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PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 AND INVESTORS' RIGHTS

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On Dec. 22, 1995, the U.S. Senate voted 68 to 30¹ to override President Bill Clinton's veto of the Private Securities Litigation Reform Act of 1995. Following the House of Representatives' similar vote two days earlier, the act thereby became law effective immediately. The act shifts the balance of power in federal securities litigation away from investors. The significance of the shift is demonstrated by the surge of lawsuits filed by investors in the days just before the act became law. This article discusses the history behind the act, its major provisions, and the impact it will have on investors' abilities to bring claims for securities fraud.

HISTORY OF FEDERAL SECURITIES FRAUD CLAIMS

During the past 20 years, a cottage industry of lawyers who specialize in representing investors in class action lawsuits against corporations, their directors and officers, auditors, and attorneys has gained prominence. Lawyers have been attracted to these cases in the past by the court-approved attorney's fee, which has typically been a percentage of the recovery or a multiple of the time invested by the lawyers (commonly known as the lodestar).

Investors' abilities to bring claims under federal securities laws² was greatly enhanced by a 1971 Supreme Court decision, *Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co.*³ In *Banker's Life*, the Court ruled that, although not expressly provided, a private cause of action was implied by Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5⁴. Rule 10b-5 was drafted almost nonchalantly in 1942 as an attempt to close a loophole in the existing rules. When the issue of fraud in the purchase of securities arose, Milton Freeman, a drafter of the rule, made an appointment with the Securities and Exchange Commission (SEC). According to Freeman:

I do not remember whether we got there that morning or after lunch. We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, "Well," he said, "we are against fraud, aren't we?" That is how it happened.

JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5.⁵

The basic elements of a cause of action under Rule 10b-5 are (1) a misrepresentation or omission of fact; (2) which is material; (3) made with fraudulent intent ("scienter"); (4) in connection with a purchase or sale of securities; (5) upon which the plaintiff relied; and (6) the statement or omission was the proximate cause of the loss.⁶

RECENT JUDICIAL DECISIONS HAVE DIMINISHED INVESTORS' ABILITIES TO RECOVER UNDER FEDERAL SECURITIES LAWS

An increasingly conservative federal judiciary has greatly limited the ability of investors to bring claims under federal securities laws. Indeed, some of the "reforms" in the Securities Litigation Reform Act are really just codifications of recent judicial decisions.

I. SHORTENED STATUTE OF LIMITATIONS

The trend began in 1991, when the U.S. Supreme Court decided the case of *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*.⁷ Before *Lampf*, the prevailing view was that the statute of limitations and repose for fraud claims under Rule 10b-5 was established by "borrowing" from the statute of limitations provided by the most analogous state law. In some states, the statute was as long as six years from discovery of the fraud.⁸ In *Lampf*, the Court established a uniform statute of limitations for securities fraud claims under Rule 10b-5, requiring claims to be brought within one year of discovery and no more than three years from the allegedly fraudulent transaction.⁹

II. PLEADING WITH PARTICULARITY REQUIRED

Courts in securities cases have applied greater scrutiny to pleading requirements under Rule 9(b) of the Federal Rules of Civil Procedure. Rule 9(b) requires a plaintiff to plead fraud with particularity. Some courts, including the 2nd Circuit Court of Appeals, have recently ruled that the allegations must create a "strong inference" of scienter, or fraudulent intent.¹⁰

III. NO AIDING AND ABETTING LIABILITY

The Supreme Court also recently ruled that an investor cannot bring a claim against someone who, although not directly involved in the fraud, assisted in the fraud by aiding and abetting.¹¹

IV. SECTION 12(2) CLAIMS DO NOT APPLY TO PRIVATE OFFERINGS

Section 12(2) of the Securities Act of 1933 provides a cause of action for prospectus fraud.¹² Section 12(2) does not require scienter but instead puts the burden of proving a lack of intent (and a lack of negligence) on the defendant. Moreover, Section 12(2) may not require a showing of reliance.¹³ Until recently, many practitioners believed that Section 12(2) applied to private placement of securities as well as to public offerings. In *Gustafson v. Alloyd Co.*,¹⁴ however, the Supreme Court resolved the issue, again limiting the rights of investors, by holding that Section 12(2) does not apply to private transactions.

V. THE RISE OF THE "BESPEAKS-CAUTION" DOCTRINE

The "bespeaks-caution" doctrine eliminates liability for incorrect forward-looking statements, such as projections, if they are accompanied by "meaningful cautionary statements." The 3rd Circuit explained that "bespeaks caution" is essentially shorthand for the well-established principle that a statement or omission must be considered in context, so that accompanying statements may render it immaterial as a matter of law.¹⁵ Although the "bespeaks-caution" doctrine originated in a 1977 decision,¹⁶ only recently has the doctrine been applied regularly.¹⁷

VI. THE SECURITIES LITIGATION REFORM ACT

The Securities Litigation Reform Act resulted from extensive lobbying by the accounting industry, the securities industry, and high-technology companies who have been more susceptible to lawsuits because of the volatility of their stocks. Reform was also supported by public retirement funds. Moreover, litigation reform was part of the Republican Party's "Contract with America." Among those who opposed the act were consumer advocates such as Ralph Nader, who called its enactment a victory for "financial crooks and swindlers."¹⁸

The bill was passed on Dec. 6, 1995, but vetoed by President Clinton on Dec. 19, 1995. In a message to Congress accompanying the bill, President Clinton expressed his support for the stated goals of the bill, but said he could not sign the bill as written and as interpreted by the Statement of Managers (the explanatory statement written by the House-Senate Conference Committee). President Clinton expressed his view that the bill would "have the effect of closing the courthouse door on investors who have legitimate claims."¹⁹

After President Clinton vetoed the bill, the SEC issued a press release saying that, though it opposed the version passed, it remained committed to responsible litigation reform and pledging to provide assistance. On Nov. 15, 1995, SEC Chairman Arthur Levitt sent a letter to Senate Banking Committee Chairman Alfonso D'Amato, R-N.Y., supporting one portion of the bill. The SEC has not publicly commented on the act since Congress overrode the veto.

KEY PROVISIONS OF THE SECURITIES LITIGATION REFORM ACT

The act contains three titles. Titles I and II are directed to reforming the litigation process by attempting to reduce what Congress perceived as abusive litigation and coercive settlements. Title III requires auditors, key beneficiaries of Titles I and II, to detect and disclose fraud in some instances, but does not impose civil liability for failure to do so.

How the Securities Litigation Reform Act Changes Securities Litigation:

- "Professional plaintiffs" are discouraged through a variety of procedural and economic disincentives.
- Institutional investors are encouraged to act as class representatives.
- The settlement process is revamped to limit counsel fees and increase the availability and value of settlement notices to the class.
- An automatic stay of discovery pending the court's ruling on a motion to dismiss is provided.
- Joint and several liability is abolished in favor of proportionate liability in some cases where violations are deemed to be "unknowing."
- Courts are required to make specific findings about compliance with Rule 11, and there is a rebuttable presumption in favor of fee shifting for violations. Courts may require a bond to cover such sanctions.
- Securities fraud must be pled with greater specificity.
- A formula for calculating damages is provided by statute.
- Liability for projections is eliminated if accompanied by meaningful cautionary statements.

Key Proposals that were not included:

- Proposals to lengthen the statute of limitations for private securities fraud actions.
- Proposals to impose aiding and abetting liability for reckless, in addition to intentional, conduct.

I. "PROFESSIONAL PLAINTIFFS" ARE DISCOURAGED IN FAVOR OF INSTITUTIONAL INVESTORS

Congress was concerned about litigation started by so-called "professional plaintiffs" who purchase a small number of shares of many corporations, sometimes on the advice of class action lawyers, in order to quickly file a class action lawsuit on an announcement of bad news about any one of the companies. In some instances, professional plaintiffs have earned a bounty or other financial reward. Congress discouraged such individuals in procedural and economic ways.

Under the act, plaintiffs who seek to represent a class must make certain sworn representations and promises at the time the lawsuit is filed. Among other things, they must represent that they reviewed and authorized the complaint, and did not purchase the subject security at the direction of counsel or in order to participate in litigation. They must also disclose all of their transactions in the subject security, and disclose all other cases in the prior three years in which they sought to represent a class. Finally, they must promise to provide deposition and trial testimony. No one can be a lead plaintiff more than five times in a three-year period without consent of the court. And lead plaintiffs can recover no more than their allocated share of the recovery, plus their actual costs.

Institutional investors, on the other hand, are encouraged to act as class representatives. The plaintiff filing the case must publish notice of the lawsuit in a national business-oriented publication within 20 days of filing. Any investor wishing to be class representative—and to select class council—can file a motion within 60 days thereafter. The investor with the largest financial stake in the litigation is presumed to be the most representative plaintiff.

II. SETTLEMENT NOTICES MUST INCLUDE CERTAIN MINIMUM INFORMATION

Congress was concerned that class members sometimes were not adequately informed about the terms of class action settlements. Under the act, settlement notices must state the amount of potentially recoverable damages as compared with the settlement amount, the attorneys' fees and costs to be awarded, and the reasons for settling—all in plain English. The act limits counsel fees to a reasonable percentage of the total recovery to the class, but does not dictate the method for determining counsel fees.

III. DISCOVERY IS STAYED PENDING A MOTION TO DISMISS

An additional concern of Congress was the cost of discovery. Congress was concerned that the high cost of class action discovery was a coercive pressures that caused innocent defendants to settle meritless litigation—and, accordingly, encouraged plaintiffs to file meritless lawsuits. To minimize that coercive pressure, the act provides for an automatic stay of discovery pending the court's ruling on a motion to dismiss. It is unclear whether the stay is imposed when defendants move to dismiss only part of the lawsuit.

IV. JOINT AND SEVERAL LIABILITY IS REPLACED BY PROPORTIONATE LIABILITY

Under a system of joint and several liability, joint tortfeasors are each liable for the investor's entire loss. Congress was concerned that, as a result, defendants with relatively little culpability were being forced to pay the entire loss because the more culpable defendants were often judgment-proof. Some believe that joint and several liability contributed to the increase in lawsuits by creating coercive pressure for innocent parties to settle meritless lawsuits rather than risk being held liable for the plaintiff's entire loss.

Under the act, joint and several liability is eliminated in all cases except where the defendant's violation was "knowing" *or* when the plaintiff's loss was more than 10 percent of his or her net worth so long as the plaintiff's net worth does not exceed \$200,000. In place of joint and several liability, Congress adopted a system of proportionate liability.

Under proportionate liability, the jury will be asked to assign (as a percentage) responsibility for the plaintiff's loss to all persons claimed by any party to have been responsible. Defendants will pay only for their share of the total damages. If one or more responsible parties are judgement-proof, their liability is allocated back to the other responsible parties. No party, however, shall be required to pay more than a total of 150 percent of its own proportionate share of the loss.

The change from joint and several liability to proportionate liability is perhaps the most significant change included in the act. It applies to individual as well as to class actions, and shifts more of the risk that some defendants will be judgement-proof from the joint tortfeasor to the investor.

V. RULE 11 IS ENHANCED AND AN AWARD OF ATTORNEYS' FEES IS PRESUMED TO BE THE APPROPRIATE SANCTION

The act requires the court to make specific findings at the conclusion of the lawsuit as to whether all parties and attorneys have complied with Rule 11 of the Federal Rules of Civil Procedure. If the court finds a violation, the act mandates a sanction and creates a rebuttable presumption that the appropriate sanction for a "substantial violation" is an award to the prevailing party of all attorneys' fees and costs that it incurred in the entire case. In class actions, the act gives the court discretion to require the parties and their attorneys to post a bond or provide other security to pay costs and fees that may be awarded.

These provisions contributed to President Clinton's decision to veto the bill. President Clinton argued in his message to Congress that these provisions were too close to a "loser-pays" system and treated plaintiffs more harshly than defendants.

VI. ENHANCED PLEADING STANDARDS LEGISLATED

The act requires the plaintiff to plead with specificity each statement or omission that is misleading and the reasons that the statement or omission is misleading. Additionally, the complaint must plead facts which provide a strong inference that the defendant acted with fraudulent intent.

While the language of the act appears consistent with the 2nd Circuit's application of Rule 9(b),²⁰ the Conference Committee report notes that Congress did not intend to codify the 2nd Circuit law on the subject. Instead, the committee intended to strengthen existing pleading requirements.

President Clinton, noting that he would support a codification of the 2nd Circuit's pleading standard, argued that the Conference Committee's interpretation of the act went even further and was too likely to be relied on by judges interpreting the act. Interestingly, in debate after President Clinton's veto, Sen. Pete Domenici, R-N.M., one of the Senate conferees, argued that the pleading standard of the act *was* the 2nd Circuit's standard.

VII. DAMAGES ARE CALCULATED ACCORDING TO A NEW FORMULA

Damages in securities cases have been calculated a number of ways—some of which Congress believed gave some investors a windfall. Congress was concerned that forces other than the fraud might be responsible for some of the loss. To address these concerns, the act requires damages in most cases to be calculated based on the difference between the investor's purchase or sale price and the average trading price of the security during the 90-day period beginning on the day the true information is disseminated to the public.

VIII. "BESPEAKS-CAUTION" DOCTRINE IS CODIFIED AS A SAFE HARBOR

One of the most controversial provisions of the act is the provision to provide a safe harbor for companies who wish to disseminate their projections. The safe harbor allows companies to publish projections (which must be clearly identified as forward-looking statements) without fear of civil liability if the projections are accompanied by "sufficient and meaningful cautionary statements" identifying important factors that could cause actual results to differ from those projected.

Opponents of the act such as Ralph Nader argued that the provision would give "corporate America" a license to deceive. Proponents of the act argued that the fear of litigation was chilling the "robustness and candor of disclosure."²¹

President Clinton supported the language of the act on this issue. He took exception to the Conference Committee's report, however, arguing that it weakened the cautionary language that the act itself contained. President Clinton expressed concern that courts would place too much reliance on the report. SEC Chairman Arthur Levitt also supported this provision of the act.

In spite of all the controversy, however, this provision may not be revolutionary. The "bespeaks-caution" doctrine, discussed above, provides much of the same protection in those courts that have embraced the doctrine. The act's safe harbor does not apply to projections made in conjunction with initial public offerings, tender offerings, and penny-stock offerings. And it does not apply to companies that have been judicially or administratively sanctioned for securities fraud during the prior three-year period.

IX. SECURITIES FRAUD NO LONGER CONSTITUTES RACKETEERING FOR PURPOSES OF CIVIL RICO

The act amends the Racketeer Influenced and Corrupt Organizations Act (RICO) to exclude acts that constitute securities fraud from the definition of racketeering. Securities fraud

defendants are thereby freed from the threat of treble damages or other severe remedies available under RICO.

X. THE SEC'S AUTHORITY TO PROSECUTE AIDERS AND ABETTERS IS CONFIRMED

After *Central Bank of Denver*²² (discussed above), there was some question whether the SEC had authority to prosecute parties who "aid and abet" securities fraud. The act resolves the question by expressly providing that authority.

XI. AUDITORS MUST DETECT AND DISCLOSE ILLEGAL ACTS

Title III of the act requires auditors to include procedures designed to detect illegal acts. If in their audits illegal acts are discovered, regardless of whether the illegal acts could have a material effect on the company's financial condition, the auditor must disclose them to the company's management or board of directors. The company is then, in turn, required to disclose them to the SEC. If the company fails to make disclosure to the SEC, the auditor must resign and report the illegal acts directly to the SEC.

ALTERNATIVES AVAILABLE TO WRONGED INVESTORS

Although the act plainly reduces investors' rights—and contrary to the protest of some critics of the act—victims of securities fraud are not left without remedies. In particular, securities industry arbitration provides an efficient forum for investors to bring claims against brokerage firms and investment bankers. State law claims, such as those under Minnesota's Securities Act²³ and the Consumer Fraud Act,²⁴ are good alternatives to federal claims. Those state law claims provide for an award of attorneys' fees to the victim of securities fraud—a remedy that is not available under the federal statutes.²⁵

Moreover, the act requires the SEC, within six months of the date of enactment, to study the impact of the act on senior citizens and qualified retirement plans. If the SEC concludes that senior citizens and qualified retirement plans require more protection, it is to make appropriate recommendations to Congress. No doubt there will be amendments to the act.

Finally, although the act establishes significant hurdles and disincentives to bringing federal securities law claims in federal court, it does not prohibit them. The best claims will still be brought and will still be successful. As with any significant legislation, judicial interpretation and future amendments will be important guides to practitioners.

¹ Two days earlier, the House of Representatives voted 319 to 100 to override the veto. Minnesota's senators and representatives voting to override the veto were Sen. Rod Grams, and Reps. Gil Gutknecht, David Minge, James Ramstad, Bruce Vento, Martin Sabo, and Bill Luther. Sen. Paul Wellstone and Rep. James Oberstar voted against the override. Rep. Colin Peterson did not vote.

² The primary federal securities laws are the Securities Act of 1933 (15 U.S.C. § 77a *et seq.*) and the Securities Exchange Act of 1934 (15 U.S.C. § 78a *et seq.*), Other federal

securities laws include the Investment Advisors Act of 1940 (15 U.S.C. § 80b-1 *et seq.*); the Investment Company Act of 1940 (15 U.S.C. § 80a-1 *et seq.*); and the Securities Investor Protection Act of 1970 (15 U.S.C. §§ 78aaa-111).

³ Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971).

⁴ 17 C.F.R. § 240.10b-5.

⁵ A. Jacobs, *Litigation and Practice Under Rule 10b-5* § 5.02 (1995)(quoting Freeman, *Conference on Codification of the Federal Securities Laws*, 22 Bus. Law. 793, 922 (1967)); also quoted in SEC v. Clark, 915 F.2d 439, 451 (9th Cir. 1990).

⁶ Davidson v. Wilson, 973 F.2d 1391, 1400 (8th Cir. 1992).

⁷ *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991).

⁸ The time of discovery has been defined as when the investor receives "inquiry notice" – that is, when the investor becomes aware of facts that would lead a reasonable person to investigate. *Trogenza v. Great Am. Communications Co.*, 12 F.3d 717 (7th Cir. 1993).

⁹ The Court went on to rule that *Lampf* applied retroactively to all cases then pending. Congress, concerned with the application of *Lampf* to pending cases, enacted Section 27A(b) of the 1934 Act, which in essence reversed *Lampf* as to pending cases. Congress' action was ultimately ruled unconstitutional in *Plaut v. Spendthrift Farm, Inc.*, 115 S. Ct. 1447 (1995).

¹⁰ *See, e.g.*, *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994); *Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1176 (2d Cir. 1993); *Weisburgh v. St. Jude Medical, Inc.*, 158 F.R.D. 638, 642 (D. Minn. 1994), *aff'd*, 62 F.3d 1422 (8th Cir. June 29, 1995).

But see In re GlenFed, Inc. Sec. Litig., 42 F.3d 1541, 1545 (9th Cir. 1994) (rejecting the 2nd Circuit's view as irreconcilable with Fed. R. Civ. P. 9(b)).

¹¹ *Central Bank of Denver v. First Interstate Bank of Denver*, 114 S. Ct. 1439 (1994). Persons who aid and abet, however, may still have direct liability under the securities laws:

Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met.

Id. at 1455 (emphasis in original).

¹² 15 U.S.C. §§ 77b(10), 771(2).

¹³ *See, e.g.*, *Austin v. Loftsgaarden*, 675 F.2d 168, 176 n. 16 (8th Cir. 1982), *rev'd on other grounds sub nom.* *Randall v. Loftsgaarden*, 478 U.S. 647 (1986).

¹⁴ *Gustafson v. Alloyd Co.*, 115 S.Ct. 1061 (1995).

¹⁵ *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 371 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1219 (1994).

¹⁶ *See Polin v. Conductron Corp.*, 552 F.2d 797 (8th Cir. 1977), *cert. denied*, 434 U.S. 857 (1977).

¹⁷ *See Moorhead v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 949 F.2d 243, 245-46 (8th Cir. 1991); *Saltzberg v. TM Sterling/Austin Assoc., Ltd.*, 45 F.3d 399, 400 (11th Cir. 1995); *Romani v. Shearson Lehman Hutton*, 929 F.2d 875, 879 (1st Cir. 1991); *I. Meyer Pincus & Assoc., P.C. v. Oppenheimer & Co.*, 936 F.2d 759, 763 (2d Cir. 1991); *Luce v. Edelstein*, 802 F.2d 49, 56 (2d Cir. 1986); *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357 (3d Cir. 1993), *cert. denied*, 114 S. Ct.1219 (1994); *Rubinstein v. Collins*, 20 F.3d 160, 166-68 (5th Cir. 1994); *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037, 1040 (6th Cir. 1991); *In re Convergent Technologies Sec. Litig.*, 948 F.2d 507, 516 (9th Cir. 1991).

¹⁸ *Senate Overrides President's Veto; Securities Litigation Reform Bill Now Law*, Sec. Reg. & Law Rep., Jan. 5, 1996.

¹⁹ *Investor Risk Is Major Concern In Veto Of Litigation Overhaul*, Cong. Q., Dec. 23, 1995.

²⁰ *See, e.g.*, *Shields*, 25 F.3d at 1124.

²¹ Former SEC Chairman Richard Breeden, in testimony to the Senate Securities Subcommittee.

²² *Central Bank of Denver v. First Interstate Bank of Denver*, 114 S. Ct. 1439 (1994).

²³ Minn. Stat. §§ 80A.01, *et seq.*

²⁴ Minn. Stat. §§ 325 F.68-.70.

²⁵ *See, e.g.*, Minn. Stat. §§ 80A.23; 8:31.

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