EVALUATING THE PREEMPTION EVIDENCE: HAVE THE PROPONENTS MET THEIR BURDEN?

RICHARD H. WALKER*

I

INTRODUCTION

Striking an appropriate balance between state and federal regulation of our securities markets is a difficult task. For more than sixty years, these markets have operated under a system of overlapping state and federal regulation. It is a system that has, for the most part, served investors well, and has contributed to our markets' reputation as the fairest and most liquid in the world.

While federal law is supreme in the area of securities regulation, it never has been the exclusive source of authority over market participants. State regulation of securities preceded federal regulation by more than twenty years.[1] State legislatures began enacting laws regulating securities transactions early this century, and today every state has enacted a securities act.[2] The federal securities laws were enacted in the 1930s in the wake of the market crash of 1929. With state law considered inadequate to address the widespread abuses that led to the crash,[3] the federal securities laws were viewed as a supplement to, rather than a substitute for, state blue sky laws. Both the Securities Act of 1933

This article is also available at http://www.law.duke.edu/journals/lcp.

This paper expands upon remarks delivered by the author at the Duke Law School-ILEP conference, *Deterring Corporate Misconduct*, held in Naples, Florida on November 15, 1997. Subsequent to the speech upon which this article is based, the Commission expressed its support for the Senate version of the preemption bill.

* Director, Division of Enforcement, United States Securities and Exchange Commission; formerly General Counsel, United States Securities and Exchange Commission.

The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of Mr. Walker and do not necessarily reflect the views of the Commission or its staff. *See* 17 C.F.R. § 200.735-4(e)(2) (1995). The author would like to thank David M. Levine for his assistance in the preparation of this article.

1. Kansas is credited with enacting the first blue sky law, a state statute providing for regulation and supervision of securities offerings and sales, in 1911. *See* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 367 (2d ed. 1990).

2. *See id.*

3. *See* Schreiber v. Burlington N., Inc., 568 F. Supp. 197, 201 (D. Del. 1983) (discussing abuses leading to enactment of the federal securities laws).

("Securities Act")[4] and the Securities Exchange Act of 1934 ("Exchange Act")[5] contain express savings clauses preserving state law rights and remedies.[6]

The philosophy underlying our system of dual sovereignty in the area of securities regulation has remained relatively constant over the last sixty years. The markets, on the other hand, have undergone rapid growth and development. Markets today are not just national, they are global, with technological advances improving access to the markets, facilitating trade and commerce world-wide. These changes have led to a reconsideration of whether our system of joint federal and state regulation achieves the proper balance between the protection of investors and the promotion of capital formation.

Recently, Congress has begun to reexamine the respective roles of federal and state law in regulating global markets. In 1996, for example, Congress enacted the National Securities Markets Improvement Act of 1996 ("NSMIA"),[7] which strikes a new balance between federal and state regulation of securities registration, investment adviser registration and oversight, and other matters. NSMIA eliminates duplication that previously existed in the overlapping, and sometimes inconsistent, requirements of federal and state law in these areas. Congress's goal in enacting NSMIA was to redivide federal and state regulation in order to promote efficiency and capital formation in the financial markets.[8] While NSMIA substantially reordered regulatory responsibilities between the states and the federal government, it did nothing to alter the traditional balance between federal and state law enforcement authority and public and private rights of action.

Three bills have recently been introduced in Congress that would pick up where NSMIA left off,[9] striking a new balance between the rights of action provided to injured investors under federal and state law. Each of the three bills would preempt certain state law causes of action involving companies with nationally traded securities. Two of the three would apply only to class actions.[10] The introduction of these bills has triggered a spirited debate about the benefits and burdens of state law securities fraud causes of action, evoking strong responses from market participants, legislators, and academics. For example, members of the high-technology and accounting industries favor the movement toward abolishing class actions at the state level.[11] There is also

4. 15 U.S.C §§ 77a-77aa. (1994).

5. *See id.* §§ 78a-78mm.

6. Securities Act of 1933 § 16, 15 U.S.C. § 77p; Securities Exchange Act of 1934 § 28, 15 U.S.C. § 78bb.

7. Pub. L. No. 104-290, 110 Stat. 3416 (1996).

8. *See* SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, THE SECURITIES INVESTMENT PROMOTION ACT OF 1996 2 (June 26, 1996).

9. *See* H.R. 1653, 105th Cong. (1997) (introduced by Reps. Campbell, Klug, and Dooley); H.R. 1689, 105th Cong. (1997) (introduced by Reps. Eshoo and White); S. 1260, 105th Cong. (1997) (introduced by Senators Gramm, Dodd, Domenici, Boxer, Faircloth, Feinstein, Hagel, Reid, Wyden, Allard, Moseley-Braun, Murray, Lieberman, and Bennett).

10. *See* H.R. 1689, 105th Cong. (1997); S. 1260, 105th Cong. (1997).

11. Seventeen business and high-technology organizations, including the American Electronics Association and the American Institute of Certified Public Accountants, have banded together to form

strong support on Capitol Hill for uniform standards governing the litigation of securities fraud lawsuits.[12] Others, including members of the plaintiffs' bar and various investor groups, oppose the bills.[13] It appears likely that the debate over uniform national standards will soon be resolved, one way or the other, as key congressional figures have pledged to press for legislation early in the coming session.[14]

This article begins with a discussion of the arguments that have been made in favor of preemption, and then turns to the countervailing considerations. Next comes a summary of the three preemption bills introduced to date in Congress. The final analysis concludes that, while Congress is likely to find otherwise, the case has not yet been made for broad preemption.

II

THE CASE FOR PREEMPTION

What led to current efforts to alter substantially the system of dual sovereignty that has governed our markets for the last sixty years? A number of factors have contributed to the introduction of uniform standards legislation, including the following: possible loopholes in the Reform Act; fears kindled by Proposition 211, a plaintiff-friendly California ballot initiative; a reported migration of securities class actions from federal to state courts in the wake of the Reform Act; and, ironically, certain findings in the *Staff Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995* (the "Staff Report" or "Report") prepared by the Office of the General Counsel of the Securities and Exchange Commission ("SEC" or "Commission").[15]

---

the "Uniform Standards Coalition, Inc." The Coalition has been the strongest and most active advocate for uniform standards.

12. H.R. 1689, the preemption bill introduced by Reps. Anna Eshoo and Rick White, has more than 100 bi-partisan sponsors.

13. *See, e.g., Hearings before the Subcomm. on Finance and Hazardous Materials, House Comm. On Commerce on Implementation of the Private Securities Litigation Reform Act of 1995*, 105th Cong. 3 (1997) (testimony of Leonard B. Simon testifying on behalf of the National Association of Securities and Commercial Law Attorneys) ("Because it is not clear that there will be *any* means for defrauded investors to recover fraud losses under federal law after passage of the PSLRA, we oppose any further reduction in investor protections, particularly suggestions that state antifraud remedies should be preempted.").

14. *See Lott Says Senate Will Act on "Uniform Standards" Bill Before Easter,* Press Release, Jan. 28, 1998 (stating Lott's intention to enact S. 1260 within a few months time); *Oversight Hearing on Securities Litigation Abuses, Concerning S. 1260, The "Securities Litigation Uniform Standards Act of 1997" Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 105th Cong. 6 (1997) (statement of Senator Phil Gramm.) ("It's going to be my plan, as Chairman, to move very early next year to try to bring this bill to the floor of the Senate, to vote on it. Our objective is to try to make this C well, certainly in this subcommittee and probably in the full committee C our first order of business next year. I think this is very important.") [hereinafter *October 29 Hearing*].

15. 105th Cong. (1997). While the Staff Report made certain findings that have been trumpeted by preemption proponents, *see infra* notes 35-36 and accompanying text, the Report's ultimate conclusion was that, based on the limited experience with the Reform Act, legislative changes were *not* in order at the present time. *Id.*

A. The Reform Act

The issue of litigation reform has generated considerable debate in recent sessions of Congress.[16] The debate has centered on essentially three issues. First, whether the litigation system promotes, or unnecessarily tolerates, frivolous securities litigation (that is, strike suits filed solely for their settlement value) or marginal securities litigation (that is, litigation that, while not wholly frivolous, is disproportionately costly compared to the likely harm to investors). Second, whether securities class actions have failed to represent fairly the best interests of the investor class. Third, whether securities litigation imposes undue financial burdens on accountants and other professional advisers, requiring replacement of joint and several liability with some form of proportionate liability.

The 103rd Congress answered each of these questions in the affirmative. Passage of the Reform Act over a veto by President Clinton marked the most significant alterations to the conduct of private securities litigation since passage of the federal securities laws. The Act's principal provisions are the following:

(1) a "safe harbor" for forward-looking statements;[17]

(2) a stay of discovery while a motion to dismiss is being decided;

(3) heightened pleading standards requiring specific recital of facts giving rise to a "strong inference" of fraud;

(4) a "lead plaintiff" provision designed to wrest control of class action litigation from lawyers and to empower institutional shareholders in this context;

(5) mandatory sanctions for violation of Federal Rule of Criminal Procedure 11; and

(6) a system of proportionate, as opposed to joint and several, liability for defendants who are not found to have knowingly committed fraud.

The Act itself does not preempt any state rights or remedies and leaves intact the savings clauses found in both the Securities Act[18] and the Exchange Act.[19] In fact, the only statement in the legislative record on the subject shows that preemption was absent from the minds of the legislators.[20]

---

16. The groundwork for the litigation reform debate was laid in 1991, with the Supreme Court's decision that private actions brought under Section 10(b) of the Exchange Act must be commenced within one year after discovery of the alleged violation, and no more than three years after the violation occurred. *See* Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991). Hearings in the 102nd Congress to consider the impact of *Lampf* provided a forum for airing concerns about alleged abuses in the system of private litigation under the securities laws; since those concerns were not resolved, the debate continued in the 103rd and 104th Congresses.

17. A safe harbor provision gives protection to those who make an effort to comply with the law.

18. Securities Act of 1933 § 16, 15 U.S.C. § 77p (1994).

19. Securities Exchange Act § 28(a), 15 U.S.C. § 78bb(a) (1994).

20. *See Hearings Concerning the Common Sense Legal Reform Act, Subomm. on Telecomm. and Finance, House Comm. on Commerce*, 103rd Cong. at 110. (colloquy of Rep. Chistopher Cox with Professor Daniel Fischel) (stating in context of discussion of post-Reform Act litigation strategies, "So if you were a plaintiff, who like any plaintiff has a choice of forum, and if you were one of the investors who were defrauded in Orange County, for example, you might file your suit in state court or in federal court depending on how you saw your advantage").

Almost from the date of its enactment, the Reform Act has been criticized as either going too far in limiting investors' rights or not going far enough to eliminate frivolous litigation. Critics of the Reform Act that say it has not achieved its purpose point to apparent loopholes in the Act that they claim have led plaintiffs and their counsel to manipulate the system by simply filing suit in state court where the federal reforms do not apply. In particular, they point out that the absence of a safe harbor in state court exposes issuers to the same unacceptable risks of suit that existed before passage of the Act and that the discovery stay is too easily avoided by parallel state court lawsuits where discovery may be permitted to proceed.[21] Critics also point out that the number of new case filings, after a short-lived decline, is approximately the same as pre-Act levels.[22] They argue that stronger measures are needed, specifically pre-emption of state causes of action, to achieve Congress's goal of curbing frivolous litigation.

B. Proposition 211

Following passage of the Reform Act, all eyes quickly turned to California. Members of the plaintiffs' bar placed a bold initiative on the state's November 1996 ballot that would have made California state courts a haven for securities class actions. Popularly known as Proposition 211, the initiative was titled "The Retirement Savings and Consumer Protection Act" by its drafters, a title so misleading that the state attorney general changed its name to "Attorney-Client Fee Arrangement-Securities Fraud Initiative."[23] Proposition 211 ignited a firestorm of nationwide opposition. Opponents of the measure feared it would undo the reforms enacted in the Reform Act and cause California to become a mecca for the filing of securities lawsuits.[24] The provisions of Proposition 211 that generated particular alarm included the following:

(1) Extension of the fraud-on-the-market presumption of reliance to common law fraud actions, where punitive damages are available;

(2) Imposition of liability on those who "participated or assisted" in a fraud;

(3) Mandatory punitive damages when the conduct involved was "willful, outrageous, or despicable";

(4) Joint and several liability for all defendants;

(5) A bar preventing issuers from indemnifying any of their officers or directors; and

(6) No caps on attorneys' fees.

Both proponents and opponents of Proposition 211 opened their war chests during the campaign, making it the most expensive ballot initiative in Califor-

21. *See* Edward Brodsky, *Discovery Abuses: A Shifting Target*?, N.Y.L.J., Apr. 9, 1997, at 3; Karen Donovan, *Full Stop for Fraud Suits in States*, NAT'L L. J., MAR. 23, 1998, at A1.

22. *See* John C. Coffee, *First Anniversary: PSLRA of 1995*, N.Y.L.J., Jan. 30, 1997, at 5.

23. *See* Damon Darlin, *A Nice, Clean California Industry*, FORBES, Aug. 26, 1996, at 46-47.

24. *See* Neil A. Lewis, *California Measure Could Trump U.S. Law on Securities Suits*, N.Y. TIMES, Apr. 30, 1996, at A13.

nia's history.[25] After opposition from President Clinton, Senator Dole, and SEC Chairman Arthur Levitt, the measure was soundly defeated by a vote of three to one.[26]

The defeat of Proposition 211 did little to allay the fears of its opponents that the measure would soon be reintroduced, either in California or elsewhere. Even before the votes were counted, those opposed to the initiative were already considering alternative strategies in the event the initiative passed. One such strategy was the enactment of legislation that would preempt Proposition 211 and any similar measures adopted in other states.

The preemption movement was launched when the opponents of Proposition 211, fresh from their victory, turned their attention to Washington, D.C., to seek federal legislation ensuring that similar initiatives did not resurface in any state.[27] For preemption supporters, the red carpet to Capitol Hill was thus rolled out by Proposition 211.[28]

C. The Migration of Securities Class Actions to State Courts

Proponents of preemption soon found additional support for their position. Fanning the flames of the preemption movement were reports of a migration of securities fraud class actions from federal to state courts.[29]

1. *The Quantity of State Cases*. Various authorities have collected data on the quantity of securities litigation in state courts before and after the Reform Act. The data, though, is inconsistent and does not provide a supportable basis for preemption.

A study conducted by Professors Joseph Grundfest and Michael Perino found that, during the first year after passage of the Reform Act, sixty-nine

---

25. *See* David S. Jackson, *Litigation Valley in California, High-Tech Firms Battle Securities Lawyers over a Plaintiff-Friendly Referendum*, TIME, Nov. 4, 1996, at 72 ("The battle over Proposition 211 is already the most expensive ballot initiative in history. Nearly $46 million has been spent so far, the bulk coming from opponents, including the Big Six accounting firms and high-tech firms from Apple to Xilinx.").

26. *See* Elizabeth Corcoran, *California Voters Reject Proposition 211*, WASH. POST, Nov. 7, 1996, at D3.

27. The fear that measures similar to Proposition 211 would be introduced in other states has so far proved to be unfounded. There have been no efforts made to liberalize the blue sky laws of any state. In fact, three states—Arizona, Montana, and Ohio—have adopted the reforms contained in the Reform Act thereby narrowing, rather than broadening, state court remedies for securities violations. *See* ARIZ. REV. STAT. §§ 44-2081-2087 (1997); 1997 Mont. Laws 468; OHIO REV. CODE ANN. §§ 1707.432-438 (Banks-Baldwin 1997).

28. *See October 29 Hearing*, *supra* note 14, at 36 (statement of Senator Christopher Dodd) ("[W]ithout a national standard for liability, the potential threat is always there that one state will change its laws in such a way as to become the haven for litigation. This almost happened in California last year with Proposition 211. The potential remains it could successfully happen elsewhere in the future.").

29. *See, e.g.*, Mike France, *Bye, Fraud Suits. Hello, Fraud Suits.*, BUS. WK, June 24, 1996, at 127 (discussing movement of securities class actions from federal to state court in effort by plaintiffs' bar to sidestep the Reform Act).

companies were sued in state court securities class actions.[30] Grundfest and Perino reported that there was a "de minimis" level of class actions at the state level in prior years,[31] and concluded that the Reform Act likely "has induced a material substitution effect that may have shifted weaker claims to state court."[32]

2. *The Quality of the State Cases*. The Commission has consistently stressed that data on the quantity of lawsuits tells us little.[33] Of paramount importance is the quality of the claims in each lawsuit. There has yet to be conducted an empirical study that convincingly supports the accusation that the cases appearing in state court are of poor quality. The Staff Report analyzed twenty-six state class action complaints, representing thirty-seven percent of the complaints filed in state court during 1996. The allegations appeared to resemble closely those found in federal complaints:

> (i)15% of the state court complaints we reviewed were based solely on failed forecasts (as compared to 12% at the federal level);
>
> (ii) 46% contained insider trading allegations (as compared to 48% at the federal level);
>
> (iii) 38% contained allegations of accounting irregularities (as compared to 43% at the federal level);
>
> (iv) 15% contained allegations of a restatement of the financials (as compared to 18% at the federal level);
>
> (v) 8% contained allegations of a concurrent government investigation (as compared to 15% at the federal level); and
>
> (vi) 15% contained none of the above allegations (as compared to 14% at the federal level).[34]

State complaints having no parallel federal action, however, were more likely to be based solely on failed forecasts. These are precisely the kind of cases which most concerned Congress. We analyzed 16 stand-alone state complaints. The results were as follows:

> (i) 25% of these complaints were based solely on failed forecasts (as compared to 12% at the federal level);
>
> (ii) 25% contained insider trading allegations (as compared to 48% at the federal level);

---

30. *See* Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year's Experience*, CORNERSTONE RES., Feb. 27, 1997, at 8.

31. *See id*.

32. *Id*. at 4.

33. *See Hearing Concerning the Impact of the Securities Litigation Reform Act of 1995 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 105th Cong. 4 (1997) (testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission) ("As the Staff Report noted, however, meaningful conclusions cannot be drawn about the effectiveness of the Reform Act purely from the raw number of filings. Numbers alone do not reveal whether the cases are meritorious or meritless.") [Hereinafter Levitt July 24 Testimony].

34. Staff Report, *supra* note 15 and accompanying text, at 71-2.

(iii) 31% contained allegations of accounting irregularities (as compared to 43% at the federal level);

(iv) 13% contained allegations of a restatement of the financials (as compared to 18% at the federal level);

(v) 6% contained allegations of a concurrent government investigation (as compared to 15% at the federal level); and

(vi) 25% contained none of the above allegations (as compared to 14% at the federal level).[35]

While this review suggests that the mix of allegations at the federal level is stronger than the mix at the state level, the Staff Report explicitly cautioned that "the small sample size does not allow for a definitive assessment of the stand-alone state complaints."[36] Nevertheless, some advocates have cited these statistics in support of preemption.[37] At present, however, the data is insufficient to justify broad preemption.

D. The SEC Staff Report

The Staff Report was prepared by the Commission's Office of the General Counsel in response to a request from President Clinton. While the overall conclusion of the Report was that it was too soon to gauge the effects of the Reform Act, the Report did make a number of preliminary observations. It identified three principal areas of concern regarding the implementation of the Reform Act. Two of the problem areas identified by the Commission (the safe harbor and the discovery stay) have been seized upon by preemption proponents to support their case.[38]

1. *Concerns with the Safe Harbor for Forward-Looking Statements.* Based on anecdotal evidence, the staff noted that the safe harbor is not encouraging companies voluntarily to disclose more forward-looking information.[39] Issuers informed the staff that their primary concern is the lack of judicial guidance regarding the required "meaningful cautionary" language.[40] Concern about

---

35. *See id.* at 73.

36. *Id.* at 74.

37. *See, e.g.*, *Hearing on S. 1260, The "Securities Litigation Uniform Standards Act of 1997" Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 105th Cong. 49 (1997) (testimony of Robert Hinckley, on behalf of the American Electronics Association) ("[According to the SEC] the number of state court class actions alleging fraud based on a company's failure to achieve a forecast or prediction is double the number of such cases being filed in federal court.").

38. The third problem area identified in the Staff Report is lack of institutional involvement pursuant to the Reform Act's lead plaintiff provision. It does not appear likely that preemption would encourage institutional participation or otherwise address the problem.

39. The staff's preliminary observation concerning the use of the safe harbor was primarily based on interviews of corporate officers and outside counsel for issuers.

40. Staff Report, *supra* note 15 and accompanying text, at 25. The Middle District of North Carolina recently handed down the first decision interpreting the safe harbor. *See* Rasheedi v. Cree Research, Inc., 1997 U.S. Dist. Lexis 16968 (M.D.N.C. Oct. 17, 1997). Although the court dismissed the complaint on safe harbor grounds, the opinion does not seek to define the term "meaningful" cautionary statements.

potential liability under state law, where the statements may not be protected by the federal safe harbor, was the second most frequently cited reason for not making more forward-looking disclosure.[41] This finding has served as one of the main battle cries in favor of preemption.[42] While any such problem could be rectified by a narrow preemption bill simply importing the safe harbor into state securities class actions, those favoring preemption have used it as a cornerstone in their case for broad preemption.

A recent study, however, calls into question the Staff Report's finding and the arguments based thereon by preemption proponents. The study, conducted by three business school professors, analyzed the disclosures made by 547 computer, software, and drug firms, during the year before and after passage of the Reform Act.[43] The main finding of the study is that "there was a significant post-Act increase in both the frequency of firms issuing forecasts and the mean number of forecasts issued."[44] Specifically, the study found that the number of firms issuing projections increased by five percent post-Reform Act and the mean number of forecasts issued increased from 2.1 pre-Reform Act to 2.5 post-Reform Act.[45]

Notwithstanding this recent study, the absence of safe harbor protection in state court poses a real problem. Admittedly some form of preemption may be in order here. At least in theory, if there is no safe harbor in state court, there is no safe harbor at all. While more issuers may be making projections now than before the Reform Act, such disclosure would likely become even more commonplace should causes of actions for failed forecasts be foreclosed in state court.

2. *Concerns with the Discovery Stay*. The Staff Report recognized that, in a fair number of cases, the plaintiffs' bar brought cases in state court that were similar to cases brought in federal court.[46] Such parallel cases permitted plaintiffs to obtain discovery that they could not get in federal court due to the

---

41. *See* Staff Report, *supra* note 15 and accompanying text, at 25.

42. *See October 29 Hearing*, *supra* note 14, at 20 (testimony of Robert Hinckley, Vice President, Xilinx, on behalf of the American Electronics Association) ("[B]ecause of both the reality and the threat of state court suits, high technology companies are reluctant to rely on the federal safe harbor."); *id.* at 75 (testimony of Daniel Cooperman, General Counsel, Oracle Corp.) ("The conflicting state standards which govern private securities litigation fundamentally reduce a corporation's willingness to provide any forward-looking information to the public."); *Hearing on the Implementation of the Private Securities Litigation Reform Act of 1995 Before the Subcomm. on Finance and Hazardous Materials of the House Comm. on Commerce*, 105th Cong. 5-6 (1997) (written testimony of Bruce G. Vanyo) ("As a result of plaintiffs freely filing failed predictions cases in state court, where there is no safe harbor protection, public companies cannot be expected to make forward-looking statements, precisely contrary to Congress's intent in enacting the safe harbor. . . .").

43. *See* Marilyn Johnson, Ron Kasznik, & Karen K. Nelson, *The Impact of Securities Litigation Reform on the Disclosure of Forward-Looking Information by High Technology Firms*, Research Paper No. 1471 (Jan. 1998).

44. *Id*. at 23.

45. *See id*. at 12.

46. Staff Report, *supra* note 15 and accompanying text, at 70 (stating that 26 of the 195 federal class actions filed in 1996 were tied to a parallel state action).

discovery stay. The absence of an automatic discovery stay in state court actions was seen as creating the potential for evasion of the federal discovery stay. Again, while this problem is capable of being remedied by a narrow targeted preemption bill importing the discovery stay into state law, it has supplied ammunition for those seeking broad preemption.[47]

III

THE CASE AGAINST BROAD PREEMPTION

A. The Reform Act is Not Tried and Tested

Throughout the preemption debate, the Commission has preached an important message: The short time since passage of the Act has not allowed for sufficient practical experience with its key provisions or for many court decisions interpreting those provisions. In particular, the appellate courts have had virtually no opportunity to interpret the Act. No case has made its way to a jury; relatively few motions to dismiss have been decided; and there have been even fewer reported settlements. This alone mandates a cautious approach toward making federal securities law the exclusive law of the land.

The initial decisions interpreting the Reform Act have focused mainly on the Act's heightened pleading standards, with disagreement among the district courts as to the proper interpretation of the standards. To date, fourteen cases have held that the Reform Act meant to adopt the standard existing in the Second Circuit prior to the Act's passage.[48] The Second Circuit standard allows a plaintiff to plead either that the defendant had a motive and opportunity to commit the fraud or facts constituting strong circumstantial evidence of conscious behavior or recklessness.[49] There have been six cases, however, that have refused to follow the Second Circuit standard. These cases hold that after the Reform Act, plaintiffs may no longer allege merely reckless behavior,[50] but

---

47. *See, e.g.*, AMERICAN ELEC. ASS'N, A WHITE PAPER ON SECURITIES LITIGATION REFORM, 10-12 (1997) (highlighting the problem).

48. *See* Rehm v. Eagle Fin. Corp., 954 F. Supp. 1246 (N.D. Ill. 1997); Fugman v. Aprogenex, Inc., 961 F. Supp. 1190 (N.D. Ill. 1997); In re The Wellcare Management Group, Inc. Sec. Litig., 964 F. Supp. 632 (N.D.N.Y. 1997); Page v. Derrickson, No. 96-842-CIV-T-17C, 1997 WL 148558 (M.D. Fla. Mar. 25, 1997); Galaxy Inv. Fund, Ltd. v. Fenchurch Management, Ltd., 1997 U.S. Dist. LEXIS 13207 (N.D. Ill. Aug. 29, 1997); Pilarcyzk v. Morrison Knudsen Corp., 965 F. Supp. 311 (N.D.N.Y. 1997); OnBank & Trust Co. v. FDIC, 967 F. Supp. 81 (W.D.N.Y. 1997); In re Health Management, Inc. Sec. Litig., No. CV 96-889, 1997 WL 413895 (E.D.N.Y. July 21, 1997); Gilford Ptnrs. L.P. v. Sensormatic Elec. Corp., 1997 U.S. Dist. LEXIS 13724 (N.D. Ill. Sept. 10, 1997); Weikel v. Tower Semiconductor Ltd., No. 96-3711 (D.N.J. Oct. 2, 1997); Marksman Partners, L.P. v. Chantal Pharmaceuticals Corp., 927 F. Supp. 1297 (C.D. Cal. 1996); Zeid v. Kimberley, 930 F. Supp. 431 (N.D. Cal. 1996), *appeal docketed*, No 97-16070 (9th Cir.); STI Classic Fund v. Bollinger Indus., Inc., No. 3:96-CV-823-R, 1996 WL 866699 (N.D. Tex. Nov. 12, 1996); Fischler v. AmSouth Bancorporation, No. 96-1567-CIV-T-17A, 1996 WL 686565 (M.D. Fla. Nov. 14, 1996).

49. *See* Shields v. Citytrust Bancorp., Inc., 25 F.3d 1124, 1128 (2d Cir. 1994); Beck v. Manufacturers Hanover Trust Co., 820 F.2d 46, 50 (2d Cir. 1978).

50. Friedberg v. Discreet Logic Inc., 959 F. Supp. 42 (D. Mass. 1997); Powers v. Eichen, 961 F. Supp. 233 (S.D. Cal. 1997); Norwood Venture Corp. v. Converse Inc., 959 F. Supp. 205 (S.D.N.Y.

rather may only plead facts demonstrating that the defendants acted consciously. The Commission strongly believes that liability based on reckless misconduct is vital to investor protection and has appeared as amicus on the issue in three Reform Act cases arguing in favor of the Second Circuit standard.[51] The issue will soon be addressed by federal appellate courts.[52]

All states currently allow a securities fraud cause of action based on reckless behavior. In the event federal appellate courts rule that recklessness no longer suffices, state courts would provide a vital safety net. Otherwise, allowing corporate executives to "look the other way" without liability would promote corporate misconduct and detract from investor confidence. The issue is of such importance that it alone counsels caution in the preemption debate.

B. State Courts Afford Important Rights and Remedies to Investors Unavailable at the Federal Level

State courts offer defrauded investors at least two significant benefits unavailable in federal court: private rights of action against aiders and abettors, and longer statutes of limitations. The Commission has always relied on private actions in both federal and state courts as an important supplement to the Commission's efforts to combat fraud and misconduct in the markets. In 1994, the Supreme Court ruled that there is no private right of action against aiders and abettors under Section 10(b) of the Exchange Act.[53] The Commission strongly urged Congress to restore this right,[54] however Congress declined to do so. In contrast, each state provides a form of cause of action against aiders and abettors.

In 1991, the Supreme Court imposed a short statute of limitations in federal securities fraud actions.[55] The Court held that a private action under Section 10(b) of the Exchange Act must be brought within one year after discovery of the fraud, but in no event later than three years after occurrence of the underlying conduct.[56] In contrast, thirty-three states provide longer statutes of limita-

---

1997); Voit v. Wonderware Corp., 977 F. Supp. 363 (E.D. Pa. 1997); In re Comshare Inc. Sec. Litig., No. 96-73711-DT (E.D. Mich. Sept. 18, 1997), *appeal docketed*, No. 97-2098 (6th Cir.).

51. The Commission has appeared in *In re Silicon Graphics.* No. C-96-0393; *In re Comshare Inc.*, No. 97-2098; and *Zeid*, No. 97-16070.

52. At the time of this writing, *Silicon Graphics* and *Zeid* are pending before the Ninth Circuit of Appeals and *Comshare* is pending before the Sixth Circuit Court of Appeals. Decisions are expected in 1998.

53. *See* Central Bank v. First Interstate Bank, 511 U.S. 164 (1994).

54. *See Impact of U.S. Supreme Court Decisions: Central Bank of Denver of First Interstate Bank of Denver: Hearings Before the Senate Subcomm. on Sec. of the Senate Comm. on Banking, Hous. & Urban Affairs*, 103d Cong. 14 (1994) (testimony of Arthur Levitt) ("Legislation is also needed to restore aiding and abetting liability in private actions which are a necessary supplement to [the SEC's] overall enforcement program.").

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

56. *Id*. at 356-61.

tions.[57] The Commission has urged Congress to lengthen the federal limitations period to three years after discovery of the fraud, but no later than five years after occurrence of the misconduct.[58] Congress has not done so.

C. No Apparent Migration of Securities Class Actions to State Courts

In opposition to the findings of the study performed by Grundfest and Perino,[59] two more recent studies cast doubt on whether there has in fact been a migration of cases to state courts and, if so, whether the movement was anything other than a brief transitory phenomenon. One of the studies was conducted by Price Waterhouse, which tallied the number of state securities class actions between 1991 and 1997. The results were as follows:[60]

State Class Actions

Year	*Number*
1991	46
1992	31
1993	47
1994	67
1995	52
— Passage of the Reform Act —	
1996	66
1997	44

According to this study, the number of state securities class actions in the years following passage of the Reform Act is on par with the years prior to passage. There was an average of fifty-five securities class actions filed per year in state court during 1996 and 1997; the average number filed during 1991 through 1995 was fifty-three. Also, the National Economics Research Associates ("NERA") issued a study in July 1997 finding that the 1996 trends in the number of state class action filings were "transient."[61] The NERA study found that the number of filings during the first five months of 1997 had returned to the level observed in the five years prior to passage of the Reform Act.[62]

In any event, whether or not there has been a migration of class actions to state court in the wake of the Reform Act, two things are clear: The percentage of such litigation in comparison to all litigation in state court is minute, and

57. *See Hearing Concerning S. 1260, the "Securities Litigation Uniform Standards Act of 1997" before the Subcomm. on Securities of the Senate Comm. On Banking, Housing, and Urban Affairs* 104th Cong. (1997).

58. *See The Securities Investors Legal Rights Act of 1991: Hearings Before the House Sucomm. on Telecommunications and Fin., Comm. On Energy and Commerce,* 102nd Cong. (1991) (testimony of Richard C. Breeden, former Chairman, SEC) (expressing strong support for lengthening the statute of limitations in private securities actions).

59. *See supra* notes 30-32 and accompanying text.

60. PRICE WATERHOUSE, SECURITIES LITIGATION STUDY 1 (Jan. 1998).

61. *See Federal Shareholder Class Action Filings Rise to Pre-Reform Act Levels as State Filings Fall,* NERA, July 1997.

62. *See id.*

second, the incidence of such litigation is highly concentrated in just one state, California. There are approximately fifteen million civil cases filed in state court annually,[63] roughly fifty of which are securities class actions. Of these fifty securities class actions, roughly sixty-two percent are filed in California.[64] Arguments in support of broad-based preemption based on an average of less than one suit per week filed in state court topple of their own weight.

IV

CONGRESSIONAL RESPONSE

Notwithstanding the findings of the Staff Report, various members of Congress have introduced preemption bills that go far beyond addressing the Reform Act problem areas identified by the Commission. On May 21, 1997, Representative Anna Eshoo (D-Cal.) and Representative Rick White (R-Wash.) jointly introduced a bill that would preempt most state securities fraud class actions.[65] In a press release issued at the time their bill was introduced, Representatives Eshoo and White made clear that, based on the Grundfest and Perino Study,[66] they believed a migration of cases to state court was occurring and that legislation was needed to end this practice.[67] Five months later, on October 7, 1997, Senators Christopher Dodd (D-Conn.) and Phil Gramm (R-Tex.) introduced a companion bill in the Senate.[68] It appears that concern over a shift in litigation to state court was the motivating factor behind the Dodd-Gramm bill as well.[69]

The provisions of House Bill 1689 and Senate Bill 1260 are similar. First, each bill preempts cases alleging either the making of a material misrepresentation or omission, or the use of a manipulative or deceptive device or contriv-

---

63. *See October 29 Hearing*, *supra* note 14, at 79.

64. *See* Levitt July 24 Testimony, *supra* note 33, at 16.

65. *See* Securities Litigation Uniform Standards Act, H.R. 1689., 105th Cong. (1997). Rep. Tom Campbell (D-Cal.) had introduced similar legislation on May 16, 1997. *See* H.R. 1653. It appears, however, that the momentum is behind H.R. 1689. The main difference between H.R. 1689 and H.R. 1653 is that the former would only preempt class actions, while the latter would preempt all actions.

66. *See supra* note 30 and accompanying text.

67. *See* Press Release, Rep. Eshoo and Rep. White Introduce Uniform Standards Legislation for Securities Strike Suits, May 21, 1997 ("A federal preemption over state jurisdiction in these cases is needed because lawyers are now avoiding federal courts in favor of state courts, where companies are more vulnerable. From early 1996 through October 1996, securities class actions filed in federal court decreased by approximately 20% from the same period in 1995. However, suits of this type in state courts have nearly doubled in the same period.").

68. Securities Litigation Uniform Standards Act of 1997, S. 1260, 105th Cong.

69. *See October 29 Hearing*, *supra* note 14, at 5 (statement of Senator Gramm) ("We held a hearing earlier this year to take a look at how the new law [the Reform Act] was being received and how it was working. We discovered from that hearing that what was occurring is that it [sic] has simply been a shift of all these lawsuits into state court. So, Senator Dodd and I thought about this, looked at it and decided to introduce a bill that basically said that for class action suits, and class action suits only, where you are dealing with a stock that is traded nationally, so there is clearly an overriding national interest, that those suits have to be filed in federal court."); Lynn Stevens Hume, *Senators Introduce Preemption Bill; GFOA, Others Call Move Unwarranted*, BOND BUYER 1 (Oct. 8, 1997) (quoting Senator Dodd as stating that the bill will "address this state litigation problem before it gets completely out of control").

ance in connection with the purchase or sale of a security. The bills' language appears to be based, at least in part, on that of Exchange Act Rule 10b-5, the antifraud provision most often charged in federal class actions.

Second, each bill preempts only "class actions," defined primarily as those suits where "damages are sought on behalf of more than twenty-five persons." The twenty-five person threshold appears somewhat arbitrary and low. Further, the bills defined "class action" to include any "single lawsuit, or any *group* of lawsuits filed in or pending in the same court."[70] The Commission has expressed concern about the effects of allowing the grouping of lawsuits combined with the low twenty-five person threshold:

> [I]f [twenty-five] plaintiffs filed separate individual lawsuits, arising from the same set of facts, in the same state court, it is likely that each of these lawsuits would be preempted because they would be regarded as a "group" of lawsuits involving common questions of law or fact. In an era where it is not uncommon for a corporation to have hundreds of millions of shares outstanding and hundreds of thousands of investors, the twenty-five person limit, combined with the allowance for grouping, could serve to preempt many individual actions.[71]

Third, each bill preempts not only state blue sky statutory claims but all common law claims as well, which include claims for fraud and negligent misrepresentation. Further, these claims are preempted even if brought as pendent claims in federal court, where the terms of the Reform Act would apply. This last point has received little attention. If the purpose of preemption is to ensure that the Reform Act is not frustrated, it is unclear why state claims cannot be heard in federal court, where defendants will have all the safeguards of the Reform Act.

The Senate and House bills differ in one key aspect—the types of securities falling within their coverage. Senate Bill 1260 only preempts cases based on transactions involving a "covered security." Keying off of a definition provided by the National Securities Market Improvement Act of 1996, Senate Bill 1260 defines "covered security" to include primarily those listed on the NYSE, AMEX, or Nasdaq NMS, or securities issued by investment companies. House Bill 1689 defines "covered security" significantly more broadly, covering *all* securities of an issuer so long as the issuer had outstanding *any* security listed on the NYSE, AMEX, or Nasdaq NMS.

If either bill were to pass into law, the result would be that most securities class actions could no longer be brought in state court under state law. The main exception would be the continuing availability of state class actions against companies issuing penny and microcap stocks, an exception the Com-

---

70. Securities Litigation Uniform Standards Act of 1997, H.R. 1689., 105th Cong.; Securities Litigation Uniform Standards Act of 1997, S. 1260, 105th Cong.

71. Letter from Isaac C. Hunt, Jr. SEC Commissioner to Senator Wayne Allard, (Nov. 21, 1997) (on file with author).

mission favors.[72] The Commission has also advised the Congress that it strongly supports the rights of individuals to continue to sue in state court.[73]

VI

CONCLUSION

By the time this article is published, Congress will likely have taken action on one or more of the three legislative proposals that have been introduced. There appears to be strong support for imposing additional limitations on private securities actions, although the reasons asserted in favor of legislation broadly preempting state law claims do not withstand careful analysis. Nevertheless, the legislation must also be evaluated from the point of view of whether it is desirable to adopt a national standard for claims involving securities traded over national exchanges. Such a standard undoubtedly would provide greater certainty to issuers selling securities nationwide and would help effectuate key Reform Act provisions such as the safe harbor and the discovery stay.

Any national standard that is enacted, however, must be one that adequately protects the rights of injured investors. Given the current assaults on the existing standard that permits recovery for reckless conduct, we must proceed cautiously. If Congress elects to preempt state law claims that permit recovery for reckless behavior in favor of a federal standard that is limited to deny such recovery, we will have achieved a uniform standard but at an unacceptable cost.

72. *See October 29 Hearing*, *supra* note 14, at 18 (noting a rise in fraud in these markets and concluding that due to the concerns of both the federal government and the states in this area, preemption of class claims involving penny and micro-cap stocks is unwarranted.)

73. *See id.* at 17 (pointing out that individual actions at the state level are particularly appropriate when claims against stock brokers for churning or misappropriation are involved).