S4778–03, S4815 (May 13, 1998).

170. *See id.* at S4811.

actions for the purpose of using these cases to circumvent the Reform Act's discovery stay provision. If and when the defendant secures a discovery stay under the Reform Act, the plaintiffs may then seek to continue to take discovery in the state court action for use in the federal case.

Uniform standards legislation may not be necessary to address this concern for several reasons. First, state courts that have considered the issue appear to have generally concluded that they have discretion to stay discovery in state court securities fraud class actions if they believe the suit was brought to circumvent the Reform Act's discovery stay.[171] The proponents of uniform standards legislation have offered few reasons to believe state courts are not adequately equipped to make such determinations. To the contrary, some state courts have adopted innovative measures designed to prevent circumvention of the Reform Act's discovery stay while not hindering the legitimate use of discovery mechanisms by state court litigants.

For instance, in *Howard Gunty, Inc. Profit Sharing Plan v. Quantum Corp.*,[172] a parallel action to a federal securities fraud class action, the Superior Court of California, County of Santa Clara, recently entered an order establishing what it referred to as a "temporary ethical wall." The court noted that it had discretion under California law to stay the action in its entirety due to the existence of the parallel federal action. Reasoning from this premise, the court concluded that "[i]n order to preserve defendants' rights under the PSLRA, and in accordance with principles of comity,"[173] it would order a temporary ethical wall precluding the state court plaintiffs and their attorneys from using or sharing any discovery from the state court case with the federal plaintiffs and attorneys until the Reform Act's discovery stay was lifted.[174]

Second, even if concern with discovery stay circumvention was sufficiently grave to warrant federal legislation, there may be significantly less intrusive means of accomplishing this legislative end than preempting state causes of action in their entirety. While the consequences of alternative approaches would have to be explored, it is not obvious why amendments to the Federal Rules of Civil Procedure or Federal Rules of Evidence could not largely address any problem with opportunistic misuse of state court discovery procedures.

Third, and finally, the effect uniform standards legislation, if passed, will have on this practice is also unclear. Plaintiffs' lawyers may continue to attempt to circumvent the Reform Act's discovery stay by filing parallel state court lawsuits

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171. *See, e.g.*, Boris Feldman, *The Securities Class Battlefield Circa 1998*, AMERICAN BAR ASSOC. CENT. FOR CONTINUING LEGAL EDUC. NAT. INST., June 4–5, 1998, at 2 ("[P]laintiffs have not had much success milking the state cases for discovery that they can then use to file a federal complaint.... Other courts have simply stayed discovery in the state case until the federal motions to dismiss were over.").

172. Howard Gunty, Inc. Profit Sharing Plan v. Quantum Corp., No. CV760370 (Super. Ct. Cal. Oct. 30, 1997), <http://securities.stanford.edu/decisions/quantum/cv760370/971030.html>.

173. *Id.*

174. *Id.*

that do not qualify as "class actions" or meet other requirements of the uniform standards bills.

b. Use of the Reform Act's Safe Harbor

Proponents of uniform standards legislation have also argued that the threat of state court litigation inhibits issuers' use of the Reform Act's safe harbor for forward-looking statements. Anecdotal evidence compiled by the SEC staff in connection with the Report to the President and the Congress on the First Year of Practice under the Private Securities Litigation Reform Act, however, indicated that issuers were not making use of the safe harbor for a number of additional reasons, including the lack of court decisions interpreting the safe harbor, concern that including a list of cautionary statements would be cumbersome, and fear of Commission enforcement action.[175]

Whether passage of uniform standards legislation would substantially increase use of the safe harbor is uncertain. Whether it does lead issuers to make more forward-looking statements depends on whether the types of actions the safe harbor would not apply to—most notably, SEC enforcement actions and non-"class actions" in state courts, including those by institutional investors—will continue to deter use of the safe harbor. In addition, other reasons offered by issuers for not using the safe harbor—most notably issuers' concern about the lack of judicial construction of the safe harbor—may continue to detract from the number of issuers making forward-looking statements.

c. Effect on State Corporate Law

Generally, proponents of uniform standards legislation have acknowledged that the legislation is not intended to preempt state corporate law.[176] While S. 1260 was apparently not drafted to achieve this purpose, the Commission's testimony on the bill raised a concern that some state corporate law causes of action, especially claims made pursuant to the fiduciary duty of disclosure recognized under Delaware law, may have been preempted by the bill as drafted.[177] More generally, the Commission's concern over the breadth of the bill's definition of "class action" was prompted in part by its fear that that definition,

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175. *See* 144 CONG. REC. S4778–03, S4815 (May 13, 1998), at 25–26 & n.79.

176. *Securities Litigation Act, Hearing on S. 1260 Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urb. Aff.*, at *12-14, Feb. 23, 1998, *available in* 1998 WL 96488 (F.D.C.H.) (prepared testimony of John F. Olson, of Gibson, Dunn and Crutcher).

177. *See id.* at 31. The fiduciary duty of disclosure generally imposes on directors and majority stockholders the duty to disclose fully and fairly all material facts within their control when seeking stockholder action in connection with a tender offer, a vote of stockholders or action by written consent. *See generally* Lawrence A. Hamermesh, *Calling Off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087 (1996). When the stockholder action involves the purchase or sale of a security (e.g., corporate buy-back programs and tender offers), S. 1260 as originally drafted could have had the effect of eliminating state causes of action arising out of such transactions.

interpreted literally, could be read to include certain shareholder derivative actions.[178]

The original co-sponsors of S. 1260 and the Chairman of the Senate Banking Committee offered a substitute amendment to S. 1260 to address both these concerns. The substitute amendment added a new sub-section to the bill intended to preserve most claims alleging a breach of the fiduciary duty of disclosure and revised S. 1260's definition of "class action" to ensure that the bill does not preempt cases brought as shareholder derivative actions. The substitute amendment was approved by the Senate Banking Committee on April 29, 1998.

Even with these amendments, uniform standards legislation, if passed, may affect the scope of the fiduciary duty of disclosure. For instance, the Delaware Supreme Court has declined to decide whether directors have a fiduciary duty of disclosure in the absence of a request for shareholder action.[179] Some plaintiffs, maintaining that such a duty exists, have based claims on allegations that directors breached their fiduciary duty of disclosure by filing financial statements with false, inflated figures.[180] Depending on the terms of any bill that may be passed, claims of this sort may no longer be viable after passage of uniform standards legislation.

VI. CONCLUSION

The securities fraud class action has undergone significant changes over a relatively short time period. Although some of the impact of the developments discussed in this article is already evident, their ultimate effect on the securities class action—both individually and in the aggregate—remains to be seen. As Congress continues to consider uniform standards legislation and as the courts continue to interpret and apply the Reform Act and the Supreme Court's decisions in *Lampf* and *Central Bank*, we urge proceeding with caution to make sure that the private securities class action remains "a most effective weapon in the enforcement of the securities laws."[181]

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178. S. 1260's original definition of "class action" included cases in which "one or more parties seeking to recover damages did not personally authorize the filing of the lawsuit." In shareholder derivative actions, the party seeking to recover damages—the corporation—typically has not "authorize[d] the filing of the lawsuit." In fact, in many states a shareholder is not permitted to bring a derivative action unless the shareholder first demands that the corporation bring suit and such demand is refused.

179. *See* Kahn v. Roberts, 679 A.2d 460 (Del. 1996).

180. *See, e.g.*, Malone v. Brincat, No. 15510, 1997 WL 697940. (Del. Ch. Oct. 31, 1997). The Vice Chancellor granted the director defendants' motion to dismiss the complaint, ruling that no fiduciary duty of disclosure exists absent a request for shareholder action. *Id.* at *5. The court reasoned that, if it were to find to the contrary, it would be "duplicat[ing]" federal remedies under the securities laws. *Id.* at *8. *See also id.* at *8 ("When a shareholder is damaged merely as a result of the release of inaccurate information into the marketplace, unconnected with any Delaware corporate governance issue, that shareholder must seek a remedy under federal law."). The decision in *Malone* has been appealed and is currently pending before the Delaware Supreme Court.

181. Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310 (1985) (internal quotations omitted).