Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA's Internal-Information Standard on '33 and '34 Act Claims

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HEIGHTENED PLEADING AND DISCOVERY STAYS: AN ANALYSIS OF THE EFFECT OF THE PSLRA’S INTERNAL-INFORMATION STANDARD ON ’33 AND ’34 ACT CLAIMS

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I. INTRODUCTION ................................................................. 539
 II. HEIGHTENED PLEADING STANDARDS IN SECURITIES FRAUD CASES ... 541
     A. Ernst & Ernst v. Hochfelder and Rule 9(b) ...................................... 541
     B. Applying Rule 9(b) to Securities-Fraud Complaints ..................... 545
         1. The Ninth Circuit’s Pre-Reform Act Analysis of Particularized Pleading....................................................... 546
         2. The Second Circuit’s Approach to Particularized Pleading .......... 549
 III. THE RATIONALE BEHIND THE REFORM ACT AND ITS HEIGHTENED PLEADING STANDARD ................................................................. 552
 IV. THE REFORM ACT’S PLEADING STANDARD VIEWED IN LIGHT OF THE COMMON LAW PRECEDING IT ............................................................. 561
     A. Cases Applying the Second Circuit’s Standard ......................... 565
         1. Marksman v. Chantal Pharmaceuticals................................. 565
         2. Rehm v. Eagle Finance Corp........................................... 567
     B. Rejecting the Second Circuit’s Standard .............................. 569
         1. In re Silicon Graphics, Inc. Securities Litigation (“Silicon I”) 569
         3. Hockey v. Medhekar................................................. 574
     C. Opinions On the Reform Act’s Stay-of-Discovery Provision ......... 576
     D. Summary ........................................................................... 578
 V. CORRECTING THE PROBLEM THROUGH MANAGERIAL-JUDGE LEGISLATION ................................................................. 579

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VI. THE UNINTENDED CONSEQUENCES OF THE REFORM ACT’S
HEIGHTENED PLEADING STANDARD .................................................. 583
  A. The Common-Law Approach to Complaints with Multiple
Counts ........................................................................................................ 583
  B. The Reform Act and Its Legislative History ................................. 586
  C. The Policy and Purpose of the Securities Act ............................ 590
  D. Summary ............................................................................................ 593

VII. CONCLUSION ..................................................................................... 594

This Article presents a new model for analyzing securities-fraud claims. It
then discusses the pleading and stay-of-discovery requirements enacted by
Congress in the Private Securities Litigation Reform Act of 1995 (the
“Reform Act”), arguing that the combined impact of these provisions is
likely to be overinclusive.

The Reform Act’s pleading standard is best understood in light of the
commom law preceding it. To survive a motion to dismiss under pre-Reform
Act pleading standards, plaintiffs had to plead specific types of facts derived
from internal company information. Plaintiffs met this internal-information
standard through the use of the Federal Rules of Civil Procedure’s liberal
discovery provisions. The Reform Act, aimed at abusive securities litigation,
both prohibits such discovery and heightens the pleading standard necessary
to survive a motion to dismiss. By combining these reforms, the Reform Act
implements a standard that is outcome determinative and, if strictly applied,
virtually impossible to meet.

Early decisions under the Reform Act illustrate the outcome
determinative impact of these provisions and reveal that despite Congress’s
stated intent to resolve the circuit split on the applicable pleading standard,
the Reform Act’s language and legislative history have left the courts in a
quandary. As a result, the beginning of a new circuit split is already apparent.
To resolve these problems, I propose that Congress repeal the stay-of-
discovery requirements and, instead, adopt managerial-judge provisions to
process securities fraud claims. Such a mechanism would better balance the
competing goals of protecting the markets and limiting so-called abusive
litigation.

Finally, I consider whether the Reform Act’s pleading standards apply to
claims pursuant to the Securities Act of 1933 (“Securities Act”) and conclude
that, contrary to their practice before the Reform Act, courts should not apply
the new scienter-based pleading standard to the negligence and strict-liability
claims of the Securities Act. I support this argument with references to both
the Reform Act's plain language and legislative history, and the Securities Act's purpose. The post-Reform Act decisions considering this issue have relied on pre-Reform Act case law without considering whether the Reform Act changed that law, resulting in some incorrectly applying the pleading standard to plaintiffs' claims under the Securities Act.

I. INTRODUCTION

In late December 1995, Congress voted to override President Clinton's veto of the Reform Act. The Reform Act significantly changes many provisions of the Securities Act and the Securities Exchange Act of 1934 (the "Exchange Act") (collectively, the "Acts"). Final adoption of the Reform Act ended a debate, which began in earnest in 1993, about whether to reform the Acts. The debate now shifts to what the reforms as drafted by Congress really mean and what the impact of the Reform Act will be. This Article examines two of those reforms, the "heightened pleading" standard and stay-of-discovery provisions.

Part II explores the common-law bases for the Reform Act's heightened pleading standard, focusing on the Ninth and Second Circuits, and presents a new model for reviewing the complaints in these cases. Part II concludes that in order to meet the common-law pleading standards developed by the Ninth and Second Circuits prior to the Reform Act, plaintiffs needed access to internal company information. Plaintiffs had met the heightened pleading standards by engaging in discovery and then repleading their complaints.

Part III briefly discusses the motivation for reform of securities litigation

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and the Reform Act and its legislative history. The Reform Act is compromise legislation resulting from several years of debate over perceived problems with private securities litigation. The primary concern was that plaintiffs’ attorneys were filing frivolous class-action suits which, given the extensive and expensive discovery available, forced companies to settle meritless claims. Thus, the perception was that plaintiffs were filing suits first and searching for claims later through the Federal Rules of Civil Procedure’s liberal discovery provisions.

Part IV examines the Reform Act’s attempt to resolve these concerns through the adoption of pleading standard and stay-of-discovery provisions. Together these reforms are designed to improve the quality of initial complaints and to prevent plaintiffs from engaging in discovery before their complaints have passed muster. Part IV concludes that the heightened standard for pleading scienter, in combination with the provisions of the Reform Act’s section 21D(b)—which require plaintiffs to plead with specificity the reasons why an alleged misstatement was misleading when made—are, in light of the common law preceding them, very restrictive changes. Indeed, I argue that when the stay-of-discovery and pleading-standard provisions are combined and strictly applied, they are outcome-determinative and result in the dismissal of virtually all securities fraud lawsuits, even those which may be meritorious.

Part IV also examines significant post-Reform Act motion-to-dismiss opinions and concludes, consistent with this Article’s interpretation of the provisions, that, when strictly applied, the pleading standard and discovery stay severely limit plaintiffs’ ability to survive motions to dismiss. I further conclude that despite Congress’s stated intent to eliminate the differences between the circuits’ pre-Reform Act pleading standards, the provisions it adopted are already creating the beginning of a circuit split that the Supreme Court will need to resolve.

As a result, I argue in Part V that Congress should enact a managed-discovery plan, which would address the problem of frivolous suits and the resulting imbalance of power between plaintiffs and defendants through managerial-judge provisions, but would not be as draconian in its impact on the private-enforcement mechanisms for the Acts. Managerial-judge legislation, with explicit managed-discovery provisions, would address the expressed concern of defendants—extensive and expensive discovery—without preventing the access to the internal company information that the newly-adopted pleading standard requires at the motion-to-dismiss stage.

Finally, in Part VI, I explore the application of the Reform Act’s pleading provisions to the Securities Act. Specifically, I argue that because section 21D(b) amends only the Exchange Act, it should be applied to dismiss only
claims under that Act. Before the Reform Act, many circuits held that when a 
complaint pleads allegations under both Acts, the complaint may “sound in 
fraud,” and all allegations—even those of strict liability or negligence causes 
of action—must be dismissed if not pleaded with the requisite particularity 
required by Federal Rule of Civil Procedure 9(b). I argue, however, that 
courts should apply the new pleading standard only to claims under the 
Exchange Act and allow claims brought pursuant to the Securities Act to 
survive dismissal under the more lenient standard of Federal Rule of Civil 
Procedure 12(b)(6). Such an approach is consistent with both the Reform 
Act’s language and the Securities Act’s underlying policies.

II. HEIGHTENED PLEADING STANDARDS IN SECURITIES FRAUD CASES

A. Ernst & Ernst v. Hochfelder and Rule 9(b)

The circuits were initially divided over whether a claim brought pursuant 
to the implied cause of action available under section 10(b) and Rule 
10b-5 of the Exchange Act (an “Exchange Act Claim”) required a

7. There are eight express causes of action available pursuant to the Securities Act and the 
(creating liability for misrepresentations and omissions in registration statements); § 12, 15 U.S.C. 
prospectuses and for sale of unregistered securities); and § 15, 15 U.S.C. § 77o (1994) (creating 
(creating liability for certain manipulations of securities traded on stock exchanges); § 16, 15 U.S.C. 
liability for misleading statements in certain periodic reports filed with SEC); § 20, 15 U.S.C. § 78t 
section 12(2) liability to misstatements and omissions in public-offering prospectuses and oral 
communications).

In addition, there are four implied causes of action under the Exchange Act: § 10b, 15 U.S.C. 
§ 78j (1994), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1992) (general fraud liability provisions); 
connection with proxy solicitations); § 14(e), 15 U.S.C. § 78n(e) (1994) and Rule 14e-3, 17 C.F.R. 
§ 240.14e-3 (prohibiting fraud in connection with tender offers); and § 13(e)(1), 15 U.S.C. § 78nn(e)(1) 
(prohibiting fraud in connection with issuer’s repurchase of its own shares). See Joseph A. Grundfest, 
Dismantling Private Rights of Action Under the Federal Securities Laws: The Commission’s Authority, 
107 HARV. L. REV. 961, 964 n.3 (1994) (citations omitted) [hereinafter Grundfest I].


9. See id. at 193 n.12.


12. As noted above, there are numerous express and implied causes of action available to 
plaintiffs under the Exchange Act. See supra note 7. This Article, however, focuses only on the most 
prolific cause of action, the implied § 10(b)/Rule 10b-5 claims. See Grundfest I, supra note 7, at 
965 (saying the “private right of action implied under Rule 10b-5 has become civil plaintiffs’ primary 
weapon in their battle against securities fraud”). This Article refers to the section 10(b)/Rule 10b-5
plaintiff to prove scienter on the part of the defendants or simply that the defendants had acted negligently. In 1976, however, the Supreme Court in *Ernst & Ernst v. Hochfelder* held that plaintiffs must prove the defendants acted with “scienter—[the] intent to deceive, manipulate or defraud.” In reaching this holding, the Court relied, in part, on the need to restrict the reach of the implied cause of action. Accordingly, to state an Exchange Act Claim, a plaintiff must plead that (1) the defendant made a misstatement or omission (2) of a material fact (3) with scienter, and (4) that her reliance on that misstatement or omission (5) caused her injury. Since that time, the courts have used the scienter element, in conjunction with Rule 9(b), as a tool to screen out inadequate complaints at the motion-to-dismiss stage.

On a motion to dismiss, securities fraud complaints, like all complaints, are subjected to the standards imposed by Federal Rule of Civil Procedure 8 ("Rule 8"). Under Rule 8, plaintiffs need only plead "a short and plain statement of the claim showing that [they are] entitled to relief." The purpose of this requirement is to permit plaintiffs to set forth allegations without requiring that every element of the claim be pleaded with specificity or particularity.

Because scienter is an element of an Exchange Act Claim, however, complaints alleging such liability are also subject to the strictures of Rule 9(b). Rule 9 sets the standard for “Pleading Special Matters,” providing in clause (b):

[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other conditions of mind of a person may be averred generally.

Separating certain cases, or elements of those cases, from those allowed to be pleaded “with a short plain statement of the facts,” Rule 9(b) requires that fraud claims be treated differently from those to which Rule 8 alone

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14. See id. at 208.
19. 5 WRIGHT & MILLER, supra note 17, at § 1218.
Plaintiffs who assert claims of fraud must do more than show the existence of a claim. They must particularize the "circumstances" of the alleged fraud. The standard, as adopted by various courts, therefore, affects not only the pleading of scienter, but also the pleading of most elements of an Exchange Act Claim.

Before the Reform Act, advocates for reform claimed that the typical securities fraud class-action complaint was filed immediately after a drop in the company's stock price and was occasioned not by fraud, but by the

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20. See id.

21. By way of comparison, consider a different cause of action, such as a gender discrimination claim. The typical failure-to-hire case requires the plaintiff to plead her allegations in conformity only with Rule 8. Thus, a gender-discrimination complaint need allege, in simple form, only that the plaintiff was denied a job for which she was qualified, and for which the company hired a man, and that the company made its decision on the basis of gender. Unlike the securities fraud context, the gender discrimination plaintiff is allowed to plead this aspect of her complaint on the basis of information and belief. Accordingly, under Rule 8, she need provide only a short, plain statement of the facts entitling her to a remedy, and discovery begins.

In order to prove her claim, the plaintiff will need access to company information, which she will obtain through discovery. For example, she can request documents pertaining to the company's evaluations of herself and any other individuals considered for the position, depose anyone involved in the hiring or selection process, and request company statistics concerning the numbers and genders of persons considered or eligible for the position in question as well as other comparable positions within the company.

All of this discovery is internal information to which the plaintiff is entitled under the Federal Rules and to which she would not have access without discovery. Moreover, in the absence of some direct evidence of discrimination, the plaintiff will need this type of internal information to prove her case. In contrast, under both the pre- and post-Reform Act pleading standard, securities fraud plaintiffs need access to internal information not only to prove their claims, but also to plead them. See infra notes 40-51, 65-71, 224-30, 238-45 and accompanying text. As this Article discusses, the Reform Act denies them that discovery.

22. See Ayres I, supra note 6, at 339 (statting that reform proponents contend that plaintiffs' lawyers filed fraud suits without investigating claims whenever companies' stock prices fell more than 10%); see also Securities Litigation 1994: Hearing on H.R. 417 Before the Subcomm. on Telecomm. and Fin. of the House Comm. on Energy and Commerce, 103d Cong. 217 (1994) (testimony of Stephen F. Smith, General Counsel and Dir. of Investor Relations, Exabyte Corp.) (noting that complaints submitted by plaintiffs' attorneys were often computer-generated boilerplates) [hereinafter Smith Testimony]; 141 CONG. REC. S12,201-02, S12,203 (daily ed. Aug. 10, 1995) (statement of Mr. Domenici) (arguing a drop in stock price is "signal for a small group of specialized lawyers to file class-action lawsuits alleging fraud—often within hours of drop); 141 CONG. REC. S17,965-03, S17,968 (daily ed. Dec. 5, 1995) (statement of Mr. Domenici) (citing a National Association of Securities and Commercial Law Attorneys study finding 21% of fraud cases were filed within 48 hours of drop in stock price); see id. at S17,979 (statement of Mr. Failoroth) (citing a National Law Journal study in which 12 of 46 claims were filed within one day of drop in stock price), S17982 (statement of Mr. Dole) (arguing that even huge gains in stock price sometimes prompt fraud claims). But see Langevoort Testimony, supra note 6, at 119 (suggesting that no meaningful correlation exists between stock-price drops and filing of fraud claims); Securities Litigation 1994: Hearing on H.R. 417 Before the Subcomm. on Telecomm. and Fin. of the House Comm. on Energy and Commerce, 103d Cong. 267 (1994) (testimony of Leonard B. Simon, attorney) (same) [hereinafter Simon Testimony]; 141 CONG. REC. S17,933-04, S17,951 (daily ed. Dec. 5, 1995) (statement of Mr. Bryan) (citing University of California study showing that only 3% of 589 stocks, which dropped over 20% in five days, were sued).
desire of the plaintiffs' counsel to extract an unwarranted settlement from defendants. This quick response of the plaintiffs\textsuperscript{23} to market changes, in combination with the defendants' argument that the suits lacked merit, resulted in courts attempting to determine, at the pleading stage, whether the alleged misstatements were actually fraudulent and, thus, when revealed as such, caused the stock to plummet, or whether the decreased stock price was instead due to business or economic factors.\textsuperscript{24}

Courts have developed and applied a wide variety of Rule 9(b) standards to screen complaints, focusing on the specificity of the allegations as a measure of whether the plaintiffs appear to have a legitimate claim of fraud.\textsuperscript{25}

The Second Circuit noted that these cases

present an inevitable tension between two powerful interests. On the one hand, there is the interest in deterring fraud in the securities markets and remedying it when it occurs. That interest is served by recognizing that the victims of fraud often are unable to detail their allegations until they have had some opportunity to conduct discovery of those reasonably suspected of having perpetrated a fraud . . .

On the other hand, there is the interest in deterring the use of the litigation process as a device for extracting undeserved settlements as the price of avoiding the extensive discovery costs that frequently ensue once a complaint survives dismissal, even though no recovery would occur if the suit were litigated to completion.\textsuperscript{26}

Through the Reform Act, Congress sought, in part, to resolve both this tension and the differing pleading standards among the circuits.\textsuperscript{27}

\textsuperscript{23} For simplicity this Article refers to plaintiffs, but the reader should keep in mind that plaintiffs in these cases function primarily as stakeholders; their attorneys run the litigation. See infra note 75.

\textsuperscript{24} Because "only a fraction of financial deteriorations reflect fraud," plaintiffs must do more than aver two different financial statements; they must point to facts to show the difference is attributable to fraud. See DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir. 1990).

\textsuperscript{25} See Sec. Fraud Litig.: Concerning Litig. Under the Fed. Sec. Laws before the Subcomm. on Telecomm. and Fin. Comm. on Energy and Commerce, 103d Cong. 38 (1994) (statement of Arthur C. Levitt, Chairman, SEC) (testifying that although Rule 9(b) does not normally apply to allegations about defendants' state of mind, courts in the First, Second, Fifth, and Seventh Circuits required plaintiffs to allege facts giving rise to strong inference of fraud for scienter element) [hereinafter Levitt Testimony]. For a discussion of the standard in those and all other circuits, see infra note 33. See also infra notes 35-71 and accompanying text.

\textsuperscript{26} In re Time Warner Inc. Sec. Litig., 9 F.3d 259, 263 (2d Cir 1993). The Time Warner court then expressed the difficulty it faced when adjudicating such competing interests in the absence of either statutory guidance from Congress or regulatory guidance from the SEC. Id.

\textsuperscript{27} See 141 CONG. REC. S17,933-04, S17,954 (daily ed. Dec. 5, 1995) (statement of Mr. Dodd) (arguing conflicting pleading standards resulted from Congressional inaction); Levitt Testimony, supra note 25 (noting circuit split and arguing that harmonizing standards would be beneficial).
B. Applying Rule 9(b) to Securities-Fraud Complaints

Because the circuits, and the courts within them, analyze Exchange Act Claims differently, it is useful to have a model to compare how the courts are actually applying Rule 9(b) to determine whether to dismiss a complaint. In DiLeo v. Ernst & Young, the Seventh Circuit addressed the question of pleading with particularity and applied Rule 9(b) to hold that investors making an Exchange Act Claim must distinguish themselves from others who were simply adversely affected by "business reverses."\(^{28}\) The court stated that plaintiffs could meet this standard in the following manner: "Although states of mind may be pleaded generally, the 'circumstances' must be pleaded in detail. This means the who, what, when, where, and how: the first paragraph of any newspaper story."\(^{29}\)

An adaptation of this holding, which considers whether the plaintiffs have pleaded the who, what, when, where, why, and how of the alleged fraud, provides a model for gaining insight into the approach different circuits use to review such complaints. Courts generally agree that Rule 9(b) requires plaintiffs to allege with particularity the following: who made the alleged misstatement or omission; what she said; when she said it; and where she said it.\(^{30}\) The purpose of these criteria is relatively straightforward: "to give notice of plaintiff’s claim of fraud and to inform each individual defendant of what role he is alleged to have played in the fraud."\(^{31}\) The courts, however, disagree about the last two elements—whether plaintiffs must plead with particularity facts showing why an alleged misstatement was misleading or false when made, and how the defendants then knew or should have known that it was misleading.\(^{32}\)

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28. DiLeo, 901 F.2d at 629; see also Colby v. Hologic, Inc., 817 F. Supp. 204, 206 (D. Mass. 1993) (saying the case presented "the grimly familiar picture of disappointed investors crying fraud after fortunes were lost when a promising corporation stumbled in the winds of New England's lingering economic winter").

29. DiLeo, 901 F.2d at 627. Since deciding DiLeo, the Seventh Circuit has further heightened its pleading standard to require greater particularity. See infra note 33.


32. For example, the First Circuit requires plaintiffs to plead both the why and the how elements with specificity. See, e.g., Sarabian v. Amoskeag Bank Shares, Inc., 24 F.3d 357 (1st Cir. 1994) (requiring that plaintiffs plead with particularity both facts to show that alleged misstatement was misleading when made and facts surrounding scienter). The Ninth Circuit focuses on the why element. See, e.g., In re GlenFed, Inc. Sec. Litig., 42 F.3d 1541, 1547-49 (9th Cir. 1994) (requiring plaintiffs to plead with particularity facts showing alleged misstatement was misleading when made, but plaintiffs may aver scienter generally).

Courts within the Second, Third, Fourth, Fifth, Seventh, Eighth, and D.C. Circuits focus, only on the how elements. See, e.g., In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410 (3d Cir. 1997)
An analysis of cases from the Ninth and Second Circuits reveals how the application of the how and why factors affects Exchange Act complaints. These two courts have extensively reviewed securities fraud matters, and, prior to the Reform Act, each applied Rule 9(b) to such cases in a way that highlights the distinction between the two factors. The Ninth Circuit focused on what this Article refers to as the falsity, or "why" element; the Second focused on the scienter, or "how" element.\textsuperscript{33}

1. The Ninth Circuit's Pre-Reform Act Analysis of Particularized Pleading

In the 1994 case, In re GlenFed, Inc. Securities Litigation,\textsuperscript{34} the Ninth

(adopting Second Circuit standard by holding plaintiff must plead scienter either by alleging defendants had motive and opportunity to commit fraud or acted with conscious or reckless behavior); Kowal v. MCI Communications Corp., 16 F.3d 1271, 1278-79 (D.C. Cir. 1994) (holding, in context of allegedly false projections, that plaintiffs must plead facts to show that company lacked reasonable basis or issued alleged misstatement in less than good faith); Tuchman v. DSC Communications Corp., 14 F.3d 1061, 1068 (5th Cir. 1994) (holding plaintiff must set forth facts from which scienter may be inferred); In re Time Warner, Inc. Sec. Litig., 9 F.3d 259, 269-71 (2d. Cir. 1993) (focusing on scienter allegations and requiring particularity in pleading such allegations); Arazie v. Mullane, 2 F.3d 1456, 1468 (7th Cir. 1993) (requiring pleading of facts from which scienter may be inferred); Buffets, Inc. Sec. Litig. [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,210 at 95,061-62 (D. Minn. Nov. 22, 1995) (noting that Eighth Circuit had not decided pleading issue; finding that in order to defeat dismissal, complaint must set forth facts "explaining why it is claimed that the representations were known by each of the Defendants to be untrue or misleading when they were made"); Borow v. nView Corp., 829 F. Supp. 828, 833, 836 (E.D. Va. 1993) (finding that to meet Rule 9(6) standard, plaintiffs must allege "probable facts" tending to show that when alleged misstatements were made, they were not actually or reasonably believed).

Other circuit and district courts have found that neither element must be pleaded with specificity. See, e.g., Auslender v. Energy Management Corp., 832 F.2d 354 (6th Cir. 1987) (reversing dismissal of claim for failure to plead with particularity, holding sufficient minimal allegation that defendants knew or were reckless in not knowing certain facts were false); Seattle-First Nat'l Bank v. Carlsbad, 800 F.2d 1008 (10th Cir. 1986) (per curiam) (holding plaintiffs need only identify who, what, where, and when of alleged fraud; Rule 9(b) must be read in conjunction with Rule 8); Hekker, 1996 WL 578335, at *6 (noting Eleventh Circuit had not decided whether scienter had to be pleaded with particularity, then finding sufficient general allegations that defendants knew "true" facts or acted with reckless disregard for truth when making allegedly misleading statements).

33. Compare GlenFed, 42 F.3d at 1547 (stating that under Rule 9(b) plaintiffs must plead with specificity allegations to show why an alleged misstatement or omission was false when made, but need not plead scienter allegations with particularity), with Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124 (2d Cir. 1994) (holding that plaintiffs must plead circumstances surrounding knowledge or recklessness with specificity).


34. 42 F.3d 1541 (9th Cir. 1994) (en banc) (reversing prior opinion in same matter which held Rule 9(b) imposed particularity requirement for scienter element).
Circuit reevaluated its prior approach to securities fraud claims, reviewed the actual text of Rule 9(b), and rejected the Second Circuit’s scienter approach as beyond the language of the Rule’s second sentence.\(^{35}\) Reasoning that the language of Rule 9(b) plainly states that the circumstances surrounding the alleged fraud, but not the state of mind connected with it, must be pleaded with particularity, the Ninth Circuit held that plaintiffs had to plead the circumstances surrounding the alleged fraud (the who, what, where, when, and why) with particularity,\(^ {36} \) but could aver the how element simply by “saying that scienter existed.”\(^ {37} \) Thus, the Ninth Circuit distinguished facts indicating whether an alleged misstatement was false or misleading when made from the defendants’ knowledge of those facts.\(^ {38} \)

In practice, this standard usually required plaintiffs to have access to internal company information and documents. For example, the Ninth Circuit stated that its Rule 9(b) standard required plaintiffs to plead with particularity “contemporaneous facts, conditions, or statements” that tended to show the alleged misstatement was misleading when made.\(^ {39} \) An examination of *In re GlenFed* reveals the plaintiffs met this standard, in part, by contrasting GlenFed’s September 30, 1990 10-Q statement that it “expected no net loss on the sale of its subsidiaries” with contemporaneous statements from board meetings indicating (1) the environment for the sale of a subsidiary real estate development company was unfavorable, (2) interest in buying that subsidiary was limited, and (3) all bids were unsatisfactory.\(^ {40} \) The court held that these three allegations of contemporaneous internal information, which appeared to contradict GlenFed’s public 10-Q statement, were sufficient to allow the alleged misstatement to withstand dismissal.\(^ {41} \)

Of key importance to the court’s analysis was the plaintiffs’ reliance on internal company information to support the argument that the complaint

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35. See supra notes 18-21 and accompanying text.

36. The Ninth Circuit’s approach appears to be consistent with the Seventh Circuit’s statement in DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir. 1990). Despite the actual language of DiLeo, the Seventh Circuit requires plaintiffs to plead facts to support the scienter element of their claim. See, e.g., Arzate, 2 F.3d at 1466-67 (dismissing complaint where plaintiffs failed to plead with particularity facts supporting their allegations that defendants knew or should have known of alleged problems before public announcements).

37. GlenFed, 42 F.3d at 1547.

38. See id. at 1546-47.


40. GlenFed, 42 F.3d at 1550.

41. See id. The court noted, however, that other statements in the record appeared to contradict the internal statements to which the plaintiffs pointed. See id. It then stated that “whether or not, in light of contemporaneous statements which appear to conflict with one another, the charged statement was in fact materially misleading” was a question appropriate for either summary judgment or a motion to dismiss pursuant to Fed. R. Civ. P. 12(b)(6). Id.
should survive Rule 9(b). For example, in support of other alleged misstatements, the plaintiffs pointed to, and the court considered, other internal documents, including "non-public" audit documents that corroborated allegations that GlenFed lacked control over, or failed to monitor, certain loans and outdated appraisals of the collateral securing its loans. 42 These contemporaneous internal statements and documents, the court held, showed that the plaintiffs had gone beyond merely pleading that the "defendants' public statements were false, without explaining [why] they were false." 43 Thus, the court held that the plaintiffs met the requisite standard by pointing to specific internal problems or statements that contradicted the allegedly misleading public statements. 44

In contrast, the court dismissed other allegations, specifically noting that the plaintiffs had failed to juxtapose the alleged misstatements with explanations of which

internal controls [were] missing, why the information defendants purportedly used as a basis for their optimistic statements was unreliable, or what information within GlenFed revealed that foreclosures and defaults were increasing[,] ... nor which 'specific loss situations' the defendants were concealing[,] ... or the number of non-performing assets (NPA). 45

For example, the court held "patently insufficient" allegations that internal controls were missing. 46 Instead, the court noted that the reasons cited by the plaintiffs to support their allegations of fraud both had to be contemporaneous in nature and have a nexus to the alleged misstatement. 47

This standard required plaintiffs to plead, for example, two contemporaneous public statements which contradicted each other or to juxtapose the company's public statement with conflicting non-public information. Because the former situation is unlikely to occur, 48 the court's holding implicitly required plaintiffs to point to internal documents or

42. See id. at 1550-51.
43. Id. at 1551.
44. The Ninth Circuit's internal-information requirement for pleading the why aspect of the alleged fraud often resembles one of the Second Circuit's tests for pleading the how of the alleged fraud. See infra notes 66-71 and accompanying text.
45. GlenFed, 42 F.3d at 1552 (emphasis added).
46. Id.
47. See id.
48. But see Elliott J. Weiss, The New Securities Fraud Pleading Requirement: Speed Bump or Road Block?, 38 Ariz. L. Rev. 675, 705 (1996) (stating that plaintiffs should be able to meet pleading standards through use of "information superhighway").
information to survive dismissal.\textsuperscript{49} In the absence of a whistle-blower or disgruntled former employee, however, such information is available only through discovery. Prior to the Reform Act, plaintiffs met this standard because they were able to begin discovery shortly after filing their first complaint and continue it throughout several versions of the complaint and motions to dismiss.\textsuperscript{50}

2. The Second Circuit's Approach to Particularized Pleading

In contrast to the Ninth Circuit's pleading standard, the Second Circuit developed a Rule 9(b) pleading standard which focused primarily on the requisite mental state of the defendants, thereby contravening the second sentence of the Rule.\textsuperscript{51} The Second Circuit required that "the facts alleged in the complaint give rise to a 'strong inference' of fraudulent intent."\textsuperscript{52} In the absence of direct evidence of fraud, the Second Circuit delineated two ways in which the plaintiffs could meet its pleading requirement for the scienter element.\textsuperscript{53} First, the plaintiffs could allege facts establishing a motive to commit fraud and the opportunity to do so.\textsuperscript{54} Second, the plaintiffs could allege facts constituting circumstantial evidence of either recklessness or conscious behavior.\textsuperscript{55} The Second Circuit defined motive to "entail concrete

\textsuperscript{49} Consider also Fecht v. Price Co., 70 F.3d 1078, 1083-84 (9th Cir. 1995), where the court denied a motion to dismiss based on internal information pleaded in the complaint because allegations that the company’s public statements were undermined by specific sales figures pleaded on a store-by-store basis allowed the complaint to meet the requisite specificity. Again, the court relied on internal company information when denying the motion to dismiss. See also Pilarczyk v. Morrison Knudsen Corp., 965 F. Supp. 311 (N.D.N.Y. 1997) (dismissing post-Reform Act complaint where plaintiffs failed to identify who knew of internal information when).

\textsuperscript{50} See, e.g., O’Rear v. American Family Life Assurance Co. of Columbus, 784 F. Supp. 1561 (M.D. Fla. 1992) (ruling on a motion to dismiss third amended complaint); Motions to Dismiss and Complaints, In re Copley Pharmaceutical [on file with author]. The Reform Act, however, stays all discovery until after resolution of the motion to dismiss. See infra notes 238-45 and accompanying text; see also Medhekar v. U.S. District Court, Northern District of California, 99 F.3d 325 (9th Cir. 1996) (reversing the District Court and holding that section 21D(b)(3)(B) stays all discovery, including Fed. R. Civ. P. 26 automatic disclosures).

\textsuperscript{51} See, e.g., Shemtob v. Shearson, Hammill & Co., 448 F.2d 442 (2d Cir. 1971) (holding that Rule 9(b) should be strictly applied); Denny v. Barber, 576 F.2d 465, 470 (2d Cir. 1978). One recent Second Circuit decision appears to hold that plaintiffs must plead both the why and the how elements. See San Leandro Emergency Med. Group Profit Sharing Co., Plan v. Philip Morris Co., 75 F.3d 801, 812 (2d Cir. 1996). This case was decided after the Ninth Circuit’s 1995 decision In re GlenFed, Inc. Securities Litigation, 42 F.3d 1541 (9th Cir. 1994). See also Salinger v. Projectvision, Inc., 972 F. Supp. 222 (S.D.N.Y. 1997) (finding plaintiffs failed to plead either element with specificity).

\textsuperscript{52} In re Time Warner Inc. Sec. Litig., 9 F.3d 259, 268 (2d Cir. 1993) (citations and quotations omitted).

\textsuperscript{53} See id. at 268-69; see also Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1129-30 (2d Cir. 1994).

\textsuperscript{54} See Shields, 25 F.3d at 1130.

benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged, and opportunity to "entail the means and likely prospect of achieving concrete benefits by the means alleged."

In determining whether the scienter allegations in a complaint met the motive-and-opportunity test, the Second Circuit, and the district courts within it, generally found sufficient allegations of trades by insiders in suspicious amounts or at suspicious times. The information necessary to establish such trades is available in publicly filed forms from officers and directors. Thus, the Second Circuit has held that such trades allowed it to draw an inference that the defendants acted with the requisite state of mind. Accordingly, prior to the Reform Act, plaintiffs in the Second Circuit could, at the pleading stage, use allegations of motive and opportunity to support a claim of scienter, thereby surviving dismissal on the basis of publicly-available information.

In contrast, courts within the Second Circuit usually rejected plaintiffs' attempts to support scienter claims by pleading motives that were applicable to any similarly-situated company. For example, the courts rejected the following types of allegations as inadequate to establish scienter: preserving good relations with suppliers, encouraging retailers to place orders, forestalling loan defaults, or protecting executive positions; ensuring incentive compensation; maintaining a company's high bond rating; and raising capital, protecting the company's financial interests, or preventing the

56. Shields, 25 F.3d at 1130.
57. See, e.g., Goldman v. Belden, 754 F.2d 1059, 1070 (2d Cir. 1985) (noting that defendants profited from allegedly bullish statements by selling significant number of shares of stock); see also Jordan Eih & Michael Dicke, Insider Stock Sales in Rule 10b-5 Corporate Disclosure Cases: Separating the Innocent from the Suspicious, 1 STAN. J. L., BUS. & FIN. 97 (1994); Vanessa O'Connell, Lawyers Scan Insider Sales to Build Suits, WALL STREET J., June 5, 1996, at C1. Indeed, such allegations support an inference of scienter in every court requiring that scienter be pleaded with particularity. See, e.g., Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1224 (1st Cir. 1996) (holding allegations of insider trades in suspicious amounts or at suspicious times permit an inference of scienter); Buffets, Inc. Sec. Litig., [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶99,210 at 95,062 (D. Minn. May 17, 1996) (concluding that, although insider trades alone are insufficient to allege scienter, suspicious timing or amounts or unusual trades will meet pleading standard); cf Acito v. IMCERA Group, Inc., 47 F.3d 47 (2d Cir. 1995) (finding inside sales by outside director not sufficient where they were disclosed in advance, were not unusual in amount or timing, and no other defendants sold at same time).
termination of an officer. 62 Thus, motives typical of businesses or business people in general did not meet the Second Circuit’s requirement for pleading the defendants’ state of mind. 63

Plaintiffs could also meet the Second Circuit’s scienter standard by pleading facts constituting circumstantial evidence of either recklessness or conscious behavior. 64 In application, this test was similar to the Ninth Circuit’s standard for pleading the falsity of the misrepresentations, but required plaintiffs to plead contemporaneous facts, conditions, or statements to show that defendants knew or should have known that an alleged misstatement was misleading when made. 65 In practice, this standard also usually required the plaintiffs to make allegations based on internal company information. The difference was one primarily of focus: the Second Circuit examined such information in the context of the how element, and the Ninth in the context of the why element. For example, in Shields v. Citytrust Bancorp, Inc. 66 the Second Circuit dismissed the plaintiffs’ allegations, holding insufficient the plaintiffs’ attempts to pair alleged misstatements with conclusory allegations of fraudulent intent. 67 According to the court, the plaintiffs should have contrasted the alleged misstatements with contemporaneous internal loan-loss reserve reports. 68 Further, the court specifically noted that companies were allowed to make optimistic statements about their future unless the “current data” before the officers and directors indicated otherwise. 69 In this manner, the Second Circuit’s recklessness analysis, like the Ninth Circuit’s why approach, implicitly forced plaintiffs to make allegations based on information they were likely to find only through discovery. 70


63. See id.

64. See San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Co., 75 F.3d 801 (2d Cir. 1996) (where plaintiffs seek to plead scienter through recklessness, their circumstantial allegations must meet a higher standard of detail than those under motive test); see also Glickman, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) at 94,640.

65. See, e.g., Shields v. Citytrust Bancorp, 25 F.3d 1124, 1129 (2d Cir. 1994) (rejecting as insufficient allegations that did not contrast public disclosures with current internal data); see also supra note 38 and accompanying text.

66. 25 F.3d 1124 (2d Cir. 1994).

67. See id. at 1129.

68. See id.

69. Id. at 1129-30.

70. See also Serabian v. Amoskeag Bank Shares, Inc., 24 F.3d 357, 365 (1st Cir. 1994) (rejecting, in part, a defense motion to dismiss which specifically referred to internal reports and public statements plaintiffs cited as support for their claims). Again, the Reform Act eliminated such discovery while motions to dismiss are pending. See infra notes 238-45 and accompanying text.

Not all of the cases can be explained by the internal/external standard described in this Article. However, many of the opinions that deny motions to dismiss without requiring the plaintiffs to point to
III. THE RATIONALE BEHIND THE REFORM ACT AND ITS HEIGHTENED PLEADING STANDARD

During the early 1990s, momentum for revisions to the Acts began to build. Those calling for reform cited many bases for their claim that the private enforcement mechanism for securities regulation was broken. In general, the debate focused on two major points. First, according to industry groups, the transaction cost of filing such suits was minimal, allowing corroborating internal information have unique publicly-available facts. For example, in *Cosmas v. Hassett*, 886 F.2d 8, 13 (2d Cir. 1989), the plaintiffs alleged that the chief executive officer made positive statements about anticipated sales to China at a time when China had recently imposed import restrictions. The court held that such allegations "support[ed] an inference of fraud by pleading adequate circumstantial evidence to indicate conscious misconduct by the defendants—i.e., that the defendants knew of the import restrictions at the time they made the allegedly fraudulent statements." See id. In another Second Circuit case, public allegations of bribes made to "secure foreign business or business concessions" permitted the plaintiffs to withstand, in part, a motion to dismiss. *Decker v. Massey-Ferguson, Ltd.*, 681 F.2d 111, 118-19 (2d Cir. 1982); see also *City of Painesville, Ohio v. First Montauk Fin., Corp.*, 178 F.R.D. 180, 185-89 (N.D. Ohio 1998) (finding complaint met heightened pleading standard, but noting that company had previously disclosed existence of Securities and Exchange Commission investigation and indictments in Florida).

Plaintiffs also succeed in meeting the pleading standard when the case involves a highly-regulated industry, in which certain information is either public or in which the regulated nature of the industry puts a higher burden on officers and directors. *See In re Gaming Lottery Sec. Litig.*, 1998 WL 276177, at *7 (S.D.N.Y. May 27, 1998) (noting that as officers of highly-regulated company, defendants should have been aware of the normal time period for issuance of gambling license and reasons for non-issuance and that pleadings indicated that defendants appeared to have known that issuance was in question before making information public). An additional category of cases in which plaintiffs succeed in meeting the pleading standard without access to internal information are those in which the alleged misstatement and correction appear in close proximity to each other. *See, e.g., In re Stratosphere Corp. Sec. Litig.*, 1 F. Supp. 2d 1096, 1112 (D. Nev. 1998) (noting that "shortness in time" between prior statement and "later revealed truth" can serve as circumstantial evidence that alleged misstatement was false or misleading when made).

71. *See Attitude Shift: Acknowledging Abuses in Shareholder Litigation Seen at SEC, 26 Rep.* (BNA) No. 26, at 937 (July 1, 1994) (discussing shift in SEC's attitude toward securities litigation reform; noting reform was one of "hottest topics on [SEC's] agenda") [hereinafter *Attitude Shift*].

72. *See Grundfest I, supra note 7, at 971-75. The main focus of Grundfest's article is that the SEC has the power to disimply the private right of action for section 10(b)/Rule 10b-5 claims and should exercise it. See id. at 998-1022. He also discusses and analyzes the arguments underlying the demands for reform of the private securities litigation laws. See id. at 971-75. Also summarizing the reform debate are Joel Seligman, *The Merits Do Matter*, 108 HARV. L. REV. 438 (1994) (arguing that although SEC may have prospective power to disimply such private right, private enforcement of securities laws is important to integrity of market and evidence offered by proponents of reform is insufficient to support their case); Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727 (1995) (responding to Seligman's article; arguing that evidence indeed supported some reforms and urging SEC to explore such reforms) [hereinafter Grundfest II]; Phillips & Miller, *supra* note 6, at 1010-15; *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995*, U.S. Securities and Exchange Commission, at 5-9 (April, 1997).

73. *See Phillips & Miller, supra note 6, at 1011-12, 1014.*
plaintiffs (in reality, plaintiffs’ attorneys)\textsuperscript{74} to file class-actions quickly and easily,\textsuperscript{75} often the day after a company’s stock price dropped.\textsuperscript{76} This ease in filing, they claimed, was resulting in strike suits.\textsuperscript{77} In fact, reform proponents argued that allegations in the complaints often amounted only to claims of “fraud by hindsight,”\textsuperscript{78} which plaintiffs later supported through the liberal discovery provisions of the Federal Rules of Civil Procedure.\textsuperscript{79} Thus, according to reform advocates, plaintiffs engaged in a file-first-and-research-the-complaint-later strategy.

This power to conduct wide-ranging discovery, industry representatives argued, caused another problem, an imbalance of power between plaintiffs and defendants that allowed plaintiffs to extract settlements from defendants—even in matters lacking merit.\textsuperscript{80} In essence, the argument was

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\textsuperscript{74} Much of the debate focused on the allegedly inappropriate practices of plaintiffs' counsel. For example, proponents of reform argued that plaintiffs' attorneys hired professional plaintiffs to be class representatives, raced to the courthouse to secure their position as lead counsel, and included law and accounting firms as defendants to increase settlement value. These tactics, reform proponents claimed, resulted in plaintiffs' attorneys, not class members, dictating the pace and merits of litigation. See id. at 1009-10 (noting that plaintiffs' attorneys "rushed" to courthouse to file complaints, citing example computer-generated complaint that failed to update allegations from previous lawsuit); 141 CONG. REC. S12,201-02, S12,203 (daily ed. Aug. 10, 1995) (statement of Mr. Domenici) (quoting "prominent securities class-action attorney" as stating, "I have the greatest practice of law in the world, I have no clients."); 141 CONG. REC. S17,933-04, S17,933-04 (daily ed. Dec. 5, 1995) (statement of Mr. D'Amato) (noting same plaintiff appeared in thirteen lawsuits and that plaintiffs often own as few as ten shares of stock in company sued); 141 CONG. REC. S17,965-03, S17,969 (daily ed. Dec. 5, 1995) (statement of Mr. Domenici) (arguing lack of plaintiff participation results in plaintiffs' attorneys recovering "lion's share" of settlement); id. at S17,979 (statement of Mr. Faircloth) (arguing average investor receives six to seven cents of every dollar recovered); see id. at S17,982 (statement of Mr. Frist) (arguing plaintiffs' attorneys' incentive is quick settlement and trial avoidance, creating conflict of interest with investors). As stated supra in note 23, for simplicity this Article refers to plaintiffs.

\textsuperscript{75} See Smith Testimony, supra note 22, at 219 (arguing that combination of class-action, contingent-fee, and fraud-on-the-market doctrines contributes to plaintiffs' counsel's ease in filing such suits).

\textsuperscript{76} See supra note 22.

\textsuperscript{77} See Phillips & Miller, supra note 6, at 1011-12.

\textsuperscript{78} Courts use the term "fraud by hindsight" to refer to allegations usually found insufficient to survive motions to dismiss. Such a claim usually "rests upon the assumption that the defendants must have known about the severity of [the current problem causing the stock price decrease] earlier because conditions became so bad later on." Serabian v. Amoskeag BankShares, Inc., 24 F.3d 357, 367 (1st Cir. 1994).

\textsuperscript{79} See Phillips & Miller, supra note 6, at 1014 (noting that plaintiffs “blanketed” defendants with discovery demands before rulings on motions to dismiss); see also H.R. CONF. REP. NO. 104-369, at 37 (referring to discovery in such class actions as “fishing expeditions”); 141 CONG. REC. S17,933-04, S17,933 (daily ed. Dec. 5, 1995) (statement of Mr. D'Amato) (stating that one company was forced to produce 1500 boxes of documents for discovery at a cost of $1.4 million). This "file first and discover later" approach allowed courts to adopt the above-described internal-information pleading standard. See supra notes 40-51, 65-71 and accompanying text.

\textsuperscript{80} See Phillips & Miller, supra note 6, at 1012-14; see also Grundfest I, supra note 7, at 973-74; Konstantinakos v. FDIC, 719 F. Supp. 35, 38 (D. Mass. 1989) (noting high "strike suit" value of securities fraud claims); Smith Testimony, supra note 22, at 219 (arguing discovery imbalance
that plaintiffs were able to serve discovery requests, and defendants had to comply, regardless of whether the suit had merit.

The discovery requests were broad.81 For example, discovery demands often included requests for everything from minutes and documents relating to board meetings to every sales contract entered into by the company. Moreover, reform proponents argued, those same document requests covered periods of time not even at issue in the lawsuit.83 In addition to the production of documents, discovery in these cases usually involved depositions, lasting several days, of chief executive officers, presidents, chief financial officers, members of the board of directors, and other employees. The number of depositions often exceeded the number of depositions to which plaintiffs were entitled under local Federal District Court Rules.84 This discovery began shortly after the plaintiffs filed the complaint and continued throughout the entire motion-to-dismiss period.85

Further, reform proponents contended, courts took months, sometimes even years, before hearing arguments and issuing opinions on motions to dismiss.86 The opinions, in turn, usually granted plaintiffs leave to replead their complaints, often several times, before dismissing the complaint with prejudice. This process, industry advocates complained, made winning an initial motion to dismiss nothing more than a Pyrrhic victory.87 Defendants protested that they were subjected to lengthy and expensive discovery procedures, the costs of multiple motions to dismiss, and an uncertain outcome.88 Indeed, they said that this abuse of the discovery process often led to settlement—even of frivolous cases.89 Thus, they argued, plaintiffs’

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81. See 141 CONG. REC. S12,201-02, S12,202 (daily ed. Aug. 10, 1995) (statement of Mr. Domenici) (claiming plaintiffs’ attorneys typically “request an extensive list of documents and ... schedule an ambitious agenda of sworn testimony”).
82. See, e.g., In re Dataware Sec. Litig., Plaintiffs’ First Request For Production of Documents (on file with author); see also Phillips and Miller, supra note 6, at 1014.
83. See, e.g., In re Dataware Sec. Litig., Plaintiffs’ First Request For Production of Documents (including requests for the time period of December 31, 1992 to July 31, 1994 for a class period which extended only from July 20, 1993 to December 8, 1993) (on file with author).
84. See, e.g., MASSACHUSETTS FED. R. CT. 26.1(c) (limiting depositions to ten per party); IDAHO R. CT. 30.1 (creating ten-deposition presumption).
85. See Phillips & Miller, supra note 6, at 1014.
86. See In re Bay Financial Sec. Litig., Order Denying Motion to Dismiss [on file with author].
88. See Glassman v. Computervision Corp., 90 F.3d 617, 628 (1st Cir. 1996) (reporting judges were “mindful that the case comes to us after over three years of litigation and full discovery”).
89. See Langevoort Testimony, supra note 6, at 120 (noting that discovery costs create pressure
attorneys were able to make profits on cases where no fraud was present.90

Second, those pressing for reform argued that start-up companies, primarily emerging high-technology companies, were hardest hit by strike suits.91 These companies, reformers contended, were sued at a higher rate than other companies, not because they were actually committing fraud, but because they were risky enterprises subject to fluctuations in sales and revenues and, therefore, volatile stock prices.92 As a result, according to their advocates, companies were often sued for what was actually a downturn in the economy. And again, given the wide-ranging and expensive discovery allowed, those same advocates argued that companies were forced to settle meritless cases.93

The courts also expressed frustration with the system and urged reform. For example, in 1993, the Second Circuit opined that given the complex nature of these cases, the "judicial system [was] not well suited to the formulation of a universal resolution of the tensions" between the competing interests of deterring fraud and the use of securities litigation to extract on defendants to settle, often prematurely; 141 CONG. REC. S12,201-02, S12,205 (daily ed. Aug. 10, 1995) (statement of Mr. Domenici) (calling current discovery rules "legalized extortion"); see also 141 CONG. REC. S17,933-04, S17,955 (daily ed. Dec. 5, 1995); see also Frank H. Easterbrook, Discovery as Abuse, 69 B.U. L. REV. 635, 636-37 (1989) (commenting on discovery abuse and its impact on settlement).

90. See Phillips & Miller, supra note 6, at 1014 (stating that plaintiffs' counsels were able to achieve settlements which compensated them "handsomely," irrespective of merit in underlying claims).

91. See id. at 1012-13; see also Joseph A. Grundfest and Michael A. Perino, Securities Litigation Reform: First Year's Experience, in PRACTICING LAW INSTITUTE, SECURITIES REGULATION 1997, at 955 (1997) (noting that high technology companies were "among the most vocal proponents" of reform and were involved in a disproportionate number of pre-Reform Act suits); Securities Litigation: Hearings on the Impact of Central Bank of Denver v. First Interstate Bank of Denver on Securities Law Enforcement and Litig. Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 103d Cong. 66 (1994) (statement of Stuart J. Kaswell, senior vice president and general counsel, Securities Industries Association) (noting that young, high-tech firms are most common targets of securities-fraud litigation) [hereinafter Kaswell Testimony]; 141 CONG. REC. S17,965-03, S17,971 (daily ed. Dec. 5, 1995) (claiming that 53% of firms in Silicon Valley had been named as defendants in securities suits); see id. at S17,972 (citing American Electric Association's claim that every one of top ten Silicon Valley companies had been sued for fraud).

92. See Phillips & Miller, supra note 6, at 1013; see also Grundfest II, supra note 73, at 735; Smith Testimony, supra note 22, at 220; 141 CONG. REC. S12,201-02, S12,205 (daily ed. Aug. 10, 1995) (quoting Ed McCracken, The New Threat to High-Tech Firms, SAN FRANCISCO CHRONICLE, June 28, 1995 (arguing research and development risks make stock prices of high-technology firms especially volatile); see id. at S12,206 (quoting Robert G. Gilbertson, Yes: Bill Would Protect Growing Companies, HARTFORD COURANT, July 13, 1995 (arguing sharp revenue and earnings jumps are the cause of volatility in high-technology stocks); 141 CONG. REC. S17,965-03, S17,971 (daily ed. Dec. 5, 1995) (Exhibit 2, letter from the American Electric Association) (stating that rapid product development results in stock volatility).

93. See Phillips & Miller, supra note 6, at 1014-15; see also Langevoort Testimony, supra note 6, at 120; Easterbrook, supra note 90.
unwarranted settlements.94 The court further noted that

[In the absence of a more refined statutory standard than the vague contours of section 10(b) or a more detailed attempt at rulemaking than the SEC has managed in Rule 10b-5, despite 50 years of unavailed opportunity, courts must adjudicate the precise cases before them, striking the balance as best they can.95

According to the court, the lack of reform had serious consequences, including that any standard applied would produce inconsistent outcomes, which would, in turn, create uncertainty in both the securities industry and litigation.96 The court further noted that regardless of its attempt carefully to delineate between real and frivolous claims of fraud, any dismissal of an Exchange Act Claim would create the "opportunity for unremedied fraud," and any ruling permitting such a claim to proceed would create an "opportunity to extract an undeserved settlement."97 As "unattractive as these prospects [were]," it concluded, neither provided a "sound basis" for, nor permitted "avoidance of, decision."98

Congress became convinced that these perceived frivolous lawsuits were discrediting the integrity of the market and the enforcement system and, therefore, that the class-action mechanism was in need of repair.99 Accordingly, it began to consider proposals for reform.100 In early 1995, the reform effort became part of Congress's Contract With America and focused on the "Common Sense Legal Reforms Act of 1995" in the House101 and a

95. Id. at 263-64.
96. See id. at 264.
97. Id. at 264.
98. Id.; see also Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 189 (1994) (stating that "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general").
100. See id.; see also Phillips & Miller, supra note 6, at 1013. The first legislation to gain support was filed in 1990 by Representative Wyden (D-Or.). See Phillips & Miller, supra note 6, at 1062 n.31; see also H.R. 417, 103d Cong., 1st Sess. (1993) (legislation filed by Representative Tunziz (D-La.). It was quickly followed by a proposal from Senator Dodd (D-Conn.). See S. 1976, 103d Cong., 2d Sess. (1994). These bills were "relatively moderate," focusing primarily on providing relief for defendants "only peripherally involved in alleged frauds" and preserving the class-action "device for injured investors." Barbara Moses, Securities Litigation Reformed?, 29 REV. SEC. & COMMODITIES REG., 37, 38 (1996). Both bills died in committee. See id.
proposal\textsuperscript{102} of Senator Dodd and his co-sponsor, Senator Domenici, in the Senate.\textsuperscript{103}

In addition to many other reforms, the Senate bill contained language modeled on the scienter pleading standard used by the Second Circuit and designed to force plaintiffs in all circuits to research their complaints carefully before filing and, thereby, increase the transaction costs of filing such suits. The language provided that, in order to survive a motion to dismiss, a complaint alleging fraud under the Exchange Act had to establish a strong inference of scienter by (1) alleging facts sufficient to show that the defendant had both the motive and the opportunity to commit fraud, or (2) alleging facts that constituted strong circumstantial evidence of conscious misbehavior or recklessness by the defendant.\textsuperscript{104} Thus, the initial Senate reform effectively defined the level of pleading required for scienter allegations, and therefore, Exchange Act Claims, to survive a motion to dismiss.

Both the House and the Senate voted to pass the bills and, in November 1995, the conferees met to reconcile their differences.\textsuperscript{105} The Conference Committee agreed upon a final form of the bill, based primarily upon the Senate version, and prepared a Conference Committee Report (the "Conference Report"), which was accompanied by an explanation titled the Joint Explanatory Statement of the Committee of Conference—Statement of Managers—"Private Securities Litigation Reform Act of 1995" (the "Joint Statement").\textsuperscript{106} The Conference Report deleted the above-described language defining the required state of mind to be pleaded for scienter. Instead, section 21D of the Conference Report amends the Exchange Act as follows:

(b) REQUIREMENTS FOR SECURITIES FRAUD ACTIONS.—
(1) MISLEADING STATEMENTS AND OMISSIONS.—In any private action arising under this title in which the plaintiff alleges that the defendant—
(A) made an untrue statement of a material fact; or
(B) omitted to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading;
the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading,

\textsuperscript{103} See Ayres I, supra note 6, at 350. After hearings and amendments, both bills were reported out of committee and sent to the floor for debate and votes. See id.
\textsuperscript{105} See id.
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.

(2) REQUIRED STATE OF MIND.—In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

(3) MOTION TO DISMISS; STAY OF DISCOVERY.—
(A) DISMISSAL FOR FAILURE TO MEET PLEADING REQUIREMENTS.—
In any private action arising under this title, the court shall, on the motion of any defendant, dismiss the complaint if the requirements of paragraphs (1) and (2) are not met.

(B) STAY OF DISCOVERY.—In any private action arising under this title, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.\(^\text{107}\)

Despite its heading, section 21D(b)(2) does not actually define the mental state required for scienter or even the level of pleading necessary to survive a motion to dismiss; it provides only that the courts should apply a heightened pleading standard to complaints brought pursuant to the Exchange Act. Moreover, section 21D(b)(3) eliminates the discovery previously available to plaintiffs.


(C) PRESERVATION OF EVIDENCE.

(i) IN GENERAL.—During the pendency of any stay of discovery pursuant to this paragraph, unless otherwise ordered by the court, any party to the action with actual notice of the allegations contained in the complaint shall treat all documents, data compilations (including electronically recorded or stored data), and tangible objects that are in the custody or control of such person and that are relevant to the allegations, as if they were the subject of a continuing request for production of documents from an opposing party under the Federal Rules of Civil Procedure.

(ii) SANCTION FOR WILFUL VIOLATION.—A party aggrieved by the willful failure of an opposing party to comply with clause (i) may apply to the court for an order awarding appropriate sanctions.

\textit{Id.} For similar stay-of-discovery provisions adopted for Securities Act matters, see 109 Stat. at 749.
The Joint Statement discussion regarding these changes has created uncertainty among the courts sufficient to signal the beginning of what is likely to be a circuit split as to the meaning of the reforms.\textsuperscript{108} The Joint Statement first says that the Conference Committee based the language on the Second Circuit’s pleading standard and that the changes were written specifically to conform to Rule 9(b)’s notion of pleading with “particularity.”\textsuperscript{109} The Joint Statement then notes that the Second Circuit standard requires plaintiffs to state facts with particularity which give “rise to a ‘strong inference’ of the defendant’s fraudulent intent.”\textsuperscript{110} Immediately thereafter, the following language appears: “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{111} This sentence is followed by a footnote (“Footnote 23”) which states that: “For this reason, the Conference Report chose [sic] not to include in the pleading standard certain language relating to motive, opportunity, or recklessness.”\textsuperscript{112} Thus, the Joint Statement indicates that the Conference Committee did not define the relevant state of mind and, arguably, encourages courts to define the level of pleading for scienter more rigorously than the Second Circuit had prior to the adoption of the Reform Act.\textsuperscript{113}

Both the Senate\textsuperscript{114} and the House\textsuperscript{115} adopted the bill by significant

\textsuperscript{108} See infra notes 246-48 and accompanying text.


\textsuperscript{110} Id.

\textsuperscript{111} Id.

\textsuperscript{112} Id. at 747 n.23.

\textsuperscript{113} See In re Glenayre Tech. Inc. Sec. Litig., 982 F. Supp. 294 (S.D.N.Y. 1997) (noting statute did not change substantive law of scienter but did increase level of specificity required in pleading that state of mind).

Much confusion existed as to the effect of the amended language. Many members of Congress believed that the new pleading requirement was more strenuous than the Second Circuit’s. See, e.g., 141 CONG. REC. S17,933-04, S17,960-61 (daily ed. Dec. 5, 1995) (statement of Mr. Specter) (criticizing proposed pleading standard as impossible to meet); 141 CONG. REC. S17,965-03, S17,080 (daily ed. Dec. 5, 1995) (statement of Mr. Heflin) (noting that most courts rejected Second Circuit’s approach and that proposed reforms raised even that requirement); see id. at S17,984 (statement of Ms. Mosley-Braun) (calling new pleading standard significantly higher than Second Circuit’s); 141 CONG. REC. H14,039-02, H14,041 (daily ed. Dec. 6, 1995) (statement of Mr. Dingell) (referring to adopted standard as “highly burdensome” and bemoaning deletion of Specter amendment).

Other members of Congress, however, took the position that the Reform Act adopted the Second Circuit’s pleading standard. See, e.g., 141 CONG. REC. S17,933-04, S17,960-61 (daily ed. Dec. 5, 1995) (statement of Mr. Dodd) (saying “the legislation adopts the Second Circuit’s pleading standard”); 141 CONG. REC. S17,965-03, S17,966 (daily ed. Dec. 5, 1995) (statement of Mr. Hatch) (stating that “conference report adopts the pleading standard utilized by the Second Circuit”); see Lerach & Isaacs, supra note 33, at 913 (arguing that Congress did not intend to adopt a scienter standard more stringent than Second Circuit’s).

\textsuperscript{114} See 141 CONG. REC. S17,933-04, S17,997 (daily ed. Dec. 5, 1995) (voting 65 to 30 for
margins. Shortly thereafter, President Clinton vetoed it.\footnote{116} In the message accompanying his veto (the “Veto Message”), the President stated that although he supported the effort “to end frivolous lawsuits,” he was not “willing to sign legislation that w[ould] have the effect of closing the courthouse door on investors who have legitimate claims.”\footnote{117} He further indicated his belief that the Reform Act “could well prevent” victims of fraud from having recourse to the courts.\footnote{118}

The President specifically objected to the heightened pleading standard. He indicated that the Conferees’ intent to raise the pleading standard beyond that defined by the Second Circuit was unacceptable,\footnote{119} because it would “erect a higher barrier to bringing suit than any now existing—one so high that even the most aggrieved investors with the most painful losses may get tossed out of court before they have a chance to prove their case.”\footnote{120} Thus, President Clinton indicated his concern that Congress, in its attempt to prevent meritless suits, may have created legislation that was over-inclusive and would too often allow actual fraud to go unremedied. Congress, however, overrode President Clinton’s veto,\footnote{121} and the Reform Act became law.\footnote{122} Under the new pleading standard, plaintiffs in all circuits must now plead the circumstances surrounding the alleged fraud with particularity. In short, the Reform Act requires courts to dismiss any complaints which do not:

(1) specify each statement or omission alleged to be misleading

\footnote{115} See 141 CONG. REC. H14,039-02, H14,055 (daily ed. Dec. 6, 1995) (voting 320 to 102 for passage).


\footnote{117} Id.

\footnote{118} See id.

\footnote{119} See 141 CONG. REC. H15,215 (daily ed. Dec. 20, 1995). The President also objected to aspects of two other provisions of the Conference Committee Report that are not discussed at length in this Article. Those provisions are: the extent of the availability of a “safe harbor” for certain forward-looking statements accompanied by cautionary statements, and the disparate treatment of plaintiffs and defendants in the provisions of the Reform Act awarding sanctions. See id.

\footnote{120} Id.

\footnote{121} See 141 CONG. REC. H15,224 (Dec. 20, 1995); 141 CONG. REC. S19,180 (Dec. 22, 1995).

(presumably the who, what, where, and when elements);
(2) specify the reasons why the alleged misstatement or omission was misleading (the why element);
(3) if the allegation is based upon information and belief, specify the facts upon which the belief is formed (also the why element); and
(4) where scienter is an element of the offense, state with particularity all facts giving rise to a "strong inference that the defendant acted with the required state of mind" (the how element).123

These changes essentially raise the transaction cost for filing suits, and, thereby, attempt to restore the balance of power between plaintiffs and defendants. To see how this pleading standard will work in practice, it is helpful to consider it in the context of the preexisting common law.124

IV. THE REFORM ACT'S PLEADING STANDARD VIEWED IN LIGHT OF THE COMMON LAW PRECEDING IT

By requiring plaintiffs to plead with particularity all elements of their claims, including specifically "the reason or reasons why an alleged misstatement was misleading when made" and "facts giving rise to a strong inference that the defendants acted with scienter,"125 the Reform Act adopts both the Ninth and Second Circuit tests—or more simply, requires plaintiffs to plead with specificity the how and why of the alleged fraud.126 Further, given Footnote 23, the Reform Act arguably urges courts to increase the Second Circuit's standard for the how factor.127

123. 1934 Act § 21D(b)(1)-(2).
124. The above-described pleading standard applies to most types of allegedly misleading statements. The Reform Act does, however, contain a "safe harbor" for certain types of so-called forward-looking statements, including plans for future operations, anticipated economic performance, and projections. The plaintiff must prove, and therefore plead, that those statements were made with actual knowledge of their falsity. See Reform Act § 21B(c)(1)(B). One court addressed this issue in a post-Reform Act case and noted that recklessness may not suffice in pleading such cases. See Hockey v. Medhekar, No. C-96-0815 (MHP), 1997 WL 203704, at *10 (N.D. Cal. Apr. 15, 1997).
125. See supra notes 39-71 and accompanying text.
126. See Lerach and Isaacson, supra note 33, at 912.
127. See, e.g., infra note 176 and accompanying text. The Reform Act standard is similar to the one applied in the First Circuit. See Seabian v. Amoskeag Bank Shares, Inc., 24 F.3d 357, 365, n.10, 367 & n.16 (1st Cir. 1994) (reversing dismissal of certain claims where plaintiff had pointed to internal documents which contradicted contemporaneous public statements—the why element—and alleged that some defendants who actually received reports were informed of accounting information underlying alleged fraud—the how element); see also Maldonado v. Dominguez, 137 F.3d 1, 9-10 nn.5-6 (1st Cir. 1998) (noting that Reform Act did not apply to case, but that Congress intended to increase pleading standard above pre-Reform Act, Second Circuit level, and that change in First Circuit's pre-Reform Act standard was unnecessary because it already exceeded the Second Circuit's); In re Boston Tech. Sec. Litig. [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,174, at 90,572 (D. Mass. 1998) (noting that to satisfy scienter elements, plaintiffs generally identify "internal reports,
This new pleading standard, Congress stated, would help to eliminate strike suits. Certainly, it will at least do that.128 The question, however, is whether, when combined with the stay-of-discovery provision, the Reform Act will also eliminate those suits that have merit, but which, without the discovery necessary to satisfy the pleading standard, cannot be pleaded with the requisite particularity.

As Section II of this article detailed, the common-law standard preceding the Reform Act sets forth a level of pleading specificity that usually required plaintiffs to base their pleadings on internal company information.129 And, as previously noted, throughout the development of that standard, plaintiffs had access to such internal information—through the discovery provisions of the Federal Rules of Civil Procedure.130 Thus, plaintiffs who did not have the requisite internal company information at the time they filed a complaint could revise and replead their allegations. The plaintiffs amended their complaints while the discovery process progressed, resulting in several amended and consolidated complaints and concomitant motions to dismiss.131 For example, in the GlenFed case, the plaintiffs amended their pleadings to juxtapose a publicly-filed company report and externally-made company statements with what company officers said at a board meeting and in internal audit documents.132 Without discovery, as in the post-Reform Act context,133 plaintiffs usually do not have access to board meeting notes or audit documents—the very type of information the GlenFed court held was necessary to withstand the motion to dismiss.134 Yet, in attempting to define

memoranda1" and allege both contents and defendants possession of those documents at relevant time).

128. See Miller Testimony, supra note 6, at 162 (arguing Reform Act would chill filing of class-action securities claims—even those which had merit); Securities Litigation, 1994: Hearings on H.R. 417 Before the Subcomm. on Telecomm. and Fin. of the House Comm. on Energy and Commerce, 103d Cong. 118, 242 (1994) (Testimony of Mark J. Griffin) (hereinafter Griffin Testimony) (stating that proposed legislation would limit rights of investors to recover for fraud); Simon Testimony supra note 22, at 285 (stating that proposed reforms would “virtually end securities class-actions by defrauded investors” and “substantially weaken deterrence against fraud”); cf. Seligman, supra note 73, at 446-47 (noting that application of Rule 9(b) standard to cases results in dismissal of meritorious cases).

129. See supra notes 35-71 and accompanying text.

130. See supra notes 79-86 and accompanying text.

131. See, e.g., Serablan v. Amoskeag Bank Shares, 24 F.3d 357 (1st Cir. 1994) (reviewing Third Amended Complaint); see also Phillips & Miller, supra note 6, at 1014.

132. See supra notes 34-50 and accompanying text.

133. See infra notes 238-45 and accompanying text.

134. See supra notes 40-51 and accompanying text. Although the court denied the motion to dismiss certain allegations, it indicated those allegations might well have been deficient in other respects. See Phillips & Miller, supra note 6, at 1550; cf. Glassman v. Computervision Corp., 90 F.3d. 617 (1st Cir. 1996) (affirming the lower court’s dismissal of the plaintiff’s complaint, based in part on fact that discovery was complete and the next stage would be summary judgment).
the Reform Act’s pleading standard, courts are looking to the case law preexisting the Act.\textsuperscript{135} The case law applied a standard that implicitly required pleadings based on internal information. When combined and strictly applied, therefore, the Reform Act’s two provisions are likely to result in the almost certain dismissal of complaints—regardless of whether the fraud allegations have merit.\textsuperscript{136}

Further, allegations based on publicly-available, insider-trading information, which withstood a Rule 9(b) motion to dismiss in the Second Circuit prior to the Reform Act,\textsuperscript{137} are arguably insufficient after the Act. At most, such allegations meet only the scienter provision, the \textit{how} element of the Reform Act, not the requirement that plaintiffs plead with specificity the

\textsuperscript{135} See, e.g., infra notes 145-61 and accompanying text; see also Weiss, supra note 49 (arguing the Joint Statement language creates confusion over the appropriate interpretation of pleading standard).

\textsuperscript{136} One article suggests that plaintiffs might use corporate inspection statutes to gain access to the discovery necessary to meet the Reform Act’s pleading standards. See Randall S. Thomas & Kenneth J. Martin, \textit{Using State Inspection Statutes for Discovery in Federal Securities Fraud Actions}, 77 B.U. L. REV. 69 (1997). Although this idea has some merit, it is problematic for several reasons. First, the empirical evidence in the article indicates that plaintiffs are not always successful in gaining access to such information. See id. at 73 (reporting shareholders gain access to books and records in only slightly more than two-thirds of inspection cases). Further, according to the article, plaintiffs are more likely to gain access to information such as stocklists, which are beneficial in shareholder proxy fights, than to obtain the right to inspect books, board meeting minutes, or the other information necessary to plead securities fraud claims with particularly. See id. (noting that plaintiffs obtain stocklists in 78\% of stocklist cases, but non-stocklist cases are successful only two-thirds of time).

Second, plaintiffs who attempt to use such inspection statutes for books and records experience delays of up to nine months. See id. Thus, what are effectively one-year statutes of limitation for most securities fraud matters would pose a serious barrier for plaintiffs who attempt to obtain information through inspection statutes. See Law v. Medco Research, Inc., 113 F.3d 781, 785-86 (7th Cir. 1997) (noting that statute of limitations for 1933 Act cases is one year and that this same limitation period applies to 1934 Act cases with three-year statutes of repose); Fujisawa Pharm. Co., Ltd. v. Kapoor, 115 F.3d 1332, 1334 (7th Cir. 1997) (holding one-year statute of limitations for Exchange Act case is triggered when plaintiff learns or should have learned “through the exercise of ordinary diligence” facts to warrant further investigation into fraud); Lampf, Pleva, Lipkind, Prupis & Petrigow v. Gilbertson, 501 U.S. 350 (1991) (holding that equitable tolling does not apply to statute of limitations in securities fraud suits).

Third, in order to obtain such books and records, plaintiffs must articulate a “proper purpose.” Although at least so far the Delaware courts have not applied the proper-purpose test with the same particularity as Rule 9(b), they have held that a plaintiff must do more than raise a “speculative” possibility of corporate mismanagement to obtain books and records. See, e.g., Security First Corp. v. United States Die Casting & Dev. Co., 687 A.2d 563, 568 (Del. 1997). Thus, plaintiffs must provide some evidence of the alleged mismanagement to justify further investigation. See id. If expanded, this criteria could prohibit plaintiffs who have no evidence of fraud—or precisely those plaintiffs who need the discovery—from obtaining it.

Finally, although plaintiffs have used the inspection statutes to gain access to corporate books and records, history shows that when plaintiffs attempt to expand corporate causes of action in Delaware, where many corporations are chartered, the Delaware courts tend to shut down such mechanisms. See NELL MINOW & ROBERT MONKS, \textit{CORPORATE GOVERNANCE} 35 (1995) (discussing influence of corporations headquartered in Delaware on state’s judicial branch). Thus, any effective use of such statutes is likely to be short-lived.

\textsuperscript{137} See supra notes 58-60 and accompanying text.
falsity of the alleged misstatement, the why element. As defined by the Ninth Circuit, this element requires the pleading of contemporaneous facts, conditions, or statements to show that an alleged misstatement was false or misleading when made. Again, plaintiffs usually meet this standard by referring to internal company information.\textsuperscript{138}

As a consequence, the Reform Act is likely to allow only the more flagrant and obvious cases of securities fraud to proceed past a motion to dismiss, while being overinclusive in its elimination of cases where it is more difficult to identify, and therefore to plead, fraud.\textsuperscript{139} Presumably, the SEC, with its limited resources, pursues the flagrant and obvious cases of securities fraud.\textsuperscript{140} Arguably, however, the more difficult to identify frauds are precisely the ones that the plaintiffs, who function as private attorneys general, pursue.\textsuperscript{141} Indeed, the Commissioner of the SEC has stressed that private mechanisms are important to the enforcement of the Acts.\textsuperscript{142} Because the plaintiffs lack access to the information the Reform Act requires them to plead at the motion-to-dismiss stage, however, the strict application of the heightened-pleading standard in combination with the stay-of-discovery provision is likely to result in unredressed fraud.

Indeed, an analysis of decisions applying section 21D(b) reveals that this conclusion is correct. As previously discussed, the language in section 21D(b)(2) left room for alternative views of what pleading standard Congress favored for scienter or the how element.\textsuperscript{143} As a result, some of the post-Reform Act opinions have found that Congress intended to adopt the Second Circuit's standard while others have found that it intended to strengthen that standard. What these decisions make clear is that the choice of a pleading

\textsuperscript{138} See supra notes 40-51 and accompanying text.

\textsuperscript{139} See Lynn A. Stout, Type I Error, Type II Error, and the Private Securities Litigation Reform Act, 38 Ariz. L. Rev. 711, 712 (1996) (noting that impact of section 21D(b)(2) combined with stay-of-discovery provisions may be to increase number of unremedied instances of fraud); Weiss, supra note 49, at 707.

\textsuperscript{140} See, e.g., SEC v. Crow, No. 96-1661 SCM, 1996 WL 635379 (S.E.C.) (S.D. Cal. Nov. 1, 1996) (where officer sold 75,000 shares of stock in company before bad earnings announcement and, thereby, avoided $1.2 million in losses, SEC filed complaint against former CEO and president alleging he caused company to overstate earnings and file false financial report).

\textsuperscript{141} See Stout, supra note 139, at 712; see also Griffin Testimony, supra note 129, at 241 (quoting SEC Chair Levitt's statement that private, class-action suits are "essential to the effective operation of the federal securities laws"); 141 CONG. REC. S17,933-04, S17,955 (daily ed. Dec. 5, 1995) (statement of Mr. Dodd) (saying private securities litigation plays "vital" enforcement role); 141 CONG. REC. S12,201-02, S12,204 (daily ed. Aug. 19, 1995) (quoting J. Carter Beene, Stop Choking Wall Street, N.Y. TIMES, June 27, 1995) (stating that former commissioner of SEC stresses importance of strict enforcement of securities laws).

\textsuperscript{142} See Attitude Shift, supra note 72, at 937 (noting SEC views legitimate shareholder suits as "important adjunct to [its] enforcement program").

\textsuperscript{143} See supra notes 110-14 and accompanying text.
standard is likely to be outcome determinative; adopting the Second Circuit's standard increases the likelihood that a complaint will survive a motion to dismiss, but strengthening that standard will usually result in dismissal.

A. Cases Applying the Second Circuit's Standard

Some courts have applied the Second Circuit's approach, without any analysis or explanation of why they chose it. Others, however, have reviewed the language of section 21D(b)(2) and the Joint Statement and concluded that Congress intended to adopt the Second Circuit's pre-Reform Act pleading standard. Two of these opinions contain discussions which help to illuminate both how the courts determined the standard to apply and what they considered in applying it.

1. Marksman v. Chantal Pharmaceuticals

In *Marksman v. Chantal Pharmaceuticals*, a district court in the Ninth Circuit rejected the defendant's argument that Congress intended to adopt a more rigorous measure for pleading scienter than the Second Circuit's and had, therefore, necessarily eliminated the "motive-and-opportunity" test. The *Marksman* court stated that although the Joint Statement included

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147. Id. at 1309-11. The court also rejected the defendants' argument that the Reform Act abolished liability for reckless conduct. See id. at 1309 n.9.
language which might be interpreted to support the defendants' contention, the following factors were more persuasive:

(1) the Conference Committee's emphasis on the stringency of the Second Circuit's standard implied that its jurisprudence most closely approximated the Reform Act's pleading requirements; 148
(2) the motive-and-opportunity test is quite stringent, 149 and
(3) Footnote 23 of the Joint Statement (which contained the language stating that Congress intended to adopt a standard more stringent that the Second Circuit's) was an insufficient basis on which to "jettison" the motive-and-opportunity test. 150

The court further reasoned that because the Committee chose to "imbed" Footnote 23 in the legislative history, it could also have chosen to express explicit disapproval for the motive-and-opportunity test. 151 Finally, the Marksman court found that the motive-and-opportunity test is consistent with Congress's stated purpose—making such cases more difficult to plead 152—because the test is an "exacting" one, which requires that the allegations "yield a 'strong' inference of fraudulent intent." 153 The court did not, however, explain how using a pre-Reform Act standard would fulfill what it found was Congress's intent, making such cases more difficult to plead.

Adopting the Second Circuit's motive-and-opportunity test, however, allowed the court to avoid dismissing a complaint containing serious allegations concerning insider trading. Analyzing the complaint, the court first rejected allegations based on "generic" motives applicable to any CEO (including a motive to enhance the value of her stock holdings, to complete a private placement of stock, and to protect her position). 154 The court did, however, find persuasive the plaintiffs' allegation that the CEO had sold $6.3 million worth of stock, representing twenty percent of her total holdings, before adverse information about the company became public. 155 Furthermore, the court found that these trades were inconsistent with the CEO's stock-trading patterns, because she had sold no stock during the prior three years. 156 These insider sales, the court concluded, met the plaintiffs'
burden for pleading the requisite scienter under the Reform Act.\(^\text{157}\) The court next found that the complaint met the Second Circuit's recklessness standard.\(^\text{158}\) First, the plaintiffs' allegation that Marksman had violated Generally Accepted Accounting Principles ("GAAP") by inappropriately counting consignment sales as revenue was insufficient by itself to support an inference of recklessness.\(^\text{159}\) The court found, however, that the GAAP allegations combined with allegations about the CEO's stock sales, the timing of a recent private-placement offering, and overstated revenues met the Second Circuit's and thus the Reform Act's pleading standard.\(^\text{160}\)

2. Rehm v. Eagle Finance Corp.

In another post-Reform Act case, Rehm v. Eagle Finance Corp.,\(^\text{161}\) a district court in the Seventh Circuit found that, although Congress "specifically declined to make the Second Circuit's case law an explicit part of the statute,"\(^\text{162}\) the Second Circuit's standard was consistent with the language and purpose of the Reform Act.\(^\text{163}\) Accordingly, the court found that the plaintiffs could plead the requisite level of scienter if they could meet either the motive-and-opportunity or the recklessness test.\(^\text{164}\) The court,

\(^{157}\) See id.; see also Zuckerman v. Foxmeyer Health Corp., 4 F. Supp. 2d 618 (N.D. Tex. 1998) (finding stock trades sufficient to support scienter element, where one insider sold $10.7 million in stock days before company filed for bankruptcy, and another bought shares whenever company was discussing sale of subsidiaries); Bryant v. Apple South, Inc. [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,275, at 90,251 (M.D. Ga. July 29, 1998) (finding scienter allegations sufficient where plaintiffs described nature of internal forecasting reports and timeframe of publication, and noting that defendants had "dumped" large percentage of personal stock holdings within weeks of negative announcement); Partners, L.P. v. Sensormatic Elecs. Corp., No. 96-C-4072, 1997 WL 570771, at *17 (N.D. Ill. Sept. 16, 1997) (finding plaintiffs' allegations of insider trades met Second Circuit's motive-and-opportunity test for scienter, but dismissing complaint for failure to plead other circumstances of alleged fraud with particularity).

\(^{158}\) See Marksman, 927 F. Supp. at 1313-15. This portion of the opinion is less clear than the stock-sale analysis, in part because the court refers to the stock sales as part of its finding that the plaintiff had successfully pleaded recklessness. See id. at 1314, 1314-15 n.13.

\(^{159}\) See id. at 1313.

\(^{160}\) See id. at 1313-14; see also Friedberg v. Discreet Logic, 959 F. Supp. 42, 50-51 (D. Mass. 1997) (finding that knowledge about product line combined with significant personal profits from allotment sales was sufficient to meet conscious misbehavior standard).

\(^{161}\) 954 F. Supp. 1246 (N.D. Ill. 1997).

\(^{162}\) Id. at 1251.

\(^{163}\) See id. at 1252. The Rehm court supported its conclusion with three factors: (1) the Conference Committee's "strong inference" language "mirrors" the Second Circuit language for Rule 9(b) cases; (2) the Joint Statement indicated that Congress explicitly based this language on the Second Circuit's approach; and (3) the Second Circuit's standard balances the Reform Act's conflicting goals—curtailing abusive litigation and protecting aggrieved plaintiffs. See id. The Rehm court stated that it was not bound by the Second Circuit's interpretation of its standard, but that the Second Circuit's standard was the appropriate one to apply. See id.

\(^{164}\) See id. Like the Marksman court, the Rehm court rejected general allegations about the
however, rejected the plaintiffs’ stock trade allegations. Instead, the court found that two of the defendants had not sold stock during the class period, thus belying the presumption that their inside knowledge of impending bad times had triggered such sales. The court also found that the third defendant’s sales were small in magnitude and not unusual in timing.\textsuperscript{165}

In applying the recklessness test to the complaint, the \textit{Rehm} court, like the \textit{Marksman} court, found that GAAP allegations, without additional allegations of facts tending to show the defendants’ knowledge of, or reckless disregard for, those accounting deviations, were insufficient.\textsuperscript{166} The court then considered the magnitude of the alleged violations in combination with several other factors,\textsuperscript{167} including allegations that the defendants “were responsible for calculating and releasing the [allegedly incorrect] information”,\textsuperscript{168} that the GAAP violations concerned credit-loss reserves, the “‘defining characteristic’ of the [defendants’] loan servicing business”;\textsuperscript{169} and that the defendants issued positive business statements allegedly designed to “mollify public doubt” about the company’s business.\textsuperscript{170} The court found these allegations supported the scien
ter element, opining that it did not want to raise the pleading standard so high that it would “preclude valid securities fraud claims.”\textsuperscript{171}

Both decisions highlight the tension discussed throughout this article: balancing what may be abusive securities fraud litigation with the important service plaintiffs provide as private attorneys general. Finding the appropriate mechanism to separate the frivolous cases from those that might have merit is a difficult task to achieve through pleading standards alone.\textsuperscript{172}

\footnotesize{defendants’ motives and looked primarily to the timing and amount of stock sales. \textit{See id.} at 1253-54.  
\textsuperscript{165} \textit{See id.} The court rejected the idea that because it was the defendant’s only stock sale, it should be viewed as unusual. Instead, the court found that only sixteen months had elapsed since the stock was issued, and it focused on the small percentage (6%) of the defendant’s total holdings that were sold. \textit{See id.}  
\textsuperscript{166} \textit{See id.}  
\textsuperscript{167} \textit{See id.}  
\textsuperscript{168} \textit{Id.}  
\textsuperscript{169} \textit{Id.} at 1256.  
\textsuperscript{170} \textit{Id.} The court specifically found that the defendants publicly announced contrary indications regarding the soundness of the company’s accounting practices. The company first declared it had made the appropriate adjustments to its loss reserves to solve the accounting problems. Less than two weeks after making this statement, however, the defendants announced that the company’s accounting system was severely deficient. \textit{See id.}  
\textsuperscript{171} \textit{Id.} at 1257; \textit{see also} Fugman v. Aprogenex, Inc., 961 F. Supp. 1190 (N.D. Ill. 1997) (citing \textit{Rehm} and adopting Second Circuit standard before denying motion to dismiss claim based on non-forward-looking
statements).  
\textsuperscript{172} \textit{See Stout, supra} note 140, at 719 (suggesting that changing pleading standard is not most efficacious way to address strike-suit problem); \textit{Sec. Fraud Litig.: Concerning Litig. Under the Fed. Sec. Laws Before the Subcomm. on Telecomm. and Fin. Comm. on Energy and Commerce,} 103d Cong.}
B. Rejecting the Second Circuit's Standard

Three opinions from courts within the Ninth Circuit found that the Reform Act heightened the pleading standard for scienter and then applied that new standard to the complaints before them. These opinions reveal the new standard, when strictly applied, is difficult to meet and therefore outcome determinative.173

1. In re Silicon Graphics, Inc. Securities Litigation ("Silicon I")

The first opinion under the Reform Act finding that Congress raised the pleading hurdle was In re Silicon Graphics, Inc. Securities Litigation ("Silicon I").174 At the beginning of its analysis of the Reform Act, the Silicon I court specifically noted that prior to the Reform Act, plaintiffs in the Ninth Circuit were required to plead with particularity why the alleged misstatements or omissions were false or misleading, but were allowed to plead the scienter element of their case generally.175 The court then found that Congress intended to adopt a more stringent pleading standard for the scienter element; Footnote 23 indicates that Congress did not "simply codify" the Second Circuit standard.176 Instead, according to the court, Congress's language in the Joint Statement, its rejection of language which would have codified the Second Circuit's criteria,177 and its implicit rejection of the President's Veto Message (which stated that Congress was adopting a more strict standard)178 revealed an intent to raise the required level of pleading.179 Indeed, the court explicitly rejected Marksman.180 Instead, the court found that adopting a more rigorous standard than the Second Circuit's would better reflect Congress's intent to protect markets and investors by

127, 130 (testimony of Janet Cooper Alexander, Professor of Law, Stanford Law School) [hereinafter Alexander Testimony] (stating that proposed pleading reform risks eliminating good and bad claims); Levitt Testimony, supra note 25, at 38 (warning strict requirements may preclude meritorious cases because plaintiffs are denied access to inside information). But see Weiss, supra note 49, at 678 (noting that any pleading standard creates trade-off between discouraging strike suits and rectifying fraud, and concluding that no standard can strike perfect balance).


175. See id. at *5.

176. See id.

177. See supra notes 110-14 and accompanying text.

178. See supra notes 117-23 and accompanying text.


180. See id. at *6 n.4.
discouraging frivolous and abusive securities litigation. Accordingly, the court found that post-Reform Act plaintiffs "must allege specific facts that constitute circumstantial evidence of conscious behavior by defendants." This standard amounts to a requirement that plaintiffs must plead evidence of subjective intent with specificity.

The Silicon I court's finding that the Reform Act required it to apply a new, stricter standard was key to its dismissal of the plaintiffs' allegations. The plaintiffs had met the Ninth Circuit's preexisting requirements by indicating the who, what, where, when, and why elements of the alleged fraud, but the court found that the plaintiffs failed to allege scienter with sufficient particularity. In reaching this conclusion, the court applied Second Circuit law, reasoning that "[h]aving found that the pleading standard under the [Reform Act] was at least as strict as the Second Circuit's, [it could not] require anything less" of the plaintiffs in this case. The court also rejected what it called the plaintiffs' "unsubstantiated" allegations that Silicon Graphics had internal forecasts and budgets revealing that the Company faced serious financial problems. The court noted that "every sophisticated corporation" uses internal forecasts, and, therefore, if general allegations of "negative internal reports" sufficed, every company would be exposed to litigation whenever its stock price dropped.

Next, the court considered the defendants' alleged insider trades, finding neither the amount nor the timing of stock sales suspicious. According to the court, the sales amounted to only a small fraction of the defendants' total

181. See id. at *5.
182. Id. at *6. The court rejected the plaintiffs' argument that congressional statements during the post-Veto debate revealed that the Reform Act actually adopted the Second Circuit's standard. See id. The court reasoned that a few statements by individuals were insufficient to overcome the language of the Joint Statement. See id. Instead, according to the court, the "authoritative source" for interpreting Congress's intent was the Committee Reports (here the Joint Statement) on the Reform Act. See id. (citing Garcia v. United States, 469 U.S. 70, 76 (1984) (quoting Zuber v. Allen, 396 U.S. 168, 186 (1969))).
183. See Powers v. Eichen, 977 F. Supp. 1031 (S.D. Cal. 1997) (agreeing with Silicon I court's reasons for adopting higher pleading standard, and finding combination of defendants' insider trades and proximity of alleged misstatements to bad news was sufficient to deny motion to dismiss); see also Volt v. Wonderware Corp., 977 F. Supp. 363 (E.D. Pa. 1997) (finding Reform Act increased Second Circuit's pleading standard, then denying motion to dismiss when plaintiffs alleged (1) insider trades for three defendants, including one defendant's trades amounting to 70% of holdings; and (2) strategy on part of defendants to inflate stock value for specific strategic combination).
185. See id. at *12.
186. Id.
187. See id. (citing Complaint at para. 30).
188. Id.
189. See id.
holdings, and the alleged trading patterns in the questioned time frame were consistent with those made in previous quarters.\textsuperscript{190} The court then dismissed the complaint\textsuperscript{191} and allowed the plaintiffs twenty days in which to replead.\textsuperscript{192}

2. In re Silicon Graphics, Inc. Securities Litigation: ("Silicon II")\textsuperscript{193}

The plaintiff repled, and in May 1997, the court issued a second opinion\textsuperscript{194} addressing whether allegations of recklessness were sufficient to support an inference of scienter under the Reform Act.\textsuperscript{195} This time, the court reviewed the Second Circuit's law on recklessness.\textsuperscript{196} It divided the cases into three different categories: (1) those allowing "unqualified allegations of recklessness [to] suffice to establish scienter",\textsuperscript{197} (2) those finding recklessness sufficient to support scienter only where the defendant had a fiduciary duty to the plaintiff,\textsuperscript{198} and (3) those requiring actual intent or circumstances implying intent.\textsuperscript{199} The court noted that although the Second Circuit had not expressly overruled the earlier cases in categories (1) and (2), the more recent, type (3) cases required a strong inference of fraudulent intent.\textsuperscript{200} Congress, the court found, rejected the more lenient standards similar to (1) and (2) above when drafting the Reform Act,\textsuperscript{201} and therefore implicitly adopted the third, most strict approach.\textsuperscript{202} Thus, the court concluded "[m]otive, opportunity, and non-deliberate recklessness may provide some evidence of intentional wrongdoing, but are not alone sufficient to support scienter unless the totality of the evidence creates a strong inference of fraud."\textsuperscript{203} Instead, it found that "in order to state a private securities fraud claim, plaintiffs must create a strong inference of knowing or intentional misconduct," defined as deliberate recklessness.\textsuperscript{204}

\begin{thebibliography}{10}
\bibitem{190} See id.
\bibitem{191} See id. at *16.
\bibitem{192} See id.
\bibitem{193} 970 F. Supp. 746 (N.D. Cal. 1997).
\bibitem{194} The court specifically rejected pleas from the plaintiff and the SEC to reconsider its finding that the Reform Act adopted a pleading standard more stringent than the Second Circuit's. See id. at 754.
\bibitem{195} See id. at 755-57.
\bibitem{196} See id.
\bibitem{197} Id. at 755 (citing Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir. 1974) (en banc)).
\bibitem{198} See id. (citing Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44 (2d Cir.), amended, 1978 WL 4098 (2d Cir. May 22, 1978)).
\bibitem{199} See id. (citing Wechsler v. Steinberg, 733 F.2d 1054, 1058 (2d Cir. 1984)).
\bibitem{200} See id.
\bibitem{201} See id. at 756.
\bibitem{202} See id.
\bibitem{203} Id. at 757.
\bibitem{204} Id. The court also rejected the plaintiffs' argument that the Reform Act pleading standard did

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Applying this test to the plaintiffs' complaint, the court first found that, despite the plaintiffs' protestations to the contrary, the allegations in the complaint were based on information and belief. Under the Reform Act, such allegations require plaintiffs to "state with particularity all facts on which that belief is formed." As a consequence, the court found that the plaintiffs had to plead "the sort of information" referred to by legislators who had criticized this provision, including "the names of confidential informants, employees, competitors, Government employees, members of the media, and others who had provided information leading to the filing of the case" as well as any existing "whistle-blower.

The court found the plaintiffs' scienter allegations failed to satisfy these requirements. The plaintiffs had bolstered their *Silicon I* allegations of negative internal reports with descriptions of financial, budget, and other reports. These descriptions included the dates and contents of some reports. For example, the plaintiffs pleaded that "all defendants received a 'flash' report generated by the finance department on October 3-4, 1996, showing that sales were below forecasted levels." According to the court, these allegations were "more elaborate" than those in *Silicon I*, but were still "too generic" to support the requisite inference of fraud.

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205. See *Silicon II*, 970 F. Supp. at 763. The court found that paragraph 96 of the plaintiffs' complaint revealed that they did not have personal knowledge about their allegations; therefore, the complaint had to be based on information and belief. See id. Paragraph 96 read:

Plaintiffs have alleged the foregoing based upon the investigation of their counsel, which included a review of SEC's SEC filings, securities analysts reports and advisories about the Company, press releases issued by the Company, media reports about the Company and discussions with consultants, and believe that substantial evidentiary support will exist for the allegations set forth... after a reasonable opportunity for discovery.

Id. For the text of the Reform Act on information and belief, see supra note 108 and accompanying text.


207. *Id.* at 763 (citing statements of Representative Bryant, 141 CONG. REC. H2848 (Mar. 8, 1995), and Representative Dingell, 141 CONG. REC. H2849 (Mar. 8, 1995)).

208. The court again found that the plaintiffs had not pleaded the who, what, where, when, and why elements with the requisite specificity. See *id.* at 767.

209. *See id.* at 766.

210. *See id.*

211. *Id.* at 767.

212. *See id.* The court reasoned, as it had in *Silicon I*, that the Second Circuit had rejected similar
Instead, the court found that the plaintiffs had to allege specific details about the internal reports, including: titles, dates, authors, recipients, and contents, as well as the names of sources from which the plaintiffs acquired the alleged reports.\textsuperscript{213} After stating that some of the documents the plaintiffs had submitted in camera suggested that they possessed information that would improve the complaint, the court granted the plaintiffs a final opportunity to replead.\textsuperscript{214}

Finally, the court turned to the allegations about the defendants' stock trades, scrutinizing each individual's trades as a proportion of his total holdings and in light of his prior trading patterns.\textsuperscript{215} The court rejected claims about three of the defendants, finding that trades amounting to 2.6\%, 4.4\%, and 7.7\% of available stocks and options were consistent with prior trading patterns and were therefore insufficient to buttress allegations of scienter.\textsuperscript{216} The court did find it significant, however, that two defendants, who did not have a trading history for comparison, had traded 43.6\% and 75.3\% of their available stocks and options during the class period.\textsuperscript{217} The court concluded that these trading allegations might be sufficient to meet the pleading standard if the plaintiffs were also able to provide further information on their allegations about negative internal reports.\textsuperscript{218}

Thus, the \textit{Silicon II} court found that allegations of unusual insider trades alone were insufficient to meet the Reform Act's new heightened pleading standard.\textsuperscript{219} This finding, however, eliminates the plaintiffs' main avenue for pleading scienter with publicly available information.\textsuperscript{220} Nevertheless,

\footnotesize{\textsuperscript{213} \textit{See id.}} \textsuperscript{214} \textit{See id.} \textsuperscript{215} \textit{See id.} \textsuperscript{216} \textit{See id. at 768.} \textsuperscript{217} \textit{See id.} \textsuperscript{218} \textit{See id.} The plaintiffs declined to replead, claiming that their original pleadings were sufficient and that they could not add to them without disclosing protected work product. The court rejected this contention, noting that assuming the information was sufficient for the complaint to withstand dismissal, it would be subject to immediate discovery. The court then dismissed the complaint with prejudice. \textit{See In re Silicon Graphics, Inc. Sec. Litig., No. C 96-0393 FMS, 1997 WL 337580 (N.D. Cal. June 5, 1997).} The case is now on appeal to the Ninth Circuit. \textsuperscript{219} \textit{See also Weng v. Lumiys, Inc., 2 F. Supp. 2d 1231 (N.D. Cal. 1998) (noting that stock sales are insufficient to support scienter allegations).} \textsuperscript{220} Another case that reveals how severe the emphasis on internal information in the new pleading requirement can be is \textit{Zeid v. Kimberley}, 973 F. Supp. 910 (N.D. Cal. 1997). The \textit{Zeid} court dismissed the complaint, noting that the plaintiffs failed to support their "general allegations" with references to inconsistent contemporaneous statements or "information made by or available to Defendants." \textit{Id.} at 920. The court found that in order to plead the \textit{why} element, the plaintiffs needed to quantify allegedly "poor sales," or reference reports or other information to show that the company's "sales staff was performing badly." \textit{Id.} Further, the court specifically found insufficient a general
Silicon II reveals that when strictly defined and applied, the Reform Act’s test is very stringent. Furthermore, because the pleading standard results in the dismissal of claims, it is unlikely that we will ever know with certainty what the ultimate affect of the pleading standard will be.

3. Hockey v. Medhekar

In another post-Reform Act case, Hockey v. Medhekar, a different judge in the Northern District of California concurred with the Silicon I opinion finding that the Reform Act adopted a standard more strict than the Second Circuit’s. The Hockey court, however, faced a slightly different problem from its Silicon counterpart. Because the alleged misstatements pleaded by the Hockey plaintiffs were, according to the court, forward-looking in nature, they were subject to a safe-harbor provision of the Reform allegation that the defendants “had access” to internal information. See id. Instead, the court found that the plaintiffs had to reference such reports or information to survive dismissal. See id.

In another example of the severity of the pleading standard in a stayed-discovery context, the court found that lists of customers with estimates of allegedly “improper” sales were insufficient. See id. at 923. According to the court, a sufficient complaint would “allege facts regarding the underlying transactions with particularity,” including the names of employees who made statements about product returns to customers, the dates of such returns, and cites to purchase orders and quotes of sales terms. See id.

Regarding scienter, the court found inadequate an alleged motive to inflate the company’s stock price to obtain a better acquisition price, partly because the defendants had revealed all the alleged problems and suffered a stock-price decrease before completing the acquisition. See id. at 924. The court also used its finding that the plaintiffs failed to allege the why element with particularity to support its finding on the how element: “Plaintiffs fail to allege contemporaneous facts showing that each allegedly misleading statement was false when made. Thus, there are no specific facts to create an inference that Defendants knew the statements were false.” Id. Zeid is also now on appeal to the Ninth Circuit. See also Novak v. Kasaks, 997 F. Supp. 425 (S.D.N.Y. 1998) (finding that complaint failed to identify internal information sufficient to support allegations and, where plaintiffs relied on consultants for such information, requiring that those consultants be identified in complaint; noting that counsel’s statements as to internal information were insufficient and finding that plaintiffs had to identify exact documents); In re Health Management Sys., Inc. Sec. Litig., No. 97 Civ. 1365 (HB), 1998 WL 283286, at *4 (S.D.N.Y. June 1, 1998) (dismissing allegations which did not specify customers, nature of customers’ payment problems, or extent of decreased profitability and lower margins); In re Digi Int’l, Inc. Sec. Litig., 6 F. Supp. 2d 1089, 1099 (D. Minn. 1998) (dismissing allegations of problematic product-return policy, where plaintiffs failed to specify terms of program, including which products were included, how long returns were to be extended, manner in which program “encouraged” customers to delay returning products, how program affected number of returns).

221. See, e.g., Novak v. Kasaks, 997 F. Supp. 425 (S.D.N.Y. 1998) (requiring, for scienter analysis, that counsel assert that defendants actually knew or actually saw certain internal documents, not just that they should have seen or known about them).


223. See id. at *10-*11. The court also rejected the plaintiffs’ argument that the Reform Act’s pleading requirements were substantive changes in the law and did not, therefore, apply to conduct which took place before their enactment. See id. at *2-*4.
The Reform Act explicitly denotes the requisite state of mind applicable to forward-looking statements: plaintiffs must prove that the person making the statement did so "with actual knowledge . . . that the statement was false or misleading."225

The Hockey court first reviewed the complaint’s misstatement allegations for compliance with the Ninth Circuit’s and the Reform Act’s why or falsity element. It found the plaintiffs’ allegations insufficient, noting that they had relied on “as-yet-unconducted discovery” to substantiate their allegations.226 Such reliance on future discovery, the court reasoned, was inappropriate because the Reform Act’s stay-of-discovery provision was enacted to prevent such pleading practices.227 Specifically, the court found insufficient the plaintiffs’ reliance on “unidentified ‘negative internal non-public information.’”228 Instead, the court required that, at a minimum, the plaintiffs plead facts sufficient to show the internal documents existed;229 identify the “particular corporate document[s] or data”; describe when such documents were created; and state who was responsible for their preparation or allege whether they were regularly prepared.230

The court noted that, in the absence of discovery, this stringent pleading standard was difficult for the plaintiffs to meet.231 It found, however, that it could not ignore the “clear mandate” of the Reform Act despite the harsh consequences to the plaintiffs.232

In its analysis of the scienter or how element, the court rejected the plaintiffs’ contention that proof of recklessness was sufficient to meet the Reform Act’s standard.233 It distinguished Marksman and Zeid, noting that they did not involve forward-looking statements and therefore were not subject to what it found was the Reform Act’s new actual knowledge requirement.234 Then, citing to Silicon I, the court found that the plaintiffs’

224. See id. at *5-*6. The plaintiffs argued that the alleged misstatements were not forward-looking, but the court disagreed. See id. The court also stated that if the plaintiffs chose to replead the complaint, they should make clear which alleged misstatements were forward-looking. See id. at *6 n.8.
225. Id. at *9-*10 (quoting the Reform Act, § 27A(c)(1)(B)(i)). This distinction allowed the court to avoid a lengthy analysis of Footnote 23.
226. Id. at *7.
227. See id.
228. Id. at *7.
229. See id.
230. See id. at *8.
231. See id.
232. Id.; see also James D. Cox, Making Securities Class Actions Virtuous, 39 ARIZ. L. REV. 497, 521 (1997) (arguing that many forms of fraud may become public only after statute of limitations has expired and that Reform Act’s discovery-stay provision is therefore particularly harsh).
234. See id.
reliance on unidentified internal documents was insufficient to plead scienter for forward-looking statements as well.235

Assuming, without so finding, that suspicious insider trades might meet the requisite inference of actual knowledge, the court dismissed the plaintiffs' trading allegations as insufficient.236 It found that neither the timing nor the amounts of the trades were suspicious: the defendants sold more stock before the class period than during it, and sold only a small percentage of their total holdings.237 Accordingly, the court dismissed the complaint in its entirety, allowing the plaintiffs sixty days to replead.238 This opinion, like the Silicon decisions, further emphasizes the outcome-determinative nature of the internal-information pleading standard and, makes clear that without discovery, plaintiffs are unlikely to meet the heightened standard.239

C. Opinions On the Reform Act's Stay-of-Discovery Provision

The stay-of-discovery provisions of the Reform Act have received

235. See id.; see also Fugman v. Aprogenex, Inc., 961 F. Supp. 1190 (N.D. Ill. 1997) (dismissing allegations of fraudulent forward-looking statements, without discussion of Reform Act standard, where plaintiffs failed to plead facts showing alleged misstatements were false when made).

236. See Hoke, 1997 WL 203704, at *11. The court specifically noted that some of the alleged insider sales occurred before the date of the alleged misstatements and could not, therefore, "serve as motivation for" those misstatements. See id.

237. See id. at *11. The Hoke court, like all of the others considering this question post-Reform Act, found allegations that the defendants desired to increase the price of the company's stock insufficient to allege motive. See id. at *11 & n.12.

238. See id. at *11. The court's instructions to the plaintiffs reveal its frustration with the nature of their first complaint. In its closing paragraph, the court stated the following:

Should plaintiffs choose to file an amended complaint, the court orders that plaintiffs: 1) specify which statements were allegedly false and which were allegedly misleading due to omissions; 2) clarify which allegedly false and misleading statements were forward-looking and which were not; 3) clearly state the bases for each of their allegations; and 5) avoid gratuitious hyperbole (such as exclamation marks) and shorten the background portion of the complaint.

Id.; see also Wengler v. Lumisys, Inc., 2 F. Supp. 2d 1231, 1243 (N.D. Cal. 1998) (criticizing complaint and noting that review of it "require[d] a laborious deconstruction and reconstruction of a great web of scattered, vague, redundant, and often irrelevant allegations); In re Glenayre Tech., Inc. Sec. Litig., 982 F. Supp. 294, 299 (S.D.N.Y. 1997) (granting leave to replead, but requiring plaintiffs to indicate in "bold face type or otherwise" factual allegations new or different from those in first amended complaint).

239. See Glenayre, 982 F. Supp. at 297-98 (applying heightened standard to deny motion to dismiss complaint containing allegations of pending FCC action, but granting leave to replead given "troubling nature" of allegations); In re Baesa Sec. Litig., 969 F. Supp. 238, 241-42 (S.D.N.Y. 1997) (finding heightened standard to be whether complaint states "sufficient particulars to reasonably raise a strong inference that a given defendant participated in the making of the allegedly fraudulent misrepresentations or omissions either with knowledge of their falsity or with reckless disregard for a known and obvious danger of their being untrue"; then dismissing complaint for conclusory scienter allegations); Havenick v. Network Express, Inc., 981 F. Supp. 480 (E.D. Mich. 1997) (finding plaintiffs failed to plead who, what, when, where, and why elements with particularity, and that allegations of insider trades were insufficient to meet post-Reform Act heightened scienter standard).
considerable attention. Many plaintiffs have filed motions requesting discovery, and most have been denied. In an early order issued in the Hockey litigation described above, the district court granted the plaintiffs some discovery by distinguishing between the term “automatic disclosures” under Federal Rule of Civil Procedure 26 and the Reform Act’s use of the term “discovery.” The court found that by using the word “discovery,” not “disclosure,” in the Reform Act, Congress sought to distinguish between the two. As a result, the court ruled that although the plaintiffs were not entitled to discovery, they were entitled to Rule 26 automatic disclosures.

The district court certified its order for immediate appeal, and the Ninth Circuit quickly reversed the lower court, holding that Congress intended to prevent plaintiffs from filing first and then searching for evidence to support their claims. Thus, the opinions reviewing the stay-of-discovery provisions are uniform—discovery is unavailable until after the resolution of motions to dismiss.


242. Id. at 251.

243. Id. at 252.

244. See id. This distinction appears to be one of form over substance. Parties may, but need not, provide documents to meet their Rule 26 obligations. See Fed. R. Civ. P. 26(a)(1)(B) (parties shall provide “a copy of, or a description by category and location of all documents”). Thus, plaintiffs would have gained little through this mechanism.


246. See Medhekar v. United States District Court for the Northern District of California, 99 F.3d 325 (9th Cir. 1996).

D. Summary

As the opinions discussed above reveal, some courts have found that Congress intended to adopt the Second Circuit's standard, while others have found that the Reform Act calls for a more stringent measure.248 Many of the new opinions are from district courts within the Ninth Circuit, making it likely that, in the near future, the Ninth Circuit will provide some guidance as to which courts—Marksman or Silicon and Hockey—that court believes have interpreted the Reform Act correctly. Early opinions from courts within the Second Circuit reveal a similar split, with some courts adopting its pre-Reform Act pleading standard, while others require that complaints meet an increased standard.249 These cases indicate that a circuit split is probable. At this stage, however, the early opinions confirm this Article's claim respecting the likely impact of the Reform Act: when vigorously applied, the combination of a strict pleading standard with a stay of discovery creates a pleading barrier so high that few complaints will survive it.

As noted in the discussion of Footnote 23 of the Joint Statement and the text surrounding it,250 Congress not only declined explicitly to adopt the Second Circuit's standard but also appeared to indicate that it wanted a more stringent review of the particularity of complaints. If courts adopt this stricter interpretation, then the plaintiffs must plead the scienter or how element with more particularity than previously acceptable in the Second Circuit, plead the falsity or why element with specificity, and meet the criteria for these standards without discovery.251

This new requirement for scienter means, as stated above, that insider-trading allegations are no longer sufficient to meet the scienter requirement.252 Indeed, this is one of the teachings of Silicon II.253 The problem with this standard, however, is that pleadings based only on routine publicly-available information such as insider trades are insufficient, and

judge asked plaintiffs whether some limited discovery would aid them in meeting Reform Act's "stringent" requirements, and plaintiffs responded that their complaint was already sufficient).


250. See supra notes 109-14 and accompanying text.

251. See supra notes 174-219 and accompanying text.

252. See supra notes 215-19 and accompanying text.

253. See id.
post-Reform Act plaintiffs must meet an internal-information standard designed for pre-Reform Act cases.\(^{254}\) Accordingly, the Reform Act's pleading standard, if strictly applied and interpreted, will eliminate most private securities-fraud lawsuits and be overinclusive in its impact.\(^{255}\)

V. CORRECTING THE PROBLEM THROUGH MANAGERIAL-JUDGE LEGISLATION

As stated above, the momentum for reform was based primarily on the perception that plaintiffs' attorneys were filing minimally sufficient complaints and then using their entitlement to extensive and expensive discovery to hold the defendants hostage and demand settlements.\(^{256}\) In its attempt to correct this perceived imbalance of power between plaintiffs and defendants, Congress adopted both the pleading and stay-of-discovery provisions and shifted the power almost entirely to the defendants.\(^{257}\) Yet, as discussed above, strict application of the pleading standard without discovery may have serious consequences for the future of such claims. To remedy this situation, Congress should adopt a solution that balances both the need to maintain private enforcement and the need to limit frivolous suits. It could achieve this balance by enacting a managed-discovery provision. Such a provision would achieve the same goal in a less draconian manner, while protecting what Congress, the SEC and scholars agree is an important goal—providing a tool necessary to enforcement of the Acts and thereby maintaining fair and efficient markets.\(^{258}\)

A managed-discovery program might work as follows. After the plaintiffs

\(^{254}\) As discussed earlier in this paper, see supra note 71, other public information may suffice, but such information is relatively rare. Two post-Reform Act cases illustrate this point. The first case, In re Valujet, Inc., Securities Litigation, No. 99,579, 1997 WL 710380 (N.D. Ga. 1997), survived the heightened pleading standard because after the plane crash, FAA reports that appeared to contradict earlier company public statements became public. The second case, In re Health Management, Inc., Securities Litigation, 970 F. Supp. 192 (E.D.N.Y. 1997), also survived the heightened pleading standard. The allegations in this case included a withdrawn auditor's opinion, a letter from an analyst inquiring into the same financial problems that led to the auditor's withdrawal, and an SEC inquiry. See also City of Painesville, Ohio v. First Montauk Fin. Corp., 178 F.R.D. 180, 185-89 (N.D. Ohio 1998) (finding complaint met heightened pleading standard, but noting that company had previously disclosed existence of Securities and Exchange Commission investigation and indictments in Florida); cf. Glenayre, 982 F. Supp. at 297-98, 299 (noting allegations of pending FCC action, but denying motion to dismiss with leave to replead).

\(^{255}\) This strict standard could have a serious, and unintended, impact on Securities Act claims, for which scienter is not an element. See infra notes 272-361 and accompanying text.

\(^{256}\) See supra notes 74-91 and accompanying text.


\(^{258}\) See Joint Statement of the Managers at 31; Seligman, supra note 73, at 455-46 (class actions ensure enforcement of mandatory disclosure systems, and, thereby, deter fraud, reduce insider trading, and increase confidence in markets).
file and serve the complaint and a lead plaintiff is chosen, discovery would be stayed for a brief initial time period, for example, twenty days.\textsuperscript{259} The court would require defendants and plaintiffs to file briefs on the motion to dismiss and schedule an argument, with a short deadline for deciding and issuing its opinion on the motion. Any alleged misstatements that fail to meet the standard motion-to-dismiss strictures of Federal Rule of Civil Procedure 12(b)(6),\textsuperscript{260} as well as any alleged misstatements for which the plaintiffs have not pleaded with specificity the publicly-available elements (who, what, when, and where) would be dismissed with prejudice.\textsuperscript{261} This would allow the court to focus on the more difficult how and why elements.

Once the court has narrowed the contours of the complaint to include only those alleged misstatements pleaded with some particularity and which appear to be actionable, the court would design a limited discovery program to fit the remaining alleged misstatements. This program might include production of a limited set of documents and a prohibition on depositions.\textsuperscript{262}


\textsuperscript{260} This Article focuses on the particularity arguments under Rule 9(b), and does not address the arguments defendants usually raise pursuant to Rule 12(b)(6). Frequently, defendants argue that certain alleged misstatements are not actionable because they are not material as a matter of law. These types of statements fall into two general categories. The most prominent are statements that “bespeak caution” or that by their nature warn against the eventuality over which the plaintiffs are now suing. See, e.g., Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1213-14 (1st Cir. 1996) (dismissing various statements as nonactionable under the “bespeaks caution” doctrine). The other general category of dismissible statements are those on which a reasonable investor would not rely because they amount merely to “puffing.” See, e.g., Shapiro v. UJB Fin. Corp., 964 F.2d 272 (3d Cir. 1992) (where alleged misrepresentations or omissions are obviously unimportant to investor, court may rule they are not actionable); Colby v. Hologic, 817 F. Supp. 204, 211 (D. Mass. 1993) (finding nonactionable statement that “long term prospects [were] bright”).

\textsuperscript{261} See supra notes 31-32. Generally, courts have been reluctant to dismiss with prejudice complaints at the initial motion to dismiss stage. See, e.g., May v. Borick, No. CV 95-8407 LGB (Ex), 1996 WL 397442 (C.D. Cal. Apr. 16, 1997) (dismissing with prejudice first-amended complaint, or second complaint); Neubronner v. Young, [Current Transfer Binder] Fed. Sec. L. Rep. ¶99,478 at p. 97,215 (CCH) (9th Cir. Apr. 8, 1997) (affirming dismissal with prejudice of second-amended complaint). The rationale for doing so here, however, is that when a statement is nonactionable as a matter of law, it should not reappear in later versions of the complaint. Similarly, because the who, what, where and when elements are publicly available, any failure to plead them with specificity in the initial complaint is inexcusable. See Wenger v. Lumisys, Inc., 2 F. Supp. 2d 1231 (N.D. Cal. 1998) (dismissing certain alleged misrepresentations where plaintiffs failed to plead exact statements as released to marketplace; noting that content of publicly-made statements are not matters “peculiarly within” knowledge of company).

\textsuperscript{262} Obviously, allowing document discovery but not depositions amounts to a decision about which form of discovery is the most revealing and which is the most burdensome, and the appropriate balance between different types of discovery. Requiring top officers to participate in depositions before a complaint meets some minimal standard would be inefficient and would not help to diminish settlement pressure. In the absence of so-called “smoking-gun” documents, however, depositions are perhaps a better way for plaintiffs to discover facts concerning intent.
The type of documents discoverable would, of course, depend on the allegations, but Congress could require judges to tailor the type of discoverable documents, and the time period for relevant discovery, to the surviving portions of the complaint. For example, in the type of case frequently cited in the reform debates—a new, emerging company sued within a year of its initial public offering ("IPO") and immediately following a drop in its stock price—the court might require production of the CFO’s IPO files, the underwriter’s IPO files and the accountants’ work papers pertaining to recent audited financials referenced in the offering documents. Again, the court would establish a strict schedule for the production and review of documents—for example, ten days for each party to meet its obligations—and then require plaintiffs to replead their complaint on the basis of the limited discovery. This structured discovery program would address the defendants’ concerns about extensive and expensive discovery, while allowing plaintiffs access to the information necessary to meet the newly-adopted pleading standard.

The affect of requiring, by statute, judges to take an active role in the discovery process would be significant. Compared to the pre-Reform Act situation, limiting the discovery mechanism would shift the balance of power in the direction of defendants. It would decrease the amount of discovery available to plaintiffs prior to a final decision on a motion to dismiss and, accordingly, decrease the costs of such suits. Consequently, the incentive for the defendants to settle simply to avoid those costs would also decrease.

The obvious response to such a proposal is that judges can implement phased or managed discovery now. The answer to that point is that they can, but most do not—at least in these types of cases. Indeed, those

263. See Levitt Testimony, supra note 25, at 36 (advocating “more active case management on the part of the judiciary”); Alexander Testimony, supra note 173, at 135 (saying active case management by judges could help “streamline” process).

264. Judges would also become more familiar with the facts in the case and be better able to assess the likelihood of settlement.

265. Many commentators have argued that defendants settle meritless suits simply to avoid further discovery or the disruption of their business or because they are risk-averse. See, e.g., Janet Cooper Alexander, Do the Merits Matter?: A Study of Settlement in Securities Class Actions, 43 STAN. L. REV. 497, 569 (1991); Lucian Arye Bebchuk, Suing Solely to Extract a Settlement Offer, 17 J. LEGAL STUD. 437, 440 (1988); Avery Katz, Effect of Frivolous Suits on the Settlement of Litigation, 10 INT’L REV. L. & ECON. 3, 4-5 (1990); see also S. CONG. REP. No. 104-369, at 37 (including testimony estimating that securities-fraud discovery costs may amount to 80% of total costs).

266. See Crawford-El v. Britton, 118 S. Ct. 1584, 1597 (1998) (noting that trial judge has “broad discretion to tailor discovery narrowly and to dictate the sequence of discovery”).

267. See, e.g., In re Lotus Dev. Corp. Sec. Litig., 875 F. Supp. 48, 53 (D. Mass. 1995) (refusing to stay discovery for additional time where complaint was “not so clearly deficient” as to supersede policy underlying Rule 26 provisions); see also Cox, supra note 230, at 523 (noting that courts could and should have, but have not, played role in other aspects of securities class actions).
involved in litigation and discovery disputes know that judges generally dislike the discovery process and prefer not to become involved in it. As a result, defendants are left without bargaining power or any control over the process. By giving defendants a statutory power to enforce a streamlined discovery process, however, Congress could encourage judges to take the active role required in securities fraud claims.

Further, this program would right what, in securities fraud matters unlike most other areas of the law, is a discovery imbalance. Generally, litigation contains an internal limitation on both parties’ discovery demands that works as simply as the proverbial golden rule: do unto others as you would have them do unto you. It is, in fact, likely that judges understand this maxim and, as a result, grant all but the most frivolous discovery requests on the assumption that the demands will even out in the end.

In securities cases, however, the discovery imbalance lacks an internal limitation and therefore requires an external correction. Despite their voluminous discovery requests to defendants, plaintiffs have very little to offer in the form of reciprocal discovery. Indeed, since the adoption of the fraud-on-the-market doctrine in 1988, proposed class plaintiffs are not required ever to have had any contact with the company or the individual defendants they are suing. They may not even recall the content of the complaint and may know little about the company or its products. As a result, in the average securities case, the plaintiffs’ document production consists solely of trading slips, and, in contrast to the defendants’ depositions, which may last several days, class plaintiff depositions usually last for only part of one day.

268. Consider for example, a recent antitrust case in which the court specifically noted that the plaintiff’s discovery requests to a nonparty were overbroad and not even limited to the industry in question. See Concord Boat Corp. v. Brunswick Corp., 169 F.R.D. 44, 50-51 (S.D.N.Y. Oct. 21, 1996). Although the court specifically noted that it had the authority to modify the plaintiffs’ requests it declined to do so. See id. at 53. For a discussion of judges and their role in managing discovery, see Samuel Issacharoff & George Loewenstein, Untended Consequences of Mandatory Disclosure, 73 Tex. L. Rev. 753, 782-83 (1995).

269. See Easterbrook, supra note 90, at 644-46 (discussing benefits of judicial control over discovery process).


271. See, e.g., Priest v. Zayre Corp., 118 F.R.D. 552, 554 (D. Mass. 1988) (finding no merit in defendants’ argument that proposed plaintiff should be disqualified because he had no memory of documents cited in complaint); Basic, 485 U.S. at 241, 250 (holding reliance on misrepresentations may be presumed).

272. See, e.g., Priest, 118 F.R.D. at 554.

273. Defendants who attempt to obtain additional information, for example, concerning the proposed plaintiffs’ trades in other stocks, generally lose such motions. See, e.g., Burstein v. Applied Extrusion Tech., Inc., 153 F.R.D. 488, 488-91 (D. Mass. 1994) (denying motion to compel securities-trading information unrelated to company at issue); In re Dataware Sec. Litig. (Motion to Compel and
Statutorily limited discovery provisions, however, would create an external constraint. Further, such a statutory provision would give defendants a legal rule to which they could point and, thereby, provide them with a basis to pressure judges to enforce the externally-created discovery limit.\textsuperscript{274}

VI. THE UNINTENDED CONSEQUENCES OF THE REFORM ACT'S HEIGHTENED PLEADING STANDARD

As discussed above, the Reform Act stays all discovery while motions to dismiss are pending under either the Securities Act or the Exchange Act.\textsuperscript{275} Based on this author's interpretation of the standard adopted, however, plaintiffs must have access to internal company information in order to meet the new pleading standard.\textsuperscript{276} This standard may have an unintended consequence on claims brought pursuant to the Securities Act. Before the Reform Act, many circuits held that when a complaint included Exchange Act and Securities Act claims, dismissal of all counts—even those for which scienter was not an element—was appropriate on the ground that the complaint sounded in fraud. This section argues both from doctrine and from theory that in the post-Reform Act era, courts should decline to dismiss in their entirety complaints that plead claims under section 11\textsuperscript{277} and section 12(2)\textsuperscript{278} of the Securities Act ("Securities Act Claims") along with an Exchange Act Claim. Instead, courts should allow Securities Act Claims which meet the strictures of Rule 12(b)(6)\textsuperscript{279} to withstand dismissal.

A. The Common-Law Approach to Complaints with Multiple Counts

Often, complaints that allege the defendants committed fraud under the Exchange Act also include Securities Act Claims.\textsuperscript{280} The effect of the Exchange Act Claim is to expand the class period and thereby the potential damages.\textsuperscript{281} The elements of these allegations, however, are strikingly

\textsuperscript{274} See William M. Richman et al., The Pleading of Fraud: Rhymes Without Reason, 60 S. CAL. L. REV. 959, 992-94 (1987) (suggesting limited discovery combined with forfeited bond payments by plaintiffs for cases in which plaintiffs allege information exclusively within province of defendants or for strike suits).

\textsuperscript{275} See supra notes 238-45 and accompanying text.

\textsuperscript{276} See, e.g., supra notes 221-37 and accompanying text.


\textsuperscript{279} See supra note 16-18 and accompanying text; supra note 258.


\textsuperscript{281} See 15 U.S.C. § 77k(e) (1994) (limiting damages to (1) the difference between the purchase price of security—not to exceed the public offering price and value of security at time of lawsuit; (2)
different. In contrast to an Exchange Act Claim, which requires a plaintiff to plead and prove scienter, a section 11 claim is, with respect to the issuer, a strict liability claim. Liability for issuers under this provision is "virtually absolute, even for innocent misstatements." For other defendants, it operates as a negligence claim. Thus, to plead such a claim, plaintiffs need allege only that they bought stock in the company; that a representation in a registration statement was materially false or misleading; that the defendants are liable under section 11(a); and that they are acting within the one-year statute of limitations. Generally speaking, section 12(2) claims, which are based on misleading statements in a prospectus, are negligence claims. Thus, such claims should be subjected only to the short-and-plain-statement standard of Rule 8(a).

Despite these important differences, many courts have held that when a complaint sounds in fraud, all counts of the complaint are subject to the strictures of Rule 9(b), which has its roots in the scienter element. Indeed, some courts have held that even where the Securities Act Claims in a

the price for which security was sold before lawsuit; or (3) the price for which security was sold after commencement of lawsuit but before judgment—if less than (2); and including provision for defendants to prove price decline was due to factor other than registration statement; see also 15 U.S.C. § 77l (1994 & Supp. II 1996) (allowing recovery at tender of "consideration paid for" security, with interest, minus amount of income received thereon . . . or damages). Prior to the Reform Act, no such limitation existed for 1934 Act cases. See, e.g., Caremark, Inc. v. Coram Healthcare Corp., 113 F.3d 645, 649 n.6 (7th Cir. 1997) (ruling damages in 10b-5 cases are usually based on difference between purchase price of stock and what value would have been if truth were known).

282. See supra notes 18-21 and accompanying text.
283. See 15 U.S.C. § 77k(a) (1994); see also Shaw, 82 F.3d at 1123 (holding allegations that defendants possessed information they failed to disclose do not convert non-scienter claims into allegations of fraud; "[otherwise, any allegation of non-disclosure of material information would be transformed into a claim of fraud"); Stewart v. Bennett, 359 F. Supp. 878 (D. Mass. 1973) (holding section 11 proscribes innocent or negligent misstatements).
285. Non-issuer defendants, such as underwriters, have a due-diligence defense, or a defense of reasonable care, available to them under section 11(b). See 15 U.S.C. § 77k(b) (1994); see also Herman & MacLean, 459 U.S. at 382. As a result, claims against them are negligence-like in their application. See HAROLD S. BLOOMENTHAL, SECURITIES LAW HANDBOOK § 14.08 (1996).
286. See, e.g., In re Gap Stores Sec. Litig., 79 F.R.D. 283 (D.C. Cal. 1978) (to prevail plaintiff must prove registration statement contained false or misleading statement or omission at effective date and need not prove reliance, causation, or scienter).
287. See 15 U.S.C. § 77l (1994 & Supp. II 1996); Nelson v. Quimby Island Reclamation Dist. Facilities Corp., 490 F. Supp. 1364 (D.C. Cal. 1980) (noting a party may violate section 12(2) even if merely negligent). These claims are harder to prove because they require privity between the seller and the buyer. Thus some courts have held that when underwriters handle the sale of the securities, the issuer cannot be liable under section 12(2). See, e.g., Shaw, 82 F.3d at 1214-16.
288. See supra notes 16-17 and accompanying text.
complaint do not allege intent, knowledge or scienter, if the complaint incorporates allegations either pertaining to or underlying an Exchange Act Claim, it "sounds in fraud." 290 Others have assumed, without so stating, that Rule 9(b) applies. 291 Thus, the courts have dismissed entire complaints for failure to plead with particularity, even when a complaint containing the Securities Act Claims, pleaded separately, would not be dismissed for that reason. 292

This approach misconstrues the statutes underlying Securities Act Claims which, like their Exchange Act counterparts, protect investors from misstatements and omissions. Nothing in the provisions of the Securities Act requires plaintiffs to prove, and thereby to plead, scienter or fraud. Indeed, Securities Act Claims are not fraud claims at all. 293 Thus, it appears that courts have inappropriately used Rule 9(b) as a mechanism to screen out entire complaints rather than just the scienter-based claims. 294 The fact that courts have increased their use of Rule 9(b) in securities-fraud matters at a

290. Shapiro, 964 F.2d at 287; cf. Schwartz v. Celestial Seasonings, Inc., 124 F.3d 1246 (10th Cir. 1997) (assuming without deciding that Rule 9(b) may apply to Securities Act Claim but declining to do so when allegation that defendants failed to make "reasonable investigation" of allegedly misleading statements was negligence-like); Sheppard v. TCW/DW Term Trust 2000, 938 F. Supp. 171 (S.D.N.Y. 1996) (applying Rule 9(b) analysis only to 10(b) allegations, and finding that where complaint does not incorporate by reference allegations of fraud into counts alleging violations of sections 11, 12(2) and 15 of the Securities Act, complaint does not sound in fraud). But see In re NationsMart Corp. Sec. Litig., 130 F.3d 309 (8th Cir. 1997) (noting that even if plaintiffs alleged fraud in complaint containing section 11 claims, such allegations "would be mere surplusage"); Fed. R. Civ. P. 8(e)(2) (stating that when complaint includes multiple counts and one would be sufficient, "pleading is not made insufficient by the insufficiency of one or more of the alternative statements").

291. See, e.g., Sears, 912 F.2d at 892-93.

292. See, e.g., Shaw, 82 F.3d 1194 (analyzing two complaints, one alleging only Securities Act claims and one alleging both Securities and Exchange Act claims). Compare id. at 1211 (holding that for purposes of motion to dismiss complaint alleging only Securities Act Claims, court assumes misstated allegations were misleading when made), with id. at 1223 (holding that where complaint alleges both Securities and Exchange Act Claims, it "sounds in fraud," and plaintiffs must plead all allegations with particularity); but see Nelson v. Paramount Communications Inc., 872 F. Supp. 1242, 1246 (S.D.N.Y. 1994) (holding that Rule 9(b) is not applicable to Securities Act Claims); In re Ann Taylor Stores Sec. Litig., 807 F. Supp. 990, 1003 (S.D.N.Y. 1990) (same); Ross v. Warner, 480 F. Supp. 268, 273 (S.D.N.Y. 1979) (same).

293. See Shaw, 82 F.3d at 1223 (noting that fraud is not an element of Securities Act Claims).

294. Indeed, the Supreme Court has held that the federal courts can not use Rule 9(b) except for complaints alleging fraud and mistake. See Leatherman v. Tarrant County Narcotics Intelligence & Coordination Unit, 507 U.S. 163, 168 (1993). Moreover, although sparse, the history of Rule 9(b) does not support its expansion to non-fraud claims. See Richman et al., supra note 271, at 967-77 (noting that Rule 9(b) has its roots in "reluctance to question settled transactions," and torts of deceit involving face-to-face business transactions, and that particularized pleadings have become more "a matter of reflex than logic"); see also Union Switch & Signal Co. v. Day, 16 F.2d 4, 6 (2d Cir. 1926) (noting that claim "sounds in fraud" where "without the dolus no cause of action is stated"). Thus, the doctrine appears to have evolved as a sorting mechanism; that is, when a complaint alleges, for example, a contract claim, but is actually based on a fraud claim, the complaint should be subject to Rule 9(b). Rule 9(b) should not, however, apply to a complaint alleging two distinct contract and fraud claims. The same is true of a complaint alleging claims under both Acts.
rate that appears to be greater than that for other types of fraud claims exacerbates this problem.\textsuperscript{295} The Reform Act, however, creates a statutory standard that applies only to Exchange Act Claims, an implied cause of action—not the express Securities Act Claims. Accordingly, courts should now begin to analyze the counts in these complaints separately.

\textbf{B. The Reform Act and Its Legislative History}

The first step in interpreting any statute is to look at the text of the statute itself because elected representatives vote for the statute, not committee reports or floor debates.\textsuperscript{296} A review of the Reform Act reveals that the pleading-standard provision, unlike the common law preceding it, applies only to Exchange Act Claims.\textsuperscript{297} Indeed, the language of section 21D(b), as well as several other provisions of the Reform Act, supports such an interpretation.

Section 101(b) of the Reform Act contains the heightened pleading standard.\textsuperscript{298} It amends only the Exchange Act by inserting section 21D.\textsuperscript{299} Subsection (b) of section 21D, titled “REQUIREMENTS FOR SECURITIES FRAUD ACTIONS”\textsuperscript{300} restricts the applicability of the heightened pleading standard provision to matters “arising under this title.”\textsuperscript{301} The term “title” refers to the Exchange Act.\textsuperscript{302} Thus, as drafted, the

\begin{footnotesize}
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\item See S. WRIGHT & MILLER, supra note 17, § 1297, at 613-14.
\item See, e.g., INS v. Elias-Zacarias, 502 U.S. 478, 482 (1992) (advising that statutory construction begins with words and text).
\item Presumably, the new pleading standard applies to any Exchange Act claim for which scienter is an element, including proxy claims brought pursuant to § 14(a), 15 U.S.C. § 78u(a) (1994). See Union of Needletrades v. May Dept. Stores Co., No. 97 Civ. 3120, 1997 U.S. Dist. WL 714886, at *5-6 (S.D.N.Y. Nov. 14, 1997) (noting Reform Act pleading standard applies to proxy claims). This new standard is likely to create its own controversy in the realm of proxy litigation because, although most circuits have adopted a negligence standard, at least one has held that these causes of action require proof of scienter. Compare, e.g., Henkwowitz v. Nutri/System, Inc., 857 F.2d 179, 189-90 (3d Cir. 1988) (holding negligence is appropriate standard in 14a-9 case), with Adams v. Standard Knitting Mills, Inc., 623 F.2d 422, 428 (6th Cir. 1980); see also RANDALL S. THOMAS & CATHERINE T. DIXON, ARANOW & EINHORN ON PROXY CONTESTS FOR CORPORATE CONTROL, § 18.04[E] (1998) (discussing standard and doctrines adopted by various courts).
\item The language of § 101(b) states: “(b) SECURITIES EXCHANGE ACT OF 1934.—Title I of the Securities Exchange Act of 1934 (78a et seq.) is amended by inserting after section 21C the following new section: . . .”
\item Id. at 746.
\item Id. at 747.
\item It is worth noting that Congress amended the Exchange Act directly. See id. at 752. Accordingly, although courts may look to how courts proceeded under Rule 9(b) before the Reform Act to determine how to apply the new heightened pleading standard, they should not consider the Rule 9(b) approach to determine when the new pleading standard applies. On the latter point, Congress has spoken. Thus, Congress has both redefined the pleading standard and indicated when it should be
\end{enumerate}
\end{footnotesize}
heightened pleading standard applies only to Exchange Act Claims, not to Securities Act Claims.

Further, the language and purpose of Rule 9(b) and the basis for the common law preceding the Reform Act support the argument that, as adopted, the heightened pleading standard applies only to Exchange Act Claims. As discussed above, the Rule 9(b) analysis has its roots in the scienter element of such claims, an element not required for Securities Act Claims. Indeed, Securities Act Claims are not fraud claims at all. At the most, they are negligence claims. Thus, the rationale for invoking Rule 9(b) in the first place—scienter—is not applicable. As a result, it would be both illogical and contrary to the plain language of the statute to apply the heightened pleading standard to any claim other than those brought pursuant to the Exchange Act.

Other provisions of the Reform Act further support the argument that the heightened pleading standard does not apply to Securities Act Claims. For example, many sections of the Reform Act contain amendments identical to those in both the Securities Act and the Exchange Act. Specifically, Congress included identical stay-of-discovery provisions for both the Securities Act and the Exchange Act. Indeed, the stay-of-discovery provision for the Exchange Act immediately follows the heightened pleading standard. Other identical provisions amending both Acts include the passages referring to: certifications required to be filed with class action complaints; appointment of lead plaintiffs; awards to class representatives; applied.

303. See supra notes 18-21 and accompanying text.
304. See supra notes 279-85 and accompanying text.
305. See supra notes 281-84 and accompanying text.
306. Cf. Richman et al., supra note 271, at 979-84 (challenging three common reasons for applying Rule 9(b) to Exchange Act Claims: (1) because allegations of securities fraud arise in an impersonal context and many firms sued remain both viable and profitable, concern about harm to defendants' reputations is unfounded; (2) adequate notice is not unique to securities fraud, therefore, such claims do not require review different from general Rule 12 options; and (3) although potential for strike suits exists, it is better remedied by Rule 11, not Rule 9(b)).
307. Indeed, Title III of the Reform Act, "AUDITOR DISCLOSURE OF CORPORATE FRAUD," lends further support to this argument. See 109 Stat. at 762-64. This provision of the Reform Act requires public accountants performing audits required by the 1934 Act to implement provisions both to detect and report fraud. Title III, however, amends only the 1934 Act. Such a provision was unnecessary for § 11 claims for two reasons. First, § 11 does not require proof of fraud or that an alleged misstatement or omission be knowingly made, only that it be made. Second, § 11 provides auditors with a due-diligence defense.
309. See id. at 747.
310. Compare id. at 737-38, with id. at 743 (requiring plaintiffs to certify they read complaint before filing).
311. Compare id. at 738-740, with id. at 743-45 (creating new standards for courts to apply when
settlements filed under seal; attorneys' fees; disclosure of settlement terms; attorney conflicts of interest; sanctions for "abusive litigation"; written interrogatory rights; and prohibitions on attorneys' fees from SEC disgorgement funds. By making so many parallel changes, Congress arguably demonstrated that when it intended to make the same change in both Acts, it did so. Congress did not, however, include a provision like section 21D(b) in the portion of the Reform Act amending the Securities Act. It is reasonable to infer from this absence that Congress did not intend for the pleading standard to apply to Securities Act Claims, therefore, courts should not extend the pleading standard to such claims.

The Reform Act also contains some provisions which amend only the Exchange Act because certain reforms were applicable only to it. For example, Congress added damages limitations to the Exchange Act. A similar amendment to the Securities Act was unnecessary because damages for Securities Act Claims were already defined statutorily. The same is true of the Reform Act's amendment requiring parties to provide security for the payment of costs for Exchange Act Claims: the Securities Act already contains such a provision. These amendments, like section 21D(b), were

appointing lead plaintiff).

312. Compare id. at 740, with id. at 745 (restricting cash awards to class representatives).
313. Compare id. at 740, with id. at 745 (detailing certain settlement provisions).
314. See id. at 745 (setting limitations on attorneys' fees).
315. Compare id. at 740-41, with id. at 745-46 (providing descriptions of information to be disclosed with settlement terms).
316. Compare id. at 741, with id. at 746 (requiring courts to determine whether attorneys who are both members of class and wish to represent class should be allowed to do so).
317. Compare id. at 741-42, with id. at 747-48 (mandating that courts review pleadings and make findings concerning compliance with Federal Rule of Civil Procedure 11(b)).
318. Compare id. at 742, with id. at 748 (requiring courts to submit, at defendants' requests, interrogatories to jury about its findings of scienter).
319. Compare id. at 756, § 103(b)(1)(f), with id. § 103(b)(2)(4) (prohibiting practice of paying attorneys fees from SEC disgorgement funds).
320. "It is generally presumed that Congress acts intentionally and purposely when it includes particular language in one section of a statute but omits it in another." BFP v. Resolution Trust Corp., 511 U.S. 531, 537 (1994); see also 2A NORMAN J. SINGER, STATUTES AND STATUTORY CONSTRUCTION § 46.05 (1992) (stating that courts consider entire legislative scheme of which provision is part; interpretation should not be confined to individual sections).
321. Section 103(a) of the Reform Act, which contains prohibitions on referral fees, amends the Exchange Act, but contains a reference incorporating its provisions into the Securities Act as well. This passage supports the argument that Congress amended both of the Acts with identical conditions only when it intended to do so. Compare 109 Stat. 756 § 103(b)(1)(f), (b)(2)(4), with id. § 103(a)(8).
322. See id. at 766.
323. See 15 U.S.C. §§ 77k(e), 77l (1994 & Supp. II 1996); see also supra note 278.
324. See 109 Stat. at 746, § 101(a)(8).
necessary only in the Exchange Act, thereby lending further support to the contention that section 21D(b) applies only to such claims.\(^{326}\)

Finally, section 102 of the Reform Act, which amends both the Securities\(^{327}\) and Exchange Acts\(^{328}\) to create a safe harbor for certain forward-looking statements,\(^{329}\) reveals that Congress carefully chose when to incorporate scienter into the Securities Act. The safe-harbor provisions are identical; each contains language concerning scienter.\(^{330}\) These reforms allow certain statements to qualify for protection as forward-looking in nature and, thereby for immunity from suit, unless a plaintiff is able to show either (1) that the alleged misstatement was made with "actual knowledge that the [it] was false or misleading"\(^{331}\) or (2) that it was made with the approval of an executive officer who knew that it was false or misleading.\(^{332}\) The inclusion of a specific definition of the state of mind for scienter in these provisions of the Reform Act reveals that Congress was cognizant of the difference between the Acts. Therefore, Congress’s omission of such a change in the Securities Act also reveals its intent. Thus, courts should not extend the pleading provisions to Securities Act Claims.

Although the text of the statute is arguably clear and therefore resort to the legislative history of the Reform Act is unnecessary,\(^{333}\) a brief look at the published legislative history accompanying the Senate Report\(^{334}\) reveals Congress’s intent to apply the heightened pleading standard only to Exchange Act Claims.\(^{335}\) For example, in the description of section 104 of the Senate Bill reported out of the Banking, Housing, and Urban Affairs Committee (the "Committee")—"Requirements for securities fraud actions"—the Committee described the stay-of-discovery and heightened pleading

\(^{326}\) The location of this provision in the Reform Act is particularly interesting. It appears between the settlement-disclosure and attorney conflict-of-interest provisions discussed supra notes 305-17 and accompanying text. Thus, although Congress specifically amended both the Acts with identical provisions on either side of this one, it did not incorporate this amendment into both.


\(^{329}\) See supra notes 222-23.


\(^{331}\) Id.

\(^{332}\) Compare id. at 750, § 27A(c)(1)(B)(ii), with id. at 754, § 21E(c)(1)(B)(ii).


\(^{334}\) The House of Representatives did not issue such a Report. See 141 CONG. REC. 679 (1995); see also Garcia v. United States, 469 U.S. 70, 76 (1984) ("[T]he authoritative source for finding the Legislature's intent lies in the Committee Reports on the bill, which 'represent[t] the considered and collective understanding of those congressmen involved in drafting and studying proposed legislation'" (quoting Zuber v. Allen, 396 U.S. 168, 186 (1969))); RTC v. Gallagher, 10 F.3d 416, 421 (7th Cir 1993) (Conference Report "is most persuasive evidence of congressional intent besides the statute itself").

\(^{335}\) See id. at 705.
standard provisions. When the Committee discussed the stay-of-discovery amendments, it noted its intent to add such a stay to each of the Acts. It did so. The second paragraph of the Committee’s description, however, which addresses the heightened pleading standard, specifically states that the provision applies only to Exchange Act Claims. Taken together, these two paragraphs in the Committee’s report, which appear near each other, reveal that Congress intended the pleading standard to apply only to Exchange Act Claims.

C. The Policy and Purpose of the Securities Act

In general terms, the Securities Act regulates public offerings of securities and the Exchange Act regulates aftermarket trading. Thus, the Securities Act requires transactional reporting and the Exchange Act periodic reporting for companies that have made an initial public offering of securities under the Securities Act. The purpose of the Securities Act is to require a company that wants to raise capital by issuing securities to the market to provide disclosures to potential investors sufficient to enable them to make “rational investment decision[s].” Accordingly, the Securities Act requires extensive disclosures about a company, based on the premise that informational asymmetries exist between issuers and purchasers, such that purchasers can act rationally only when they have access to otherwise non-public information about the company in question.

These informational asymmetries are most serious in IPOs—the type of offering often at issue in complaints raising both Securities Act and

336. Id. 337. See id. The Report states: “Section 104(a) (1) amends section 20 of the 1933 Act by adding a new subsection (k) and (l) and adds a new section 36(c) to the 1934 Act, (i) requiring the court to stay discovery . . . .” Id.

338. See id. The Report states: “Section 104(b) amends the 1934 Act by adding a new section 36, establishing pleading standards for section 10(b) actions alleging untrue statements or omissions of a material fact.” Id.

339. The accompanying provision of the Report which contains the “ADDITIONAL VIEWS OF SENATORS GRAMM, MACK, FAIRCLOTH, BENNET, GRAMS, AND FRIST,” lends further support to this interpretation. See CONG. REC. at 711, 713. Here the Senators discuss the “Standard of Liability (Section 104)” and refer specifically to Rule 10b-5 actions. See id. at 713.


341. See id.

342. See id. at 126.

343. See id.

344. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (noting the Securities Act “was designed to provide investors with full disclosure of material information concerning public offerings”); see also ROBERT CHARLES CLARK, CORPORATE LAW 719 (1986).
Exchange Act Claims. By definition, an IPO is the company’s first issuance of securities to the market. Before the IPO, the company was not subject to the periodic-reporting requirements of the Exchange Act; consequently, potential investors had limited information about the company.\footnote{345}

The Securities Act addresses this informational asymmetry by requiring IPO issuers to file both a registration statement\footnote{346} and a prospectus,\footnote{347} which is part of the registration statement.\footnote{348} To meet the disclosure requirements, these documents must include a wide range of information about the company.\footnote{349} For example, a company must describe its history, business, and current operations, including products, markets, and competition;\footnote{350} capital structure;\footnote{351} financial condition and past performance;\footnote{352} directors and officers, detailing both compensation arrangements and describing their relationship to the issuer;\footnote{353} offering terms and plans for using the offering proceeds;\footnote{354} commission agreements with the underwriters;\footnote{355} and pending

\footnote{345. The informational-asymmetry problem is less acute in the case of an offering of a company that has been public for several years and, therefore, subject to the periodic reporting requirements of the 1934 Act. Indeed, the duplicativeness of the Acts’ provisions in this context has received considerable criticism. See, e.g., John C. Coffee, Jr., Reengineering Corporate Disclosure: Coming Debate Over Company Registration, 52 WASH. & LEE L. REV. 1143 (1995); Milton H. Cohen, Truth in Securities Revisited, 79 HARV. L. REV. 1340 (1966).


The SEC’s Wallman Commission has proposed additional reforms to shift the focus of the Acts from a transaction-based to a registration-based system and which is designed to ease the cost of and restrictions on the sale of securities. See Wallman Commission Report (the “Report”). The Wallman Commission’s proposal for a new registration-based system excludes IPO’s from eligibility in the registration-based system. Further, the Report actually proposes an increase in §11 liability for some offerings. Thus, despite the overall changes and integration advocated by the Wallman Report, it continues to highlight the differences in the stated purposes underlying the two Acts—particularly in the context of initial public offerings.

\footnote{346. See 15 U.S.C. § 77e(c) (1994). Other public offerings are also subject to these provisions.

\footnote{347. See 15 U.S.C. § 77e(b) (1994). Again, other public offerings are also subject to these provisions.

\footnote{348. See id.

\footnote{349. See, e.g., Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1202 (1st Cir. 1996) (noting that “[t]he obligations that attend the preparation of [Securities Act filings] embody nothing if not an affirmative duty to disclose a broad range of material information”).


\footnote{351. See id. § 229.201.

\footnote{352. See id. § 229.301-304.

\footnote{353. See id. § 229.400-402 (4-1-96).

\footnote{354. See id. § 229.504.}
legal proceedings, if any. The extensiveness of the obligatory disclosures is further evidence of their importance and supports the argument that courts should interpret the Reform Act in a manner that allows for the enforcement of these obligations.

An analogy to the “disclose or abstain” standard applied to insider trading cases further reveals the importance of Securities Act disclosures and their enforcement. When a company “goes public,” many of the securities offered for sale are owned by its officers and directors. Those same officers and directors often own additional securities and options to purchase securities which are not offered for sale, but which they expect will increase in value after the public offering. Although they possess considerable information about the company and its short-term and long-term prospects for the future, potential investors have access only to the information provided pursuant to the Securities Act or additional information the company chooses to disclose. In this way, IPOs are analogous to insider trading and the “disclose or abstain” analogy applies. Therefore, officers and directors must disclose material information about the company or refrain from engaging in a public offering.

Given the informational asymmetries present in both initial public offerings and insider trading, it makes sense that Congress would have left unchanged the express and accessible remedies designed to enforce the Securities Act’s disclosure provisions. These remedies are an important means of ensuring that the private enforcement mechanism will continue to function. If courts extend the Reform Act’s more stringent, Exchange Act pleading standard to Securities Act remedies, they diminish the enforcement power of those remedies. Therefore, courts should not extend the new pleading requirements to Securities Act Claims.

The express nature of the Securities Act enforcement mechanisms also supports the argument that the courts should refrain from imposing the new pleading standard on such claims. Unlike the implied cause of action for an Exchange Act Claim, Securities Act Claims are express causes of action that allow private investors to enforce a company’s disclosure obligations. These remedial provisions act as the incentive for a company to adhere to its

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355. See id. § 229.103.
356. See id. § 229.509.
357. See United States v. O’Hagan, 65 U.S.L.W. 4650 (U.S. June 25, 1997) (No. 96-482) (holding insiders are subject to a duty to disclose inside information or to abstain from trading in order to prevent corporate insider from taking improper advantage of uninformed shareholders).
359. See supra note 341.
disclosure obligations. By crafting express causes of action, Congress indicated the importance it attached to the completeness and accuracy of public-offering disclosures and its intent to subject public offerings, and thereby the companies, officers, and directors making them, to investor scrutiny. In similar vein, Congress's reforms of the Exchange Act Claims may be viewed as its attempt to remedy the uncertainty inherent in the implied cause of action. Conversely, Congress's decision not to make similar changes to the Securities Act Claims may be viewed as a reflection of its intent to protect its earlier-drafted express causes of action.

Finally, claims under the Securities Act are easier to prove than those under the Exchange Act, further indicating the importance Congress attached to the requisite disclosures. Securities Act Claims are strict liability and negligence causes of action. In order to prove liability, plaintiffs need not prove the more difficult element of scienter. In addition, unlike Exchange Act Claims, Securities Act Claims do not require plaintiffs to prove reliance on the alleged misstatement or omission, again making the claims easier to prove. Thus, these express and accessible Securities Act provisions further reflect the importance Congress attached to them.

D. Summary

The full disclosure provisions of the 1933 Act, the process it regulates, the raising of capital by company insiders, and its express and accessible enforcement provisions reveal that Congress intended to ensure that companies desiring to raise capital in the market disclose a broad range of information to that market. The purpose of these disclosures is to eliminate the informational asymmetry generally present in public offerings and particularly in IPOs. Indeed, these disclosures diminish the insider-trading aspects of these offerings. Given the importance of the disclosure obligations and their enforcement, courts should not restrict those provisions by applying the Reform Act's stringent pleading standard to Securities Act claims.

360. See supra notes 337-53 and accompanying text.
361. See supra notes 280-84 and accompanying text.
362. See Shaw, 82 F.3d at 1223 (emphasizing "[f]raud is not an element of a claim under either section 11 or 12(2), and plaintiff asserting such claims may avoid altogether any allegations of scienter or reliance"); see supra notes 302-04 and accompanying text.
363. See supra note 283 and accompanying text.
364. Congress did not amend the Securities Act's enforcement provisions. By not doing so, Congress indicated that it still expects companies to provide full and accurate disclosures in public-offering documents and intends for plaintiffs to have access to the enforcement provisions. The Wallman Report further supports this point of view. See supra note 341.
365. See Herman & MacLean v. Huddleston, 459 U.S. 375, 383 (1982) (indicating basic purpose of Securities Act is "to provide greater protection to purchasers of registered securities").
Moreover, the stringency of the standard as applied in the *Silicon* and *Hockey* cases discussed above emphasizes the importance of analyzing such claims separately. For example, in one post-Reform Act opinion the court analyzed a complaint containing both Securities Act and Exchange Act Claims and incorrectly concluded that because prior to the Reform Act, its circuit had held that such complaints were grounded fraud, they should still be analyzed under that standard. The court reached this conclusion by looking only to Ninth Circuit law before the Reform Act and rejected the plaintiffs' attempt to plead both Securities Act and Exchange Act Claims as one that simply inserted “boilerplate language” into the complaint. It then dismissed the entire complaint for failure to plead with particularity, thereby highlighting the problem discussed in this Part of the Article. Heightened pleading standards may result in the dismissal of strict liability and negligence causes of action based on a pleading standard premised on intentional behavior. The statute reveals that Congress did not intend such an outcome. Therefore, courts should decline to apply the heightened pleading standards to Securities Act Claims and allow litigation over those claims to proceed.

**VII. Conclusion**

By using a new model to make sense of the pre-Reform Act pleading standards, this Article creates a base from which to evaluate the new pleading standard and stay-of-discovery provisions. My analysis of those pleading standards highlights an implicit condition—that in order to survive a motion to dismiss, plaintiffs must plead internal company information in their complaints. This internal-information standard, when combined with the new stay-of-discovery provision, creates a requirement that if strictly applied is outcome determinative and likely to be overinclusive in its elimination of such claims. Early decisions under the Reform Act support this argument. I

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367. *See id.* at *8.
368. *See id.* at *13.
370. *See Feiner v. SS & C Tech.*, 11 F. Supp. 2d 204 (D. Conn. 1998) (refusing to apply heightened pleading standard to complaint alleging only 1933 Act claims, noting that claims sounded in negligence, not fraud and that scienter standard might apply only to complaints alleging claims from both Acts).
propose that Congress correct this problem by repealing the stay of discovery and instead adopting managerial judge provisions to process such claims. Such a mechanism would better balance the competing goals of protecting the markets and limiting abusive litigation.

This Article further predicts, on the basis of the early Reform Act decisions, that despite Congress's stated intent to resolve the split among the circuits on the applicable pleading standard, the language of the Reform Act and its legislative history have left the courts in a quandary. As a result, the beginning of a new split between the circuits is already apparent and further review by the circuits and the Supreme Court is likely.

Finally, this Article argues that the Reform Act's pleading standards do not apply to the negligence and strict-liability claims of the Securities Act of 1933. Courts that fail to make this distinction diminish the enforcement power of that Act. The early cases discussing such claims indicate that a circuit split is equally likely on this issue as well.