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The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung

By John C. Coffee, Jr.*

INTRODUCTION

Much commentary about securities litigation shares the implicit premise that the Private Securities Litigation Reform Act of 1995 (Reform Act)\(^1\) is, for better or worse, a fait accompli—that is, legislation whose meaning is fixed and whose impact, while still debatable, is not contingent on future events. This Article sees it differently: the Reform Act is more like wet clay that has been shaped into an approximation of a human form by an apprentice craftsmen and has now been turned over to the master sculptor for the details that will spell the difference between high art and merely competent mediocrity. Legislation, like art, requires interpretation, and until that interpretive process is further along, the Reform Act must be regarded as still in its early formative period.

In short, the future of the Reform Act remains to be decided. Thus, while others may wish to evaluate the Reform Act in normative terms as either "good" or "bad" legislation—a necessary response to real problems or an overreaction to imaginary ones—the more important inquiry in this Article’s estimation is to survey the discretion that federal courts possess and the range of decisions that they shortly will be called upon to make with regard to the Reform Act. Congress has simply left too many ambiguous gaps and statutory hiatuses for the Reform Act’s impact to be reliably assessed at this point.

The process of judicial interpretation by which these gaps are filled in seems likely to be shaped by three principal considerations. First, although Congress has spoken, it put many of its most vehement and specific statements into the legislative history of the Reform Act.\(^2\) The Supreme Court

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has shown, however, that it will pay little attention to statements in legislative history that are not "anchored" to some provision in the statutory text. Thus, practitioners who are relying on the often emphatic statements in the legislative history may be omitting a critical step: is there a sufficient nexus between a statement in the legislative history and the statutory text to make the statement enforceable?

Second, the Securities and Exchange Commission (SEC or Commission) could have an even more decisive role than the courts in shaping the Reform Act. Under the Supreme Court’s decision in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, courts must defer to the administrative agency with regard to construction of a statute that the agency administers. Unless Congress has spoken to the precise question at issue, "the question for the court is whether the agency's answer is based on a permissible construction of the statute." To be sure, the Reform Act does not present the classic case for *Chevron* deference, because much in the Reform Act involves the processes of litigation, an area where the SEC has neither primary jurisdiction nor special expertise. Still, in some areas—most notably, the Reform Act's safe harbor for forward-looking information—the SEC could adopt definitional rules (e.g., defining what constitutes a "meaningful cautionary statement"). Although the SEC has shown little appetite for activism to date in this area (possibly out of a prudent desire to let matters rest until congressional tempers cool), SEC rulemaking eventually could have a decisive impact on the significance of the Reform Act (particularly if congressional majorities change and the SEC feels less vulnerable than it may feel today about its budget).

Third, adaptive responses by the parties to the new legislation are predictable and will seek to exploit these statutory ambiguities. A period of intense gamesmanship and experimentation seems likely, as new litigation strategies are attempted (with predictably mixed results). In addition, new players, such as institutional investors willing to take on the responsibilities of the "lead plaintiff," may or may not materialize. At best, monitoring may improve because of institutional oversight; but, at worst, some plaintiffs' lawyers may simply exploit the lead plaintiff concept to impose a tax on the other participants.

The structure of this Article follows from this tripartite division. Part I examines those areas where courts will necessarily struggle with statements in the Reform Act's legislative history. This process has already begun, and the first results confirm this Article's predictions. Part II then considers the scope of the SEC's rulemaking authority with regard to the Reform Act, and Part III turns to the new litigation tactics with which both sides

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5. *Id.* at 844.
6. *Id.* at 843.
are likely to experiment. While it is not this Article's thesis that the Reform Act will have only marginal significance or that courts will seek to nullify its provisions, the extent of judicial discretion that the Reform Act currently affords courts is nonetheless extraordinary. Add to this picture the facts that the Reform Act primarily addresses litigation and that federal courts have long been conscious of the advantages of procedural uniformity, and a hypothesis suggests itself: courts are likely to resist efforts to develop a separate procedural jurisprudence uniquely applicable to securities class actions. If so, less may change than has been predicted.

**JUDICIAL INTERPRETATION: THE TENSIONS IN THE LEGISLATIVE HISTORY**

Simply stated, some of the boldest, broadest statements in the Reform Act’s legislative history have only a tenuous connection to its statutory text. Two examples stand out: the Reform Act’s new pleading standards and its safe harbor for forward-looking information. These were, of course, two of the most controversial provisions in the Reform Act, and the two whose unacceptability was primarily stressed by the President in his veto message. In each case, some of the strongest statements in the Reform Act’s legislative history arguably lack any anchor in the Reform Act’s statutory text.

**PLEADING STANDARDS**

The pre-passage debate over the Reform Act became the most heated when it turned to the Reform Act’s pleading standards. Some of the provisions, however, affect only modest change; others have an impact that is still largely unpredictable. New section 21D (entitled “Private Securities Litigation”) to the Securities Exchange Act of 1934 (1934 Act) provides examples that fall into both categories. Specifically, new section 21D(b)(1) requires the complaint in a securities fraud case to “specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.” In truth, the first clause in this provision does not go much (if at all) beyond the prevailing law in most federal circuits today, which normally requires plaintiffs to

8. Id. § 77z-2.
11. Id. § 78u-4(b)(1).
plead with specificity, except "when factual information is peculiarly within the defendant's knowledge or control." 12

In contrast, the second clause in section 21D requiring the plaintiff to "state with particularity all facts on which that belief is formed" when pleading on information and belief is more of a wild card. Does this provision require the plaintiff to disclose confidential sources of information (for example, the identity of, and substance of communications from whistleblowers inside the corporate issuer)? Would it require that information normally protected as attorney work product be disclosed? Some have argued that it may. 13 Courts seem unlikely to go this far, but today, major question marks clearly overhang any pleading made on information and belief.

If the Reform Act's impact on the particularity of the pleadings is uncertain, its effect on pleading scienter is clearer and more drastic. When scienter must be alleged (as under Rule 10b-5), 14 new section 21D(b)(2) of the 1934 Act requires that the complaint "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 Although this provision will not apply to the negligence-based or strict liability provisions of the securities laws, 16 it will require that actions based on Rule 10b-5 plead facts giving rise to at least a strong inference of recklessness on the part of each defendant. On its face, this provision seems only to codify what the Second Circuit already required 17 (although it certainly rejected the Ninth Circuit's far more liberal pleading standard, which basically permitted conclusory pleadings of fraud). 18

But according to the Reform Act's legislative history, this provision may

12. Shapiro v. UJB Fin. Corp., 964 F.2d 272, 285 (3d Cir.), cert. denied, 506 U.S. 934 (1992) (quoting In re Craftmatic Sec. Litig., 890 F.2d 628, 645 (3d Cir. 1990)). Shapiro also required the complaint to set forth the facts on which a belief was formed when the pleading was based on information and belief. Id. at 284-85.


16. For example, it will not apply to §§ 11 or 12 of the Securities Act of 1933 (1933 Act), or § 16(b) of the 1934 Act. 15 U.S.C.A. § 77k (1994 & West Supp. 1996); id. §§ 77l, 78p(b).

17. See Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1128 (2d Cir. 1994) (holding particularized facts must raise "strong inference of fraud."). The Second Circuit's approach has been more or less adopted by at least three other circuits. See Tuchman v. DSC Comm. Corp., 14 F.3d 1061, 1068 (5th Cir. 1994); Greenstone v. Cambex Corp., 975 F.2d 22, 25 (1st Cir. 1992); DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir.), cert. denied, 498 U.S. 941 (1990).

impose requirements that go well beyond those of the Second Circuit.\textsuperscript{19} In the Second Circuit, the requirement that the plaintiff plead facts raising a "strong inference of fraud" is tempered by a mitigating rule that recognizes that the plaintiff can satisfy this requirement by "alleg[ing] facts showing a motive for committing fraud and a clear opportunity for doing so."\textsuperscript{20} Other courts outside the Second Circuit seem also to have sometimes followed this rule.\textsuperscript{21}

To fully reflect the Second Circuit's standard, Senator Arlen Specter added an amendment on the Senate floor to S. 240, which instructed courts that a strong inference of fraud could be established by particularized pleadings of motive, opportunity, or recklessness.\textsuperscript{22} This provision was, however, deleted from the final Conference Report. Alone, this deletion might have had relatively little significance because the statutory language quoted above could easily have been read as simply a shorthand instruction to apply the Second Circuit's well-known standard. At most, different circuits might have taken slightly different approaches to when a showing of motive and opportunity raised a strong inference of fraud.

But the deletion did not stand alone. Rather, the Statement of Managers, which constitutes the legislative history to the Conference Report, states that Congress desired a stricter rule than the Second Circuit's standard:

Regarded as the most stringent pleading standard, the Second Circuit requirement is that the plaintiff state facts with particularity, and that these facts, in turn, must give rise to a 'strong inference' of the defendant's fraudulent intent. 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.\textsuperscript{23}

A footnote to this paragraph then explains the deletion of the Specter Amendment: "For this reason, the Conference Report chose not to include

\textsuperscript{19} See House Report, \textit{supra} note 2, at 31-49.

\textsuperscript{20} San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris Co., Inc., 75 F.3d 801, 813 (2d Cir. 1996); see also Shields, 25 F.3d at 1128.

\textsuperscript{21} In particular, the First, Fifth and Seventh Circuits appear to follow some variant of the Second Circuit's rule. See Tuchman, 14 F.3d at 1068; Greenstone, 975 F.2d at 25; DiLeo, 901 F.2d at 629; Fujisawa Pharmaceutical Co., Ltd. v. Kapcor, 814 F. Supp. 720, 728 (N.D. Ill. 1993).

\textsuperscript{22} 141 CONG. REC. S17,959-61 (daily ed. Dec. 5, 1995) (statement of Senator Specter). The Specter Amendment provided that a "strong inference" could be raised by "alleging facts to show the defendant had both motive and opportunity to commit fraud, or by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness by the defendant." The full text of the Specter Amendment, which was passed by the full Senate by a vote of 57 to 42 on June 28, 1995, is set forth in 2 Sweeping Reform, \textit{supra} note 13, at 795-98.

\textsuperscript{23} House Report, \textit{supra} note 2, at 41.
in the pleading standard certain language relating to motive, opportunity, or recklessness.\(^2\)

But if this provision does not codify the Second Circuit’s standard, what standard does it codify? How much stricter is it? Here, the above-quoted language has its own ambiguity. Although it implies that the statutory standard is to be stricter than the Second Circuit’s standard, it gives no indication of how much stricter. Even the above-quoted footnote says only that “certain language” relating to motive and opportunity was deleted,\(^2\) not that a showing of motive and opportunity in a given case is insufficient to show scienter.

Indeed, the more closely that one examines the legislative history on this point, the murkier the issue gets. On December 5, 1995, Senator D’Amato submitted the report of the Conference Committee to the full Senate, reviewed the proposed legislation topic by topic, and said only the following about its new stricter pleading standards: “The legislation creates a uniform standard for complaints that allege securities fraud. This standard is already the law in New York. It requires a plaintiff plead facts giving rise to a strong inference of the defendant’s fraudulent intent.”\(^2\) In short, rather than reversing or tightening the Second Circuit’s standard, the legislation was presented as essentially codifying it.

A colloquy then followed between Senators Dodd and Specter, with the latter objecting that the Conference Report, by deleting the motive and opportunity language in the Specter Amendment, “omits a very critical factor in giving guidance as to how a plaintiff meets this tough standard for pleading state of mind.”\(^2\) Although Senator Specter objected that “the plain truth of the matter is that this is an impossible pleading standard... you simply do not have a way that a plaintiff realistically can go into the Federal court under the securities acts and have a fair chance to state a case,”\(^2\) Senator Dodd responded that the language endorsed the Second Circuit’s standard, but simply permitted individual courts some discretion on a case by case basis: “We are using the standards in the [S]econd [C]ircuit in that regard, then letting the courts—as these matters will—test. They can then refer to specific cases, the [S]econd [C]ircuit, otherwise, to determine if these standards are based on facts and circumstances in a particular case.”\(^2\) To be sure, Senator Dodd’s reply is less than crystal clear, but he appears to be saying that courts could find well-pleaded particularized allegations of motive and opportunity to be sufficient in some cases, but not necessarily in all cases. At no point, either in the Senate debates on December 5th and 6th or in the debate in both Houses follow-

\(^{24}\) Id. at 48 n.23.
\(^{25}\) Id.
\(^{26}\) 141 CONG. REC. S 17,934 (daily ed. Dec. 5, 1995).
\(^{27}\) Id. at S17,960.
\(^{28}\) Id.
\(^{29}\) Id.
ing the presidential veto, did any Senator or Representative argue that the Reform Act should be read to disable the plaintiff from pleading facts showing motive and opportunity as a means of pleading scienter.

Whatever the Senators’ intent, it is an entirely different question whether courts will give effect to statements in legislative history that seem to impose an additional or different requirement beyond that in the statutory language. Novel as this issue may seem to the securities lawyer, it has often been faced by the Supreme Court, which has divided over it with some regularity. Although Justice Scalia has become well-known for his view that legislative history is a “make-weight” and a “fairyland,” the majority of the Court continues to accord legislative history considerable weight in most circumstances.

Nonetheless, there is at least one clear limitation on the majority’s willingness to consider legislative history: any such statement must be “anchored” to the text of the statute. Most recently, in Shannon v. United States, the Court confronted a statute whose conference report specifically “endorsed” a procedure used in one circuit by which the jury was given specific instructions in connection with the insanity defense. As clear and specific as this statement was, the Court still gave no weight to this congressional “endorsement” and instead adopted a very different procedure, stating “[w]e are not aware of any case . . . in which we have given authoritative weight to a single passage of legislative history that is in no way anchored in the text of the statute.”

Quoting a D.C. Circuit decision, the Court added that “courts have no authority to enforce [a] principle gleaned solely from legislative history that has no statutory reference point.”

While Shannon rejected an “endorsement” in legislative history of one circuit’s approach, the legislative history of the Reform Act’s new pleading standard arguably presents the mirror-image situation: the rejection (or non-endorsement) in legislative history of the Second Circuit’s interpretation of its own pleading rule. From Shannon’s perspective then, courts should simply focus on the statutory text and ignore the surplusage in the legislative history.

Still, however equivocal the legislative history is, it can be argued that the President’s veto message resolved any ambiguity and unmistakably


31. Bank One Chicago, 116 S. Ct. at 642. See, in particular, the concurring opinion of Justice Stevens. Id. at 643-45 (Stevens, J., concurring).


33. Id. at 2426.

34. Id.

framed the issue. The President's veto message clearly emphasized that the President found any standard stricter than the Second Circuit's pre-existing standard to be unacceptable.\(^{36}\) Accordingly, proponents of a stricter standard might argue that in overriding the President's veto, Congress was unequivocally adopting a stricter standard. The problem with this line of argument is two-fold. First, this is simply not what Congress said it was doing. For example, rejecting the President's criticisms of the Reform Act's pleading standards, Senator Bradley answered the President on the Senate floor just before the veto was overridden:


But even within the [S]econd [C]ircuit, there are varying interpretations of the standard. That is why the conference report deliberately rejects a complete codification of the [S]econd [C]ircuit and adopts language which is substantially similar to the language in the Senate-passed bill and its report language.\(^{37}\)

Senator Domenici followed Senator Bradley and made basically the same point that the Act adopted the "Second Circuit's pleading standard."\(^{38}\)

Second, the President's characterization of the Reform Act cannot determine what Congress itself intended. In summary, that intent seems only to have been to give federal courts discretion to determine how they would apply the core provisions of the Second Circuit approach.

Operationally then, how are the new pleading standards likely to play out? The most likely answer is about the same as they worked in the recent past in the Second Circuit. Thus, if plaintiffs can show that senior executives sold a significant stake in their corporation while the corporation itself withheld any reference to pending adverse developments, this normally should be sufficient to show motive and opportunity—and hence raise a "strong inference" of scienter against the individual defendants.\(^{39}\) As to the non-trading defendants, however, the action is likely to be dismissed. As a result, the classic "stock drop" case may survive only when there has been suspicious trading activity by insiders (or their tippees) or some similar form of self-dealing. Even before the Reform Act, there were distinct signs that courts were moving in this direction and declining to

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37. Id. at S19,149 (daily ed. Dec. 22, 1995).
38. Id. at S19,150.
39. See, e.g., San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris Co., Inc., 75 F.3d 801, 814 (2d Cir. 1996) (affirming dismissal of the complaint against all senior executives of Philip Morris, except an executive who had sold substantial shares). For other cases in which suspicious trading by defendants has given rise to the requisite inference of fraud, see Rubinstein v. Collins, 20 F.3d 160, 169-70 (5th Cir. 1994); Greenstone v. Cambex Corp., 975 F.2d 22, 26 (1st Cir. 1992); Schneider v. Vennard (In re Apple Computer Sec. Litig.), 886 F.2d 1109, 1117 (9th Cir. 1989), cert. denied, 496 U.S. 943 (1990).
allow allegations of material misrepresentations or omissions to survive a
motion to dismiss, unless plaintiffs could plead reasons why the defendants’
self-interest lead them to withhold disclosure.\textsuperscript{40}

This trend has accelerated with the first decisions under the Reform
Act. The first decision to consider the Reform Act’s heightened pleading
standards, \textit{Marksman Partners, L.P. v. Chantal Pharmaceutical Corp.}\textsuperscript{41} adopted
the Second Circuit’s “motive and opportunity” test for proof of scienter
in its entirety. Responding to the defendants’ claim that footnote 23 to the
Statement of Managers\textsuperscript{42} made clear that Congress had not codified the
Second Circuit’s test, the court displayed exactly the polite disdain for
legislative history as a source of substantive policy that this Article has
suggested is predictable:

The footnote, embedded as it is in the legislative history and not the
body of the statute, implies that Congress chose not to codify motive
and opportunity as pleading requirements but does not indicate that
Congress chose to specifically disapprove the motive and opportunity
test. \textit{This Court has little doubt that when Congress wishes to supplant a judi-
cially-created rule it knows how to do so explicitly, and in the body of the statute.}\textsuperscript{43}

On the merits, the court found the “motive and opportunity” test to be
consistent with the Reform Act’s purposes, relatively invulnerable to abuse,
and to represent a tested and proven pleading rule which courts outside
the Second Circuit should also adopt.\textsuperscript{44}

Applying the “motive and opportunity” test to the facts of the case
before it, the \textit{Chantal} court faced exactly the type of seemingly meritorious
“stock drop” case that many had believed would not survive the Reform
Act’s new pleading standards. Basically, the defendant corporation had
reported a very substantial rise in revenues by including in earnings sales

\textsuperscript{40} See Brogren v. Pohlad, 1995 U.S. Dist. LEXIS 19927, at *9 (D. Minn. Sept. 27, 1995);

\textsuperscript{41} 1996 U.S. Dist. LEXIS 7179 (C.D. Cal. May 21, 1996). One other case has also
addressed the Reform Act’s pleading standards and, without discussion, applied both prongs
of the Second Circuit’s standard. In Zeid v. Kimberley, 1996 WL 310124, Civ. No. 96-
20136 (N.D. Cal. June 6, 1996), the court dismissed the complaint (but with leave to replead)
after finding that it failed to “include ‘facts constituting circumstantial evidence of either
reckless or conscious behavior.’ \textit{Id.} at *7 (quoting ZVI Trading Corp. Employees’ Money
Purchase Pension Plan and Trust v. Ross (\textit{In re Time Warner Sec. Litig.}), 9 F.3d 259, 269
(2d Cir. 1993)). The principal factual difference between \textit{Zeid} and \textit{Chantal}, which each in-
volved the allegedly premature recognition of income on consignment sales, was that there
was no allegation of insider stock sales prior to disclosure of the adverse developments in
\textit{Zeid}.

\textsuperscript{42} See supra text accompanying note 24.

\textsuperscript{43} 1996 U.S. Dist. LEXIS 7179 at *36-*37 (emphasis added) (citation omitted).

\textsuperscript{44} \textit{Id.} at *34-*39. The court stressed that the Senate Banking Committee Report indi-
cated that the Committee did not wish to “adopt a new and untested pleading standard that
would generate additional litigation.” \textit{Id.} at *39 (citing S. REP. NO. 98, 104th Cong., 1st
that had been made on consignment to buyers who had a continuing right to return the product. These consignment sales had accounted for fifty percent of the firm's 1995 revenues, and ninety percent of its estimated revenues for the final quarter of 1995.\textsuperscript{45} When Barron's revealed the highly questionable accounting underlying recognition of the sales in earnings, the corporation's stock price fell sixty-two percent in two days.\textsuperscript{46} One month earlier, the corporation's founder and CEO had sold twenty percent of her holdings for $6.3 million at the height of the market.\textsuperscript{47} To show motive and opportunity, the plaintiffs raised four arguments: (i) the company's improper accounting enhanced the value of the company's stock; (ii) similarly, it enabled the company to complete a substantial private placement at an inflated price; (iii) it protected the executive position and compensation of the company's founder and CEO; and (iv) it enabled the CEO to sell a substantial portion of her own stock holdings at an inflated price.\textsuperscript{48} Interestingly, the district court appeared to reject the first three of these arguments, relying on Second Circuit precedents holding that "'allegations of motive that are generally held by similarly positioned executives and companies . . . are insufficient.'"\textsuperscript{49} But it found the fourth factor sufficient.\textsuperscript{50} Although Chantal does not imply that a twenty percent stock sale will always suffice to show motive and opportunity, it does make clear that unusual trading patterns and the receipt of substantial proceeds will constitute a sufficient showing to defeat a motion to dismiss.\textsuperscript{51}

As an alternative ground for its decision, the Chantal court also adopted the second prong of the Second Circuit's pleading rule,\textsuperscript{52} which permits the plaintiff to raise the requisite inference of fraud by pleading facts that show "strong circumstantial evidence of conscious misbehavior or recklessness."\textsuperscript{53} Here, it found that the clear violation of a GAAP accounting principal when coupled with other facts satisfied this standard.\textsuperscript{54} Conceiv-

\textsuperscript{45} Chantal's projected revenues for 1995 "represented nearly an 8000% increase in revenues from fiscal 1994." \textit{Id.}

\textsuperscript{46} \textit{Id.} at *10.

\textsuperscript{47} \textit{Id.} at *9.

\textsuperscript{48} \textit{Id.} at *40.


\textsuperscript{50} Chantal, 1996 U.S. Dist. LEXIS at *42.

\textsuperscript{51} \textit{Id.} at *42-*44; \textit{see also} Acito, 47 F.3d at *54 (2d Cir. 1995) (requiring that insider transactions be "unusual" and out of line with prior trading pattern to satisfy required standard).

\textsuperscript{52} \textit{Id.} at *45-*49.

\textsuperscript{53} \textit{Id.} at *46. The court noted that the strength of the complaint's allegations would have to be corresponding greater under this prong. \textit{Id.}

\textsuperscript{54} The court made clear that an accounting violation standing alone would not constitute strong circumstantial evidence of conscious misbehavior or recklessness. \textit{Id.} at *47 (citing
ably, this alternative holding could prove to have the greater significance because it frees the plaintiff from necessarily having to demonstrate conduct tantamount to insider trading by a defendant. In cases where there are not suspicious sales by insiders, it alone will be available. This alternative standard also answers a question that the Chantal court did not squarely face: why should the action continue against the corporate defendant because of the self-interested misconduct of an individual defendant? The implicit answer may be that when the corporation's own actions appear on their face reckless, the court need not worry about the fairness of holding the corporation vicariously liable for the insider's misdeeds.

**LEAVE TO REPLEAD**

The predictable independence of federal courts has also manifested itself in a refusal to dismiss with prejudice an action that fails to satisfy the Reform Act's pleading standards. Section 21D(b)(3)(A) of the Reform Act provides that "[i]n any private action arising under this [title], the court shall, on the motion of any defendant, dismiss the complaint if the requirements of" the Reform Act's pleading standards are not met.\(^5\) This sounds mandatory. Still, in Zeid v. Kimberley,\(^5\) the first court to constitute this language wrote:

"[T]here is nothing in this language to indicate that district courts are required to dismiss securities fraud claims without leave to amend. Further, without a clear directive from Congress, this Court refuses to read into the Reform Act any limitation on the ability of trial courts to permit an opportunity to amend."\(^5\)

At work here seems to be an unsurprising distaste for special procedural rules applicable to a limited context and inconsistent with the Federal Rules of Civil Procedure. But as a result, plaintiffs may get a second chance to replead, with the result that the harshness of the Reform Act's pleading requirements may be significantly mitigated.

**DISCOVERY**

Traditionally, stays of discovery have been disfavored, with the burden being on the defendants to justify them.\(^5\) The Reform Act, however, Dannenberg v. PaineWebber, Inc. (In re Software Toolworks, Inc. Sec. Litig.), 50 F.3d 615, 627 (9th Cir. 1994)). The determinative factor for the court may have been the corporation's own self interest in completing a substantial private placement without disclosure. For similar findings that violations of accounting rules can raise an inference of fraud, see Malone v. Microdyne Corp., 26 F.3d 471, 478-79 (4th Cir. 1994) and In re Chambers Development Sec. Litig., 848 F. Supp. 602, 620 (W.D. Pa. 1994).

contains several special stay provisions in order to limit what Congress perceived as fishing expeditions by plaintiffs.\textsuperscript{59} A particularly important such provision is set forth in both section 27A(f) of the 1933 Act and section 21E(f) of the 1934 Act, which each provide with regard to forward-looking statements:

\begin{quote}
In any private action arising under this subchapter, the court shall stay discovery (other than discovery that is specifically directed to the applicability of the exemption provided for in this section) during the pendency of any motion by a defendant for summary judgment that is based on the [safe harbor contained in these sections].\textsuperscript{60}
\end{quote}

Uniquely, this stay provision is not subject to the "undue prejudice" exception that is tacked onto the Reform Act's other stay provisions.

On its face, this provision's intent seems clear enough: plaintiffs cannot get general discovery, but can obtain discovery "specifically directed to the applicability of" the safe harbor. Again, however, the Statement of Managers may conflict with the statutory language by instructing courts to limit discovery: "The first prong of the safe harbor requires courts to examine only the cautionary statement accompanying the forward-looking statement. \textit{Courts should not examine the state of mind of the person making the statement.}"	extsuperscript{61} Simply stated, the issue again is whether this ban on "state of mind" discovery is sufficiently anchored to the statutory text.

From the plaintiffs' perspective, one can argue that this instruction is in considerable tension with the statutory text, because it would effectively preclude discovery "specifically directed to the applicability of the exemption."\textsuperscript{62} From the defendants' perspective, however, the legislative history merely explains that the first prong of the safe harbor expresses an entirely objective test, which makes inquiry into the defendants' subjective state of mind superfluous. That is, under subsection (c)(1)(A)(i) of the safe harbor provisions in both the 1933 Act and the 1934 Act, a "forward-looking statement" cannot create private civil liability if it is "identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."\textsuperscript{63} To the extent that this first prong of the safe harbor looks only to the objective meaning of the cautionary statements provided, discovery directed to the

\textsuperscript{59} Section 101 of the Act adds § 27(b) to the 1933 Act and § 21D(b)(3) to the 1934 Act, which each stay discovery during the pendency of a motion to dismiss. 15 U.S.C.A. § 77z-1 (West Supp. 1996); id. § 78u-4. Both these stays are subject to an "undue prejudice" limitation.

\textsuperscript{60} Id. § 77z-(l); id. § 78u-5(f) (emphasis added).

\textsuperscript{61} HOUSE REPORT, supra note 2, at 44 (emphasis added). For the conflicting statutory language, see § 15 U.S.C.A. § 77z-2(c)(1)(A) (West Supp. 1996); id. § 78u-5(c)(1)(A).

\textsuperscript{62} See supra text accompanying note 43.

good faith or state of mind of its draftsmen arguably would not be "specifically directed to the applicability of the exemption provided for in" subsection (c)(1)(A)(i).

Although there is certainly a logic to this position, the ambiguous character of the word "meaningful" clouds that logic. In the context in which it is used, the phrase, "meaningful cautionary statements," seems intended to draw a contrast between substantive disclosure and "boilerplate," "pro forma" risk disclosure, and thus it requires some individualized tailoring to the issuer's specific circumstances. Alone, this could justify limited discovery: was the forward-looking statement tailored to the company's individual circumstances as management appreciated those circumstances? Some may also believe that the term "meaningful" incorporates an element of good faith, and hence a statement written in bad faith becomes "non-meaningful." Indeed, cases applying the "bespeaks caution" doctrine (the intellectual parent of the Reform Act's safe harbor) have recognized that the doctrine does not "offer protection against a certain kind of statement: one that is misleading because it either fails to state a material fact or states a material fact falsely."

Consistent with this interpretation, the Statement of Managers recognized that, to satisfy this first prong, "[t]he cautionary statements must convey substantive information about factors that realistically could cause results to differ materially from those projected" and that the cited "important factors" must be "relevant to the projection." Arguably, this focus on "realism" and "relevance" could justify some discovery of the forward-looking statement's draftsmen, who were presumably required to make such judgments. In short, even if the first prong sets forth an objective standard, it does not necessarily follow that this forecloses all discovery, and some inquiry into the "meaningfulness" of the risk disclosures still seems authorized. If so, the text and the legislative history are again in conflict, because what the text gives, the legislative history attempts to take away.

To be sure, courts can easily sidestep this conflict when it is clear on the face of the cautionary statement that detailed disclosures, tailored to the facts of the issuer's individual circumstances, were provided. But in the grayer cases that will eventually emerge, courts could find that the term "meaningful" connotes a sense of sincerity and good faith or at least an individualized focus on the company's special position in the industry, which in either case may make some discovery of the draftsmen's state of mind justifiable.

The foregoing analysis may overrate the importance of the stay provi-

65. HOUSE REPORT, supra note 2, at 43 (emphasis added).
66. Id. at 43-44 (emphasis added).
sion in sections 27A and 21E, because this stay applies only to motions for summary judgment that are based on the Reform Act's safe harbor for forward-looking information. In contrast, when a motion to dismiss is made, other provisions in the Reform Act govern and provide that discovery is to be stayed during the pendency of the motion, subject to a special and limited exception for "undue prejudice." Defendants may therefore prefer to move to dismiss and avoid arguments about whether requested discovery is "specifically directed to the applicability" of the safe harbor. Obviously, this discrepancy raises a question as to when a motion to dismiss (in contrast to a motion for summary judgment) can be successfully used based on the Reform Act's safe harbor provisions.

Under the "bespeaks caution" doctrine, motions to dismiss increasingly have been successful. Under the Reform Act's expanded safe harbor, the availability of a motion to dismiss may initially depend upon which of the safe harbor's two prongs the defendant is seeking to utilize. Under the first prong, which purports to codify the "bespeaks caution" doctrine, the defendant seemingly need show only that "meaningful cautionary statements" were provided that satisfied the statutory standard. On its face, this seems an objective standard that might be determined off the face of the pleadings (or certainly defendants will so claim). The second prong instead focuses on whether "the plaintiff fails to prove that the forward-looking statement . . . was made with actual knowledge . . . that the statement was false or misleading." This seems to be a subjective standard, which almost certainly contemplates that the plaintiff should receive a chance to prove scienter and hence to obtain discovery. Hence, only a motion for summary judgment at the completion of discovery should logically be able to raise this second prong's defense. As a practical matter, this means that defendants will rely much more on the first (or "bespeaks caution") prong of the safe harbor than its second prong. Motions to dismiss based on the former predictably will be filed even before the defendant files its answer.

Still, it does not follow that a motion to dismiss always can be used to assert the first prong of the safe harbor. The legislative history to the safe harbor makes clear that the safe harbor does not apply to false statements of "historical fact" included within a forward-looking statement. Hence,

70. Id. § 77-2(c)(1)(B).
71. See HOUSE REPORT, supra note 2, at 44 ("A cautionary statement that misstates historical facts is not covered by the safe harbor.").
to the extent that misstatements (and possibly omissions) of material facts are alleged, plaintiffs may be able to avoid a motion to dismiss. Of course, this will not always be possible, but this tactic may in turn induce corporate counsel to avoid or minimize statements of "historical fact" in their "meaningful cautionary statements." Unfortunately, the net result implies information loss for investors.

**KNOWING LIES AND THE SAFE HARBOR**

Probably the most striking feature of the Reform Act's safe harbor is the immunity it seems to give to a bald, knowing lie that is surrounded by "meaningful cautionary statements." As the safe harbor is drafted, a person making a forward-looking statement need satisfy only one of the safe harbor's two alternative tests. The first of these tests covers forward-looking statements "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement," while the second test protects the statement if "the plaintiff fails to prove that the forward-looking statement . . . was made with actual knowledge . . . that the statement was false or misleading." Arguably, the second prong would add nothing and thus would be superfluous if the first prong did not protect a false statement that was accompanied by "meaningful cautionary statements."

As a matter of statutory interpretation, any reading of these two prongs that renders the second prong superfluous must be avoided. Still, to read the first (or bespeaks caution) prong as immunizing a deliberately false projection simply because some "important factors" that could prevent the projection from being fulfilled were also disclosed requires one to believe Congress saw some policy reason to protect knowing falsehoods. Not only does this interpretation sound unseemly, but there is also a semantic problem: can a cautionary statement truly be "meaningful" if it qualifies a lie? Put differently, one could easily read "meaningful" to require that the cautionary statements provide corrective disclosures that offset or at least significantly dilute the false statement. That is, statements that did not correct or minimize the lie are arguably not "meaningful." On this theory, if the cautionary language did not provide substantive risk disclosure that rendered the false statement either immaterial or made reliance upon it unreasonable, then arguably the cautionary statements would fail to satisfy the "meaningfulness" criterion.

Ultimately, to construe the "bespeaks caution" prong not to protect knowingly false forward-looking statements that are accompanied by cautionary statements, it is necessary to suggest an interpretation that assigns a non-redundant role to the second prong. Only then do the two prongs

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73. Id. § 77z-2(c)(1)(B); id. § 78u-5(c)(1)(B).
have a plausible relationship. One possible such interpretation is the following, which focuses on the level of scienter that the plaintiff must show:

(i) The “bespeaks caution” prong provides protection when the cautionary statement renders the false statement (whether made knowingly or recklessly) either objectively immaterial or incapable of being reasonably relied upon, but not otherwise; and

(ii) The second prong immunizes recklessly made false statements that fail the first prong because their cautionary statements did not satisfy the above “meaningfulness” criterion.

Under this construction, a knowingly false forward-looking statement would only be protected when it had been rendered immaterial or incapable of reasonable reliance, but a recklessly false forward-looking statement would always be protected by the second prong (even when not properly qualified by meaningful cautionary statements).

This proposed interpretation that a “meaningful cautionary statement” is one that sufficiently corrects or mitigates the false statement so as to render it either immaterial or “non-reliable” is consistent with the “bespeaks caution” doctrine, which the safe harbor was originally intended to codify.74 “Bespeaks caution” decisions have differed in terms of whether they have found a properly qualified forward-looking statement to be immaterial or incapable of reasonable reliance, but they have agreed that the doctrine did not protect false statements.75 Although it is likely that the Reform Act’s safe harbor was intended to go well beyond the “bespeaks caution” case law and relax the “specific tailoring” requirement imposed by the majority of the “bespeaks caution” cases,76 this does not imply that a knowingly false statement unaccompanied by a special qualification must escape liability.

Two serious problems must, however, be faced by this proposed interpretation that meaningful cautionary statements must render the knowingly false statement immaterial or incapable of reasonable reliance. First, there is a problem in the interrelationship between clauses (i) and (ii) of subsection (c)(1)(A) of the safe harbor.77 Subsection (c)(1)(A)(ii) provides that a forward-looking statement cannot result in private liability if it is “im-

74. House Report, supra note 2, at 43, notes that “[t]he Conference Committee safe harbor like the Senate safe harbor, is based on aspects of SEC Rule 175 and the judicial [sic] created ‘bespeaks caution’ doctrine.”

75. See supra note 55 and accompanying text.

76. For cases requiring that warnings be “tailored to the specific future projections, estimates, or opinions,” see Kaufman v. Trump’s Castle Funding (In re Donald J. Trump Casino Sec. Litig.), 7 F.3d 357, 371-72 (3d Cir. 1993), cert. denied, 114 S. Ct. 1219 (1994).

77. 15 U.S.C.A. § 77z-2(c)(1)(A)(i)-(ii) (West Supp. 1996). Clause (i) provides that a forward-looking statement cannot result in private liability if it is “identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward looking statement.” Id.
material." Thus, if subclause (i) of subsection (c)(1)(A) is read to require that the "meaningful cautionary statements" render the false statement immaterial, arguably subclause (ii) sounds superfluous. A closer look at the drafting history, however, explains this puzzle. The October 26, 1995 draft conference report shows that subsection (c)(1)(A)(ii) originally said "otherwise immaterial," implying in effect that a properly qualified forward-looking statement was also immaterial as a matter of law. In the November 9, 1995 draft and in the final conference report, the word "otherwise" was dropped, probably as a simplifying language change. Given this evolution of the language, subclause (i) appears to be saying that a forward-looking statement that is properly qualified by "meaningful cautionary statements" becomes immaterial, but, even if not so qualified, it can be immaterial for other and independent reasons under subclause (ii). Indeed, the Statement of Managers virtually spells this out.79

How much qualification is necessary to render a false statement immaterial? On this question, the legislative history sheds only oblique light. On the one hand, the Statement of Managers warns that "boilerplate warnings will not suffice as meaningful cautionary statements," but, on the other hand, it opines that "not all factors" that could cause actual results to deviate from predicted results need be disclosed. Both assertions deal only with the extreme ends of the continuum and nothing in the legislative history purports to define "meaningful."

The second and subtler problem for courts comes from another brief sentence in the Statement of Managers, which acknowledges that "[a] cautionary statement that misstates historical facts is not covered by the safe harbor." Appropriate as this distinction is between "historical" and "forward-looking" information, it might also be read as a negative pregnant, which implies that false forward-looking statements are protected by the safe harbor (while backward-looking "historical" statements are not). The best answer to this interpretation is to concede that false forward-looking statements are indeed sometimes protected, but only when the cautionary disclosure is "meaningful." Of course, this takes us back full circle to our initial question of what "meaningful" means.

78. See 2 Sweeping Reform, supra note 13, at 127.
79. House Report, supra note 2, at 44. Referring to subsection (c)(1)(A)(ii), the Statement of Managers states: "Courts may continue to find a forward-looking statement immaterial ... on other grounds." Id. (emphasis added). To clarify this point, the Conference Committee included language in the safe harbor provision that no liability attaches to forward-looking statements that are "immaterial." Id. This explanation that a forward-looking statement could be "immaterial ... on other grounds" implies that it is also immaterial under clause (i) when properly qualified by meaningful cautionary statements. Id.
80. Id. at 43.
81. Id. at 44.
82. Id.
OTHER SOURCES OF LIABILITY FOR FORWARD-LOOKING STATEMENTS

Assume for the sake of argument that courts do decide that the "be-speaks caution" prong of the safe harbor is satisfied so long as some "important factors" are disclosed and no material misstatement of "historical" fact is made. Unquestionably, this is a possible interpretation. If so, is there any remaining source of liability for a knowingly false projection?

Two possibilities need to be considered: (i) the duty, if any, to update prior disclosures, and (ii) the mandatory obligation to disclose certain forward-looking information in the Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A), which Regulation S-K requires the issuer to include in its periodic reports filed under the 1934 Act.83

The long-uncertain status of the duty to update is no less obscure under the Reform Act. Although the Reform Act is quick to announce that nothing in its safe harbors "shall impose upon any person a duty to update a forward-looking statement,"84 this statement borders on the tautological. Safe harbors do not by definition impose duties or create liabilities; rather, they are exceptions from rules that do. Had Congress wished to eliminate liability for the failure to update, it simply could have provided that there shall be no liability for a forward-looking statement that was accurate when made because circumstances changed after the date on which it was made. But Congress did not say this and seems to have been content to leave existing law intact. Those decisions that have suggested that there is a duty to update have basically limited this duty to forward-looking statements that were likely to continue to be relied upon by investors.85 As a result, many statements covered by the safe harbors could fall within this zone. As a practical matter, the potential for liability may be greatest when oral forward-looking statements incorporate by reference previously filed cautionary statements that have not been updated.

A more speculative basis for liability is that the failure to disclose certain types of forward-looking information may constitute a material omission.


84. 15 U.S.C.A. § 77z-2(d) (West Supp. 1996); id. § 78u-5(d).

under the mandatory provisions of the MD&A. Indeed, to the extent that the MD&A does require specific forward-looking disclosures, these disclosures could also be found to be materially misleading if they were accompanied only by a listing of a few "important factors." Specifically, Item 303 of Regulation S-K requires a reporting company to include in its MD&A a description of "any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." In substance, this would seem to amount to a mandatory obligation (at least when the trend or event is "known"), and, as the SEC's recent decision in In re Bank of Boston Corp. illustrates, an unjustified failure to make such a forecast can result in at least administrative liability. Reviewing the SEC's administrative decisions on the MD&A, one commentator has recently generalized that

[the common theme from these cases is that a projection, trend or prospective event must be discussed if either the issuer's management felt the matter important enough to tell a third party, whether the board of directors, prospective buyers or public investors, or third parties felt it important enough to tell or alert the issuer's management.]

Alone, this gloss on the MD&A could require updating (at least as of the time of Form 10-Q or 10-K filings) of a previously made forward-looking statement.

What complicates the MD&A disclosure obligation, however, is a special definition of materiality that the SEC applies only in this context. Essentially, if management is unable to determine that a known trend, demand, commitment, event or uncertainty "is not reasonably likely to occur," then it must objectively evaluate the consequences of that trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. In short, disclosure of a known trend, uncertainty or event is

87. 60 S.E.C. 2695 (Dec. 22, 1995).
88. Id. Bank of Boston failed to disclose "material facts and known trends and uncertainties [in its Form 10-Q] concerning the deterioration of its loan portfolio which [it] reasonably could expect would have a material unfavorable impact on its financial condition and results from operation." Id.


90. Interpretative Release, supra note 66.
required unless management can determine that a material effect on the registrant’s financial condition or results of operations is not reasonably likely to occur.

At first glance, this theory may seem to cast a substantial cloud over the Act’s safe harbor. Yet, because the MD&A’s standard of materiality is different from the probability/magnitude tradeoff that the Supreme Court endorsed in Basic Inc. v. Levinson, several courts have found that a violation of Item 303’s requirements “does not lead inevitably to the conclusion that such disclosure would be required under Rule 10b-5. Such a duty to disclose must be separately shown.” Indeed, one recent review of the cases finds no instance in which private liability has been imposed for a failure to make a disclosure mandated by Item 303.

Still, even if the theory is undeveloped, recent SEC administrative decisions may spur its growth, and there seems no inherent policy reason why a failure to disclose information mandated by Item 303 should not be actionable in a private action (assuming that the plaintiff proves materiality under Basic’s normal standard). The greater practical difficulty will probably be proving scienter, which cannot be assumed simply because material omissions were made. Still, other facts (such as recent stock sales) may sometimes show the requisite motive and opportunity sufficient to satisfy at least the Second Circuit’s test.

Corporate counsel may, of course, seek to treat the MD&A as falling within the Reform Act’s safe harbor by expressly identifying the MD&A as forward-looking statements and attaching “meaningful cautionary statements.” But Item 303 has its own mandatory requirements, which are not superseded by the Reform Act. For example, in one well-known enforcement action, the issuer failed to acknowledge in its MD&A that an austerity program initiated by the Brazilian government would result in a material decline in its revenues from a major subsidiary. Today, it is arguable that under the Reform Act’s safe harbor this same issuer might well escape private liability if it had forecast flat earnings (and thus no decline), at least provided that it had listed some “important factors” in its “meaningful forward-looking statements.”

95. See supra note 39 and accompanying text.
cautionary statements." What it cannot do, however, is ignore the known event (i.e., the austerity program) and make no disclosure about its known likely impact on its future revenues. Thus, even if its projection of flat earnings is permissible, its failure to disclose a known material trend or event that undercuts that projection is not.

As a result, a day-versus-night distinction arises between "known events or uncertainties," whose impact may well have to be disclosed in all material detail, and optional forward-looking statements, which need only be surrounded by "meaningful cautionary statements." Known trends or events may also be deemed to involve "historical facts," which the Statement of Managers recognizes cannot be misstated.97

AN ASSESSMENT

Although the Reform Act seeks to tilt the balance in securities litigation in favor of the defendant at virtually every juncture, one juncture that experienced litigators recognize as critical received relatively little attention: the permissible scope of a motion to dismiss under Rule 12(b)(6) of the Federal Rules of Civil Procedure.98 The utility of such a motion to defendants in securities litigation has expanded in recent years, and it is now clear that the court can look beyond the face of the complaint.99 Thus, if a plaintiff chooses to focus on one snippet of a prospectus or press release and ignore surrounding statements, courts can and do look at the entire disclosure when defendants seek to supplement the record for purposes of their Rule 12(b)(6) motion.100 Nonetheless, all well-pleaded facts alleged by the plaintiff must be taken as true for purposes of a motion to dismiss, and few courts will delve into fact-intensive allegations at the motion to dismiss stage.101

Ultimately, the protective capacity of the safe harbor may hinge significantly on whether a motion to dismiss can effectively assert it. If courts resist the use of motions to dismiss and defendants must rely on motions for summary judgment, discovery will be possible and costly, and plaintiffs will thereby gain leverage in settlement negotiations. The draftsmen of the Reform Act probably understood this and therefore provided that the safe harbor could be raised by either a motion to dismiss or motion for summary judgment.102 In addition, leaving nothing to chance, they authorized

97. HOUSE REPORT, supra note 2, at 44.
98. FED. R. CIV. P. 12(b)(6).
100. See San Lendro Emergency Medical Group, 75 F.3d at 808-09.
102. 15 U.S.C.A. § 77z-2 (West Supp. 1996); id. § 78u-5 (referring to a motion to dismiss); see also id. § 77z-2(0); id. § 78u-5(f) (authorizing a special stay "during the pendency of any motion by a defendant for summary judgment" based on the safe harbor).
the court in connection with a motion to dismiss to consider any "cautionary statement accompanying the forward-looking statement" (even if not cited in the plaintiffs' complaint).

The problem that the Reform Act does not address, however, arises when the plaintiff pleads with particularity that the forward-looking statement was not accompanied by "meaningful cautionary statements" and that the "important factors" it cites failed to provide adequate substantive information sufficient to satisfy the Reform Act's standards. Although this tactic will not work as a conclusory pleading, cautious courts, attuned to the usual distinctions between a motion to dismiss and a motion for summary judgment, may well feel compelled to side with the plaintiff and deny a motion to dismiss when the adequacy of the cautionary statements have been "meaningfully" attacked. Although the defendant may still eventually triumph at the summary judgment stage, its victory will be costly (and sometimes pyrrhic).

This leads to a final, more generalized observation: it is difficult to graft special procedural rules for securities litigation onto the ancient stem of federal civil procedure. Some grafts simply may not take, and resistance, conscious or unconscious, from courts is to be expected.

**ADMINISTRATIVE INTERPRETATION: TO WHAT EXTENT CAN THE SEC MODIFY THE REFORM ACT?**

*Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.* is the seminal decision of modern administrative law and is generally read to require judicial deference to the administrative agency's construction of the critical terms in its statute. Under *Chevron*, when a court faces an interpretation of a statute by an agency responsible for administering that statute, it must first determine if Congress has spoken directly to the issue. If it has not, then the court must defer to any "reasonable" agency interpretation of the statute.

Let us assume then that at some point in the future the SEC were to adopt rules purporting to interpret important terms in the Reform Act. Faced with such a legal challenge to such a rule raised by some litigant, a court would need to conduct a two-part inquiry: (i) had Congress spoken directly to the statutory question; and (ii) if not, was the SEC's interpretation "reasonable"? Clearly, such an analysis can yield different answers
to different specific questions, but a few obvious questions are discussed below.

**THE SAFE HARBOR: WHAT SCOPE FOR SEC RULEMAKING?**

Assume that a registrant disclosed three out of five "important factors" on which it knew that its projection of future earnings depended, but it deliberately withheld disclosure of the two most important factors, because its disclosure of these factors would tend to stigmatize and discredit senior management officials of the firm. Today, such incomplete disclosure may suffice to meet the Reform Act's standards, because the minimal disclosure provided did identify "important factors that could cause actual results to differ materially from those in the forward-looking statement." At least if some substantive significant information is conveyed (i.e., more than boilerplate), the Reform Act's modest standards may be satisfied.

But SEC rulemaking might change this picture. For example, consider the result on the same facts if the SEC were to adopt a rule defining "meaningful cautionary statements" to require the disclosure of the "most important factors then believed by management to be likely to cause actual results to differ materially from those in the forward-looking statement." Such a rule is not unlike language that the SEC informally suggested prior to the Reform Act's adoption (but which the Conference Committee declined to adopt). Although this language was not accepted, no negative inference is generally drawn from congressional inaction.

The initial issue for a reviewing court in a case challenging such a rule would be whether the Reform Act directly spoke to this issue. Clearly, the Reform Act's legislative history says that not all "important factors" need be disclosed. But, permitting the company to withhold some "important factors" is not inconsistent with defining "meaningful" to require disclosure of the "most important factors believed by management to be likely to cause actual results" to deviate from forecasted results. Seemingly, this is an example of the kind of tightening of the safe harbor that SEC rulemaking could affect without transgressing the outer constraints imposed by the statute or evident in its legislative history.

To be sure, even this example is not free from doubt. The Statement of Managers does seek to preclude inquiry into the "state of mind" of any person, and this could be read as a direct congressional statement addressing and precluding any SEC effort to identify the most important factors.

Still, if this hurdle can be passed, the next question is easier. Such an SEC rule seems reasonable in relation to the Reform Act's overall structure

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107. These suggestions were informally made, either as a form of technical assistance that the SEC normally provides to the Congress or through suggestions made by individual Commissioners. They are not, for the most part, reflected in the House or Senate hearings.

108. HOUSE REPORT, supra note 2, at 44.
and purpose. Here, the overall purpose of the 1934 Act remains the disclosure of material information to investors, and a requirement that an issuer not withhold the most important factors actually known to it seems fully consistent with (and reasonable in light of) those purposes.

THE NEW SEC EXEMPTIVE AUTHORITY

One of the most important unresolved questions under the Reform Act involves the scope of the Commission’s exemptive authority under the Reform Act. Subsection (g) to both sections 27A and 21E grants the Commission the following seemingly unlimited authority:

Exemption Authority—In addition to the exemptions provided for in this section, the Commission may, by rule or regulation, provide exemptions from or under any provision of this title, including with respect to liability that is based on a statement or that is based on projections or other forward-looking information, if and to the extent that any such exemption is consistent with the public interest and the protection of investors, as determined by the Commission.109

Read literally, this authority transcends the narrow topic of forward-looking statements, or even that of litigation reform generally, and could encompass far-ranging exemptions (e.g., exemptions from section 5 of the 1933 Act or new safe harbors under sections 11 and 12(2) thereof).110 Adding to this impression of a broad scope is the subsection of the Reform Act that follows—subsection (h) (entitled Effect on Other Authority of Commission) to both sections 27A and 21E—which states that the Commission may “adopt similar rules and regulations with respect to forward-looking statements under any other statute under which the Commission exercises rulemaking authority.”111 Because subsection (h) is expressly limited to forward-looking statements, while subsection (g) is not (and indeed subsection (g) lists rules with respect to liability for forward-looking statements as an illustrative example), the statutory structure of sections 27A and 21E suggest that a much broader grant of authority was intended under (g) than under (h) (otherwise subsections (g) and (h) would largely be duplicative).

The counterargument to this claim begins with the fact that subsection (a) of the same two statutory provisions suggests a narrower scope to the entire section, one limited to the context of forward-looking statements: “(a) Applicability—This section shall apply only to a forward looking statement made by. . ."112 Proponents of this narrower view read this language to mean that both sections 27A and 21E concern only the topic of forward-

112. Id. §§ 77z-2(a), 78u-5(a).
looking statements. Although this narrower interpretation is currently the "politically correct" one within the staff of the Commission, it faces an obvious problem. The minimum intent of subsections (g) and (h) seems to be to authorize safe harbors beyond the scope of subsection (a) (such as, for example, forward-looking statements made by a nonreporting company). If then (g) and (h) must go beyond the scope of subsection (a) to have any real meaning, it seems contradictory to read them as constrained by (a).

Whatever the SEC decides on this issue, it seems likely that courts will defer to the SEC's decision, both under the *Chevron* line of cases and because the Statement of Managers is relatively silent on this point.\(^\text{113}\) Important as this issue is, it may be mooted by the impending passage of the Fields Bill, which contains an even broader and clearer grant of exemptive authority for the SEC.\(^\text{114}\)

**ADAPTIVE RESPONSES: HOW WILL THE TACTICS CHANGE?**

The Reform Act is likely to affect significantly the litigation tactics of both sides. In particular, plaintiffs' lawyers will need to consider a variety of options that they have previously resisted, including the following:

**A MIGRATION TO STATE COURTS?**

In some jurisdictions, there are strong incentives for plaintiffs to sue in state court, either under state law theories or based upon the 1933 Act.\(^\text{115}\) For example, the Arizona securities fraud statute is clearly modelled after Rule 10b-5,\(^\text{116}\) but even an innocent misrepresentation can violate it, because there it does not require the plaintiff to prove scienter.\(^\text{117}\) Moreover, Arizona (as with several other states) makes securities fraud a predicate

\(^{113}\) The Statement of Managers does direct the SEC to consider additional safe harbors for non-qualifying issuers. *House Report, supra* note 2, at 31-49. This direction is hardly exhaustive of subsection (g)'s scope, but it can be cited as showing that the draftsmen were primarily focused on forward-looking statements.

\(^{114}\) Both the House and Senate have passed legislation that contains a broad grant of exemptive authority for the SEC. In the Senate, S.1815 ("Securities Investment Promotion Act of 1996") was passed by unanimous consent on June 27, and in the House, H.R. 3005 ("Securities Amendments of 1996") passed by a vote of 407-8 on June 19, 1996. See *BNA Pensions & Benefits Daily*, July 9, 1996 (available on LEXIS, News Library, Curnws File).

\(^{115}\) Unlike the Securities Exchange Act of 1934, the Securities Act of 1933 does not provide that federal courts have exclusive subject matter jurisdiction, and thus claims arising under the 1933 Act can be asserted in state court.


offense for its state "little RICO" statute, which provides for treble damages.\(^{118}\) Plaintiffs may be even more attracted to state courts by their desire to obtain punitive damages, which can be sought at the state level, but are unavailable as a measure of damages under the federal securities laws.\(^{119}\)

Still, the tradeoff for plaintiffs between state and federal court is complicated, and some important factors still tip in the direction of federal court. In state court, at least in any common law action for fraud, deceit, or negligent misrepresentation, the primary problem for plaintiffs will be their likely inability to utilize the "fraud on the market" doctrine that typically governs in federal securities fraud cases;\(^{120}\) instead, plaintiffs may be required to prove actual reliance on the alleged misrepresentations or omissions.\(^{121}\) Indeed, in 1993 in \textit{Mirkin v. Wasserman},\(^{122}\) the California Supreme Court observed that up to that point (with the exception of one unpublished opinion) no state court had applied the fraud on the market doctrine to common law fraud claims.\(^{123}\) Since then, the situation has become cloudier. Although no state has upheld the "fraud on the market" doctrine,\(^{124}\) several have found that plaintiffs need not plead direct reliance in actions based on the state's Blue Sky statute.\(^{125}\) Although it is difficult


\(^{119}\) Section 28(a) of the Securities Exchange Act of 1934 has long been read to preclude awards of punitive damages. 15 U.S.C. § 78bb(a) (1994).

\(^{120}\) \textit{Basic Inc. v. Levinson}, 485 U.S. 224, 241-47 (1988). Circuits disagree about the scope of this doctrine, with some applying it only to efficient markets.

\(^{121}\) \textit{Mirkin v. Wasserman}, 858 P.2d 568, 570 (Cal. 1993).

\(^{122}\) \textit{id.}


\(^{125}\) \textit{See Rosenthal}, 908 P.2d at 1100-04 (Colo. 1996); \textit{Weatherly v. Deloitte & Touche}, 905 S.W. 2d 642, 648-49 (Tex. Ct. App. 1995) ("Texas Securities Act does not require the buyer to prove reliance on the seller's misrepresentations or omissions"). In \textit{Rosenthal}, although the Colorado Supreme Court refused to adopt or reject the "fraud on the market" doctrine, it actually reinstated the class action, reversing the lower court and finding that it was sufficient for the plaintiffs to plead that the defendants' misstatements or omissions had caused them harm. \textit{Rosenthal}, 908 P.2d at 1103-04.
to predict the future behavior of other state courts, many seem likely by one means or another to spare plaintiffs from the traditional common law pleading requirements for fraud.

Of course, state statutory law may change, and a major effort to create a "friendly" state forum that could serve as an attractive substitute to federal court is currently being promoted by plaintiffs' lawyers in a statewide referendum in California. But this effort confronts a variety of problems. Phillips Petroleum Co. v. Shutts raises a particularly high obstacle to class certification of a multi-state class action by holding that the U.S. Constitution's Full Faith and Credit Clause would preclude the application of California law to the non-resident class members holding claims under the laws of their respective jurisdictions. Further, the attempt to impose punitive damages based on out-of-state conduct by the defendant has been found to violate the Due Process Clause. More generally, the Court may be in the process of placing limits on the capacity of one state to regulate in a manner that effectively sets national policy or constrains the choices of other states.

Regardless of the fate of the "fraud on the market" doctrine in state courts, plaintiffs may still have reason to migrate to state court. Although it is often assumed that the "fraud on the market" doctrine is critical to the availability of a class action, this may overstate the case. One possible alternative might be to plead a limited class action in which the "common questions of law and fact" are defined so as to exclude the "individual" issue of reliance.

126. See Neil Lewis, California Measure Could Trump U.S. Law on Securities Suits, N.Y. TIMES, Apr. 30, 1996, at A13. (describing ballot initiative that would authorize a class action under a provision paralleling Rule 10b-5 against both primary violators and those aiding or "assisting" the fraud). The California initiative would also allow plaintiffs' lawyers to solicit clients and would deny the state authority to limit punitive damages. Id.


128. Id. at 814-23. Federal courts have found that in a class action covering residents of multiple states, variations in state law are likely to "swamp any common issues and defeat the predominate" requirement of Rule 23 of the Federal Rules of Civil Procedure. See Castano v. American Tobacco Co., 84 F.3d 734 (5th Cir. 1996); Georgine v. Amchem Prod., 83 F.3d 610 (3d Cir. 1996).


130. The BMW decision may breathe new life into the Supreme Court's decision in Healy v. Beer Institute, 491 U.S. 324, 335-36 (1989), which held that the Commerce Clause constrained a state from imposing its own policy choices on, or restricting the "autonomy" of neighboring states. See BMW, 116 S. Ct. at 1597 ("We think it follows from these principles of state sovereignty and comity that a State may not impose economic sanctions on violators of its laws with the intent of changing tortfeasors' lawful conduct in other States"). This language, however, occasioned sharp dissent.

131. Most securities class actions are certified under FED. R. CIV. P. 23(b)(3). To certify such a class action, the federal court must find that there are both common issues of law or fact, which the class members share, and that these issues "predominate" over individual issues. State class action rules typically parallel Rule 23 and thus require a similar finding of "predominance." A court, however, may certify a class action with respect to particular issues only. Id.
issues (chiefly, materiality and scienter), plaintiffs would still be required to prove causation in an individual proceeding. As a practical matter, this would be costly for all sides (including the judicial system), but it is far from clear that the defendant could comfortably rely on this defense. Settlement (possibly at a reduced level) still seems likely.\(^\text{132}\)

The more problematic issue for plaintiffs seeking to utilize a state class action is whether the state court can certify a nationwide class action composed primarily of out-of-state residents. That is, while the state court class action will work relatively efficiently for an action primarily involving state residents, much more difficult problems arise when a nationwide class action is pleaded. Typically, the state’s Blue Sky statute will not apply to out-of-state transactions, unless there exists a strong “transactional nexus” between the out-of-state purchaser and the forum jurisdiction.\(^\text{133}\) Hence, difficult conflict-of-law questions arise as to governing law and as to whether a class can be certified whose members will be asserting the laws of multiple jurisdictions.\(^\text{134}\)

As a result, securities fraud class actions in state court seem feasible today mainly in those cases where the offering was conducted from or within a single jurisdiction and the law of a single jurisdiction applies to the claims of the class members. But these cases are far from rare, and some of them shift to state court.

**SUE WHERE THE REFORM ACT LEAST APPLIES**

The Reform Act is selective. Its special pleading rules with regard to scienter apply only to the 1934 Act and not to causes of action under the 1933 Act (which do not require proof of scienter).\(^\text{135}\) Similarly, the Reform Act’s safe harbor does not apply to nonreporting companies and to a

\(^{132}\) Such a proceeding seems feasible only in “large claimant” class actions in which the individual damages are substantial (as, for example, they are in some limited partnership cases that are today tried in state courts). In a “small claimant” class action where the individual damages are modest but the class is large, it is unlikely that the individual claimants will seek to prove either reliance or their individual damages.


\(^{134}\) Such classes have been certified in the mass tort context, but typically these classes have been “settlement classes,” which are certified “for settlement purposes” only. The Supreme Court has, of course, permitted a nationwide class to be certified in state court, provided that actual notice and a right to opt out is given to all class members. See Phillips Petroleum Co. v. Shutts, 472 U.S. 797 (1985). Some recent decisions, however, have tightened the standards for certification and rejected the proposed class when the action would represent a nationwide class and involve the substantive laws of most states. See In re Rhone-Poulenc Rorer Inc., 51 F.3d 1293, 1299 (7th Cir.), cert denied, 116 S. Ct. 184 (1995); Castano v. American Tobacco Co., 84 F.3d 734 (5th Cir. 1996).

\(^{135}\) See supra note 14 and accompanying text.
variety of specific transactions;\textsuperscript{136} nor does it apply to statements made in the issuer’s financial statements.\textsuperscript{137} Finally, under the new “bad boy” provisions of both the 1933 and 1934 Acts, the safe harbor does not apply to companies that during the preceding three years have either been (i) convicted of certain criminal offenses under the 1934 Act, or (ii) made the subject of a judicial or administrative decree or order arising out of a governmental action that (I) prohibits future violations of the antifraud provisions of the securities laws; (II) requires that the issuer cease and desist from violating the antifraud provisions of the securities laws; or (III) determines that the issuer violated the antifraud provisions of the securities laws.\textsuperscript{138}

Because any enforcement action (other than the very few that are resolved by a defendant’s verdict) will result in one of these outcomes, this provision vastly increases the significance of SEC administrative actions.

As a practical matter, these provisions define the most likely targets of future private class actions. Leading this field of eligible targets in the future is the initial public offering (IPO), to which the Reform Act expressly denies its safe harbor.\textsuperscript{139} Predictably, plaintiffs’ lawyers will prefer to focus on these targets, relying in particular on sections 11 and 12(2) of the 1933 Act, rather than attack the more formidable defenses afforded to “reporting” issuers who qualify for the Reform Act’s safe harbor. In short, although the Reform Act protects many companies, it may well increase the litigation exposure of others.

Of course, these issuers can still seek to rely on the “bespeaks caution” doctrine, which has no statutory limits. As a result, courts will continue to decide cases involving “forward-looking” information, interpreting both the Reform Act and the traditional “bespeaks caution” doctrine. Possibly, this will cause the two bodies of case law to converge.

Politically, the greater exposure of IPO and nonreporting companies (and the other classes of registrants denied the safe harbor) will exert a continuing pressure on the SEC to grant additional exemptions pursuant to its earlier discussed exemptive authority.\textsuperscript{140}

\textbf{FOCUSING ON CORE DEFENDANTS}

For several reasons, the Reform Act significantly weakens the incentive to sue a peripheral defendant. First, it may be very difficult to satisfy the pleading rules under the 1934 Act in order to show scienter on the part of such a defendant. Second, the “proportionate liability” provisions of

\textsuperscript{137} Id. §§ 77z-2(b)(2)(A), 77u-5(b)(2)(A).
\textsuperscript{138} Id. §§ 77z-2(b)(1)(A), 77u-5(b)(1)(A).
\textsuperscript{139} Id. §§ 77z-2(b)(2)(D), 78u-5(b)(2)(D).
\textsuperscript{140} See supra notes 92-96 and accompanying text.
the Reform Act also undercut the incentive to sue such a defendant.\textsuperscript{141} The Reform Act’s proportionate liability scheme supersedes the federal securities laws prior system of “joint and several” liability with a new system under which persons against whom final judgments are entered are generally liable only for the portion of the judgment that corresponds to the percentage of liability that the fact-finder specifically assigns to them.

Previously, an obvious incentive existed to sue outside directors under section 11 of the 1933 Act,\textsuperscript{142} because such directors were typically well insured and there was little question that the insurer would honor its policy (whereas the insurance carrier might well resist payment on claims made by inside officers on the grounds that its policy expressly excluded liability for knowing fraud). Thus, by naming the directors, the plaintiffs’ lawyer brought additional resources into the settlement negotiations. Now, this has changed, because the fact-finder will likely assign a low percentage (say ten to fifteen percent) to the outside directors with the result that the costs of litigating against them (plus the inevitable delay) may not justify the incremental recovery.

There are, of course, exceptions to this generalization. For example, if the company and its insiders are insolvent (or their insurance carrier is claiming that its policy does not cover their conduct), the outside directors may be the only “deep pocket” that can justify the litigation. But in this case, the real question becomes whether the plaintiff can show that these defendants “knowingly” committed the violations complained of (in which case the defendant becomes jointly and severally liable).\textsuperscript{143} Even then, however, there is still a further “Catch 22”—the more the plaintiffs establish that the violation is a knowing one (rather than simply “reckless”), the greater the likelihood that the insurance carrier will be able to resist coverage based on its exclusion for knowing fraud.

\textit{LOOK FOR “COOKED BOOKS,” NOT “VAPORWARE”}

Fraud involving financial statements receives far less protection under the Reform Act than fraud involving product announcements or similar projections. This is both because the financial statements are specifically excluded from the coverage of the safe harbor,\textsuperscript{144} and because most data about past financial performance would not in any event qualify as a forward-looking statement.

\textsuperscript{141} 15 U.S.C.A. §§ 77k(f), 78u-4(g) (West Supp. 1996).
\textsuperscript{143} Section 21D(g) of the 1934 Act, 15 U.S.C.A. § 78u-4(g) (West Supp. 1996), states that joint and several liability shall be imposed “only if the trier of fact specifically determines that such covered person knowingly committed a violation of the securities laws.”
\textsuperscript{144} See id. §§ 77z-2(b)(2)(A), 78u-5(b)(2)(A) (excluding forward-looking statements “included in a financial statement prepared in accordance with generally accounting accepted principles.”).
False statements about product availability or capability (so-called "vaporware") are protected and insulated with great care by the Reform Act. This probably testifies more to the political strength of the Silicon Valley constituencies that lobbied for the safe harbor’s adoption than to the frequency of such suits.

How significant will this new relative immunity for high-technology companies be for the future of securities class actions? One pending study seems to suggest that such cases represent only a small fraction of securities class actions—but also constitute the cases in which the median recoveries are the highest. In their study of 348 settled securities class actions, Professors Carleton, Weisbach and Weiss find that only six percent of the settlements were attributable to cases in which the plaintiff’s allegation was that the defendant disseminated misleading information about products under development, but these cases also had the largest median damages and the shortest class periods. In short, the data shows that these cases were few, but also hints that they were legally meritorious. But even if legally meritorious, there is reason to doubt the social value of such litigation. Uniquely, “vaporware” is more a tactic for marketing products to consumers than securities to investors. Although doubtful ethically, it is well understood by consumers and almost universally employed within the computer industry.

CONCLUSION

The recurrent message of this Article has been twofold. First, assessments of the Reform Act are premature until events play out further and courts exercise some of the discretion they have been given. Second, the Reform Act does not represent in any sense a radical discontinuity with prior practice, but rather accelerates trends that were preexisting.

Indeed, efforts to measure the impact of the Reform Act are apt to be confounded by extrinsic developments that may loom as large as the Reform Act itself, in terms of their overall effect on securities litigation. For example, the Supreme Court’s decision in Matsushita Electric Industrial Co. v. Epstein could do as much as anything in the Reform Act to undercut the incentive to bring and maintain a meritorious suit, because it invites defendants to encourage multiple plaintiffs to sue them in different forums so defendants can settle with the lowest bidder among them. Over time, such a structure chills the rational plaintiffs’ lawyer’s incentive to invest significant time or money in the prosecution of meritorious actions.

The continuity between trends and developments preceding the Reform

Act and the Reform Act itself is perhaps the most significant phenomenon, one that prevents reliance on a simple political "story" that sees the Reform Act as simply the consequence of an aberrational Congress or a temporary shift to the right by a disenchanted public. In truth, both public and judicial attitudes toward large scale class litigation have shifted—from the visionary idealism of the 1960s to the harsher cynicism of the 1990s. Well before the Reform Act’s passage, federal courts had begun to tighten pleading requirements, to grant motions to dismiss in securities cases, and to articulate the "bespeaks caution" doctrine to protect the disclosure of forward-looking information. The Reform Act may well have carried these trends too far, but it did not initiate any of them.

Why did this happen? A partial answer may begin with the fact that the Reform Act is highly selective. It probably will have only a marginal effect on the classic "cooked books" case involving long-term financial fraud or overstatement of earnings and/or assets, but it could immunize "vaporware" and other forms of non-financial projections to the point that such cases simply disappear.

From a public policy perspective, this likely impact raises an important but difficult tradeoff. On the one hand, the prospect looms that high-tech companies will face a "market for lemons"—that is, an environment in which few companies can signal that their future product announcements are credible and most, as a result, face a general market skepticism about such information. This danger is real, but hardly certain. After all, "vaporware" was primarily directed at the consumer market, not the securities market, and loss of consumer trust has not been reported as a major obstacle in this market. In any event, issuers may develop market mechanisms by which to assure analysts and the market that their product announcement statements are credible. Still, because high-tech industries are almost by definition composed of young, start-up companies that face virtually binary "boom or bust" prospects, this will not be easy, because the incentive to dissemble is real and obvious.

On the other hand, "vaporware" may have been too endemic a practice to expect antifraud rules to reverse ingrained industry practices. Also, the costs of deterrence were uniquely visited on a volatile and self-conscious


149. This doctrine also has a long history. See Donald C. Langevoort, Disclosures that "Bespeak Caution," 49 BUS. LAW. 481 (1994).


151. This may reflect the fact, however, that commercial consumers have contractual remedies that investors lack and can simply rescind their commitments to purchase if delivery is delayed.
industry that had unusually high political clout. All this, of course, could have been said about prior aggressive SEC initiatives against insider trading or questionable overseas payments in the 1970s, where practices were also long ingrained. What is new and different that has produced this stronger counterreaction?

One hypothesis is that the United States will tolerate more aggressive enforcement of the law from public servants, motivated by idealism, than from "private attorneys general," motivated by profit. The bar, as a whole, has an image today of the securities plaintiffs' lawyer as both overzealous and self-regarding. This image may be unfair, wrong, oversimple—or all of the foregoing. But it suggests that the range of social misbehavior that the "private attorney general" can effectively monitor may be limited. To the extent that there is a perception that the "private attorney general" is reaping windfalls in areas where the social harm is unclear, the legitimacy of private enforcement is undercut. Ironically, the Reform Act may help restore the private plaintiffs' lawyer's tarnished credibility, because it strongly encourages the private enforcer to bring suit only in cases where the private enforcer can raise a strong inference of fraud. It thus invites the private enforcer to reclaim the moral high ground.

This will be possible, of course, only if courts temper the Reform Act and disdain the more extreme statements in its legislative history. The early signs are that courts are doing just that. Whether the dominant force is the quirky independence of federal courts or their predictable resistance to attempts to Balkanize the landscape of private civil litigation by recognizing different procedural rules for different causes of action, the overall pattern is one of continuity, not radical change. What courts were doing before the Reform Act, they are now doing after it—only more so.

152. Many would dispute such a characterization of the plaintiffs bar. See, e.g., Seligman, supra note 147. Nor is it this author's own assessment. My own view is that it is a hopeless task to ask what percentage of securities class actions are "frivolous," because at the time of their filing few class actions are either frivolous or meritorious in the eyes of the plaintiffs' lawyers. Only once the plaintiff has obtained some opportunity for discovery can the plaintiff form an accurate assessment of the action's likely merit. Thus, the optimal reform would probably combine a high pleading standard at a delayed point with a brief opportunity for discovery. In this light, one attraction of the Second Circuit's "motive and opportunity" standard, which as a practical matter focuses on insider sales, is that this factor can be identified at low cost to the plaintiff's lawyer because such sales do usually come to light as a result of § 16(b) of the 1934 Act.

153. The leading such indicator is Marksman Partners, L.P. v. Chantal Pharmaceutical Corp., 1996 U.S. Dist. LEXIS 7179 (C.D. Cal. May 21, 1996), which fully adopted the Second Circuit's "motive and opportunity" and "strong circumstantial evidence" pleading standards. Another respect in which courts have tempered the Act's pleading standards is by granting leave to replead. See Zeid v. Kimberley, 1996 WL 310124, Civ. No. 96-20136 (N.D. Cal. June 6, 1996); see also supra notes 54-56 and accompanying text.