THE NONTRIAL ADVERSARIAL MODEL

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I
INTRODUCTION

During the past two decades, a nontrial adversarial model has evolved for deciding private securities law claims. Underlying this evolution are three different types of dynamics:

(1) a dramatic growth in the size of securities class actions, epitomized by the Washington Public Power Supply System litigation of the 1980s[1] and the Court's approval of the fraud-on-the-market presumption, rather than a requirement of individual proof of fraud, in *Basic, Inc. v Levinson*;[2]

(2) a significant growth in the cost and litigation leverage of discovery;[3] and

(3) a fundamental shift in the political orientation of Congress in securities litigation, illustrated by the gravitation from unanimous support for greater insider trading penalties during the 1980s[4] to the hostility toward plaintiffs' attorneys after the 1994 congressional election.[5]

This comment is also available at http://www.law.duke.edu/journals/64LCPSeligman.

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1. *See, e.g.*, Joel Seligman, *The Washington Public Power Supply System Debate*, 14 J. CORP. L. 889 (1989).

2. 485 U.S. 224, 247 (1988).

3. *See The Statement of the Managers on the Private Securities Litigation Reform Act of 1995*, [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,710, at 87,200 (Dec. 13, 1995).

> Congress has been prompted by significant evidence of abuse in private securities lawsuits to enact reforms to protect investors and maintain confidence in our capital markets. The House and Senate Committees heard evidence that abusive practices committed in private securities litigation include: (1) the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action; (2) the targeting of deep pocket defendants, including accountants, underwriters, and individuals who may be covered by insurance, without regard to their actual culpability; (3) the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle; and (4) the manipulation by class action lawyers of the clients whom they purportedly represent.

Id.

4. *See, e.g.*, Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264; Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677.

5. *See* Securities Litigation Uniform Standard Act of 1998, Pub. L. No. 105-353, 112 Stat. 32270 (codified as amended in scattered sections of 15 U.S.C.).

While this nontrial adversarial model is not unique to the field, it is more pronounced in private securities class actions than in most other areas. Virtually every private securities class action in recent years has been resolved through a pretrial motion or a settlement.[6] A trial on the merits is a rare exception.[7] The central issue raised as a result of this shift is whether the nontrial adversarial model makes sense in the area of securities litigation. Professor Elliott Weiss supports this shift in his article "Pleading Securities Fraud."[8] However, the answer to this question should await a more comprehensive study of the Private Securities Litigation Reform Act of 1995 ("PSLRA").

II

DEVELOPMENT OF THE NONTRIAL ADVERSARIAL MODEL

The origins of this shift to the nontrial adversarial model can be traced back to the Supreme Court's discussion of strike suits in its 1975 decision *Blue Chip Stamps v. Manor Drug Stores*.[9] There, the Supreme Court expressed its concern regarding the potential for a large number of plaintiffs in securities class actions to abuse their leverage under the Federal Rules of Civil Procedure's discovery rules to force settlements in frivolous lawsuits.[10] As a result, after *Blue Chip Stamps*, the "successful assertion of a [Rule 9(b)] defense based on the failure of a plaintiff to have pleaded fraud with sufficient particularity increased in federal securities" cases.[11]

Underlying this increase in the number of dismissals based on Rule 9(b) motions were profound changes in judicial interpretation of the Rule's application in private securities cases. During this period, federal courts found the Rule to require them to dismiss securities claims that were mere conclusory allegations to the effect that a defendant's conduct was fraudulent or in violation of Rule 10b-5,[12] or that the defendant's reports represented a "false, misleading, and inflated picture of assets, earnings, and business."[13] An example of this interpretation of the Rule is found in the following statement by the First Circuit Court of

6. *See, e.g.,* Joel Seligman, *The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority,"* 108 HARV. L. REV. 438, 445-50 (1994).

7. *See id*.

8. *See* Elliott J. Weiss, *Pleading Securities Fraud*, 64 LAW. & CONTEMP. PROBS. 5 (Spring/Summer 2001).

9. 421 U.S. 723, 740-41 (1975).

10. *Id*.

11. 10 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 4531 & n.152 (3d ed. 1996). Senator Domenici, for example, summarized the litigation experience of a leading—if not *the* leading—plaintiffs' litigation firm, which in 1990 and 1991 filed 111 cases, and found that 38% were dismissed on a motion, with the balance of cases subsequently settled. 140 CONG. REC. S3706 (daily ed. Mar. 24, 1994) (statement of Sen. Domenici).

12. *See, e.g.*, Greenstone v. Cambex Corp., 975 F.2d 22, 25-27 (1st Cir. 1992); Farlow v. Peat, Marwick, Mitchell & Co., 956 F.2d 982 (10th Cir. 1992); Moore v. Kayport Package Express, Inc., 885 F.2d 531, 540 (9th Cir. 1989) ("While statements of the time, place, and nature of the alleged fraudulent activities are sufficient, mere conclusory allegations of fraud are insufficient.").

13. Decker v. Massey-Ferguson, Ltd., 681 F.2d 111, 115 (2d Cir. 1982).

Appeals in *Wayne Investment Inc. v. Gulf Oil Corp.*: "It is well settled that Rule 9 'requires specification of the time, place, and content of an alleged false representation, but not the circumstances or evidence from which fraudulent intent could be inferred.'"[14] This opinion epitomized the movement toward stricter pleading requirements for fraud for plaintiffs under Rule 9(b) after *Blue Chip Stamps*.

Despite this growing trend, "[o]n a motion to dismiss, [courts still] read the complaint generously and drew all inferences in favor of the pleader."[15] Courts still gave deference to the plaintiffs' complaint for two central reasons. First, Rule 9(b) did not require "the pleading of detailed evidentiary matter."[16] This meant that courts could not get a clear idea of the strength of a case prior to the discovery phase of litigation. As a result, judges needed to be more cautious in dismissing claims to protect valid lawsuits. A second reason was that Rule 9(b) also did not "require any particularity in connection with an averment of intent, knowledge or condition of the mind."[17] Instead, it merely "require[d] the identification of the circumstances constituting fraud so that the defendant can prepare an adequate answer from the allegations."[18] Under Rule 9(b), scienter could still be averred generally.[19]

In the years before the PSLRA, the Second Circuit significantly tightened these pleading requirements. In 1990, for example, the court held that "[a]lthough scienter need not be alleged with great specificity, plaintiffs are still required to plead the factual basis which gives rise to a 'strong inference' of fraudulent intent."[20] By 1994, this had hardened into a stricter pleading standard that required a "strong inference" of fraud.[21]

In 1995, as part of the PSLRA, Congress adopted new pleading requirements for private securities class actions. These are, *in toto*:

> (1) MISLEADING STATEMENTS AND OMISSIONS. In any private action arising under this title in which the plaintiff alleges that the defendant:

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14. 739 F.2d 11, 13 (1st Cir. 1984) (quoting McGinty v. Beranger Volkswagen, Inc., 633 F.2d 226, 228 (1st Cir. 1980)).

15. Cosmas v. Hassett, 886 F.2d 8, 11 (2d Cir. 1989).

16. Walling v. Beverly Enter., 476 F.2d 393, 397 (9th Cir. 1973); *see also* Shapiro v. UJB Fin. Corp., 964 F.2d 272, 284 (3d Cir. 1992) ("[C]ourts should be sensitive to the fact that application of [Rule 9(b)] prior to discovery 'may permit sophisticated defrauders to successfully conceal the details of their fraud.'") (quoting Christidis v. First Pa. Mortgage Trust, 717 F.2d 96, 99-100 (3d Cir. 1983)); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 379 (2d Cir. 1974) ("[A] complainant is not required to plead evidence.").

17. *Walling*, 476 F.2d at 397; s*ee also* Tomera v. Galt, 511 F.2d 504, 508 (7th Cir. 1975).

18. *Walling*, 476 F.2d at 397.

19. FED. R. CIV P. 9(b); *see, e.g.*, Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 272-73 (3d Cir. 1978).

20. 902 F.2d 169, 172 (2d Cir. 1990).

21. *See* Shields v. Citytrust Bancorp., Inc., 25 F.3d 1124, 1129 (2d Cir. 1994); *accord* Lucia v. Prospect St. High Income Portfolio, Inc., 36 F.3d 170, 174 (1st Cir. 1994) (The "pleading requirement is required 'even when the fraud relates to matters peculiarly within the knowledge of the opposing party.'") (quoting Romani v. Shearson Lehman Hutton, 929 F.2d 875, 878 (1st Cir. 1991)). In contrast, the Ninth Circuit rejected en banc the conclusion that pleading a strong inference of fraud is consistent with Rule 9(b). *See In re* GlenFed, Inc. Sec. Litig., 42 F.3d 1541 (9th Cir. 1994) (en banc).

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

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

(2) REQUIRED STATE OF MIND. In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.[22]

The Manager's Statement made clear Congress' intent to alter existing federal securities law pleading requirements. It states in relevant part:

> Regarded as the most stringent pleading standard, the Second Circuit requirement is that the plaintiff state facts with particularity, and that these facts, in turn, must give rise to a "strong inference" of the defendant's fraudulent intent. Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard. The plaintiff must also specifically plead with particularity each statement alleged to have been misleading. The reason or reasons why the statement is misleading must also be set forth in the complaint in detail. If an allegation is made on information and belief, the plaintiff must state with particularity each statement alleged to have been misleading. The reason or reasons why the statement is misleading must also be set forth in the complaint in detail. If an allegation is made on information and belief, the plaintiff must state with particularity all facts in the plaintiff's possession on which the belief is formed.[23]

These pleading requirements are the culmination of this movement by courts toward greater protections for defendants in securities class action suits.

III

PROFESSOR WEISS'S ANALYSIS

Professor Weiss's article focuses on the 1995 Act pleading standards, particularly what he characterizes as "the basic requirement," 15 U.S.C. § 78u-4(b)(1), which requires pleading of "each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the mistake or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."[24] In Weiss's view, a stringent interpretation of the basic requirement is essential to implementing Congress's goal of protecting issuers and others from frivolous and speculative claims of securities fraud.[25] With typical analytical precision, Professor Weiss analyzes how courts should address the application of the basic requirement, believing as he does that these issues will prove to be even more

22. 15 U.S.C. § 78u-4(b)(1)-(2) (Supp. IV 1998).

23. Private Securities Litigation Reform Act, Rel. No. 1692, [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,710 at 87,207 (Dec. 13, 1995).

24. 15 U.S.C. § 78u-4(b)(1) (Supp. IV 1998).

25. *See* Weiss, *supra* note 8, at 8.

significant than the issues relating to motive, opportunity, and degrees of recklessness that have preoccupied attorneys, courts, and commentators to date.[26]

Professor Weiss may be right. But I think the larger point is that the PSLRA both augmented the pleading with particularity standard in § 78u-4(b)(1) *and* either equaled or *exceeded* the Second Circuit's earlier strong inference of intent standard in § 78u-4(b)(2).[27] Both represent significant obstacles to a plaintiff's initiation of a class action. What gives them particular significance is that Congress in the PSLRA created other obstacles to litigation at trial on the merits. One of these, inspired by Weiss,[28] was Congress's adoption of a procedure for the appointment of lead plaintiffs in class actions.[29] As the PSLRA states, not more than twenty days after the complaint is filed, the plaintiff must file "in a widely circulated national business oriented publication or wire service" a notice advising the plaintiff class regarding the claims asserted and that any member of the class may move within sixty days to serve as lead counsel.[30] Also, not later than ninety days after the filing of the plaintiffs' initial notice regarding lead counsel, the court is required to appoint as lead plaintiff "the member or members of the purported plaintiff class that the court determines to be most capable of adequately representing the interests of class members (…'the most adequate plaintiff')."[31] During this period, limited discovery is permitted if a plaintiff "demonstrates a reasonable basis for finding that the presumptively most adequate plaintiff is incapable of adequately representing the class."[32] As the statute states, "the most adequate plaintiffs, subject to court approval, shall select and retain counsel to represent the class."[33] These provisions make it more difficult for plaintiffs to bring securities class action lawsuits.

Professor Jill Fisch focuses her paper on aggregation and auction procedures in the selection of lead counsel under the PSLRA.[34] She questions the statutory basis for aggregation of unrelated investors into a lead plaintiff group, as well as judicial development of auction procedures for selection of lead counsel, which originated with the 1990 Oracle Securities litigation[35] and have been followed in

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26. *See id*. at 7.

27. *See, e.g.,* Press v. Chem. Inv. Serv. Corp., 166 F.3d 529, 537-38 (2d Cir. 1999) (heightening the requirement to Second Circuit "strong inference of intent" standard); *In re* Advanta Corp. Sec. Litig., 180 F.3d 525 (3d Cir. 1999) (same); *In re* Comshare, Inc. Sec. Litig., 183 F.3d 542, 551-53 (6th Cir. 1999) (similar); Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1283 (11th Cir. 1999) (following 6th Circuit); Williams v. WMX Tech, Inc., 112 F.3d 175, 178 (5th Cir. 1997). *But see In re* Silicon Graphics Inc. Sec. Litig., 183 F.3d 970, 974 (9th Cir. 1999) (elevating pleading requirement above Second Circuit standard).

28. *See* Elliot J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053 (1995).

29. *See* 15 U.S.C. § 77z-1(a)(3) (Supp. 2000); *id* § 78u-4(a)(3) (Supp. IV 1998).

30. 15 U.S.C. § 77z-1(a)(3)(A); *id.* § 78u-4(a)(3)(A).

31. 15 U.S.C. § 78u-4(a)(3)(B)(i). The criteria for selection are delineated in 15 U.S.C. § 77z-1(a)(3)(B)(iii) and 15 U.S.C. § 78u-4(a)(3)(B)(iii).

32. 15 U.S.C. § 77z-1(a)(3)(B)(iv); *id.* § 78u-4(a)(3)(B)(iv).

33. 15 U.S.C. § 77z-1(a)(3)(B)(v); *id.* § 78u-4(a)(3)(B)(v).

34. *See* Jill E. Fisch, *Aggregation, Auctions and Other Developments in the Selection of Lead Counsel Under the PSLRA*, 64 LAW & CONTEMP. PROBS. 57 (Spring/Summer 2001).

35. *See In re* Oracle Sec. Litig., 131 F.R.D. 688 (N.D. Cal. 1990).

post-PSLRA cases such as *In re Cendant Corp. Litigation*[36] and Judge Walker's 1999 decision in *Wenderhold v. Cylink Corp*.[37] Professor Fisch questions the wisdom of weakening the relationship between lead counsel and the client class, while acknowledging that the objective of the auction process is to maximize recovery for the plaintiff class.[38]

I have a different concern with the PSLRA's lead counsel procedures. To the extent that they are used,[39] the process has created a great deal of collateral litigation that further delays trials on the merits. For example, there have been reported cases on the selection of the lead plaintiff in terms of largest financial interest,[40] aggregation of claims,[41] disclosure of adequate information about the lead plaintiff,[42] whether the proposed lead plaintiffs are capable of adequately protecting the interests of class members,[43] and whether defendants have standing to oppose the appointment of a lead plaintiff.[44] Simultaneously, the courts have wrestled with a separate but related issue: What, if any, discovery rights does the plaintiff have in the period covered by the 15 U.S.C. § 78u-

36. 182 F.R.D. 144 (D.N.J. 1998).

37. 188 F.R.D. 577 (N.D. Cal. 1999).

38. *See* Fisch, *supra* note 34, at 59.

39. For the most part, however, institutional investors have used the lead plaintiff procedure sparingly. In 1996, the procedure was employed in only eight of 105 securities cases filed in federal court; in 1997, in only nine of 175 cases did institutions seek the role of lead plaintiff. *Institutional Investors Not Opting to Lead Class Suits, Despite Potential Recoveries*, 30 Sec. Reg. & L. Rep. (BNA) 405 (Mar. 13, 1998).

40. *See* Gluck v. Cellstar Corp., 976 F. Supp. 542 (N.D. Tex. 1997). In this case, the court appointed as lead plaintiff the shareholder with the largest financial interest of any class member (who also satisfied the Rule 23 requirements) and rejected a proposal for a co-lead plaintiff because the largest shareholder might potentially be subject to typicality and adequacy challenges. *See id.*at 547-48. The court, however, did recognize that "co-lead plaintiffs might be appropriate in certain situations, such as two institutional investors with roughly equal economic losses in a particular case, or two or more smaller investors with roughly equal interests where there is no plaintiff with a significantly larger interest than all other plaintiffs." *Id.* at 549-50; *see also In re* Donnkenny Inc. Sec. Litig., 171 F.R.D. 156, 157-58 (S.D.N.Y. 1997) (naming shareholder with largest financial interest as the lead plaintiff); Blaich v. Employee Solutions, Inc., [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,109, at 90,147 (D. Ariz. 1997) (rejecting plaintiff group's request to obtain discovery "in order to demonstrate that the presumptively most adequate plaintiff is incapable of adequately representing the class").

41. *See, e.g.*, Yousefi v. Lockheed Martin Corp., 70 F. Supp. 2d 1061 (C.D. Cal. 1999). There, the court acknowledged that "the majority of courts addressing the issue have permitted the aggregation of claims," but declined to appoint 137 lead plaintiffs. *See id.* at 1067-68.

42. *See* Switzenbaum v. Orbital Sciences Corp., 187 F.R.D. 246 (E.D. Va. 1999). In this case, the court did not appoint the lead plaintiff applicant with the largest damages when the group chose not to provide meaningful information about the identity of its members. *See id.* at 250.

43. *See* Wenderhold v. Cylink Corp., 187 F.R.D. 577 (N.D. Cal. 1999).

44. *See* Takeda v. Turbodyne Tech., Inc., 67 F. Supp. 2d 1129 (C.D. Cal. 1999). In this case, the court ruled that the defendants had no standing to oppose the appointment of a lead plaintiff but addressed their concerns sua sponte. *See id.* at 1137-39. Another court held that a defendant may not oppose a plaintiff's motion regarding satisfaction of the lead plaintiff provision, 15 U.S.C. § 78u-4(a)(3)(B) (Supp. IV 1998), but may object to the adequacy of certification and notice when these "are prerequisites to consideration of a motion for lead plaintiff." *See* Greebel v. FTP Software, Inc., 939 F. Supp. 57, 61 (D. Mass. 1996); s*ee also* King v. Livent, Inc., 36 F. Supp. 2d 187 (S.D.N.Y. 1999) (sustaining defendant objections to notice requirements in appointment of lead counsel).

4(b)(3) stay of discovery during the pendency of a motion to dismiss?[45] This adds to the delay in meritorious suits.

IV

CONCLUSION

The basic policy issue suggested by the elevation of standards for a plaintiff to survive a motion to dismiss for failure to plead with sufficient particularity, the lead plaintiff litigation-within-litigation, and related discovery stays is whether a dispute resolution system in which litigation on the merits is increasingly remote makes sense. To be sure, a nontrial system reduces the costs and burden of litigation on corporations, reduces frivolous or nonmeritorious litigation, and may strengthen desirable entrepreneurial risk-taking. But a nontrial system also may systematically reduce incentives to comply with a mandatory disclosure system and reduce the deterrent impact of fraud remedies. I am skeptical as to whether these types of policy issues have been effectively studied before or after the PSLRA. Certainly a mere longitudinal count of the number of federal or state claims filed does not address the merits of the evolving nontrial system. Professor Weiss's more demanding inquiry into the merits of specific complaints suggests that marshalling better evidence is possible. In the Special Study of Securities Markets (1961-1964), the Securities and Exchange Commission itself addressed the quality of bank and insurance corporation disclosures and linked this study to a proposal concerning the scope of the 1934 Act. An appropriate study of the PSLRA could address such topics as the following:

(1) to what extent have trials on the merits been delayed;
(2) to what extent have the percentage of trials on the merits declined; and
(3) to what extent has the quality of information in the mandatory disclosure system been enhanced or deteriorated.

These are serious questions that are overdue for study. Were the results of such a study available, we would be better positioned to address the claims of Professor Weiss. Analysis of the appropriate pleading standard would be quite different if there has been a material increase in the delay of meritorious claims or if claims that appear to be meritorious are being dismissed before trial. The claims of Professor Fisch that the aggregation and auction procedures have

45. 15 U.S.C. § 78u-4(b)(3)(B) has been held to stay discovery required by Rule 26 of the Federal Rules of Civil Procedure. *See* Medhekar v. U.S. Dist. Ct., 99 F.3d 325 (9th Cir. 1996). The stay also applies to the period during which a motion for reconsideration of a dismissal decision was under review. *See* Powers v. Eichen, 961 F. Supp. 233 (S.D. Cal. 1997). In *SG Cowen Sec. Corp. v. United States Dist. Ct. for N.D. of Cal.*, 189 F.3d 909 (9th Cir. 1999), the court followed *Medhekar* and held that limited discovery may not be permitted so that a plaintiff might uncover facts sufficient to satisfy the Act's pleading requirements. *See id.* at 913. As the court in *Medhekar* stated, "Congress clearly intended that complaints in these securities actions should stand or fall based on the actual knowledge of the plaintiffs rather than information provided by the defendants after the action has been filed." 99 F.3d at 328.

weakened the relationship between legal counsel and the client class also may be viewed in a different light if auction procedures are comparatively infrequent. It would be worth studying the outcome of auction procedures as well. Do plaintiffs, in fact, receive higher net payments from auction procedures than non-auction procedures? Since both classes of cases are typically settled and the number of auction cases to date is small, there will be practical limits to the value of the data.

Despite the need for these questions to be addressed, the issues that Professors Weiss and Fisch raise are serious ones. The assembly of more empirical evidence would only improve the quality of this analysis and give us a better understanding of the real effects of the nontrial adversarial model on securities class actions suits.