

# The PSLRA Decade of Decadence: Improving Balance in the Private Securities Litigation Arena with a Screening Panel Approach

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*Predictability and uniformity are two hallmarks of an effective justice system, and the [proposed PSLRA] pleading reforms make the system more effective and predictable.<sup>1</sup>*

## I. INTRODUCTION

Notwithstanding debate, controversy, and a presidential veto, the United States Congress enacted the Private Securities Litigation Reform Act (PSLRA) in December of 1995.<sup>2</sup> The PSLRA introduced unprecedented and sweeping changes to the procedural and pleading rules governing private securities fraud lawsuits.<sup>3</sup> Two notable PSLRA provisions are a stay of discovery while litigants await a mo-

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1. 141 CONG. REC. 23,039 (1995) (Sen. Domenici). Senator Domenici was an original co-sponsor of the PSLRA. *Id.*

2. Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C. (2000)). President Clinton supported the legislation's goals, but he feared that the bill as presented to him would "have the effect of closing the courthouse door on investors who have legitimate claims." 141 CONG. REC. 37,797 (1995) (stating President Clinton's veto message); see also John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, 337 (1996) (recounting in detail the PSLRA's legislative path and concluding that the Act "seems to suffer from a lack of agreement on the nature and extent of the problems it was seeking to redress, with the result that the Act does not appear to reflect any uniform policy or provide any theoretical framework for its many provisions") (footnote omitted).

During a 1993 hearing leading up to the PSLRA, Subcommittee Chairman Senator Christopher J. Dodd of the Subcommittee on Securities of the Senate Commission on Banking, Housing, and Urban Affairs remarked:

[A]fter a long [first] hearing that lasted well into the afternoon, we found no agreement on whether there is in fact a problem, the extent of the problem, or the solution to the problem. In my experience with this subcommittee, I've never encountered an issue where there is such disagreement over the basic facts. We often argue about policy, we argue about ideology, we often argue about politics, but it is rare that we spend so much time arguing about basic facts.

*Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Sec. of the S. Comm. on Banking, Hous., & Urban Affairs*, 103d Cong. 280 (1993) [hereinafter *Private Litigation Hearings*].

3. See Hillary A. Sale, *Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA's Internal-Information Standard on '33 and '34 Act Claims*, 76 WASH. U. L.Q. 537, 539 (1998); 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, 1058 n.9 (1999) [hereinafter Ramirez, *Arbitration*] ("The vast overbreadth of the PSLRA belies any stated intention that one of its goals was investor protection."); Avery, *supra* note 2, at 378 (concluding that the PSLRA will involve years of judicial interpretation to resolve uncertainties that the Act creates).

tion to dismiss and a pleading standard more demanding than Federal Rule of Civil Procedure 9(b).<sup>4</sup> The heightened pleading standard requires a complainant to “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”<sup>5</sup> Legislators never enacted a test for “strong inference” or defined its meaning, even though they extensively debated and proposed many interpretations.<sup>6</sup> In tandem, the heightened pleading standard and stay of discovery ensure that only the sturdiest complaints survive a motion to dismiss, thereby elevating this stage of litigation to paramount importance.<sup>7</sup>

Accounting industry and high-tech corporate professionals lavishly lobbied and contributed to Congress for securities litigation reform.<sup>8</sup> They presented compelling but inconclusive evidence to Congress contending that lawyers were increasingly filing securities fraud lawsuits to extort settlements rather than commencing lawsuits

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4. See 15 U.S.C. §§ 78u-4(b)(2), 78u-4(b)(3)(B) (2000). Rule 9(b) requires a plaintiff to plead fraud with particularity, but the plaintiff can generally allege intent. FED. R. CIV. P. 9(b); A.C. PRITCHARD & HILLARY A. SALE, WHAT COUNTS AS FRAUD? AN EMPIRICAL STUDY OF MOTIONS TO DISMISS UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT 29 (Univ. of Mich. John M. Olin Center for Law & Economics, Working Paper No. 03-011, 2003) (arguing that the heightened pleading standard is now the most challenging hurdle in a securities fraud class action case); Robert J. Giuffra Jr., *CEOs Beware: The Strike Suit Lives*, WALL ST. J., Sept. 13, 1999, at A45 (stating that “[t]he main check on strike suit-lawyers is the ability of a federal judge to throw out a flawed complaint before discovery”).

5. 15 U.S.C. § 78u-4(b)(2).

6. See Joseph A. Grundfest & A.C. Pritchard, *Statutes with Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation*, 54 STAN. L. REV. 627, 634 & 650-60 (2002) (documenting the competing factions within Congress that introduced varying interpretations of “strong inference”); Nathenson v. Zonagen Inc., 267 F.3d 400, 411 (5th Cir. 2001) (“The PSLRA neither mandated nor prohibited any particular method of establishing a strong inference of scienter.”).

7. Compare Sale, *supra* note 3, at 562, and Ramirez, *Arbitration*, *supra* note 3, at 1087-88 (arguing that the stay of discovery coupled with the heightened pleading standard potentially filters meritorious lawsuits), with 141 CONG. REC. 38,323 (1995) (indicating the stay of discovery in tandem with the heightened pleading standard “provide[s] a filter at the earliest stage (the pleading stage) to screen out lawsuits that have no factual basis”); see also BERNARD BLACK ET AL., OUTSIDE DIRECTOR LIABILITY 34 (Univ. of Mich. John M. Olin Center for Law & Economics, Working Paper No. 250, 2003) (finding only one securities case from the past decade that proceeded to trial); PRITCHARD & SALE, *supra* note 4, at 4 (characterizing the motion to dismiss as the “main event”).

8. See Steven A. Ramirez, *Depoliticizing Financial Regulation*, 41 WM. & MARY L. REV. 503, 585 (2000) (contending the money backing the PSLRA warped the legislative process, producing a result “fundamentally at odds with sound regulation”); 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, 24 (1996) (stating that money from the accounting industry and high-tech industries backed lobbying efforts behind the PSLRA); Ann Reilly Dowd, *Look Who’s Cashing in on Congress*, MONEY, Dec. 1997, at 132 (stating that accounting and high-tech industry donations in 1995-96 for congressional campaigns was the most spent by special interest groups, tallying in at \$29.6 million). When asked about lobbyists’ influence on Capital Hill, Former SEC Chairman Arthur Levitt stated, “It’s almost impossible to compete with the effect that money has on these congressmen.” Jane Mayer, *The Accountants’ War*, THE NEW YORKER, Apr. 22, 2002, at 64. Arthur Levitt served as SEC Chairman from July 1993 until February 2001. U.S. SECURITIES & EXCHANGE COMMISSION, SEC BIOGRAPHY: CHAIRMAN ARTHUR LEVITT, at <http://www.sec.gov/about/commissioner/levitt.htm> (last modified Mar. 1, 2003).

on the basis of the underlying merits.<sup>9</sup> In particular, putative securities defendants contended that plaintiffs' attorneys would sue securities issuers following a stock price decline, make costly discovery requests, and name the issuer's "deep-pocket" accounting firm and other professionals as part of a scheme to induce a settlement offer.<sup>10</sup> Conversely, pundits warned that excessive restrictions to pursuing securities fraud claims could insulate fraudfeasors from suit and filter meritorious lawsuits.<sup>11</sup>

Nearly a decade of PSLRA governance, scholarly theses, empirical studies, and disjointed court interpretations inductively suggest that the stay of discovery coupled with the heightened pleading standard is a quixotic method of screening securities litigation.<sup>12</sup> For ex-

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9. See Gary W. Shorter, *Cong. Res. Service, CRS Report for Congress, Securities Litigation Reform: Have Frivolous Shareholder Suits Exploded?*, CRS-34 (May 16, 1995). A Congressional Research Service study concerning the litigation reform hearings indicated that empirical evidence of securities litigation abuse was inconclusive. *Id.* The report concluded:

On balance, the evidence does not appear to be compelling enough for one to definitively assert that warrantless class action suits have exploded and that they are now the preponderant part of class action securities suits before the U.S. District Courts. It is indeed quite possible that some growth in the number of these 'bad' cases has been occurring, but both this and the extent to which this growth may have occurred remain currently less than clear.

*Id.*; see also Arthur Levitt, Private Litigation Under the Federal Securities Laws, Address Before the Securities Regulation Institute 3 (Jan. 26, 1994) (transcript on file with THE BUSINESS LAWYER, University of Maryland School of Law) (stating that it is difficult to deduce whether strike suits in 1994 were any more or less prevalent than one or two decades ago). *But see Securities Litigation Reform Proposals S. 240, S. 667, and H.R. 1058, Hearings Before the Subcomm. on Sec. of the Comm. on Banking, Hous., & Urban Affairs U.S.S., 104th Cong. 3 (1995)* [hereinafter *Securities Litigation Reform Proposals*] (quoting Senator Dodd, a PSLRA sponsor, as remarking "the record is replete with" instances of abusive securities litigation).

10. Plaintiffs' attorneys, rather than the plaintiffs (e.g., shareholders), shouldered the criticism because they most often dictated the class action's pace, disposition, and merits. See 141 CONG. REC. 35,274 (1995) (statement of Sen. Domenici) (reporting a National Association of Securities and Commercial Law Attorneys study that contended plaintiffs' attorneys filed complaints 21% of the time within forty-eight hours of a stock price decline); 141 CONG. REC. 23,039 (1995) (statement of Sen. Domenici) (contending that certain specialized lawyers filed securities fraud class action lawsuits within hours of a stock price decline); *Securities Litigation Reform: Hearings Before the Subcomm. on Telecomms. & Fin. of the Comm. on Energy & Commerce H.R., 103d Cong. 217 (1994)* [hereinafter *Securities Litigation Reform*] (testimony of Stephen F. Smith, General Counsel and Director of Investor Relations, Exabyte Corp.) (alleging plaintiffs' attorneys often utilized computer-generated boilerplate complaints); Avery, *supra* note 1, at 339 (indicating that certain plaintiffs' lawyers commenced securities fraud lawsuits without investigation whenever a stock price declined over 10%); Richard M. Phillips & Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers*, 51 BUS. LAW. 1009, 1011 (1996).

11. See, e.g., *Securities Litigation Reform Proposals, supra* note 9, at 184 (statement of David J. Guin, on behalf of the National Association of Securities and Commercial Law Attorneys) (stating that litigation reform measures "unreasonably tip the scales of justice in favor of defendants" and that this will undermine investor confidence and hurt capital markets). *Securities Litigation Reform, supra* note 10, at 38 (statement of Arthur C. Levitt, Chairman, SEC) (warning that restrictive pleading standard rules may prevent plaintiffs with meritorious claims from accessing necessary information); *Private Litigation Hearings, supra* note 2, at 122-23 (statement of Mark J. Griffin, Director, Division of Securities, Utah Department of Commerce) (recounting a pre-PSLRA decade of unprecedented financial scandals and devastation as a backdrop for legislators to consider while examining concerns raised by reform proponents).

12. See, e.g., Grundfest & Pritchard, *supra* note 6, at 633 (finding "that the PSLRA would not have been enacted but for a conscious agreement to disagree over the proper interpretation of the 'strong inference' provision"); PRITCHARD & SALE, *supra* note 4, at 1 (suggesting empirically that the different heightened pleading standard interpretations between the most pro-plain-

ample, scholars have contended that legislators resolved their discord over the meaning of “strong inference” by agreeing to an ambiguously phrased pleading standard “designed to frustrate doctrines of judicial interpretation as a price of enactment.”<sup>13</sup> Predictably, the judiciary has interpreted the heightened pleading standard in a myriad of ways, with the courts of appeals each gravitating toward one of three interpretive styles.<sup>14</sup> An empirical study published in 2004 sampled motions to dismiss decisions for the Second Circuit and the Ninth Circuit.<sup>15</sup> Respectively, these circuits tend to interpret the heightened pleading standard in a pro-plaintiff and a pro-defendant manner.<sup>16</sup> Notably, the researchers concluded that courts in the Second Circuit granted motions to dismiss 36% of the time, while courts in the Ninth Circuit granted dismissals 63% percent of the time.<sup>17</sup>

After a decade of PSLRA decadence that included unprecedented corporate and accounting debacles, Congress should reconsider how the heightened pleading standard affects the securities litigation arena.<sup>18</sup> When considering that “strong inference” was born of debate and remains riddled with subjectivity, it is pious fiction to

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tiff and pro-defendant circuit courts resulted in a significantly different dismissal rate); Ramirez, *Arbitration*, *supra* note 3, at 1062 (contending “that Congress or the SEC should begin to implement an arbitration program that ultimately would require agreements to arbitrate all securities disputes involving publicly-traded companies before a SEC-sponsored forum”); Sale, *supra* note 3, at 538 (proposing “Congress repeal the stay-of-discovery requirements and, instead, adopt managerial-judge provisions to process securities fraud claims”).

Defendants may question whether the PSLRA is a complete success. A major impetus for the PSLRA was to implement a uniform federal pleading standard. Compare S. REP. NO. 104-98, at 15 (1995), reprinted in 1995 U.S.C.A.N. 679, 694 (urging Congress to enact “a uniform and stringent pleading requirement to curtail the filing of abusive lawsuits”) (emphasis added), with Colloquium, *Securities Litigation Update: Recent Developments Under the PSLRA and the Uniform Standards Act*, 1 (2003), at [http://www.gdclaw.com/fstore/documents/pubs/SecLit\\_PSLRA.pdf](http://www.gdclaw.com/fstore/documents/pubs/SecLit_PSLRA.pdf) (last visited Jan. 25, 2004) (“In any event, the caselaw under the PSLRA . . . surely cannot be said to provide certainty or predictability, and in that respect the ultimate congressional goal of eliminating meritless litigation continues to be elusive.”).

13. See Grundfest & Pritchard, *supra* note 6, at 633.

14. See, e.g., *Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 345 (4th Cir. 2003) (characterizing the legislative history as inconclusively establishing a method of demonstrating a strong inference of intent, therefore implementing “a flexible, case-specific analysis” approach when reviewing pleadings); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 533-34 (3d Cir. 1999) (affording the legislative history little weight and instead focusing on the plain meaning of strong inference announced prior to the PSLRA); *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 979 (9th Cir. 1999) (finding the legislative history required plaintiffs to prove a strong inference by pleading facts indicating deliberate recklessness).

15. PRITCHARD & SALE, *supra* note 4, at 1.

16. *Id.*

17. *Id.* at 21.

18. The three distinct courts of appeals pleading standard interpretations have “led to an increase in litigation over the proper venue for securities class actions.” Grundfest & Pritchard, *supra* note 6, at 670 n.153 (quoting Jordan Eth & Daniel S. Drosman, *The Private Securities Litigation Reform Act: Five Years Young*, 34 REV. OF SEC. & COMMODITIES REG. 153, 160-61 (2001)); see also Sale, *supra* note 3, at 579 (opining that strictly interpreting the pleading standard while staying discovery presented serious consequences for post-PSLRA claimants by shifting power nearly entirely to defendants); Robert S. Greenberger, *Questioning the Books: Panel, in Enron's Wake, to Review Lawsuit Curbs*, WALL ST. J., Feb. 6, 2002, at A8 (reporting Senator Patrick Leahy as saying securities litigation reform laws fostered a “Wild West” mentality amongst corporate and accounting practitioners).

hope the United States Supreme Court will articulate a tractable linguistic construct.<sup>19</sup>

As a solution to heightened pleading standard woes, this Note proposes a pre-motion to dismiss evidentiary review proxy, such as a screening panel approach with panel-managed discovery.<sup>20</sup> The panel approach concerns fact reviewing and managing discovery during the

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19. See, e.g., Eth & Drosman, *supra* note 18, at 160-61 (characterizing “strong inference” as a hotly contested private securities litigation issue); Grundfest & Pritchard, *supra* note 6, at 635 (using statistical analyses that suggested heightened pleading standard interpretations go beyond legislative history and statutory interpretations, but depended on factors such as docket load, frequency of such litigation, whether a high-tech sector defendant, political affiliation of appointing president, etc.).

As of November 2004, the United States Supreme Court has denied at least four petitions for writ of certiorari with cases involving the interpretation of the PSLRA heightened pleading standard. See, e.g., No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp., 320 F.3d 920 (9th Cir. 2003), *cert. denied*, 540 U.S. 966 (2003); Scholastic Corp. v. Truncellito, 252 F.3d 63 (2d Cir. 2001), *cert. denied*, 534 U.S. 1071 (2001); Desaigoudar v. Meyercord, 223 F.3d 1020 (9th Cir. 2000), *cert. denied*, 532 U.S. 1021 (2001); Novak v. Kasaks, 216 F.3d 300 (2d Cir. 2000), *cert. denied*, 531 U.S. 1012 (2000).

20. The panel approach could embody various quasi-adjudicatory aspects of arbitration proceedings, medical malpractice screening panels, or Commodity Futures Trading Commission (CFTC) reparations proceedings, and the like. For example, the screening approach could involve mandatory arbitration prior to commencing a lawsuit. Rather than pre-litigation arbitration, a 1999 article authored by Steven A. Ramirez recognized the PSLRA imbalances and “propose[d] that private securities claims relating to public companies be arbitrated to the maximum extent possible.” Ramirez, *Arbitration*, *supra* note 3, at 1060. His arbitration model would preferably involve an SEC-sponsored securities arbitration forum. *Id.* at 1121-22.

Many states have enacted medical malpractice screening panels for some of the same reasons this Note proposes a screening panel approach: reduce litigation costs, minimize frivolous claims, control skyrocketing judgments, and relieve an overburdened judicial system. See, e.g., Jean A. Macchiaroli, *Medical Malpractice Screening Panels: Proposed Model Legislation to Cure Judicial Ills*, 58 GEO. WASH. L. REV. 181, 186-87 (1990) (documenting the reasons for medical screening panels, assessing the pros and cons of various state panels, and concluding with a model panel). Medical screening panels typically include three to seven members consisting of attorneys, judges, laypersons, and health care providers who render an opinion as to whether the health care provider is subject to a claim for medical malpractice. *Id.* at 186. Since panel decisions typically are nonbonding, litigants receiving an unfavorable panel decision may still opt for a trial. Alan Feigenbaum, Note, *Special Juries: Detering Spurious Medical Malpractice Litigation in State Courts*, 24 CARDOZO L. REV. 1361, 1380 n.105 (2003) (citing Committee on Medical Liability, *Technical Report: Alternative Dispute Resolution in Medical Malpractice*, 107 PEDIATRICS 602, 604 (2001) (reporting nearly half the states using malpractice screening panels render nonbinding opinions)). Panel usage has attracted constitutional challenges for violations of due process, equal protection, and separation of powers. See Kristine Cordier Karnezis, Annotation, *Validity and Construction of State Statutory Provisions Relating to Limitations on Amount of Recovery in Medical Malpractice Claim and Submission of Such Claim to Pretrial Panel*, 80 A.L.R.3d 583, 602-09 (1977). Courts have responded to screening panel challenges with conflicting holdings. See generally Macchiaroli, *supra* at 197-238 (documenting constitutional challenges to medical malpractice screening panels, including conflicting judicial holdings).

Finally, a screening approach could model the quasi-adjudicatory approach that the CFTC uses for reparations hearings. Section 14 of the Commodity Exchange Act vested the CFTC with authority to administer a reparations procedure for Commodity Exchange Act or CFTC rules violations. 7 U.S.C. § 18 (2000). Complainants apply to the CFTC for an order to pay reparations. 7 U.S.C. § 18(a)(1). If granted, the order is enforceable in federal district court. 7 U.S.C. § 18(d). The United States Supreme Court has commented that when Congress implements a non-Article III tribunal, including the reparations procedure, the Court will examine “the practical effect that the congressional action will have on the constitutionally assigned role of the federal judiciary.” *Commodity Futures Trading Comm’n v. Schor*, 478 U.S. 833, 851 (1986). In *Schor*, the Court considered the narrowness, purpose, and expertise of the CFTC reparations proceeding and determined that the CFTC quasi-adjudicatory process did not offend Article III. See *id.* at 852-54. Arguably, Congress could vest the SEC with narrow authority to screen private securities complaints without offending Article III enumerated powers.

critical pre-motion to dismiss period.<sup>21</sup> Like a grand jury, the panel could assess evidence, interview parties, and then report its findings to the court.<sup>22</sup> The panel could consist of securities practitioners with diverse marketplace experiences who synergistically combine so that complex, technical, tenuous, and novel allegations receive vigorous review. In turn, the judiciary could review the complaint in light of the panel's findings and then apply the inherently subjective heightened pleading standard.<sup>23</sup>

This Note proceeds in the following manner. Part II begins by highlighting pre-PSLRA securities litigation events that precipitated calls for reform, followed by the enactment of the PSLRA and legislative history details concerning "strong inference."<sup>24</sup> Part III synthesizes court opinions, scholarly theses, and research studies of the post-PSLRA era relating to the heightened pleading standard.<sup>25</sup> The information presented in Parts II and III inductively suggests that the PSLRA heightened pleading standard warrants improvement, so Part IV proposes a screening panel approach to improve the securities litigation screening process.<sup>26</sup>

## II. SECURITIES MARKETPLACE REGULATION

### A. *Private Securities Litigation in the pre-PSLRA Era*

Congress enacted the Securities Exchange Act of 1934 (Exchange Act) to provide laws for regulating the various securities exchange

21. Securities lawsuits that have survived a motion to dismiss, summary judgment, and class certification have nearly always settled. See PRITCHARD & SALE, *supra* note 4, at 4. Pre-PSLRA securities common law developed in a manner that frequently required plaintiffs to include internal company information in their pleadings. See Sale, *supra* note 3, at 562. Compare *Fecht v. Price Co.*, 70 F.3d 1078, 1083-84 (9th Cir. 1995) (relying on internal company information to deny a motion to dismiss in this pre-PSLRA case), with *Pilarczyk v. Morrison Knudsen Corp.*, 965 F. Supp. 311, 324 (N.D.N.Y. 1997) (granting motion to dismiss since plaintiffs could not allege who possessed internal information when in this post-PSLRA case). The likely consequence of shielding internal information with the stay of discovery is that only cases involving flagrant and obvious abuses will amass enough proof to survive a motion to dismiss. Sale, *supra* note 3, at 564. Panel-managed discovery could prevent pre-PSLRA abusive discovery requests by plaintiffs' attorneys while avoiding post-PSLRA restrictions that lead to filtering of meritorious complaints.

22. The panel approach could embody characteristics of a grand jury model. Grand juries consist of a cross-section of qualified individuals with unique viewpoints and experiences. See *In re Grand Jurors Ass'n, Bronx County, Inc.*, 25 N.Y.S.2d 154, 154 (N.Y. Spec. Term 1941). They investigate allegations and interview parties, but they do not act as a final arbiter of culpability. *United States v. Washington*, 431 U.S. 181, 191 (1977); *Ewing v. Mytinger & Casselberry, Inc.*, 339 U.S. 594, 599 (1950) (noting a grand jury "does not determine his guilt; it only determines whether there is probable cause to believe he is guilty").

23. Recognizably, implementing a panel approach out of whole cloth begs countless questions concerning size, costs, tenure, conflicts, unanimity, oversight, composition, appealability, confidentiality, constitutionality, subsequent admissibility, and investigatory authority. Importantly, this Note does not address these and other concerns but instead begins a process of exploring whether the current securities litigation arena warrants an improved or alternative screening method for securities complaints.

24. See *infra* Part II.A-B.

25. See *infra* Part III.

26. See *infra* Part IV.

marketplaces and to authorize the creation of the Securities and Exchange Commission (SEC).<sup>27</sup> The SEC serves many functions such as enforcing federal securities laws, promoting stability in the exchange marketplaces, protecting investors, and maintaining the integrity of the securities industry.<sup>28</sup> Under § 10(b) of the Exchange Act, Congress vested the SEC with broad authority to enact “rules and regulations” that are necessary to administer and interpret the Securities and Exchange Acts and tangentially related securities legislation.<sup>29</sup> On its own, § 10(b) is “nonself-operative”; in other words, the SEC must exercise its delegated authority and enact rules that give the Exchange Act effect.<sup>30</sup> An example of an exercise of § 10(b) rulemaking by the SEC is Rule 10b-5.<sup>31</sup> This sweeping anti-fraud Rule prohibits buyers and sellers of securities from making materially untrue statements or omitting material facts that would mislead others.<sup>32</sup> The broad and sweeping language of Rule 10b-5 has led it to become the cornerstone rule of SEC enforcement actions.<sup>33</sup>

Because of limited resources, the SEC cannot investigate and pursue every reported securities violation.<sup>34</sup> Therefore, the SEC and the judiciary consider private lawsuits an indispensable way for victims to seek redress, deter fraud, and supplement SEC enforcement actions.<sup>35</sup> Neither § 10(b) nor Rule 10b-5 expressly authorizes a private cause of action, but federal courts have granted an implied right

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27. Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. § 78a-78mm (2000)).

28. U.S. SECURITIES & EXCHANGE COMMISSION, THE INVESTOR'S ADVOCATE: HOW THE SEC PROTECTS INVESTORS AND MAINTAINS MARKET INTEGRITY, at <http://www.sec.gov/about/whatwedo.shtml#create> (last modified Jan. 12, 2005). The SEC also defers to self-regulatory organizations, such as the New York Stock Exchange, as needed in order to encourage proactive measures and responsibility for self-regulators. See *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware*, 414 U.S. 117, 130 (1973). The SEC has four divisions: the Division of Corporation Finance, the Division of Market Regulation, the Division of Enforcement, and the Division of Investment Management, each headed by a Director. See 69 AM. JUR. 2D *Securities Regulation* § 3 (1993).

29. See 15 U.S.C. §§ 78j(a)(1), 78w(a)(1) (2000).

30. Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 963, 977 (1994); see also 7 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 3401 (3d ed., rev. 2003).

31. 17 C.F.R. § 240.10b-5 (1984). Rule 10b-5 makes it unlawful for buyers and sellers of securities “[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . .” *Id.*

32. *Id.* The SEC originally adopted Rule 10b-5 in 1942 to plug securities law loopholes that addressed seller conduct only but overlooked purchaser misbehavior. Grundfest, *supra* note 30, at 979-80.

33. See *Ketchum v. Green*, 557 F.2d 1022, 1025 (3d Cir. 1977).

34. *Berner v. Lazzaro*, 730 F.2d 1319, 1322 (9th Cir. 1984). Even with considerably more resources, the SEC still would not “investigate or prosecute every instance in which a public company’s disclosure is questionable . . . .” *Private Litigation Hearings*, *supra* note 2, at 36 (statement of William R. McClucas, Director, Division of Enforcement, SEC).

35. *Herman & Maclean v. Huddleston*, 459 U.S. 375, 380 (1983). Private litigants have different incentives for commencing securities litigation than the SEC. Grundfest, *supra* note 30, at 970. Private parties have more incentive to pursue lower quality claims because defendants may settle to avoid prolonged litigation costs or steep adverse judgments. *Id.*

since 1946.<sup>36</sup> Moreover, the SEC has encouraged courts to recognize the Rule 10b-5 implied right, and the United States Supreme Court has characterized the implied right as “beyond peradventure.”<sup>37</sup>

By the 1970s, private securities litigation had evolved from “a necessary supplement to [SEC] action” to a state of “vexatiousness” more prevalent and severe than other types of litigation.<sup>38</sup> In response, the United States Supreme Court issued opinions in the 1970s that heightened barriers for plaintiffs, such as *Ernst & Ernst v. Hochfelder*.<sup>39</sup> In *Hochfelder*, the Court addressed the degree of culpability needed to prevail in a private cause of action under § 10(b) and Rule 10b-5.<sup>40</sup> The Court held that mere negligence will not suffice, concluding that a plaintiff must prove the defendant acted with a level of scienter akin to a “mental state embracing intent to deceive, manipulate, or defraud.”<sup>41</sup> Although the Court chose not to address whether “reckless behavior” in certain instances satisfies the scienter requirement, courts of appeals subsequently decided that it did so.<sup>42</sup>

Thereafter, the judiciary formulated different pleading standards for § 10(b) and Rule 10b-5 claims that comported with the Federal Rules of Civil Procedure 9(b) standard of pleading fraud and the holding announced in *Hochfelder*.<sup>43</sup> The Ninth Circuit announced a pleading standard consistent with Rule 9(b) of permitting plaintiffs to allege intent generally but requiring particularity for the remaining elements necessary for securities fraud claims.<sup>44</sup> In contrast, the Second Circuit required plaintiffs to plead scienter with particularity.<sup>45</sup> Plaintiffs could demonstrate particularity by pleading facts indicating that defendants had the “motive and opportunity to commit fraud, or . . . by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness.”<sup>46</sup> Continuing through the early 1990s, the United States Supreme Court steadfastly heightened plain-

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36. See *Herman & Maclean*, 459 U.S. at 380 n.10; *Kardon v. Nat'l Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946).

37. See *Herman & Maclean*, 459 U.S. at 380.

38. Compare *J. I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964), with *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975).

39. 425 U.S. 185 (1976). See, e.g., *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 478-80 (1977) (holding that mere breaches of fiduciary duties are not actionable under Rule 10b-5); *Blue Chip Stamps*, 421 U.S. at 754-55 (holding that only securities purchasers or sellers have standing to sue for a Rule 10b-5 violation).

40. *Hochfelder*, 425 U.S. at 187-88.

41. *Id.* at 193 n.12.

42. *Id.*; see also *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 408 (5th Cir. 2001) (citing numerous courts of appeals opinions holding that recklessness satisfies the scienter requirement).

43. PRITCHARD & SALE, *supra* note 4, at 6. Rule 9(b) requires a plaintiff to plead fraud with particularity, but the plaintiff can generally allege intent. FED. R. CIV. P. 9(b).

44. See *In re Glenfed, Inc. Sec. Litig.*, 42 F.3d 1541, 1547 (9th Cir. 1994).

45. PRITCHARD & SALE, *supra* note 4, at 7.

46. *Shields v. Citytrust Bancorp., Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994).

tiffs' requirements for securities actions.<sup>47</sup> In *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*,<sup>48</sup> the Court concluded that a plaintiff must commence a § 10(b) and Rule 10b-5 cause of action within one year from discovering facts giving rise to the cause of action.<sup>49</sup> Displeased with the *Lampf* holding, Congress commenced hearings to debate extending the statute of limitations, but the hearings spawned a greater debate to reform private securities litigation rules.<sup>50</sup>

At congressional hearings, the most outspoken critics lobbying for securities litigation reform were early 1990s "Big 6" accounting firms<sup>51</sup> along with high-technology companies.<sup>52</sup> The accounting firms argued that they were victims of strike suits reaching epic proportions.<sup>53</sup> Reform proponents alleged that nearly every stock price decline greater than 10% resulted in a strike suit, with some lawsuits filed the day that the stock price plummeted.<sup>54</sup> The Big 6 firms con-

47. See, e.g., *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994) (holding that aiding and abetting securities fraud does not give rise to a private cause of action under § 10(b) and Rule 10b-5).

48. 501 U.S. 350 (1991).

49. *Id.* at 364.

50. See, e.g., *Securities Investor Protection Act of 1991: Hearing Before the Subcomm. on Sec. of the S. Comm. on Banking, Hous., & Urban Affairs*, 102d Cong. (1991); *Securities Investors Legal Rights: Hearing Before the Subcomm. on Telecomm. & Fin. of the House Comm. on Energy & Commerce*, 102d Cong. (1991).

51. The Big 6 accounting firms consisted of Arthur Andersen & Co., Coopers & Lybrand, Deloitte & Touche, Ernst & Young, KPMG Peat Marwick, and Price Waterhouse. *In re Ikon Office Solutions, Inc.*, 277 F.3d 658, 662 n.1 (3d Cir. 2002). In July of 1998, Coopers & Lybrand and Price Waterhouse merged and became PricewaterhouseCoopers, which led to a new denomination known as the Big 5. *Id.* After the collapse of Arthur Anderson in 2002, the Big 5 became the Big 4. Patricia A. McCoy, *Crisis in Confidence: Corporate Governance and Professional Ethics*, 35 CONN. L. REV. 989, 1002 n.46 (2003).

52. By 1993, Washington insiders had described the accounting profession's lobbying group as "one of the best financed and most powerful in Washington." See Ed Roberts, *Big Six Firms Branch Out to Create Lobby, Making Liability Reform Top 1993 Priority*, THOMSON'S INT'L BANK ACCT., May 10, 1993, at 5. From 1989 to 1990, hard and soft money contributions from the accounting industry totaled \$2,192,402; from 1991 to 1992, \$4,064,972; from 1993 to 1994, \$5,131,842; and from 1995 to 1996, \$7,782,990. CONSUMERS & INVESTORS FOR CORPORATE RESPONSIBILITY, PREVENT FINANCIAL FRAUD: REPEAL ACCOUNTANT IMMUNITY ACT—THE 1995 PRIVATE SECURITIES LITIGATION REFORM ACT (PSLRA), at <http://enronwatchdog.org/topreforms/topreforms5.html> (last visited Jan. 14, 2005); see also S. REP. NO. 104-98, at 33 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 711 (commenting that plaintiffs targeted volatile high technology issuers and their respective firms).

53. A strike suit is a lawsuit "based on no valid claim, brought either for nuisance value or as leverage to obtain a favorable or inflated settlement." BLACK'S LAW DICTIONARY 1448 (7th ed. 1999). See S. REP. NO. 104-98, at 4 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 683 (indicating that strike suits "are often based on nothing more than a company's announcement of bad news"); 138 CONG. REC. 23,475 (1992) (statement of Sen. Domenici) (asserting the surge in securities litigation "has reached epidemic dimensions").

54. See *Securities Litigation Reform Proposals*, supra note 9, at 239 (statement of Dr. Charles C. Cox, Senior Vice-President, Lexecon Inc.) (testifying that plaintiffs often filed strike suits the same day, or shortly thereafter, the stock price declined). Technology industry representatives claimed entrepreneurial lawyers would file strike suits whenever the stock price decreased 10% or more. See *Private Securities Litigation Staff Report Prepared at the Direction of Senator Christopher J. Dodd Chairman, Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs United States Senate* at 20 n.37 (May 17, 1994) [hereinafter *Staff Report*], reprinted in *Abandonment of the Private Right of Action For Aiding and Abetting Securities Fraud/Staff Report on Private Securities Litigation: Hearing Before the Subcomm. on Sec. of the Comm. on Banking, Hous., and Urban Affairs U.S. S.*, 103d Cong. 190 (1994).

tended that “entrepreneurial lawyers” would find a publicly traded company with a red flag financial issue, such as a 10% drop in stock value, and name the auditing firm to the lawsuit for their “deep pockets” rather than blameworthiness.<sup>55</sup> Lead plaintiff’s counsel would then make voluminous discovery requests that were so expensive to comply with that it made sense economically to settle the lawsuit rather than protract litigation.<sup>56</sup>

In response to increasing strike suits and settlement costs, the Big 6 issued a Statement of Position in 1992 to Congress arguing for private securities litigation reform.<sup>57</sup> The Big 6 contended that unless Congress eliminated joint and several liability, auditing services would decrease and the capital markets would suffer.<sup>58</sup> Reform opponents countered that eliminating joint and several liability or imposing tougher procedural rules would decrease audit quality by insulating auditors from tenuously projected forward looking statements.<sup>59</sup> Plaintiffs also contended that the growth in securities litigation was reflective of increases in shares traded and initial offerings in the technology sector.<sup>60</sup> Moreover, critics feared that enacting a heightened pleading standard would discourage meritorious claimants from seeking redress.<sup>61</sup>

### B. *Private Securities Revolution: The PSLRA*

Despite inconclusive evidence of private securities litigation abuses, Congress enacted the PSLRA in December of 1995.<sup>62</sup> Among

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55. See S. REP. NO. 104-98, at 9 (1995), reprinted in U.S.C.C.A.N. 679, 688 (indicating that “the deeper the pocket,” the more likely the auditing firm would get named in a strike suit).

56. J. Michael Cook et al., *The Liability Crisis in the United States: Impact on the Accounting Profession*, J. OF ACCOUNTANCY, Nov. 1992, at 19; see also Giuffra Jr., *supra* note 4, at A45 (stating discovery expenses accounted for nearly 80% of securities litigation costs). The discovery process enabled plaintiffs to compel defendants, “at great expense, to turn over hundreds of thousands of pages of memos, e-mail[s] and notes.” *Id.* In turn, employees devoted hours compiling discovery requests and answering depositions. See S. REP. NO. 104-98, at 14 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 693. Securities class actions also “have a much higher settlement rate than other types of class actions.” *Id.* at 6, reprinted in 1995 U.S.C.C.A.N. 679, 685.

57. See Cook et al., *supra* note 56, at 19.

58. Private securities litigation reform was also a Republican Party platform promise during the 1994 elections. See Edmund L. Andrews, *Republicans Agree to Soften A Bill to Curb Investor Suits*, N.Y. TIMES, Feb. 11, 1995, at A1. The platform, dubbed the “Contract with America,” included ten proposals designed to revamp government programs and the legal system, if the GOP gained control of the House of Representatives. See Greenberger, *supra* note 18, at A8.

59. Ho Young Lee & Vivek Mande, *The Effect of the Private Securities Litigation Reform Act of 1995 on accounting discretion of client managers of Big 6 and non-Big 6 auditors*, AUDITING: A JOURNAL OF PRACTICE & THEORY, Mar. 2003, at 2.

60. See Grundfest, *supra* note 30, at 973-74.

61. See *supra* note 11; *infra* text accompanying note 85.

62. See 141 CONG. REC. 38,354 (1995). Proponents for reform provided mostly anecdotal evidence to support allegations that widespread abuses permeated the securities litigation arena. See *Staff Report*, *supra* note 54, at 17-23; PRITCHARD & SALE, *supra* note 4, at 2 (opining that Congress decided to reform the securities litigation arena notwithstanding “the lack of solid data”).

other things, Congress intended the PSLRA to discourage and weed out meritless securities fraud suits.<sup>63</sup> To do so, it drastically changed pleading and procedural laws governing private securities cause of actions, such as claims involving § 10(b) and Rule 10b-5 violations.<sup>64</sup> Notably, the PSLRA established a pleading standard more stringent than Rule 9(b):

In any private action arising under this chapter 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 chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.<sup>65</sup>

Congress did not define “strong inference” or “required state of mind.”<sup>66</sup> Besides the heightened pleading standard, the PSLRA requires an automatic stay of discovery until a court rules on a motion to dismiss.<sup>67</sup> Consequently, plaintiffs are left to satisfy the heightened pleading standard rigors with public information sources such as the issuer’s past filings, SEC releases, or news media reports.<sup>68</sup> Joint and several liability now applies only to defendants held by a court to have “knowingly” violated securities laws.<sup>69</sup> Otherwise, if the trier of fact determines culpability as less than knowingly, defendants pay only damages proportionate to their percentage of responsibility.<sup>70</sup>

On Capitol Hill, legislators could not agree on what constitutes a strong inference of fraudulent behavior, nor could they agree to a minimally required state of mind for culpability.<sup>71</sup> The Senate bill adopted the pre-PSLRA Second Circuit pleading standard.<sup>72</sup> The bill proposed that a plaintiff could satisfactorily show a strong inference of fraud “(A) by alleging facts to show that the defendant had both mo-

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63. PRITCHARD & SALE, *supra* note 4, at 11.

64. See HAROLD S. BLOOMENTHAL, 2 SECURITIES LAW HANDBOOK § 27:11 (2004). The PSLRA creates a safe harbor for forward looking statements so long as “meaningful cautionary statements” qualify the projections. See *id.* § 78u-5(c)(1)(A)(i) (2000). Forward-looking statements are nearly any sort of financial or management prospective disclosure made by a company to the public. See *id.* § 78u-5(i)(1). To recover damages, plaintiffs must prove loss causation, which “is a form of proximate cause that requires a plaintiff to allege and prove that, but for the defendant’s wrongdoing, the plaintiff would not have incurred the damages that form the basis of the suit.” Ramirez, *Arbitration*, *supra* note 3, at 1077; see also 15 U.S.C. § 78u-4(b)(4). In response to the race to the courthouse problem, the PSLRA requires the judge, in most circumstances, to designate lead plaintiff status to the litigant with the most at stake. See 15 U.S.C. § 78u-4(a)(3)(B)(i).

65. 15 U.S.C. § 78u-4(b)(2).

66. See *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 407 (5th Cir. 2001); *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 977 (9th Cir. 1999).

67. 15 U.S.C. § 78u-4(b)(3)(B). “The stay of discovery operates to prevent plaintiffs with baseless claims from squeezing a nuisance settlement from an innocent defendant.” *Miller v. Champion Enters., Inc.*, 346 F.3d 660, 691 (6th Cir. 2003).

68. PRITCHARD & SALE, *supra* note 4, at 4.

69. See 15 U.S.C. § 78u-4(f)(2)(A).

70. See *id.* § 78u-4(f)(2)(B)(i).

71. See *Avery*, *supra* note 2, at 347; Grundfest & Pritchard, *supra* note 6, at 653-60, 664 (discussing the Congressional debates concerning the heightened pleading standard).

72. See S. Res. 240, 104th Cong. (1995).

tive and opportunity to commit fraud; or (B) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness . . . .”<sup>73</sup>

The Conference Committee refused to adopt the Senate bill test, explaining in the Statement of Managers report: “Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit’s case law interpreting this pleading standard.”<sup>74</sup> Accordingly, the Conference Committee deleted language that referred to “motive, opportunity, or recklessness.”<sup>75</sup> During floor debates of the Conference Committee bill, legislators argued that a pleading standard higher than the Second Circuit’s would be enormously difficult to satisfy.<sup>76</sup> Ironically, Conference Committee bill sponsors Senator Chris Dodd and Senator Pete Domenici responded to pundits by stating that the Conference bill adopted the Second Circuit standard.<sup>77</sup>

The state of mind requirement also spawned considerable disagreement.<sup>78</sup> The House bill proposed that reckless conduct should give rise to a cause of action.<sup>79</sup> The former Chairman of the SEC, Arthur Levitt, testified before Congress in support of the reckless standard.<sup>80</sup> He reasoned that a reckless standard would assure that market participants disseminated accurate information compared with a higher knowledge standard that would invite misconduct and be virtually impossible to prove and recover against.<sup>81</sup> In the end, Congress did not specify a particular standard, but instead codified “the required state of mind” requirement, which courts have deduced to mean the standard announced by the United States Supreme Court in *Hochfelder*.<sup>82</sup>

Although the House of Representatives and Senate passed the Conference Committee bill, President Bill Clinton vetoed it.<sup>83</sup> He expressed concern with the Statement of Managers’ intentions to raise

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73. 141 CONG. REC. 17,447 (1995).

74. H.R. CONF. REP. NO. 104-369, at 41 (1995).

75. *Id.* at 48 n.23.

76. *See, e.g.*, 141 CONG. REC. 35,266 (1995) (statement of Sen. Specter); *Id.* at 35,291 (statement of Sen. Moseley-Braun).

77. *See* 141 CONG. REC. 35,265, 35,275 (1995). The United States Supreme Court has given deference to sponsors of legislation when legislative intent is at issue. *See, e.g.*, *Nat’l Woodwork Mfrs. Ass’n v. NLRB*, 386 U.S. 612, 639 (1967).

78. *See* Grundfest & Pritchard, *supra* note 6, at 671.

79. *See* H.R. Res. 1058, 104th Cong. (1995).

80. *Securities Litigation Reform Proposals*, *supra* note 9, at 247, 251-52 (testimony of Arthur Levitt, Chairman, SEC).

81. *Id.* at 252 (testimony of Arthur Levitt, Chairman, SEC).

82. *See* 15 U.S.C. § 78u-4(b)(2) (2000); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).

83. *See* 141 CONG. REC. 38,354 (1995) (Senate vote); *Id.* at 37,807 (1995) (House of Representatives vote); 141 *Id.* at 37,797 (President Clinton veto message).

the required pleading standard beyond the Second Circuit level.<sup>84</sup> President Clinton predicted that a pleading standard higher than the Second Circuit would mean that “even the most aggrieved investors with the most painful losses may get tossed out of court before they have a chance to prove their case.”<sup>85</sup> Notwithstanding the President’s veto, the House and the Senate collected the necessary votes and passed the PLSRA into law.<sup>86</sup>

### III. THE POST-PSLRA DECADE IN RETROSPECT

#### A. *Disjointed Court of Appeals Pleading Standard Interpretations*

The courts of appeals have interpreted the heightened pleading standard differently with interpretations taking a pro-plaintiff, a pro-defendant, or a middle-ground stance.<sup>87</sup> The Second and Third Circuits interpret the PSLRA pleading standard in the most pro-plaintiff fashion.<sup>88</sup> These two Circuits generally agree that demonstrating either “‘motive and opportunity to commit fraud’ or . . . facts that ‘constitute strong circumstantial evidence of conscious misbehavior or recklessness’” satisfies the PSLRA pleading requirement.<sup>89</sup> The Second Circuit announced this standard prior to the PSLRA in *Shields v. Citytrust Bancorp, Inc.*<sup>90</sup> and affirmed it after Congress enacted the PSLRA in *Press v. Chemical Investment Services Corp.*<sup>91</sup> Without discussing the PSLRA legislative history, the court announced that the heightened pleading standard followed the one established in *Shields*.<sup>92</sup>

After the *Press* decision, a different Second Circuit panel addressed the PSLRA pleading standard in *Novak v. Kasaks*.<sup>93</sup> Finding nothing ambiguous with the pleading requirement, the court concluded that Congress intended to adopt a pleading standard no more stringent than the pre-PSLRA Second Circuit pleading standard.<sup>94</sup> The court then tempered this conclusion, explaining that Congress’ failure to adopt the *Shields* motive and opportunity language suggests that the Second Circuit is not wed to the prevailing Second Circuit standard, such as the one affirmed in *Press*.<sup>95</sup> The court explained

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84. 141 CONG. REC. 37,798 (1995) (President Clinton veto message).

85. *Id.* (President Clinton veto message).

86. 141 CONG. REC. 37,807, 38,354.

87. *See Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 658 (8th Cir. 2001).

88. Grundfest & Pritchard, *supra* note 6, at 671.

89. *Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529, 538 (2d Cir. 1999) (quoting *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994)).

90. *See Shields*, 25 F.3d at 1128.

91. 166 F.3d 529, 537-38 (2d Cir. 1999).

92. *See id.* at 538.

93. 216 F.3d 300 (2d Cir. 2000).

94. *Id.* at 310.

95. *Id.* The court cited the *Press* pleading standard as “dicta.” *Id.*

that plaintiffs cannot rely on pleading motive and opportunity as “magic words”; instead, a plaintiff must also allege particular facts or circumstances that are probative of conscious reckless behavior.<sup>96</sup> For example, the plaintiff could demonstrate a strong inference of fraudulent intent by demonstrating that the defendant benefited from the fraud in a concrete and personal matter, engaged in prohibited behavior deliberately, knew or could access information that would suggest their public affirmations were inaccurate, or failed to verify information they were obliged to monitor.<sup>97</sup> After *Novak*, different Second Circuit panels vacillated between following *Press* and *Novak*.<sup>98</sup>

The seminal Third Circuit case to interpret the PSLRA pleading standard was *In re Advanta Corporate Securities Litigation*.<sup>99</sup> Speaking for the court, Judge Scirica<sup>100</sup> found little to gain from analyzing “the conflicting expressions of legislative intent . . . .”<sup>101</sup> The court announced a pleading standard predicated on plain meaning principles and the fact that Congress adopted language nearly verbatim to a pre-PSLRA Second Circuit case.<sup>102</sup> Accordingly, the court concluded that the PSLRA describes a pleading standard nearly equivalent in stringency to the *Press* standard, except the plaintiff must allege facts with particularity as the PSLRA requires.<sup>103</sup>

On the opposite coast of the Second and Third Circuits, and opposite in pleading standard interpretation, the Ninth Circuit took a pro-defendant stance.<sup>104</sup> The Ninth Circuit case of *In re Silicon Graphics, Inc. Securities Litigation*<sup>105</sup> raised the PSLRA pleading standard to an unprecedented level.<sup>106</sup> Judge Sneed authored the *Silicon* opinion and began with the following:

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96. *See id.* at 311.

97. *See id.*

98. *Compare* *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 168-69 (2d Cir. 2000) (relying only on the pre-PSLRA motive and opportunity pleading standard as sufficient), *with* *Rothman v. Gregor*, 220 F.3d 81, 90 (2d Cir. 2000) (following the additional guidelines suggested by the court in *Novak*). In *Ganino*, the court issued its decision on September 6, 2000. *Ganino*, 228 F.3d at 154. In *Rothman*, the court issued its opinion on July 11, 2000. *Rothman*, 220 F.3d at 81.

99. 180 F.3d 525 (3d Cir. 1999).

100. Although not mentioned in *In re Advanta*, Judge Scirica advised Congress in drafting the PSLRA pleading standard. *See* BLOOMENTAL, *supra* note 64, at § 29:12. Judge Scirica issued letters on behalf of the Judicial Conference advising lawmakers to adopt a pleading standard that harmonized with language found in FRCP 9(b). *See* 141 CONG. REC. 38,204 (1995) (remarks of Senator Pete Domenici regarding a letter dated October 31, 1995, from Judge Anthony J. Scirica) (“He writes on behalf of the Judicial Conference.”).

101. *See In re Advanta*, 180 F.3d at 533.

102. *See id.* at 533-34. Judge Scirica found the similarities between the pre-PSLRA Second Circuit case, *Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 53 (2d Cir. 1995), and the PSLRA pleading standard compelling. *Compare Acito*, 47 F.3d at 52 (stating “[p]laintiffs must also allege facts that give rise to a strong inference of scienter as well”), *with* 15 U.S.C. § 78u-4(b)(2) (2000) (requiring a plaintiff’s complaint to “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind”).

103. *See In re Advanta*, 180 F.3d at 534-35.

104. *See* *Grundfest & Pritchard*, *supra* note 6, at 671.

105. 183 F.3d 970 (9th Cir. 1999).

106. *See id.* at 991 (Browning, J., dissenting).

We hold that a private securities plaintiff proceeding under the PSLRA must plead, in great detail, facts that constitute strong circumstantial evidence of *deliberately reckless or conscious misconduct*. Our holding rests, in part, on our conclusion that Congress intended to elevate the pleading requirement above the Second Circuit standard requiring plaintiffs merely to provide facts showing simple recklessness or a motive to commit fraud and opportunity to do so. We hold 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. In order to show a strong inference of deliberate recklessness, plaintiffs must state facts that come closer to demonstrating *intent*, as opposed to mere motive and opportunity. Accordingly, we hold that particular facts giving rise to a strong inference of deliberate recklessness, at a minimum, [are] required to satisfy the heightened pleading standard under the PSLRA.<sup>107</sup>

Judge Sneed reasoned that the PSLRA required state of mind should correlate with the type of private securities claim alleged.<sup>108</sup> For instance, a private cause of action based on § 10(b) and Rule 10b-5 should apply the established § 10(b) state of mind requirement, which is scienter as established by the Court in *Hochfelder*.<sup>109</sup> Although every court of appeals has held recklessness also meets the scienter standard announced in *Hochfelder*, Judge Sneed insisted that the *Hochfelder* opinion suggests that recklessness in the context of § 10(b) is more akin to intentional conduct.<sup>110</sup> For this reason plus the PSLRA “strong inference” language, Judge Sneed concluded that the PSLRA required state of mind is “deliberate recklessness.”<sup>111</sup>

The dissent in *Silicon* characterized Judge Sneed’s pleading standard as a glaring departure from sister courts of appeals.<sup>112</sup> Judge Browning emphasized that no other court of appeals had read the PSLRA to require a deliberate recklessness pleading standard.<sup>113</sup> Besides Judge Browning, the SEC opposed the deliberate recklessness state of mind requirement.<sup>114</sup> In a Brief of Amicus Curiae, the SEC stressed that the simple recklessness standard was essential and effective for private § 10(b) enforcement and necessary to ensure truthful disclosures.<sup>115</sup> The SEC characterized the PSLRA pleading standard

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107. *Id.* at 974 (emphasis added).

108. *Id.* at 975.

109. *Id.* (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976)).

110. *See Ottmann v. Hanger Orthopedic Group*, 353 F.3d 338, 343 (4th Cir. 2003) (stating that every court of appeals has concluded recklessness meets the scienter requirement established in *Hochfelder*); *In re Silicon*, 183 F.3d at 977.

111. *In re Silicon*, 183 F.3d at 977.

112. *See id.* at 995 n.14 (Browning, J., dissenting).

113. *See id.* (Browning, J., dissenting).

114. *See* Brief of the Securities and Exchange Commission, Amicus Curiae at 17, *In re Silicon* (No. 97-16240).

115. *See id.* at 17, 20. The SEC has pointed out that it most often predicates its law enforcement cases on a recklessness standard. *See id.*

as a procedural rule for § 10(b) cause of actions, not, as Judge Sneed had decided, a substantive change to the uniformly accepted meaning of scienter.<sup>116</sup>

Most of the remaining courts of appeals have implemented a case-by-case analysis that focuses on complaint-specific allegations and less on formalistic tests.<sup>117</sup> The Fourth Circuit in 2003 was the most recent court of appeals to formulate a PSLRA pleading standard.<sup>118</sup> In *Ottmann v. Hanger Orthopedic Group, Inc.*,<sup>119</sup> the court adopted a “flexible, case-specific analysis” that examines the totality of the circumstances rather than follow any specific pleading test.<sup>120</sup> Since the PSLRA does not contain any particular pleading tests or standards, the court reasoned that Congress was more concerned with the amount of proof rather than the type.<sup>121</sup> In *Ottmann*, the court explained that district courts should not focus on specific categories, such as motive and opportunity, but instead should determine whether the complaint as a whole establishes a strong inference of recklessness.<sup>122</sup>

Another heightened pleading standard issue that has divided courts is whether the PSLRA “strong inference” language means a judge should weigh competing inferences drawn from a complaint, or whether a judge should give credence to an inference most favorable to a plaintiff. The PSLRA strong inference requirement conflicts with two longstanding judiciary principles: (1) before a court grants a FRCP 12(b)(6) motion, it should view the allegations contained within a complaint “in the light most favorable to” plaintiffs;<sup>123</sup> and (2) the fact-finder decides competing inferences during the trial.<sup>124</sup> Accordingly, federal courts have faced the issue of how to deal with competing inferences, such as those that favor or discredit a plaintiff’s proof of scienter. In *Pirraglia v. Novell, Inc.*,<sup>125</sup> the Tenth Circuit held that it will not weigh competing inferences to determine whether a plaintiff alleged a strong inference of recklessness.<sup>126</sup> The court said its role was to determine whether a complaint demonstrated a strong infer-

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116. *See id.* at 18-19.

117. *See, e.g.*, *Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 345 (4th Cir. 2003); *Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 658-60 (8th Cir. 2001); *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 410-11 (5th Cir. 2001); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 550-51 (6th Cir. 2001); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 196 (1st Cir. 1999).

118. *See Ottmann*, 353 F.3d at 344.

119. *Id.* at 338.

120. *Id.* at 345.

121. *Id.* (citing *Greebel*, 194 F.3d at 195).

122. *Id.*

123. *Sutton v. Utah State Sch. for the Deaf & Blind*, 173 F.3d 1226, 1236 (10th Cir. 1999).

124. *Miller v. Glanz*, 948 F.2d 1562, 1565 (10th Cir. 1991).

125. 339 F.3d 1182 (10th Cir. 2003).

126. *Id.* at 1188.

ence of recklessness.<sup>127</sup> With two equally strong inferences, each favoring a party, the court explained that favoring an inference would encroach upon the fact-finder's role.<sup>128</sup> In contrast to *Pirraglia*, the Sixth Circuit in *Miller v. Champion Enterprises, Inc.*<sup>129</sup> decided that only "the most plausible of competing inferences" satisfied the strong inference requirement.<sup>130</sup>

### B. *Other Observations*

The different courts of appeals interpretations raise concerns about whether judges are dismissing meritorious claims or denying motions to dismiss for frivolous claims.<sup>131</sup> The issue warrants considerable concern because from 1996 through 2003, plaintiffs have filed more class action lawsuits on average annually in the Ninth and Second Circuits than in any other circuit.<sup>132</sup> Notably, these two circuits have adopted heightened pleading standard interpretations that are generally pro-defendant and pro-plaintiff, respectively.<sup>133</sup> Although observers have tallied up and compared pre and post-PSLRA motion to dismiss statistics as a means of evaluating the pleading standard, few studies have involved rigorous empirical investigation.<sup>134</sup> However, in 2004, researchers published an empirical study that compared motions to dismiss for securities class action cases located in the Second and Ninth Circuits.<sup>135</sup> The researchers found similarities and differences in dismissal rates depending upon the allegation involved,

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127. *Id.*

128. *Id.*

129. 346 F.3d 660 (6th Cir. 2003).

130. *Id.* at 673.

131. Compare PRITCHARD & SALE, *supra* note 4, at 2 (questioning how disparate courts of appeals dismissal rates affects SEC and congressional policy making), with RICHARD PAINTER ET AL., THE FEDERALIST SOCIETY FOR LAW AND PUBLIC STUDIES, PRIVATE SECURITIES LITIGATION REFORM ACT: A POST-ENRON ANALYSIS 6 (2003) <http://www.fed-soc.org/pdf/PSLRAFINALII.PDF> (last visited Feb. 14, 2005) (opining that market conditions have impacted the volume and type of securities lawsuits more than the "legal environment or anything else").

132. CORNERSTONE RESEARCH: SECURITIES CLASS ACTION CASE FILINGS, 2003: A YEAR IN REVIEW 13 (2004) [hereinafter CORNERSTONE]; PRITCHARD & SALE, *supra* note 4, at 5. Plaintiffs filed an annual average of fifty-one class action lawsuits in the Ninth Circuit from 1996 through 2002, with the Second Circuit filing average standing at thirty-seven. CORNERSTONE, *supra* at 13. These two courts of appeals also have the two highest annual average maximum dollar loss amounts from 1996 through 2002. *Id.*

133. See Grundfest & Pritchard, *supra* note 6, at 671.

134. Compare PRITCHARD & SALE, *supra* note 4, at 2 (using regression analyses to analyze motions to dismiss in the Second and Ninth Circuits), with PAINTER ET AL., *supra* note 131, at 3-10 (analyzing non-empirically pre and post-PSLRA statistics such as dismissal rates, number of filings, settlement averages, etc.), CORNERSTONE RESEARCH, POST-REFORM ACT SECURITIES LAWSUITS, SETTLEMENTS REPORTED THROUGH DECEMBER 2003 (2004) (averaging and reporting various statistics related to class action securities lawsuits), and Stanford Law School Securities Class Action Clearinghouse, at <http://securities.stanford.edu/index.html> (last modified Feb. 2, 2005) (reporting and synthesizing pre and post-PSLRA class action securities litigation numbers, averages, percentages, and statistics).

135. PRITCHARD & SALE, *supra* note 4, at 1.

such as insider trading or a GAAP violation.<sup>136</sup> Overall, for allegations governed by the PSLRA, courts in the Second Circuit granted motions to dismiss 36% of the time, while courts in the Ninth Circuit granted dismissals 63% of the time.<sup>137</sup> The authors characterized this discrepancy as “strongly significant” and concluded, “the Ninth Circuit’s post-PSLRA reputation as a tougher venue in which to win securities fraud class actions is born out by the data . . . .”<sup>138</sup> The 27% difference in dismissal rates between the Second and Ninth Circuits strongly suggests that the heightened pleading standard leads judges to dismiss meritorious claims and deny motions to dismiss for frivolous claims.<sup>139</sup>

In light of the ambiguities plaguing the heightened pleading standard and noticeably different dismissal rates, it seems inevitable that the United States Supreme Court or Congress will intervene and provide clarification.<sup>140</sup> However, the plaintiffs who frequently lose appellate decisions challenging the pleading interpretation have rarely filed a petition for writ of certiorari.<sup>141</sup> For example, *Silicon* presented an ideal case for United States Supreme Court review since it involved “a pure question of law with a clear circuit split,” but the plaintiffs did not petition.<sup>142</sup> Moreover, as of November 2004, the Court has denied at least four petitions for writ of certiorari with cases

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136. *Id.* at 5, 21. Researchers also examined the dismissal rate for the Milberg Weiss law firm and found that the Ninth Circuit is less likely to dismiss its cases than the Second Circuit. *Id.* at 5.

137. *Id.* at 21.

138. *Id.* at 5, 21; *see also* PAINTER ET AL., *supra* note 131, at 8 (reporting a 10.7% dismissal rate in the Ninth Circuit eighteen months prior to *Silicon*, increasing to a 21.4% dismissal rate in the thirty months following the opinion).

139. Moreover, some observers have contended that the high dismissal rate in the Ninth Circuit has bred forum shopping. *See* Robert A. Horowitz & Karen Y. Bitar, *Pleading Scierter in Securities Fraud Class Actions*, 222 N.Y. L.J. 1, 1 (1999) (stating that “there is an incentive for plaintiffs’ counsel to file their cases in the jurisdictions with the most lenient pleading requirement”). In 2002, plaintiffs filed fifty-three securities class action lawsuits in the Second Circuit compared with forty-three in the Ninth Circuit. *See* CORNERSTONE, *supra* note 132, at 13. In 2003, plaintiffs in the Ninth Circuit filed thirty-four lawsuits, the lowest annual number of filings since 1997. *Id.*; *see also* DAVID S. DE BERRY & STEVEN L. WHITE, SIGNIFICANT DEVELOPMENTS SINCE PASSAGE OF SECURITIES REFORM LEGISLATION 6, *available at* <http://www.hfpinsurance.com/articles/JLRv14n2.pdf> (last visited Feb. 14, 2005) (speculating that an increase in Second Circuit filings while a decrease in Ninth Circuit filings may have indicated that plaintiffs were filing securities lawsuits in more pro-plaintiff venues). A securities litigation attorney remarked, “Securities class actions are unusual in the sense that they are national in scope, giving the plaintiffs a lot of leeway in choosing a forum . . . .” *See* Tamara Loomis, *Securities Fraud Lawyers Seek Review of a Key Class Action Ruling*, 224 N.Y. L.J. 2 (2000). An observer characterized plaintiffs’ choice of venue as “a game of roulette, with the outcome turning on whether a securities class action is filed in New York or Silicon Valley.” *See* Giuffra Jr., *supra* note 4, at A45.

140. Sale, *supra* note 3, at 540 (recognizing as far back as 1998 the need for the United States Supreme Court to resolve emerging disjointed pleading standard interpretations).

141. Grundfest & Pritchard, *supra* note 6, at 676 (observing that through 2001, out of twenty-two appellate decisions that went in favor of the defendants, only one plaintiff had filed a petition for writ of certiorari).

142. *Id.* One securities litigation attorney opined that the plaintiffs in *Silicon* worried about receiving “an answer they didn’t like . . . .” Loomis, *supra* note 139, at 2.

involving pleading standard interpretation.<sup>143</sup> Notably, a plaintiff petitioned in only one of the aforementioned four.<sup>144</sup>

Observers have speculated that the plaintiffs have not petitioned more often because they do not expect a favorable Court decision.<sup>145</sup> Therefore, “[t]he apparent strategy is to keep the issue away from the Court for as long as possible because the plaintiffs’ bar prefers to tolerate a mixed set of decisions at the circuit level rather than risk a uniform, but negative, interpretation from the Supreme Court.”<sup>146</sup> Even if the Court issued an opinion concerning the heightened pleadings standard, clarity is not certain to follow.<sup>147</sup> The Court could issue an opinion that itself generates a host of ambiguities in which lower courts would then have to resolve.<sup>148</sup> When considering that the Court denied one of the four petitions for certiorari in 2003, the post-Enron era,<sup>149</sup> it is hard to fathom any more of a ripe time for the Court to have addressed a central issue concerning the PSLRA.<sup>150</sup>

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143. No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp., 320 F.3d 920 (9th Cir. 2003), *cert. denied*, 540 U.S. 966 (2003); Scholastic Corp. v. Truncellito, 252 F.3d 63 (2d Cir. 2001), *cert. denied*, 534 U.S. 1071 (2001); Desaioudar v. Meyercord, 223 F.3d 1020 (9th Cir. 2000), *cert. denied*, 532 U.S. 1021 (2001); Novak v. Kasaks, 216 F.3d 300 (2d Cir. 2000), *cert. denied*, 531 U.S. 1012 (2000).

144. *See Novak*, 216 F.3d at 300, *cert. denied*, 531 U.S. at 1012.

145. *See Grundfest & Pritchard*, *supra* note 6, at 676.

146. *Id.*

147. *Id.*

148. *See id.* at 641.

149. *Compare Oral Testimony Concerning Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, (Mar. 21, 2002) (testimony of Harvey L. Pitt, Chairman, SEC), <http://www.sec.gov/news/testimony/032102oraltestimony.htm> (testifying before Congress about Enron and related debacles, and declaring that the PSLRA has not eroded investor rights or protections), with Carrie Johnson, *Fight Renewed over Limits on Investor Suits*, WASH. POST, May 10, 2002, at E01 (“Surveying the post-Enron wreckage, Sen. Richard C. Shelby (R-Ala.) says Congress needs to take some blame, noting that seven years ago lawmakers passed a measure [the PSLRA] that made it more difficult for investors to sue corporations and accounting firms involved in fraud.”).

Unprecedented corporate and accounting debacles involving Arthur Anderson, WorldCom and Cendant occurred during the post-PSLRA era. Since 1995, “every Big Five auditor has been hit by multiple accounting debacles at [sic] high-profile clients.” Jonathan Weil, *Basic Principle of Accounting Tripped Enron*, WALL ST. J., Nov. 12, 2001, at C1. Accounting giant Arthur Anderson violated even the most elementary of generally accepted accounting principles while auditing Enron. *Id.* Enron admitted accounting statements dating back to 1997 were unreliable. *Id.* WorldCom fraudulently overstated profits by approximately 10.6 billion dollars and then petitioned for bankruptcy in the summer of 2002. Jonathan Weil, *Missing Numbers—Behind Wave of Corporate Fraud; A Change in How Auditors Work—‘Risk Based’ Model Narrowed Focus of Their Procedures, Leaving Room for Trouble—A \$239 Million Sticky Note*, WALL ST. J., Mar. 25, 2004, at A1. “In 1999, Cendant agreed to pay shareholders \$2.8 billion—a record at the time—to settle accounting-fraud lawsuits stemming from the merger of CUC International Inc. with HFS Inc. in 1997, which created Cendant.” Ryan Chittum, *Cendant Cuts Silverman’s Benefits—Chief Executive’s Contract Also Is Shortened in Bid To Settle Compensation Suit*, WALL ST. J., Apr. 20, 2004, at A3.

150. Evidence suggests that the PSLRA may have facilitated corporate accounting scandals of the Enron era. Under the PSLRA, joint and several liability now only applies to defendants who were specifically held to have “knowingly” violated securities laws; otherwise, defendants only pay damages proportionate to their percentage of responsibility for culpability held to be less than knowingly. *See* 15 U.S.C. §§ 78u-4(f)(2)(A), 78u-4(f)(2)(B)(i) (2000). An empirical study published in 2003 examined whether the elimination of joint and several liability under the

It is questionable whether many legislators consider the heightened pleading standard problematic enough to warrant clarification.<sup>151</sup> Moreover, scholars have argued that Congress purposely drafted the heightened pleading standard ambiguously as a necessary means of legislative compromise.<sup>152</sup> Since the legislators could not agree on pleading standard specificities, scholars have contended that legislators memorialized their pleading standard viewpoints, sometimes by sneaking them in, into the legislative history as a means of preserving their agenda.<sup>153</sup> Scholars have concluded that Congress would not have enacted the PSLRA “but for a conscious agreement to disagree over the proper interpretation of the ‘strong inference’ provision. The net result of these competing efforts was a statute and legis-

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PSLRA led to a rise in income-increasing discretionary accruals, which is an accounting practice that risks overstating income. Lee & Mande, *supra* note 59, at 3. The authors built upon a 1998 study demonstrating that auditors followed less conservative auditing practices if they did not face the risk of joint and several liability under the PSLRA. *Id.* (citing D. Chan & S. Pae, *An Analysis of the Economic Consequences of the Proportionate Liability Rule*, 15 CONTEMPORARY ACCOUNTING RESEARCH 457 (1998)). The researchers hypothesized that if the 1998 study was accurate, they would expect income-increasing discretionary accruals to have risen by Big 6 client managers during the PSLRA era. *See* Lee & Mande, *supra* note 59, at 3. Therefore, they posited that reporting flexibility of clients with Big 6 auditing firms would increase more than non-Big 6 clients following the passage of the PSLRA. *See id.* They explained that “[w]hen the legal environment in the auditing industry changes, auditors’ cost structures are affected by the change and their incentives to influence client managers’ accounting discretion may be affected. Auditors can maximize their utility by increasing or decreasing the level of their influence on client managers’ accounting choices.” *Id.* The researchers examined “2,600 companies three years before and after the [PSLRA],” and their results indicated income-increasing discretionary accruals for Big 6 auditees increased, but non-Big 6 auditees’ discretionary accruals remained the same. *See id.* at 2. The study suggested that affording defendants’ litigation relief from abusive strike suits with the elimination of joint and several liability may have contributed to accounting malfeasance. *See* John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 288-90 (2004) (opining that decreased litigation risks due in part to the PSLRA contributed to aggressive accounting practices).

151. This Note’s author could not locate any proposed congressional bills concerning changes to the heightened pleading standard. *But see, e.g.*, Comprehensive Investor Protection Act of 2002, H.R. 3818, 107th Cong. §§ 12(e), 12(a) (2002) (proposing changes to the PSLRA, *inter alia*, that if the plaintiff named an auditor as a defendant, then the stay of discovery is not applicable; permitting the plaintiff to compel work papers of accountant defendants; and reinstating joint and several liability involving secondary defendants).

152. *See* Grundfest & Pritchard, *supra* note 6, at 666. The authors examined thirty-three courts of appeals decisions and one hundred sixty-seven district court decisions and concluded that Congress’ ability to draft the pleading standard ambiguously as a means of legislative compromise prevailed over the courts’ abilities to interpret the pleading standard uniformly. *See id.* at 633-34.

153. *Compare* H.R. CONF. REP. NO. 104-369, at 41 (1995) (“Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit’s case law interpreting this pleading standard.”), *with* H.R. CONF. REP. NO. 104-369, at 48 n.23 (1995) (“For this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness.”). In a subsequent legislative debate, Representative Hon. John D. Dingell, a PSLRA opponent, alleged that a staff assistant had “slipped” footnote twenty-three into the report without anyone’s knowledge or concurrence. 144 CONG. REC. 27,384 (1998). *But see* Bankamerica Corp. v. United States, 462 U.S. 122, 139 (1983) (indicating the judiciary should give more deference to supporters’ interpretations of legislation than opponents). *See* WILLIAM N. ESKRIDGE, JR. ET AL., CASES AND MATERIALS ON LEGISLATION 831 (3d ed. 2001) (analogizing that legislators assemble statutes in the same manner that families decorate Christmas trees, “with ornaments being added or subtracted willy nilly, and at the last minute, just to satisfy enough interest groups and legislators to gain . . .” passage).

lative history designed to frustrate doctrines of judicial interpretation as a price of enactment.”<sup>154</sup> In light of the ambiguity, thesis, and legislative discord amongst the legislators responsible for the PSLRA, it seems unlikely that current and future Congresses would want to rehash the strong inference definition debate.<sup>155</sup> Despite a seemingly apathetic stance toward the pleading standard woes, Congress should consider how the marketplace perceives the issue, and whether investors’ concerns warrant improving the pleading standard.<sup>156</sup>

154. See Grundfest & Pritchard, *supra* note 6, at 633. The authors’ thesis utilized the “bar-gaining in the shadow of the law” concept. See *id.* at 637. This concept suggests that legislators and the judiciary consider how the crafting and interpreting of statutory language affect’s one another, so they operate and maneuver in one another’s shadow. See *id.*

155. See *supra* notes 2, 71-86 and accompanying text (highlighting the congressional debates and bills leading to the enactment of the PSLRA). Congress reacted to turn-of-the-millennium corporate and auditing fraud by enacting the Sarbanes-Oxley Act (SOX). Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.). The SOX contains some provisions that affect private securities litigation, but the Act noticeably avoids any direct amendment to the PSLRA, “and, for the most part, anything that would directly aid plaintiffs bringing a private action under the Securities Acts.” BLOOMENTHAL, *supra* note 64, at § 25:8. Because Senator Sarbanes sponsored SOX but was a leading opponent of the PSLRA, he apparently did not want to venture down a path that lessened his chances of congressional approval, so SOX is void of provisions that could directly help plaintiffs satisfy the heightened pleading standard. See *id.* For example, SOX limits plaintiffs from obtaining information acquired by the Public Company Accounting Oversight Board (PCAOB), a private not for profit corporation created by SOX to oversee auditors of publicly traded companies. See *id.* Plaintiffs would likely consider PCAOB information helpful to satisfy the heightened pleading standard. See *id.*

In 2004, the National Economic Research Associates (NERA) examined how SOX affected private securities litigation. They reported:

Seventeen months after SOX passed in July 2002, any immediate effects of the legislation on securities class actions would likely now be evident in the data. NERA’s research finds that while securities litigation continues to increase as a long-term trend, there is no statistically significant change in the number of filings or the size of settlements since the passage of SOX.

ELAINE BUCKBERG ET AL., RECENT TRENDS IN SECURITIES CLASS ACTION LITIGATION: 2003 EARLY UPDATE 2 (NERA Economic Consulting, Working Study, Feb. 2004).

156. See, e.g., S. REP. NO. 104-98, at 37 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 715 (statement of Sens. Sarbanes, Bryan, and Boxer) (commenting that investor “confidence is maintained because investors know they have effective remedies against persons who would defraud them”); Steven A. Ramirez, *Fear and Social Capitalism: The Law and Macroeconomics of Investor Confidence*, 42 WASHBURN L.J. 31, 36-37 (2002) [hereinafter Ramirez, *Fear*] (theorizing that the government best maintains investor confidence in the marketplace by managing their fears with appropriate legislation). Investor confidence not only affects the U.S. securities marketplace but also macroeconomic well-being. See *id.* at 40-41. “Macroeconomics measures overall economic activity; . . . it forecasts future economic activity; and it attempts to formulate policy responses designed to reconcile forecasts with target values of production, employment, and prices.” ENCYCLOPEDIA OF ECONOMICS 619 (Douglas Greenwald ed., 1982). In 2002, the United States Supreme Court recognized the importance of federal securities polices that promote investor confidence. See *SEC v. Zandford*, 535 U.S. 813, 819 (2002) (citing with approval *United States v. O’Hagan*, 521 U.S. 642, 658 (1997); *United States v. Naftalin*, 441 U.S. 768, 775 (1979)). Securities industry observers opine that when investors perceive or fear the U.S. securities marketplace as providing inadequate safety, they may investment elsewhere. See, e.g., ADAM C. PRITCHARD, SHOULD CONGRESS REPEAL SECURITIES CLASS ACTION REFORM? 3 (Univ. of Mich. John M. Olin Center for Law & Economics, Working Paper No. 03-003, 2003) (postulating that investors may direct their capital elsewhere when faced with mounting concerns of fraud in the marketplace). The Federal Reserve Board Chairman Alan Greenspan testified before Congress that investor confidence correlates with macroeconomic success. See *Federal Reserve Board’s semiannual monetary policy report to the Congress: Hearing Before the Comm. on Banking, Hous., & Urban Affairs*, (July 16, 2002) (testimony of Chairman Alan Greenspan), <http://www.federalreserve.gov/boarddocs/hh/2002/July/testimony.htm>. In a public

### C. Summary

The aforementioned information illustrates the complexity and interplay between the legislative and judiciary branches, marketplace forces, and lobbyist pressures. Pre-PSLRA strike suits and abusive discovery requests precipitated the need for some degree of improved regulation or deterrence.<sup>157</sup> An aggressive lobbying effort pressured legislators for reform.<sup>158</sup> Legislators attempted to improve the securities litigation arena with a heightened pleading standard, but they could not agree on the details.<sup>159</sup> Nevertheless, Congress vested the judiciary with the task of applying the standard, but the judiciary, for nearly a decade, has interpreted the standard in a myriad of ways.<sup>160</sup> Meanwhile, scholars have debated the pleading standard's meaning and logic while statisticians have quantified its disparate impact.<sup>161</sup> When post-PSLRA-era corporate and accounting debacles occurred, the scandals inflamed and complicated the debates concerning whether the PSLRA has encouraged aggressive marketplace behavior.<sup>162</sup> Nearly a decade of legislative history analysis, judiciary discord, and scholarly debate inductively suggest that the heightened pleading works like a Rorschach ink blot test—observers interpret the inkblot (i.e., the pleading standard) according to their perceptions and viewpoints.<sup>163</sup> The next Part presents an approach that moves away

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statement released in June of 2002, Pacific Stock Exchange Chairman and Chief Executive Officer Philip D. DeFeo remarked:

Investors are understandably shaken by the dramatic loss in market value these past two years. . . . Investors have grown weary of significant losses, and are now wary of a marketplace where the information provided cannot be trusted. As long as investors do not trust the financial system, investment performance will lag economic performance. Lacking confidence, they will overweight risk, discount values and potential returns, and shy away from committing new capital to the market. I believe this can and will act as a brake on essential capital formation. I believe [this] will weaken and slow both the economic recovery and long-term growth.

Philip D. DeFeo, Remarks at the National Association of Securities Professionals (June 19, 2002), at [http://www.pacificex.com/news/pub\\_state/pub\\_state\\_investor\\_confidence.html](http://www.pacificex.com/news/pub_state/pub_state_investor_confidence.html). After WorldCom declared bankruptcy, foreign capital fled the U.S. marketplace. See, e.g., Edmund L. Andrews, *Turmoil at WorldCom: The Overseas Reaction; U.S. Businesses Dim as Model for Foreigners*, N.Y. TIMES, June 27, 2002, at A1 (indicating the lowest value of the dollar to the euro for the past twenty-eight months); Barbara Hagenbaugh, *Foreign Investors Shun U.S. Stocks; Choosing Bonds Bad for Business, Good for Consumers*, USA TODAY, July 19, 2002, at 1B (discussing the exodus of foreign investors from the U.S. marketplace).

157. See *supra* note 10, notes 53-56 and accompanying text.

158. See *supra* notes 8, 51; Ramirez, *Fear*, *supra* note 156, at 59.

159. See *supra* note 6, notes 151-55 and accompanying text.

160. See *supra* note 14, notes 87-130 and accompanying text.

161. See *supra* notes 131-56 and accompanying text.

162. See, e.g., Jonathan Cohn, *Daily Express Matter of Interest*, THE NEW REPUBLIC ONLINE (Jan. 14, 2005), at <http://www.tnr.com/doc.mhtml?pt=FYIZeGy6cAADhnOzaQedxR%3D%3D> (quoting experts that contended the PSLRA fostered corporate debacles such as Enron); RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 220 (6th ed. 2003) (discussing how changes in opportunity costs affect criminal behavior).

163. See, e.g., *Securities Litigation Reform*, *supra* note 10, at 120 (testimony of Donald C. Langevoort, Lee S. & Charles A. Speir, Professors of Law, Vanderbilt University School of Law). In 1994 congressional hearings leading up to the PSLRA, Donald C. Langevoort testified

from pleading standard linguistic constructs and emphasizes a thorough and judicious pre-motion to dismiss fact review process.

#### IV. IMPROVING BALANCE WITH THE SCREENING PANEL APPROACH

As a remedy for heightened pleading standard shortcomings, Congress could implement a pre-motion to dismiss evidentiary review proxy using a screening panel approach with panel-managed discovery powers.<sup>164</sup> As a grand jury does, the panel could examine evidence, interview parties, assess the allegations, and then issue an opinion to the judiciary concerning their findings.<sup>165</sup> Panel-managed discovery is a balanced remedy to the conundrum, “You can’t get discovery unless you have strong evidence of fraud, and you can’t get strong evidence of fraud without discovery.”<sup>166</sup> By combining marketplace practitioners with diverse backgrounds, panel members could synergistically combine so that complex and novel securities issues receive qualified review.<sup>167</sup> After the panel has completed its investigation, it could

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that Congress should consider how perceptions of the securities litigation arena affect marketplace participants:

The major reason for reforming the securities litigation system, however, is one of perception: no matter what the degree of actual dysfunction, many economic actors plainly believe that the system is harmful and counterproductive because of its invitation to frivolous or unnecessary litigation. The perception that we have a fair, controlled system is crucial. I have no doubt that fear of dysfunctional litigation is adversely affecting capital marketplace decisions . . . . Something must be done to alter the perception of abuse.

*Id.* Some observers suggest the converse is true in the post-PSLRA era. *See, e.g., Ramirez, Fear, supra* note 156, at 59 (arguing that the PSLRA created a “perception of insulation” for putative defendants). One commentator has taken the opposite view:

The intuitive link between the PSLRA’s barriers to lawsuits and the misbehavior that has unfolded in corporate boardrooms and financial markets is all too easy to make. Unfortunately, public policy is too frequently driven by such intuitions based on the latest headlines rather than hard evidence. In this case, the hard evidence does not support the call to repeal the PSLRA.

PRITCHARD, *supra* note 156, at 15.

164. *Id.*; *see supra* note 20 (suggesting panel approach models).

165. *See, e.g.,* 38 AM. JUR. 2D *Grand Jury* § 1 (1999) (explaining the many aspects of a grand jury, such as its duties, authority, investigatory powers, and tenure).

166. Greenberger, *supra* note 18, at A8 (quoting Jack Coffee, law professor at Columbia University). The PSLRA stay of discovery provision in its entirety reads as follows:

Stay of discovery. In any private action arising under this chapter, 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.*

15 U.S.C. § 78u-4(b)(3)(B) (2000) (emphasis added). Although the statute vests the judiciary with authority to permit limited discovery, most judges do not grant limited discovery in PSLRA-related complaints. *See Sale, supra* note 3, at 581. Moreover, “judges generally dislike the discovery process and prefer not to become involved in it.” *Id.* at 582.

167. For example, the panel could consist of retired judges, accounting professionals, attorneys, analysts, and so on. Securities litigation often entails complex and specialized issues such as accounting and financial analysis. Ramirez, *Arbitration, supra* note 3, at 1118. A panel comprised of experts with securities marketplace knowledge and experience may be more likely to deduce the defendant’s motivation rather than a judge or a lay jury. *See id.* at 1119; *In re Japanese Elec. Prods. Antitrust Litig.*, 631 F.2d 1069, 1086-87 (3d Cir. 1980) (denying the right to a jury trial because the case involved exceptionally complex issues); Symposium, *Judges’ Opinions on Procedural Issues: A Survey of State and Federal Trial Judges Who Spend at Least Half Their*

then issue an opinion to the judiciary.<sup>168</sup> In turn, the judiciary could review the complaint in conjunction with the opinion and then apply the heightened pleading standard in the most informed, albeit subjective, fashion possible. Panel management could fall under the auspice of the SEC.<sup>169</sup>

## V. CONCLUSION

This Note posits that the heightened pleading standard is a hopelessly subjective linguistic construct incapable of a uniform application, even if the United States Supreme Court rendered an interpretation. From the legislative history to judicial opinions, the information suggests that the pleading standard was born of debate and will remain riddled with subjectivity.<sup>170</sup> When post-PSLRA corporate and accounting debacles occurred, observers further questioned the logic and efficacy of the heightened pleading standard.<sup>171</sup> In light of the aforementioned observations, this Note contends that the heightened pleading standard is a quixotic method of screening securities lawsuits.<sup>172</sup>

As a remedy for pre- and post-PSLRA securities litigation shortcomings, this Note proposes an evidentiary review proxy, such as a pre-motion to dismiss screening panel approach with panel-managed discovery.<sup>173</sup> The panel approach concerns fact reviewing and discovery management during the critical pre-motion to dismiss period.<sup>174</sup> Like a grand jury, the panel could assess evidence, interview parties, and then report its findings to the judiciary.<sup>175</sup> The panel could consist of securities practitioners with diverse marketplace experiences who synergistically combine so that complex, technical, tenuous, and novel

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*Time on General Civil Cases*, 69 B.U. L. REV. 731, 747 (1989) (surveying two hundred federal judges and finding 53% believe "in some complex civil cases, trial before a panel of experts would be preferable to trial by jury").

168. Symposium, *supra* note 167, at 733 (finding that 44% of two hundred federal judges surveyed would welcome the advice of scientific panels for their assessment of witnesses' validity and their evidence presented).

169. Congress has vested the SEC with authority to resolve securities marketplace issues too politically charged for resolution on Capitol Hill. Grundfest, *supra* note 30, at 966; *see also* Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 458-60 (1990) (documenting congressional compromises that resulted in vesting the SEC with enhanced authority).

170. *See supra* notes 2, 6, 87-130, 151-55 and accompanying text.

171. *See supra* notes 18, 149, 151, 155, 156.

172. *See supra* notes 87-130 (varying judicial pleading standard interpretations), notes 131-39 (reporting empirically a 27% difference in dismissals between the Second and Ninth Circuits), notes 140-50 and accompanying text (indicating little United States Supreme Court motivation to clarify the strong inference debate notwithstanding a writ of petition for certiorari in the post-Enron era), notes 151-55 and accompanying text (compelling evidence that Congress purposely drafted the heightened pleading standard ambiguously knowing full well the effect it would have on the judiciary).

173. *See supra* note 20.

174. *See supra* note 21 and accompanying text.

175. *See supra* notes 22, 165 and accompanying text.

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allegations receive vigorous review.<sup>176</sup> The screening panel approach is an effort to move the pleading standard debate away from a linguistic construct problem and toward a fair and balanced pre-motion to dismiss evidentiary review proxy.<sup>177</sup> It recognizes the pre- and post-PSLRA benefits and drawbacks, offers a way for the judiciary to apply the heightened pleading standard in the most informed, albeit subjective, fashion possible, and improves the balance of the securities litigation arena.

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176. *See supra* note 167.

177. *Cf. Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 345 (4th Cir. 2003) (recognizing that Congress was more concerned with the amount of proof rather than the type and thus adopting a flexible, case-specific analysis that examines the totality of the circumstances rather than follow any specific pleading test).

