What Congress Said About the Heightened Pleading Standard: A Proposed Solution to the Securities Fraud Pleading Confusion

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Cover Page Footnote
I would like to dedicate this Note to my grandfathers.

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WHAT CONGRESS SAID ABOUT THE HEIGHTENED PLEADING STANDARD: A PROPOSED SOLUTION TO THE SECURITIES FRAUD PLEADING CONFUSION

Patricia J. Meyer*

INTRODUCTION

In courtroom one, a plaintiff files suit against Company X, a company in which she had invested a substantial amount of her savings. She lost a large amount of that money because X made its financial picture look promising when, in reality, the company was suffering financial difficulties. The plaintiff had been looking for a good investment, and through research, she had found the financial statements of and several articles about Company X in which its managers had forecasted a brilliant future for the company. Despite these rosy representations, Company X was financially distressed and had issued inflated reports in an attempt to gain the capital necessary to solve its production problems. Unfortunately for the plaintiff, the false and misleading statements that Company X made led to the loss of her hard-saved money.

In courtroom two, a “hired” plaintiff recovers a large sum of money from a budding technology firm after she has filed a “cookie cutter” complaint and threatened to engage in a drawn-out securities fraud suit.¹ The lawyer for the plaintiff knew that the technology company would settle. To get into court and coerce the company into settling, the plaintiff simply had to plead that the company had the motive and opportunity to profit by a false, public statement they issued. The plaintiff knew that the company would pay because the discovery process necessary to prove the alleged statement was not false, and that the plaintiff was bringing a frivolous suit, would cost much more than a quick settlement.

Congress attempted to strike a balance between meritorious suits, exemplified by the first case, and frivolous suits, typified by the second case, by redefining the pleading standard for private securities fraud suits. Congress wanted to allow real suits into court, while protecting

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businesses from "strike" suits that are easily filed by professional plaintiffs. The Private Securities Litigation Reform Act of 1995 ("PSLRA")\(^2\) represents Congress' attempt to resolve the conflict between the above two scenarios—between the true fraud victim plaintiff and the professional plaintiff.\(^3\) In an attempt to strike a balance between meritorious and frivolous suits, Congress standardized the pleading requirements for section 10(b) actions under the 1934 Securities Exchange Act ("Exchange Act").\(^4\) The goal of this legislation was to establish a clear pleading standard to resolve the existing circuit split regarding the correct application of Federal Rule of Civil Procedure 9(b) to securities fraud cases.\(^5\) Unfortunately, the new legislation has only caused further confusion among plaintiffs and courts alike, creating multiple pleading standards and, consequently, inconsistent rulings. The result of the PSLRA has been still more confusion as to the appropriate standard. There are three different interpretations of the PSLRA's standard currently in the federal courts;\(^6\) two in the


\(^{3}\) Congress cited four abuses targeted by the PSLRA:
(1) The routine filing of lawsuits following a significant stock decline without regard to the issuer's culpability and "with only faint hope" that discovery would lead to a "plausible cause of action";
(2) The targeting of "deep pocket defendants" without regard to their culpability;
(3) Discovery practices that impose burdensome costs upon defendants and make it "economical" for them to settle; and
(4) The "manipulation" by class action lawyers of the persons they purport to represent.


\(^{5}\) See infra Part I.B. Securities fraud claims are usually brought under section 10(b) of the Exchange Act. Under 10(b), the SEC is given the power to promulgate rules to enforce the federal securities laws. Rule 10b-5 is one such rule. 17 C.F.R. § 240.10b-5 (1997); see infra text accompanying notes 10-11.

\(^{6}\) See, e.g., In re Baesa Sec. Litig., 969 F. Supp. 238, 241-42 (S.D.N.Y. 1997) (finding that the PSLRA does not change the substantive nature of scienter, but does expressly heighten the pleading standard for securities fraud cases); Rehm v. Eagle Fin. Corp., 954 F. Supp. 1246, 1253 (N.D. Ill. 1997) (concluding "that a reading of § 78u-4(b)(2) that adopts a scienter pleading standard equivalent to the Second Circuit rule best comports with the language, history, and purpose of the PSLRA"); In re Silicon Graphics, Inc. Sec. Litig., No. C 96-0393, 1996 WL 664639, at *6 (N.D. Cal. Sept. 25, 1996) ("Congress did not intend to codify the Second Circuit standard under the [PSLRA].") The three lines of cases will be discussed in depth in part II.C. of this Note.
Second Circuit alone.7

This Note analyzes the three prevailing interpretations of the standards for pleading and proving scienter under the PSLRA. Part I discusses how the 1934 Securities Exchange Act was previously applied by the federal courts, highlighting the different pleading standards that the Second and Ninth Circuits applied to section 10(b) and rule 10b-5 cases. Part II details the passage of the 1995 PSLRA, which was designed to rectify the ambiguity in the old statute that led to the conflicting views of the Ninth and Second Circuits. Specifically, part II describes the legislative history of the PSLRA with an eye toward discerning Congress's intent with respect to the new pleading standard. Finally, part II documents the three divergent views of the PSLRA's pleading standard to demonstrate the PSLRA's ambiguity. Part III then argues that the PSLRA heightened the pleading requirement for scienter beyond the strict standard previously endorsed by the Second Circuit, but did not go so far as to make a substantive change in the meaning of scienter. Part III further argues that because the prior Second Circuit standard for pleading struck the correct balance between meritorious and frivolous plaintiffs, Congress should amend the PSLRA to adopt it.

I. REQUIREMENTS FOR PRIVATE SECURITIES FRAUD CASES:
SECTION 10(b) AND RULE 10B-5 CLAIMS

Congress passed the 1934 Securities Exchange Act during the Great Depression "to promote investor confidence in the United States securities markets and thereby to encourage the investment necessary for capital formation, economic growth, and job creation."8 Congress was particularly concerned about the "flagrant betrayal of . . . fiduciary duties by directors and officers of corporations" in securities transactions.9 Therefore, to protect investors from these abuses, Congress drafted legislation that put a check on corporate management.

Section 10(b) of the Exchange Act makes it unlawful for any person "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulation as the [Securities and Exchange Commission] may prescribe . . .."10 Section 10(b) delegated to the SEC, as part of its authority to enforce the federal securities laws in general, the authority to promulgate rules to enforce the Exchange

Act. Rule 10b-5 makes it unlawful "[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 . . . ." For a plaintiff to bring a successful 10b-5 claim, she must allege both reliance on a material misstatement and scienter, or that such misrepresentation was made knowingly. The next part of this Note undertakes an explanation of the scienter requirement for 10b-5 actions.

A. The Substantive Requirements of Scienter

Scienter is a necessary element in all 10b-5 claims. The Supreme Court, in Ernst & Ernst v. Hochfelder, defined scienter as the "mental state embracing intent to deceive, manipulate, or defraud." The requirement of proving scienter placed "a burden on the plaintiff to prove that the 'defendants either knew the misleading nature of their statements, or made the statements in reckless disregard of adverse facts that could have been disclosed without extraordinary effort.'" Plaintiff's burden can be satisfied by clear evidence of intent to deceive. While proof of intentional acts of deception clearly fulfill the scienter requirement, some cases presented the question of whether reckless conduct by corporate officers when issuing securities would likewise fulfill the scienter requirement. The first case to find that reckless conduct might constitute scienter appeared in a district

13. Id. at 507.
15. Id. at 193 n.12.
18. See id.
19. Note that the Supreme Court chose not to answer the question of whether recklessness sufficient to meet the scienter standard in Hochfelder. Id. at 193 n.12. In Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., the Supreme Court ruled out claims for aiding and abetting liability under section 10(b), 511 U.S. 164, 183 (1994).
20. The Court held that there can be no claim for aiding and abetting under § 10(b), reasoning that there is nothing in the statutory text which explicitly provides for secondary liability. Similarly, defendants have argued that a strict reading of § 10(b) precludes liability for anything other than knowing or intentional conduct.

court in Oklahoma in 1976. In 1977, the Seventh Circuit then adopted a recklessness standard in *Sundstrand Corp. v. Sun Chemical Corp.*

The *Sundstrand* court defined recklessness as:

a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it. Since the *Sundstrand* case, over half of the appellate circuits found that this standard of recklessness constitutes scienter in 10(b) and 10b-5 cases. Every circuit that had addressed the issue of recklessness prior to the PSLRA agreed that recklessness would suffice to meet the scienter definition. Consequently, prior to the PSLRA, scienter

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21. 553 F.2d 1033 (7th Cir. 1977).

22. Id. at 1045 (quoting Franke, 428 F. Supp. at 725).

23. See SEC v. Carriba Air, Inc., 681 F.2d 1318, 1324 (11th Cir. 1982); Hackbart v. Holmes, 675 F.2d 1114, 1118 (10th Cir. 1982); Broad v. Rockwell Int'l Corp., 642 F.2d 929, 961-62 (5th Cir. 1981) (en banc); McLean v. Alexander, 599 F.2d 1190, 1197 (3d Cir. 1979); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1025 (6th Cir. 1979); Cook v. Avien, Inc., 573 F.2d 685, 692 (1st Cir. 1978); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 46-47 (2d Cir. 1978).

24. See Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1570 (9th Cir. 1990) (noting that reckless conduct that is "highly unreasonable" and "represents 'an extreme departure from the standards of ordinary care ... to the extent that the . . . defendant must have been aware of it' " (quoting Rolf, 570 F.2d at 47)); In re Phillips Petroleum Sec. Litig., 881 F.2d 1236, 1244 (3d Cir. 1989) (adopting the *Sundstrand* definition for scienter); Woods v. Barnett Bank of Fort Lauderdale, 765 F.2d 1004, 1010 (11th Cir. 1985) (noting that "severe recklessness," defined as "an extreme departure from the standards of ordinary care," constituted scienter (quoting Broad, 642 F.2d at 961-61)); Dirks v. SEC, 681 F.2d 824, 844 & n.27 (D.C. Cir. 1982) (stating that recklessness would be enough to constitute scienter), rev'd on other grounds, 463 U.S. 646 (1983); Hackbart, 675 F.2d at 1117-18 (expressly recognizing that recklessness behavior which is "an extreme departure from the standards of ordinary care" constitutes scienter); Stokes v. Lokken, 644 F.2d 779, 783 (8th Cir. 1981) (noting that at the very least, "gross" recklessness will suffice as scienter); Broad, 642 F.2d at 961-62 (noting that "severe recklessness" constitutes scienter); Mansbach, 598 F.2d at 1023 (expressly holding that "recklessness is a sufficiently culpable state of mind for liability under § 10(b) and Rule 10b-5"); Cook, 573 F.2d at 692 (stating that reckless conduct "comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence" (quoting Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977)); Rolf, 570 F.2d at 47 (noting that recklessness is enough to meet the scienter requirement). The Fourth Circuit has not explicitly found that recklessness fulfills the scienter requirement, but district courts in the circuit have so held. See In re EPIC Mortgage Ins. Litig., 701 F. Supp. 1192, 1250 (E.D. Va. 1988) (noting that recklessness constitutes scienter), aff'd in part, rev'd in part on other grounds sub. nom., Foremost Guar. Corp. v. Meritor Sav. Bank, 910 F.2d 118 (4th Cir. 1990).
under the 1934 Exchange Act consisted of both reckless and intentional misrepresentation.\textsuperscript{25}

B. The Pleading Requirements of 10b-5 Fraud Cases

Generally speaking, in a civil case, a plaintiff is only required to file a short and plain statement to set forth a claim for relief.\textsuperscript{26} When pleading fraud, however, the Federal Rules of Civil Procedure provide a higher pleading standard.\textsuperscript{27} Rule 9(b) states that “[i]n all averments

\begin{itemize}
\item \textsuperscript{25} While almost all the circuits have accepted that recklessness fulfills the scienter requirement, see supra note 23, there is much debate regarding what constitutes reckless conduct. The application of the \textit{Sundstrand} standard has been far from uniform. For example:
\item [\textsuperscript{26}] Fed. R. Civ. P. 8(a).
\item [\textsuperscript{27}] See Fed. R. Civ. P. 9(b).
\end{itemize}
of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge and other condition of mind of a person may be averred generally. Circuit courts have held that Rule 9(b) applies to 10(b) and 10b-5 claims.

To state a 10b-5 cause of action, a plaintiff was required to plead three things: (1) that the defendant made a false statement or omitted a material fact; (2) that the act was done with scienter; and (3) that plaintiff's reliance on defendant's action caused plaintiff injury. Pleading the first and third prongs of the requirement usually caused little difficulty for the plaintiff. The pleading of scienter, however, presented questions for the plaintiff.

Under the pre-PSLRA Exchange Act, the circuits were split as to how Fed. R. Civ. P. 9(b)'s "stated with particularity" requirement meshed with the 10b-5 actions' pleading requirements. For example, Rule 9(b) is not met if a complaint vaguely attributes fraudulent statements to a defendant. Congress left it to the courts to determine the specificity of facts needed to meet the Rule 9(b) standard in a 10b-5 action. A split regarding the stringency of the pleading standard developed at the circuit court level. The split centered around a lenient Ninth Circuit interpretation and a stringent Second Circuit interpretation of the pleading requirement. While neither circuit, consistent with Fed. R. Civ. P. 9(b), accepted a "bare bones complaint," and both required "plead[ing of] additional facts before allowing a suit alleging

28. Id.
29. See In re GlenFed, Inc. Sec. Litig., 42 F.3d 1541, 1545 (9th Cir. 1994) (en banc) (finding "implicitly or explicitly, that [Fed. R. Civ. P.] Rule 9(b) applies to actions brought under the federal securities laws"); Ross v. A.H. Robins Co., 607 F.2d 545, 556 (2d Cir. 1979) (stating that "[a] plaintiff unable to allege those specific facts necessary under Fed. R. Civ. P. 9(b) which would raise a strong inference of scienter... would not be able to establish a prima facie case under § 10(b)").
To state a valid Rule 10b-5 claim, "a plaintiff must allege that the defendant: 1) made a misstatement or omission, 2) of material fact, 3) with scienter, 4) in connection with the purchase or sale of securities, 5) upon which the plaintiff relied, and 6) that reliance proximately caused the plaintiff's injury."
31. E.g., Mills v. Polar Molecular Corp., 12 F.3d 1170, 1175 (2d Cir. 1993) (explaining that to meet the Rule 9(b) requirements a complaint must specify the fraudulent statements, who said them, and when, where, and why they were said); DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir. 1990) (same).
32. GlenFed, 42 F.3d at 1541; see Marksman Partners, L.P. v. Chantal Pharm. Corp., 927 F. Supp. 1297, 1309 (C.D. Cal. 1996) (noting that the PSLRA "leaves little doubt ... that the lenient GlenFed standard can no longer be said to constitute the sum of scienter pleading requirements" (emphasis added)).
33. Time Warner, 9 F.3d at 265 (noting that, if courts use a less strict standard, they will burden companies with the "expense of discovery or by a settlement extracted under threat" even where the company was not at fault).
open market fraud to proceed," the two circuits fashioned different standards for plaintiffs' pleadings. Plaintiffs in the Ninth and Second Circuits had to plead securities fraud differently just to get their securities fraud claims into court.

The Ninth Circuit interpretation of the pleading requirement is best illustrated by In re GlenFed, Inc. Securities Litigation. According to GlenFed, the model for Fed. R. Civ. P. 9(b) is the English Rules of Practice of 1937. Thus, the Ninth Circuit held that courts must be true to the English Rules to properly interpret the exact requirements of Rule 9(b). Judge Fletcher, writing for the Ninth Circuit Court of Appeals, found that, "we are not permitted to add new requirements to Rule 9(b) simply because we like the effects of doing so." In other words, the majority found that, regardless of whether changing the pleading standard would strike the proper balance between meritorious and strike plaintiffs, it was not the courts' place to make that decision. Thus, the Ninth Circuit's view was that the courts were required to interpret Rule 9(b) as limiting what was required to plead fraud, even if it had the undesirable effect of allowing too many frivolous suits.

Accordingly, to meet the Ninth Circuit pleading requirement, a plaintiff could aver scienter generally—simply by saying that scienter existed—because that is all Rule 9(b) explicitly required. The Ninth Circuit later held that: "In a securities fraud action, a pleading is sufficient under Rule 9(b) if it identifies the circumstances of the alleged fraud so that the defendant can prepare an adequate answer." Stated differently, the Ninth Circuit required that a statement made by a plaintiff describe the circumstances which she believes constitute fraud and a declaration that such actions constitute fraud.

35. 42 F.3d 1541 (9th Cir. 1994) (en banc).
36. Id. at 1545 & n.4.
37. Id. Order 19, Rule 22 of the English Rules of Practice of 1937 stated: "Whenever it is material to allege malice, fraudulent intention, knowledge, or other condition of the mind of any person, it shall be sufficient to allege the same as a fact without setting out the circumstances from which the same is to be inferred." Id. (citation omitted).
38. Id. at 1546 (noting that whether or not the Second Circuit test deters "strike suits," the court can not merely adopt the test because it believes it weeds out such suits).
39. Id.
40. Id. at 1546-47.
41. Fecht v. Price Co., 70 F.3d 1078, 1082 (9th Cir. 1995) (quoting Kaplan v. Rose, 49 F.3d 1363, 1370 (9th Cir. 1995)); see also Kaplan, 49 F.3d at 1370 (9th Cir. 1994) (stating that "[t]he pleading must state precisely the time, place, and nature of the misleading statements, misrepresentations, and specific acts of fraud").
42. GlenFed, 42 F.3d at 1549.
Contrary to the lenient Ninth Circuit standard, the Second Circuit adopted a much stricter pleading standard. According to the Second Circuit, scienter is a necessary element of every 10b-5 action, and though it need not be plead with “great specificity,” the facts alleged in the complaint must “give[ ] rise to a ‘strong inference’ of fraudulent intent.” The Second Circuit required that a plaintiff plead “those events which they assert give rise to a strong inference that the defendants had knowledge of the facts . . . or recklessly disregarded their existence.” In *Beck v. Manufacturers Hanover Trust Co.*, the court announced a test to notify plaintiffs of what was necessary to plead a “strong inference” of scienter. A plaintiff could prove a “strong inference” by alleging facts establishing a motive to commit fraud and an opportunity to do so. Alternatively, a plaintiff could allege facts constituting circumstantial evidence of either reckless or conscious behavior. If a plaintiff attempting to establish a “strong inference” of scienter was unable to satisfy the motive and opportunity prong, “the strength of [her] circumstantial allegations [had to] be correspondingly greater.”

In an attempt to rectify the differences between the two opposing circuit standards, Congress enacted section 21D(b) of the PSLRA. With the PSLRA, Congress wanted to standardize pleading and properly balance frivolous and meritorious claims. Unfortunately, Congress’s good intentions were thwarted by the statute’s ambiguous language. The next section analyzes the requirements of the PSLRA.

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43. *See In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 268-69 (2d Cir. 1993). Although Time Warner was most often followed, there was also a second line of cases in the Second Circuit that required an even higher standard for recklessness in 10(b) cases than Time Warner. *See, e.g., In re Leslie Fay Cos. Sec. Litig.*, 871 F. Supp. 656, 692 (S.D.N.Y. 1995) (finding that for outside auditors “only behavior which is either deliberate or so reckless that an inference of fraudulent intent might be drawn by a reasonable finder of fact” will constitute scienter).

44. *Connecticut Nat'l Bank v. Fluor Corp.*, 808 F.2d 957, 962 (2d Cir. 1987) (quoting Goldman v. Belden, 754 F.2d 1059, 1070 (2d Cir. 1985)).


47. 820 F.2d 46, 50 (2d Cir. 1987).

48. *Id.*

49. *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 269 (2d Cir. 1993). The Second Circuit defined “motive and opportunity” in *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124 (2d Cir. 1994). “Motive would entail concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged. Opportunity would entail the means and likely prospect of achieving concrete benefits by the means alleged.” *Id.* at 1130.

50. *Time Warner*, 9 F.3d at 269. Recklessness has been long recognized as sufficient to satisfy the scienter requirement in every circuit that has addressed the issue. *See supra* note 23 and accompanying text.

51. *Beck*, 820 F.2d at 50.

52. *See infra* notes 114-15 and accompanying text.
By 1993, it was evident that Congress needed to make changes in the securities law, and as a result, Congress began the long process of reforming the 1934 Exchange Act to eliminate the confusion over the application of Rule 9(b) to securities fraud cases.\textsuperscript{53} It was not until 1995, however, that Congress passed the PSLRA.

The early 1995 legislation mirrored the prior attempts to reform the Exchange Act.\textsuperscript{54} Each version of the legislation had the goal of ending the circuit split as to pleadings.\textsuperscript{55} In fact, in 1994, Securities Exchange Commission ("SEC") Chairman Arthur Levitt testified before Congress and requested that it "harmonize the differ[ent] [pleading] standards applied by the circuit courts of appeals."\textsuperscript{56} It was not until the 104th Congress, however, with the bi-partisan backing of Senators Christopher Dodd (D-CT) and Pete Domenici (R-NM) that Congress was able to pass any reform legislation.

In each draft of the legislation, the issue of what constituted scienter was in contention.\textsuperscript{57} And, as the Ninth Circuit noted, it was "a job for Congress . . . in the process of amending the Federal Rules" to resolve the conflict among the circuits and set forth a clear pleading standard for plaintiffs to follow.\textsuperscript{58} The quest for reform legislation that culminated in the 1995 PSLRA was an attempt to take that action.

\section*{A. The Legislative History of the PSLRA}

The legislative history of the PSLRA gives insight to the intent of Congress in its passage of the PSLRA. To fully understand the final Conference Committee version, it is important to look at the development of the statute in both the Senate and the House. The following part reviews the history of the bill.


\textsuperscript{55} See infra Part II.C (examining the various drafts of the PSLRA).


\textsuperscript{57} See infra Part II.A.

\textsuperscript{58} In re GlenFed, Inc. Sec. Litig., 42 F.3d 1541, 1546 (9th Cir. 1994); accord Leatherman v. Tarrant County Narcotics Intelligence and Coord. Unit, 507 U.S. 163, 168 (1993) (finding that to heighten a pleading standard, Congress, and not the judiciary, must act).
1. The House Version of the PSLRA

The PSLRA was first introduced on January 4, 1995, in the House as Title II of H.R. 10. The original draft included changes to the 1934 Exchange Act in both the substantive requirement of scienter and the pleading requirements. The draft added a section 10A(a) to the Exchange Act that required plaintiffs to plead that the defendant made the fraudulent statement knowingly and recklessly. It also added a new section 10A(b) to the Exchange Act, requiring a plaintiff to plead with specificity facts demonstrating the state of mind of each defendant at the time the statements were made.

Both the House Committee on Commerce and the Committee on the Judiciary received the bill for consideration. Throughout January and February of 1995, the Commerce Committee's Subcommittee on Telecommunications and Finance held hearings on H.R. 10. The Subcommittee called before it SEC representatives, corporate CEOs, and investors. On February 10, 1995, SEC Chairman Arthur Levitt testified that the proposal to require plaintiffs to prove that defendants had actual knowledge that the statements defendants made were false would be too difficult for many plaintiffs to do at the pre-discov-

60. H.R. 10 stated in pertinent part:

Sec. 10A REQUIREMENTS FOR SECURITIES FRAUD ACTIONS:

(a) SCIENTER.—In any action under section 10(b), a defendant may be held liable for money damages only on proof—

(1) that the defendant made an untrue statement of a material fact, or omitted to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading; and

(2) that the defendant knew the statement was misleading at the time it was made, or intentionally omitted to state a fact knowing that such omission would render misleading the statements made at the time they were made.

(b) REQUIREMENT FOR EXPLICIT PLEADING AND PROOF OF SCIENTER.— In any action under section 10(b) in which it is alleged that the defendant—

(1) made an untrue statement of a material fact; or

(2) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading; the complaint shall allege specific facts demonstrating the state of mind of each defendant at the time the alleged violation occurred. The complaint shall also specify each statement or omission alleged to have been misleading and the reasons the statement or omission is misleading. If an allegation regarding the statement or omission is made on information and belief, the complaint shall set forth with specificity all information on which that belief is formed. Failure to comply fully with this requirement shall result in dismissal of the complaint for failure to state a cause of action.

61. Id. § 10A(a).
62. Id. § 10A(b).
65. Id. at 39-237.
ery stage.\textsuperscript{66} Levitt also noted that the choice not to include recklessness on the part of large companies, in the definition of scienter, concerned the SEC,\textsuperscript{67} primarily because the SEC did not want to see substantive changes made in the meaning of scienter.\textsuperscript{68} The agency thought that “[l]iability for reckless misconduct was ‘needed to protect the integrity of the disclosure process which . . . represents the integrity of the markets.’”\textsuperscript{69} As a result of the testimony, the subcommittee amended H.R. 10 on February 14, 1995.\textsuperscript{70} The amended version continued to premise liability based both on recklessness and intentional

\textsuperscript{66} Id. at 191-221. In a hearing before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce, Professor Arthur R. Miller of Harvard University remarked that an identical 1994 proposal seems to suggest that at the outset of a case, the plaintiff must have the clearest proof of each individual defendant’s state of mind. That is totally unrealistic. It is only in the rarest of instances that this type of evidence exists. It would be impossible [to plead this type of evidence] in the vast majority of cases.

\textsuperscript{67} House Hearings, supra note 64, 201-02.

\textsuperscript{68} Id.


Chairman Levitt said:

We really want corporations—we want executives of corporations—to worry about the accuracy of their disclosures. It is the best way I know to assure the markets of a continuous stream of reliable, accurate information. Any higher scienter standard threatens the process that has made our markets what they are. Indeed, an actual knowledge standard could create a legal incentive to ignore indications of fraud. The phrase, “Ignorance is bliss,” could take on, unhappily, new meaning.

House Hearings, supra note 64, at 194-95. He continued:

The Commission has consistently supported a recklessness standard because such a standard is needed to protect the integrity of the disclosure process. The law should sanction corporations and individuals who act recklessly when making disclosures, because that is the only way to assure the markets of a continuous stream of accurate information. Any higher scienter standard would lessen the incentives for corporations and other issuers to conduct a full inquiry into areas of potential exposure, and thus threaten the process that has made our markets a model for nations around the world.

Id. at 202.

\textsuperscript{70} 141 Cong. Rec. D191 (daily ed. Feb. 14, 1995). The new text for Section 10A(a) read as follows:

(a) SCIENTER.—
deception.\textsuperscript{71} It now required plaintiffs to "make specific allegations which, if true, would be sufficient to establish scienter as to each defendant at the time the alleged violation occurred."\textsuperscript{72}

While the Committee took the SEC's advice as to recklessness, the SEC was still dissatisfied with the stringency of the pleading standard. The following day, the SEC issued a press release concerning the amended bill's pleading requirement and the reckless conduct standard.\textsuperscript{73} To plead scienter under the new House amendment, a plaintiff would have to plead specific allegations which would "sufficiently

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(1) IN GENERAL.—In any private action arising under this title based on
a misstatement or omission of a material fact, liability may not be established unless the defendant possessed the intent to deceive, manipulate, or defraud. The defendant may be found to have acted with such intent only on proof that—

(A) the defendant directly or indirectly made a fraudulent statement;
(B) the defendant possessed the intention to deceive, manipulate, or defraud; and
(C) the defendant made such fraudulent statement knowingly or recklessly.

(2) FRAUDULENT STATEMENT.—For purposes of paragraph (1), a fraudulent statement is a statement that contains an untrue statement of a material fact, or omits a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading.

(3) KNOWINGLY.—For purposes of paragraph (1), a defendant makes a fraudulent statement knowingly if the defendant knew that the statement of a material fact was misleading at the time it was made, or knew that an omitted fact was necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading.

(4) RECKLESSNESS.—For purposes of paragraph (1), a defendant makes a fraudulent statement recklessly if the defendant, in making such statement, acted with willful blindness such that the defendant was consciously aware of a high probability that the statement was false, and took deliberate actions in order to avoid ascertaining its truth or falsity. A defendant who actually believed the statement was true is not reckless.

Lerach & Isaacson, supra note 69, at 935-36 n.238 (quoting H.R. 10, Committee Print § 204 (Feb. 14, 1995) (emphasis added)).

71. The substitute provision on pleading scienter, for section 10A(b) read as follows:

Section 10A(b): (b) REQUIREMENT FOR EXPLICIT PLEADING AND PROOF OF SCIENTER.—In any private action to which subsection (a) applies, the complaint shall specify each statement or omission alleged to have been misleading, and the reasons the statement or omission is misleading. The complaint shall also make specific allegations which, if true, would be sufficient to establish scienter as to each defendant at the time the alleged violation occurred. It shall not be sufficient for this purpose to plead the mere presence of facts inconsistent with a statement or omission alleged to have been misleading. If an allegation is made on information and belief, the complaint shall set forth with specificity all information on which that belief is formed.

Id. at 936 n.239 (quoting H.R. 10, Committee Print § 204 (Feb. 14, 1995)).

72. Id.

establish” that the defendant acted knowingly or recklessly.4 According to the agency, the new “sufficient[ly] establish” standard would place undue burden on plaintiffs.5 The SEC pointed out that, at that time, the most stringent formulation of the pleading requirements mandated that plaintiffs plead facts giving rise to a “strong inference” of fraudulent intent.6

Despite the SEC’s concern, the amended H.R. 10 was reintroduced on the House floor on February 27, 1995 as H.R. 1058.7 Although the report from the subcommittee ultimately contained the SEC’s objection, the subcommittee declined to incorporate it into the legislation.8 Following some debate, an overwhelming majority of the House—325 votes to 99 votes—passed H.R. 1058.9

2. The Senate Version of the PSLRA

On January 18, 1995, Senator Domenici introduced S. 240, “Private Securities Litigation Reform Act of 1995,” to the Senate floor.80 S. 240 proposed a new section 39 to the Exchange Act, requiring plaintiffs to plead “specific facts” relating to the “state of mind” of each defendant.81 The bill was sent to the Senate Committee on Banking,

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4. See supra note 71.
5. See SEC Release, supra note 73. Levitt believed that the proposed provisions did not strike a balance between meritorious and strike suits and would adversely affect many investors. Id. The Commission disliked the new scienter standard in H.R. 10 because a plaintiff now had to “establish” that the defendant acted knowingly. The SEC felt that this would rule out the prior Second Circuit motive and opportunity test. Id.
10. 141 Cong. Rec. S1075-S1084 (daily ed. Jan 18, 1995). This legislation was a bipartisan bill.
11. S. 240, 104th Cong. § 39 (1995). The new section read as follows:
SEC. 39. REQUIREMENTS FOR SECURITY FRAUD ACTIONS
(a) INTENT.— In an implied private action arising under this title in which the plaintiff may recover money damages from a defendant only on proof that the defendant acted with some level of intent, the plaintiff’s complaint shall allege specific facts demonstrating the state of mind of each defendant at the time the alleged violation occurred.
(b) MISLEADING STATEMENTS AND OMISSIONS.— In an implied action arising under this title in which the plaintiff alleges that the defendant—
(1) made an untrue statement of a material fact; or
(2) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading; the plaintiff shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and
Housing, and Urban Affairs, where the Securities Subcommittee reviewed it.\(^8\)

The Subcommittee on Securities held hearings on S. 240 on March 2, March 22, and April 6, 1995.\(^3\) Again, among the many to testify before the Committee was SEC Chairman Levitt.\(^4\) He came before the subcommittee to ask the Senate to amend the legislation’s provisions relating to the pleading of scienter.\(^5\) Chairman Levitt said: “I would say that the standards for pleading a defendant’s state of mind should be conformed to the Second Circuit standard, that a plaintiff plead with particularity facts that give rise to a strong inference [of fraudulent intent].”\(^6\) He felt that by codifying the Second Circuit standard for pleading scienter, the goal of striking a balance between real suits and frivolous suits would be realized.\(^7\)

The Senate Banking Committee, consequently, added the “strong inference” standard of the Second Circuit to its legislation.\(^8\) The amended S. 240 added a new section 36 to the Exchange Act with language that required a plaintiff to “specifically allege facts giving rise to a strong inference that the defendant acted with the required state of mind.”\(^9\) The Committee adopted the Second Circuit standard because its efficacy had been tested by the Second Circuit.\(^10\)

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\(^{84}\) Id. at 228-36, 247-57.

\(^{85}\) Id. at 248-49.

\(^{86}\) Id. at 231.

\(^{87}\) Id. at 249.

\(^{88}\) Sec. 36 REQUIREMENTS FOR SECURITIES FRAUD ACTIONS.

(a) misleading statements and omissions.- In any private action arising under this title in which the plaintiff alleges that the defendant-

(1) made an untrue statement of a material fact; or

(2) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading; the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the plaintiff shall set forth all information on which that belief is formed.

(b) required state of mind.- In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the plaintiff’s complaint shall with respect to each act or omission alleged to violate this title, specifically allege facts giving rise to a strong inference that the defendant acted with the required state of mind.


Committee noted, however, that it did not intend to codify the case law that had been generated in the Second Circuit regarding this standard.  

The Banking Committee reported back to the full Senate in June of 1995. Senator Arlen Specter proposed an amendment that he believed would clarify the "strong inference" standard. His amendment essentially codified the test that the district courts of the Second Circuit had previously developed through case law. He proposed that language almost mirroring the Second Circuit test be added to the legislation:

(1)[A] strong inference that the defendant acted with the required state of mind may be established either—

(A) by alleging facts to show that the defendant had both motive and opportunity to commit fraud; or

(B) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness by the defendant.

Senator Specter believed that this additional language in S. 240 established guidelines for what would meet the strong inference pleading requirement for scienter. The opposition to the amendment expressed concerns that this amendment would expressly limit how a plaintiff could successfully plead scienter. Nevertheless, Senator Specter's amendment passed, by a vote of 57 to 42, and became part of S. 240. Thus, the Senate version of the PSLRA essentially codified the Second Circuit standard.

3. The Conference Committee Report on the PSLRA

At the Conference Committee called to rectify the differences between the House and Senate versions of the PSLRA, the Committee dropped Senator Specter's amendment from the proposed statute. The Committee also changed the language of the pleading requirement from requiring a plaintiff to "specifically allege facts" to "state

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91. Id.
94. Id.
98. Id.
with particularity” facts which give rise to a strong inference that the defendant acted with the required state of mind. On November 28, 1995, the final Conference Committee report and the accompanying Statement of Managers was submitted to both houses of Congress for approval.

Senator Dodd, who served as a manager on the Conference Committee for the Senate, explained that there was no debate at the Conference on the changed wording in the pleading standard, because the change came from the Judicial Committee. The Judicial Committee requested that the Conference Committee make a “change in the language of the statute...to conform with the language of Rule 9(b) of the Federal Rules of Civil Procedure, which governs how attorneys should draft fraud complaints.” Critics of the bill were concerned, however, about the Conference Committee’s pleading standard. In particular, many focused on the Statement of Managers that reported that the bill was not a codification of the Second Circuit standard but, rather, a more stringent requirement. Despite these concerns, the Conference Report passed the House by a vote of 319 to 100 and the Senate by a vote of 65 to 30.

4. The Presidential Veto

On December 20, 1995, President William Jefferson Clinton vetoed the PSLRA. Despite supporting the need for reform in securities fraud laws, he found that “the pleading requirements of the Conference Report with regard to a defendant’s state of mind impose[d] an unacceptable procedural hurdle to meritorious claims being heard in Federal courts.” President Clinton stated that he was willing to endorse the Second Circuit standard, but not the more stringent one de-
lineated in the Statement of Managers. He felt that any higher standard would preclude defrauded plaintiffs, with legitimate claims, from bringing suit in Federal court. President Clinton recognized the need to strike a balance between legitimate plaintiffs and plaintiffs who were filing "strike suits," and he was not comfortable that the PSLRA met that goal. 

B. Overriding the Veto: The New Pleading Standard

On December 20, 1995, the House reopened debate on the PSLRA. The Senate followed suit by reopening debate on December 21, 1995. After lively discussion on the floor of both houses, both the House and Senate voted to override President Clinton's veto and the PSLRA passed as an official amendment to the 1934 Exchange Act.

At all times during the discussion of the override, Congress kept the goal of the legislation in mind. Senator Feinstein addressed the Senate: "I want to protect the small investor... and yet do away with the kind of lawsuit that happens because a company's stock drops, a suit is filed, they press discovery and they move and collect a large settlement from the company, when the suit may be baseless." Despite an agreement on the common goal of the PSLRA, many Congresspersons still were confused by the language of the Statement of

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110. Id.
111. Id.
112. See id.
113. See id.

(b) Requirements for securities fraud actions
(1) Misleading statements and omissions
In any private action arising under this chapter in which the plaintiff alleges that the defendant---
(A) made an untrue statement of a material fact; or
(B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading; the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.
(2) Required state of mind
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.

Mangers concerning the "heightened standard." Although the Statement of Managers is not binding, it reflects Congress's perception of the meaning of the statute. Thus, many in Congress were concerned that the standard was too high. Enough Congresspersons, however, were convinced that the PSLRA standard was not unduly burdensome to permit override of Clinton's veto.

C. Utter Confusion Ensues: Three Lines of Cases

Despite its good intentions, the PSLRA has fallen far short of its goal to clarify the scienter pleading requirement. In fact, three distinct lines of cases have developed, each with a different interpretation of the PSLRA. The first line of cases follows the holding of *In Re Baesa Securities Litigation*. *Baesa* held that the PSLRA does not change what constitutes scienter, but does require a heightened pleading standard. The second line of cases, typified by *In re Silicon Graphics, Inc. Securities Litigation*, adopts the most stringent view of the "heightened" pleading standard imposed by the PSLRA. This court held that a plaintiff must plead circumstantial evidence of conscious behavior. The third line of cases, exemplified by *Pilarczyk v. Morrison Knudsen Corp.*, held that the PSLRA adopted the prior Second Circuit test and the Second Circuit case law interpreting the scienter pleading standard.

1. Heightened Pleading Requirement But No Change to the Substantive Requirement of Scienter

In *Baesa*, Judge Rakoff addressed the issue of the PSLRA's new pleading and scienter standard. The *Baesa* court concluded that the

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118. *See supra* note 105.
119. *See* Garcia v. United States, 469 U.S. 70, 76 (1984) ("[T]he authoritative source for finding the Legislature's intent lies in the Committee Reports on the bill, which 'represen[t] the considered and collective understanding of those Congressmen involved in drafting and studying proposed legislation.'" (quoting Zuber v. Allen, 396 U.S. 168, 186 (1969))); *see also* Resolution Trust Corp. v. Gallagher, 10 F.3d 416, 421 (7th Cir. 1993) (stating that a conference report is "the most persuasive evidence of congressional intent besides the statute itself").
124. 969 F. Supp. at 238.
PSLRA only changed the pleading requirement, leaving the substantive definition of scienter untouched.125

In November of 1993, Baesa, an Argentinean bottling company publicly traded on the New York Stock Exchange, entered an agreement with Pepsico, Inc.126 Pepsico acquired 24% of Baesa's common stock in exchange for 35 million dollars, various Pepsi bottling rights and distribution rights in Argentina, and the right to make certain Baesa management decisions.127 In 1996, the president of Baesa resigned and Pepsico took control of the company.128 Pepsico announced that Baesa had suffered substantial losses because of "accounting irregularities."129 Baesa shareholders filed a securities fraud suit against Baesa, claiming that between November 1995 and August 1996, Baesa issued "numerous false and misleading public statements that materially overstated the company's assets and earnings and effectively concealed the company's deteriorating financial position."130 The opinion of the court noted, however, that the "[c]omplaint [by the shareholders] [was] noticeably skimpy in setting forth particular facts from which one might strongly infer that Baesa ... or Pepsico had knowledge" that the financial reports were false.131

Judge Rakoff found that, when addressing the issue of securities fraud, courts must distinguish the mental state required to prove actual securities fraud cases from the pleading elements necessary to allege that mental state when the lawsuit is filed.132 According to the Baesa court, the PSLRA only addresses the latter issue.133 By focusing on the statutory language of the amendment, Judge Rakoff concluded that the definition of what constitutes scienter was not changed by the PSLRA,134 but rather that the PSLRA expressly altered what was required to plead—and not prove—scienter.135

Specifically, the Baesa court focused on the statutory language of section 21D(b)(2) to conclude that the substantive definition of scienter was not altered by the legislation.136 The court reasoned that its

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125. Id. at 242.
126. Id. at 240.
127. Id.
128. Id.
129. Id. "[T]he legally cognizable allegations of fraudulent conduct largely center on financial and other irregularities at Baesa's Brazilian subsidiary, a separate company known as 'PCE,' that is not a party to this case but the financial statements of which were included in Baesa's public reports." Id.
130. Id.
131. Id.
132. Id.
133. Id.
134. Id. at 241-42. Judge Rakoff cited to Director, Office of Workers' Compensation Programs, Dep't of Labor v. Greenwich Collieries, 512 U.S. 267, 280 (1994), to support his theory that, "[w]hen the statutory text is so plain," the court should not resort to legislative history. Basea, 969 F. Supp at 241.
135. Id. at 242.
136. Id. at 240.
definition of scienter would have to come from either another section of the Exchange Act or from existing case law. Because the Exchange Act does not define scienter, the Baesa court looked to case law. In prior cases, recklessness and intent to deceive had been deemed sufficient to meet the scienter definition. Thus, the court noted that, "[w]hile the Supreme Court remains free to overrule that determination, nothing in the [PSLRA] purports to do so." Consequently, Judge Rakoff concluded that while the PSLRA had changed the pleading standard, the underlying scienter element of a 10b-5 claim had not changed.

The Baesa court then examined what the PSLRA's pleading standard required. The language of the statute was suggested by prior law in the Second Circuit, and the statute did not "single[ ] out any . . . special kind of particulars as presumptively sufficient." Therefore, "[t]he conclusion follow[ed] from the plain language of the statute that the mere pleading of motive and opportunity [did] not . . . automatically suffice to raise a strong inference of scienter." Consequently, under the PSLRA, a plaintiff must "set forth sufficient particulars, of whatever kind, to raise a strong inference of the required scienter." Although pleading motive and opportunity would have satisfied the old Second Circuit pleading requirement, such a pleading, by itself, is no longer automatically sufficient under the PSLRA. The court made this point very clear:

This, of course, does not mean that particulars regarding motive and opportunity may not be relevant to pleading circumstances from which a strong inference of fraudulent scienter may be inferred. In some cases, they may even be sufficient by themselves to do so. But, under the Reform Act, and in contrast to prior Second Circuit precedent, they are not presumed sufficient to do so. Rather, under the Reform Act formulation, the pleadings must set forth sufficient particulars, of whatever kind, to raise a strong inference of the required scienter.

Although not engaging in its own interpretive analysis, the district court in Press v. Quick & Reilly noted that "[a] judge in this district has recently held, after thorough analysis of the . . . [PSLRA], a pleading of motive and opportunity alone is not sufficient to raise a strong

137. Id.
138. Id. at 240-41.
139. Id. at 241.
140. Id.
143. Id.
144. Id.
145. Id.
146. Id.
inference of fraudulent scienter."
Accordingly, a pleading now
must set forth particulars that give rise to "a strong inference that the
Defendants acted with fraudulent scienter." Consistent with the
Baesa court, the Press court found that even if motive and opportunity
were pled, there still needed to be facts alleged that gave rise to the
requisite "strong inference" of fraud. Consequently, the Press
court agreed with Baesa that the old Second Circuit test, while illustrative,
was no longer a dispositive way to plead scienter in 10b-5 cases.

2. A Heightened Pleading Standard Alters the Substantive Nature
   of Scienter

In September of 1996, the Northern District of California inter-
preted the PSLRA in In re Silicon Graphics ("Silicon Graphics I"). In
addressing the pleading requirement, the court argued that Con-
gress supplanted the Ninth Circuit's prior standard with the
PSLRA. Silicon Graphics I held that, under the PSLRA, neither op-
tion of the Second Circuit test is dispositive. Further, the court be-
lieved that Congress effectively altered the substantive nature of
scienter.

Silicon Graphics, Inc., a publicly traded corporation, "design[ed]
and [sold] desktop graphics work stations, multi-processor servers, ad-
vanced computing platforms, and application software." In late
August of 1995, Silicon Graphics stock was being traded for $44-7/8.
On October 19, 1995, Silicon Graphics announced a thirty-three per-
cent growth in revenue for the first quarter. Despite these show-
ings, the market considered this a disappointing result. In an effort
to reassure investors that Silicon Graphics would be able to meet its
growth targets, management "issued periodic updates . . . reasserting
its confidence about [its] second quarter results." Due to the confi-
dent remarks of the company's management, the stock price re-

Baesa, 969 F. Supp. at 238).
148. Id.
149. Id.
150. Id.
152. See supra note 29 and accompanying text.
154. Id.
155. Id. at *1.
156. Id.
157. Id.
158. Id.
159. Id.
bounded strongly, reaching the high $30 price range. By January of 1996, however, rumors of "lower than anticipated" results once again led the stock to plummet to "a low of $22 per share." Plaintiffs filed a class action complaint alleging violations of 10(b) on January 29, 1996.

The court dismissed this suit, with leave to amend, for failure to plead scienter adequately under the PSLRA. According to Judge Fern Smith, "Congress adopted a more stringent pleading standard" than previously used, when it enacted the PSLRA. The Silicon Graphics I court explained that "Congress did not simply codify the Second Circuit standard" but, in fact, intended to strengthen the pleading requirement.

The court first looked at the Conference Committee report accompanying the PSLRA. The court noted that the report explicitly stated that "it [did] not intend to codify the Second Circuit's case law" interpreting the "strong inference" pleading standard. The court also noted that by eliminating the Specter Amendment, which was essentially the codification of the Second Circuit standard, Congress cemented its intent to heighten the pleading standard beyond the old Second Circuit standard. Finally, the court turned to President Clinton's veto message and Congress's response: "Further emphasizing [Congress's] 'crystal clear' intent to heighten the pleading standard, Congress overrode the veto."

Although the court concluded Congress had eschewed the prior Second Circuit test for scienter, it also had to grapple with the PSLRA's pleading standard. In justifying its interpretation of the statute, the court explained: "[T]he authoritative source for finding the Legislature's intent lies in the Committee Reports on the bill, which 'represen[t] the considered and collective understanding of those Congressmen involved in drafting and studying proposed legislation.'" After reviewing this legislative history, the court held

162. Id. at *16.
163. Id. at *5.
164. Id. at *5.
“that plaintiff must allege specific facts that constitute circumstantial evidence of conscious behavior by defendants.” Because Congress did not include the motive, opportunity, and recklessness language from the Second Circuit standard, the court noted that the PSLRA adopted a stricter pleading standard. By requiring the pleading of conscious behavior, the Silicon Graphics I court effectively removed the opportunity for the plaintiffs to plead recklessness as a form of scienter.

The plaintiffs of Silicon Graphics I filed an amended class action complaint and, in May of 1997, Judge Smith again ruled that the complaint did not establish a “strong inference” of fraud. The Silicon Graphics II court relied on the legislative history of the PSLRA and the history of 10(b) actions to find that the Second Circuit standard was no longer sufficient to plead scienter. “After reviewing the arguments and the legal authorities, the Court believe[d] that its original interpretation [in Silicon Graphics I] was correct.”

Despite affirming its original ruling, the court noted that “[i]n certain areas of the law recklessness [was] considered to be a form of intentional conduct for purposes of imposing liability for some act.” The court explained that the Sundstrand standard that had been adopted by many circuits “appear[ed] compatible with the Supreme Court cases.” But, even within this standard, there “is conflicting authority about what constitutes scienter for purposes of Section 10(b).” One line of cases in the Second Circuit required “actual intent or circumstances implying actual intent before finding scienter.” The Silicon Graphics II court stated that this latter approach “[was] more consistent with Supreme Court precedent regarding Section 10(b) scienter.” Thus, the Silicon Graphics II court held that “[m]otive, opportunity, and non-deliberate recklessness may provide

Corp. v. Gallagher, 10 F.3d 416, 421 (7th Cir. 1993) (finding that a conference report “is the most persuasive evidence of congressional intent besides the statute itself”) and In re Kelly, 841 F.2d 908, 912 n.3 (9th Cir. 1988) (stating that committee reports, not “[s]tray comments by individual legislators,” provide the best expression of legislative intent).

173. Id.
175. Id. at 755-57.
176. Id. at 754.
177. Id. at 755 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976)).
178. Id. at 755. The Sundstrand standard is discussed in supra notes 21-25.
180. In re Leslie Fay Cos. Sec. Litig., 871 F. Supp. 686, 692 (S.D.N.Y. 1995) (finding that, for outside auditors, “only behavior which is either deliberate or so reckless that an inference of fraudulent intent might be drawn by a reasonable finder of fact” will constitute scienter (internal quotation marks and citation omitted)).
some evidence of intentional wrongdoing, but are not alone sufficient to support scienter unless the totality of the evidence creates a strong inference of fraud." It appears that although the court confirmed its Silicon Graphics I holding, it wavered as to whether evidence of recklessness could constitute scienter.

3. No Substantive or Pleading Requirement Changes: The Second Circuit Test is Still Valid

In direct opposition to the Silicon Graphics I holding, the district court in Pilarczyk v. Morrison Knudsen Corp. held that the PSLRA codified the Second Circuit standard that had previously been used to determine whether a plaintiff had met the pleading requirement for the 1934 Exchange Act. The Pilarczyk court represents the least stringent interpretation of the PSLRA.

The plaintiffs were principles in TMS, a N.Y. corporation engaged in the business of rebuilding turbochargers. In 1992, representatives of Morrison Knudsen Corporation (“MK”) approached several plaintiffs regarding the potential acquisition of TMS by MK. TMS received “glowing reports” about MK during the negotiation period. In fact, in 1991, the annual report of MK highlighted its successes. As a result, TMS agreed that MK would buy TMS.

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182. Id. at 757 (emphasis added).
183. Id. The Silicon Graphics I holding has been followed most recently in Friedberg v. Discreet Logic Inc., 959 F. Supp. 42 (D. Mass. 1997). Turning to the Conference Committee Report of the PSLRA to interpret the “strong inference” requirement, the Friedberg court pointed out that “[t]he Conference Committee regarded the Second Circuit pleading standard as the ‘most stringent pleading standard’ previously used by the circuits. Id. at 48 (citing H.R. Conf. Rep. No. 104-369, at 41 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 740). While acknowledging that the Second Circuit test was the strictest, the Committee expressed its desire to heighten it still further: “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.” Id. (quoting H.R. Conf. Rep. No. 104-369, at 41 & n.23, reprinted in 1995 U.S.C.C.A.N. 730, 740 & n.23). The court reasoned that if the Conference Committee had wanted to merely adopt the Second Circuit standard, then they would have adopted the Senate version of the legislation, S. 240. Id. at 48-49. From the Committee’s rejection of S. 240 (the Second Circuit test) and its embrace of an even higher standard, the Friedberg court concluded that the PSLRA commands a pleading standard stronger than that previously used in the Second Circuit. Id. (citing H.R. Conf. Rep. No. 104-369, at 41, reprinted in 1995 U.S.C.C.A.N. 740).
185. Id. at 313.
186. Id. at 314.
187. Id.
188. Id. The successes included: “(1) winning a $380 million Illinois contract to manufacture 313 cars, the largest transit award in MK history; and (2) a $155 million contract to build 88 cars for the California Department of Transportation.” Id. The court cited a 1991 report which stated that: MK is well-positioned to meet the growing needs of the vast transportation market. The company is unsurpassed in its ability to design, construct, man-
agreement was drawn up which provided that MK could acquire TMS for $14,000,000. The transaction would be structured as a tax-free reorganization in which TMS would exchange its stock for MK stock. The deal closed on December 30, 1992. On July 19, 1994, MK issued a press release announcing a 40.5 million-dollar loss. The plaintiffs alleged that “MK knew of certain problems in its rail systems business” when the deal was closed, but never alerted them to the problem.

According to Judge McAvoy, the requisite “strong inference” of fraud may be established by using the Second Circuit standard, as the Reform Act merely adopted the stringent pleading requirements of the Second Circuit. According to the Pilarczyk court, therefore, “[t]he requisite ‘strong inference’ of fraud may be established either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness.”

In Rehm v. Eagle Finance Corp., a district court in the Northern District of Illinois held that Congress did not adopt a more restrictive pleading standard than the Second Circuit standard and did not bind courts to any particular interpretation of the scienter standard when it passed the PSLRA. The court cited three factors as support for its interpretation of the PSLRA: the statutory language, the legislative history, and the purpose of the amendment to the 1934 Act.

The Eagle court found that the language of the PSLRA “mirror[ed] the language traditionally employed by the Second Circuit in its application of Rule 9(b) to scienter pleadings.” The court also found that the legislative history supported its interpretation of the PSLRA.

age construction, operate and finance complex infrastructure projects. MK also has gained a reputation for quality and excellence in both the manufacture of new rail cars and the remanufacture of rail cars and locomotives. MK is the only U.S.-owned and operated manufacturer of new transit cars necessary to meet the country’s growing urban transit needs.

Id. (citation omitted).
189. Id.
190. Id.
191. Id.
192. Id. at 315.
193. Id.
194. Id.
196. Pilarczyk, 965 F. Supp at 320 (citing In re Time Warner Inc. Sec. Litig., 9 F.3d 259, 268-69 (2d Cir. 1993)).
198. Id. at 1252.
199. Id.
200. Id.
The court noted that the Senate Banking, Housing, and Urban Affairs Committee remarked: "The Committee does not adopt a new and untested pleading standard that would generate additional litigation. Instead, the Committee chose a uniform standard modeled (sic) upon the pleading standard of the Second Circuit."\textsuperscript{201} Finally, the court believed that by adopting the Second Circuit standard, the "conflicting policy concerns underlying the act" would be satisfied.\textsuperscript{202}

III. \textit{In re Baesa: The Right Result, The Wrong Answer}

The \textit{Baesa} decision is the best statutory interpretation of the PSLRA. Although \textit{Baesa} represents the best reading of the PSLRA, it is not the best solution to the strike suit problems that Congress sought to eradicate. To properly resolve the strike suit problem, Congress should codify the tested and proven Second Circuit approach.

A. The \textit{Baesa} Court Got It Right

The \textit{Baesa} decision represents the correct interpretation of the PSLRA; the plain language of the statute and the circumstances surrounding its passage make it clear that the PSLRA heightened the pleading standard for scienter in 10b-5 actions, but did not go so far as to alter whether recklessness qualifies as scienter.\textsuperscript{203}

1. Heightened Pleading Standard for Scienter

Section 21D(b) of the PSLRA was specifically introduced to rectify the circuit split between the Second and Ninth Circuits.\textsuperscript{204} The split revolved around the required specificity of scienter pleading in 10b-5 actions.\textsuperscript{205} Courts agreed that conscious intent and some forms of recklessness constituted scienter.\textsuperscript{206} Thus, the circumstances surrounding the bill indicate that the PSLRA attempted to change the pleading requirements to get into court, not what a plaintiff would actually have to prove once there.\textsuperscript{207}

Furthermore, the overall goal of the PSLRA was to deter the filing of strike suits while still allowing meritorious suits to go forward.\textsuperscript{208}

\textsuperscript{202} Id.
\textsuperscript{203} Lerach & Isaacson, supra note 69, at 896 (stating that "[s]ection 21D(b)(2) scrupulously avoids any implication that it alters the standard for what actually constitutes scienter under the Exchange Act").
\textsuperscript{204} See supra Part I.B (discussing the pre-PSLRA circuit split).
\textsuperscript{205} See supra Part I.B.
\textsuperscript{206} See supra note 25.
\textsuperscript{207} Lerach & Isaacson, supra note 69, at 913 (noting that "[s]ection 21D(b)(2) preserves existing law for the state of mind necessary to establish liability").
To screen strike suits, the standard for scienter had to be heightened at the commencement of the suit. Congress was well aware that changing either the pleading or the substantive scienter standard to eliminate strike suits might preclude meritorious plaintiffs from the courtroom. Thus, Congress chose to strike such a balance by heightening only the pleading standard for scienter.  Baesa correctly realized that while Congress raised the pleading standard, it did not raise it so high as to preclude reckless conduct from constituting scienter.  Baesa recognized that Congress did not eliminate recklessness as a sufficient form of scienter for pleading 10b-5 actions, because it knew meritorious plaintiffs would be excluded from the courtroom because they would not be able to meet the higher standard without the benefits of discovery. Thus, the Baesa decision correctly reflects the balancing Congress intended.

The language of the statute, as well as the circumstances and history surrounding its passage, further illustrates that Congress only heightened the pleading standard—not the proof standard—for scienter in the PSLRA. In describing scienter, Congress’s choice of the wording,

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209. By requiring more of plaintiffs prior to the commencement of the law suit, Congress was effectively trying to curb the number of strike plaintiffs who file cookie cutter complaints with little factual backing for their claims. 141 Cong. Rec. S17,934 (daily ed. Dec. 5, 1995) (statement of Sen. D’Amato) (“The conference report stops abusive securities litigation before it starts. It will help to weed out frivolous complaints before companies have to start paying enormous legal bills.”).

210. See, e.g., 141 Cong. Rec. S17,936 (daily ed. Dec. 5, 1995) (statement of Sen. Sarbanes) (“This legislation will affect far more than frivolous suits. . . . This bill will make it more difficult for investors to bring and recover damages in legitimate fraud actions . . . .”). President Clinton was also concerned that the new standard would preclude legitimate plaintiffs from the courtroom. 141 Cong. Rec. H15,215 (daily ed. Dec. 20, 1995) (statement of President Clinton) (“I believe that the pleading requirements of the Conference Report . . . impose an unacceptable procedural hurdle to meritorious claims being heard in Federal courts.”).

211. See supra Part III.A.1. By increasing only the pleading standard and not changing the substantive nature of scienter, plaintiffs can still plead recklessness as a form of scienter. They will now have to allege more specific facts of recklessness or conscious intent to defraud. See infra Part III.A.2. Many observers have noted that eliminating recklessness as a form of scienter would preclude many meritorious suits. See Hearing on Private Securities Reform Act by the Subcomm. on Sec. of the Comm. on Banking, Hous. and Urban Affairs of the United States Senate, 104th Cong., (statement of Mark J. Griffin, Director, Division of Securities, Utah Department of Commerce, on behalf of the North American Securities Administrators Association). Arthur Levitt, Chairman of the SEC, testified before the House subcommittee that “a retreat from the recklessness standard would greatly erode the deterrent effect of private actions.” House Hearings, supra note 64, at 191-212 (statement of Arthur Levitt).


213. Many small investors will not be able to give detailed specifics to the fraud they are alleging without first having the benefit of discovery. The lack of information available to them prior to discovery is just too great to overcome.
“required state of mind,” indicates a desire to preserve the substantive definition of scienter. The U.S. Supreme Court has stated that “[a] fundamental canon of statutory construction is that, unless otherwise defined, words will be interpreted as taking their ordinary, contemporary, common meaning.”

The Court also has explained that, “Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation” when it uses the same language in another statute. Because Federal courts had long-settled the issue that intentional conduct and some form of recklessness met the definition of scienter, Congress’s inclusion of the “required state of mind” language in the PSLRA suggests that Congress maintained the substantive definition of scienter.

The fact that the PSLRA did not alter scienter in section 21D is also evident from two other passages of the statute. First, in the PSLRA, Congress changed the substantive nature of scienter for forward-looking statements in section 21E. The new law created a “safe harbor” that protects defendants from liability for forward-looking statements. If a plaintiff wants to plead fraud based on forward-looking statements the plaintiff must prove that the statements made by the defendant were made with “actual knowledge” that the statements were false. It would be redundant to include this provision if, in every 10(b) suit, a plaintiff had to plead “actual knowledge.”

Second, Congress carefully ensured that reckless conduct would not give rise to joint liability. Section 21D(g) states, with respect to that subsection, that a defendant “knowingly commits a violation of the securities law” only if she acts with “actual knowledge” of falsity.
Thus, when Congress wanted to alter the definition of scienter to require actual knowledge, it did so specifically in the PSLRA. Because there is no language indicating a substantive change in scienter in section 21D(b)(2), Congress must have intended scienter to remain unchanged for the typical 10b-5 suit.

At least one court has wrongly interpreted the PSLRA as changing scienter. As discussed above, the plain language of the PSLRA compels the courts to not read the PSLRA as altering the substantive nature of scienter. The Silicon Graphics I court, however, interpreted the statute to conclude that a "plaintiff must allege specific facts" of "conscious behavior" on the part of the defendant in order to meet the scienter requirement for securities fraud actions. The court's holding—requiring pleading of a "conscious" intent—directly conflicts with the "required state of mind" language of the statute, which, as shown earlier, must include reckless conduct as a form of scienter.

Silicon Graphics I effectively places a plaintiff in an impossible situation. While the court requires a plaintiff to plead scienter with something more than recklessness, at trial recklessness still would suffice as proof because the statute did not change the substantive scienter standard. This leaves the plaintiff in the untenable position of having to plead more to get into court than she has to prove once in court. The Supreme Court has said that when a reading of a statute leads to absurd results, the statute "[should] be given a reasonable application consistent with . . . the legislative purpose" of the stat-

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225. This is evidenced by the change in standard for forward looking statements and joint liability. See id. § 78u-5(c), 4(g)(2)(A). There is a cannon of statutory interpretation that supports this finding as well: expressio unius est exclusio alterius. This means that "expression of the one is exclusion of the other." Antonin Scalia, A Matter of Interpretation: Federal Courts and the Law 25 (1997). Thus, because the court included a specific caveat that recklessness did not qualify as scienter in two sections of the statute, it must qualify in the others.


227. See supra Part III.A.1.


229. See supra notes 207-24 and accompanying text.

230. Silicon Graphics I, 1996 WL 664639, at *6 ("Because Congress chose not to include that language from the Second Circuit standard relating to motive, opportunity, and recklessness, Congress must have adopted the Conference Committee view . . . . The Court therefore holds that plaintiff must allege specific facts that constitute circumstantial evidence of conscious behavior by defendants.").

231. See supra Part I.A (discussing the substantive nature of scienter).

233. United States v. American Trucking Ass'ns, 310 U.S. 534, 543 (1940) (noting that if interpreting the plain meaning of the words leads to "absurd or futile results... this Court has looked beyond the words to the purpose of the act"); see also Armstrong Paint & Varnish Works v. Nu-Enamel Corp., 305 U.S. 315, 332-33 (1938) (same).

234. In re Baesa Sec. Litig., 969 F. Supp. 238, 242 (S.D.N.Y. 1997) (noting that "[i]f the Reform Act... does nothing to disturb the substantive law of what is the required mental state for a securities fraud violation, it does expressly address, and alter, what is required to plead the requisite scienter").

235. See supra Part III.A.1.


237. Shannon v. United States, 512 U.S. 573, 583 (1994) (finding that legislative history must be "anchored in the text of the statute" in order for it to have interpretative weight).
ticularity facts giving rise to a *strong inference* that the defendant acted with the required state of mind.\(^\text{238}\)

Nowhere in the statute is the "strong inference" requirement defined.\(^\text{239}\) While these words have been defined in the context of the Second Circuit standard,\(^\text{240}\) when taken out of their fuller context, they no longer have the same meaning.\(^\text{241}\) Although presumably not a codification of the Second Circuit test, the adoption of the strong inference language suggests that the Second Circuit test may still provide some insight into the standard. Thus, the PSLRA standard remains somewhat vague and ambiguous; while it is possible to say that the old Second Circuit test is helpful, it is still difficult to discern the precise standard. The vagueness of the statutory language is further evidenced by the three different interpretations courts have given the "strong inference" phrase since the passage of the PSLRA.\(^\text{242}\) Because of the statute's ambiguous language, courts are justified in turning to the language of the legislative history to interpret the statute.\(^\text{243}\)

The legislative history of the PSLRA helps illuminate Congress's intentions. Some commentators have argued that Congress codified the Second Circuit standard.\(^\text{244}\) The legislative history reveals, however, that Congress had the opportunity to codify the language of the Second Circuit pleading standard, but it specifically declined to do so.\(^\text{245}\) Further, the "deletion [of the Specter Amendment] did not

\(^{238}\) 15 U.S.C. § 78u-4(b)(2) (1995) (emphasis added). The language had previously been used by the Second Circuit. See, e.g., Mills v. Polar Molecular Corp., 12 F.3d 1170, 1176 (2d Cir. 1993) (stating that "although Rule 9(b) allows a pleader to aver intent generally, a 10b-5 complaint nevertheless must allege facts that raise a strong inference of fraudulent intent"); Ross v. A. H. Robins Co., 607 F.2d 545, 558 (2d Cir. 1979) (requiring 10b-5 plaintiffs to plead facts which give rise to a "strong inference of knowledge").


\(^{240}\) See infra note 248.

\(^{241}\) If Congress intended to merely codify the Second Circuit standard, then they would have adopted more language from that standard. As noted above, a canon of statutory interpretation dictates that if Congress had adopted the Second Circuit standard, in its entirety, then it would have adopted the corresponding language. See supra note 216 and accompanying text. The Supreme Court has recognized that if language is taken from another statute, then Congress and the courts are presumed to know the interpretation. See supra note 215 and accompanying text.

\(^{242}\) See supra Part II.D.


\(^{244}\) See Lerach & Isaacs, supra note 69, at 956; see also Weiss, supra note 34, at 675 (finding that "most observers viewed [the PSLRA] as little more than a codification of the Second Circuit's long-standing interpretation of Federal Rule of Civil Procedure 9(b)").

\(^{245}\) See supra note 99 and accompanying text. The Conference Committee had S. 240 in front of it, which contained the Specter Amendment codifying the Second Circuit pleading standard. See 141 Cong. Rec. S9201 (daily ed. June 28, 1995) (adding the Specter amendment to S. 240, the bill that went to the Conference Committee from the Senate). Congress specifically chose not to adopt this language by deleting the
stand alone.\textsuperscript{246} The Conference Committee also made it clear that the Second Circuit test was no longer applicable to the pleading standard for securities fraud cases in the Statement of Managers:\textsuperscript{247}

Regarded as the most stringent pleading standard, the Second Circuit requirement is that the plaintiff state facts with particularity, and that these facts, in turn, must give rise to a “strong inference” of the defendant’s fraudulent intent. Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit’s case law interpreting this pleading standard.\textsuperscript{248}

In a footnote following this remark, the Conference Committee said, “[f]or this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness.”\textsuperscript{249} By using the Second Circuit language, but not including the Second Circuit test for pleading, Congress crafted a more stringent pleading requirement. Moreover, the Senate also made it clear that the PSLRA intended to heighten the pleading standard for scienter.\textsuperscript{250} The Senate Banking, Housing, and Urban Affairs Committee said:

The Committee does not adopt a new and untested pleading standard that would generate additional litigation. Instead, the Committee chose a uniform standard \textit{modeled upon} the pleading standard of the Second Circuit . . . . The Committee does not intend to codify the Second Circuit’s case law interpreting this pleading standard, although courts may find this body of law instructive.\textsuperscript{251}

The only proper interpretation of the foregoing comments is that the Senate adopted a more stringent standard than any previously being used. Because the Senate language—with the conscious deletion of the Specter amendment—was used in the PSLRA, it follows that the PSLRA adopted the most stringent pleading standard.

President Clinton also interpreted the new legislation as requiring a plaintiff to provide more factual information as to the nature of the


\textsuperscript{248} Id.

\textsuperscript{249} Id. at n.23.


\textsuperscript{251} Id. (emphasis added) (citations omitted).
fraud in the initial complaint filed with the court. He vetoed the act because he felt that a heightened pleading standard would prevent plaintiffs who had legitimate fraud suits, but needed discovery to uncover more facts, from getting their day in court. President Clinton had previously indicated to Congress he would support legislation that codified the Second Circuit pleading requirements. His refusal to support the PSLRA strongly suggests that the PSLRA contained a pleading standard more stringent than the prior Second Circuit standard.

The Baesa decision cites to the PSLRA’s legislative history to conclude that Congress intended to “raise[] the bar” for plaintiffs to get into court. Unlike the Silicon Graphics I court, however, the Baesa court recognized that the standard for pleading could only be raised so much as to not affect the substantive definition of scienter. According to the Baesa court, a plaintiff must “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” This means that “the pleadings must set forth sufficient particulars, of whatever kind, to raise a strong inference of the required scienter.” The court noted that the pleading standard does not “single[] out any special kind of particulars as presumptively sufficient” to meet the strong inference standard. The Baesa court does not, therefore, define exactly what particulars will constitute a “strong inference” of scienter; rather, it correctly leaves the exact standard open to a factual inquiry on a case-by-case basis.

253. Id.
254. Id.
255. See Coffee, supra note 246, at 523-24 (“Accordingly, proponents of a stricter standard might argue that in overriding the President’s veto, Congress was unequivocally adopting a stricter standard.”).
256. See supra Part II.D.1.
258. Id. (quoting the Reform Act language).
259. Id. (stating that “the mere pleading of motive and opportunity does not, of itself, automatically suffice to raise a strong inference of scienter . . . . [O]f course, [this] does not mean that particulars regarding motive and opportunity may not be relevant to pleading circumstances from which a strong inference of fraudulent scienter may be inferred”).
260. Id.
261. Id. The court noted that:

[T]he question then is whether the well-pleaded non-conclusory factual allegations of the Complaint, read most favorably to plaintiffs and with every reasonable inference construed in plaintiffs’ favor, state sufficient particulars to reasonably raise a strong inference that a given defendant participated in the making of the allegedly fraudulent representations or omissions . . . .

Id.
The *Pilarczyk* decision, conversely, does not comport with the legislative history of the PSLRA. By adopting the Second Circuit test, the *Pilarczyk* court expressly disregarded the Conference Committee's Report. Although this court puts forth the best policy solution to the current problem of pleading scienter, *Pilarczyk* is wrong on the law. Based on the statute's plain language and legislative history, the *Baesa* court interprets the law correctly. The *Baesa* decision leads to the conclusion that the PSLRA standard is vague and unclear. This is why further Congressional action is needed.

**B. Congressional Action Is Necessary to Fix the Mess**

Although the *Baesa* decision represents the best interpretation of the PSLRA, it does not strike the balance Congress intended. This Note proposes that Congress amend the Exchange Act again to rectify the further confusion it has created with respect to the pleading standard. The Second Circuit standard should be adopted by Congress because it gives fair notice to plaintiffs and because, substantively, it best strikes the best balance between meritorious and strike suits.

The Second Circuit encompasses New York City, the seat of the financial world and the home of the New York Stock Exchange. It thus has jurisdiction over innumerable securities fraud cases. The Senate explicitly recognized the Second Circuit as the "leading circuit" in the areas of securities fraud cases when it was determining which existing pleading standard the PSLRA should adopt, if any. Further, the Second Circuit has a wide body of case law exploring the limits of its pleading test.

By adopting the Second Circuit case law, Congress can effectively give fair notice to all plaintiffs of what the statute requires to get into court. A single standard, one that has case law to support it, will ensure that plaintiffs are treated uniformly. A plaintiff that has a claim in California (the Ninth Circuit) should be required to meet the same standard as that of a plaintiff in New York (the Second Circuit).

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263. *Id.* While legislative history is not authoritative, it should be used when statutes are unclear. See *Burlington N. R.R. v. Oklahoma Tax Comm'n*, 481 U.S. 454, 461 (1987).

264. *See infra* Part III.B.


266. *See, e.g.*, *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124 (2d Cir. 1994) (giving just one example of the many cases that the Second Circuit has decided in 10b-5 cases). Senator Dodd, a sponsor of the bill, said he believed the adopted standard was really the Second Circuit standard and that "[t]his legislation is there for [sic] using a pleading standard that has been successfully tested in the real world." 141 Cong. Rec. S8895 (daily ed. June 22, 1995).

267. Prior to the passage of the PSLRA, plaintiffs in the Ninth Circuit had an easier time pleading scienter than those plaintiffs in the Second Circuit. See *supra* Part I.B.
Judges in the Second Circuit have already delineated the contours of scienter under the test, making it easier for a plaintiff to know if they have sufficient facts to plead their 10b-5 case.

Besides yielding fair and uniform results, the Second Circuit test best strikes the balance between meritorious and strike suits:

[T]he continued availability of the Second Circuit criteria is consistent with the interests of institutional investors and their beneficiaries in enforcing the antifraud provisions of the federal securities laws. Allowing plaintiffs to satisfy the Act's standard through allegations of recklessness or motive and opportunity strikes the appropriate balance between encouraging greater corporate disclosure . . . and discouraging frivolous litigation without eviscerating protections against fraudulent conduct.\(^{268}\)

Given the sheer number of cases the courts within the Second Circuit have adjudicated, the Second Circuit has had the opportunity to delineate what facts will constitute scienter for pleading purposes. The following analysis of three Southern District of New York cases illustrates that the Second Circuit is well-versed in determining the limits of the scienter standard.

In Acito v. IMCERA Group, Inc.,\(^{269}\) for example, the plaintiffs claimed that IMCERA "misled the investing public by disseminating materially false information and failing to correct prior statements, in violation of Rule 10b-5."\(^{270}\) IMCERA produces three principal product lines: medical, specialty chemical, and agricultural and animal health products.\(^{271}\) In 1989, IMCERA's agricultural and animal health product subsidiary bought out Coopers Animal Health, Inc. ("Coopers") and acquired their Kansas City plant.\(^{272}\) As part of the consolidation, IMCERA applied for Federal Drug Administration ("FDA") approval for the manufacture of seven additional animal health products at the Coopers plant.\(^{273}\) The FDA inspected the plant, but found thirty-four deficiencies.\(^{274}\) Consequently, the FDA delayed approval for the products.\(^{275}\) In late 1991, IMCERA issued an annual report to its shareholders stating that its "position in the market was greatly enhanced by the acquisition of Coopers" and "expressed optimism for the upcoming year."\(^{276}\) The company repeated its optimism for the 1992 fiscal year in later announcements to the

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269. 47 F.3d 47 (2d Cir. 1995).
270. Id. at 50.
271. Id.
272. Id.
273. Id.
274. Id.
275. Id.
276. Id.
shareholders. On January 17, 1992, a FDA inspector gave IMCERA a “twenty-page report citing eighty-five manufacturing deficiencies uncovered at the Kansas City plant.” The day, IMCERA suspended production on seven products at the Coopers plant. IMCERA did not, however, notify the investing public of the suspension in production until February 18, 1992. “On February 19, as a result of the suspended sales and IMCERA’s new position on projected earnings, IMCERA shares dropped $4.50, or almost 12% . . . .” The plaintiffs claimed that IMCERA’s representation of an optimistic future, after the FDA noted deficiencies in their first two inspections, was materially misleading. The plaintiffs’ pleading alleged that IMCERA’s Chairman of the Board and former CEO, George Kennedy, had a motive and an opportunity to defraud investors.

The Plaintiffs attempted to plead the “motive and opportunity” option for scienter by alleging:

(1) all defendant officers of IMCERA were motivated to inflate the value of IMCERA stock because the increase in stock price had a direct effect on their executive compensation; (2) defendant Kennedy was motivated because he stood to benefit from the inflated value of IMCERA stock when he sold 384,000 shares in December and January; and (3) defendant Kennedy directly benefited from the delay because he sold 30,000 of his shares in January 28, 1992.

The court noted that the first claim was without merit. If this claim sufficed as scienter, “virtually every company in the United States that experience[d] a downturn in stock price could be forced to defend securities fraud actions.” The court further held that the second claim did not fulfill the motive requirement for scienter, because Kennedy’s stock sales occurred before the FDA disclosed the results of the third Coopers plant inspection. Further, the court explained that “the sale of stock by one . . . director does not give rise to a strong inference of an intent to deceive the investing public.” As to the third claim of motive, the court found that “unusual insider trading activity . . . may permit an inference of bad faith and scienter,” but the plaintiffs did not “establish that Kennedy’s stock sales were ‘unusual.’” To support its conclusion that the sales did not constitute unusual insider activity, the court stressed that no other defendant

277. Id. at 51.
278. Id.
279. Id.
280. Id.
281. Id.
282. Id.
283. Id. at 54.
284. Id.
285. Id.
286. Id.
287. Id.
288. Id.
sold their shares in the time period between the halt of production of some of the Kansas City products and public disclosure of the failed FDA inspection.\textsuperscript{289} For the above reasons, the Acito court found that pleadings of the plaintiff did not give rise to a "strong inference" of scienter.\textsuperscript{290}

In contrast, another court found that "motive and opportunity" was sufficiently pled to meet the scienter standard in RMED International, Inc. v. Sloan's Supermarkets, Inc.\textsuperscript{291} In this case, RMED, who purchased Sloan stock in late 1993, "allege[d] that defendants . . . fail[ed] to disclose to its shareholders and investors that defendants were targets of an investigation by the United States Federal Trade Commission ("FTC") concerning the illegal concentration in New York City of supermarkets" owned and controlled by the defendant.\textsuperscript{292} Before 1991, all Sloan's stores were owned by Old Sloans's.\textsuperscript{293} In April 1991, though, Red Apple (owned by the CEO of Sloan's, Catsimatidis) bought twenty-one Sloan's stores from Old Sloan's.\textsuperscript{294} The FTC began to investigate whether the sale of the 21 stores resulted in a violation of the antitrust laws.\textsuperscript{295} In March of 1993, Sloan's acquired another eleven Sloan's supermarkets from Old Sloan's (now operating under the name CKMR).\textsuperscript{296} "Thus, from April 1991 to [March of 1995], Red Apple . . . operated 21 Sloan's supermarkets and from March 1993 to [March 1995], Sloan's has operated 11 Sloan's supermarkets" throughout New York City.\textsuperscript{297} Catsimatidis was aware of the FTC investigation, but, "[n]evertheless, between February 28, 1993 and January 14, 1994, Sloan's communicated with its shareholders and made a number of SEC filings without ever disclosing the existence of the ongoing FTC investigation."\textsuperscript{298} One annual report from Sloan's even declared that they were still actively seeking additional stores in the food industry.\textsuperscript{299} On May 27, 1994, the FTC issued a complaint against Sloan's.\textsuperscript{300} As a result of this complaint, the stock price of Sloan's fell and did not recover.\textsuperscript{301} RMED subsequently filed suit against Sloan's for failing to disclose the FTC investigation.\textsuperscript{302}

\textsuperscript{289} Id.
\textsuperscript{290} Id.
\textsuperscript{291} 878 F. Supp. 16 (S.D.N.Y. 1995).
\textsuperscript{292} Id. at 17.
\textsuperscript{293} Id.
\textsuperscript{294} Id.
\textsuperscript{295} Id.
\textsuperscript{296} Id. The owner of Red Apple, Catsimatidis, was also the Chairman of the Board, CEO, Treasurer, and 37% stockholder of Sloan's. Id.
\textsuperscript{297} Id.
\textsuperscript{298} Id. at 18.
\textsuperscript{299} Id.
\textsuperscript{300} Id.
\textsuperscript{301} Id.
\textsuperscript{302} Id.
The RMED court found that the complaint "clearly alleg[ed] acts sufficient to establish that defendants had a motive to commit fraud and had an opportunity to do so."303 The court found that even though Sloan's may not have been able to predict the outcome of the FTC investigation, "the facts in the complaint sufficiently alleg[e]d that Catsimatidis knew that Sloan's was in potential jeopardy of either divestiture or restrictions on the future acquisition of supermarkets in New York City or both."304 Catsimatidis had a motive to maintain the appearance of financial health because "for the entire period of the FTC investigation, [he] was the president and sole shareholder of Red Apple. He was also chairman of the board, chief executive officer, treasurer and 37% shareholder of Sloan's."305 Further, the court held that the defendants clearly had opportunity "by failing to disclose the existence of the FTC investigation in the SEC filings or the communications to shareholders . . . ."306 Thus, the court found that the "motive and opportunity" test for defining scienter had been met.307

The RMED court also illustrates a positive finding of recklessness on the part of a defendant. According to the court, the "inference of recklessness necessary to satisfy the scienter requirement can be shown by 'facts demonstrating . . . that the defendant disseminated material "knowing [it was] false or that the method of preparation was so egregious as to render [the] dissemination reckless."'308 The court found three alleged facts that met the "recklessness" requirement for scienter:

1. Defendants' knew of the FTC investigation at the time RMED acquired 226,600 shares of Sloan's stock.
2. Defendants engaged in a continuous and prolonged pattern of misrepresentations and omissions in their SEC filings and communications to their shareholders . . . .
3. Catsimatidis had control over and intimate knowledge of Sloan's business, and therefore had a strong motive to keep Sloan's prospects appearing healthy.309

Because the FTC complaint alleged antitrust violations and sought relief in the form of divestment of Sloan's, the court explained that this indicated that Sloan's would be affected by the resolution of the FTC complaint.310 The court held, therefore, that the defendants acted

303. Id. at 19.
304. Id.
305. Id.
306. Id.
307. Id.
309. Id. at 20 (citation omitted).
310. Id.
recklessly in failing to inform RMED of the pending FTC investigation. Consequently, scienter was adequately pled.

Finally, the district courts in the Second Circuit have well developed case law on the limits of pleading recklessness. Their expertise is illustrated by the case of Plymack v. Copley Pharmaceutical, Inc. Copley is a manufacturer of generic drugs. The plaintiffs "purchased Copley stock in February 1988 through a private placement arranged by . . . Ladenburg, a New York investment advisory firm." At the time the plaintiffs bought their stock, 23% of Copley was owned by Harder Pharmaceutical Limited Partnership ("HPLP"). The Ladenburg group bought approximately 6% of the Copley stock. Terrence Harder and John Moroney represented HPLP and the Ladenburg group on the Copley board of directors, respectively. In April 1991, HPLP wished to sell its interest in Copley, and Harder said that HPLP wished to hire Ladenburg to find a buyer. Moroney stated that if HPLP sold its shares, Ladenburg should also sell its shares. In September 1991, TA Associates ("TA") "cold called" a person at Copley. Copley offered TA the HPLP/Ladenburg block of stock, but TA declined this offer. Instead, TA proposed "a three-way transaction." According to the deal:

TA would buy convertible, interest-bearing debentures in Copley, and Copley, using the funds injected by TA along with some of its own cash, would purchase the stock held by HPLP and the Ladenburg group. The closing of the TA-Copley debenture transaction was conditioned on Copley's purchasing all of the shares comprising the HPLP-Ladenburg group block.


311. Id. at 19-20.
312. Id. at 20.
314. Id. at *1.
315. Id.
316. Id.
317. Id.
318. Id.
319. Id.
320. Id.
321. Id. "A cold call is the practice of making unsolicited calls to potential customers by brokers. Brokers hope to interest customers in stocks, bonds, mutual funds, financial planning, or other financial products or services in their cold calls." Dictionary of Finance and Investment Terms 93 (John Downes & Jordan Elliot Goodman eds., 4th ed. 1995).
322. Id.
323. Id.
324. Id.
325. Id. at *2.
326. Id. at *2 n.4.
statement with the SEC.\textsuperscript{327} Subsequently, in October 1992, Copley made an initial public offering of its stock.\textsuperscript{328} On March 29, 1993, Herbert Hochberg, an investment banker for Landenburg who had helped Moroney on the Copley sale, “notified plaintiffs that Landenburg believed that Copley had provided Landenburg with false and misleading information about Copley’s financial condition and future prospects prior to closing.”\textsuperscript{329} Plaintiffs alleged that Landenburg acted recklessly by failing to obtain accurate and relevant information about Copley prior to their investment in the stock.\textsuperscript{330}

The \textit{Plymack} court recognized that pleading recklessness was one way to meet the scienter requirement for securities fraud cases.\textsuperscript{331} The court noted, however, that a “claim premised on recklessness [could not] stand where plaintiffs [had] not established facts leading to an inference of wilful [sic] blindness, and, in particular, where defendant had no apparent motive ‘for deliberately shutting [its] eyes’ to the truth.”\textsuperscript{332} Although the plaintiffs alleged that there had been “storm warnings” that Landenburg should have seen with regard to information Copley gave Landenburg,\textsuperscript{333} the court believed that the plaintiffs’ claims were merely “allegation[s] of recklessness,” insufficient to constitute scienter.\textsuperscript{334}

\textbf{Conclusion}

In passing the PSLRA, Congress properly decided to resolve the unsettled nature of 10b-5 pleading and strike a balance between meritorious and frivolous fraud suits. Despite these worthwhile goals, the standard Congress instated is shrouded in ambiguity. Although the statute’s text and history compel the conclusion that the PSLRA’s pleading standard is more stringent than the prior Second Circuit test, the exact standard specified remains unclear. It is thus Congress’s job—the job of the policy-making organ of the federal government—to implement a new 10b-5 pleading standard. The Second Circuit’s test (and expertise) should be adopted by Congress because it strikes the best balance between strike and meritorious suits and implements a uniform, well tested pleading standard.

\textsuperscript{327} \textit{Id.} at *2.
\textsuperscript{328} \textit{Id.}
\textsuperscript{329} \textit{Id.}
\textsuperscript{330} \textit{Id.} at *5.
\textsuperscript{331} \textit{Id.} at *6.
\textsuperscript{332} \textit{Id.} (last alteration in the original) (quoting \textit{In re Fischbach Corp. Sec. Litig.}, No. Civ. 89-5826, 1992 WL 8715, at *3, *6 (S.D.N.Y. Jan. 15, 1992)).
\textsuperscript{333} \textit{Id.}
\textsuperscript{334} \textit{Id.}