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NOTE

SEEKING ENLIGHTENMENT FROM ABOVE: CIRCUIT COURTS SPLIT ON THE INTERPRETATION OF THE REFORM ACT'S HEIGHTENED PLEADING REQUIREMENT

INTRODUCTION

The private securities litigation system is essential to the integrity of American capital markets. Private securities litigation is an invaluable tool with which defrauded investors can regain their losses without resorting to government assistance.¹ For these reasons, the Securities and Exchange Commission ("SEC" or "Commission") has frequently stressed the importance of private actions under the federal securities laws.² These actions help deter wrongdoing, thereby supplementing the SEC's own enforcement efforts.³ The system, however, is undermined by abusive and frivolous lawsuits.⁴ To

¹ Statement of Managers, The Private Securities Litigation Reform Act of 1995, H.R. CONF. REP. NO. 104-369 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 1995 WL 709276 [hereinafter Statement of Managers]; *see also* Frank v. Cooper Indus., SEC Litigation Release No. 14356 (Dec. 15, 1994), 58 S.E.C. Docket 697, 1994 WL 707203.

² *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *J.I. Case Co. v. Borak*, 377 U.S. 426, 432-33 (1964); *see also* Frank v. Cooper Indus., SEC Litigation Release No. 14356, 58 S.E.C. Docket 697, 1994 WL 707203 ("The Commission has consistently stressed the importance of and supported private rights of action under the antifraud provisions of the securities laws."); Arthur Levitt, *Between Caveat Emptor and Caveat Vendor: The Middle Ground of Litigation Reform*, Remarks at the 22nd Annual Securities Regulation Institute, San Diego, California (Jan. 25, 1995).

³ Indeed, in *Bateman Eichler*, the Court recognized that it has "repeatedly . . . emphasized that implied private actions provide 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.'" 472 U.S. at 310 (quoting *Borak*, 377 U.S. at 432 and citing *Blue Chip Stamps*, 421 U.S. at 730); *see also* Frank v. Cooper Indus., SEC Litigation Release No. 14356, 58 S.E.C. Docket 697, 1994 WL 707203; John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, 335 (1996).

⁴ *See* Statement of Managers, H.R. CONF. REP. NO. 104-369, *reprinted in* 1995

curb this abuse, Congress enacted the Private Securities Litigation Reform Act of 1995 ("Reform Act" or "Act").⁵ In doing so, however, Congress has unleashed a flood of litigation to clear up ambiguities in the statute.

Among the most litigated provisions of the Reform Act is the pleading standard for scienter (the required state of mind) in private securities fraud litigation. To date, six circuit courts—the First, Second, Third, Sixth, Ninth, and Eleventh—have rendered conflicting decisions regarding what Congress intended when it enacted the Reform Act. Additionally, there is dicta from the Fourth Circuit on this issue. These decisions cry for clarity and uniformity from the Supreme Court.⁶

This Note provides an overview of the circuit court conflict, the impact this conflict has on securities regulation, and the need for the Supreme Court's guidance on the scienter issue. Part I discusses the road to the Reform Act, including the impetus behind the legislation. Part II states the holdings of the circuit court cases that have construed the Reform Act and articulates the SEC's position on the scienter issue. Essentially, seven circuits have spoken on the issue, following three different lines of interpretation. Part III analyzes the Reform Act's plain language and legislative history to show why the Supreme Court, if petitioned, should conclude that Congress did not change the substantive standard for scienter when it enacted the Reform Act. Rather, it altered the nature of the allegations needed to allege scienter. Furthermore, this Note will demonstrate why the Supreme Court should find that the required state of mind for private securities fraud actions could be pleaded through circumstantial evidence of conscious misbehavior or recklessness but not through allegations of motive and opportunity to commit fraud.

U.S.C.C.A.N. 730, 1995 WL 709276.

⁵ Pub. L. No. 104-67, 109 Stat. 737 (codified at 15 U.S.C. § 78u-4(b)(1)-(2) (2000)).

⁶ At this time, no cases have petitioned the Supreme Court for certiorari.

I. BACKGROUND

A. *Section 10(b) of the Securities Exchange Act of 1934*⁷ and *Rule 10b-5*⁸

Government regulation of securities transactions emerged as part of the aftermath of the market crash in 1929.⁹ During the Great Depression, Congress promulgated the Securities Act of 1933¹⁰ ("1933 Act") and the Securities Exchange Act of 1934¹¹ ("Exchange Act") to encourage investor confidence in United States securities markets and thereby, to stimulate the investment necessary for capital formation, economic growth, and job creation.¹² The 1933 Act provides investors with full disclosure of material information regarding public securities offerings and protects investors against fraud.¹³ By imposing specified civil remedies, Congress intended for the 1933 Act to promote ethical standards of honesty and fair dealing in securities transactions.¹⁴ The Exchange Act provides for regulation of transactions upon securities exchanges and in over-the-counter markets.¹⁵ With the primary intention of safeguarding investors from manipulation of stock prices, the Exchange Act imposes regular reporting requirements on corporations whose stock appears on national securities exchanges.¹⁶

Section 10(b) of the Exchange Act makes it unlawful for any person "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regu-

⁷ 15 U.S.C. § 78j(b).

⁸ 17 C.F.R. § 240.10b-5 (2001).

⁹ See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 (1976).

¹⁰ 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a et seq. (1933)).

¹¹ 48 Stat. 891 (codified at 15 U.S.C. §§ 72a et seq. (1934)).

¹² See Pub. L. No. 104-67, Private Securities Litigation Reform Act of 1995, S. REP. NO. 104-98 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 1995 WL 372783.

¹³ See *Hochfelder*, 425 U.S. at 195 (citing H.R. REP. NO. 73-85, at 1-5 (1933)).

¹⁴ See *id.* While both the 1933 Act and the Exchange Act contain express civil remedies and criminal penalties, Congress realized that a strict statutory regime would not efficiently regulate securities trading. See *id.* Therefore, as part of the Exchange Act, Congress created the SEC, which is provided with "an arsenal of flexible enforcement powers." *Id.* (citing examples in both the 1933 Act and the Exchange Act of the SEC's enforcement power).

¹⁵ *Id.*; see also S. REP. NO. 73-792, at 1-5 (1934).

¹⁶ See S. REP. NO. 73-792, at 1-5.

lations as the Commission may prescribe.”¹⁷ Under this Section, the SEC promulgated Rule 10b-5, which declares it unlawful “[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.”¹⁸ To allege securities fraud under either § 10(b) or Rule 10b-5, a plaintiff must show that the defendant (1) made a misstatement or omission, (2) of a material fact, (3) with scienter, (4) on which the plaintiff relied, (5) that proximately caused his injury.¹⁹ The plain language of § 10(b) does not create a civil remedy for its violation.²⁰ Moreover, neither Congress,²¹ nor the Commission when adopting Rule 10b-5,²² envisioned such a remedy. Nonetheless, courts have found that Congress implicitly sanctioned such actions, and it is now well-established that § 10(b) and Rule 10b-5 give litigants a private right of action in securities fraud cases.²³ However, since § 10(b) lawsuits are a creature of the courts and not the legislature, judges have vast discretion in determining their parameters.²⁴ As a result, conflicting legal standards have developed, creating considerable uncertainty and the occasion for abuses of, amongst others, professional firms, investors, and issuers.²⁵

¹⁷ 15 U.S.C. § 78j(b) (Supp. 2000).

¹⁸ 17 C.F.R. § 240.10b-5 (2001).

¹⁹ See *Hochfelder*, 425 U.S. at 199 n.18; *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1281 (11th Cir. 1999) (citing *Ross v. Bank South, N.A.*, 885 F.2d 723, 728 (11th Cir. 1989) (en banc)).

²⁰ See 15 U.S.C. § 78j(b); see also *Hochfelder*, 425 U.S. at 196.

²¹ *Hochfelder*, 425 U.S. at 196 (citing Note, *Implied Liability Under the Securities Exchange Act*, 61 HARV. L. REV. 858, 860 (1948)); see also S. REP. NO. 104-98, reprinted in 1995 U.S.C.C.A.N. 679, 1995 WL 372783 (“Congress has never expressly provided for private rights of action when it enacted Section 10(b).”).

²² *Hochfelder*, 425 U.S. at 196 (citing *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 463 (2d Cir. 1952)).

²³ See, e.g., *Hochfelder*, 425 U.S. at 196; *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971); see also S. REP. NO. 104-98, reprinted in 1995 U.S.C.C.A.N. 679, 1995 WL 372783.

²⁴ See S. REP. NO. 104-98, reprinted in 1995 U.S.C.C.A.N. 679, 1995 WL 372783.

²⁵ See *id.* (“The lack of congressional involvement has left judges free to develop conflicting legal standards.”).

B. *Setting the Stage: What is All the Fuss About?*

On December 22, 1995, over President Clinton's veto,²⁶ the Reform Act became effective, ending a long legislative effort to revise both the substantive and procedural law governing private actions under the federal securities laws.²⁷ The Reform Act was intended to address concerns about abusive practices in securities class action lawsuits.²⁸ To comprehend the need for such reforms, it is necessary to review the genesis of the Reform Act.

Supporters of the Reform Act, including accountants, securities firms, and the high technology industry, believe that they are victims of "strike suits"—actions filed whenever there is a sudden fall in a company's stock price.²⁹ These suits allege that the issuer and its agents fraudulently misled shareholders by misrepresenting a company's operations or performance to inflate its stock price.³⁰ Securities class action critics claim that plaintiffs' attorneys file "strike suits" against deep

²⁶ Private Securities Litigation Reform Act of 1995, Veto Message from the President of the United States, H.R. DOC. NO. 104-150, *reprinted in* 141 CONG. REC. H15,214 (daily ed. Dec. 20, 1995), *available at* 1995 WL 752858 [hereinafter Veto Message]. *See infra* note 204 and accompanying text.

²⁷ For a comprehensive study of the road leading to the Reform Act, see generally Avery, *supra* note 3.

²⁸ Indeed, Senator D'Amato remarked, "There is broad agreement on the need to reform. Shareholders' groups, Corporate America, the SEC, and even lawyers all want to curb abusive practices." S. REP. NO. 104-98, *reprinted in* 1995 U.S.C.C.A.N. 679, 1995 WL 372783 (citation omitted). In the conference report, the committee members announced that the purpose of the Reform Act was to restrict abuses in securities class action litigation, including the following: (1) the practice of filing lawsuits against issuers of securities in response to any significant change in stock price, regardless of defendant's culpability; (2) the targeting of "deep pocket" defendants; (3) the abuse of the discovery process to coerce settlement; and (4) the manipulation of clients by class action attorneys. Statement of Managers, H.R. CONF. REP. NO. 104-369, *reprinted in* 1995 U.S.C.C.A.N. 730, 1995 WL 709276.

²⁹ *See* Statement of Managers, H.R. CONF. REP. NO. 104-369, *reprinted in* 1995 U.S.C.C.A.N. 730, 1995 WL 709276; *see also* Robert J. Giuffra, Jr., *CEO's Beware: The Strike Suit Lives*, WALL ST. J., Sept. 13, 1999, at A45 (discussing the danger of strike suits) [hereinafter Giuffra, *Strike Suit*]. Strike suits are defined as "shareholder derivative action[s] begun with [the] hope of winning large attorney fees or private settlements, and with no intention of benefitting [the] corporation on behalf of which [the] suit is theoretically brought." BLACK'S LAW DICTIONARY 992 (6th ed. 1990). The Supreme Court made the class action feasible in corporate disclosure suits in its decision in *Basic, Inc. v. Levinson*, which validated the "fraud on the market" theory. 485 U.S. 224 (1988).

³⁰ *See* Giuffra, *Strike Suit*, *supra* note 29, at A45.

pocket defendants—regardless of any underlying culpability—solely for their settlement value.³¹ These lawyers file suits alleging “a laundry list of cookie-cutter complaints” against companies within hours or days after a company announces unexpected bad news.³² When the complaint is filed, plaintiffs’ attorneys often abuse the discovery process by imposing burdensome costs on defendants with the faint hope that discovery requests will uncover some plausible claim not alleged in the complaint.³³

These abusive practices can wreak havoc on the business sector.³⁴ The dynamics of private securities fraud lawsuits generate powerful incentives to settle, making securities class actions settle at a significantly higher rate than other types of class actions.³⁵ For defendants, the massive discovery costs create enormous pressure to settle, thereby forcing even innocent parties to settle frivolous securities class actions.³⁶ Even

³¹ See Statement of Managers, H.R. CONF. REP. NO. 104-369, *reprinted in* 1995 U.S.C.C.A.N. 730, 1995 WL 709276.

³² See H.R. REP. NO. 104-50, at 16 (1995), *available at* 1995 WL 79795.

³³ See *id.*; see also S. REP. NO. 104-98, *reprinted in* 1995 U.S.C.C.A.N. 679, 1995 WL 372783.

³⁴ Indeed, as Senator Dodd recognized, “The flaws in the current private securities litigation system are simply too obvious to deny. The record is replete with examples of how the system is being abused and misused.” S. REP. NO. 104-98, *reprinted in* 1995 U.S.C.C.A.N. 679, 1995 WL 372783 (citation omitted). Senator D’Amato concurred, noting that “[l]awyers who bring meritorious suits do not benefit when strike suit artists wreak havoc on the Nation’s boardrooms and court-houses. Our economy does not benefit when the threat of litigation deters capital formation.” *Id.* (citation omitted).

³⁵ The House Committee on Commerce remarked on the impact of class actions:

Whether a shareholder lawsuit is meritorious or not, the corporation sued must spend a great deal of money to defend itself. It is common for a corporation simply to agree to a substantial settlement out of court. Despite the absence of wrongdoing by managers, corporations are essentially forced to pay large sums of money to avoid even larger expenses associated with legal defense. This has been described by some as legal extortion. Advocates of litigation reform cite empirical studies that show virtually all claims in a 10b-5 class actions, meritorious or not, are settled. The settlement bears no relationship to the underlying damages, but instead is related principally to the amount claimed or the defendant’s insurance coverage.

Joel Seligman, *The Private Securities Reform Act of 1995*, 38 ARIZ. L. REV. 717, 721 (1996) (quoting H.R. REP. NO. 104-50, at 15).

³⁶ See Statement of Managers, H.R. CONF. REP. NO. 104-369, *reprinted in* 1995 U.S.C.C.A.N. 730, 1995 WL 709276.

if a company is willing to bear the expense of litigation, it inevitably settles rather than face a potentially injurious jury verdict.³⁷ For example, one commentator noted that if the potential damages are \$100 million, and it will cost \$3 million to bring the case to trial, then if a company's chances of ultimately winning are 90%, it may be a wise business decision to settle for a portion of \$13 million, which is the discounted likelihood of losing plus attorney's fees.³⁸ Indeed, of the approximately 300 private securities lawsuits filed every year, almost 93% settle, at an average cost of \$8.6 million.³⁹ These settlements are usually based on the size of the defendants' pockets and not on the merits of the case.⁴⁰

At the same time, abusive litigation threatens the investing public by undermining a pillar of federal securities laws—disclosure to investors of information about the financial condition of publically traded companies.⁴¹ Private securities litigation under § 10(b) and Rule 10b-5 can restrict the free and open communication among management, analysts, and investors.⁴² Indeed, according to the SEC, "[T]he threat of mass shareholder litigation, whether real or perceived, has had detrimental effects."⁴³ Fearing a lawsuit if their projections

³⁷ See H.R. REP. NO. 104-50, at 17, available at 1995 WL 79795.

³⁸ See Edward Brodsky, *Circuit Split on Stock Fraud Scierter Pleading Standard*, N.Y.L.J., Sept. 8, 1999, at 3 (citing *Private Litigation under the Federal Securities Laws: Hearings before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 103 Cong. 104-05 (1993) (statement of Edward R. McCracken, President, Silicon Graphics)); see also S. REP. NO. 104-98, reprinted in 1995 U.S.C.C.A.N. 679, 1995 WL 372783 ("The settlement value to defendants turns more on the expected costs of defense than the merits of the underlying claim.").

³⁹ S. REP. NO. 104-98, reprinted in 1995 U.S.C.C.A.N. 679, 1995 WL 372783 (citation omitted).

⁴⁰ See *id.*; Statement of Managers, H.R. CONF. REP. NO. 104-369, reprinted in 1995 U.S.C.C.A.N. 730, 1995 WL 709276.

⁴¹ Statement of Managers, H.R. CONF. REP. NO. 104-369, reprinted in 1995 U.S.C.C.A.N. 730, 1995 WL 709276 ("[T]he investing public and entire U.S. economy have been injured by the unwillingness of the best qualified persons to serve on boards of directors and of issuers to discuss publicly their future prospects, because of fear of baseless and extortionate securities lawsuits.").

⁴² S. REP. NO. 104-98, reprinted in 1995 U.S.C.C.A.N. 679, 1995 WL 372783 (recognizing the need to encourage the voluntary disclosure of information by issuers).

⁴³ In fact, SEC Chairman Arthur Levitt remarked, "There is no denying that there are real problems in the current system—problems that need to be addressed not just because of abstract rights and responsibilities, but because investors and

fail to materialize, risk-adverse corporate managers are unwilling to discuss publicly their future business plans.⁴⁴ As a result, investing becomes more risky because "investors often receive less, not more, information."⁴⁵ Furthermore, investors are the ultimate losers when outrageous settlements are paid by issuers. When an insurer must pay attorneys' fees and settlement payments, and spend management and employee resources in defending frivolous lawsuits, the issuers' own investors suffer.⁴⁶ A survey of venture-backed companies existing for less than ten years revealed that one in six had been sued at least once and that these cases consumed an average of 1,055 hours of management time and \$692,000 in legal fees.⁴⁷

C. Pre-Reform Act Standards

The standards for pleading scienter were relatively well-established prior to the enactment of the Reform Act. Before the Reform Act, the Second Circuit employed the most stringent pleading standard for scienter among the circuits.⁴⁸ In a

markets are being hurt by litigation excess." *Id.* (citing Arthur Levitt, Between Caveat Emptor and Caveat Vendor: The Middle Ground of Litigation Reform, Remarks at the 22nd Annual Securities Regulation Institute, San Diego, California (Jan. 25, 1995)).

⁴⁴ See Statement of Managers, H.R. CONF. REP. NO. 104-369, *reprinted in* 1995 U.S.C.C.A.N. 730, 1995 WL 709276; S. REP. NO. 104-98, *reprinted in* 1995 U.S.C.C.A.N. 679, 1995 WL 372783 (recognizing that the threat of litigation has caused corporate management to refrain from providing shareholders forward-looking information about their companies).

⁴⁵ See S. REP. NO. 104-98, *reprinted in* 1995 U.S.C.C.A.N. 679, 1995 WL 372783.

⁴⁶ Indeed, the Conference Committee recognized that investors are always the "ultimate losers" when issuers are forced to pay extortionate settlements. Statement of Managers, H.R. CONF. REP. NO. 104-369, *reprinted in* 1995 U.S.C.C.A.N. 730, 1995 WL 709276. Similarly, the Council for Institutional Investors remarked, "We are . . . hurt if a system allows someone to force us to spend huge sums of money in legal costs by merely paying ten dollars and filing a meritless cookie cutter complaint against a company or its accountants when that plaintiff is disappointed in his or her investment." S. REP. NO. 104-98, *reprinted in* 1995 U.S.C.C.A.N. 679, 1995 WL 372783 (citation omitted).

⁴⁷ See S. REP. NO. 104-98, *reprinted in* 1995 U.S.C.C.A.N. 679, 1995 WL 372783 (citation omitted). For an additional discussion of the background to the Reform Act, see U.S. Securities and Exchange Commission, Office of General Counsel, *Report to the President and the Congress on the First Year of Practice under the Private Securities Litigation Reform Act of 1995* (April 1997), at <http://www.sec.gov/news/studies/lreform.txt> [hereinafter SEC General Counsel Report].

⁴⁸ In its conference report, Congress described the Second Circuit's standard as

§ 10(b) or Rule 10b-5 securities fraud case, the Second Circuit required plaintiffs to allege "particular facts that give rise to a strong inference of fraudulent intent."⁴⁹ In the Second Circuit, plaintiffs could establish scienter by alleging either (1) facts "that constitute strong circumstantial evidence of conscious misbehavior or recklessness" or (2) facts to show that defendants had "both motive and opportunity to commit fraud."⁵⁰ This was in direct contrast to other circuits that applied a more lenient standard. For example, the Ninth and Third Circuits allowed plaintiffs to aver scienter generally, requiring only a mere statement in the complaint that scienter existed, instead of specific facts supporting the allegation.⁵¹ Nevertheless, by allowing plaintiffs to plead mere motive and opportunity to commit fraud, the Second Circuit has undermined its purportedly strict pleading standard.⁵² Indeed, the Second Circuit recently admitted that it has been "lenient in allowing scienter issues to resist summary judgment based on fairly tenuous inferences."⁵³

D. *The Supreme Court's "Contribution" to Scienter—Ernst & Ernst v. Hochfelder*

The Supreme Court has provided little guidance to lower courts in the area of securities litigation, especially regarding the scienter pleading standard. In *Ernst & Ernst v.*

"the most stringent pleading standard." Statement of Managers, H.R. CONF. REP. NO. 104-369, reprinted in 1995 U.S.C.C.A.N. 730, 1995 WL 709276; see also, e.g., *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 548 (6th Cir. 1999) (noting that before the Reform Act, the Second Circuit applied the "most stringent test" regarding how a plaintiff may plead scienter under § 10(b) or Rule 10b-5).

⁴⁹ *Shields v. Citytrust Bancorp.*, 25 F.3d 1124, 1128 (2d Cir. 1994); accord *In re Time Warner, Inc. Sec. Litig.*, 9 F.3d 259, 269 (2d Cir. 1993).

⁵⁰ *Shields*, 25 F.3d at 1128. This standard remained unchanged following the Reform Act's passage. See, e.g., *Stevelman v. Alias Research Inc.*, 174 F.3d 79, 84 (2d Cir. 1999); *Press v. Chem. Inv. Serv. Corp.*, 166 F.3d 529, 538 (2d Cir. 1999); *Chill v. Gen. Elec. Co.*, 101 F.3d 263, 267 (2d Cir. 1996).

⁵¹ See, e.g., *In re Glenfed, Inc. Sec. Litig.*, 42 F.3d 1541, 1545-47 (9th Cir. 1994); *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 285 (3d Cir. 1992).

⁵² See Robert J. Giuffra, Jr., *Pleading Scienter under the PSLRA*, N.Y.L.J., July 22, 1999, at 5 [hereinafter Giuffra, *Pleading Scienter*].

⁵³ *Press*, 166 F.3d at 538 (citing *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1467 (2d Cir. 1996) ("Whether or not a given intent existed is, of course, a question of fact.") and *In re Time Warner*, 9 F.3d at 270-71 ("Whether a given intent existed is generally a question of fact.")).

Hochfelder,⁵⁴ the Supreme Court defined "scienter" as "a mental state embracing intent to deceive, manipulate, or defraud."⁵⁵ In doing so, the Court rejected lower court decisions that allowed civil liability under § 10(b) and Rule 10b-5 for negligent conduct. The Court noted that § 10(b) prohibits the use of "any manipulative or deceptive contrivance" in violation of SEC rules, and it held that "[t]he words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct."⁵⁶ While the *Hochfelder* Court expressly declined to consider whether reckless behavior could suffice for civil liability under § 10(b) and Rule 10b-5, it acknowledged that "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act."⁵⁷ Following *Hochfelder*, but before the Reform Act, virtually all the circuit courts that have considered the issue have held that some form of "recklessness" could satisfy the scienter element.⁵⁸ However, the terminology of "recklessness" varies widely among the circuits, with some courts allowing recklessness approaching gross negligence to suffice, while others have held that conscious disregard or deliberate recklessness is required.⁵⁹ Nevertheless,

⁵⁴ 425 U.S. 185 (1976).

⁵⁵ *Id.* at 194.

⁵⁶ *Id.* Thus, as a threshold matter, to establish liability under § 10(b), a plaintiff must assert in his complaint that the defendant acted with sufficient scienter. See *SEC v. United States Envtl. Inc.*, 155 F.3d 107, 111 (2d Cir. 1998).

⁵⁷ *Hochfelder*, 425 U.S. at 194 & n.12.

⁵⁸ See, e.g., *SEC v. Steadman*, 967 F.2d 636, 641 (D.C. Cir. 1992); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990) (en banc); *McDonald v. Alan Bush Brokerage Co.*, 863 F.2d 809, 814 (11th Cir. 1989); *In re Philips Petroleum Sec. Litig.*, 881 F.2d 1236, 1244 (3d Cir. 1989); *Van Dyke v. Coburn Enter., Inc.*, 873 F.2d 1094, 1100 (8th Cir. 1989); *Hackbart v. Holmes*, 675 F.2d 1114, 1117-18 (10th Cir. 1982); *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 961-62 (5th Cir. 1981) (en banc); *Mansbach v. Prescott*, 598 F.2d 1017, 1024 (6th Cir. 1979); *Cook v. Avien, Inc.*, 573 F.2d 685, 692 (1st Cir. 1978); *Rolf v. Blyth Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1978); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044 (7th Cir. 1977).

⁵⁹ See Giuffra, *Pleading Scienter*, *supra* note 52, at 5. Indeed, as Giuffra noted: As matters now stand, some courts require plaintiffs to plead "mere recklessness," whatever that means, while others require "conscious disregard" or "deliberate recklessness." This uncertainty has turned litigation of motions to dismiss and for summary judgment in securities class actions into a game of roulette, the outcome of which depends on how a particular judge defines recklessness in a particular case.

most of the federal courts of appeals have generally adopted the definition of recklessness espoused by the Seventh Circuit in *Sundstrand Corp. v. Sun Chemical Corp.*⁶⁰ In *Sundstrand*, the court stated:

[R]eckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the ordinary standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.⁶¹

E. Passage of the Reform Act

Since § 10(b) and Rule 10b-5 claims involve allegations of fraudulent conduct, courts have required that they be pleaded according to Rule 9(b) of the Federal Rules of Civil Procedure.⁶² This rule requires that when a plaintiff asserts fraud, "the circumstances constituting fraud or mistake shall be stated with particularity."⁶³ Although Rule 9(b) applies a heightened pleading requirement to securities fraud cases, the Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*⁶⁴ recognized that "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and kind from that which accompanies litigation in general."⁶⁵ The Court further noted that baseless claims of securities fraud tend to "delay the nor-

Id. Compare *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1283 (11th Cir. 1999) (requiring "severe recklessness"), with *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 550 (6th Cir. 1999) (requiring mere "recklessness"), and *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 977 (9th Cir. 1999) (requiring "deliberate recklessness"). Nonetheless, all three courts cite the definition of "recklessness" articulated in *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977).

⁶⁰ 553 F.2d 1033. See *infra* notes 93, 102, 107 & 116 and accompanying text.

⁶¹ *Sundstrand*, 553 F.2d at 1045 (quoting *Franke v. Midwestern Okla. Dev. Auth.*, 428 F. Supp. 719, 725 (W.D. Okla. 1976)).

⁶² See FED. R. CIV. P. 9(b).

⁶³ However, Rule 9(b) allows malice, intent, knowledge, and other condition of the mind of a person to be averred generally. *Id.* The Third Circuit noticed that this provision of Rule 9(b) is inconsistent with the Reform Act's requirement that plaintiffs "state with particularity facts giving rise to a strong inference of scienter." For this reason, the court found that the Reform Act supercedes Rule 9(b) as it relates to Rule 10b-5 actions. *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 531 (3d Cir. 1999).

⁶⁴ 421 U.S. 723 (1975).

⁶⁵ *Id.* at 739-44.

mal business activities of a corporate defendant" while the plaintiff embarks on a fishing expedition of business documents in hopes of finding relevant evidence.⁶⁶ Similarly, Congress acknowledged that Rule 9(b) failed to prevent abusive practices by private litigants.⁶⁷ In fact, Congress expressed the same concerns that the Supreme Court voiced in *Blue Chip Stamps*, recognizing that frivolous securities fraud litigation "unnecessarily increase[s] the cost of raising capital and chill[s] corporate disclosure, [and is] often based on nothing more than a company's announcement of bad news, not evidence of fraud."⁶⁸ Moreover, the circuit courts could not agree on a uniform interpretation of Rule 9(b), resulting in vastly different applications of the rule among the courts.⁶⁹

Therefore, in an attempt to create uniformity among the circuits and to protect "investors, issuers and all who are associated with our capital markets" from abusive litigation, Congress promulgated the Reform Act.⁷⁰ This amendment to the Exchange Act makes many changes to the private securities litigation system. One of the most notable modifications enacted by the Reform Act is the heightened pleading standard, which requires that:

In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.⁷¹

⁶⁶ *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 548 (6th Cir. 1999) (discussing *Blue Chip Stamps*, 421 U.S. at 741).

⁶⁷ Statement of Managers, H.R. CONF. REP. NO. 104-369, reprinted in 1995 U.S.C.C.A.N. 730, 1995 WL 709276 ("[R]ule [9(b)] has not prevented abuse of the securities laws by private litigants.").

⁶⁸ S. REP. NO. 104-98, reprinted in 1995 U.S.C.C.A.N. 679, 1995 WL 372783.

⁶⁹ Statement of Managers, H.R. CONF. REP. NO. 104-369, reprinted in 1995 U.S.C.C.A.N. 730, 1995 WL 709276 ("[T]he courts of appeals have interpreted Rule 9(b)'s requirements in conflicting ways, creating distinctly different standards among the circuits.").

⁷⁰ *Id.* Senator Domenici stated that he expected the Reform Act to "return some fairness and common sense to our broken securities class action litigation system, while continuing to provide the highest level of protection to investors in our capital markets." S. REP. NO. 104-98, reprinted in 1995 U.S.C.C.A.N. 679, 1995 WL 372783 (citation omitted).

⁷¹ 15 U.S.C. § 78u-4(b)(1) (2000).

The Reform Act also provides that failure to meet this requirement may, on the defendant's motion, result in dismissal of the claim.⁷²

Even though Congress intended the Reform Act to create a uniform requirement for pleading scienter in securities fraud cases, the Act has failed to achieve that goal.⁷³ In fact, five years after its passage, there is confusion and contradiction among the circuit courts over the stringency of the "strong inference" standard.⁷⁴ Although Congress has admitted that the Reform Act's "strong inference" language is based partly on the pleading standard followed by the Second Circuit, it has explicitly declined to adopt the Second Circuit's lenient case law interpreting the factual showing necessary to create the requisite strong inference.⁷⁵ Thus, courts have no guidance on what characteristic patterns of facts may be pleaded to establish the "required state of mind," and, as a result, they have applied three different approaches.

II. THE CIRCUIT COURT SPLIT

As stated above, the lengthy congressional debate concerning the Reform Act concentrated on whether to adopt the Second Circuit's two-prong pleading standard for scienter. While the standard imposes a requirement that pleadings raise a "strong inference" of scienter, it enables plaintiffs to meet that burden merely by alleging facts that show that the defendant had the motive and opportunity to commit fraud or that the defendant was reckless.⁷⁶ When interpreting the Reform Act,

⁷² *Id.* § 78u-4(b)(3)(A).

⁷³ Edward Brodsky, *Scienter Under the Reform Act of 1995*, N.Y.L.J., Apr. 14, 1999, at 3 (noting that the Act has failed to standardize the requirements for pleading scienter in securities fraud actions) [hereinafter Brodsky, *Scienter*]. For a thorough discussion of the immediate impact of the Reform Act on the effectiveness of the securities law and on investor protection, see generally SEC General Counsel Report, *supra* note 47.

⁷⁴ Brodsky, *Scienter*, *supra* note 73, at 3.

⁷⁵ In the Statement of Managers, Congress stated that "[t]he Conference Committee language is based in part on the pleading standard of the Second Circuit . . . [but the Conference Committee] does not intend to codify the Second Circuit's case law interpreting this pleading standard." H.R. CONF. REP. NO. 104-369, reprinted in 1995 U.S.C.C.A.N. 730, 1995 WL 709276.

⁷⁶ See *Press v. Chem. Inv. Serv. Corp.*, 166 F.3d 529, 538 (2d Cir. 1999).

circuit courts have taken three different approaches. Basically, there are two issues that the courts are grappling with. First, did the Reform Act alter the "required state of mind" (scienter) requirement for actions brought under § 10(b) and Rule 10b-5 or is some form of recklessness still sufficient as a substantive threshold for a plaintiff seeking to establish scienter?⁷⁷ Second, did the Reform Act restrict the factual evidence that may be alleged to establish a "strong inference" of scienter?⁷⁸ Precisely, are the two pre-Reform Act evidentiary methods articulated by the Second Circuit still available to show scienter?⁷⁹ So far, the Second and Third Circuits have found that the Second Circuit's permissive motive and opportunity or recklessness standard still satisfies the Reform Act's heightened pleading requirement, and the SEC agrees. By contrast, the First, Sixth, Ninth, and Eleventh Circuits have all rejected the Second Circuit's motive and opportunity standard, finding that the evidentiary base is not enough to establish a strong inference of scienter.⁸⁰ Instead, those circuits have each employed a more stringent standard. Additionally, the Fourth Circuit

⁷⁷ See *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 191 (1st Cir. 1999). Initially, the scienter debate focused on pleading standards, namely whether the Second Circuit's long-established motive and opportunity test, or some more stringent standard, applied post-Reform Act. However, the Ninth Circuit's decision in *Silicon Graphics* added an additional issue: whether pleading recklessness still suffices as the substantive "state of mind" requirement under the Reform Act.

⁷⁸ See *id.* at 191-92.

⁷⁹ See *id.*

⁸⁰ *Press* is not the final word from the Second Circuit. Recently, the Second Circuit heard an appeal from *Novak v. Kasaks*, in which the court considered the pleading standard for scienter under the Reform Act. See 997 F. Supp. 425, *reh'g*, 26 F. Supp. 2d 65 (S.D.N.Y. 1998), *vacated by* 216 F.3d 300 (2d Cir.), *cert. denied*, 121 S. Ct. 567 (2000). The district court ruled that "evidence of motive and opportunity no longer suffices to plead scienter," and it dismissed the complaint. *Id.* at 430. The Second Circuit recognized the split in authority regarding the proper interpretation of the Reform Act's new pleading requirement, particularly the debate concerning whether allegations of motive and opportunity to commit fraud are sufficient to plead scienter, and it noted the Reform Act's "conflicting expressions of legislative intent." *Novak v. Kasaks*, 216 F.3d 300, 310-11 (2d Cir. 2000). Ultimately, the Second Circuit held:

[T]he [Reform Act] adopted our "strong inference" standard Although litigants and lower courts need not and should not employ or rely on magic words such as "motive and opportunity," we believe that our prior case law may be helpful in proving guidance as to how the "strong inference" standard may be met.

Id. at 311.

has chimed in with dicta regarding the scienter issue. The interpretations and standards of all seven circuits, and the opinion of the SEC, are detailed below.⁸¹

A. *The First Line of Cases*

1. The Second Circuit: *Press v. Chemical Investment Services Corp.*⁸²

In February, 1999, the Second Circuit in *Press* declared that Congress "heightened the requirement for pleading scienter to the level used by the Second Circuit."⁸³ In *Press*, the

⁸¹ The approach in the Fifth Circuit is still indefinite. See *Williams v. WMX Techs. Inc.*, 112 F.3d 175, 178 (5th Cir. 1997). In *Williams*, without mentioning scienter and without any analysis, the court held that, under the Reform Act, the necessary pleading requirements of Rule 9(b) in a securities fraud action could be established by the Second Circuit's two-prong approach. *Id.*; see also *Bryant*, 187 F.3d at 1283 n.20 (discussing *Williams*).

However, at least one district court in the Fifth Circuit that has addressed the pleading issue in the context of a § 10(b) or Rule 10b-5 action has determined that pleading motive and opportunity is no longer acceptable to establish scienter. See *In re Parachelsus Corp. Sec. Litig.*, No. H-96-3464, 1998 WL 1108373 at *3 (S.D. Tex. Nov. 2, 1998). In *In re Parachelsus*, the court distinguished *Williams* on the ground that *Williams* pertained to Rule 9(b), rather than § 10(b) or Rule 10b-5, actions. See *id.* at *8 n.2.

Currently before the Fifth Circuit is an appeal from *In re Zonagen Inc. Securities Litigation*, where the circuit court will confront this issue in the context of a § 10(b) claim. See *Nathanson v. Zonagen*, No. 99-20449 (5th Cir. 1999). Relying on *Williams*, the district court found that the Reform Act codified the Second Circuit pleading standard, but it ruled that the plaintiffs failed to meet that standard. *In re Zonagen Inc. Sec. Litig.*, No. H-98-0693 (S.D. Tex. Mar. 31, 1999). The Commission has filed an amicus brief urging that the Reform Act does not depart from the Second Circuit standard. See Miranda S. Schiller & Howard W. Murage, *Circuit Courts Divided on What 'Scienter' Means Under New Standards of Private Securities Litigation Reform Act*, SEC. L. WKLY., Oct. 20, 1999, at 27 n.9 (discussing the recent judicial developments in the Fifth Circuit).

For a brief general discussion of the "most important" federal court decisions in the Reform Act's first year of enactment and the practical problems of litigating under the Reform Act that have come to light in the first year of enactment, see SEC General Counsel Report, *supra* note 47, at Part IV.

⁸² 166 F.3d 529 (2d Cir. 1999). For a discussion of federal district courts that have held that the Reform Act essentially codified the Second Circuit approach, see Richard H. Walker & J. Gordon Seymour, *Recent Judicial Developments Affecting the Private Securities Fraud Class Action*, 40 ARIZ. L. REV. 1003, 1025 & n.124 (1998) (discussing and citing cases).

⁸³ The court adopted the pre-Reform Act two-prong standard enunciated in *Shields v. Citytrust Bancorp.*, 25 F.3d 1124, 1128 (2d Cir. 1994), which allows plaintiffs to allege either motive and opportunity to commit fraud or strong cir-

buyer of a T-bill brought a claim under § 10(b) against the brokerage firm because the firm had delayed paying funds to him upon maturity of his T-bill, thereby creating a windfall for the broker-dealer.⁸⁴ To plead scienter, Press alleged that the brokerage firm had a motive to keep possession of his proceeds for its own use, and that the brokers had the opportunity to do so because the proceeds of the T-bill at maturity were in their control.⁸⁵ Finding that Press "barely alleged motive and opportunity," the court concluded that he nonetheless satisfied the pleading standards.⁸⁶ In doing so, however, the court did not engage in any evaluation of the Reform Act's text or its much debated legislative history, and it ignored Congress' express refusal to codify the Second Circuit's case law. Ultimately, the court dismissed Press' claim without regard to the issue of pleading scienter.⁸⁷

cumstantial evidence of conscious misbehavior or recklessness. See *Press*, 166 F.3d at 538. The Second Circuit standard was first announced in *Ross v. A.H. Robins Co.*, 607 F.2d 545, 558 (2d Cir. 1979). There, the Second Circuit stated, "It is reasonable to require that the plaintiffs specifically plead those events which they assert give rise to a strong inference that the defendants had knowledge of the [true facts] or recklessly disregarded their existence." *Ross*, 607 F.2d at 558.

⁸⁴ *Press*, 166 F.3d at 532-34.

⁸⁵ *Id.*

⁸⁶ *Id.* However, while the Second Circuit has resisted accepting general allegations of scienter, the court stated that it is not inclined to create a "nearly impossible pleading standard when the 'intent' of a corporation is at issue." *Id.* Indeed, it recognized that to require more in pleading of motive, would make it "virtually impossible to plead scienter in a financial transaction involving a corporation, institution, bank, or the like that did not involve comments from a corporate individual." *Id.* at 538.

⁸⁷ The court dismissed the complaint on the basis that it failed to plead two essential elements of a § 10(b) claim: materiality and reliance. *Press*, 166 F.3d at 538. For this reason, one commentator has termed the *Press* court's language regarding scienter as dicta. He reasons that since the complaint was dismissed without regard to pleading scienter, it was not necessary for the court to determine if scienter was present, let alone articulate the proper standards for it. See Giuffra, *Pleading Scienter*, *supra* note 52, at 5.

2. The Third Circuit: *In re Advanta Corp., Securities Litigation*⁸⁸

The Third Circuit in *In re Advanta* reached the same result as the Second Circuit in *Press*; however, unlike the Second Circuit, it embarked on a comprehensive evaluation of congressional intent.⁸⁹ Nevertheless, the court accorded the legislative history negligible weight, terming it "contradictory and inconclusive."⁹⁰ Instead, the court focused on the Reform Act's language. Recognizing that the text of the Reform Act "closely mirrors language employed by the Second Circuit," the court held that Congress' use of the "strong inference" language compels the conclusion that the Reform Act adopts a method of pleading "approximately equal in stringency to that of the Second Circuit."⁹¹ The court noted that this requirement allows plaintiffs to allege "with particularity" facts that give rise to a strong inference of scienter as a basis for liability, but that "blanket assertions of motive and opportunity," such as "catch-all allegations," undermine Congress' rigorous standard and are no longer sufficient.⁹² Furthermore, the court was consistent with the Second Circuit in accepting recklessness as a sufficient basis for liability.⁹³ The class action in *In re Advanta* was brought by the shareholders of Advanta against

⁸⁸ 180 F.3d 525 (3d Cir. 1999). This case was decided on June 17, 1999.

⁸⁹ See *id.* at 531-35; see also Steven B. Rosenfeld, *Circuit's Differ on Meaning of Pleadings Requirement for Scienter under the Private Securities Litigation Reform Act of 1995*, NAT'L L.J., Sept. 6, 1999, at B7 (discussing the Third Circuit's analysis).

⁹⁰ In fact, the court stated that "there is little to gain in attempting to reconcile the conflicting expressions of legislative intent The legislative history on this point is contradictory and inconclusive, and we are reluctant to accord it much weight." *In re Advanta*, 180 F.3d at 533.

⁹¹ The court noted that except for the Reform Act's "state with particularity" requirement, "the two standards are virtually identical." *Id.* at 533.

⁹² The court found this interpretation to be consistent with Congress' goal of curbing meritless securities litigation because in circuits that had not employed the Second Circuit standard, plaintiffs would now have to allege facts creating a strong inference of scienter. *Id.* at 535. Moreover, in circuits that had previously applied the Second Circuit standard, the Reform Act's requirement that plaintiffs plead facts creating the requisite state of mind "with particularity" would represent a heightening of the standard. *Id.*

⁹³ In doing so, the Third Circuit affirmed its adherence to the *Sundstrand* standard for recklessness. See *id.* (citing *McLean v. Alexander*, 599 F.2d 1190, 1197 (3d Cir. 1979) (quoting *Sundstrand*, 553 F.2d at 1045)).

the corporation and several of its officers. The plaintiffs alleged that the defendants made false and misleading statements and material omissions regarding the company's earnings potential and value of its stock in violation of § 10(b).⁹⁴ The court dismissed the claim, holding that the plaintiffs failed to meet the pleading standard by alleging "conclusory assertions" and "bare inferences" that the defendants knew of the wrongdoing.⁹⁵

B. *The Second Line of Cases*

1. The Sixth Circuit: *In re Comshare, Inc. Securities Litigation*⁹⁶

A month after *In re Advanta*, the Sixth Circuit put itself at odds with the Second and the Third Circuits by holding that the pleading of mere motive and opportunity, standing alone, is not sufficient to establish scienter.⁹⁷ Nonetheless, the court recognized that facts regarding motive and opportunity may be "relevant to pleading circumstances from which a strong inference of fraudulent scienter can be inferred"⁹⁸ and may, at times, "rise to the level of creating a strong inference of reckless or knowing conduct."⁹⁹ Moreover, the court noted that such evidence has never been held to constitute scienter for liability purposes: "[T]hose courts addressing motive and opportunity in Securities Act cases have held only that facts showing a motive and opportunity may adequately allege scienter, not that the existence of motive and opportunity may support, as scienter itself, liability under § 10(b) or Rule 10b-5."¹⁰⁰ Thus, the Sixth Circuit did not adopt the Second Circuit's two prong pleading standard, and in rejecting the standard, it refused to evaluate the Act's legislative history.¹⁰¹ Instead, finding the Reform Act's language "unambigu-

⁹⁴ *In re Advanta*, 180 F.3d at 528.

⁹⁵ *Id.* at 540.

⁹⁶ 183 F.3d 542 (6th Cir. 1999).

⁹⁷ *Id.* at 551. Nonetheless, the Sixth Circuit stated that plaintiffs could establish a strong inference of scienter if they alleged facts that demonstrated motive and opportunity to commit fraud, while simultaneously demonstrating that the defendant acted with the required state of mind—recklessly or knowingly. *Id.*

⁹⁸ *Id.* (quoting *In re Baesa Sec. Litig.*, 969 F. Supp. 238, 242 (S.D.N.Y. 1997)).

⁹⁹ *Id.*

¹⁰⁰ *In re Comshare*, 183 F.3d at 551.

¹⁰¹ In fact, the Sixth Circuit's analysis did not center on whether the Reform

ous," it applied a plain interpretation of the text and concluded that scienter could be proven by alleging facts "giving rise to a strong inference of recklessness," defined as "a mental state apart from negligence and akin to conscious regard."¹⁰² The plaintiffs in *In re Comshare* alleged that Comshare's officers sold stock while knowingly or recklessly disregarding accounting errors that prematurely recognized revenue from sales of its products, thereby artificially inflating the value of the company's stock in violation of § 10(b) and Rule 10b-5.¹⁰³ Ultimately, the court dismissed the claim, holding that the plaintiffs failed to allege facts showing that the revenue recognition errors should have been obvious or that Comshare consciously disregarded "red flags" that would have revealed the errors before discovery, and therefore, they failed to prove the requisite scienter element.¹⁰⁴

2. The Eleventh Circuit: *Bryant v. Avado Brands, Inc.*¹⁰⁵

The Eleventh Circuit in *Bryant* cited its "basic agreement" with the "middle course" employed by the Sixth Circuit.¹⁰⁶ Thus, the court held that the Reform Act does not prohibit the practice of alleging scienter by pleading "facts that denote severe recklessness"¹⁰⁷ but that the Reform Act does not

Act codified the pre-existing Second Circuit pleading standard. Rather, the court embarked on its own interpretation of the Reform Act based solely on the language of the statute. *See id.* at 549 ("Setting aside the pre-[Reform Act] Second Circuit pleading test in favor of a plain interpretation of the [Reform Act] . . .").

¹⁰² On the issue of recklessness, the Sixth Circuit is consistent with the Second and Third Circuits in holding that the Reform Act did not alter the substantive threshold for scienter and that recklessness still satisfies the scienter element. The Sixth Circuit affirmed that it followed the *Sundstrand* recklessness standard, citing the identical language relied upon by the Third Circuit for the definition of reckless conduct. *Compare id.* at 550, with *In re Advanta*, 180 F.3d at 535.

¹⁰³ *In re Comshare*, 183 F.3d at 547, 553.

¹⁰⁴ *Id.* at 553.

¹⁰⁵ 187 F.3d 1271 (11th Cir. 1999).

¹⁰⁶ *Id.* at 1283. In so deciding, the court specifically rejected the view represented by the Ninth Circuit in *Silicon Graphics* to the extent that the Ninth Circuit "suggests that Congress intended [the Reform Act] to raise the substantive state of mind requirement." *Id.* at 1284 n.21.

¹⁰⁷ While the court used a unique term—"severe recklessness"—the Eleventh Circuit noted that "'severe recklessness,' like the actionable level of scienter in most other circuits, was based on the Seventh Circuit's formulation of recklessness in [*Sundstrand*]." *Id.*

adopt the Second Circuit's motive and opportunity test.¹⁰⁸ Like the Sixth Circuit, the Eleventh Circuit recognized that motive and opportunity may be relevant to a showing of scienter, but that such allegations, without more, are not a sufficient basis for liability.¹⁰⁹ The shareholder plaintiffs in *Bryant* had similar claims to those in *In re Comshare*; specifically, they alleged that Avado Brands, Inc. made false and misleading statements and material omissions regarding the negative effects of an expansion strategy to maintain the high price of its stock.¹¹⁰ Since *Bryant* was an interlocutory appeal, the court did not apply its evaluation of the Reform Act to the facts of the case. Instead, the Eleventh Circuit vacated the district court's dismissal of the claim and remanded the case for further proceedings.¹¹¹

3. The First Circuit: *Greebel v. FTP Software, Inc.*¹¹²

As the most recent player to weigh in on the pleading standards conflict, the First Circuit issued an opinion in line with the Sixth and the Eleventh Circuits regarding what a plaintiff must allege to satisfy the Reform Act's heightened pleading standard.¹¹³ In its analysis, the court in *Greebel*, like

¹⁰⁸ *Id.* at 1283. In determining that the Reform Act did not change the existing scienter requirement, the court emphasized the "well-established and uniformly recognized precedent" throughout the country, which holds that scienter encompasses reckless behavior, to illustrate congressional intent to keep recklessness as a sufficient basis for liability. *Bryant*, 187 F.3d at 1286, 1284; see also *infra* Part III.A.2 (discussing the contemporary legal context in which Congress promulgated the Reform Act).

¹⁰⁹ Indeed, the court characterized the motive and opportunity prong as "lesser-known, lesser accepted, and certainly not well-established," and it rejected the test as inconsistent with the clear purpose of the Reform Act, which is to curb abusive securities litigation. *Id.* at 1286-87.

¹¹⁰ *Id.* at 1273-74.

¹¹¹ *Id.* at 1286. On remand, the United States District Court for the Middle District of Georgia dismissed the plaintiffs' claims, finding that "the Plaintiffs' allegations, though probative of scienter to some degree, do not compel the inference that the Defendants either knew or recklessly disregarded the truth when making the statements listed in the amended complaint." *Bryant v. Avado Brands, Inc.*, 100 F. Supp. 2d 1368, 1386 (M.D. Ga. 2000).

¹¹² 194 F.3d 185 (1st Cir. 1999).

¹¹³ *Id.* at 197 ("Our view of the act is . . . close to that articulated by the Sixth Circuit."). In *Greebel*, like in *In re Comshare*, the First Circuit's analysis did not center on whether the Reform Act adopted the Second Circuit's methods of pleading scienter. In fact, the *Greebel* court stated that the debate over the adoption or

the court in *In re Advanta*, found the legislative history inconclusive on whether the Reform Act was meant to incorporate or to reject the Second Circuit's pleading standards.¹¹⁴ The court found that the Reform Act left the meaning of scienter intact because the Act itself does not address the substantive definition of scienter and the legislative history shows no intent to alter the substantive contours of scienter.¹¹⁵ Accordingly, the First Circuit reinstated its previous definition of recklessness, as narrowly defined by the Seventh Circuit, as a means of proving the requisite state of mind.¹¹⁶ This definition, the court stated, "does not encompass ordinary negligence and is closer to a lesser form of intent."¹¹⁷ Regarding the evidentiary standard sufficient to raise a strong inference of recklessness, the First Circuit rejected the argument that facts showing motive and opportunity can *never* be enough to permit the drawing of a strong inference of scienter.¹¹⁸ However, the court cautioned that simply pleading motive and opportunity, regardless of the strength of the inferences to be drawn of scienter, is insufficient.¹¹⁹ The plaintiffs in *Greebel* were discontented shareholders of FTP Software, Inc. who brought suit against the corporation and its officers following a significant decline in the price of FTP's stock.¹²⁰ The shareholders al-

rejection of the Second Circuit standard was "besides the point" because the First Circuit has never used the categorization of patterns of facts as acceptable or unacceptable to prove scienter or to prove fraud. Instead, the First Circuit explained its approach as ad hoc—"analyz[ing] the particular facts alleged in each individual case to determine whether the allegations were sufficient to support scienter." *Id.* at 196 (citing many examples of the type of evidence that the court has considered relevant to support scienter).

¹¹⁴ In fact, the only agreement at the congressional level that the court noted was "an agreement to disagree on the issue of Second Circuit standards (other than the strong inference standard)." *Id.* at 195.

¹¹⁵ See *id.* at 198-99.

¹¹⁶ In coming to this conclusion, the First Circuit noted that the Second, Third, Fourth, Sixth, and Eleventh Circuits all ruled that the Reform Act did not change the pre-existing substantive contours of scienter and adhere to the definition of recklessness espoused by the Seventh Circuit in *Sundstrand*. See *Greebel*, 194 F.3d at 199-200.

¹¹⁷ *Id.* at 199.

¹¹⁸ *Id.* at 197.

¹¹⁹ *Id.* Furthermore, the First Circuit, like the Third Circuit, cautioned that "catch all allegations that defendants stood to benefit from wrongdoing and had the opportunity to implement a fraudulent scheme are [not] sufficient." *Id.* (quoting *In re Advanta*, 180 F.3d at 535).

¹²⁰ *Greebel*, 194 F.3d at 188.

leged that FTP failed to disclose the threats to its continued success, as well as several "questionable" sales practices.¹²¹ The First Circuit dismissed the complaint, ruling that the plaintiffs failed to explain why their allegations gave rise to a strong inference of scienter.

4. The Fourth Circuit: *Phillips v. LCI International, Inc.*¹²²

Like its sister circuits, the Fourth Circuit noted that the Reform Act did not change the standard of proof that a plaintiff must plead, or the type of evidence that a plaintiff must allege, to establish scienter in private securities fraud litigation.¹²³ Nonetheless, the court did not determine which pleading standard best achieves congressional intent because the stockholders "failed to allege facts sufficient to meet even the most lenient standard possible under the [Reform Act], the two-pronged Second Circuit test."¹²⁴ Even though the opportunity to rule on the issue was absent, the Fourth Circuit remarked that to demonstrate scienter, a plaintiff "must still prove that the defendant acted intentionally, which may perhaps be shown by recklessness."¹²⁵ Regarding the definition of recklessness, the court cited a definition from a Seventh Cir-

¹²¹ One such allegation was that FTP routinely inflated its earnings by improperly booking, as revenue, sales that were actually contingent transactions. Plaintiffs alleged that the defendants regularly "whited out" the contingency terms inserted into customer's purchase orders. *Id.* at 189. Unfortunately for the plaintiffs, the only evidence on this allegation was inadmissible as hearsay. *Id.* at 191. Therefore, even though the court found that the "white out" allegations, on their face, seemed "powerful" enough to raise a strong inference of fraud, the court dismissed the complaint. *See id.* at 201-02.

¹²² 190 F.3d 609 (4th Cir. 1999).

¹²³ *Id.* at 620 (citing *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 548 (6th Cir. 1999)) (dicta).

¹²⁴ *Id.* at 621, 620. When making this statement, the court noted the different approaches to evidentiary standards espoused by the Third, Sixth, and Ninth Circuits, remarking that the Ninth Circuit view was most restrictive of the three. *Id.* at 620-21.

¹²⁵ *Id.* at 620 (dicta); *see also* *Krim v. Coastal Physician Group, Inc.*, No. 98-2361, 1999 WL 1008975, at *1 (4th Cir. Nov. 8, 1999) (per curiam) (declining to decide the requisite pleading standard because the complaint failed under any standard but noting that the Reform Act requires a strong inference of scienter to survive a motion to dismiss).

cuit case, *Sanders v. John Nuveen & Co.*,¹²⁶ containing language identical to *Sundstrand*, the definition adopted by the Second, Third, Sixth, and Eleventh Circuits.¹²⁷ The plaintiffs in *Phillips* were former shareholders who had sold their stock in LCI shortly before a public announcement of a merger.¹²⁸ They alleged that the company's Chairman of the Board and CEO violated § 10(b) and Rule 10b-5 by making a statement that constituted a material misrepresentation designed to defraud the market by artificially underrating the value of LCI stock.¹²⁹ The Fourth Circuit affirmed the district court's grant of a motion to dismiss, ruling that the plaintiffs failed to allege both a material misstatement¹³⁰ and facts that adequately pleaded scienter.¹³¹

C. *In a Class by Itself: The Ninth Circuit, In re Silicon Graphics Inc. Securities Litigation*¹³²

As the third circuit to rule on the scienter issue, the Ninth Circuit adopted a notably stringent and unique scienter standard that makes *Silicon Graphics* the most extreme case in the Reform Act conflict. In a 2-1 decision, the court held that the Reform Act requires plaintiffs to plead "particular facts giving rise to a strong inference of *deliberate* recklessness, at a minimum, . . . to satisfy the heightened pleading standard."¹³³

¹²⁶ 554 F.2d 790, 793 (7th Cir. 1977).

¹²⁷ See *Phillips*, 190 F.3d at 621.

¹²⁸ *Id.* at 612-13.

¹²⁹ *Id.* at 613.

¹³⁰ *Id.* at 615.

¹³¹ *Id.* at 620, 621. The court noted that the plaintiffs' complaint failed to allege sufficient specific facts giving rise to a strong inference that the defendants acted with a reckless or conscious effort to defraud, *Phillips*, 190 F.3d at 621, or that the defendants had a motive to defraud. *Id.* at 622-23. The court did, however, recognize that there was an opportunity to defraud. *Id.* at 621.

¹³² 183 F.3d 970 (9th Cir. 1999).

¹³³ *Id.* at 974 (emphasis added). The Ninth Circuit's opinion was amended on August 4, 1999. The original July 2, 1999 opinion stated that a plaintiff must plead "particular facts giving rise to a strong inference of *intent*," rather than "a strong inference of *deliberate recklessness*" to establish scienter. 68 U.S.L.W. 2, July 13, 1999, at 1029 (emphasis added). Nevertheless, considering that the Ninth Circuit's interpretation of recklessness incorporates intentional conduct, see *infra* text accompanying notes 137 & 138, it is doubtful that the amended opinion will have any significant impact on the original one. See John F.X. Peloso & Stuart M. Sarnoff, *Pleading Scienter Under the Reform Act*, N.Y.L.J., Oct. 21, 1999, at 3

The court recognized that the Reform Act does not address whether motive and opportunity or circumstantial evidence of "simple recklessness" is sufficient to raise a strong inference of deliberate recklessness.¹³⁴ Analyzing the legislative history, the court concluded that Congress intended to raise the pleading requirement beyond that of the Second Circuit, and therefore, facts demonstrating "mere recklessness" or a motive and opportunity to commit fraud are no longer sufficient to establish the requisite scienter.¹³⁵ Like the Sixth and Eleventh Circuits, however, the Ninth Circuit remarked that facts proving motive and opportunity to commit fraud may provide some reasonable inference of intent, even if they are not sufficient to establish a strong inference of scienter.¹³⁶ Instead, to show a strong inference of deliberate recklessness, plaintiffs must allege facts that "come closer to demonstrating intent."¹³⁷ While the Ninth Circuit noted its adherence to the *Sundstrand* definition of recklessness, embraced by its sister circuits, the court employed an extremely strict interpretation of the definition that renders recklessness akin to "a form of intentional or knowing conduct."¹³⁸ Indeed, the court indicated that recklessness only satisfies scienter under § 10(b) if "it reflects some degree of intentional or conscious misconduct."¹³⁹ The class action plaintiffs in *Silicon Graphics* were investors who filed a

("Although the analysis was lengthier and the concept of 'deliberate recklessness' expanded, the ruling in [*Silicon Graphics*] did not change. . . .").

¹³⁴ By "simple" or "mere" recklessness, the court was referring to the standard adopted by the Second Circuit and followed by the First, Third, Sixth, and Eleventh Circuits. See *Silicon Graphics*, 183 F.3d at 977. In his dissent, Judge James R. Browning stated that the language of the Reform Act is unambiguous, and therefore, the majority was wrong to resort to legislative history. See *id.* at 992 (Browning, J., concurring in part and dissenting in part). He noted that there is no support anywhere in the Reform Act's text for concluding that proof of recklessness or motive and opportunity to commit fraud are *not sufficient* to meet the "strong inference" standard. See *id.* Rather, Judge Browning recognized that the fact that the Reform Act makes no mention of recklessness or motive and opportunity as adequate methods of pleading scienter demonstrates the Act's breadth and flexibility, not ambiguity. See *id.* (citations omitted).

¹³⁵ *Id.* at 974.

¹³⁶ *Silicon Graphics*, 183 F.3d at 974.

¹³⁷ *Id.*

¹³⁸ *Id.* at 976-77.

¹³⁹ Notably, the court neglected to distinguish "deliberate recklessness" from its prior definition of "recklessness." See *id.* at 977; see also *infra* note 159 (discussing how the Ninth Circuit, without explanation, disregarded precedent).

§ 10(b) action, alleging that the price of shares was artificially inflated because of the defendant's false and misleading statements about the company's business and future prospects.¹⁴⁰ Even though the complaint raised "some inference of intent," it lacked "sufficient detail and foundation necessary to meet either the particularity or strong inference requirements of the [Reform Act]."¹⁴¹

D. *The SEC's View*

Throughout the circuit court conflict, the SEC has steadfastly advocated that the Reform Act adopts the Second Circuit's two-prong pleading standard.¹⁴² Indeed, as amicus in *Greebel*, the SEC articulated its interpretation of the Reform Act's scienter provisions, stating that the Act allows scienter to be pleaded by alleging facts that either (1) constitute strong circumstantial evidence of recklessness or conscious misbehavior by the defendant or (2) prove motive and opportunity to commit fraud on the defendant's part.¹⁴³ Accordingly, the Commission was "disappointed" with the Ninth Circuit's conclusion that the Reform Act precluded liability under § 10(b) or Rule 10b-5 unless the plaintiff proved reckless behavior that evidenced intent.¹⁴⁴ The Commission has routinely supported

¹⁴⁰ *Silicon Graphics*, 183 F.3d at 980-83.

¹⁴¹ The *Silicon Graphics* majority emphasized that the complaint lacked details concerning who drafted and received the reports, how the plaintiff learned of them, and "countless specifics" about their contents, information the dissent remarked "is neither expected nor required at the pleading stage," and could only be ascertained if the plaintiffs obtained the reports before trial discovery—an unlikely occurrence. See *id.* at 999 (Browning, J., concurring in part and dissenting in part).

¹⁴² See *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 192 n.6 (1st Cir. 1999) (discussing the position of the SEC, as amicus).

¹⁴³ *Id.* ("While the SEC's views are not binding, they deserve consideration."); accord *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1285 (11th Cir. 1999).

¹⁴⁴ Through a spokesman, the SEC said, "We are disappointed with [the 9th Circuit's] holding and hopeful that the 9th Circuit will rehear the case en banc." SEC. L. DAILY, July 7, 1999, at d2; see also Brief for the SEC, amicus curiae, *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970 (9th Cir. 1999) (Nos. 97-16204, 97-16240), at <http://www.sec.gov/news/extra/silicon.txt> [hereinafter *Silicon Graphics Brief*]. In fact, the plaintiffs' bar in *Silicon Graphics* petitioned the court for a rehearing en banc, but the court denied the petition on October 27, 1999. See 195 F.3d 521 (9th Cir. 1999). However, five of the Ninth Circuit judges filed a forceful dissent, arguing that the majority decision "ignores the plain directives of Congress, casts aside the prior decisions of this court, and creates a striking conflict

a recklessness standard for § 10(b) liability in private securities actions, and it urges forcefully that the Reform Act made no changes to the definition of scienter.¹⁴⁵ In support of its position, the SEC emphasized, as this Note demonstrates, that all the courts of appeals that have considered the issue have held that recklessness suffices to establish liability.¹⁴⁶

III. INTERPRETATION OF THE REFORM ACT

As evidenced above, there is extensive disagreement among the circuit courts regarding the proper interpretation of the Reform Act's heightened pleading requirement. Some courts, like the Sixth Circuit in *In re Comshare*, found the statutory language unambiguous and refused to analyze the Reform Act's legislative history when evaluating the Act.¹⁴⁷ By contrast, the Ninth Circuit in *Silicon Graphics* relied heavily on legislative history to support its analysis of the Reform Act's pleading requirements.¹⁴⁸ However, neither the text nor the legislative history of the Act are indisputably clear on the scienter issue, and neither shows any agreement on the types of evidence that may be offered to prove a strong inference of scienter. As the First Circuit recognized, all that can be said with certainty is that Congress agreed on the need to curb meritless lawsuits, that it endeavored to do so by means of what are expressed as procedural requirements, and that there

with our fellow circuits." *Id.* at 522.

¹⁴⁵ *Silicon Graphics* Brief, at <http://www.sec.gov/news/extra/silicon.txt>; see also *Silicon Graphics*, 183 F.3d at 995 (Browning, J., concurring in part and dissenting in part) (discussing the SEC's position); *infra* Part III.A.4 (discussing the policy considerations in support of recklessness as a basis for liability).

¹⁴⁶ *Silicon Graphics* Brief, at <http://www.sec.gov/new/extra/silicon.txt>; see also Walker & Seymour, *supra* note 82 at 1028 (discussing the SEC's position).

¹⁴⁷ The Sixth Circuit employed a "plain interpretation" of the Reform Act and criticized the district court for overlooking "well-settled principles of statutory construction and the unambiguous language" of the Act by first examining legislative history to ascertain congressional intent on whether the pre-Reform Act Second Circuit pleading standards should apply. *In re Comshare*, 183 F.3d at 551. The First and Third Circuits evaluated the legislative history, found it equivocal on the scienter issue, and resorted to the Act's language to support its holding. See *Greebel*, 194 F.3d at 192; *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 533 (3d Cir. 1999).

¹⁴⁸ See *Silicon Graphics*, 183 F.3d at 977-79. Indeed, the *Silicon Graphics* court was the only court in this conflict to accord such heavy weight to the legislative history of the Reform Act.

was consensus on the language of the Act and on little else.¹⁴⁹ Therefore, it is necessary to analyze both the substantive and procedural issues raised by this controversial legislation.

A. *The Substantive Issue: Plain Language and the "Recklessness" Controversy*

It is a well-established maxim that statutory interpretation begins with the words of the statute.¹⁵⁰ Courts may resort to a view of congressional intent or legislative history only when the statute's language is ambiguous.¹⁵¹ Congress would save courts a lot of frustration if Congress stated its intent expressly in the text of statutes. However, in a complex area of the law like securities regulation, it is impossible to draft legislation covering every conceivable fact scenario.¹⁵² Therefore, when members of Congress disagree, they will occasionally draft legislation broadly (and, consequently, ambiguously), as they did with the Reform Act, and leave it to the courts to wrestle with the appropriate fact patterns.¹⁵³

Unfortunately for courts, the Reform Act's provision regarding scienter is recognized more for the language it excludes rather than the terms it includes. The Reform Act requires a complaint to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."¹⁵⁴ However, the Act neglects to define the substantive threshold required to establish the required "state of mind,"¹⁵⁵ and it is silent on what evidence can create

¹⁴⁹ See *Greebel*, 194 F.3d at 192.

¹⁵⁰ E.g., *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1283 (11th Cir. 1999) (citing *Consumer Prod. Safety Comm'n v. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1980)); *Silicon Graphics*, 183 F.3d at 977 (citing *Northwest Forest Resource Council v. Glickman* 82 F.3d 825, 830-31 (9th Cir. 1996)).

¹⁵¹ E.g., *In re Comshare*, 183 F.3d at 549 (citing *Consumer Prod. Safety Comm'n*, 447 U.S. at 108)).

¹⁵² See *Giuffra, Pleading Scienter*, *supra* note 52, at 5.

¹⁵³ *Id.*

¹⁵⁴ 15 U.S.C. § 78u-4(b)(2) (2000).

¹⁵⁵ See, e.g., *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 199 (1st Cir. 1999) ("The Act itself is silent on the general scienter requirements for [Rule] 10b-5 actions referring only to scienter as the 'required state of mind.'"); *Bryant*, 187 F.3d at 1284 ("The 'required state of mind' is not defined by the Reform Act."); *In re Comshare*, 183 F.3d at 549 ("[N]o provision of the [Reform Act] defines the re-

the requisite "strong inference" of scienter.¹⁵⁶ Nonetheless, except for the Ninth Circuit, courts have found that the Reform Act's standard does not purport to change the substantive law of scienter (the required state of mind for securities fraud actions),¹⁵⁷ and the SEC agrees.¹⁵⁸ Indeed, the *Silicon Graphics* court was the first and only circuit court in this debate to arrive at the remarkable conclusion that the Reform Act precluded pleading "mere" recklessness as a sufficient basis for liability under § 10(b) or Rule 10b-5, a holding that is inconsistent with both the plain language and policy of the Reform Act.¹⁵⁹

1. Legislative History¹⁶⁰

Congress almost resolved the recklessness issue expressly in the terms of the Reform Act. The initial House draft of the Act would have eliminated liability based on recklessness in securities fraud cases.¹⁶¹ However, following amendments

quired 'state of mind' in cases involving § 10(b) or Rule 10b-5.").

¹⁵⁶ See, e.g., *Greebel*, 194 F.3d at 195 ("[T]he words of the Act neither mandate nor prohibit the use of any particular method to establish an inference of scienter."); *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 977 (9th Cir. 1999) ("[T]he [Reform Act] is silent as to the central issue: the text of the [Reform Act] does not state whether motive and opportunity or circumstantial evidence of simple recklessness are sufficient to raise a 'strong inference' of [scienter].").

¹⁵⁷ See, e.g., *In re Comshare*, 183 F.3d at 549-50 (noting that the Reform Act did not change the scienter standard that a plaintiff must prove to prevail in securities fraud cases; rather, it changed what a plaintiff must plead in his complaint in order to survive a motion to dismiss); *Greebel*, 194 F.3d at 199-200; *Bryant*, 187 F.3d at 1283; *Silicon Graphics*, 183 F.3d at 995-96 (Browning, J., concurring in part and dissenting in part).

¹⁵⁸ See generally *Silicon Graphics* Brief, at <http://www.sec.gov/news/extra-silicon.txt>.

¹⁵⁹ When adopting a "deliberate recklessness" standard, the *Silicon Graphics* court disregarded prior case law. Ninth Circuit precedent included an en banc opinion that plainly held that proving recklessness satisfied the scienter requirement for a § 10(b) action. See *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1564 (9th Cir. 1990)(en banc). In *Hollinger*, the Ninth Circuit included a detailed description of what constitutes reckless conduct and nowhere does the description indicate that the correct standard is actually something termed "deliberate recklessness." See *id.* at 1569. Indeed, the new "deliberate recklessness" standard was invented by the *Silicon Graphics* panel, which offers no explanation of how this new standard diverges from the *Hollinger* recklessness standard.

¹⁶⁰ For a detailed account of the legislative history of the Reform Act, see Avery, *supra* note 3, at 346-53.

¹⁶¹ Procedurally, the House bill provided that a complaint alleging securities

and hearings in the House Subcommittee on Telecommunications and Finance, the bill finally adopted by the House imposed liability for recklessness.¹⁶² After considerable debate over the definition of recklessness, the House bill ultimately defined reckless conduct according to the standard adopted by the Seventh Circuit in *Sundstrand* and followed by virtually all circuit courts of appeals.¹⁶³ Nonetheless, the final version of the Reform Act not only neglects to provide for an express recklessness standard, but it also meticulously avoids any suggestion that recklessness is or is not sufficient for civil liability under § 10(b) of the Exchange Act.¹⁶⁴ Any provisions

fraud must plead "specific facts" demonstrating that the defendant acted with the requisite scienter. *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 531 (3d Cir. 1999) (quoting H.R. 10, 104th Cong. § 204 (1995)).

¹⁶² Apparently, the revised bill also contained a more stringent pleading standard. It required the plaintiff to "make specific allegations [in the complaint] which, if true, would be sufficient to establish scienter as to each defendant at the time the alleged violation occurred." *See id.* (quoting H.R. 1058, 104th Cong. § 4 (1995)). Rejecting a proposed amendment that would have diluted the pleading standard, the House retained this language in the final version of the bill. *See id.* Shortly after the House bill was passed, the Senate passed its own version of the Reform Act. *See infra* note 199 (discussing the pleading standard included in the Senate bill).

¹⁶³ This standard is "a highly unreasonable omission not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Sundstrand*, 553 F.2d at 1045 (citations omitted). The final House bill added a second sentence, which provided that "[d]eliberately refraining from taking steps to discover whether one's statements are false or misleading constitutes recklessness." H.R. 10, 104th Cong. § 204. It is uncertain what extent, if any, this additional sentence would have changed the result in any particular case.

¹⁶⁴ Avery, *supra* note 3, at 370. Recognizing that the provisions of the Reform Act created confusion in the federal courts, Congress restated and clarified its intention when promulgating the Reform Act. In 1998, Congress enacted the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (1998) (the "Standards Act"). Although the Standards Act did not modify or amend the text of the Reform Act, its Conference Report clarified that "[i]t is the clear understanding of the managers that Congress did not, in adopting the Reform Act, intend to alter the standards of liability under the Exchange Act." Joint Explanatory Statement of the Committee of Conference, Conference Report to Accompany S.1260, H.R. CONF. REP. NO. 105-803, at 13 (1998), available at 1998 WL 703964.

Similarly, the Senate Report that accompanied its version of the Act states that "the Committee emphasizes that the clear intent in 1995 and our continuing intent in this legislation is that neither [the Reform Act] nor [the Standards Act] in any way alters the scienter standard in federal securities fraud suits." S. REP. NO. 105-182, at 11 (1998), available at 1998 WL 226714.

from the earlier forms of the bill that would have given some recognition to the recklessness standard were removed from the final bill.

2. The Contemporary Legal Context

Even though Congress refused to expressly adopt a recklessness standard in the Reform Act, courts assume that Congress was well aware of the "contemporary legal context" surrounding the "state of mind" requirement for § 10(b) and Rule 10b-5 liability and, by its silence, left the requirement undisturbed in the Reform Act.¹⁶⁵ Indeed, every circuit court to address the question before the Reform Act's passage held that proving recklessness was adequate to allege scienter.¹⁶⁶ Congress was definitely aware of this well-established precedent when it drafted the Reform Act. In fact, the Eleventh Circuit found it clear that when Congress codified the "state of mind" requirement, it was codifying the settled law that recklessness was sufficient to allege scienter.¹⁶⁷ Therefore, even though the "required state of mind" is not defined by the Reform Act, the Act does not erase the well-settled understanding that scienter could be sufficiently alleged by pleading facts indicating reckless behavior.¹⁶⁸

Nevertheless, the Third Circuit denounced these clarifications and stated that its analysis was "unaffected" by this subsequent legislative history. *In re Advanta*, 180 F.3d at 533. It concluded that even though Congress tried to clarify its intent, "some uncertainty may still persist." *Id.* The court observed that although Congress stated that it was not codifying the Second Circuit standard, debates over earlier House and Senate bills indicated a contrary view. Indeed, these debates included remarks that the Reform Act did specifically adopt the pre-existing standard and, at the same time, that Congress intended to raise the pleading standard above that of the Second Circuit. *See id.* (citing 1844 FED. SEC. L. REP. 2 (1998)).

¹⁶⁵ *See In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 550 (6th Cir. 1999); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1284 (11th Cir. 1999).

¹⁶⁶ *See supra* note 58 and accompanying text.

¹⁶⁷ *Bryant*, 187 F.3d at 1284 (citing *Cottage Savings Ass'n v. Comm'r*, 499 U.S. 554 (1991) (noting that the Court would presume that Congress intended to codify a particular legal doctrine because decisions establishing the doctrine were part of the "contemporary legal context" in which Congress acted and because Congress left undisturbed the legal principal during subsequent re-enactments)).

¹⁶⁸ *See, e.g., Greebel v. FTP Software, Inc.*, 194 F.3d 185, 199-200 (1st Cir. 1999); *Bryant*, 187 F.3d at 1284; *In re Baesa Sec. Litig.*, 969 F. Supp. 238, 240 (S.D.N.Y. 1997) ("Since the Reform Act nowhere defines what the 'required state of mind' is for any of the kinds of actions that may be brought under this title, the

3. The "Safe Harbor" and Contribution Provisions

This conclusion is supported by Congress' express proscription of recklessness in other portions of the Reform Act.¹⁶⁹ For example, § 21E of the Exchange Act, which provides a "safe harbor" from liability for certain persons on account of "forward-looking" statements, is the only provision of the Reform Act that changes the "state of mind" standard for liability to intent or actual knowledge in private securities actions.¹⁷⁰ Under this provision, a person cannot be liable in a private action for any "forward-looking" statement if, among other things, the plaintiffs fail to show "actual knowledge" on the part of the defendants alleged to have made misleading or untrue "forward-looking" statements.¹⁷¹ Therefore, if Congress wanted to replace recklessness with actual knowledge with respect to other allegedly misleading statements, it could have done so expressly, as it did with the "safe harbor" provision.¹⁷²

Similarly, the Reform Act changed certain consequences of liability, as opposed to standards of liability, on the basis of the defendant's state of mind.¹⁷³ Regarding contribution, a new section of the Exchange Act, § 21D(g), provides that "[a]ny covered person against whom a final judgment is entered in a private action shall be liable for damages jointly and severally only if the trier of fact specifically determines that such covered person *knowingly* committed a violation of the securities laws."¹⁷⁴ For purposes of Rule 10b-5, "knowingly commits a violation of the securities laws" is defined as knowledge that "a

definition must necessarily be found either elsewhere in the Exchange Act itself or (if the action is judicially implied) in the existing case law.").

¹⁶⁹ See 15 U.S.C. § 78u-5(c)(1)(B) (2000).

¹⁷⁰ See *id.* The Reform Act also authorizes the SEC to sue aiders and abettors but only where such persons "knowingly" provide substantial assistance to another person in violation of the Exchange Act or any rules promulgated thereunder. See *id.* § 78t(f).

¹⁷¹ *Id.* § 78u-5(c)(1)(B); see also Statement of Managers, H.R. CONF. REP. NO. 104-369, reprinted in 1995 U.S.C.C.A.N. 730, 1995 WL 709276. For an in depth discussion of the "safe harbor" provision, see Avery, *supra* note 3, at 354-57.

¹⁷² See *Greebel*, 194 F.3d at 201; *Bryant*, 187 F.3d at 1284; *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 995 (9th Cir. 1999) (Browning, J., concurring in part and dissenting in part).

¹⁷³ See 15 U.S.C. § 78u-4(f)(2)(B)(i).

¹⁷⁴ *Id.* § 78u-4(f)(2)(A) (emphasis added).

representation is false or an omission renders a representation false."¹⁷⁵ The definition explicitly eliminates reckless conduct as a basis for inferring a knowing commission of a violation.¹⁷⁶

These two special provisions lead to several conclusions. First, one should not infer that Congress generally eliminated recklessness as a basis for any liability because it affirmatively removed recklessness as a basis for liability under the Act's "safe harbor" provision and as a basis for imposing joint and several liability.¹⁷⁷ Indeed, both of these provisions are explicit, in direct contrast to the vague scienter provision in the Reform Act.¹⁷⁸ Second, Congress was careful to insure that the actual knowledge requirement for imposing joint and several liability was restricted to only those provisions of the Act and not to the provisions concerning liability.¹⁷⁹ Indeed, § 78u-4(f)(1) expressly states that "nothing in this subsection shall be construed to create, affect, or in any manner modify, the standard for liability associated with any action arising under the securities laws."¹⁸⁰ If Congress intended to alter the general scienter requirement by restricting it to actual knowledge, including this language would not make sense.¹⁸¹

Therefore, while the Reform Act clarifies the pleading requirements for alleging scienter, it does not address the substantive definition of scienter.¹⁸² Instead, it refers to the "required state of mind," which, at the time Congress drafted the Act, was clearly defined by the federal courts of appeals to include reckless behavior. Accordingly, the plain text of the Act makes it clear that the Reform Act did not eliminate recklessness as a basis for liability, and therefore, the Ninth Circuit's reliance on the Reform Act's legislative history to conclude otherwise is unwarranted. Indeed, the Ninth Circuit extracted from a purely procedural provision the incorrect conclusion

¹⁷⁵ *Id.* § 78u-4(f)(10)(A).

¹⁷⁶ *See id.* § 78u-4(f)(10)(B). For a thorough discussion of the contribution provision, see Avery, *supra* note 3, at 364-66.

¹⁷⁷ *See Greebel*, 194 F.3d at 200-01; *Silicon Graphics*, 183 F.3d at 995 (Browning, J., concurring in part and dissenting in part).

¹⁷⁸ *See Greebel*, 194 F.3d at 201.

¹⁷⁹ Compare 15 U.S.C. § 78u-4(b)(1), with *id.* § 78u-4(f)(1).

¹⁸⁰ *Id.* § 78u-4(f)(1).

¹⁸¹ *Greebel*, 194 F.3d at 200-01.

¹⁸² *See id.*; *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1284 (11th Cir. 1999).

that Congress eliminated a well-settled substantive standard, putting the Ninth Circuit out in the cold as the only circuit court to reach such a conclusion in the face of compelling evidence to the contrary.¹⁸³

4. Policy Considerations

In addition to the plain language of the Reform Act, the policy behind the Act¹⁸⁴ dictates the conclusion that recklessness still satisfies the "state of mind" requirement.¹⁸⁵ Moreover, the Commission argues forcefully that the Reform Act made no change in the definition of scienter under federal securities laws and that it is sufficient under the Act to state with particularity facts giving rise to a strong inference that the defendant acted recklessly.¹⁸⁶ The SEC is uniquely qualified to assess "the proper balance between the need to insure adequate disclosure and the need to avoid the adverse consequences of setting too low a threshold for civil liability."¹⁸⁷ Therefore, the Commission supports a recklessness standard for § 10(b) liability because such a standard is needed "to protect investors and the securities markets from fraudulent conduct and to protect the integrity of the disclosure process."¹⁸⁸ Imposing a higher standard would impede the incentives for corporations to conduct a full inquiry into potentially trouble-

¹⁸³ *In re Silicon Graphics Sec. Litig.*, 195 F.3d 521, 523 (9th Cir. 1999) (Reinhardt, J., dissenting from the denial of rehearing en banc) ("[I]t is difficult to know that the [*Silicon Graphics*] majority, in interpreting a statutory enactment that so clearly is limited to dealing with the particularity of pleadings, decided to change the substantive standard governing securities fraud.").

¹⁸⁴ See *supra* Part I.B (discussing the impetus behind the Reform Act).

¹⁸⁵ See *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 535 (3d Cir. 1999); Walker & Seymour, *supra* note 82, at 1027-28 ("Neither the Reform Act nor its legislative history reflects any intention to eliminate recklessness as a basis of liability. The recklessness standard has long been recognized by the federal courts and is essential to investor protection.").

¹⁸⁶ See *Silicon Graphics* Brief, at <http://www.sec.gov/news/extra/silicon.txt>.

¹⁸⁷ *Silicon Graphics*, 183 F.3d at 995 (Browning, J., concurring in part and dissenting in part) (citing *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 n.10 (1976)).

¹⁸⁸ *Silicon Graphics* Brief, at <http://www.sec.gov/news/extra/silicon.txt>. Indeed, the Commission often relies on the recklessness standard in its own law enforcement cases. S. REP. NO. 104-98 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 1995 WL 372783; accord Statement of Managers, H.R. CONF. REP. NO. 104-369, reprinted in 1995 U.S.C.C.A.N. 730, 1995 WL 709276; see also *Silicon Graphics* Brief, *supra*.

some or embarrassing areas, threatening the disclosure process that makes US securities markets a model for markets worldwide.¹⁸⁹ A recklessness standard discourages deliberate ignorance, and it also prevents defendants from averting liability merely because plaintiffs have the daunting task of proving actual knowledge of fraud. Requiring plaintiffs to show that the defendant acted with actual subjective intent could impose serious burdens upon recovery in a § 10(b) or Rule 10b-5 claim.¹⁹⁰ Accordingly, despite the Ninth Circuit's holding in *Silicon Graphics*, the Reform Act should be construed as allowing recklessness to continue to satisfy the scienter requirement for a private securities fraud action brought under § 10(b) and Rule 10b-5.

B. *The Procedural Issue: What Must Be Pleaded to Show a Strong Inference of Scienter?*

Compared to the courts' fairly consistent approach to the substantive issue of the Reform Act, the federal courts of appeals have been more varied in their approaches to the procedural aspect of the Reform Act, i.e., the details needed in a complaint to allow a securities fraud action to withstand a motion to dismiss. Perhaps this difference is because Congress, during consideration of the Reform Act, frequently referred to the Second Circuit's two-prong pleading standard as a way of defining its own position or encouraging a particular analysis of the Act.¹⁹¹ Therefore, the Reform Act's legislative history is

¹⁸⁹ *Silicon Graphics* Brief, at <http://www.sec.gov/news/extra/silicon.txt> (citing *Sec. Litig. Reform Proposals-S.240, S.667, and H.R. 1058: Hearings before the Subcomm. on Sec. of the Senate Comm. on Banking, Housing, and Urban Affairs*, 104th Cong. 251-52 (testimony of Arthur Levitt, Chairman, Securities and Exchange Commission)); see also *supra* Part I.B (discussing disclosure to investors).

¹⁹⁰ Brief for the SEC, amicus curiae, *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542 (6th Cir. 1999) (No. 97-2098), at <http://securities.stanford.edu/briefs/comshare/-9702098/sec.html> (quoting *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1025 (6th Cir. 1979)) [hereinafter *In re Comshare* Brief]; see also *Hackbart v. Holmes*, 675 F.2d 1114, 1118 (10th Cir. 1982) ("[R]equiring the plaintiff to show [conscious] intent would be unduly burdensome."); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 46-47 (2d Cir. 1978) ("To require in all types of [Rule] 10b-5 cases that a fact finder must find a specific intent to deceive or defraud would for all intents and purposes disembowel the private cause of action under § 10(b).").

¹⁹¹ See *Phillips v. LCI Int'l, Inc.*, 190 F.3d 609, 620 (4th Cir. 1999) (noting that the legislative history of the Reform Act refers to the Second Circuit standard); see

replete with inconsistent and contradictory statements that the Reform Act either codifies or modifies the existing Second Circuit standard.¹⁹² Indeed, as one district court judge noted, "[T]he Congressional byplay that accompanies the enactment of a controversial law like the Reform Act inevitably yields a rich cornucopia of legislative history on which courts of every appetite can feed."¹⁹³ The Reform Act's plain language merely requires that the complaint "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."¹⁹⁴ However, the language of the Act includes the "strong inference" aspect of the Second Circuit standard, and the legislative history of the Act contains extensive debate over the efficacy of the Second Circuit's "recklessness" and "motive and opportunity" pleading methods. Since the Reform Act does not explain how to meet the heightened pleading standard, it suggests that Congress intended to leave the issue to judicial interpretation.¹⁹⁵

The most striking interpretation of the Reform Act's heightened pleading standard was employed by the Ninth Circuit in *Silicon Graphics*. In direct contrast to the other circuits, the Ninth Circuit extracted haphazardly from the Act's legislative history to support its holding that plaintiffs in a private securities fraud action must allege conscious behavior

also *supra* note 75 and accompanying text.

¹⁹² See *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 195 (1st Cir. 1999) (finding that the legislative history is inconsistent on whether the Reform Act intended to either embody or reject the Second Circuit pleading standard); see also *infra* note 203 and accompanying text.

¹⁹³ *In re Baesa Sec. Litig.*, 969 F. Supp. 238, 242 n.2 (S.D.N.Y. 1997) (citing ROBERT A. KATZMANN, COURTS AND CONGRESS 64-65 (1997)). The First Circuit apparently agrees, noting that the legislative history is "irretrievably conflicted" regarding the methods of establishing a strong inference of scienter—"with all sides finding some support for their position." *Greebel*, 194 F.3d at 192.

¹⁹⁴ See 15 U.S.C. § 78u-4(b)(1) (2000).

¹⁹⁵ The First Circuit remarked that the only agreement Congress apparently reached was to disagree on the issue of the Second Circuit standards, and "to leave such matters for courts to resolve." *Greebel*, 194 F.3d at 195; see also *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 993 (9th Cir. 1999) (Browning, J., concurring in part and dissenting in part) (finding that Congress' decision not to adopt or reject particular factual patterns that might satisfy the strong inference standard meant that the "task was left to the courts"); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534 (3d Cir. 1999) ("In our view, the fact that Congress considered inserting language directly addressing [the Second Circuit pleading standard], but ultimately chose not to, suggests that it intended to leave the matter to judicial interpretation.").

to withstand a motion to dismiss.¹⁹⁶ A careful and studied look at the Reform Act's legislative history will reveal why the majority's analysis in *Silicon Graphics* is flawed and therefore, why the Supreme Court should reject the Ninth Circuit's holding. Additionally, a review of Congress' vision in implementing the Act will show why the motive and opportunity standard should be rejected, despite its support by the Second and Third Circuits and the SEC. As this Note will emphasize, a more reasoned resolution is for the Supreme Court to find that Congress did not raise the scienter standard beyond recklessness and that a strong inference of recklessness could be alleged by circumstantial evidence of conscious misbehavior or recklessness, but not just by evidence of motive and opportunity.

1. An Examination of the Reform Act's Legislative History

The controversy over the Reform Act's "strong inference" standard has its impetus in the Senate precursor to the bill—S.240—in which the language originated.¹⁹⁷ In its report to the full Senate, the Senate Committee on Banking, Housing and Urban Affairs explained the basis for this pleading standard:

The Committee does not adopt a new and untested pleading standard that would generate additional litigation. Instead, the Committee chose a uniform standard modeled upon the pleading standard of the Second Circuit. Regarded as the most stringent pleading standard, the Second Circuit requires that the plaintiff plead facts that give rise to a "strong inference" of defendant's fraudulent intent. The Committee does not intend to codify the Second Circuit case law interpreting this provision, although courts may find this body of law instructive.¹⁹⁸

During a subsequent floor debate, Senator Specter tried to make this support of the Second Circuit standard even more definitive. He offered an amendment closely tracking the lan-

¹⁹⁶ See *infra* Part III.B.2 (discussing the Ninth Circuit's treatment of the Reform Act's legislative history).

¹⁹⁷ The Senate bill required plaintiffs to allege "specific facts demonstrating the state of mind of each defendant at the time the alleged violation occurred." S.240, 104th Cong., § 104 (1995), reprinted in 141 CONG. REC. S1078 (daily ed. Jan. 18, 1995), available at 1995 WL 18795.

¹⁹⁸ S. REP. NO. 104-98, reprinted in 1995 U.S.C.C.A.N. 679, 1995 WL 372783.

guage of the Second Circuit pleading standard.¹⁹⁹ The Senate adopted this amendment, but it was deleted by the Conference Committee.²⁰⁰ In the Statement of Managers, the Conference Committee explained the standard that it adopted:

The Conference Committee language is based in part on the pleading standard of the Second Circuit. The standard also is specifically written to conform the language to Rule 9(b)'s notion of pleading "with particularity." 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 standards, it does not intend to codify the Second Circuit's case law interpreting this pleading standard.²⁰¹

The accompanying footnote stated, "For this reason, the Conference Report chose not to include in the pleading standard

¹⁹⁹ See Amend. 1485, S.240, 104th Cong. (1995), reprinted in 141 CONG. REC. S9170 (daily ed. June 27, 1995), available at 1995 WL 383008. The amendment added a provision following the general requirement that the complaint allege facts giving rise to a strong inference that the defendant acted with the required state of mind, which provided:

(2) strong inference of fraudulent intent. For purposes of paragraph (1), a strong inference that the defendant acted with the required state of mind may be established either

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

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

Id. Senator Specter specifically noted that his amendment was based on Second Circuit case law, particularly *Beck v. Manufacturers Hanover Trust Co.*, 820 F.2d 46 (2d Cir. 1987). *Id.* at S9171 (statement of Sen. Specter). The Specter amendment was passed by a vote of 52 to 47. *Id.* at S9201 (daily ed. June 28, 1995), available at 1995 WL 382792. The Senate bill was passed on June 28, 1995 by a vote of 70 to 29. See *id.* at S9219.

²⁰⁰ The Conference Committee addressed the differences between the House and Senate versions of the Reform Act and released their report on November 28, 1995. See Statement of Managers, H.R. CONF. REP. NO. 104-369, reprinted in 1995 U.S.C.C.A.N. 730, 1995 WL 709276. In addition to deleting the Specter Amendment, the Conference Committee changed the language of the pleading standard from "specifically allege" to "plead with particularity." This change was based on the recommendation of the Judicial Conference that the provision be amended to comply with the language of Rule 9(b) of the Federal Rules of Civil Procedure, see *id.*, which requires that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." FED. R. CIV. P. 9(b).

²⁰¹ Statement of Managers, H.R. CONF. REP. NO. 104-369, reprinted in 1995 U.S.C.C.A.N. 730, 1995 WL 709276.

certain language relating to motive, opportunity, or recklessness,"²⁰² apparently referring to the Second Circuit's current pleading standard.²⁰³ President Clinton vetoed the Reform Act, citing the Statement of Managers as one of his reasons. In the President's veto message he stated:

I believe that the pleading requirements of the Conference Report with regard to a defendant's state of mind impose an unacceptable procedural hurdle to meritorious claims being heard in Federal courts. I am prepared to support the high pleading standard of the U.S. Court of Appeals for the Second Circuit—the highest pleading standard of any Federal circuit court. But the conferees make crystal clear in the Statement of Managers their intent to raise the standard even beyond that level. I am not prepared to accept that.²⁰⁴

Subsequently, both houses of Congress overrode the President's veto and enacted the Reform Act into law without any modification to the pleading standard.

²⁰² *Id.* at n.23.

²⁰³ *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 532 (3d Cir. 1999) (noting that the footnote was "an apparent reference to Second Circuit case law interpreting the pleading requirement for scienter"). Confusion and contradiction arose because despite the fact that Congress explicitly rejected the Second Circuit standard, statements made by members of Congress indicate the contrary. For example, during debate on the Senate floor, Senator Domenici, co-sponsor of the Reform Act and one of the Conference Committee Managers, stated that "the conference report adopts the pleading standard utilized by the [S]econd [C]ircuit [C]ourt of [A]ppeals." 141 CONG. REC. S17,969 (daily ed. Dec. 5, 1995) (statement of Senator Domenici), available at 1995 WL 713530. Senator Dodd, another Manager, explicitly agreed with Senator Domenici's assertion. *See id.* at S17,959 (daily ed. Dec. 5, 1995) (statement of Senator Dodd), available at 1995 WL 713537.

²⁰⁴ Veto Message, H.R. DOC. NO. 104-150, reprinted in 141 CONG. REC. H15,214 (daily ed. Dec. 20, 1995), available at 1995 WL 752858. President Clinton also referred to the Specter amendment in his veto message. He stated that Congress' deletion of the amendment, which specifically incorporated Second Circuit case law, and its indication to "strengthen" the existing pleading requirements of the Second Circuit shows that "the conferees meant to erect a higher barrier to bringing suit than any now existing—one so high that even the most aggrieved investors with the most painful losses may get tossed out of court before they have a chance to prove their case." *Id.*

In floor debate following the President's veto, Senator Dodd reenforced his position that contrary to the President's belief, the pleading provision in the Reform Act was the Second Circuit standard. 141 CONG. REC. S19,068 (daily ed. Dec. 21, 1995) (statement of Senator Dodd), available at 1995 WL 755363. Additionally, Senator Domenici criticized President Clinton's reliance on the language in the Statement of Managers, remarking, "A statement of managers is not law, everyone knows that." *Id.* (statement of Senator Domenici).

2. Two Approaches to Analyzing the Reform Act's Legislative History

In rejecting recklessness as a sufficient basis for scienter and circumstantial evidence of both recklessness and motive and opportunity as appropriate methods for pleading scienter, the Ninth Circuit grasped at the Reform Act's legislative history, employing a flawed analysis and placing unwarranted reliance on ambiguous statements. First, the court claimed that the Conference Committee "implicitly rejected" the Second Circuit's pleading standard²⁰⁵ when it declined to incorporate the language in the Specter amendment.²⁰⁶ However, several reasons show why this conclusion is untenable. First, the legislative history demonstrates that the Committee rejected the Specter Amendment because it was an "incomplete and inaccurate" codification of Second Circuit case law²⁰⁷ and not because the Committee intended to proscribe the methods in which a "strong inference" of the required state of mind may be plead.²⁰⁸ In fact, the Managers reassured the amendment's proponents that courts could use the Second Circuit test as "guidance," even though the Reform Act did not expressly provide that plaintiffs could plead scienter using the two-prong pleading standard.²⁰⁹ Moreover, the Ninth Circuit failed to

²⁰⁵ *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 978 (9th Cir. 1999) ("[T]he joint conference committee . . . declined to incorporate the Specter Amendment in the final version of the [Reform Act]. In doing so, they implicitly rejected the Second Circuit's two-pronged test."). In coming to this conclusion, the court relied upon *Gulf Oil Corp. v. Copp Paving Co.*, 419 U.S. 186 (1974), for the proposition that if the conference committee expressly declined to adopt proposed statutory language, its action "strongly militates against a judgment that Congress intended [the] result that it expressly declined to enact." *Id.* (quoting *Gulf Oil Corp.*, 419 U.S. at 200).

²⁰⁶ See *supra* note 199 and accompanying text (discussing Specter Amendment).

²⁰⁷ 141 CONG. REC. S19,067 (daily ed. Dec. 21, 1995) (Senator Dodd quoting from memorandum of Prof. Grundfest), available at 1995 WL 755363. In Senator Dodd's view, the amendment completely omitted a critical qualification in the case law: it failed to show that where motive is not apparent, a plaintiff may plead scienter by identifying circumstances that indicate wrongful behavior, but "the strength of the circumstantial allegations must be correspondingly greater" than the number of cases. *Id.* at S17,960 (daily ed. Dec. 5, 1995) (statement of Senator Dodd), available at 1995 WL 713530.

²⁰⁸ *Silicon Graphics*, 183 F.3d at 993 (Browning, J., concurring in part and dissenting in part).

²⁰⁹ *Id.* (citing 141 CONG. REC. S19,068 (daily ed. Dec. 21, 1995) (statement of Senator Dodd) ("We left out the guidance. That does not mean that you disregard

recognize that if Congress had codified a recklessness standard for pleading that would apply to all statements, which the Specter Amendment proposed, that standard would be inconsistent with the provisions of the Reform Act requiring a different scienter for certain statements.²¹⁰ For example, the Reform Act's provision regarding "forward-looking" statements requires that plaintiffs prove that such statements were made with actual knowledge.²¹¹

Furthermore, the Ninth Circuit inappropriately relied upon footnote 23 in the Statement of Managers²¹² to support its holding.²¹³ The court appears to have determined that because footnote 23 referred to motive and opportunity and recklessness, but not to conscious behavior, Congress must have intended that only evidence of conscious behavior would suffice to meet the strong inference test.²¹⁴ This assumption is seriously flawed. The Ninth Circuit ignored the plain fact that Congress deleted not only the provision regarding motive and opportunity and recklessness, but it also declined to include in the Reform Act any language relating to "circumstantial evidence of conscious misbehavior,"²¹⁵ a variation of the second approach to satisfying the Second Circuit pleading standard.²¹⁶ In fact, the *Silicon Graphics* majority adopted a pleading test—"deliberate or conscious recklessness"—that explicitly focuses on conscious misbehavior.²¹⁷ A more rational explanation is that Congress declined to incorporate the

it.")). See *supra* note 198 and accompanying text.

²¹⁰ *Silicon Graphics*, 183 F.3d at 993 (Browning, J., concurring in part and dissenting in part).

²¹¹ See *supra* Part III.A.3 (discussing the "safe harbor" provision).

²¹² See *supra* note 202 and accompanying text.

²¹³ *Silicon Graphics* Brief, at <http://www.sec.gov/news/extra/silicon.txt> ("The court's apparent reliance on footnote 23 in the statement of managers to support its holding . . . is misplaced.").

²¹⁴ See *Silicon Graphics*, 183 F.3d at 978.

²¹⁵ *Press v. Chem. Inv. Serv. Corp.*, 166 F.3d 529, 538 (2d Cir. 1999) (quoting *Shields v. Citytrust Bancorp.*, 25 F.3d 1124, 1128 (2d Cir. 1994)) (allowing plaintiffs to prove scienter by alleging facts that constitute strong circumstantial evidence of "conscious misbehavior" or recklessness).

²¹⁶ *Silicon Graphics*, 183 F.3d at 994 (Browning, J., concurring in part and dissenting in part) ("[T]he majority does not suggest that despite this omission, conscious misbehavior no longer provides an appropriate basis for inferring scienter."); see also *Silicon Graphics* Brief, at <http://www.sec.gov/news/extra/silicon.txt>.

²¹⁷ *Silicon Graphics*, 183 F.3d at 979-80; see also *supra* notes 133 & 134 and accompanying text.

Second Circuit guidance because it intended only to adopt the "strong inference" pleading standard and not to mandate or proscribe particular factual circumstances that might satisfy the standard, preferring to leave that task to the courts.²¹⁸ Indeed, the First Circuit noted, "[I]t would be unusual for Congress to legislate on what fact patterns could or could not prove fraud or scienter."²¹⁹ Therefore, a careful reading of the Statement of Managers indicates no support for the conclusion that the Conference Committee eliminated recklessness as satisfying scienter or that it eliminated any method of proving scienter in private securities actions.²²⁰

Lastly, the Ninth Circuit placed undue reliance on the President's concern, announced in his veto message, that the Reform Act would raise the pleading standard above the pre-existing Second Circuit test.²²¹ In doing so, the court incorrectly assumed that when Congress overrode the President's veto, it agreed with the President that the Reform Act, as passed, incorporated a pleading standard more demanding than the Second Circuit standard.²²² However, during the Senate debate following the President's veto, the Reform Act's supporters clearly disagreed with the President's interpretation of the legislation and reaffirmed their view that the Reform Act was faithful to the Second Circuit test.²²³ Therefore, it is

²¹⁸ *Id.* at 993-94 (Browning, J., concurring in part and dissenting in part). In fact, Senator Dodd noted:

[I]nstead of trying to take each case that came under the second circuit, we are trying to get to the point where we would have well-pleaded complaints. We are using the standards in the second circuit in that regard, then letting the courts—as these matters will—test. They can then refer to specific cases, the second circuit, otherwise, to determine if these standards are based on facts and circumstances in a particular case.

141 CONG. REC. S17,960 (daily ed. Dec. 5, 1995) (statement of Sen. Dodd), available at 1995 WL 713530; see also *Silicon Graphics* Brief, at <http://www.sec.gov/news/extra/silicon.txt>.

²¹⁹ *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 195 (1st Cir. 1999).

²²⁰ See *Silicon Graphics* Brief, at <http://www.sec.gov/news/extra/silicon.txt> ("Nowhere did the conference committee suggest that it was eliminating recklessness as satisfying the scienter requirement, or indeed, that it was eliminating evidence of motive and opportunity or circumstantial evidence of fraudulent intent (be it conscious or reckless) as factors that the court might consider in determining whether the strong inference had been established.").

²²¹ *Silicon Graphics*, 183 F.3d at 979; see also *supra* note 204 and accompanying text (discussing the President's veto message).

²²² *Silicon Graphics*, 183 F.3d at 994 (Browning, J., concurring in part and dissenting in part).

²²³ *E.g.*, 141 CONG. REC. S19,067 (daily ed. Dec. 21, 1995) (Senator Dodd quot-

apparent that the Ninth Circuit, perhaps in haste to find support for its position, looked beyond the Reform Act's plain language and employed an untenable analysis of congressional intent to support its holding.

3. The Fate of the "Motive and Opportunity" Standard

Contrary to the Ninth Circuit's belief, all that can be extracted from a careful analysis of the Reform Act's legislative history is that Congress did not mandate what factual circumstances must be alleged to plead scienter. Rather, the courts are left with this daunting task. Therefore, it appears that plaintiffs are permitted to use both allegations of motive and opportunity and circumstantial evidence of conscious misbehavior or recklessness to allege scienter. After all, a look at the cases reveals that congressional intent has been met. In fact, in six of the seven cases discussed in this Note, dismissal was affirmed, emphasizing Congress' vision in enacting the Reform Act "to curtail the filing of meritless lawsuits."²²⁴ These cases were all decided in favor of the defendants, regardless of the court's position on the underlying Reform Act issues.²²⁵

Nonetheless, the statistics paint a more dismal picture. Since Congress passed the Reform Act, there has been an increase in private securities fraud lawsuits, suggesting that congressional intent may not yet be fully effectuated. Indeed,

ing from memorandum of Prof. Grundfest), available at 1995 WL 755363; *id.* at S19,150 (daily ed. Dec. 22, 1995) (statement of Senator Domenici) ("The President objected to the pleading standard. Yet it is the Second Circuit's pleading standard."), available at 1995 WL 759560; *id.* at S19,068 (daily ed. Dec. 21, 1995) (Statement of Rep. Lofgren) ("The President says he supports the second circuit standard for pleading. So do I. That is what is included in this bill.").

Similarly, the First Circuit criticized such heavy reliance on the President's veto message. The defendant in *Greebel* relied on the same flawed argument as the defendant in *Silicon Graphics*. The First Circuit noted that "[w]hile the President's view of what Congress meant has some informational value, we give that view little weight: the real issue is what the intent was of Congress, not the President." *Greebel*, 194 F.3d at 195.

²²⁴ For example, the Ninth Circuit observed that "[i]n the absence of greater particularity and more incriminating facts, we have no way of distinguishing [the plaintiffs'] allegations from countless 'fishing exhibitions' which the [Reform Act] was designed to deter." *Silicon Graphics*, 183 F.3d at 988.

²²⁵ In the seventh case, the Eleventh Circuit vacated and remanded a district court decision declining to dismiss the claims. See *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1286 (11th Cir. 1999).

commentators noted that "the Reform Act, rather than reducing the incidence of securities class actions, may have actually had the perverse effect of increasing the number of issuers sued."²²⁶ Precisely, as of January 20, 2001, 923 companies have been sued in 924 federal class actions filed since 1996, the year after Congress passed the Reform Act.²²⁷ In 1998, at least 235 companies were named defendants in federal class action securities lawsuits—a record high number—surpassing pre-Reform Act figures.²²⁸ Currently, the litigation rate is close to one lawsuit a day for every trading day that the stock market is open.²²⁹ Additionally, class actions have had an immense impact on the judiciary. An average securities class action requires more judicial time than either the average civil action or non-class action securities fraud case.²³⁰ Such realities serve no one's interest.

²²⁶ Joseph A. Grundfest & Michael A. Perino, *Securities Class Action Litigation in Q1 1998: A Report to NASDAQ from the Stanford Law School Securities Class Action Clearinghouse*, at Stanford Securities Class Action Clearinghouse, <http://securities.stanford.edu/report/nasdaq/98q1.html> (June 2, 1998). Grundfest and Perino explain this phenomenon:

Such an equilibrium is possible if the Reform Act simultaneously made securities litigation riskier (because it increased the number of actions dismissed in pretrial proceedings) while also decreasing the relative investment that the plaintiffs' law firm would have to make in each case (because the Act's discovery stay means that dismissals would occur before expensive pretrial proceedings commence).

Id.

²²⁷ Stanford Securities Class Action Clearinghouse, <http://securities.stanford.edu> (last modified Jan. 30, 2001).

²²⁸ In 1994, the year before the Reform Act was promulgated, 227 companies were named defendants in private securities fraud actions. *Securities Fraud Litigation Sets Record in 1998, Companies Sued at a Rate Close to One a Day*, Press Release, Stanford, CA, at <http://securities.stanford.edu/news/990125/pressrel.html> (Jan. 27, 1999). Since 1996, 923 companies have been sued in federal court. Stanford Securities Class Action Clearinghouse, <http://securities.stanford.edu> (visited Jan. 30, 2001). Also, since that time, the number of class actions filed in federal courts has increased almost two-fold: 110 cases were filed in 1996, 234 cases were filed in 1998, and 195 cases were filed in 2000. *Id.* Nonetheless, the number of class action lawsuits filed in 2000 is down from the number filed in 1999–206. *Id.*

²²⁹ *Securities Fraud Litigation Sets Record in 1998, Companies Sued at a Rate Close to One a Day*, Press Release, Stanford, CA, at <http://securities.stanford.edu/news/990125/pressrel.html> (Jan. 27, 1999).

²³⁰ Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year's Experience*, at http://securities.standford.edu/report/pslra_yrl/index.html (visited Feb. 10, 2000).

Therefore, the equivocal aftermath of the Reform Act supports the notion that the issues left unsettled by the Act deserve careful attention by the courts to ensure that Congress' overall goals are met. Private anti-fraud actions are an essential supplement to the SEC's own enforcement efforts.²³¹ But, at the same time, investors are not well-served by frivolous lawsuits.²³² Thus, courts should employ a delicate balancing test when determining the methods that will suffice to allege scienter under the Reform Act. The Reform Act attempts to balance competing interests by raising the threshold for pleading fraud to exclude non-meritorious cases early in the litigation, thereby avoiding the often enormous costs that discovery can impose on defendants. However, courts must be mindful that setting the Act's pleading threshold too high would create a bar to meritorious claims, a result Congress did not intend.

Regarding the procedural issue, it would be nonsensical to eliminate recklessness as a basis for pleading scienter if, as this Note discusses, circuit courts all around the country have concluded that recklessness suffices to establish liability under § 10(b) and Rule 10b-5. However, eliminating motive and opportunity as a ground for pleading scienter keeps the balance between the Reform Act's competing interests in check.²³³ Indeed, the Eleventh Circuit declined to adopt the motive and opportunity standard because "the clear purpose of the Reform Act was to curb abusive securities litigation," and because the court believed that "the motive and opportunity analysis is inconsistent with that purpose."²³⁴ Moreover, courts rejected the motive and opportunity standard, relying on the same logic that they used to support the recklessness pleading standard.

²³¹ See sources cited *supra* notes 2 & 3 and accompanying text.

²³² See *supra* notes 4, 41-47 and accompanying text.

²³³ The Eleventh Circuit noted that if courts let private securities fraud class actions proceed to discovery on mere allegations of motive and opportunity, such a practice would "upset the delicate balance of providing a remedy for genuine fraud while preventing abusive strike suits that the Reform Act sought to achieve." *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1286 (11th Cir. 1999) (quoting *Carley Capital Group v. Deloitte & Touche, L.L.P.*, 27 F. Supp. 2d 1324, 1339 (N.D. Ga. 1998)).

²³⁴ *Id.* Apparently the Third Circuit agrees with this contention because it noted that "[p]ermitt[ing] blanket assertions of motive and opportunity to serve as a basis for liability under the Exchange Act would undermine the most rigorous pleading standard Congress has established." *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 535 (3d Cir. 1999).

For instance, the Eleventh Circuit noted that the Reform Act "makes no express mention of the motive and opportunity test developed in the Second Circuit, and certainly does not expressly codify it."²³⁵ Furthermore, both the Eleventh and Sixth Circuits distinguished the motive and opportunity prong from the recklessness prong by recognizing that evidence of a defendant's motive and opportunity does not constitute a "state of mind" for purposes of § 10(b) or Rule 10b-5 liability.²³⁶ For this reason, those circuits concluded that plaintiffs may not establish a strong inference of scienter under the Reform Act merely by alleging facts showing a motive and opportunity "where those facts do not simultaneously establish that the defendant acted recklessly or knowingly, or with the required state of mind."²³⁷ Lastly, the Eleventh Circuit noted that unlike the well-established and uniformly recognized case law finding that recklessness suffices for liability under Rule 10b-5, "the motive and opportunity analysis was certainly not so well-established throughout the circuits at the time that the Reform Act was passed that it was codified sub silentio."²³⁸ Therefore, while evidence supports the contention that the Reform Act meant to codify recklessness as a sufficient method to establish liability, it does not support the conclusion that Congress intended to codify the "lesser-known," "lesser-accepted," and "certainly not well-established" method of pleading scienter by alleging motive and opportunity to commit fraud.²³⁹

Nonetheless, rejecting motive and opportunity as a basis for proving scienter does not mean that such allegations have no place in securities litigation. On the contrary, even those

²³⁵ *Bryant*, 187 F.3d at 1285.

²³⁶ See *id.* at 1285-86; *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 551 (6th Cir. 1999).

²³⁷ *In re Comshare*, 183 F.3d at 551; accord *Bryant*, 187 F.3d at 1286 (noting that, unlike recklessness, motive and opportunity is not a substantive state of mind standard and concluding that "the Reform Act did not codify the motive and opportunity analysis").

²³⁸ In fact, the Eleventh Circuit stated that only the Second and Ninth Circuits applied the motive and opportunity analysis before the Reform Act's passage. *Bryant*, 187 F.3d at 1286. Furthermore, within the Second Circuit, the court recognized that the motive and opportunity test has been applied in a "seemingly inconsistent fashion." *Id.* (comparing *In re Time Warner, Inc. Sec. Litig.*, 9 F.3d 259, 259 (2d Cir. 1993), with *Shields v. Citytrust Bancorp*, 25 F.3d 1124, 1128 (2d Cir. 1994)).

²³⁹ *Id.* at 1286-87.

courts rejecting the standard recognize that facts regarding motive and opportunity may be relevant to alleging situations from which a strong inference of scienter may be inferred and may occasionally rise to the level of creating such an inference.²⁴⁰ These courts are merely stating that "the bare pleading of motive and opportunity" does not, by itself, suffice to establish the required state of mind.²⁴¹

CONCLUSION

Although the circuit courts have reached fairly consistent results in applying the Reform Act's heightened pleading standard, they are sharply divided on two crucial issues. Without intervention and clarification from the Supreme Court, the disposition of private securities fraud cases will continue to fall at the whim of a particular court's interpretation of the Reform Act's requirements.²⁴² Since defendants frequently file motions to dismiss securities fraud complaints on the basis that plaintiffs have failed to properly plead state of mind, the viability of a securities class action can turn on the level of particularity that is required and the types of allegations that suffice to aver scienter. Such uncertainty concerning an important issue of federal law cannot persist.

Thus, the Supreme Court should impose a national pleading standard to create uniformity among the lower federal courts. First, the Court should resolve the uncertainty surrounding the meaning of recklessness. Although every circuit court has permitted some variant of recklessness, and virtually

²⁴⁰ *In re Comshare*, 183 F.3d at 551 (citing *In re Baesa Sec. Litig.*, 969 F. Supp. 238, 240 (S.D.N.Y. 1997)); accord *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 197 (1st Cir. 1999); *Bryant*, 187 F.3d at 1286. But see *In re Comshare* Brief at n.46, at <http://securities.stanford.edu/briefs/comshare/9702098/sec.html> (stating that the SEC disfavors an approach that allows motive and opportunity to be used simply as factors to be considered in evaluating circumstantial evidence of conscious misbehavior or recklessness).

²⁴¹ *Comshare*, 183 F.3d at 551; accord *Greebel*, 194 F.3d at 197 (rejecting the argument that "facts showing motive and opportunity can never be enough to permit the drawing of a strong inference of scienter"); *Bryant*, 187 F.3d at 1285.

²⁴² One commentator has noted that the uncertainty arising from the Reform Act has turned the litigation of motions to dismiss and for summary judgment in securities class actions into a "game of roulette," the outcome of which depends on how a particular judge interprets the state of mind requirement. Giuffra, *Strike Suit*, *supra* note 29, at A45.

every circuit court has cited the *Sundstrand* definition of recklessness, there is great disparity regarding the interpretation of that definition. Second, the Court should mandate that a strong inference of scienter can be alleged only by facts constituting strong circumstantial evidence of conscious misbehavior or recklessness and not just by facts indicating motive and opportunity to commit fraud. There is simply nothing in either the Reform Act's plain language or legislative history that supports the conclusion that allegations of motive and opportunity alone are sufficient to impose on defendants and courts the huge expense of a securities fraud class action. An additional policy consideration strongly supports rejecting such a standard: naming a party in a civil suit for fraud should not be viewed lightly.²⁴³ Plaintiffs can easily craft a complaint that alleges violations of the securities laws,²⁴⁴ but defendants can get no legal redress for the serious injury to reputation that an unwarranted fraud claim can bring.²⁴⁵ Indeed, the Eleventh Circuit recognized the danger of accepting motive and opportunity as evidence of scienter when it noted that "greed is a ubiquitous motive, and corporate insiders and upper management always have the opportunity to lie and manipulate."²⁴⁶

Surprisingly, at this time no party has petitioned the Supreme Court for certiorari. Nevertheless, a quick resolution of this debate is essential because a Supreme Court ruling will provide a meaningful and comprehensive heightened pleading standard that will guide courts and parties in separating the meritless securities class action complaints, which should be dismissed at the pleading stage, from the worthy ones that should proceed—a practice that serves everyone's interest.

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²⁴³ Statement of Managers, H.R. CONF. REP. NO. 104-369, reprinted in 1995 U.S.C.C.A.N. 730, 1995 WL 709276.

²⁴⁴ S. REP. NO. 104-98, reprinted in 1995 U.S.C.C.A.N. 679, 1995 WL 372783.

²⁴⁵ Statement of Managers, H.R. CONF. REP. NO. 104-369, reprinted in 1995 U.S.C.C.A.N. 730, 1995 WL 709276.

²⁴⁶ *Bryant*, 187 F.3d at 1286 (quoting *Carley Capital Group v. Deloitte & Touche, L.L.P.*, 27 F. Supp. 2d 1324, 1339 (N.D. Ga. 1998)).

