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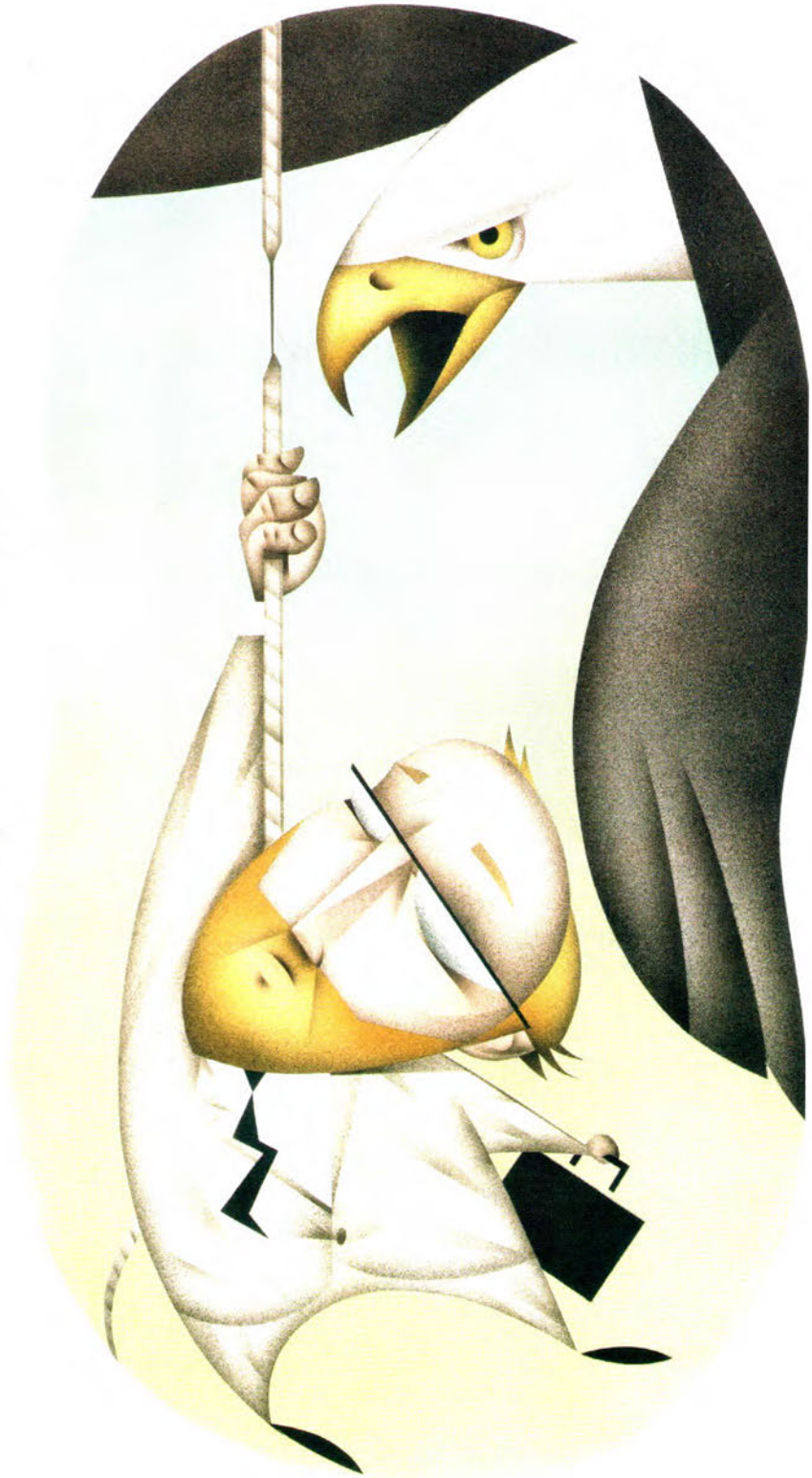
After the
**stock market
collapse of 1929,**
Congress enacted securities laws to cure an atmosphere of fraud. But in the last 30 years Congress and the courts have taken significant steps to knock out the one enforcement measure that makes all corporations accountable — **the jury, the final arbiter when corporate wrong-doing is alleged.**

What the law giveth

Securities litigation and the jury of the 21st century

By **Larry T. Bates**

with Erin Huber, Wesley Lotz,
Marilyn Montano and Eric Porterfield



the law taketh away

I. Introduction and Background

The recent corporate financial scandals involving such entities as Enron, MCI WorldCom, and even Martha Stewart pose the question: "When and how did this corporate fraud begin?" It is perhaps too much of a coincidence that every branch of the federal government has had its turn in eviscerating the protection afforded to individuals by the Securities Laws. Federal laws protecting shareholders against securities fraud were a response to this country's early years of corporate irresponsibility. After the stock market crash of 1929 and the

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The greatest barriers to private securities enforcement began with a series of U.S. Supreme Court cases reducing or eliminating avenues for private plaintiffs.

ensuing Great Depression, Congress responded with the Securities Act of 1933 and a year later with the Securities and Exchange Act of 1934 ("Acts"). These Acts sought to cure the atmosphere of fraud created by corporations seeking to maximize profits, even at the expense of their shareholders. The Acts were designed to heighten fiduciary duties in securities transactions, replacing the traditional caveat emptor with full disclosure by the seller. Congress and President Franklin D. Roosevelt hoped shifting this burden to corporations would restore public confidence in financial markets.

The courts initially followed Congress' lead. Federal courts broadly interpreted the new Acts, emphasizing their remedial nature. For example, federal courts implied a private right of action beginning in the 1940s. The Securities and Exchange Commission ("SEC") also recognized the crucial role of private enforcement of securities claims, endorsing private suits under its Rule 10(b)-5.¹ However, the grim memories of the Great Depression eventually faded. After decades of unqualified success in creating the most vibrant and successful capital markets in the world, the courts began to view private securities lawsuits as vexatious and frivolous. In the last 15 years, the federal government has taken significant steps to keep private securities litigants out of court. This time, Congress has followed the lead of the federal courts.

Although beginning as early as the 1970s, commentators agree that the greatest barriers to private securities enforcement began with a series of U.S. Supreme Court cases reducing or eliminating avenues for private plaintiffs. Congress has taken its cues from the Court, enacting two statutes that both expand current barriers and place new hurdles in front of plaintiffs.

These obstacles are very favorable to defendants: heightened pleading standards, mandatory stays of discovery, affirmative defenses, liberal use of sanctions against plaintiffs, stringent causation requirements, and preemption of certain class action suits. As a result, prosecuting private suits is a far greater risk for plaintiffs than ever before. In addition, disposing of the traditional method for enforcement of securities laws has placed an increased burden on the SEC. While the recent reforms leave public enforcement virtually untouched, Congress has given little more than lip service to its promise to increase the funding of the SEC. Therefore, as the law stands today, corporations can operate with far less fear that they will be held accountable by either their shareholders or the SEC.

II. The Role of the Supreme Court in Narrowing Plaintiffs' Avenues for Recovery under the Securities and Exchange Act

A trilogy of adverse Supreme Court rulings in the last 15 years has severely limited the availability of federal securities causes of action. These decisions virtually closed the door for plaintiffs attempting to reach a jury to adjudicate securities fraud and eliminated the deterrent effect of federal private causes of action. Liability for aiding and abetting securities fraud has been a hot topic in the wave of securities lawsuits related to the Enron scandal, as plaintiffs attempt to reach the deep pockets of the accounting, financial, and law firms associated with the bankrupt energy giant. Plaintiffs face an uphill battle in trying to recover from these associated entities due to a combination of judicial rulings and legislative reforms in the 1990s that severely curtailed aiding and abetting liability for

securities violations. The elimination of aiding and abetting liability for securities violations likely contributed to a climate of corporate irresponsibility that enabled the recent wave of financial scandals to occur.

The elimination of aiding and abetting liability can be traced directly to the Supreme Court's 1994 decision in *Central Bank v. First Interstate Bank*.² In *Central Bank*, the Supreme Court announced that Rule 10(b)-5 of the Securities and Exchange Act did not create a cause of action for aiding and abetting securities violations.³ The practical effect of the decision was to limit liability for securities fraud to the primary violator, making it virtually impossible for litigants to pursue a cause of action against parties who indirectly supported the commission of securities fraud. Although the Private Securities Litigation Act ("PSLRA") restored aiding and abetting liability in SEC enforcement actions, *Central Bank* continues to bar private causes of action for aiding and abetting. Given the structural limitations on SEC enforcement discussed elsewhere in this comment, the elimination of aiding and abetting liability in private rights of action takes on added significance.

The *Central Bank* decision was the culmination of a judicial effort over the past thirty years by the Burger Court and Rehnquist Court to curtail securities litigation. Two other notable Supreme Court decisions in the 1990s significantly narrowed the avenues available to plaintiffs in federal securities litigation. In *Lampf v. Gilbertson*, the Supreme Court dramatically shortened the statute of limitations for securities fraud claims, holding that the statute of limitations bars 10(b)-5 claims arising later than one year from the date of the discovery or more than three years from the date of the transaction.⁴ A further blow to

MAJOR DEVELOPMENTS IN THE WAR AGAINST PRIVATE LITIGATION AND THE ROLE OF THE JURY

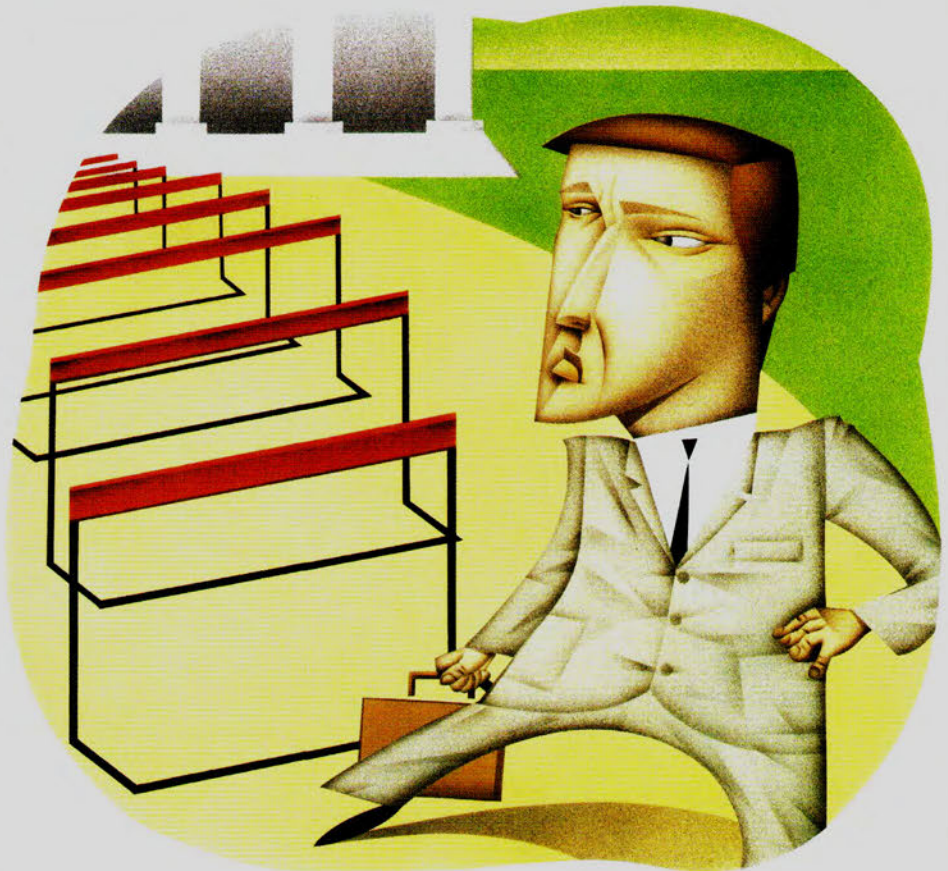
During the past 30 years both Congress and the courts have worked in unison to undermine what had, in effect, become our most important mechanism for enforcing the securities laws that were enacted after the market collapse of 1929 to cure the atmosphere of fraud that had existed when corporations sought to maximize profits at the expense of shareholders: private enforcement actions by shareholders.

Private securities lawsuits worked to coerce corporate responsibility by making corporations accountable to those that were most directly and adversely affected by the corrupt and/or irresponsible actions of management. At the heart of this enforcement mechanism was, of course, the jury, the final arbiter when corporate wrong-doing was alleged. However, after decades of unqualified success in creating the most vibrant and successful capital markets in the world, Congress and the courts began to view private securities lawsuits as vexatious and frivolous. During these past 30 years, the federal government has taken significant steps to keep private securities litigants out of court — to prevent juries from exercising their constitutional role in the resolution of disputes. Given the vital role that private causes of action have played in unearthing and deterring securities fraud, these actions have probably decreased the incentive for corporate management to avoid securities laws violations.

1. ELIMINATION OF AIDING AND ABETTING LIABILITY: The practical effect of eliminating aiding and abetting liability is to limit liability for securities fraud to the primary violator, making it virtually impossible for litigants to pursue a cause of action against parties who indirectly supported the commission of securities fraud — such as in Enron.

2. HEIGHTENED PLEADING REQUIREMENTS: Congress expanded on the pleading requirements of Rule 9(b) to now require that plaintiffs plead with “particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” Courts now have far more discretion to dismiss securities cases at the most preliminary stage, which will result in far fewer cases making it to the jury.

3. MANDATORY STAY OF DISCOVERY: Federal law now provides



that in the most common form of private enforcement litigation, discovery against defendants will be indeterminately stayed upon the filing of a motion to dismiss by the defendant. Plaintiffs will be unable to use discovery to unearth evidence of fraud early in the proceedings which will make it more likely that defendants will prevail on their motions to dismiss and thus many plaintiffs will never have the opportunity to present their claims to a jury.

4. EXPANDED SAFE HARBOR PROVISIONS: Congress has substantially expanded the safe harbor provision for forward-looking statements. New safe harbor also includes oral statements which means companies can now make protected forward-looking statements by mass media. Expanded safe harbor will make it easier for defendants to obtain summary judgments - regardless of the merits of a particular plaintiff's claims.

5. SANCTIONS PROVISIONS FOR RULE 11 VIOLATIONS: Congress has now mandated sanctions for rule 11 violations in securities lawsuits and created a rebuttable presumption that an award of attorneys fees and costs to the defendant is the appropriate sanction. The new sanctions rule appears to have discouraged plaintiffs from pursuing claims in federal courts.

6. PREEMPTION OF STATE CLASS ACTIONS: Congress has preempted most class actions alleging securities fraud in connection with the purchase of securities traded on the major exchanges. Preemption here displaces state law entirely. Plaintiffs not only lose their right to litigate their claim in state court, but they also lose the right to litigate the state claim in federal court through supplemental jurisdiction. Significantly, the discovery stay applicable in securities lawsuits when defendants move to dismiss a case will be available to stay discovery in any private action in state court while the federal case is pending.

securities plaintiffs came in *Gustafson v. Alloyd*, where the Supreme Court limited the class of plaintiffs who can bring rescission suits for securities fraud to purchasers in a

securities laws sent a dangerous message to corporations and litigants that securities fraud was not likely to result in significant jury awards. Given the vital role of private causes of action

judgment on an affirmative defense under the “bespeaks caution” doctrine. This doctrine creates “safe harbor language” which provides more protection for forward-looking

The judiciary’s systematic narrowing of the federal securities laws sent a dangerous message to corporations and litigants that securities fraud was not likely to result in significant jury awards.

public offering, effectively eliminating suits by shareholders who acquired stock by secondary trades.⁵ One survey of Supreme Court decisions over this period concluded that in “forty federal securities law decisions, the Court decided thirty-two cases for defendants and, in almost every one, significantly narrowed the reach of federal securities laws.”⁶

The impact of these Supreme Court decisions was not limited to their particular holdings, but instead created a ripple effect that significantly limited the attractiveness and availability of federal securities litigation. Lower courts responded to the Supreme Court’s open hostility to securities litigation by further narrowing the scope of securities laws and preventing critical liability issues from ever reaching the jury. For example, lower court retrenchment can be seen in the aggressive dismissal of cases under Rule 9(b)⁷, the judicial limitations on causation, and the evolution of the “bespeaks caution” doctrine⁸, all of which began in the federal courts, eventually to become statutory barriers. (Each of these doctrines is discussed in greater detail below.) In the words of one author, “lower courts developed doctrines that effectively robbed juries of the ability to determine if the given conduct constituted fraud by granting judicial discretion over the issue, which invariably resulted in claim termination.”⁹ The judiciary’s systematic narrowing of the federal

in unearthing and deterring securities fraud, these decisions probably decreased the incentive for corporate executives and directors to carefully avoid securities violations.

III. Congress Follows Suit: The Private Securities Litigation PSLRA of 1995

Taking the lead of the federal courts, Congress enacted the Private Securities Litigation Reform Act (“PSLRA”) of 1995,¹⁰ responding to a perceived increase in frivolous “strike” suits. Strike suits are unmeritorious claims alleging federal securities violations in the hope that the defendant will quickly settle to avoid expensive litigation. The sponsors of the PSLRA designed the act to discourage non-meritorious claims, while still allowing plaintiffs to bring and succeed on meritorious claims. The PSLRA both codified new barriers to plaintiffs and expanded on those already existing. These provisions include heightened pleading requirements, stays of discovery, affirmative defenses, sanctions, and stricter causation standards.¹¹ The pleading requirements of the PSLRA require a higher burden of proof at the pleading stage, both for the scienter required and the facts necessary to prove scienter. The PSLRA also provides for mandatory stays of discovery any time a motion to dismiss is filed. These motions are also more likely to be granted because defendants may now seek summary

statements than that received in the past.¹² Coupled with more stringent causation requirements, courts can now easily dispose of claims long before they would reach a jury. The combination of these factors makes it more difficult for plaintiffs to discover evidence of wrongdoing while also making it easier for defendants to insulate their statements from liability for fraud. The actual effect on plaintiffs has begun to materialize. While the number of complaints remained relatively stable, the number of dismissals increased substantially. The number of settlements also decreased; however, those cases that did settle after the PSLRA tended to be larger. In response to the difficulty in succeeding on a federal securities cause of action under the PSLRA, more plaintiffs seemed to be filing their securities actions in state court.

A. The Genesis of the Pleading Standards: Federal Rule 9(b)

Even prior to the current reform movement, federal courts were disposing of securities lawsuits based on pleading deficiencies. Federal courts already had a “heightened pleading standard” in the Federal Rules of Civil Procedure. Federal Rule of Civil Procedure 9(b) provides: “In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of

mind of a person may be averred generally.”¹³ Because claims under the securities laws are often predicated on fraud, plaintiffs were required to aver fraud with particularity. Just as in any other fraud claim, plaintiffs were vulnerable to dismissal if they could not specifically allege the circumstances amounting to fraud in their purchase or sale of securities.

However, unlike other fraud claims, plaintiffs in securities actions were held to an even higher standard. Even before the heightened pleading standards of the PSLRA, federal courts were stretching Rule 9(b), sometimes in ridiculous ways, to prevent securities lawsuits from getting to a jury.¹⁴ Commentators generally agree that federal courts were dismissing cases on the pleadings or at the summary judgment stage with increasing frequency even before the PSLRA.¹⁵ Although difficult to precisely quantify, some statistics do exist to support this proposition. The very statistics that Congress relied on in passing the PSLRA show that a significant number of cases filed are dismissed on a motion. In 1994, Senator Pete Domenici summarized testimony from a leading plaintiffs’ securities litigation firm showing that for the years 1990 and 1991, 38% of their cases were dismissed on motions, with the balance settling.¹⁶ The Big Six accounting firms also report similar numbers resulting from private securities litigation against their firms. Between 1990 and 1992, nearly a third of the cases were dismissed on motions.¹⁷ Of approximately 128 total cases, only five cases were actually tried and only two resulted in verdicts for plaintiffs.¹⁸ Furthermore, in a letter to Congress, the Securities Industry Association reported that in 1992, 46 motions to dismiss for failure to meet the requirements of Rule 9(b) were filed, and 29 lawsuits were dismissed. Therefore, 63% of the motions to dismiss on this ground were successful.¹⁹ These numbers show that suits were frequently dismissed at the preliminary stages, even before the more defendant-friendly standards of the PSLRA.

B. The PSLRA’s Heightened Pleading Requirements

The PSLRA expanded on Rule 9(b)’s already stringent pleading requirements. In order to succeed on a claim that a defendant made misleading statements or omissions, a plaintiff must now meet the requirements of section 21D, “Private Securities Litigation.” Section 21D (b)(2) addresses the state of mind, or scienter requirement.²⁰ This section provides:

*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.*²¹

The preceding portion of this section, (b)(1), provides for the factual pleadings required to prove the scienter requirement. In order to survive the pleadings stage:

[i]n 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 statement made, in the 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, 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.²²

The legislative history of the PSLRA indicates that Congress adopted the Second Circuit’s standard for pleading fraud with particularity as required by Rule 9(b) of the Federal Rules of Civil Procedure.²³ The Second Circuit required the plaintiff to plead facts giving rise to a “strong inference” of fraudulent intent. However, the PSLRA did not codify the Second Circuit’s interpretation, which was the most stringent at the time the PSLRA was passed.

The Supreme Court has not yet addressed either the scienter requirement or the factual pleadings required to prove scienter. The circuit courts differ both in their definitions of recklessness and in whether motive and opportunity are sufficient to give rise to a strong inference of recklessness. There are three distinct camps. The most lenient standard to meet is that adopted by the Second and Third Circuits, while the Ninth Circuit has the most stringent standard. The First, Fifth, Sixth, Eighth, Tenth, and Eleventh Circuits have all adopted an intermediate position. All of the circuit courts agree, however, that a general averment of scienter is insufficient to meet the pleading requirements of the PSLRA. Furthermore, all of the circuit courts agree that some form of recklessness is sufficient to establish scienter.

The Second Circuit takes the position that the PSLRA did not alter its pleading standard for scienter,²⁴ except by adding the words “with particularity.”²⁵ Whereas previously the Second Circuit had the most stringent standard for pleadings, its standard is now considered to be the most lenient of the three approaches. In order to satisfy the recklessness requirement in the Second Circuit, a plaintiff must prove that the conduct was “highly unreasonable” and “an extreme departure from the standards of ordinary care ... to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.”²⁶ Technically, the Second Circuit views intent as the required state of mind. However, recklessness is the minimum culpable conduct from

which intent can be inferred.²⁷ As for the factual pleadings required to allege scienter, a complaint need only allege facts establishing a motive and opportunity to commit fraud and giving rise to a strong inference of recklessness. The Third Circuit has also held that scienter can be established with allegations of motive and opportunity.²⁸

By contrast, the Ninth Circuit, which previously had the most lenient approach, has adopted the most stringent interpretation of the PSLRA pleading requirements. The Ninth Circuit now requires "deliberate recklessness."²⁹ Furthermore, in *In re Silicon Graphics* the Ninth Circuit has held that motive and opportunity alone can never satisfy the factual pleading requirements for scienter.³⁰ The *In re Silicon Graphics* decision illustrates the requirement that a plaintiff must plead, in great detail, facts that constitute circumstantial evidence of deliberately reckless or conscious misconduct. No other circuit court has followed the Ninth Circuit's position.

The Sixth Circuit first expressed the view, now adopted by a majority of the circuit courts, that motive and opportunity are relevant but not determinative of scienter. The Sixth Circuit, joined by the First,³¹ Fifth,³² Eighth,³³ Tenth,³⁴ and Eleventh³⁵ Circuits, allow a plaintiff to satisfy the PSLRA pleading requirements by alleging facts that give rise to a strong inference of reckless behavior.³⁶ However, alleging motive and opportunity alone, though relevant, is not enough.³⁷

Regardless of what circuit a plaintiff finds himself in, it will certainly be more difficult for cases to survive the pleadings stage after the passage of the PSLRA. Every circuit court to consider the issue has adopted a standard that is the same or more stringent than the most difficult standard for plaintiffs to meet prior to the PSLRA. As a result, courts now have far more discretion to dismiss securities cases at the most preliminary stage. When combined with other provisions, the heightened pleading requirements mean far more cases will never make it to a jury. This

conclusion is borne out in the higher dismissal rates in the aftermath of the PSLRA.

C. PSLRA's Mandatory Stay of Discovery

Before the PSLRA, courts took a dim view of defendants seeking a stay of discovery. As a general rule, stays of discovery were disfavored.³⁸ However, broad access to discovery was considered to be the main evil that facilitated "strike suits" because of the "astronomical" costs associated with discovery.³⁹ Plaintiffs were allegedly filing bare bones complaints then engaging in extensive document production requests.⁴⁰ Defendants allegedly felt compelled to settle as the costs of the suit escalated.⁴¹ Congress listened to the business community and included serious limitations on discovery when it enacted the PSLRA. The PSLRA takes a two-fold approach to curbing this perceived abuse by plaintiffs. As already demonstrated, the PSLRA instituted heightened pleading requirements that forced plaintiffs to plead their allegations of fraud with great specificity.⁴² Coupled with these new standards, the PSLRA dramatically altered the presumption in favor of broad access to discovery. The PSLRA now provides a statutory basis for defendants seeking to halt discovery. Specifically, the PSLRA provides:

- (b) Stay of discovery; preservation of evidence.
- (1) In general. In any private action arising under this title [15 U.S.C §§ 77a et seq.], 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.
- (2) Preservation of evidence. During the pendency of any stay of discovery pursuant to this subsection, 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.

- (3) Sanction for willful violation. A party aggrieved by the willful failure of an opposing party to comply with paragraph (2) may apply to the court for an order awarding appropriate sanctions.
- (4) Circumvention of stay of discovery. Upon a proper showing, a court may stay discovery proceedings in any private action in a State court as necessary in aid of its jurisdiction, or to protect or effectuate its judgments, in an action subject to a stay of discovery pursuant to this subsection.⁴³

Therefore, a defendant could automatically halt discovery merely by filing a motion to dismiss. As discussed below, favorable defenses and causation standards give defendants independent incentive to file such a motion.

After the PSLRA was enacted, state court filings seemed to increase and commentators suggested that plaintiffs were filing suits in state court to avoid the automatic stay of discovery.⁴⁴ Congress once again responded to the business community by enacting the State Law after the Uniform Standards Act ("SLUSA"), discussed in detail below.⁴⁵ The SLUSA allowed defendants to remove state class action

lawsuits to federal court and have a federal judge dismiss the case.⁴⁶ Because the SLUSA sweeps securities lawsuits into federal court with only a few exceptions, this allows defendants to halt discovery in virtually every case. This is so because a defendant need only file a motion to dismiss to trigger the mandatory duty of the federal judge to stay discovery.⁴⁷

The scope of this limitation is very

have also begun interpreting this exception. It appears that the exception is being narrowly construed to give defendants the full benefit of the PSLRA. For example, in *SG Cowen Securities Corporation v. United States District Court*, the Ninth Circuit issued mandamus compelling the lower court to stay discovery.⁵² The district court had allowed the plaintiff limited discovery because she was unable to meet the

discovery and such motion is likely to be granted without any discovery, plaintiffs run a high risk of dismissal at the preliminary stages. Therefore, without discovery to flesh out their claims, many plaintiffs will be unable to present their cases to a jury.

D. The PSLRA's "Safe Harbor Language" Defense

The PSLRA also significantly

Because defendants need only file a motion to dismiss to stay discovery and such motion is likely to be granted without any discovery, plaintiffs run a high risk of dismissal at the preliminary stages.

broad. Federal courts have begun interpreting the discovery stay provision liberally. For example, in *Medhekar v. United States District Court*, the district court held that the statutorily required stay did not apply to mandatory disclosure obligations under local civil court rules and the Federal Rules of Civil Procedure.⁴⁸ However, defendants sought and obtained a writ of mandamus directing the lower court to stay the initial disclosure requirements pending disposition of defendants' motion to dismiss.⁴⁹ The Ninth Circuit found that a broad reading of the discovery stay provision was necessary because "Congress clearly intended that complaints in these securities actions should stand or fall based on the actual knowledge of the plaintiffs rather than information produced by the defendants after the action has been filed."⁵⁰

There is but one exception to the mandatory stay of discovery. A plaintiff must show "that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party" to avoid the automatic stay once a motion to dismiss has been filed.⁵¹ Federal courts

stringent pleading requirements of the PSLRA.⁵³ The Ninth Circuit once again quoted from *Medhekar* stating that "Congress clearly intended that complaints in these securities actions should stand or fall based on the actual knowledge of the plaintiffs rather than information produced by the defendants after the action has been filed."⁵⁴

This rationale is broad enough to encompass virtually any securities litigation that may come before a federal court. Because federal courts have become virtually the exclusive venue for securities suits, plaintiffs will be unable to use discovery to unearth evidence of fraud early in the proceedings. The *SG Cowen* case also demonstrates the most problematic aspect of the automatic discovery stay. The heightened pleading requirements discussed above make it difficult if not impossible for a plaintiff to survive a motion to dismiss without at least some discovery to provide evidence of the wrongdoing. As *SG Cowen* emphasizes, there will be no discovery unless and until the plaintiff meets the heightened pleading standards. Because defendants need only file a motion to dismiss to stay

expanded another existing doctrine favorable to defendants. Prior to the passage of the PSLRA, forward-looking statements were protected by two means. First, the judicially-created "bespeaks caution" doctrine, was developed in order to limit actions based on forward-looking statements.⁵⁵ Jurisdictions applied the doctrine differently, but the essential doctrine was as follows: if a forward-looking statement is accompanied by "adequate cautionary language," the forward-looking statement may be deemed immaterial for a securities fraud cause of action. Jurisdictions have different interpretations of what constitutes "adequate cautionary language" and the exact effect of such language. The "bespeaks caution" doctrine survived both the subsequent codification by the Securities and Exchange Commission as Rule 175 and the PSLRA.⁵⁶

The second means of protecting forward-looking statements is a codification of the "bespeaks caution" doctrine by the Securities and Exchange Commission in 1979 as Rule 175. The safe harbor provision codified in Rule 175 was part of an effort by the SEC to encourage forward-looking statements. Rule 175 provides in part

that:

(a) A statement within the coverage of (b) of this section which is made by or on behalf of an issuer or by an outside reviewer retained by the issuer shall be deemed not to be a fraudulent statement ... unless it is shown that such statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith.

(b) This rule applies to the following statements:

1. A forward-looking statement ... made in a document filed with the Commission, in Part I of a quarterly report on form 10-Q or form 10-QSB ... or in an annual report to shareholders ... a statement reaffirming such forward-looking statement ... an annual report made publicly available within a reasonable time after the making of such forward-looking statement; ...⁵⁷

As will be discussed below, the protection provided by Rule 175 is far narrower than that provided by the PSLRA. The safe harbor provided by Rule 175 is very limited. It applies only to forward-looking statements in certain documents filed with the SEC and certain parts of a quarterly report, or an annual report to shareholders. Unlike the later "safe harbor" provision in the PSLRA, Rule 175 provides no protection for oral statements.⁵⁸ Additionally, courts have interpreted Rule 175 as having a good faith requirement.

By contrast, the safe harbor provided by section 21E of the PSLRA is much broader.⁵⁹ Section 21E, "Application of Safe Harbor for Forward-Looking Statements", provides in part that:

(c) Safe harbor

1. In general. Except as provided in (b), in any private action arising under this title that is based on an untrue statement of a material fact or omission of a material fact necessary to make the statement not misleading, a

person referred to in (a) shall NOT be liable with respect to ANY forward-looking statement, whether written or oral, to the extent that—

A. the forward-looking statement is —
i. identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement; or
ii. immaterial; or

2. the plaintiff fails to prove that the forward-looking statement —
i. if made by a natural person, was made with actual knowledge by that person that the statement was false or misleading; or
ii. if made by a business entity; was —
a. made by or with the approval of an executive officer of that entity, and
b. made or approved by such officer with actual knowledge by that officer that the statement was false of misleading.⁶⁰

Section 21E provides far more protection to defendants for forward-looking statements than either the "bespeaks caution" doctrine⁶¹ or Rule 175. Section 21E applies to both written and oral statements. A defendant can escape liability under section 21E by satisfying either of two prongs of the test: the "actual knowledge" prong, or the "bespeaks caution" prong. There is no good faith requirement under the "bespeaks caution" prong. This defense both provides another impetus for defendants to file a motion to dismiss and increases the likelihood that such motion will be granted.⁶² As a result, plaintiffs are likely to suffer dismissal long before any opportunity to conduct any significant discovery.

Section 21E expands the protection provided for forward-looking statements by protecting both oral and written statements.⁶³ The PSLRA protects forward-looking statements in more forms than just a prospectus or quarterly report. Companies can now make protected forward-looking

statements by such media as radio and televised press conferences. This obviously expands the protection of the safe harbor and limits opportunities for successful suits by plaintiffs based on forward-looking statements.

Determining whether a forward-looking statement is protected by the safe harbor provision of PSLRA is a two-prong test. A defendant may be granted summary judgment on two grounds: (1) the plaintiff cannot prove the statement was made with actual knowledge (the "actual knowledge" prong), or (2) the statement was identified as a forward-looking statement and accompanied by meaningful cautionary language (the "bespeaks caution" prong). Under the "actual knowledge" prong of section 21E (c) (2), there is no liability unless the plaintiff can prove that the forward-looking statement was made with actual knowledge that it was false or misleading. Finally, there is no liability if the forward-looking statement is immaterial.

However, under the more controversial "bespeaks caution" prong of section 21E (c)(1), no liability can attach as long as the forward-looking statement was identified as such and accompanied by meaningful cautionary language.⁶⁴ The cautionary language must identify those important factors which could cause the actual results to differ materially from those in the forward-looking statement. Perhaps most importantly, and certainly most controversially, there is no apparent good faith requirement. For example, under a literal reading of the statute, a company could intentionally make forward-looking statements that it knew were fraudulent without any liability so long as the statements were accompanied by meaningful cautionary language.

Both the "bespeaks caution" doctrine and Rule 175 are still available as defenses. Section (c)(4) provides that the exemption provided by the PSLRA is in addition to "any exemption that the Commission may establish by rule or regulation..."⁶⁵ Furthermore, the language in (c)(1)(a)(2) regarding

immateriality would allow courts to continue to use the "bespeaks caution" doctrine.⁶⁶ The availability of these defenses allows defendants to obtain summary judgment regardless of the merit of the plaintiff's claim.

E. PSLRA's Sanctions Provisions

Another issue of particular importance to practitioners is the expanded availability of Rule 11 sanctions in securities litigation since the enactment of the PSLRA.⁶⁷ Securities defendants have aggressively relied on Rule 11 sanctions to deter plaintiffs from bringing lawsuits since the 1980s. Even before the PSLRA, studies suggest that plaintiffs were targeted with sanctions in approximately 85% of cases and that plaintiffs were actually sanctioned in 45% of those cases.⁶⁸ The stated purpose of the enhanced Rule 11 provisions in the PRSLA was to "reduce significantly the filing of meritless securities lawsuits without hindering the ability of victims of fraud to pursue legitimate claims."⁶⁹ However, given the longstanding willingness of the courts to impose sanctions, the necessity of the PRSLA provisions expanding Rule 11 sanctions appears questionable in retrospect.

The two critical Rule 11 changes contemplated by the PSLRA are requiring judges to consider sanctions at the conclusion of each federal securities lawsuit and creating a presumption that the appropriate sanction for a Rule 11 violation is to award all attorney fees and costs to the defendant. Specifically, the PSLRA requires a district court to make specific findings regarding compliance with Rule 11 upon the conclusion of a lawsuit under the Exchange Act.⁷⁰ Upon a finding that Rule 11 has been violated, the PSLRA mandates the imposition of sanctions and creates a rebuttable presumption that an award of attorney fees and costs to the defendant is the appropriate sanction. The plaintiff may rebut the presumption with evidence that an award of attorneys' fees and costs is unreasonable or that the Rule 11

violation was de minimus. Courts have effectuated the legislature's desire to severely sanction abusive securities litigation by broadly construing the Rule 11 provisions in the PSLRA in awarding attorneys fees and costs to securities defendants.⁷¹

Studies suggest that the fear of incurring Rule 11 sanctions has forced numerous plaintiffs to avoid the federal forum altogether in securities litigation. One commentator has argued that as a result of expanded Rule 11 sanctions, "only the richest law firms can afford to pursue federal claims."⁷² A 1997 study indicating that 59% of all post-reform lawsuits were filed by a single firm supports the proposition that the fear of sanctions has been a significant deterrent to filing federal securities lawsuits.⁷³ This effect has led several observers to conclude that the expansive Rule 11 sanctions provisions are "directly at odds with the important role that the private cause of action has historically played in policing securities fraud."⁷⁴

An objective evaluation of the record of securities litigation since 1995 supports the conclusion that the Rule 11 sanctions provisions in the PSLRA created a disincentive for plaintiffs' attorneys to bring federal securities lawsuits. The widespread availability of sanctions throughout the 1980s makes it difficult to argue that the sanctions provisions in the PRSLA had an immediate, adverse effect on plaintiffs. Furthermore, the Rule 11 sanctions reforms in the PRSLA only affected federal securities lawsuits, leaving sanctions in state lawsuits up to the respective states. However, it is clear that the sanctions provisions in the PSLRA have deterred plaintiffs from aggressively bringing federal securities lawsuits because of the risk of incurring enormous legal fees and costs in an unsuccessful case. At a minimum, the threat of sanctions at the federal level has forced plaintiffs into the less hospitable environment of state court, where they face additional procedural and substantive hurdles as a result of the PSLRA and SLUSA. Given the importance of private causes of action in deterring securities fraud, the expanded Rule 11

sanctions imposed on plaintiffs at the federal level by the PRSLA may have weakened the regime designed to police securities fraud and contributed to the recent wave of corporate scandals.

F. The PSLRA's Causation Standard: Loss Causation

Yet another expansion of existing law favorable to defendants is the doctrine of loss causation. In order to prove a violation under Securities and Exchange Commission Rule 10b-5 of the Securities Exchange Act of 1934, a plaintiff must prove, inter alia, that he justifiably relied on the defendant's misconduct⁷⁵ and the defendant's misconduct caused the loss.⁷⁶ Reliance and causation, however, are not simple applications of general tort concepts to securities law; they are intertwined. Special doctrines and applications in regard to reliance and causation have evolved over the years to accomplish the prophylactic purpose of Rule 10b-5.⁷⁷ A plaintiff need not prove reliance on the defendant's wrongful conduct when the defendant's conduct involves either fraudulent omissions or fraud on the market.⁷⁸ There are two types of fraudulent omission cases: complete nondisclosure and deceptive omissions. In complete nondisclosure cases, causation may be established when there is a duty to disclose and a withholding of material facts.⁷⁹ In deceptive omission cases, reliance may be presumed upon a showing of a failure to reveal material facts.⁸⁰ Once reliance is presumed, causation is circumstantially established. In most cases, the defendant may rebut the inference of causation by proving nonreliance.⁸¹ Thus, recovery may depend upon a characterization of the fraud as a material nondisclosure or omission.

The second approach to reliance in the federal courts is known as fraud on the market. In the fraud on the market theory, an investor may recover for losses incurred in transactions where fraud has affected the price of the particular security.⁸² This theory of liability, however, does require reliance as a prerequisite to recovery. As opposed to the common law

approach, proof of direct reliance on misstatements is not necessary. Instead, a plaintiff need only allege reliance on the “integrity of the market” in producing accurate price data. In order to recover damages using a fraud on the market theory, the characterization of the fraud as an omission or as a nondisclosure is irrelevant. Rather, there must be a showing of fraud that has affected the price of a particular stock, a purchase or sale in reliance on the integrity of the market price, and a loss resulting from the purchase or sale.⁸³

In regard to causation, a plaintiff must prove both transaction causation and loss causation to recover under securities law.⁸⁴ Transaction causation is defined as the causal link between a defendant’s fraud and a plaintiff’s decision to engage in the transaction in question.⁸⁵ Some courts have also characterized transaction causation as a form of “but for” causation.⁸⁶ Although a plaintiff can establish transaction causation by proving that the transaction would not have occurred but for the defendant’s fraud, this is generally not necessary. Transaction causation only requires a plaintiff to demonstrate that the defendant’s fraudulent misconduct affected the terms of the resulting transaction.⁸⁷ Courts have even described transaction causation as “merely another way of describing reliance.”⁸⁸

On the other hand, loss causation is defined as the causal connection between a defendant’s fraud and a plaintiff’s injury.⁸⁹ Loss causation is the source of much controversy and confusion.⁹⁰ Courts have alternatively viewed loss causation as a form of proximate cause⁹¹ or merely a requirement to be satisfied by proof of “some causal nexus” between a plaintiff’s pecuniary loss and a defendant’s fraudulent misconduct.⁹² Thus, the burden that a plaintiff must overcome to satisfy loss causation varies with each jurisdiction.

The majority of circuits view loss causation as requiring plaintiff to specifically identify how the defendant’s fraud caused the alleged loss.⁹³ Under the majority view, a

plaintiff who uses post-transaction loss in value to measure recoverable loss must establish a connection between the post-transaction loss in value and the defendant’s fraud.⁹⁴ The minority view defines loss causation in broader terms and allows a plaintiff to satisfy the loss causation requirement by establishing a general connection between the alleged loss and the defendant’s fraud.⁹⁵ Under the minority view, a plaintiff who uses post-transaction investment value to measure recoverable loss does not necessarily have to link the defendant’s fraud to the post-transaction investment value.⁹⁶ The plaintiff can establish loss causation by simply demonstrating that the defendant’s fraud was in some way responsible for artificially altering the transaction price.⁹⁷ It is therefore easier for plaintiffs in minority-view jurisdictions to satisfy the loss causation requirement.

In December 1995, loss causation was finally considered by a central authority when Congress enacted the PSLRA.⁹⁸ The PSLRA codified loss causation by adding section 21D(b)(4) to the 1934 Act.⁹⁹ As codified, section 78u-4(b)(4) provides that the plaintiff has the burden of proving loss causation for all private actions arising out of section 10(b) of the 1934 Act.¹⁰⁰ Unfortunately, the statute does not provide a clear analytical approach to guide courts in determining whether a plaintiff has sufficiently pled loss causation. Although the codification of loss causation does not resolve the split among the courts, it does provide courts with a central authority for loss causation analysis. The PSLRA establishes a firm foundation for evaluating the various loss causation approaches, and thus analysis of the PSLRA is essential to developing a resolution to the loss causation controversy.

Although courts continue to rely on the precedents set prior to its enactment,¹⁰¹ the PSLRA is a central authority on loss causation that can guide courts in their loss causation analyses. Section 78u-4(b)(4) expressly states that “in any private action arising under this chapter, the plaintiff shall

have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.”¹⁰² While this description of loss causation does not expressly indicate the approach that courts should utilize, it does provide courts with a central rule from which a single understanding of loss causation can be formed. A look at Congress’ purpose behind enacting the PSLRA can resolve the conflict among the possible interpretations of loss causation under the Act.

The legislative history of the PSLRA predominantly favors the majority view of loss causation for two primary reasons. First, Congress enacted the PSLRA in order to make it more difficult for plaintiffs to file frivolous securities suits.¹⁰³ Likewise, the majority view heightens a plaintiff’s burden by requiring plaintiffs who use post-transaction investment value to measure recoverable loss to prove that the defendant’s fraud caused the post-transaction loss.¹⁰⁴ Second, loss causation was first introduced into the mix of reform issues because the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs was concerned about loss causation being presumed in fraud on the market cases.¹⁰⁵ Courts following the majority view have also ruled that loss causation cannot be presumed in fraud on the market cases, whereas courts following the minority view have concluded that loss causation can be presumed in such cases.¹⁰⁶

The foregoing analysis reveals that the PSLRA is likely to be interpreted to require strict proof of causation. This requirement will in turn support broad pre-trial terminations of securities claims. When coupled with the more stringent pleading requirements,¹⁰⁷ a stricter view of loss causation will likely be another ground upon which courts may dispose of “meritless” litigation.¹⁰⁸ For example, in *Bastian v. Petren Resources Corporation*, a pre-reform case, the Seventh Circuit affirmed a dismissal for failure to adequately plead loss causation.¹⁰⁹ This is disturbing considering that

causation is generally a fact question for the jury.¹¹⁰

The pleading requirements of specific facts and/or the basis of the plaintiff's knowledge turn this question into one of law for the judge at the motion to dismiss stage.¹¹¹ A judge will have to scrutinize the pleadings to see if sufficient facts are alleged and will have the discretion to dismiss cases which theretofore would have gotten to a jury. Another disturbing ramification of the PSLRA is its effect on the reliance doctrines discussed above. In both omission and fraud on the market cases, reliance and often causation are either presumed or established.¹¹² Because plaintiffs now explicitly have the burden of proof of loss causation in all cases, this may eliminate both theories in securities cases.¹¹³ Therefore, plaintiffs will have more to prove and, consequently, greater risk of early dismissal under the new pleading standards.

G. The Effect of the PSLRA on Private Securities Litigation

Overall, the number of claims filed in federal court has remained relatively stable in the years following the passage of the PSLRA.¹¹⁴ In the year immediately following the passage of the PSLRA, the number of federal filings decreased while the number of actions filed in state court increased.¹¹⁵ However, the most significant effect of the PSLRA has been the dramatic increase in the number of cases that have been dismissed. In order to survive a motion to dismiss, a plaintiff must prove the defendant acted with a particular state of mind and must state with particularity the facts that give rise to a strong inference of that state of mind. If either of these requirements is not met, the court must dismiss the case. Plaintiffs can no longer make general allegations of fraud and amend their pleadings after discovery as they could prior to the passage of the PSLRA. These dismissals also take longer because of the discovery stays provided for in PSLRA.¹¹⁶

Another major trend following the passage of the PSLRA is that settlements are larger, but fewer.

Cases that survive motions to dismiss have been settling for larger dollar amounts. This might be for one of two reasons. First, as the bill's proponents hoped, the bill may have discouraged frivolous lawsuits while encouraging and allowing meritorious lawsuits to proceed and prevail. The increased settlement amounts might be a result of fewer frivolous claims reaching this stage of the process, leaving only meritorious claims which would take larger amounts to settle. Alternately, the increase in the settlement amounts might be a result of the practicalities of the current situation for plaintiffs filing securities lawsuits. Institutional plaintiffs and lead plaintiffs with large losses might be demanding larger settlements on those claims that survive motions to dismiss in order to compensate for those claims which did not, whether meritorious or not. Finally, as it became more and more difficult for plaintiffs to succeed in federal courts, many plaintiffs began filing their causes of action in state courts. This trend led Congress to enact the Securities Litigation Uniform Standards Act of 1998.¹¹⁷

could simply evade the PSLRA by bringing suit based on state law in state court. In the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), Congress preempts most class actions based on fraud made in connection with the purchase or sale of a nationally traded security. If SLUSA applies to a given class action suit, plaintiffs will be forced to bring such actions under the federal securities laws in federal court, where they will be subject to the stringent procedural requirements established by the PSLRA.

After the PSLRA's passage, migration to state court became apparent. Three studies attempted to count securities class actions in state courts before and after the PSLRA.¹¹⁸ However, the only consistent findings among the studies are that: (1) state filings increased in the first year after the passage of the PSLRA, and (2) the number materially decreased in the following year.¹¹⁹ The studies diverge concerning the number of suits, if any, filed in state court in the years before the passage of the PSLRA. Accordingly, it remains unclear if the state court filings in 1996

Another major trend is that settlements are larger, but fewer.

IV. Congress Strikes Again: The Securities Litigation Uniform Standards Act of 1998

In 1998 Congress perceived that the objectives of the PSLRA were being frustrated. Numerous studies suggested that plaintiffs' attorneys attempted to circumvent the PSLRA's heightened pleading requirements and discovery stays by bringing their causes of action in state courts. The PSLRA was procedural in nature, so the PSLRA's provisions only apply if the securities fraud action was filed in federal court. Therefore, plaintiffs

represented a "migration" by plaintiffs to state court. It also remains unclear whether the number of state court suits witnessed in 1997 returned to pre-PSLRA levels.

Furthermore, the filing of parallel lawsuits presented a problem after the PSLRA. In particular, some studies indicated that state law class actions prior to the PSLRA rarely were filed alone in states courts, rather they were usually attached to parallel federal claims.¹²⁰ After the passage of the PSLRA, however, the studies noted an increase in the number of class actions filed solely in state court. Such an increase has caused speculation that

plaintiffs were filing weaker claims in state court to avoid the more stringent federal standards. Of the 280 federal securities class actions filed during 1996 and 1997, 51 (18%) can be tied to a parallel state case.¹²¹ The number of parallel actions abated slightly in 1997. Specifically, during 1996, 31 of the 105 (30%) federal actions filed had a state counterpart.¹²² During 1997, only 20 of the 175 federal class actions filed had a

stay and the safe harbor defense, which would be rendered useless because the PSLRA did not cover actions in state court. Thus, the PSLRA's attempt to eliminate strike suits and afford companies greater protection failed because plaintiffs' attorneys could file any class action in state court rather than in federal court.

The migration to state courts, particularly in California, led companies (especially high-technology

B. The Purpose of SLUSA

The primary objective of SLUSA is to prevent the circumvention of the PSLRA. The Act amends § 16 of the 1933 Act¹³⁰ and § 28 of the 1934 Act¹³¹ to provide that any "covered class action" involving a "covered security" that is filed in state court "shall be removed" to the federal court for the district in which the action is pending. Thus, SLUSA partially closed the state court loophole by making federal

The shifting to state courts was disturbing because it could include the discovery stay and the safe harbor defense cover actions in state court.

companion state case.¹²³

Whether or not migration of class actions to state court occurred in the wake of the PSLRA, for numerous reasons not explained in this article, state law class action litigation was highly concentrated in California after the PSLRA's passage. A shift in the geographical concentration of state court filings has occurred that can probably be attributable to forum shopping. Initially, the PSLRA's enactment effectuated a shift in the largest concentrations of state court filings from Delaware to California.¹²⁴ From 1991 to 1995, only 11% of state court suits were filed in California, while 52% were filed in Delaware.¹²⁵ From 1996 to 1998, state court cases filed in California comprised 35% of the total, while cases filed in Delaware fell to 29%.¹²⁶ Since the passage of SLUSA (at least until 2000), however, California state court filings had fallen back to 8% of all state court filings, while Delaware filings had rebounded to 69%.¹²⁷

A. The Need for Uniform Standards

The shifting to state courts was disturbing because it could effectively undermine the PSLRA's advantages for defendants, including the discovery

firms located in Silicon Valley) to Washington D.C. to seek further legislation restricting such suits.¹²⁸ Companies argued the shift to state court would undermine the effectiveness of the PSLRA. Corporate lobbies, particularly Silicon Valley technology firms, which are especially susceptible to strike suits because of their volatile stock prices, marched a path to the Capitol. The defense lobbyists argued that plaintiffs' lawyers were evading restrictions created by the PSLRA and undermining its purpose by filing securities fraud actions in state, rather than in federal, court.

In an attempt to counteract the trend identified in the post-PSLRA studies, Congress passed the Securities Litigation Uniform Standards Act of 1998,¹²⁹ which preempts most state class action securities fraud suits. Ideally, SLUSA sought to allow companies to avail themselves fully of the protections the PSLRA provides against "strike suits." SLUSA's specific aim is to prevent plaintiffs from frustrating the objectives of the PSLRA by filing these strike suits in state court to take advantage of more favorable and inconsistent state regulation.

court the exclusive venue for most securities fraud litigation involving nationally-traded securities.

Particularly, SLUSA has three primary objectives: (1) to prevent plaintiffs from evading the protection of the PSLRA by filing class action securities fraud suits in state, rather than in federal, court, (2) to encourage companies to make disclosure of forwarding-looking statements, and (3) to establish "uniform national rules for securities class litigation" involving nationally traded securities.¹³²

According to Congress, the filing of state securities fraud actions in state court frustrated one of the most important provisions of the PSLRA: the automatic stay of discovery. Congress had considered the automatic stay of discovery to be essential to the success of the PSLRA. If discovery were not allowed during the pendency of a motion to dismiss in federal court, a company would be less likely to settle a non-meritorious action. Conversely, if discovery were permitted during the pendency of a motion to dismiss, a company might choose to settle a non-meritorious action merely to avoid the cost of discovery and the nuisance of a suit. Similarly, Congress was concerned that state court filings of securities fraud

class actions further frustrated the PSLRA's goal of encouraging the disclosure of forward looking statements. However, if a company made a forward-looking statement accompanied by meaningful cautionary statements, the PSLRA's statutory safe harbor might shield the company from liability under the federal securities laws, but would not protect the company from liability under state law. Lastly, Congress

conditions for preemption. Furthermore, Congress explicitly provided exceptions to SLUSA's preemptive scope, as discussed later.

The text of SLUSA provides that no "covered class actions based upon the statutory or common law of any state or subdivision thereof may be maintained in any state or federal court by any private litigant" alleging either: "an untrue statement or omission of a material fact in connection with the

D. The Mechanics of SLUSA

1. "Covered Securities"

The preemption is limited to "covered securities." This definition relies on the provisions added to the Securities Act of 1933 by the National Securities Management Improvement Act of 1996 (NSMIA).¹³⁷ In particular, the Securities Act preempts state registration requirements for "nationally traded securities," which

effectively undermine the PSLRA's advantages for defendants, which would be rendered useless because the PSLRA did not

intended that SLUSA should establish "uniform national rules" for securities class actions involving "national" securities.¹³³ Congress found it troubling that, without SLUSA's preemption, a company making misleading disclosures to the market could be subject to the anti-fraud laws of fifty different jurisdictions. Thus, SLUSA was passed to make federal anti-fraud provisions, governed by the PSLRA, the exclusive national standard for most securities fraud class actions.

C. The Means of Enforcing the Objective: Preemption of State Class Action Securities Fraud Suits

To achieve the goals of SLUSA, Congress preempted most class actions alleging fraud in connection with the purchase or sale of a covered security when the class action is based on state law (with noted exceptions discussed below). If SLUSA applies, state law is entirely displaced. Plaintiffs not only lose their right to litigate the claim in state court, but they also lose the right to litigate the state claim in federal court through supplemental jurisdiction. However, not all securities fraud class actions brought under state law are preempted by SLUSA; the defendant must establish the requisite

purchase or sale of a covered security," or "that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security."¹³⁴

SLUSA then excludes certain claims from its preemptive scope, which will be discussed below.

Courts have interpreted SLUSA's language as imposing four conditions that a party seeking to remove a securities fraud action to federal court must prove: (1) the claim is based on state law; (2) the claim concerns a covered security; (3) the underlying suit is a covered class action; and (4) the plaintiff alleges untrue, manipulative, or deceptive statements or omissions in connection with the purchase or sale of a covered security.¹³⁵

However, little consistency appears to exist among the courts in both their interpretations of the scope of SLUSA and their ultimate decisions regarding preemption. An accurate prediction of the outcome of a defendant's attempt to remove a case depends on the court and, more importantly perhaps, the manner in which a plaintiff couches his claim.¹³⁶

are generally defined as securities listed on the NYSE, AMEX, and the Nasdaq Market System, or a security of the same issuer that is equal in seniority or that is a senior security of the same issuer who has a security listed on the NYSE, AMEX, or Nasdaq.

Thus, SLUSA adds preemption of state securities fraud class actions to NSMIA's preemption of state registration requirements. Therefore, if the issuer has any securities listed on a national trading market, all of its securities equal or senior to that listed security are preempted from state law securities fraud actions. Only issuers whose securities are not listed on national markets, primarily micro-cap and penny stock issuers, remain subject to state actions. In other words, Congress is only preempting actions relating to securities that are being traded in interstate commerce.

2. "Covered Class Actions."

Preemption only applies to "class actions" raising state fraud claims. SLUSA relies on a unique definition of "class action" that does not mirror the definition found in Rule 23 of the Federal Rules of Civil Procedure.¹³⁸ Instead, SLUSA provides several overlapping definitions involving

multiple parties.

Specifically, SLUSA defines “covered class actions” to include:

(i) any single lawsuit in which –

(I) damages are sought on behalf of more than 50 prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of individualized reliance on an alleged misstatement or omission, predominate over any questions affecting only individualized persons or members; or (II) one or more named parties seeks to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated, and question of law or fact common to those persons or members of the prospective class predominate over any questions affecting only individualized persons or members; or (ii) any group of lawsuits filed in or pending in the same court and involving common questions of law or fact, in which – (I) damages are sought on behalf of more than 50 persons, and (II) the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose.¹³⁹

For purposes of calculating the number of persons involved in a class action, corporations, investment companies, pension plans, partnerships, and other entities, provided they have not been established for the purpose of the action, are treated as a single person under SLUSA.¹⁴⁰

More simply put, “class actions” are defined broadly to include three types of actions: Actions for damages brought on behalf of more than 50 persons; actions for damages brought on a representative basis, and a group of joined or consolidated actions where damages are sought on behalf of more than 50 persons. Thus, plaintiffs are still able to bring individual actions under state law in

state court.

Dispute has arisen over the meaning of “covered class actions,” particularly when injunctive relief is requested in absence of a request for damages. The problem arises when plaintiffs urge that because the language of SLUSA requires monetary damages to exist, plaintiffs’ request for declaratory and injunctive relief takes the claim out of a “covered class action.” The various courts’ decisions have not been consistent as to how to resolve this issue.¹⁴¹

3. “In connection with” SLUSA does not define the phrase “in connection with the purchase or sale of a covered security.”

Most of the case law has developed around the issue of whether alleged misrepresentations or omissions are “in connection with” the purchase or sale of a covered security. The U.S. Supreme Court has not had occasion to interpret this phrase in the context of SLUSA but has interpreted the identical phrase as it appears in Rule 10(b)-5, which implements section 10(b) of the 1934 Act.¹⁴² As a result, the three circuits that have interpreted this provision in SLUSA have determined that Congress intended the phrase “in connection with” to have the same meaning under SLUSA that it has under section 10(b)-5 because SLUSA was enacted as an amendment to the 1933 and 1934 Acts.¹⁴³ However, under several varying fact patterns, district courts have reached different conclusions about what allegations fall within SLUSA’s “in connection with” requirement.

4. “Purchase or Sale”

Only those actions pertaining to the “purchase or sale” of the securities defined as “covered securities” by SLUSA are preempted. Courts evaluating the fourth preemption condition have uniformly held that a plaintiff class must satisfy the *Blue Chip Stamps* standing requirement before their state claims will be considered identical to federal claims and subject to dismissal under SLUSA.¹⁴⁴ In *Blue Chip Stamps v.*

Manor Drug Stores, the United States Supreme Court held that only transacting plaintiffs have standing to bring a 10(b)-5 claim.¹⁴⁵ Non-transacting plaintiffs, those investors who claim damages not as a result of the purchase or sale of a security but because they held their securities through a period of “false buoyancy,” cannot seek redress under Rule 10(b).

Accordingly, under SLUSA, an investor who does not change his position (for example, a shareholder who holds his securities, following a company’s misleading statement to the market) is able to bring a class action based on state law.¹⁴⁶

5. Extension of Discovery Stay to State Court

One of the PSLRA’s key elements is the stay of discovery pending a court’s determination on a motion to dismiss the complaint. As mentioned, after the PSLRA’s enactment, plaintiffs would frequently file parallel federal and state proceedings in order to circumvent the PSLRA’s discovery stay by obtaining discovery in the state court actions. However, preempting class actions, but not individual actions, created an obvious loophole around the PSLRA’s discovery stay provision: plaintiffs’ lawyers were still free to bring a federal class action and a parallel state action on behalf of an individual who would otherwise be a member of the class. Therefore, in SLUSA, Congress limited the possible adverse effects of SLUSA’s exceptions by allowing a federal court to stay discovery in “any private action in a state court” while a federal action is pending.¹⁴⁷ In this way, SLUSA sought to ensure that plaintiffs’ attorneys could not file parallel actions in state and federal court and then use the state court discovery process to force a settlement of the claims.¹⁴⁸ However, whether the SLUSA discovery stay applies to state court individual as well as class actions is unresolved.¹⁴⁹

6. Removal Provisions

The defendant may remove covered class actions based on state securities fraud to federal court.¹⁵⁰ This provision is unusual in that it allows state actions

to be removed to federal court, even though such actions are preempted by SLUSA. SLUSA allows for removal of actions so that state law class actions can be dismissed in federal court. SLUSA appears to strip the state court of subject matter jurisdiction; thus, the court should dismiss the case on its own motion. However, the removal provision serves two important federal interests: it allows federal courts to interpret the scope of preemption, thus enhancing uniformity; and it triggers the PSLRA's stay of discovery.

E. Preserved State Lawsuits

SLUSA clearly articulates certain exceptions to its broad rule that securities class actions in connection with the purchase or sale of a covered security could no longer be maintained under state law. The original bills that eventually became SLUSA would have had the unintended effect of preempting a substantial body of state corporate law. The U.S. Supreme Court has zealously guarded the distinction between state corporate law and federal securities law, while Congress and the SEC have generally respected this distinction.¹⁵¹

1. Derivative Actions.

In order to preserve the role of state corporate law, the overall definition of class action was revised explicitly to exclude "an exclusively derivative action brought by one or more shareholders on behalf of a corporation."¹⁵² Derivative actions are preempted because such actions are the only enforcement vehicle available for fiduciary duties owed to the corporation, essential to corporate governance, and traditionally the province of state courts.

2. State Government Officials and Pension Fund Carve-Outs.

In addition to preserving state regulatory authority, Congress protected state financial interests with the final limitation on the scope of preemption. The preemption of state class actions is a law of general applicability that can be imposed on the states as well as individuals.

Nonetheless, a separate carve-out was made for state governments and pension funds to use state law to protect their own financial interests. Under this carve-out, state entities are allowed to bring class actions under state law. The provision saves actions by state entities from being grouped in the definition of class action.¹⁵³

Actions Under Contractual Arrangements Between Issuers and Indenture Trustees.

Also preserved are actions under contractual agreements between issuers and indenture trustees.¹⁵⁴

Delaware Carve-Outs.

Congress recognized that SLUSA's broad preemption provision would also have the unintended effect of eliminating actions brought for breach of the fiduciary duty of disclosure under state corporate law. Therefore, Congress expressly preserved actions based on the duty of disclosure through the so-called "Delaware carve-out,"¹⁵⁵ which was modeled after the fiduciary duty of disclosure law existing in Delaware at the time of SLUSA's enactment.

a. Delaware Carve-Out Background.

Congress heard testimony from several experts that SLUSA should not be drafted to preempt claims based on the breach of the fiduciary duty of disclosure. The primary concern raised by the experts was that preemption of the fiduciary duty of disclosure would raise serious federalism concerns.¹⁵⁶ The experts stressed that states had a strong interest in controlling the conduct of directors of corporations organized under their laws. Under state corporate law, issuers and their officers and directors generally owe a duty of disclosure to their shareholders. That duty of disclosure requires the issuer and its managers to speak truthfully to shareholders.

Even though the corporate law duty of disclosure significantly overlaps with the coverage of federal securities laws, actions based on corporate law duty of disclosure are generally interwoven

with other corporate law claims. Claims based on the breach of this duty typically arise out of mergers, tender offers, and other extraordinary corporate transactions, when the board is asking the shareholders to take certain actions. These claims are individual, rather than derivative, because they affect the shareholder's decision involving his individual shares, even though it may have an effect on the corporation as a whole.

Furthermore, experts argued that preempting fiduciary disclosure claims would undercut important advantages offered by state courts, particularly Delaware. These experts noted that Delaware courts have three main strengths: (1) judicial expertise, (2) a body of well-developed case law, and (3) quick resolution of corporate disputes.¹⁵⁷ The experts pointed out that these strengths offer significant benefits to companies that rely on judicial competency and established case law in planning transactions and determining corporate action. Furthermore, the Delaware courts can resolve such claims within days, rather than months. Speedy resolution of corporate disputes was seen as particularly important because many breach of duty of disclosure claims arise in takeover contexts when shareholders are being asked to tender their stock or approve a merger. According to the testifying experts, without quick resolution, the completion of such transactions could be jeopardized. Thus, to avoid losing the benefits offered by state courts, the experts urged Congress to preserve claims based on a breach of fiduciary duty of disclosure.

Ultimately, Congress was convinced by the arguments. Members of the ABA's Task Force on Securities Litigation Reform, along with SEC representatives, proposed the Delaware carve-out, which eventually became part of SLUSA. The Delaware carve-out had widespread support, including that of corporate issuers, who were interested in maintaining the predictability offered by Delaware corporate law.¹⁵⁸

The decision to match the Delaware carve-out to existing law in Delaware at

the time of SLUSA was a conscious one. The adoption of the Delaware carve-out, thus, ensured that SLUSA would not impinge upon Delaware's

concerning the equity holders' decisions with respect to voting their securities, acting in response to a tender or exchange offer, or exercising

to actions by state officials,¹⁶⁶ to actions under contractual agreements between issuers and indenture trustees,¹⁶⁷ or to the "Delaware carve-out."¹⁶⁸ In addition, SLUSA has a loophole that allows private plaintiffs to bring state law class action suits based on claims of "holding" the stock. Some of these exceptions could still be promising avenues for private plaintiffs to hold corporations accountable under more plaintiff-friendly state securities law. Except for the Delaware carve-out and the holding claim loophole, the other avenues are self-explanatory.

The Delaware carve-out preserves a plaintiffs right to pursue a class action in state court for a breach of the fiduciary duty of disclosure.¹⁶⁹ The claim must be predicated on the law of the state of incorporation or organization.¹⁷⁰ Furthermore, plaintiffs are limited to suing only when the fiduciary communicates with the shareholder and requests shareholder action.¹⁷¹ The other exception to SLUSA that is not self-explanatory is the holding claim exception. SLUSA by its own terms applies only to class actions alleging fraud in the purchase or sale of securities.¹⁷² As the name suggests, a holding claim involves the continued holding of a stock rather than the purchase or sale of the security. The basic allegation in such a claim is that the plaintiff was fraudulently induced to hold the securities which subsequently lost significant value.¹⁷³

These two exceptions are potentially impacted by the recent decision of the Delaware Supreme Court in *Malone v. Brincat*.¹⁷⁴ At the time of the adoption of SLUSA, Delaware law regarding the duty of disclosure was virtually identical with the actionable conduct preserved in the Delaware carve-out.¹⁷⁵ Before *Malone*, the defendant must have requested shareholder action in order to be liable for a breach of the duty of disclosure. *Malone* changed this by specifically holding that "directors who knowingly disseminate false information that results in corporate injury or damage to an individual stockholder violate their fiduciary duty, and may be held

The Securities and Exchange Commission routinely lacks adequate resources and personnel to enforce the securities laws.

need to regulate the conduct of corporate directors. However, the Delaware Supreme Court's decision in *Malone v. Brincat*,¹⁵⁹ discussed below, now makes Delaware's breach of duty of disclosure broader than that for which is provided in the Delaware carve-out; specifically, the court held that when a director knowingly makes a misstatement, he breaches a duty of disclosure, regardless of whether shareholder action has been requested.¹⁶⁰ Because the Delaware carve-out only applies to actions for breach of fiduciary duty of disclosure when shareholder action has been requested, SLUSA does not preserve state actions involving misleading market communications. In other words, certain state law actions based on the breach of duty of disclosure are preempted by SLUSA.

b. Basic Mechanics of the Delaware Carve-Out:

Under the Delaware carve-out, a class action is preserved in state court if it meets either one of two prongs: Subsection (i) preserves state jurisdiction for class actions if it involves the purchase and sale of securities taking place by the issuer or the issuers' affiliate exclusively from or to the issuers' equity security holders. Subsection (ii) preserves state jurisdiction for class action claims arising from an issuer's recommendation, position, or other communication with respect to the sale of the issuer's securities made

dissenters' or appraisal rights. The carve-out is limited to actions "based upon the statutory or common law of the State in which the issuer is incorporated...or organized."¹⁶¹

Stated more clearly, SLUSA's Delaware carve-out provision preserves two types of actions based on the breach of fiduciary duty of disclosure. First, under (i), shareholders who believe that their company made misrepresentations in connection with a buy-back or going-private transaction will be able to sustain a class action in state court alleging a breach of fiduciary duty of disclosure. Secondly, under (ii), shareholders who believe that their company made misrepresentations in connection with a tender offer, exchange offer, or merger will be able to bring a class action in state court alleging a breach of fiduciary duty of disclosure.¹⁶²

F. Avoiding the Effects of SLUSA: The Exceptions and the Holding Loophole

Clearly, the goal of SLUSA was to preempt state law class actions by allowing a defendant to remove to federal court and seek dismissal.¹⁶³ As already demonstrated, SLUSA also provided for several exceptions to this broad rule of preemption. To sum up, SLUSA does not apply to actions maintained in state or federal court by a private party under the law of the state of incorporation or organization,¹⁶⁴ to derivative actions,¹⁶⁵

accountable in a manner appropriate to the circumstances."¹⁷⁶ Because the carve-out only applies when shareholder action is requested, class actions based on this broader duty of disclosure under Delaware law may be preempted by SLUSA.¹⁷⁷

Holding claims have an even greater potential to be affected by the Malone decision. Because holding claims do not even come within the express wording of SLUSA, holding claims may reap the benefit of the expanded Delaware duty of disclosure. The court in Malone expressly noted that the claims against the directors for disseminating false information accrued to plaintiffs who were holders of the stock.¹⁷⁸ Therefore, the next question to be answered is whether state law holding claims can get class certification. At least three federal district court cases applying Delaware law, and one applying Texas law, have allowed a holding claim class action to proceed.¹⁷⁹ Research to date has turned up only one state court that has allowed a holding claim to proceed as a class action. The California Court of Appeal allowed a holding claim class action to proceed.¹⁸⁰ California's highest court has granted review of this case and has yet to announce its decision.¹⁸¹

Although several exceptions exist, cases taking advantage of these exceptions are still scant. In the four years since SLUSA has been adopted, no flood of litigation has ensued. Plaintiffs do not appear to be taking advantage of any of the five exceptions or the holding loophole. Research up to the time of this writing has turned up only a few examples of plaintiffs surviving removal from state court to federal court under SLUSA.¹⁸² SLUSA is perhaps too recently adopted for a definitive answer to have emerged regarding the usefulness of the foregoing exceptions. Therefore, only time will tell if plaintiffs will be able to avoid the harsh effects of recent federal securities law reform.

V. Public Enforcement

The wave of statutory and judicial barriers to effectively pursuing federal private causes of action in securities

litigation effectively shifted the burden to the Securities and Exchange Commission to accomplish its public function of enforcing the securities laws. Unfortunately, political and structural limitations prevented the SEC from playing an effective watchdog role in preventing securities fraud. As a result, it is fair to say that the ineffectiveness of the SEC in discovering and punishing securities fraud was a significant contributing factor to the recent wave of financial scandals.

One of the main limitations critics have decried is the lack of adequate funding and personnel resources for the SEC. Although the SEC was chronically underfunded throughout the 1980s, Congress appropriated ample financial resources starting in 1990 and thereafter.¹⁸³ The true funding problem that has plagued the SEC is that while the agency generates nearly \$2 billion a year in fees to finance its own enforcement operations, those funds are regularly diverted to finance general spending.¹⁸⁴ As a result, the agency routinely lacks adequate resources and personnel to enforce the securities laws.

The collapse of Enron provides a clear illustration of how inadequate SEC resources contributed to the recent wave of accounting scandals. Due to chronic understaffing, the SEC was forced to adopt a system where it only periodically reviews the financial filings submitted by publicly traded companies. According to a recent report by the Senate Governmental Affairs Committee, "the SEC staff failed to review any of Enron's post-1997 financial filings, even though the company was undergoing significant growth and substantially changing the nature of its business, and the SEC itself was aware that other gatekeepers, such as boards of directors and auditors, were proving increasingly unreliable."¹⁸⁵ The problem is not limited to Enron or merely a handful of companies, but instead represents a structural deficiency with the system of SEC review. The SEC has not reviewed the 10-K financial statements of 53% of

public companies within the past three years and even those reviews that did occur were largely cursory and unlikely to detect fraud.

This striking lack of meaningful oversight by the agency charged with enforcing the nation's securities laws undermined one of the principal deterrents against fraudulent accounting and reporting of financial data that has the potential to mislead investors. As the Committee noted, the "likelihood that a company's filings will be reviewed can also deter certain misleading reporting practices."¹⁸⁶ Company executives and directors operating free from credible oversight by the SEC have a decreased incentive to carefully scrutinize the financial information they release to the investing public, especially in light of the enormous countervailing pressures for executives and directors to generate balance sheet profitability.

Unfortunately, even the recently enacted accounting reforms have not adequately addressed the structural problems facing the SEC. First, Congress has still failed to appropriate the 72% increase in SEC funding authorized by the Sarbanes-Oxley Act of 2002.¹⁸⁷ Second, while the \$776 million in additional funding will undoubtedly help the SEC hire more staff and more effectively review financial statements, the additional funds are unlikely to completely eliminate the enormous backlog in company financial statements. The number of new financial statements being filed is likely to continue to outpace the resources of the SEC, leaving the periodic review system and the continued gaps in oversight intact. Finally, the enforcement regime contemplated by the federal securities laws depends on an effective mix of SEC enforcement and private causes of action. The continued narrowing of private plaintiff remedies by Congress and the judiciary leaves the SEC in the unenviable position of bearing the brunt of the enforcement task, while attempting to grapple with ongoing structural limitations.



ENDNOTES

1 Securities Exchange Act of 1934, § 10(b) as amended, 15 U.S.C.A. § 78j(b).

2 511 U.S. 164 (1994).

3 *Id.* at 134.

4 501 U.S. 350, 360-61 (1991).

5 513 U.S. 561 (1995).

6 Douglas M. Branson, *Running the Gauntlet: A Description of the Arduous, and Now Often Fatal Journey for Plaintiffs in Federal Securities Law Actions*, 65 U. Cin. L. Rev. 3, 6 (1997).

7 Securities Exchange Act of 1934, § 9 as amended, 15 U.S.C.A. § 78j.

8 Securities Exchange Act of 1934, § 10(b) as amended, 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5.

9 Steven A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as Well as the Frivolous*, 40 Wm and Mary L. Rev. 1055, 1070-71.

10 15 U.S.C. § 78a.

11 *Id.*

12 Securities Exchange Act of 1934, § 10(b) as amended, 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5.

13 Fed. R. Civ. P. 9(b).

14 *Eg.*, *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1130 (2d Cir. 1994) (stating that a “[P]laintiff must do more than merely charge that executives aim to prolong the benefits of the positions they hold.”); *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 263-64 (2d Cir. 1993) (reasoning that some examples of fraud may go unpunished because the law cannot eliminate all opportunities for unremedied fraud without creating opportunities for “undeserved

settlement[s]”); *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) (stating that “[a]n accountant’s greatest asset is its reputation” and it would be “irrational” to trade it merely for auditing fees); *Melder v. Morris*, 27 F.3d 1097, 1103 (5th Cir. 1994) (dismissing allegations against underwriter that fraud was motivation to generate fees because all underwriters are fee seekers).

15 John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation PSLRA of 1995*, 51 Bus. Law. 335, 341-47 (1996) (collecting authorities who agree that federal courts “are granting motions to dismiss securities law cases with greater frequency than in the past.”); see also Brian Murray & Donald J. Wallace, *You Shouldn’t Be Required to Plead More Than You Have to Prove*, 53 Baylor L. Rev. 783, 787-801 (2001) (offering a comprehensive history of Rule 9(b) pleading requirements and their application to securities actions).

16 140 Cong. Rec. S3706 (daily ed. Mar. 24, 1994) (statement of Sen. Domenici).

17 *Private Litigation Under the Federal Securities Laws: Hearings Before the Subcommittee on Securities of the Senate Committee on Banking, Housing & Urban Affairs*, 103d Cong., 1st Sess. 280, 743 (1993) (statement of Senator Dodd).

18 *Id.*

19 See *Id.* at 549 (letter from Marc E. Lackritz, President, Securities Industry Association).

20 15 U.S.C.A. § 78u-4.

21 *Id.* at § 78u-4 (b)(2).

22 *Id.* at § 78u-4 (b)(1).

23 Fed. R. Civ. P. 9(b).

24 *Press v. Chem. Inv. Servs.*, 160 F.3d 529, 538 (2d Cir. 1999).

25 *Novak v. Kasaks*, 216 F.3d 300, 309-10 (2d Cir. 2000).

26 *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 76 (2d Cir. 2001) (citation omitted).

27 *Chill v. Gen. Elec. Co.*, 101 F.3d 263, 267 (2d Cir. 1996).

28 *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534 (3d Cir. 1999).

29 *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 979 (9th Cir. 1999).

30 *Id.*

31 *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 197 (1st Cir. 1999) (asserting that “merely pleading motive and opportunity, regardless of the strength of the inferences to be drawn of scienter, is not enough”).

32 *Nathenson v. Zonagen*, 267 F.3d 400, 410-411 (5th Cir. 2001) (stating that motive and opportunity are “relevant” to pleading scienter and “may, on occasion, rise to the level of creating a strong inference of reckless or knowing conduct”).

33 *Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 660 (8th Cir. 2001) (asserting that allegations of motive and opportunity “may meet the Reform Act standard, but if so it is because they give rise to a strong inference of scienter, not merely because they establish motive and opportunity”).

34 *Philadelphia v. Fleming Cos., Inc.* 264 F.3d 1245, 1262 (10th Cir. 2001) (stating that allegations of motive and opportunity are “important” but not typically “sufficient in themselves” to establish a strong inference of scienter).

35 *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1283, 1285 (11th Cir. 1999) (stating they are in “basic agreement with the Sixth Circuit” and holding that allegations of motive and opportunity standing alone are insufficient to establish scienter).

- 36 *In re Compshare, Inc. Sec. Litig.*, 183 F.3d 542, 551 (6th Cir. 1999).
- 37 *Id.*
- 38 *In re Lotus Dev. Corp. Sec. Litig.*, 875 F. Supp. 48, 51 (D. Mass. 1995) (stating that “The burden of proof imposed on the party seeking a stay [of discovery] is a stiff one.”).
- 39 John F. Olson, David C. Mahaffey & Brian E. Casey, *Pleading Reform, Plaintiff Qualification and Discovery Stays Under The PSLRA*, 51 *Bus. Law.* 1101, 1101-1103 (1996).
- 40 H.R. Rep. No. 369, 104th Cong., 1st Sess. 31 (1995), reprinted in 1996 U.S.C.C.A.N. 730; see also *id.*
- 41 See, e.g., *Decker v. GlenFed, Inc.*
- 42 F.3d 1541, 1557 (9th Cir. 1994) (en banc) (Norris, J. concurring) (discussing “the ability of plaintiffs to extract undeserved settlements by confronting defendants with the prospect of exorbitant discovery costs.”); *ZVI Trading Corp. Employees Money Purchase Pension Plan & Trust v. Ross*, 9 F.3d 259, 263 (2d Cir. 1993), cert. denied, 114 S. Ct. 1397 (1994) (determining that “there is ... [an] 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.”).
- 42 15 U.S.C. § 78u-4(b)(2).
- 43 15 U.S.C. §§ 77z-1(b) & 78u-4(b) (identical language).
- 44 Richard H. Walker, David M. Levine & Adam C. Pritchard, *The New Securities Class Action: Federal Obstacles, State Detours*, 39 *Ariz. L. Rev.* 641, 643-44 (1997).
- 47 Joshua D. Ratner, *Comment, Stockholders’ Holding Claim Class Actions under State Law after the Uniform Standards Act of 1998*, 68 *U. Chi. L. Rev.* 1035, 1048 & n.84 (2001). 46 15 U.S.C. §§ 78bb(f)(1) & (2).
- 47 See *supra* note 10.
- 48 932 F. Supp. 249, 252-53 (N.D. Cal. 1996), rev’d, 99 F.3d 325 (9th Cir. 1996).
- 49 99 F.3d at 328.
- 50 *Id.*
- 51 *supra* note 10.
- 52 189 F.3d 909, 911 (9th Cir. 1999).
- 53 *Id.*
- 54 *Id.* at 912 (quoting *Medhekar*, 99 F.3d at 328).
- 55 Securities Exchange Act of 1934, § 10(b) as amended, 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5.
- 56 *Id.*
- 57 15 U.S.C.A. § 78u-5.
- 58 Securities Exchange Act of 1934, § 10(b) as amended, 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5.
- 59 15 U.S.C.A. § 77z-2.
- 60 15 U.S.C.A. § 77z-2 (c)(1).
- 61 However, the PSLRA does not protect forward-looking statements for statements made in connection with initial public offerings.
- 62 15 U.S.C.A. Ch. 2B, § 21E (f) Stay Pending Decision on Motion.
- 63 *Id.*
- 64 Securities Exchange Act of 1934, § 10(b) as amended, 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5.
- 65 15 U.S.C.A. § 77z-2 (c)(4).
- 66 *Id.* at § 77z-2 (c)(1)(a)(2).
- 67 Fed. R. Civ. P. 11.
- 68 60 *Fordham L. Rev.* 475, 485 (1991).
- 69 See H.R. Conf. Rep. No. 104-369 at 40, reprinted in 1995 U.S.C.C.A.N. 739.
- 70 15 U.S.C. § 78u-4(c).
- 71 See, e.g., *Gurary v. Nu Tech Bio Med, Inc.*, 303 F.3d 212, 222-23 (2d Cir. 2002).
- 72 Steven A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as Well as the Frivolous*, 40 *Wm and Mary L. Rev.* 1055, 1073 n.69 (1999).
- 73 Samborn, *Fear of Filing*, A.B.A. J., May 1997.
- 74 Martin D. Chitwood & Christi C. Mobley, *Securities Reform: Its Effect on Litigation and Capital Formation*, (Calendar Call 1996), available at <http://classlaw.com/FSL5CS/articles/articles12.asp>.
- 75 See, e.g., *Gasner v. Board of Supervisors*, 103 F.3d 351, 356 (4th Cir. 1996) (providing the elements of a 10b-5 cause of action).
- 76 See *id.*
- 77 See *Herman & Maclean v. Huddleston*, 459 U.S. 375, 388-89 (1983).
- 78 *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988) (holding that a rebuttable presumption of reliance exists in fraud on the market cases because investors who buy or sell securities at the market price rely on the integrity of that price); *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 152-54 (1972) (holding that proof of reliance is no required in cases of fraudulent omissions because proof of materiality of the omission sufficiently establishes causation).
- 79 See *Affiliated Ute*, 406 U.S. at 153-54.

80 See, e.g., *Rifkin v. Crow*, 574 F.2d 256 (5th Cir. 1978); see also *Bell v. Cameron*, 669 F.2d 1278 (9th Cir. 1982) (affording the presumption of reliance even in a case of an affirmative misrepresentation rather than an omission).

81 See *supra*, note 10.

82 *Basic Inc.*, 485 U.S. at 243.

83 *Id.*

84 See, e.g., *Binder v. Gillespie*, 184 F.3d 1059, 1065 (9th Cir. 1999) (requiring both transaction and loss causation).

85 *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974).

86 See, e.g., *Ambassador Hotel Co. v. Wei-Chuan Inv.*, 189 F.3d 1017, 1027 (9th Cir. 1999) (asserting that a plaintiff must show that “but for the fraud, the plaintiff would not have engaged in the transaction at issue”).

87 *Thomas Lee Hazen, The Law of Securities Regulation*, 669, 703-04 (Hornbook Series, Student Edition 2d ed. 1990).

88 *Harris v. Union Elec. Co.*, 787 F.2d 355, 366 (8th Cir. 1986).

89 *Schlick*, 507 F.2d at 380.

90 See *Hazen*, *supra*, note 87 at 704-10.

91 See, e.g., *Robbins v. Koger Props, Inc.*, 116 F.3d 1441, 1447 (11th Cir. 1997); *Marbury Mgmt., Inc. v. Kohn*, 629 F.2d 705, 708 (2d Cir. 1980).

92 See *Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996); *In re Control Data Corp. Sec. Litig.*, 933 F.2d 616, 619 (8th Cir. 1991).

93 *Lawrence A. Steckman & Robert E. Conner, Loss Causation Under Rule 10B-5 A Circuit-By-Circuit Analysis: When Should Representational*

Misconduct Be Deemed the Cause of Legal Injury Under the Federal Securities Laws?, In *How to Prepare an Initial Public Offering 1998*, at 375, 397 (PLI Corp. Law & Practice Course Handbook Series No. B-1068, 1998).

94 See *supra*, note 27.

95 See *supra*, note 28.

96 *Id.*

97 *Id.*

98 *Private Securities Litigation PSLRA of 1995*, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.).

99 15 U.S.C. § 78u-4(b)(4).

100 *Id.*

101 See, e.g., *Coates v. Heartland Wireless Communications, Inc.*, 26 F. Supp. 2d 910, 923 (N.D. Tex. 1998) (holding that “the PSLRA does not alter the standards for pleading loss causation”); *Retsky Family Ltd. P’ship v. Price Waterhouse, LLP*, No. 97 C 7694, 1998 WL 774678, at *9-*14 (N.D. Ill. Oct. 21, 1998) (applying the PSLRA to its scienter analysis, but failing to apply it to its loss causation analysis). But see, e.g., *Castillo v. Dean Witter Discover & Co.*, No. 97 Civ. 1272 (RPP), 1998 WL 342050, at *4 (S.D.N.Y. June 25, 1998) (recognizing that the purpose of the PSLRA was to make a more stringent pleading standard for each Rule 10b-5 element and holding that the “PSLRA requires plaintiffs to link each act or omission of the defendant to the plaintiffs’ alleged losses” (citation omitted)).

102 15 U.S.C. § 78u-4(b)(4).

103 See S. Rep. No. 104-98, at 1 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 679; H.R. Conf. Rep. No. 104-369, at 31 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 730.

104 See *supra*, note 27.

105 *John W. Avery, Securities Litigation Reform: The Long and*

Winding Road to the Private Securities Litigation PSLRA of 1995, 51 *Bus. Law.* 335, 347 (1996).

106 See, e.g., *Robbins v. Koger Props., Inc.* 116 F.3d 1441, 1448 (11th Cir. 1997).

107 See 15 U.S.C. §§ 78u-4(b)(1) & (2).

108 See *Steven A. Ramirez, Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as well as the Frivolous*, 40 *Wm. & Mary L. Rev.* 1055 at 1076-78 (1999).

109 892 F.2d 680, 686 (7th Cir. 1990).

110 See *Restatement (Second) of Torts* § 328C (1965); *Davey v. Hedden*, 920 P.2d 420 (Kan. 1996) (stating that proximate cause is a question of fact for the jury).

111 See *supra* note 42.

112 See *In re Control Data Corp. Litig.*, 933 F.2d 616, 619-20 (8th Cir. 1991) (stating that under fraud on the market, causation is presumed).

113 See *supra* note 42.

114 *Sherrie R. Savett, Securities Class Actions Since the 1995 PSLRA: A Plaintiff’s Perspective*, 1332 *PLI/Corp* 127 (September-October 2002).

115 See *Joseph A. Grundfest and Michael A. Perino, Securities Litigation Reform: The First Year’s Experience, a Statistical and Legal Analysis of Class Action Securities Fraud Litigation Under the Private Securities Litigation PSLRA of 1995*. http://securities.stanford.edu/report/pslra_yr1

116 15 U.S.C. §§ 77z-1(b) & 78u-4(b) (identical language).

117 Pub.L. No. 105-353, 112 Stat. 3227 (codified as amended in part at 15 U.S.C. §§ 77p & 78bb(f)).

118 *David M. Levine & Adam C.*

Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws*, 54 *Bus. Law.* 1, 7-10 (1998) (Securities Class Action Clearinghouse (administered by the Standard University Law School), National Economic Research Associations (NERA), and Price Waterhouse studies).

119 *Id.*

120 David M. Levine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws*, 54 *Bus. Law.* 1, 7-10 (1998).

121 *Id.*

122 *Id.*

123 *Id.*

124 Peter Q. Bassett & Kelly C. Wilcove, *Recent Developments in Derivative and State Court Securities Litigation*, *Securities Litigation* 2001 841, 858 (PLI 2001).

125 *Id.*

126 *Id.*

127 *Id.*

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130 15 U.S.C. § 77p

131 15 U.S.C. § 78bb

132 David M. Levine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws*, 54 *Bus. Law.* 1, 4-7 (1998).

133 *Pub.L. No.* 105-353, § 2(5).

134 15 U.S.C. § 77p.

135 Amanda M. Rose, *Life After SLUSA: What is the Fate of Holding Claims?*, 69 *Def. Counsel J.* 455, 456-57 (October 2002).

136 *Id.* at 457.

137 75 *Pub. L. No.* 104-290, § 1, 110 *Stat.* 3416 (1996).

138 76 *Fed. R. Civ. P.* 23.

139 77 15 U.S.C. § 77p(f)(2); 15 U.S.C. § 78bb(f)(5).

140 78 15 U.S.C. § 77p(f)(2)(C); 15 U.S.C. § 78bb(f)(5)(D).

141 *Gibson v. Group Holdings, Inc.*, 2000 WL 777818 (S.D. Cal. June 14, 2000) (plaintiff removed damages from his original complaint, but the court found that the plaintiff had "selectively omitted the damages," and, thus, the plaintiff could not circumvent SLUSA's preemption by purposefully removing prayer for damages from his original complaint); compare *Wald v. C.M. Life Ins. Co.*, 2001 WL 256179 (N.D. Tex. Mar. 8, 2001) (holding that no evidence indicated that plaintiff "selectively omitted damages" from his claim for injunctive relief; thus, the underlying action was not "a covered class action" under SLUSA, and SLUSA's preemption did not apply).

142 *Securities Exchange Act of 1934*, § 10(b) as amended, 15 U.S.C.A. § 78j(b); 17 *C.F.R.* § 240.10b-5.

143 See *Behlen v. Merrill Lynch*, No. 01-16424, 2002 WL 31487586 (11th Cir. Nov. 8, 2002); *Falkowski v. Imation Corp.*, 309 F.3d 1123 (9th Cir. 2002); *Riley v. Merrill Lynch, Pierce, Fenner, & Smith*, 292 F.3d 1334, 1342 (11th Cir. 2002), cert. denied, 71 U.S.L.W. 3178 (U.S. Oct. 15, 2002) (No. 02-378); *Green v. Ameritrade, Inc.*, 279 F.3d 590, 597 (8th Cir. 2002).

144 421 U.S. 723 (1975).

145 421 U.S. 723, 751 (1975).

146 *Gordon v. Buntroc*, No. 00 CV. 303, 2000 WL 556763, at *4 (N.D. Ill. Apr. 28, 2000). Accord *Green v. Ameritrade, Inc.*, 279 F.3d 590, 598 (8th Cir. 2002); *Gutierrez v. Deloitte & Touche*, 147 F.Supp.2d 584, 587 (W.D. Tex. 2001); *Shaev v. Claffin*, 2001 WL 548567, at *5 (N.D. Cal. May 17, 2001); *Hines v. ESC Strategic Funds Inc.*, No. 3:99-0503, 1999 WL 1705503, at *6 (M.D. Tenn. Sept. 17, 1999); *Burns v. Prudential Secs.*, 116 F.Supp.2d 917, 921 (N.D. Ohio 2000).

147 15 U.S.C. § 77z-1(b)(4); 15 U.S.C. § 78u-4(b)(3)(D).

148 *Newby v. Enron Corp.*, 2002 WL 1001056 (S.D. Tex. May 1, 2002) (Defendants successfully invoked the SLUSA); see *In re Bankamerica Corp.*, 263 F.3d 795, 802 (8th Cir. 2001) (observing that the SLUSA discovery stay is aimed at state court plaintiffs who seek to circumvent the PSLRA's discovery stay).

149 See *Lapicola v. Alternative Dual Fuels, Inc.*, *Fed. Sec. L. Rep.* (CHH) 91,765 (N.D. Tex. Apr. 5, 2002); *Tobias Holdings, Inc. v. Bank United Corp.*, 177 F.Supp.2d 162 (S.D.N.Y. 2001).

150 15 U.S.C. § 77p(c), § 78bb(f)(2).

151 Adam C. Pritchard, *Constitutional Federalism, Individual Liberty, and the Securities Litigation Uniform Standards Act of 1998*, 78 *Wash. U. L.Q.* 435, 491 (2000).

152 15 U.S.C. § 77p(f)(2)(B); 15 U.S.C. § 78bb(f)(5)(c).

153 15 U.S.C. § 77p(f)(d)(2); 15 U.S.C. § 78bb(f)(3)(B).

154 15 U.S.C. § 77p(f)(d)(3); 15 U.S.C. § 78bb(f)(3)(C).

155 David M. Levine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws*, 54 *Bus. Law.* 1, 23-27 (1998).

156 Jennifer O'Hare, Director Communications and the Uneasy Relationship Between the Fiduciary Duty of Disclosure and the Anti-Fraud Provisions of the Federal Securities Laws, 70 U. Cin. L. Rev. 475, 510 n.110 (2002).

157 David M. Levine & Adam C. Pritchard, The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws, 54 Bus. Law. 1, 23-27 (1998).

158 Id.

159 722 A.2d 5, 9 (Del. 1998),

160 Id. at 14.

161 David M. Levine & Adam C. Pritchard, The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws, 54 Bus. Law. 1, 25 (1998).

162 See *Lazar v. Gregerson*, 2002 WL 535405 (N.D. Cal. Apr. 8, 2002) (plaintiffs asserted claims under California law for breach of fiduciary duty and breach of duty of candor in connection with a merger and acquisition. The court held that the claims were excepted from SLUSA by the Delaware carve-out).

163 15 U.S.C. §§ 78bb(f)(1) & (2).

164 Id. §§ 77p(d)(1)(A) & 78bb(f)(3)(A)(i).

165 Id. §§ 77p(f)(2)(B) & 78bb(f)(5)(C).

166 Id. §§ 77p(d)(2) & 78bb(f)(3)(B).

167 Id. §§ 77p(d)(3) & 78bb(f)(3)(C).

168 Id. §§ 77p(d)(1)(B) & 78bb(f)(3)(A)(i) & (ii).

169 Id.

170 Id.

171 Id. See also Jennifer O'Hare, Director Communications and the Uneasy Relationship Between the Fiduciary Duty of Disclosure and the Anti-Fraud Provisions of the Federal Securities Laws, 70 U. Cinn. L. Rev. 475, 503 (2002).

15 U.S.C. §§ 77p & 78bb(f)(1)(A).

173 Joshua D. Ratner, Comment, Stockholders' Holding Claim Class Actions under State Law after the Uniform Standards Act of 1998, 68 U. Chi. L. Rev. 1035, 1036 (2001).

174 722 A.2d 5 (Del. 1998).

175 See O'Hare, *supra* note 156.

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177 See O'Hare, *supra* note 156.

178 722 A.2d at 8.

179 *Shaev v. Clafin*, No. C 01-0009 MJJ, 2001 U.S. Dist. LEXIS 6677 (N.D. Cal. May 16, 2001) (Delaware law); *Gordon v. Buntrock*, No. 00 CV 303, 2000 U.S. Dist. LEXIS 5977 (N.D. Ill. May 3, 2000) (same); *Lalondriz v. USA Networks, Inc.*, 54 F. Supp. 2d 352 (S.D.N.Y. 1999), *aff'd*, 68 F. Supp. 2d 285 (same); *Gutierrez v. Deloitte & Touche, L.L.P.*, 147 F. Supp. 2d 584 (W.D. Tex. 2001) (Texas law).

180 *Greenfield v. Fritz Cos., Inc.*, 82 Cal. App. 4th 741 (Cal. App. 2000), review granted, 12 P.3d 1068.

181 Id.

182 *Somerville S. Trust v. USV Partners, L.L.C.*, No. CA 19446-NC, 2002 Del. Ch. LEXIS 103 (Del. Chan. Ct. Aug. 2, 2002) (suit under the law of the state of incorporation under § 78bb); *Lazar v. Gregerson*, No. C 02-0652 SI, 2002 U.S. Dist. LEXIS 6152

(N.D. Cal. April 5, 2002) (same under § 77p); *Derdinger v. Tallman*, No. 17276, 2000 Del. Ch. LEXIS 38 (Del. Chan. Ct. Feb. 25, 2000) (Del. carve-out under § 78bb); *Gibson v. PS Group Holdings, Inc.*, No. 00-CV00372 W (RBB), 2000 U.S. Dist. LEXIS 3158 (S.D. Cal. Mar. 8, 2000) (same under § 77p); *Arlia v. Blankenship*, No. 2:01-1111, 2002 U.S. Dist. LEXIS 24287 (S.D. W. Va. Dec. 16, 2002) (shareholder derivative action under § 78bb); *Shen v. Bohan*, No. CV 02-7268 ABC (PJWx), 2002 U.S. Dist. LEXIS 22485 (C.D. Cal. Oct. 16, 2002) (same); *Coykendall v. Kaplan*, No. C 02-02287 CW, 2002 U.S. Dist. LEXIS 22483 (N.D. Cal. Aug. 1, 2002) (same under § 77p).

183 See Steven A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as Well as the Frivolous*, 40 Wm and Mary L. Rev. 1055, 1081 n.124 (1999).

184 See *Hartford Courant*, Dec. 6, 2002, p. A18, LEXIS, News Library, ALLNWS File.

185 Special Rep., Senate Governmental Affairs Committee, *Financial Oversight of Enron: The SEC and Private-Sector Watchdogs*, Oct. 8, 2002, available at http://www.senate.gov/%7Egov_affairs/100702watchdogsreport.pdf.

1186 Id.

187 See *Newsday*, Dec. 6, 2002, p. A66, LEXIS, News Library, ALLNWS File. ("When Congress passed the accounting legislation, it authorized increasing the SEC's budget by 72 percent to \$776 million, but then never appropriated the funds, leaving the agency with no extra resources to confront the avalanche of cases that have followed the bankruptcy of Enron"). ■