Securities Litigation Reform

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A short memo by NEC standards, supporting limited preemption of state securities law
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MEMORANDUM TO NEC PRINCIPALS

FROM: Mozelle W. Thompson
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SUBJECT: Extension of the Private Securities Legislation Reform Act of 1995 to State Securities Class Action Suits

ACTION FORCING EVENT

In May, the President was asked by a bipartisan group of over 75 members of Congress and by representatives of the high-technology industry to support the enactment of uniform federal standards for securities fraud class actions. Since then, two bills have been introduced in the House that seek to amend the Private Securities Litigation Reform Act of 1995 to establish such standards by preemption of state law. Consumer groups have indicated strong opposition to such legislation, as have state regulators.

On Thursday, July 24, the Securities Subcommittee of the Senate Banking Committee, chaired by Senator Gramm, will hold a hearing on the issue at which the SEC will testify. Both on the Hill and among private sector parties interested in this issue, the approaching hearings have intensified inquiries about where the Administration is on the legislation, although no Executive Branch agency so far has been asked to testify.

The NEC established an interagency working group to consider the policy issues and make recommendations to the President. This memorandum outlines the working group's views and provides options for action.

DISCUSSION

The Private Securities Litigation Reform Act of 1995

In December 1995, Congress passed, over the President's veto, the Private Securities Litigation Reform Act (the "Reform Act"), which revised both substantive and procedural law governing private actions under the federal securities laws. Among other things, the Reform Act (1) created a safe harbor for forward-looking statements; (2) heightened the pleading standards for claims of fraud; (3) created a stay of discovery pending a defendant's motion to dismiss; (4) limited the exposure of certain defendants by establishing proportionate liability, rather than joint and several liability, for parties not found to have "knowingly" committed violations; and (5) required courts to assess whether all parties complied with Rule 11 of the

Federal Rules of Civil Procedure, prohibiting the filing of frivolous legal motions.

In his veto message, the President indicated his objection to three provisions of the Reform Act that would "erect procedural barriers... [and] keep wrongly injured persons from having their day in court": (1) the heightened pleading standards; (2) the breadth of safe harbor for forward-looking statements, as suggested in the language of the Conference Report; and (3) the Rule 11 sanctions, which were seen as too close to a "loser pays" standard.

In response to the passage of the Reform Act over his veto, the President requested the SEC to undertake a year-long study and provide advice on the impact of the Reform Act on the effectiveness of the securities laws and on investor protection. In its April 1997 report, the SEC concluded it was too early to determine the full impact of the Reform Act. In particular, the SEC found that judicial interpretations of the new pleading standards varied and that there had been only one decision on the application of Rule 11.

The SEC did find, however, that there had been a significant increase in securities class actions filed in state courts, particularly in California, a finding consistent with an industry-sponsored study by Stanford professor Joseph Grundfest. The SEC study also indicated that since passage of the Reform Act, public companies had failed to avail themselves of the "safe harbor" for forward-looking statements.

Studies reported in the Wall Street Journal on July 9, 1997 indicate that federal securities lawsuits are back up to their pre-Reform Act levels, and that state suits are way down from their 1996 levels. The Journal states that "the filings are back up because federal courts haven't been as inhospitable to shareholder suits as proponents of the new law had hoped."1 Wall Street Journal (July 9, 1997, page B11)

Interaction between Federal and State Securities Laws

Over the last sixty years, federal securities laws have worked in tandem with state corporate law, securities law and the common law of fraud, to contribute to public confidence in our capital markets. State law has traditionally provided a remedy for those defrauded in face-to-face transactions, and certain types of corporate actions that may involve actively traded securities (such as proxy contests, mergers and tender offers) are tried in state, not federal court.

On the other hand, until the passage of the Reform Act, large class actions alleging securities fraud in connection with securities traded in national markets were generally brought in federal court, under federal law. The reasons for this include: provisions for strict liability of issuers and underwriters in certain situations; the ability to include plaintiffs from many states in a single action; the lack of need to

prove reliance by each plaintiff on misstatements or omissions; and the expertise of the federal courts, particularly in the Second and Ninth Circuits.
Proponents of the Reform Act argued that the federal system had gone awry, and that the high tech industry, accountants, lawyers and securities firms were being unfairly targeted in meritless class-action shareholder suits. They argued the litigation burdened the cost of raising capital and stifled growth and productivity. The Reform Act was intended to reduce this burden.

The high-tech industry and Congressional supporters assert that the industry has not obtained the relief intended by the Reform Act because of the trend toward state court actions. They are also concerned that plaintiff-friendly changes could be adopted in state law (such as proposed Proposition 211 in California, which the President publicly opposed) that will make the Reform Act even less effective. Therefore, to restore the federal/state balance -- but with the benefit of the Reform Act's provisions in federal court -- they argue that a single national standard of liability should be effected through preemption of state securities laws for private class action fraud actions. During the 1996 election campaign, while Proposition 211 was being considered in California, the President indicated some sympathy with this position.

Congressional Proposals

In May, two bills were introduced in the House that would preempt certain securities fraud actions filed in state courts. H.R.1689, introduced by Representatives Eshoo (D-CA) and White (R-WA), would preempt class action securities fraud suits (with more than 25 plaintiffs) based on state law if any of the company's securities were traded on a national exchange or the Nasdaq National Market System during the period of the alleged fraud. No such action could be brought, in either state or federal court, based on state common or statutory law. The Eshoo/White bill has over 75 co-sponsors, of both parties.

H.R. 1653, introduced by Representative Campbell (R-CA), is virtually identical to the Eshoo/White bill with two exceptions. The Campbell bill preempts all suits, not just class actions. On the other hand, the bill more narrowly defines "covered security" to apply only if the security *at issue* (rather than any of the company's securities) was traded on a national exchange or the National Market System. This bill has no additional sponsors; it appears the high tech community has decided the Eshoo/White bill is more likely to pass.2

ISSUES RAISED BY EXPANDING THE REFORM ACT

As a whole, and with some exceptions, the members of the NEC working group are inclined to believe that proponents of **wholesale** preemption of state securities fraud actions (or even state securities fraud class actions) for nationally-traded securities have not yet made an effective case for such action. However, the group discussed three areas in which limited, though significant, preemptive relief may be appropriate to enhance the likelihood that the benefits of the Reform Act will be realized:

- protecting the federal discovery stay from an "end run" using state actions;
- expanding the applicability of the safe harbor for forward-looking statements; and
- limiting state suits that do not require the plaintiff to demonstrate individual reliance on the defendants' misstatements or omissions.

These could form the core of a carefully drawn statute that creates national uniformity for claims truly related to national market actions while leaving state law intact for its traditional purposes.

In addition, the Administration may want to use this opportunity to revisit some of the issues raised during consideration of the Reform Act, such as the length of the federal statute of limitations. It is quite possible, however, that a decision to revisit any of these issues -- even in combination with support for some preemption -- would be taken as an indication that the Administration was not in fact supportive of the high tech community's interests.

Discovery Stay: The Reform Act provided for a stay of discovery during the pendency of motions to dismiss unless discovery is necessary to preserve evidence or prevent undue prejudice. Since the passage of the Reform Act, many state class action suits have been filed parallel to identical federal actions. Prior to the Reform Act, parallel suits were unusual. Although it is too soon to have conclusive evidence of discovery practices in these state actions, a strong inference is that state jurisdiction in these suits is being used to obtain discovery for use in the parallel federal court action. This lack of effectiveness of the federal discovery stay is a central complaint of the proponents of a national standard. While there may be potential constitutional (Tenth Amendment) issues in requiring state courts to respect the federal discovery stay, both the Justice Department and the SEC believe it is possible to craft such a statute.3

Safe Harbor: The Reform Act established a safe harbor from liability under the federal securities fraud laws for forward-looking statements that were not known to be false when made or that were accompanied by "meaningful" cautionary statements. Such a safe harbor is not generally found in state law. The President's veto message on the Reform Act noted that it was appropriate to modify federal securities law to "ensure that companies can make reasonable statements and future projections without getting sued every time earnings turn out to be lower than expected..." But the President took issue with the language of the Conference Report that "weaken[ed] the cautionary language that the bill itself provides."

The SEC's report on the impact of the Reform Act suggested that the lack of case law or regulation on what constitutes "meaningful" cautionary statements, rather than the potential for state court litigation, might be the primary inhibition to the wider use of the safe harbor. However, the goal of the safe harbor would probably be enhanced by making it universally applicable -- in state as well as federal courts.

Reliance: Most large federal securities fraud class action suits -- the type of litigation that generates the most concern in the business community -- rely on the theory of "fraud on the market." This doctrine allows plaintiffs to bring fraud actions under the federal securities laws alleging that misinformation or omissions of material fact caused securities sold in the market to be mispriced, resulting in damage to the plaintiffs, regardless of whether each plaintiff had personal knowledge of and relied on the misinformation or the omission. This makes large class actions far more feasible than doctrines, such as common law fraud, that require individual proof of reliance.

Because until recently there has been little incentive to file these kinds of suits in state, rather than federal court, most states do not have definitive court rulings on whether fraud on the market is a permissible theory of liability. There are no state law cases allowing fraud on the market -- rather than individual reliance -- as the basis for a state common law fraud suit. Four states -- Colorado, Arizona, Texas and Montana -- explicitly allow blue sky statutory fraud suits without proof of individual reliance (the functional equivalent of fraud on the market). The California Supreme Court has ruled that reliance is required for a common law fraud action, but stated in dicta that it would not be required for a statutory securities law action -- with the result that California plaintiffs are bringing statutory blue sky fraud actions without alleging individual reliance on the assumption that the Supreme Court will uphold them. It is unclear whether other states, if the issue is raised through post-Reform Act cases moved to state court, would follow California.

Given the uncertainties of state law, but the fact that state law generally requires individual reliance, federal preemption of state cases not requiring reliance would limit large state securities fraud class actions. This could be accomplished today without overruling current state law outside of Colorado, Arizona, Texas, Montana, and probably California.

Heightened Pleading Standards: The Reform Act adopts the Second Circuit's standard that plaintiffs must plead with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind. The President in his veto message indicated that this standard -- the toughest adopted by any Court of Appeals -- would be acceptable, but that the Conference Report's virtual direction to impose an even tougher pleading standard was inappropriate. The SEC's report indicates that most courts have applied the Second Circuit standard, notwithstanding the language of the Conference Report. However, in In re Silicon Graphics, Inc. Securities Litigation, 1997 WL 285057 (ND Cal, May 23, 1997), the

District Court held that allegations of non-deliberate "recklessness" would be insufficient to satisfy the new standard. Preemption of state court suits would make it more difficult for plaintiffs to bring law suits against reckless violators, particularly if Silicon Graphics becomes the Ninth Circuit or national standard.4 An attempt to overrule Silicon Graphics by statute would be vigorously opposed by the high tech community.

Aiding and Abetting: A Supreme Court case decided while the Reform Act was being considered (Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994)) eliminated private liability for aiding and abetting a securities law violation under the federal securities law. Attempts by the Administration and others to convince Congress to overrule the case in the Reform Act were not successful. About 20 states (including California) recognize private civil liability for aiding and abetting as a statutory blue sky violation.5 Preempting state fraud actions would effectively prevent statutory aiding and abetting claims in those states, as well as common law fraud aiding and abetting claims in all other states. An attempt to restore federal private aiding and abetting liability would likely meet strong objection not only from the high tech community but also from lawyers and accountants.

Statute of Limitations: In 1991, the Supreme Court limited the statute of limitation for federal private actions for securities fraud (Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991)) to a "one/three" standard -- one year after learning of facts that should put plaintiff on notice of the fraud, but no more than three years after the conduct. During the debate on the Reform Act, the Administration supported a longer statute of limitations. However, the Reform Act did not overrule Lampf. Preemption of state court suits would remove the ability to bring state court actions on the expiration of the shorter federal statute of limitations in the 31 states, including California, that currently have longer statutes. This may be an area in which an attempt to move federal law in a direction more friendly to plaintiffs would be feasible.

OPTIONS

1. Do not support legislative action at present

The Administration could choose not to comment on the proposed legislation -- or could oppose it -- accepting the recommendation of SEC Chairman Levitt that we allow case law implementing the Reform Act to develop. We could also make the point that to the extent these suits have shifted back from state to federal court in recent months, action to preempt state law might be both unnecessary and misdirected.

If we took this position, however, members of the high tech community would reiterate their claim that the President had committed to supporting some degree of federalization of the law in this area in his comments on California's Proposition 211. They have clearly indicated they would regard failure to support some preemption as a policy reversal and betrayal. On the other hand, consumer groups as well as state regulators would applaud our action.

2. Support the Eshoo/White or Campbell proposals

The Eshoo/White bill would move large securities fraud class actions into federal courts, but would continue to allow small aggregate actions (under 25 plaintiffs) to be brought in state court under either statutory or common law. The Campbell bill has a broader scope in that it impacts all lawsuits, not just class actions. Enactment of either bill would undoubtedly reduce the number of securities fraud suits brought in state court or under state law, thereby driving them back into federal court where the provisions of the Reform Act apply.

However, as noted above, the breadth of the bills, particularly the Campbell bill, could result in many types of actions traditionally, and successfully, brought in state courts (such as common law fraud cases based on actual reliance and actions alleging fraud in the course of a tender offer or proxy fight) being forced into federal court. In some cases, such as misrepresentations in intra-state private placements, there may not be the interstate commerce predicate for federal jurisdiction. It is possible that defrauded investors in these cases may find themselves without any remedy at all.

3. Propose legislation either as a stand-alone or to modify the Eshoo/White or Campbell bills

Neither the Eshoo/White nor the Campbell bill appear sufficiently well targeted to respond to what we perceive to be the primary issues that may deserve attention. Moreover, they are overbroad and completely pro-defendant. It is arguable that in providing something more to defendants in protection against state court actions, it might be useful to tilt the balance back somewhat in federal court. A carefully drawn statute that creates national uniformity for claims truly related to national market actions while leaving state law intact for its traditional purposes could serve all parties.

A package consisting of the following might be a useful counter-proposal:

- Preempt state law liability for statements that meet the federal safe harbor standards;
- Apply the discovery stay to securities fraud suits brought in state court;
- Preempt state securities fraud actions that do not require proof of individual reliance; and
- Increase the federal statute of limitations to the earlier of three years after

discovery or five years after the act.

While it is highly unlikely that such a package would fully satisfy either the high-tech community or opponents of any preemption, it responds to the concerns that have been documented, encourages further use of the safe harbor, and balances enhanced restrictions on plaintiffs' actions in state court with respect to clearly national issues with some degree of enhanced (or restored) plaintiffs' rights in federal court.