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State Securities Litigation May No Longer Be a Class Act

Federal preemption looms on the horizon

By Susan J. Becker
Litigation News Associate Editor

State courthouse doors may soon be closed to class actions by shareholders of nationally traded stocks seeking redress for alleged misstatements and omissions in the issuer's financial forecasts.

The Securities Uniform Standards Act of 1998, passed by both the House of Representatives and the Senate this summer, preempts most securities class actions from being prosecuted in state courts. Conferees currently working to reconcile the House (H.R. 1689) and Senate (S. 1260) versions of the Act predict that the differences will be resolved and the Act will become law before year's end.

This congressional activity aims to close perceived loopholes in securities reform measures that Congress enacted in 1995. The Private Securities Litigation Reform Act of 1995 (PSLRA) substantially changed the face of securities litigation in federal courts. It heightened the pleading requirements for scienter in securities fraud litigation, limited discovery and plaintiffs' attorneys' fees, and required additional Rule 11 scrutiny of each party's behavior. One of the PSLRA's most controversial provisions created a safe harbor from liability for issuers' optimistic forward-looking financial statements if "meaningful cautionary statements" accompanied the projections.

The PSLRA's primary objective was to restrict shareholder class actions known as "strike suits." A strike suit is based on Rule 10b-5 of the 1934 Securities Act or analogous state statutory or common law. A strike suit's key allegation is that a drop in a company's stock price is evidence of fraudulent financial information provided to investors by the company's officers and directors. Companies with volatile stock prices, especially those developing and marketing electronic and emerging-technology products, are common defendants in such lawsuits.

Proponents of the 1998 Securities Uniform Standards Act assert that the PSLRA's effectiveness in reforming securities litigation has been severely compromised by the increased filing in state courts of securities class actions based on state law, often with parallel complaints filed in federal court. Unlike federal cases, state proceedings are not subject to the PSLRA's heightened pleading standards, discovery limitations, safe harbor defenses, and other restrictions.

> ***"This is one area where federal preemption is altogether appropriate so that we have just one standard."***

"Data so far suggests that rather than deterring a certain number of cases from being filed, which is probably what Congress had hoped when it passed the [PSLRA], that Act simply changed the forum in which the litigation was filed," Stanford Law Professor Michael A. Perino said during a Section of Litigation program at the 1998 ABA Annual Meeting. "The most reasonable explanation for the increase in state court litigation is the desire to evade some of the [1995] Act's procedural hurdles. Another panelist agreed with Perino's assessment: "In New Jersey, I have seen a significant increase in the number of cases filed in state court which involve nationally traded securities," said Jeffrey J. Greenbaum, Newark, NJ,

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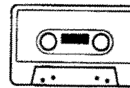

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Securities

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Co-Chair of the Section's Class Actions and Derivative Suits Committee, "One of the problems is that state court judges do not see these cases as frequently as federal judges do. Even though we have a high-quality judiciary in New Jersey, the federal judges just have a lot more background and experience with these cases, which are often complex."

Opponents of federal preemption, including many consumer groups and members of the plaintiffs' bar, argue that data on the effectiveness of the 1995 reforms is at best inconclusive and that the 1998 legislation is premature and ill conceived. Other opponents complain that the legislation impermissibly tramples on state rights.

One veteran observer views Congress's most recent action as short sighted. Elizabeth M. McGeever, Wilmington, DE, Immediate Past Co-Chair of the Section's Committee on Class Actions and Derivative Suits, has followed congressional efforts to reform securities litigation for a number of years.

"The purported justification for the legislation, the migration of securities cases to state courts in an effort to avoid the PSLRA, has yet to be proved," McGeever says. "The Act went into effect just two years ago, and the limited data we have regarding state court filings is at best conflicting. It is simply too early to evaluate whether the PSLRA has succeeded in curbing abusive securities litigation, much less to conclude that stockholder plaintiffs are regularly forum shopping in state courts solely to avoid the PSLRA."

"In addition, the proposed legislation unfairly penalizes smaller investors for whom a class action may be the only source of recovery, by divesting state courts of the jurisdiction to hear class action and anti-fraud suits," McGeever notes. "But it still allows individual actions alleging the same types of claims to be pursued in state courts."

Even if the newest round of legislation fails to address all the ills in securities litigation, some believe additional federal legislation is necessary.

"Some additional reform is appropriate," says Steven W. Hansen, Boston, Co-Chair of the Section's Securities Litigation Committee. Hansen explains one of the problems created by the PSLRA, which he believes the new legislation may resolve.

> ***"Rather than deterring cases . . . the [1995 Securities Litigation Reform Act] simply changed the forum in which the litigation was filed."***

"There is particular uncertainty in the issuer community regarding the strength of and ability to rely on some of the 1995 reforms," Hansen says. "For example, it is not at all clear whether the new federal standard for forward-looking financial statements should also apply in state cases, or whether the state standards should be different from the federal one. I think this is one area where federal preemption is altogether appropriate so that we have just one standard."

Both the House and Senate versions of the Uniform Standards Act limit state class actions by amending Section 16 of the Securities Act of 1933 and Section 28 of the Securities Exchange Act of 1934. The Senate's version of revised Section 16 provides that "no class action based on the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party," if the complaint alleges "an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security," or alleges "that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security." The House's language is similar.

The preemption applies only to nationally traded securities, and the Act is not retroactive.

The two bills define class actions subject to the statute similarly. Covered class actions include any single lawsuit, other than a shareholder derivative action, in which damages are sought on behalf of more than 50 people or class members. Class action status is accorded where common questions of law or fact predominate over individual issues, regardless of whether issues exist as to individualized reliance on any alleged misstatements or omissions.

In determining whether a lawsuit involves more than 50 plaintiffs, a corporation, investment company, partnership, pension plan, or other entity counts as a single class member unless the entity was organized only for the purpose of participating in the litigation.

The Securities Uniform Standards Act does not preempt all state class actions. A provision in both versions of the legislation, commonly referred to as the "Delaware carve out," preserves class actions based on the law of the state in which the issuer is incorporated or organized. The Act also preserves the jurisdiction of state securities commissions to investigate and bring enforcement actions.

One of the major issues the conferees must resolve is the House provision that empowers federal judges to stay discovery in parallel state court actions. Some Senators have suggested that this section may be unconstitutional.

President Clinton, whose veto of the PSLRA was overridden by Congress in 1995, supports the current legislation. Securities and Exchange Commission Chair Arthur Levitt initially opposed both the PSLRA and the current reforms, but endorsed the Senate legislation after revisions were made to address some of his concerns.

The Securities Litigation Uniform Standards Act of 1998 was the subject of spirited debate during the recent ABA Annual Meeting program entitled "Securities Class Actions in State Courts: A Way Around the Federal Securities Litigation Reform Act?" Much of the debate centered on whether the 1995 reforms were necessary and effective and whether the 1998 reforms will close the perceived loopholes in the 1995 legislation.

C. Evan Stewart, New York City, stated that, from a client's perspective, he was concerned that the reform legislation has taken focus and energy away from more important securities law issues. Stewart suggested that key issues being overlooked include the emerging recognition by courts of attorney liability in aiding and abetting securities fraud or misconduct, the appropriate limits on punitive damages awarded in arbitration, and the imminent demise of mandatory arbitration in many securities cases.

To order an audio cassette of the program, see ad on page 4.

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