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Bitter Fruit From Poisoned Trees: Congressional Protectionism and the Securities Industry

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OVERVIEW

Some legal "commentaries" treat the law as something created, maintained, interpreted, and enforced in a virtual vacuum. The reality is, "law" is a shifting and amorphous concept, influenced by economic trends, political (i.e. political action committee and other lobbyist) pressures, the legislative process which creates it, and the leanings of the judiciary, which interpret it. Any notion that the legislative, executive and judicial branches of government operate autonomously, as "separate but equal" entities, is quaint but erroneous. This article attempts to put recent developments in securities laws and securities litigation into some context.

The past ten years have brought radical changes in the way securities cases are litigated, both through legislative enactment (the 1995 Private Securities Litigation Reform Act, or "PSLRA," and the Securities Litigation Reform Act of 1998, or "SLUSA") as well as through increasingly difficult "scienter" pleading standards imposed by the federal courts interpreting those statutes.[1] SLUSA and the PSLRA have federalized all securities class actions falling within their purview, which is similar to the goal of a proposed "Class Action Fairness Act."[2] Ironically, the enforcement of those statutes — the goal of which is reduction or elimination of cases brought by securities investors — coincides with increasingly alarming and frequent news accounts of massive and systemic investor frauds perpetrated by formerly well-regarded entities.[3] When these wholesale corporate wrongdoings started to come to light, the federal courts were already well on their way to dismissing scores of investors'

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lawsuits on procedural grounds – as the motors behind SLUSA and the PSLRA intended.

On its face, the "cognitive dissonance" between known abuses and the refusal of Congress or the judiciary to punish wrongdoers by making relief available to shareholders (rather than through criminal or regulatory prosecution) makes little sense. It is only when the observer traces the current state of affairs back to the Reagan Era's generalized deregulatory drive, with its attendant weakening of public protections, that this apparent contradiction is explained. In point of fact, more and more investors have been defrauded, but due to harsh judicial rulings guided by pro-industry protectionist legislation, they are able to do less and less about it.[4]

SLUSA and the PSLRA have undoubtedly foreclosed some litigation lacking in merit. They have also undoubtedly shut down numerous meritorious suits on strictly procedural grounds. By way of example, the PSLRA's requirement that certain securities laws-based class actions be removed from state court, *and then dismissed* — has a bizarre result. Wrongdoers defrauding the requisite number of plaintiffs (50 or more) are procedurally protected. Lesser wrongdoers (those defrauding fewer than 50 investors) can still be sued in state courts. Not one single federal district or appellate court has addressed the illogic of that situation — though it has been raised at the briefing stage. The investing public and the integrity of the markets are the ultimate victims of the current unfortunate situation.

HISTORY OF LEGISLATION GOVERNING INVESTOR PROTECTION

To understand how the current anti-investor situation came to pass, a brief overview of the history of securities regulation and litigation is necessary. Before the Great Stock Market Crash of 1929, there was little support for federal regulation of securities. Approximately twenty million shareholders, taking advantage of post-war prosperity, tested their fortunes in the stock market in the 1920s. This optimism was misplaced — an estimated half of the $50 billion in new securities during that period became worthless.[5] In reaction, Congress in the 1930s produced a number of laws designed to regulate and safeguard the financial markets: the Glass-Steagal Banking Act of 1933; the Securities Act (1933); the Securities Exchange Act of 1934; the Investment Advisor's Act (1940) and the Investment Company Act of 1940. Little changed until the last quarter of the 20th Century.

Since 1975, purchasers and sellers of securities have been allowed to maintain direct individual claims under Section 10(b) of the Securities Exchange Act[6] and its attendant Rule 10b-5.[7] This entitlement to sue for securities fraud was the holding in *Blue Chip Stamps v. Manor Drug Stores*,[8] a decision which, if it came before the Court today, might turn out quite differently. Until the *Private Securities Litigation Reform Act* was enacted in 1995, an event discussed in great detail below, a successful plaintiff had to plead (and eventually prove) that the defendant acted with the requisite mental state, or "scienter," which the Supreme Court in 1980 defined to mean "a mental state embracing intent to deceive, manipulate, or defraud."[9]

The remedies afforded defrauded securities investors began to unravel in the mid-1990s. In 1994 the Supreme Court overruled prior case law to hold that there can be no civil liability for "aiding and abetting" under Section 10(b) of the Securities Exchange Act, effectively eliminating actions against banks, brokerages, or entities who facilitated a tortfeasor's fraud without obtaining a direct benefit in return.[10] Since then, the federal courts have engaged in wholesale invalidation of private causes of action grounded in other federal provisions.[11] The subsequent invalidation of federal laws by the courts, under a judicial pronouncement that Congress did not expressly "intend" for their private enforcement, ignores the primary purpose served by securities litigation brought by individuals. Regulatory agencies, which rely on governmental funding for their existence and powers, are typically understaffed and individual suits have traditionally served a critical "private attorney general" function.[12]

The PSLRA

In 1994 — the same year the Supreme Court stripped aiding and abetting liability for securities fraud from the 1934 Act — a Republican majority announced its intention to "stem [what it perceived to be] the endless tide of litigation" in the *Republican Contract With America*.[13] The *Common Sense Legal Reforms Act*, a subpart of the *Contract With America*,[14] has since been enacted by Congress as the *Private Securities Litigation Reform Act of 1995*, or "PSLRA."[15]

The seed that grew into the PSLRA was justified by its Republican authors as follows:[16]

> Since class action lawyers can make decisions that are not in the best interest of the clients without fear of reprisal and take a big

chunk of the settlement off the top, shareholders are often exploited. Strike suits are money makers for the lawyers, but such frivolous claims destroy jobs and hurt the economy.

The fruit of this "Republican revolution," the PSLRA, imposed for the first time stringent new requirements on securities class action plaintiffs.[17] These included the obligation of plaintiffs to provide a "sworn certification" along with their complaints, which must be publicized within 20 days of filing, in a national notice program. Within 60 days of notice, "any member of the purported class" may move to serve as lead plaintiff (despite the fact that no class has yet been certified).[18] The "lead plaintiff" selected by the court is that individual(s) determined "to be most capable of adequately representing the interest of class members."[19] This legislative grant of lead counsel-choosing authority to the court, rather than the plaintiff (who initiated the litigation), represented a radical departure from the common law presumption that the "first filed" plaintiff would choose his or her counsel (or, in the case of multiple overlapping cases, the various plaintiffs could choose for themselves the counsel they wished to have represent them).[20]

The PSLRA also imposed heightened pleading requirements. Subsection (b) provides that in any private action seeking money damages, the complaint "shall, with respect to each act or omission alleged . . . state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[21] As if this requirement was not deterrent enough, equally problematic is the PSLRA's imposition of an automatic stay of discovery during the pendency of any motion to dismiss.[22] The plaintiff, subject to a heightened scienter requirement, is precluded by statute from seeking the very discovery needed to satisfy his pleading obligation.

SLUSA

The severe limitations of the PSLRA were buttressed further by the *Securities Litigation Uniform Standards Act of 1998*, or "SLUSA."[23] SLUSA provides, with certain limited exceptions, that "no covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party" [alleging a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security]. A "covered class action" is defined as one where "damages are sought on behalf of more than 50 persons or prospective class members. . . ."[24] "Covered security" is intentionally broad: SLUSA adopts the definition contained in the 1933 Act, which is any security "listed, or authorized for listing, on a national securities exchange" – including but not limited to the New York Stock Exchange, the American Stock Exchange, or NASDAQ Stock Market.[25] In other words, SLUSA federalizes and operates as a bar to *all* private securities class actions based on misrepresentations or omissions, even if they are based entirely on *state* law.

LEGAL CONSEQUENCES OF THE PSLRA AND SLUSA

The "required state of mind" pleading requirement imposed by the PSLRA is, of course, directed to the elusive state of mind element of "scienter." By 2001, five federal appellate circuits had split over how specific the allegations of wrongdoing had to be in order to get into court.[26] Some state investor protection statutes, in contrast, contain no "scienter" requirement at all, even when claims arising out of the state securities laws were brought in federal court under diversity jurisdiction.[27] What SLUSA does is effectively impose a "scienter" requirement on state law securities causes of action where the requirement did not exist under state law, thereby making such suits more difficult.

Another fundamental problem with SLUSA is that currently, state claims are not only automatically removed to federal court under SLUSA when they are brought as class claims (and thus charged with an erroneous "scienter" element), SLUSA then requires their dismissal – *regardless of the merits of those claims.*

This was the result in *Riley et al. v. Merrill Lynch*, the first reported appellate challenge to SLUSA based on constitutional grounds.[28] In *Riley,* the plaintiffs' claims were brought exclusively under state law (the Florida Securities and Investor Protection Act and the Florida Deceptive and Unfair Trade Practices Act). The defendant moved to dismiss the claims in their entirety under SLUSA (it also contended that the federal court had no diversity jurisdiction because one of the defendants [a mutual fund set up as a Massachusetts business trust] had to be treated, for diversity purposes, as a citizen of every state where it had investors). When the plaintiffs voluntarily dismissed and refiled in state court, based on the SLUSA defense appearing in the motion to dismiss, the defendant immediately removed the case *back* to federal court under the removal provisions of SLUSA — placing the litigation right back in federal court, where it started.[29] The inefficiency of such a maneuver is manifest.

The district court, referring to state law protections as a "loophole in the PSLRA,"[30] imposed the PSLRA's scienter pleading requirement on the plaintiffs' state law claims *even though those state law claims had no scienter element under state law.*[31] Having thus successfully changed the plaintiffs' claim into something that was not pleaded, the federal court dismissed the plaintiffs' constitutional challenge out of hand, and dismissed all claims.[32]

The *Riley* plaintiffs – having sued alleging only *state law* causes of action – were effectively deprived of any remedy, regardless of the merits of their claims, simply because there were more than 50 individuals involved, thus making their case a "covered security" as defined under SLUSA. Had there been fewer than 50 class members in *Riley*, SLUSA could not have applied, and the case would have proceeded on the merits. Significantly, neither the trial court nor the Eleventh Circuit provided any explanation of why it was *not* unconstitutional, on equal protection or due process grounds, to deprive remedies to groups of 50 or more, while 49 (or fewer) plaintiffs could prosecute their claims.

The PSLRA's heightened pleading requirements for federal securities fraud cases seems superfluous, in that heightened pleading for fraud already existed in Federal Rule of Civil Procedure 9(b), which provides that "in all averments of fraud and mistake, the circumstances constituting fraud or mistake shall be stated with particularity," though malice, intent, and other conditions of the mind may be averred generally. The PSLRA currently imposes requirements far surpassing those of Rule 9(b). In a SLUSA context, "the complaint shall specify each statement alleged to have been misleading," and it "shall state with particularity all facts on which that belief is formed."[33] Federal courts, finding the PSLRA scienter inadequately pled, have rapidly dismissed securities claims.[34]

THE POLITICS OF LEGISLATION

The PSLRA's provision for an automatic stay of discovery pending a motion to dismiss has an Alice-in-Wonderland quality. That is, plaintiffs who lack specific details of affirmative fraud or material omissions are prevented from gathering the very facts needed to meet the stringent "scienter" pleading requirement to avoid dismissal. This is a radical shift from the general rule that adequate discovery *is* allowed before legal actions will be dismissed.[35] In other words, the PSLRA imposes a very high standard of proof at the outset of the case (before discovery is allowed) and then forbids the very discovery that may be required to satisfy that high standard of proof.

The PSLRA has also been used to defeat attempts to amend, which under Fed.R.Civ.P. 15 should be "freely given when justice so requires." In a case of first impression, a federal district court in Michigan held that allowing the plaintiffs to amend a complaint to comply with SLUSA's stringent pleading requirements would undercut the purpose of the statute – and that the PSLRA, in effect, trumps Fed.R.Civ.P. 15(a)'s liberal amendment requirement.[36] That trial-level court apparently failed to consider that privileging SLUSA's pleading requirements over Rule 15(a)'s "freely given" amendment provisions ignores a well-settled mandate from the Supreme Court that Rules of Civil Procedure have the force and effect of law.[37]

SLUSA's bar on state law class actions involving "more than 50 persons" also runs afoul of common sense. First, the selection of fifty class members as a procedural barrier is entirely arbitrary. Fifty is not a magic number, and it is certainly possible to have classes certified which consist of less than fifty claimants.[38] Second, by providing wrongdoers with an absolute procedural defense so long as at least 50 plaintiffs were injured, SLUSA actually *rewards* defendants according to the magnitude of the harm. A wholesale fraud affecting hundreds or thousands of investors cannot be sued upon under any state statute or common law, while a lesser fraud – affecting less than 50 individuals – can be redressed.

CONCLUSION

If Congress had been truly serious about eliminating abuses in litigation brought by securities plaintiffs, it could (and should) have strengthened remedies available to successful defendants (such as including adverse fee and costs provisions in the federal securities laws). Instead, Congress chose to shut down certain types of securities litigation altogether – regardless of the merits of the claims.

Unfortunately, the PLSRA, SLUSA, and current Congressional attempts to federalize all class action litigation (such as the misleadingly-named "Class Action Fairness Act") have achieved a goal sought by the securities industry and its lobbyists — immunizing wrongdoers at the expense of the investing consumer. There is no apparent "quick fix" to this problem. If Congress and the administration in power remain willing to favor corporate interests over individual interests, there is little hope that the federal judiciary – appointed by the executive branch – will do other than turn a blind eye to the problem.

NOTES:

[1] Securities litigation is not unique to the pressures listed above. By way of further example, abortion, medical malpractice, and the so-called "gay agenda" are current high-profile political and legal lighting rods. Unlike securities litigation, however, the stakes at issue in these other debates are equitable and ideological rather than primarily monetary.

[2] Currently Congress is engaged in a separate attempt to federalize all class action litigation, in a proposed *Class Action Fairness Act.* A House bill (H.R. 1115) passed the House in June of 2003 by a 253-170 vote.

[3] Enron, WorldCom, Tyco International, and Global Crossings are highly publicized examples. While Congress, in an attempt to deal with these accounting scandals, enacted the Sarbanes-Oxley Act in 1992, that legislation deals primarily with disclosures and reporting requirements, rather than investor redress. Sarbanes-Oxley has therefore not provided any meaningful relief to defrauded investors, nor is it expected to.

[4] The situation appears unlikely to change under George W. Bush, who has staffed many federal agencies with alumni of the industries they are charged with regulating. In particular, Bush appointed Harvey Pitt as Chairman of the Securities and Exchange Commission along with other individuals having ties to the accounting industry. Pitt was forced to step down on November 5, 2002, after fifteen months of ever-increasing criticism and a series of missteps embarrassing to the Bush administration. Vice-President Dick Cheney's association with Halliburton has been the subject of frequent comment as well. In a May 26, 2004 amicus brief filed by the Justice Department, the government urged the Supreme Court to adopt a direct causal connection pleading standard in a securities "fraud on the market" class action. *Dura Pharm., Inc. v. Broudo*, U.S. No. 03-932 (review granted June 28, 2004). No relief to securities investors can be expected from the current administration.

[5] Securities Exchange Commission bulletin "The Investor's Advocate: How the SEC Protects Investors and Maintains Market Integrity" (December 1999).

[6] 15 U.S.C. §78j(b).

[7] 17 C.F.R. §240.10b-5.

[8] 421 U.S. 723 (1975).

[9] Aaron v. SEC, 446 U.S. 680, 695-696 (1980).

[10] Central Bank of Denver, N.A. v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

[11] The Supreme Court has clearly "retreated from [its] previous willingness to imply a cause of action where Congress has not [expressly] provided one." Correctional Serv. Corp. v. Malesko, 534 U.S. 61, 67 n. 3 (2001). In addition to Central Bank of Denver, 511 U.S. 164, *see* Dorchester Investors v. Peak Int'l Ltd., 134 F. Supp.2d 569 (S.D. N.Y. 2001) (no basis to conclude Congress intended to provide a private cause of action under Section 34(b) of the Investment Company Act of 1940); Olmsted v. Pruco Life Ins. Co. of New Jersey, 283 F.3d 429, 432 (2d Cir. 2002) (no private right of action exists under Sections 26(f) or 27(i) of 1940 Act); White v. Heartland High-Yield Mun. Bond Fund, 237 F. Supp.2d 982 (E.D. Wis. 2002) (no private cause of action under Sections 22 or 34(b) of 1940 Act). These cases are representative of judicial decisions holding that no private remedy exists, even when a violation of federal law has taken place, and illustrate graphically the need for enforcement of securities laws through private suits. If Congress did not intend for certain laws to be enforced, it would repeal them.

[12] Recently, state securities regulators won a reprieve from Republican-led efforts to cut the ability of the states to police Wall Street. The states, led by New York Attorney General Eliot Spitzer, managed to postpone a vote on a bill authored by Louisiana Republican Richard Baker, Chairman of the House's Capital-Markets Subcommittee. *See* Randall Smith & Deborah Solomon, *State-Level Cops Retain Power*, C1, *Wall Street Journal*, July 25, 2003.

[13] The *Republican Contract With America* was the brainchild of Newt Gingrich, who became Speaker of the House in 1995 after having served as Minority Whip since 1989. It was announced by the Republican leadership at a September 27, 1994 press conference. The full text is available at: "www.house.gov/Contract/CONTRACT.html". Pundits have referred to this document as a "Contract *on* America."

[14] The *Common Sense Legal Reform Act* appears as number 9 of 10 proposed "major reforms, aimed at restoring the faith and trust of the American People in their government." *See* link at "www.house.gov/Contract/CONTRACT.html".

[15] 15 U.S.C. §78u-4.

[16] *See* note 14, "Description" link to "Common Sense Legal Reform Act" of the Republican Contract With America. A "strike suit" is a shareholder derivative action begun with the hope of winning fees or a private settlement, with little or no intention of benefiting the corporation on behalf of which the suit is allegedly brought. BLACK'S LAW DICTIONARY (6th Ed. 1990).

[17] According to a recent article, "many observers" of the legal scene have commented that the PSLRA was aimed at putting the New York-based Milberg, Weiss, Bershad, Hynes & Lerach, LLP firm (and particularly William Lerach, "the lawyer many corporate executives love to hate"), out of business. Tamara Loomis, *Milberg Weiss Stronger Than Ever Despite Reform Act*, New York Law Journal (April 24, 2003).

[18] 15 U.S.C. §78u-4(a)(2) and (3). Generally, a suit filed as a class action will be treated as one unless and until class certification is denied. *See e.g.*, Morrison v. Allstate Indem. Co., 228 F.3d 1255, 1263 (11th Cir. 2000), citing J. Moore's *Federal Practice* (2d ed. 1985); *see also* Smith v. GTE, 236 F.3d 1292, 1304 n. 12 (11th Cir. 2001).

[19] 15 U.S.C. §78u-4(3)(B).

[20] *See Manual for Complex Litigation*, Second §20.22 (Federal Judicial Center, 1995); *see also,* Newberg and Conte, *Newberg on Class Actions* §9.34 (3d ed. 1992). Until the PSLRA was enacted, courts traditionally appointed counsel in class action litigation on a "first come, first serve" basis. In re Network Associates, Inc. Sec. Lit., 76 F.Supp.2d 1017, 1020 (N.D. Cal. 1999).

[21] 15 U.S.C. §78u-4(b)(2).

[22] 15 U.S.C. §78u-4(b)(3).

[23] SLUSA amended §16 of the Securities Act of 1933 and Section 28 of the 1934 Securities Exchange Act. 15 U.S.C. §77p(b); 15 U.S.C. §78bb(f)(1).

[24] See e.g., 15 U.S.C. §78bb(f)(3)(A). An equivalent provision was inserted into the 1933 Act.

[25] 15 U.S.C. §77r(b).

[26] David Rovella, *Securities Reform Spawns Discord*, *Nat'l Law Journal* (July 18, 2001).

[27] *See, e.g.*, the *Florida Securities and Investor Protection Act*, Chap. 517 Fla. Stat.; Merrill Lynch v. Byrne, 320 So.2d 436, 440 (Fla. 3d Cir. 1975); Silverberg v. Paine Webber, 710 F.2d 678, 690 (11th Cir. 1983).

[28] 168 F.Supp.2d 1352 (M.D. Fla. 2001), aff'd 292 F.3d 1334 (11th Cir. 2002). The author was one of the plaintiff's attorneys in *Riley*.

[29] 292 F.3d at 1336.

[30] 292 F.3d at 1341.

[31] 292 F.3d at 1345-1346. Referring to the state laws as "loopholes" in the PSLRA ignores the fact that those state laws predated *both* the 1995 PSLRA *and* the 1998 enactment of SLUSA.

[32] The plaintiffs unsuccessfully argued both at the trial level and on appeal that Congress had no authority to abrogate state laws without total preemption, and that the Commerce Clause limited Congress' reach. 292 F.3d at 1346-1347.

[33] 15 U.S.C. §78u-4(b)(1).

[34] *See, e.g.,* Oxford Asset Mgt. v. Jaharis, 297 F.3d 1182 (11th Cir. 2002) (dismissing 1933 Act claims); *see also*, Judge Milton Pollack's well-publicized decisions in the consolidated In re Merrill Lynch & Co. Research Reports Securities Litigation cases, 02 MDL 1484, 02 CV 3210, 02 CV 3321 (June 20, 2003); 02 MDL 1484 (S.D. N.Y. July 2, 2003).

[35] Celotex Corp. v. Catrett, 477 U.S. 317, 322 (1986); Jones v. City of Columbus, 120 F.3d 248, 253, reh. denied 134 F.3d 387 (11th Cir. 1997), cert. denied 523 U.S. 1118 (1998). These cases deal with discovery being allowed during the summary judgment process but the Supreme Court has ruled that a complaint should not be dismissed unless it appears beyond a doubt that a complainant can prove no set of facts that support a claim for relief and all doubts should be resolved in the light most favorable to the plaintiff. Conley v. Gibson, 355 U.S. 41, 45-46 (1957); Scheuer v. Rhodes, 416 U.S. 232, 236 (1974).

[36] In re: Champion Ent. Sec. Lit., 145 F. Supp. 2d 871 (E.D. Mich. 2001).

[37] Weil v. Neary, 278 U.S. 160, 169 (1929) ("it is clear that a rule of court thus authorized and made has the force of law."); U.S. v. Prieto-Villa, 910 F.2d 601, 609 (9th Cir. 1990); U.S. v. Acosta Martinez, 89 F. Supp. 2d 173 (D. P.R. 2000) (even local rules have the force of law); Henry v. City of Tallahassee, 216 F. Supp. 2d 1299, 1310 (N.D. Fla. 2002) (same); *see also,* Dept. of Safety v. Stockman, 709 So.2d 179, 180 (Fla. 5th Dist. Ct. App. 1998) ("Any conflict between statutes and rules regarding procedure must of course be resolved in favor of the rules."). A Florida district court, in an unreported order, denied the plaintiffs a single opportunity to amend, after allowing the defendant to amend its answer to assert additional statutory defenses. Raffa v. Wachovia, Case No. 8:02-1443 (M.D. Fla. 2002).

[38] There is no fixed numerosity rule; "generally less than twenty-one is inadequate, more than forty adequate, with numbers between varying according to other factors." Cox v. American Cast Iron Pipe Co., 784 F.2d 1546, 1553 (11th Cir. 1986); Consol. Rail Corp. v. Town of Hyde Park, 47 F.3d 472, 783 (2nd Cir. 1995) (numerosity presumed at 40).