PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 (PSLRA) UPDATE

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INTRODUCTION

In December 1995, Congress passed the Private Securities Litigation Reform Act of 1995 ("PSLRA"). Congressional intent in enacting this sweeping legislation was to implement procedural protections to discourage "meritless" securities class action litigation.[1] The stated goal of the PSLRA was that it would "encourage the most capable representatives of the plaintiff class to participate in class action litigation [who would] exercise supervision and control of the lawyers for the class."[2] To achieve this goal, the PSLRA contains a number of procedural provisions intended to transfer the balance of power in securities class action litigation from counsel to those shareholders who possess a sufficient financial interest in the outcome to maintain some supervisory responsibility over both the litigation and their counsel.[3]

Fraught with controversy, the PLSRA stirred up extensive debate and contentious lobbying efforts. Proponents of the PSLRA, consisting primarily of venture capitalists, corporate interests, and accounting firms, argued that these proposed changes to the federal securities law were necessary to eliminate "meritless" private lawsuits and to encourage directors and officers of public companies to publish statements about their companies' financial prospects without fear of shareholder lawsuits. Opponents of the PSLRA, however, including numerous consumer protection groups, argued that those who lobbied for the legislation were motivated solely by their desires to protect themselves from meritorious lawsuits. In his veto message, President Clinton observed that the PSLRA would "have the effect of closing the courthouse door on investors who have legitimate claims." 141 Cong. Rec. H15214-06 (daily ed. Dec. 20, 1995). Despite these concerns, Congress overrode President Clinton's veto and the PSLRA went into effect

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[1] Statement of Managers, The Private Securities Litigation Reform Act of 1995, p. 1 ("Statement").

[2] Statement, p. 2.

[3] In re Horizon/CMS Healthcare Corp. Sec. Litig., 3. F. Supp.2d 1208, 1212 (D.N.M. 1998).

on December 22, 1995.

The PSLRA includes several provisions that represent significant departures from traditional securities law, including a heightened pleading requirement, a statutory "safe harbor" for certain "forward-looking" statements, a proportionate liability provision, and mandatory sanctions under Rule 11 under certain circumstances. In addition, the PSLRA contains certain procedural provisions such as the judicial selection of a "lead plaintiff" and mandatory stay of discovery during the pendency of a motion to dismiss. Each of these provisions places more obstacles in the way of a successful recovery of investment losses caused by securities fraud.

Since the passage of the PSLRA, courts have struggled with interpreting the PSLRA's significant changes to traditional securities law. This article will highlight those changes and the judicial interpretation of those changes, particularly emphasizing the heightened pleading standards and the lead plaintiff provisions established by the PSLRA.

I. THE APPOINTMENT OF A LEAD PLAINTIFF

A. Procedural Requirements

Prior to the passage of the PSLRA, the traditional method to determine who would serve as lead plaintiff in securities class actions was typically the "first come, first served" method. Statement of Managers, p. 3. In seeking to discourage the "race to the courthouse," the PSLRA requires that a plaintiff filing a securities fraud complaint must also file a certification attesting to his or her willingness to serve as lead plaintiff, providing his transaction information and declining any compensation other than what he would receive as a class member. 15 U.S.C.A. §§ 77z-1(a)(2), 78u-4(a)(2). Additionally, in an attempt to discourage the practice of small individual investors becoming "professional plaintiffs" in multiple securities class actions, the PSLRA prohibits any party from being lead plaintiff in more than five securities class actions during any three year period. 15 U.S.C. § 78u-4(a)(3)(B)(vi).

In order to give potential lead plaintiffs with large financial interests the opportunity to serve as lead plaintiff in the action, the Reform Act requires that a plaintiff filing a securities class action complaint must, within 20 days of filing the complaint, provide notice to all potential class members in a "widely circulated national business-oriented publication or wire service." 15 U.S.C.A. §§ 77z-1(a)(3)(A)(i), 78u-4(a)(3)(A)(i). This notice must identify the claims alleged in the action and the class period, and it must inform potential class members of their right to move to serve as lead plaintiff within sixty (60) days of the date of filing the complaint. Id. As a practical matter, such notices also typically include the name, address and phone number of the attorneys representing the class and invite any potential class member to contact such person for more information.

Under the PSLRA, any group of persons wishing to serve as lead plaintiff must move the court for appointment as lead plaintiff within sixty (60) days of the publication of the statutory notice. 15 U.S.C.A. §§ 77z-1(a)(3)(A)(i)(II), 78u-4(a)(3)(A)(i)(II). The court must rule on any outstanding motions to consolidate (which would include motions to transfer and consolidate brought under 28 U.S.C.§ 1407) prior to ruling on any motions to appoint lead plaintiff. 15 U.S.C.§§ 77z-1(a)(3)(B)(ii), 78u-4(a)(3)(B)(ii). Additionally, the court must rule on any motions to appoint lead plaintiff within ninety (90) days of the publication of the statutory notice. 15 U.S.C. §§ 77z-1(a)(3)(B)(i), 78u-4(a)(3)(B)(i).

Concurrently with the lead plaintiff appointment, the court will typically approve the lead plaintiff's selection of lead counsel. The PSLRA vests the lead plaintiff with the authority to retain lead counsel for the class, subject to the approval of the court. 15 U.S.C.A. §§ 77z-1(a)(3)(B)(v), 78u-4(a)(3)(B)(v). The PSLRA also dictates that attorneys' fees for lead counsel shall not exceed a reasonable percentage of the ultimate recovery to the class. 15 U.S.C.A. §§ 77z-1(a)(6), 78u-4(a)(6). Thus, the lead plaintiff is directed to choose the lead counsel for the class, who will be compensated by a reasonable percentage of the recovery enjoyed by the class.

B. "Most Adequate Plaintiff"

The PSLRA creates a presumption that the most adequate plaintiff is "the person, or group of persons" that (1) either filed the complaint or made a motion to be appointed lead plaintiff; (2) has the largest financial interest in the relief sought by the class; and (3) otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure. 15 U.S.C. § 78u-4(a)(B)(iii)(I).

Generally, four factors have been considered as relevant to the determination of the "largest financial interest": (1) the number of shares purchased by the movant; (2) the number of net shares purchased by the movant; (3) the total net funds expended by the movant during the class period; and (4) the losses suffered by the movant. Burke v. Ruttenberg, 102 F. Supp. 2d 1280 (N.D. Ala. 2000) (citing First Merchants Acceptance Corp., 1997 WL 461036 at *5 (N.D. Ill. 1997).

1. PSLRA's Preference for Institutional Investors

The presumption in favor of the person or group with the largest financial stake in the litigation reflects Congress' belief that class members with the largest financial interest have greater incentives to insure that the action is prosecuted in the best interests of the class. Statement, p. 5. To achieve this goal, the PSLRA seeks to encourage the selection of institutional investors as lead plaintiffs in securities class action claims. In re Network Assoc., Inc. Sec. Litig., 76 F. Supp. 2d 1017, 1020 (N.D. Cal. 1999). In large part, this is due to the fact that institutional investors are the most likely to have the largest financial interest in the case and thus they may often qualify as the "most adequate plaintiff" as defined by the PSLRA.

Despite Congressional intentions to encourage institutional investors to serve as lead plaintiffs, however, the number of institutional investors that have sought to participate as lead plaintiffs in securities class actions has still remained relatively small.[4] Courts interpreting the lead plaintiff provisions of the PSLRA have generally recognized Congress' intent to encourage participation of institutional investors in securities class actions. See, e.g., In re Lucent Technologies, Inc. Sec. Litig., 194 F.R.D. 137 (D.N.J. 2000). In recent cases where institutional investors have undertaken to participate, however, courts have refrained from automatically conferring lead plaintiff status upon them, in some cases ordering that the role

[4] See, e.g., S.E.C. Office of General Counsel, Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995 (Apr. 15, 1997), reprinted in 3 Securities Reform Act Litig. Rptr. 27, 56 (May 1998) ("Congress' efforts to encourage more active participation by institutional and other large investors has not yet taken hold...In the 105 cases filed after the first year after passage of the [PSLRA], we have found only eight cases in which institutions have moved to become lead plaintiff."); See also Memorandum of the S.E.C., Amicus Curiae at 16, In re Oxford Health Plans, Inc. Sec. Litig., MDL Docket No. 1222 (S.D.N.Y.)(asserting that "few institutions have instituted securities fraud class actions after passage of the PSLRA."); Seth Goodchild, Nothing Ventured, Nothing Gained: Ten Lessons for Institutional Investors From the 1995 Reform Act, 4 Securities Reform Act Litig. Rptr. 583-84 (Feb.-Mar. 1998)(The PSLRA has not yet brought the dramatic revolution in the leadership of these actions Congress intended...[I]nstitutional investors have remained passive observers in securities litigation, volunteering to serve as lead plaintiff only infrequently.")

be shared instead. See, e.g. In re Oxford Health Plans, Inc. Sec. Litig., 182 F.R.D. 42 (S.D.N.Y. 1998)(court appointed three groups of investors to serve as joint-lead plaintiffs, including an institutional investor, three individual investors, and a management company which included five pension funds). Courts recognize, moreover, that if an "institutional investor" does not have the largest financial interest in the relief sought by the class, it will not be deemed the "most adequate plaintiff." Netsky v. Capstead Mortgage Corp., No. 3:98-CV-1716, 2000 WL 964935 at *5, (N.D. Tex. July 12, 2000).

2. The Rebuttable Presumption of "Most Adequate Plaintiff"

Once the presumptive lead plaintiff has been determined, this presumption can be rebutted only by proving that the "presumptively most adequate plaintiff" will not fairly and adequately protect the interests of the class as a whole, or would be subject to unique defenses that render such plaintiff incapable of adequately representing the class. 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)-(II). The PSLRA provides that this presumption may be rebutted only "by a member of the purported plaintiff class." 15 U.S.C.A. §§ 77z-1(a)(3)(B)(iii)(II), 78u-4(a)(3)(B)(iii)(II). Accordingly, defendants do not have standing to respond to the issue of who should serve as lead plaintiff. Netsky v. Capstead Mortgage Corp., No. 3:98-CV-1716, 2000 WL 964935 at *7 (N.D. Tex. July 12, 2000); Takeda v. Turbodyne Techs, Inc. , 67 F. Supp 2d. 1129, 1138 (C.D. Cal. 1999); Greebel v. FTP Software Inc., 939 F. Supp. 57, 59 (D. Mass. 1996)(the "presumption may be rebutted only upon proof by a member of the purported plaintiff class")(quoting 15 U.S.C.A. § 78u-4(a)(3)(B)(iii)(II)).[5]

However, there has been substantial dispute about the definition of "the most adequate plaintiff." Specifically, two issues arise from the interpretation of the phrase "the most adequate plaintiff". First, whether an otherwise unrelated group can aggregate their losses in order to serve as lead plaintiff. Second, whether the courts can "augment" the presumptive lead plaintiff by the appointment of "co-lead" plaintiffs.

[5] But see King v. Livent, Inc., 36 F. Supp. 2d 187, 191 (S.D.N.Y. 1999)(court determined that the defendants generally do have standing to object, especially where there are no competing plaintiffs); Howard Gunty Profit Sharing v. Quantum Corp., No. 96-20711, slip op. at 6-7 (N.D. Cal. Feb. 6, 1997)("when...there are no other potential lead plaintiffs to challenge a moving party, the Court must rely on the defendants to insure that the requirements of [the PSLRA] are satisfied.")

Neither of these issues has been fully resolved by the courts.

a. Aggregation of Shareholder Damages in Order to Determine Financial Interest

Defendants contend that the PSLRA is silent on the issue of whether members of the class or a group of persons (or entities) may aggregate their damages to constitute the "largest financial interest" for the purpose of determining the "most adequate plaintiff." The PSLRA does specifically refer, however, to a "group of persons" serving as lead plaintiffs. The Securities and Exchange Commission ("SEC") does not provide guidelines to assist with the interpretation of the term "group of persons" as defined in the PSLRA. Rather, the SEC has suggested that a court should "only approve a group that is small enough to be capable of effectively managing the litigation and the lawyers." In re Baan Co. Sec. Litig., 186 F.R.D., 214, 216 (D.D.C. 1999); see also In re Oxford Health Plans, Inc. Sec. Litig., 182 F.R.D. 42, 48-49 (S.D.N.Y. 1998). The SEC has recommended that no more than three to five persons should serve as lead plaintiffs in order to ensure joint decision making and to manage the litigation effectively. Baan, 186 F.R.D. at 219. So the question remains, does the PSLRA permit aggregation of damages for the purpose of determining the most adequate plaintiff?

The majority of courts addressing this issue have permitted the aggregation of claims by unrelated parties.[6] See In re First Union Corp. Sec. Litig., No. 3:99-CV-237, 2000 U.S. Dist. LEXIS 2267 at *12 (W.D.N.C. Jan. 27, 2000)("there is now an overwhelming weight of authority allowing the appointment of such an unrelated group to serve as lead plaintiffs."); Yousefi v. Lockheed Martin Corp., 70 F. Supp. 2d 1061, 1067 (C.D. Cal. 1999)(an individual investor and an institutional investor were appointed co-lead plaintiffs as they suffered the largest financial loss); Reiger v. Altris Software, No. 98-CV-0528, 1999 WL

[6] While courts have generally held that aggregation of damages should be allowed, several courts have noted that there are certain instances where the number of proposed lead plaintiffs should be limited. See, e.g., Lubitsch v. Dataworks Corp., No. 98-2012-IEG (S.D. Cal. Feb. 9, 1999)(the court rejected the appointment of a 25-member lead plaintiff group and instead appointed a 3 member subgroup.); Mitchell v. Complete Management, Inc., No. 99 Civ. 1454, 1999 WL 728678 (S.D.N.Y. Sept. 15, 1999)(the court directed the plaintiff group to propose a lesser number of class members for appointment of lead plaintiff, as the initial proposal was for a 141-person lead plaintiff group.)

540893 (S.D. Cal. Sept. 11, 1998)("Congress made it clear that a court can consider the aggregate group's losses in determining which group has the largest financial interest."); Gluck v. CellStar Corp., 976 F. Supp. 542, 546 (N.D. Tex. 1997) ("[A]ggregating the shares of several plaintiffs for purposes of [the largest financial interest] calculation is proper under the statutory language.").

On the other hand, a minority of courts have stated that aggregation of unrelated parties should not be allowed when determining lead plaintiff in a securities class action, holding that unrelated individuals cannot qualify as a "group of persons" under the PSLRA. These courts reason that it would be inconsistent with the Reform Act "to allow a mélange of unrelated persons to serve as the lead plaintiff...Such a 'group' would be a 'lead plaintiff' in name only; in substance, those individuals would essentially constitute a collection of lead plaintiffs, unbound by any allegiance to one another and unlikely to function as a unified whole."[7]

The seminal case prohibiting aggregation of damages is In re Network Assoc., Inc. Sec. Litig., 76 F. Supp. 2d 1017 (N.D.Cal. 1999). In that case, the court prohibited the aggregation of unrelated plaintiffs and criticized the proposed aggregation as follows: "The only thing the investors in any group have in common...is the lawyer. They have no link to each other. They are not organized with any group decision making apparatus. They attended no organizing meetings. They have no cohesive identity." Id. Moreover, the Network Associates court pointed out that if aggregation of unrelated investors were allowed, "then a qualified institutional investor with the single largest loss could be trumped by a collage of individual investors with greater aggregate losses but no ability to manage the case." Id. at 1024. See also In re McKesson HBOC Sec. Litig., 97 F. Supp. 2d 993(N.D. Cal. 1999)(the court concluded that a lead plaintiff must be an individual person or entity or at most, a close-knit group of persons and would not allow aggregation of amorphous grouping of unrelated persons.)

In In re Donnkenny, Inc. Sec. Litig., 171 F.R.D. 156, 157 (S.D.N.Y. 1997), the court refused to

[7] In re Texlon Corp. Sec. Litig., 67 F. Supp. 2d 803, 813 (N.D. Ohio 1999). But see Bowman v. Legato Systems, 195 F.R.D. 655, 658 (N.D. Cal. 2000) (lawyer-selected aggregation of unrelated persons not within PSLRA definition of "group").

appoint a lead plaintiff group comprised of two unrelated institutional investors and four other individual class members. The judge reasoned that

> [t]o allow an aggregation of unrelated plaintiffs to serve as lead plaintiffs defeats the purpose of choosing a lead plaintiff. One of the principal legislative purposes of the PSLRA was to prevent lawyer-driven litigation. Appointing lead plaintiff on the basis of financial interest, rather than on a "first come, first serve" basis, was intended to ensure that institutional plaintiffs with expertise in the securities market and real financial interests in the integrity of the market would control the litigation...

Id. at 157-58.

One court recently set forth yet another approach to the aggregation issue. In Wenderhold v. Cylink Corp., 188 F.R.D. 577, 586 (N.D. Cal. 1999), the court held that:

> aggregation solely for the purpose of creating a group that would have the largest financial interest in the relief sought by the class would seem to contravene the PSLRA's purpose of shifting control of the litigation from the lawyers to the investors. Uncritical or blanket acceptance of such aggregation would permit lawyers to designate unrelated plaintiffs as a group which would allow and encourage lawyers to direct the litigation.

Id. The court went on to state that there are two circumstances in which aggregation should be permitted: (1) if the aggregation is necessary to address the existence of intra-class periods; and (2) if it can be shown to serve the PSLRA's effort to shift control of the litigation away from the lawyers and to the investors. Id. The court believed this middle course best serves the class and comports with the Reform Act. [8] Id.

b. **Appointment of "Co-Lead" Plaintiffs**

Another recent trend among several courts is to allow multiple plaintiffs to take active roles as "co-lead" plaintiffs. In In re Oxford Health Plans, Inc. Sec. Litig., 182 F.R.D. 42 (S.D.N.Y. 1998), the court appointed three groups of investors as joint lead plaintiffs, with each group exercising an equal vote. The three groups of investors consisted of (1) an institution; (2) three individual investors; and (3) a management company which included five pension funds. Id. at 44-45. The Oxford Health court noted that all three plaintiffs were qualified to represent the class. Id. The court further noted that multiple lead plaintiffs allows for "broad representation" and would provide the class with the "substantial benefits of

[8] No other court has expressly followed Wenderhold's "middle" approach.

joint decision making and joint funding." Id. at 45. See also In re Party City Sec. Litig., 189 F.R.D. 91 (D.N.J. 1999)(the court appointed two co-lead plaintiffs: one institutional investor and one individual investor.); In re Cephalon Sec. Litig., 1998 U.S. Dist. LEXIS 12321 (E.D. Pa. Aug. 27, 1998)(the court allowed two groups of plaintiffs to be appointed co-lead plaintiffs as they had the largest financial interest in the litigation.)

At least one court has disagreed with the Oxford Health holding. In LaPerriere v.Vesta Ins. Group, Inc., No. 98-AR-1407 (N.D. Ala., Acker, J.), the court refused to decide between a group of individual investors and an institutional investor. The court deemed each party "more than adequate" to represent the class as a whole. Id. The judge instead announced the use of an unconventional method of a "coin toss" to determine the lead plaintiff.[9] Id.

Thus, as evidenced by the plethora of conflicting judicial decisions, courts are still struggling to interpret the lead plaintiff provisions of the PSLRA, nearly five years after its enactment. This struggle is likely to continue, with seemingly conflicting opinions being issued, in large part because of the fact-intensive nature of the issue and because judges continue to be guided by their own judgment as to what result is in "the best interests of the class."

II. THE HEIGHTENED STANDARD FOR PLEADING SCIENTER IN SECURITIES FRAUD CLAIMS

In addition to establishing new guidelines for the appointment of lead plaintiff, the PSLRA changed the standard for pleading scienter in securities fraud claims. Prior to the passage of the PSLRA, the "required state of mind" for a Section 10(b) violation was "knowledge of falsity or recklessness." See, e.g., Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976); Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69, n. 6 (9th Cir. 1990)(en banc).

[9] Following the Court's order, the competing lead plaintiff groups in Laperriere reached an agreement concerning the appointment of lead plaintiff and lead counsel. That stipulation was approved by the Court and the "coin toss" proved unnecessary.

Under the PSLRA, to sufficiently allege scienter, the complaint must ”state with particularity facts giving rise to a **strong inference that the defendant acted with the required state of mind**.” 15 U.S.C. § 78u-4(b)(2)(emphasis added).[10] The PSLRA does not, however, provide a definition of the term “strong inference.” Id.; Schaffer v. Evolving Sys., Inc., 29 F. Supp. 2d 1213, 1221 (D. Colo. 1998). Despite the PSLRA's stated aim of providing a uniform standard for pleading Rule 10b-5 claims, the courts have applied a number of different interpretations of the PSLRA's heightened pleading standards. Since the passage of the PSLRA, several separate lines of authority have developed concerning the proper interpretation of the scienter provision.

Most circuit courts addressing the issue have concluded that the PSLRA did not revise substantive pleading requirements.[11] These courts have used the PSLRA's “required state of mind” clause as a cross-reference to Hochfelder, which establishes that scienter is established if there is knowledge of falsity or recklessness. See In re Advanta Corp. Sec. Litig., 180 F.3d 525, 534 (3d. Cir. 1999)(finding that “although the PSLRA established a uniform pleading standard, it did not purport to alter the substantive contours of scienter.”); In re Comshare, Inc. Sec. Litig., 183 F.3d 542, 550 (6th Cir. 1999)(concluding that the pre-PSLRA definition of scienter, in particular its allowance of “recklessness” still operated under the PSLRA); Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1284 (11th Cir. 1999)(stating that “when Congress codified

[10] Congress was attempting to resolve the circuit courts' divergent Rule 9(b) interpretations with the enactment of the PSLRA. Borrowing language from the pre-PSLRA Second Circuit standard, complaints must now “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” But the PSLRA's Conference Committee Report states that its strengthened pleading requirement was only “based in part” and not a full codification of the Second Circuit's pleading standard. Conf. Rep. No. 104-369 § 27 of the Securities Act and § 21D of the Exchange Act (1995). Indeed, a footnote in the Report states that “for this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness” as means for establishing a “strong inference.” Id. at 41, n. 23.

[11] This conclusion is supported by a review of two other PSLRA provisions: the statutory safe harbor for “forward-looking” statements and the proportionate liability provision. Congress expressly provided that for certain “forward-looking” statements, the required state of mind shall be “actual knowledge” that a statement is false or misleading. 15 U.S.C. § 78u-5(c)(1)(B). Likewise, in the PSLRA's proportionate liability provision, Congress provided for unrestricted liability to those who act “with actual knowledge of falsity.” 15 U.S.C.A. § 78u-4(g)(10)(A). Thus, where Congress intended to define the state of mind requirement in the PSLRA, it did so. Because Congress did not change the state of mind requirement other than for “forward-looking” statements and for purposes of proportionate liability, but instead merely referred to the “required state of mind” in connection with pleading scienter, most commentators and courts have agreed that scienter jurisprudence remained unchanged following the enactment of the PSLRA.

the 'required state of mind', it seems to us very clear that Congress was codifying the well-established law that recklessness was sufficient to allege scienter."); Greebel v. FTP Software, Inc., 194 F.3d 185, 199-200 (1st Cir. 1999)(concurring with other courts' assessments that the PSLRA did not alter the substantive pleading requirements, and further stating that if Congress had intended to change the substantive requirement, it would have done so explicitly as in other portions of the PSLRA); Phillips v. LCI Int'l., Inc., 190 F.3d 609, 620 (4th Cir. 1999)(finding that "to establish scienter, a plaintiff must still prove that the defendant acted intentionally, which may perhaps be shown by recklessness.")

A. The Ninth Circuit Standard

The Ninth Circuit, however, has taken a completely different approach. In In re Silicon Graphics, Inc. Sec. Litig., 183 F.3d 970 (9th Cir. 1999), the Ninth Circuit court concluded that recklessness "satisfies scienter under section 10(b) to the extent that it reflects some degree of **intentional or conscious misconduct**." Id. at 977 (emphasis added). Allegations that the defendant "knew" or "must have been aware" suggest intent and consciousness. Id. Thus, in order to meet Ninth Circuit substantive pleading requirements, a plaintiff must allege facts demonstrating a strong inference of "deliberate recklessness," which the court described as "no less than a degree of recklessness that strongly suggests actual intent." Id. Furthermore, plaintiffs must specifically plead their allegations of fraud and all allegations of false and misleading statements must be stated in the complaint with "great detail."[12] Id. Rejecting the Second Circuit approach, the Ninth Circuit stated that "although facts showing mere recklessness or a motive to commit fraud and opportunity to do so may provide some reasonable inference of intent, they are not sufficient to establish a strong inference of deliberate recklessness." Id. at 974.

The Ninth Circuit's decision is a significant departure from other interpretations of the "required state of mind" under the PSLRA.[13] Before Silicon Graphics, plaintiffs were required to plead only that the

[12] Under this standard, in the context of the negative internal reports alleged in Silicon Graphics, the plaintiffs were required to describe how they learned of the reports, who drafted the reports, which officers received them and their contents, including "countless specifics" regarding details about the company's internal operations. The plaintiffs' failure in Silicon Graphics to do so resulted in the dismissal of their complaint.

[13] The Silicon Graphics decision has been heavily criticized. In an amicus brief submitted on appeal of the case, the Securities and Exchange Commission requested that the Silicon Graphics court reconsider its decision. See also

defendants had acted "recklessly". In raising the scienter standard to one of "deliberate recklessness", the Silicon Graphics stringent pleading standard considerably improves defendants' chances of obtaining dismissal of securities fraud actions at the pleading stage in the Ninth Circuit. Heliotrope Gen'l, Inc. v. Ford Motor Co., 189 F.3d 971, 980 (9th Cir. 1999).[14]

B. The Second Circuit Standard

Prior to the PSLRA's enactment, in the Second Circuit a strong inference of fraudulent intent could be established in a securities fraud case either (1) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness; or (2) by alleging facts to show that defendants had both motive and opportunity to commit fraud. The High View Fund, L.P. v. Hall, 27 F. Supp. 2d 420, 426 (S.D.N.Y. 1998); see also Oxford Health Plans, 187 F.R.D. at 138.

In Novak v. Kasaks, 216 F.3d 300 (2d. Cir. 2000), the Second Circuit observed, initially, that the PSLRA "raised the nationwide pleading standard to that previously existing in this circuit and no higher (with the exception of the "with particularity" requirement)." Id. However, the court reasoned that "litigants and lower courts need and should not employ or rely on magic words such as 'motive' and ' opportunity' because Congress' failure to include language about motive and opportunity suggests that we need not be wedded to these concepts in articulating the prevailing standard." Id. The Novak court concluded that "conscious recklessness--a state of mind approximating actual intent" could satisfy the PSLRA's scienter pleading requirements. Id.

According to the Second Circuit, this standard places them on a "middle ground" between those courts which believe the PSLRA "effectively adopts the Second Circuit's [old] pleading standard for

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Bryant, 197 F.3d at 1283, 1284 n. 21 ("the opinion of the Ninth Circuit in Silicon Graphics would seem to indicate that the PSLRA substantively raised the required level of scienter...[and] is an attempt to import into the law a new and uncertain super-recklessness."); Andrew B. Weissman, Symposium on Silicon Graphics, 1 Sec. Reform Act Litig. Rptr. 673, 787 (1996)(noting that the court in Silicon Graphics "incorrectly read Congress' heightened pleading requirements as affecting the substantive elements of a securities fraud claim under Section 10(b) and Rule 10b-5.")

[14]Defrauded investors in the Ninth Circuit may take some consolation, however, from the recent decision in Howard v. Everex Systems, Inc., 228 F.3d 1057 (9th Cir. 2000)(reversing summary judgment in favor of company CEO). The court made it clear that the Silicon Graphics standard applied only as a pleading standard; the standard on summary judgment remained unaltered.

scienter wholesale, and thus plaintiffs may continue to state a claim by pleading either motive or opportunity or strong circumstantial evidence of recklessness or conscious misbehavior" and those courts which find the PSLRA to have strengthened the old Second Circuit standard "by rejecting the simple pleading of motive and opportunity." Id.

C. The Eleventh Circuit Standard and the rejection of the "motive and opportunity" test

Several circuit courts have expressly rejected the 'motive and opportunity' test, including the Eleventh Circuit. In Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1286 (11th Cir. 1999), the court held that Congress "did not codify the motive and opportunity analysis." The Bryant court noted that the PSLRA's language about the "required state of mind" involves a "condition of the mind, like willfulness or recklessness." Id. The court also noted that allegations of 'motive and opportunity' might be relevant to a showing of scienter, but alone are not sufficient "because motive and opportunity do not constitute a state of mind." Id. See also In re World Access, Inc. Sec. Litig., No. 1:99-CV-43-ODE, 2000 WL 1610611 (N.D. Ga. Mar. 28, 2000)(plaintiffs met pleading threshold by alleging eight identifiable problems associated with a switch identified in defendants' press release, averring the defendants' financial statements were false or misleading because they did not make appropriate accounting entries to reflect non-payments arising from disputes about the switches, and by alleging that defendants routinely employed "bill and hold" practices.)

The Sixth Circuit is in general agreement with the Eleventh Circuit that "motive and opportunity" is no longer sufficient to plead scienter. See generally In re Comshare, Inc. Sec. Litig., 183 F.3d 542, 551 (6th. Cir. 1999)(Court held that the "bare pleading of motive and opportunity" could not "standing alone" establish a "strong inference" of the required state of mind. The court, however, stated that the PSLRA's pleading requirements could be met by "alleging facts that give rise to a strong inference of reckless behavior.").

The First Circuit has partially rejected the "motive and opportunity" standard. In Greebel v. FTP Software, Inc., 194 F.3d 185, 195 (1st Cir. 1999), the court rejected the contention that "facts showing motive and opportunity can never be enough to permit the drawing of a strong inference of scienter." The court, however, cautioned that "merely pleading motive and opportunity [without more], regardless of the strength of the inferences to be drawn of scienter, is not enough." Id. at 197.

D. Allegations of Insider Trading

Amidst the array of conflicting judicial interpretations of the PSLRA's proper definition of "scienter", one constant has emerged. The circuits are in basic agreement that a specific and well-founded allegation that defendants reaped a direct, significant and unusual economic benefit (usually resulting from insider trading) from the alleged fraud may give rise to a strong inference of scienter. This is so regardless of whether the law of the circuit will infer scienter from allegations of motive and opportunity. Compare, e.g., Silicon Graphics, 183 F.3d at 986 (whereas mere allegations of motive and opportunity are insufficient to give rise to a strong inference of scienter, allegations of suspicious or unusual stock sales by defendants may provide circumstantial evidence of scienter.); with Novak v. Kasaks, No. 98-9641, 2000 WL 796300 (2d. Cir. June 21, 2000).

To support the requisite strong inference of scienter through allegations of stock sales by insiders, plaintiffs must establish that the stock sales during the class period were "suspicious or unusual". Silicon Graphics, 183 F.3d at 986; In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1424 (3rd. Cir. 1997); Acito v. IMCERA Group, Inc., 47 F.3d 47, 54 (2d. Cir. 1995). Among the relevant factors to consider in determining if stock sales are suspicious or unusual are: (1) the amount and percentage of shares sold by insiders; (2) the timing of the sales; (3) whether the sales were consistent with the insider's prior trading history. Silicon Graphics, 183 F.3d at 986; Provenz v. Miller, 102 F.3d 1478, 1491 (9th Cir. 1996); Oxford Health Plans, 187 F.R.D. at 140.

In Oxford Health Plans, the court denied the defendants' motion to dismiss, holding that "plaintiffs' allegations of unusually large insider trades at suspicious times are sufficient to create, along with the other allegations, a strong inference of scienter." Id. at 140. The court noted that the individual defendants sold over 1.2 million shares of Oxford common stock for total proceeds of over $78 million. Id. All of the individual defendants except one sold shares of Oxford for aggregate profits of approximately $33 million.

Id. at 139. Although the court recognized that "large volume trades" are not necessarily suspicious if the corporate insider sells only a small fraction of his or her shares in a corporation, it concluded that the defendants' class period sales were "massive by any measure" and created a strong inference of scienter. Id. at 140.

In contrast, the Silicon Graphics court held that "the stock trading by the individual defendants was not dramatically out of line with prior trading practices or otherwise suspicious enough to create a strong inference of the required deliberate recklessness." Id. at 987. In that case, the individual defendants collectively sold 10% of their available holdings in the company. Thus, the court concluded that the allegations of insider trades during the class period were insufficient to establish scienter under the Ninth Circuit's interpretation of the PSLRA.

III. RULE 9(b) PLEADING REQUIREMENTS

In addition to scienter pleading requirements, securities fraud complaints are subject to Rule 9(b)'s imposition that "the circumstances constituting fraud...shall be stated with particularity." "Particularity" requires allegations to "specify the statements the plaintiff contends were fraudulent, identify the speaker, state where and when the statements were made, and explain why the statements were fraudulent." Mills v. Polar Molecular Corp., 12 F.3d 1170, 1175 (2d. Cir. 1993). This "who, what, when, where and how" standard is well-settled and has not been changed by the PSLRA. See generally, In re Advanta Corp. Sec. Litig., 180 F.3d 525, 534 (3rd Cir. 1999). Since the PSLRA's passage, however, two particular Rule 9(b) issues have caused a split among courts: pleadings based on "information and belief" and the so-called "group pleading" doctrine.

A. Pleading on "Information and Belief"

The PSLRA goes beyond Rule 9(b)'s requirements with the additional requirement that "if an allegation regarding [an allegedly misleading] statement or omission is made on information and belief...[the complaint] must state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). Whether the PSLRA requires a plaintiff to provide the sources of information has been the subject of debate.

The Eleventh Circuit "does not require that plaintiffs plead with particularity every single fact upon which their beliefs concerning false or misleading statements are based. Rather plaintiffs need only plead with particularity sufficient facts to support these beliefs." In re Theragenics Corp. Sec. Litig., 105 F. Supp. 2d 1342, 1355 (N.D. Ga. 2000)(holding that where facts provide an adequate basis for believing that defendants' statements were false, plaintiffs need not name their confidential personal sources).[15] The First Circuit requires a pleading to "set forth the source of information and the reasons for the belief." Greebel, 194 F.3d at 194. The Eighth Circuit has likewise employed this standard, stating that "where allegations of fraud are...based only on information and belief, the complaint must set forth the source of the information and the reasons for the belief." See In re Engineering Animation Sec. Litig., 2000 U.S. Dist. LEXIS 5118 at *25 (D. Iowa 2000).

Plaintiffs often claim "investigation of counsel" as an allegation's source rather than information and belief. According to some courts, a complaint pled in this method need not set forth with particularity all the facts on which a belief is formed. See Warman v. Overland Data, Inc., 1998 WL 110018 (S.D. Cal. Feb. 20, 1998). But see In re Green Tree, 61 F. Supp. 2d 860, 872 (D. Minn. 1999)(plaintiffs should not be allowed to avoid the heightened pleading standard by claiming 'investigation of counsel.')

B. The Group Pleading Doctrine

Rule 9(b) requires a plaintiff to identify the speaker of the allegedly fraudulent statements. The Group Pleading doctrine is an exception to this rule. This doctrine provides that in the case of corporate fraud where the false or misleading information is conveyed in prospectuses, registration statements, annual reports, press releases, or other "group published information," it is reasonable to presume that these are the collective actions of the officers, therefore, no specific connection between fraudulent representations or omissions need be pleaded when the facts are exclusively within the defendant's knowledge, as is the case

[15] A consensus appears to have developed that the PSLRA does not require plaintiffs in securities fraud cases to reveal the names of confidential sources in order to meet particularity requirements. E.g., Novak v. Kasaks, 216 F.3d 300, 303 (2d Cir. 2000); Fitzer v. Security Dynamics Tech., Inc., No. 98-12496, 2000 WL 1477204 at *7 (D. Mass. Sept. 28, 2000).

when defendants are insiders or affiliates participating in the statements at issue. See, e.g., In re Oxford Health Plans, 187 F.R.D. 133, 142 (S.D.N.Y. 1999); In re Health Mgmt., Inc. Sec. Litig., 970 F. Supp. 192, 208 (E.D.N.Y. 1997); In re Checkers Sec. Litig., 858 F. Supp. 1168, 1178 (M.D. Fla. 1994).

Defendants have argued that the group published information doctrine is inconsistent with the PSLRA, which requires that "the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading" and "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." See 15 U.S.C.A. § 78u-4(b)(1) and (b)(2). Nonetheless, courts faced with this argument have generally rejected it, finding that the PSLRA did not abolish the group-published information doctrine. See In re Theragenics, 105 F. Supp. 2d at 1358 (N.D. Ga. 2000)(holding that the group pleading doctrine survives and is consistent with the PSLRA); In re BankAmerica Corp. Sec. Litig., 78 F. Supp. 2d 976 (E.D. Mo. 1999).

IV. ADDITIONAL PSLRA PROVISIONS

The Reform Act also contains a number of other provisions that substantially change traditional securities law.

A. The Statutory Safe Harbor

The PSLRA contains a "safe harbor" from liability that allows a company or its principals to release statements predicting the company's future economic performance and describing the assumptions underlying such statements. 15 U.S.C.A. §§ 77z-2, 78u-5. In that safe harbor, corporations and individual defendants may avoid liability for "forward-looking" statements that prove false if "the statement is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." 15 U.S.C. § 78u-5(c)(1)(A)(i). Even if the "forward-looking" statement has no accompanying cautionary language, the plaintiff must prove that the defendant made the statement with "actual knowledge" that it was false or misleading. 15 U.S.C.A. §§ 77z-2(c)(1)(B), 78u-5(c)(1)(B); Harris v. Ivax Corp., 182 F.3d 799, 803 (11th Cir. 1999).

A "forward-looking" statement includes (1) statements containing projections of revenues, income, earnings per share, or other financial items; (2) statements of the plans and objectives of management for future operations; and (3) statements of future economic performance. 15 U.S.C. § 78u-5(i)(1); Harris, 182 F.3d at 803-807(statement in drug company's press release that challenges unique to period in its history were not behind it, when considered in context of anticipated improvements in business, qualified as "forward-looking" statements.)

The safe harbor provision has two prongs that operate in the disjunctive:

- Under the "**actual knowledge**" prong, the issuer is protected with respect to the forward-looking statement if the plaintiff fails to prove that the statement was made with actual knowledge that the statement was false or misleading. 15 U.S.C.A. §§ 77z-2(c)(1)(B), 78u-5(c)(1)(B).
- Under the "**bespeaks caution**" prong, the person making the forward-looking statement is protected if the statement is identified as a forward-looking statement and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement. 15 U.S.C.A. §§ 77z-2(c)(1)(A), 78u-5(c)(1)(A). The "bespeaks caution" doctrine provides a mechanism by which a court can rule as a matter of law that the defendants' forward-looking statements contained enough cautionary language or risk disclosure to protect the defendant against securities fraud. This doctrine reflects nothing more than the proposition that statements must be analyzed in context.

B. Proportionate Liability

The PSLRA also limits the application of joint and several liability to defendants who knowingly commit a violation of securities laws. 15 U.S.C.A. § 78u-4(g)(2)(A). All other defendants are proportionately liable based on their percentage of responsibility for the damages. 15 U.S.C.A. § 78u-4(g)(2)(B)(i). Knowledge, for purposes of proportionate liability, exists when the defendant (1) makes an untrue statement of a material fact with knowledge of its falsity, and persons are likely to rely on the misrepresentation; (2) omits to state a fact necessary to make a material statement true, with actual knowledge that without the omitted fact, the representation is false, and persons are likely to reasonably rely on the omission; or (3) in cases not involving false representations, engages in conduct with actual knowledge of the facts and circumstances that make such conduct a violation of the securities laws. 15

U.S.C.A. § 78u-4(g)(10)(A). Reckless conduct does not constitute a knowing commission of a violation of the securities laws for these purposes. 15 U.S.C.A. § 78u-4(g)(10)(B).

C. The Automatic Stay of Discovery

The PSLRA provides that discovery is automatically stayed when a defendant files a dispositive motion to dismiss in a securities fraud claim. 15 U.S.C.A. §§ 77z-1(b)(1), 78u-4(b)(3)(B). This provision was enacted to protect defendants in private federal securities litigation from expending substantial time and resources in responding to discovery requests unless and until the court determines that a valid claim has been stated. Congress used the following reasoning:

> The cost of discovery often forces innocent parties to settle frivolous securities class actions. According to the general counsel of an investment bank, "discovery costs account for roughly 80% of total litigation costs in securities fraud cases." In addition, the threat that the time of key employees will be spent responding to discovery requests, including providing deposition testimony, often forces coercive settlements.

Statement, pp. 7-8. Thus, post-PSLRA, courts have held that discovery shall be stayed during the pendency of any motion to dismiss. See, e.g., Medhekar v. U.S. District Court, 99 F.3d 325 (9th Cir. 1996)(holding that a defendant need not provide the self-executing discovery required by Fed.R.Civ.P. 26 pending a motion to dismiss a federal securities claim.)

In addition, the PSLRA limits a court's discretion to provide relief from this restriction to those situations where exceptional circumstances make particularized discovery necessary to preserve evidence or prevent undue prejudice to a party. 15 U.S.C.A. §§ 77z-1(b)(1), 78u-4(b)(3)(B). The PSLRA also provides that the parties shall preserve all documents that are relevant to the allegations of the complaint during the pendency of the motion to dismiss. 15 U.S.C.A. §§ 77z-1(b)(2), 78u-4(b)(3)(C).

D. Mandatory Sanctions

The PSLRA also establishes a rebuttable presumption that the appropriate sanction for filing a complaint that violates Rule 11(b) is an award of all attorney's fees and costs incurred in the action. 15 U.S.C. §§ 77z-1(c)(3)(A), 78u-4(c)(3)(A). The PSLRA also provides that other filings for which Rule 11 requirements are not satisfied will justify an award of attorneys' fees incurred by the prevailing party for that particular filing. Id. The PSLRA does not, however, provide for sanctions against defendants who defend meritorious actions in bad faith.

CONCLUSION

Although nearly six years after its passage, it is still too early to draw definitive conclusions on the impact of the PSLRA on securities class action litigation. Indeed, given the pace at which courts struggle to interpret its provisions, it will probably be five years or more before we have enough information to reach any definitive conclusions on the PSLRA's impact. Moreover, because courts have interpreted the provisions and purpose of the PSLRA differently, clarification is needed on issues such as (1) whether aggregation of individual investors into groups for purposes of determining largest financial interest is permissible under the PSLRA; (2) whether appointment of co-lead plaintiffs is appropriate under the PSLRA; and (3) the proper definition of the PSLRA's heightened pleading standards. In light of the widely varying interpretations found in different jurisdictions, review by the Supreme Court may be necessary to clarify these issues.