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# Will New Legislation Preempt State Court Class Actions?

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# LEGISLATIVE UPDATE

## Will New Legislation Preempt State Court Class Actions?

*Congress wonders if securities litigation reform went far enough*

By Susan J. Becker
Litigation News Associate Editor

Proponents of 1995's federal securities litigation reform are proposing new legislation to prevent plaintiffs from using state court class actions to circumvent the restrictive federal rules.

Congress enacted significant changes in 1995 to the procedural and substantive rules governing federal court class action securities litigation, in an effort to restrict "strike suits." But strike suits have not disappeared. Strike suits are shareholder class actions brought pursuant to Rule 10b-5 of the 1934 Securities Exchange Act when the price of a company's stock falls. The key allegation is that the company fraudulently misled investors about the company's financial future.

Preliminary data indicated that such litigation was migrating to state courts to avoid the federal restrictions. More recent studies, however, do not confirm that trend. Nevertheless, Congress is now considering additional reforms to limit "strike suit" class actions in state courts.

"It is too early to tell whether the 1995 reforms have achieved the objective of curbing abusive litigation," says Elizabeth McGeever, Wilmington, DE, Co-Chair of the Section of Litigation's Committee on Class Actions and Derivative Suits. "We are only about 20 months out, and not that many cases have been tried under the new rules. There are no major summary judgment or appellate decisions in this area yet. There is just not enough of a track record to see if the 1995 legislation is achieving its goals."

> *"The data doesn't seem to justify preemptive legislation at this time."*

The very vocal critics of Rule 10b-5 securities class actions, who include the Security Industry Association, The American Institute of Certified Public Accountants, and many Silicon Valley companies, contend that many securities lawsuits are frivolous and constitute a form of blackmail used to force corporations to settle quickly—under terms generally quite lucrative for plaintiffs' counsel—instead of engaging in protracted and expensive class action litigation.

The Section of Litigation, the American Association of Retired People, and various consumer groups advance a contrary position, asserting that the sweeping reforms that Congress enacted two years ago may be doing more to deter meritorious suits than to eliminate frivolous ones.

The critics of securities class actions won a major battle by successfully lobbying Congress to enact the 1995 Private Securities Litigation Reform Act (PSLRA). Congress disregarded the opposition of the Securities Exchange Commission (SEC) and even overrode a presidential veto.

The PSLRA created a number of prodefendant rules, including:

- a heightened standard for pleading scienter in securities fraud litigation;
- an automatic stay of discovery and other proceedings during the pendency of a motion to dismiss;
- a safe harbor provision sheltering companies from liability for issuers' optimistic forward-looking financial projections if accompanied by "meaningful cautionary statements";
- a limitation on plaintiffs' attorneys' fees and elimination of bonuses to named plaintiffs;
- a procedure for the court to select lead plaintiffs and allow those plaintiffs to select lead counsel; and
- a directive for trial judges to determine each party's compliance with F.R.C.P. 11 and impose sanctions at the conclusion of the case on any party who failed to comply.

The PSLRA also eliminated most Racketeer Influenced and Corrupt Organizations Act (RICO) claims from securities litigation.

But now the proponents of the PSLRA complain that it did not go far enough. They are back before Congress, lobbying for passage of additional legislation to prevent plaintiffs' lawyers from circumventing the PSLRA by filing "strike suits" in state courts.

The House of Representatives is considering two bills and the Senate, another. The most popular bill, H.R. 1689, would preempt most class action securities proceedings in state courts. Since its introduction last May, H.R. 1689 has gained broad bipartisan support and now has 105 cosponsors.

H.R. 1689 would significantly limit shareholders' remedies, by prohibiting class actions brought by a private party in state or federal courts if the actions are based on state or municipal laws, and if the suits allege in connection with the purchase or sale of a covered security: (1) an untrue statement or omission, or (2) the use of a manipulative or deceptive device.

H.R. 1689 also declares that any class action brought by a private party in state court involving a nationally traded security would be removable to federal district court. The same rule would apply to a non-nationally traded security if the issuer had outstanding a security that was nationally traded.

Similar legislation, S. 1260, was introduced in early October and now has 18 cosponsors. It is narrower than H.R. 1689 because S. 1260 would only preempt securities class actions where the security at issue was itself nationally traded.

The third proposed bill, H.R. 1653, would grant federal courts exclusive jurisdiction over all securities lawsuits involving claims of misrepresentations or omissions in connection with the purchase or sale of a nationally traded security and would prohibit federal courts from hearing any pendent state

*(Please turn to page 7—SEC)*

## SEC

*(continued from page 4)*

law claims involving such securities.

"My research does not reveal any evidence of massive migration of class action cases to state courts," McGeever explains. "Initial studies showed there was an increase in state court filings in 1996, but that has not continued in 1997. We just don't have evidence yet that people are circumventing the federal court rules by filing in state court. So, the data don't seem to justify preemptive legislation at this time."

McGeever also questions why the proposed preemptive litigation should apply to class actions but not to individual suits. "It is somewhat ironic, given the purpose of class actions, that smaller investors won't be able to pool their resources to bring class actions in state courts to vindicate their rights, but individual litigants with sufficient means can pursue remedies in state courts," she says.

The proposed House legislation has been referred to the House Committee on Commerce's Subcommittee on Finance and Hazardous Materials, which held hearings on October 21, 1997. SEC Chair Arthur Levitt, Jr., was among those urging Congress to use caution in enacting further securities litigation reforms. Proponents of the measures to preempt state court securities class actions include the Uniform Standards Coalition (U.S. Coalition), which was formed to lobby congress for further reform on behalf of securities, high-tech, and venture capital groups, and the accounting profession.

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McGeever says her committee will continue to gather data on the impact of the 1995 reforms and monitor the developments in Congress, but she is not certain whether the committee will draft a position statement for consideration by the Section of Litigation or the ABA as a whole.

"Our committee is composed of attorneys with diametrically opposed views on the need for securities litigation reform, regardless of whether the attorneys are defense or plaintiff oriented," McGeever says. "It may be difficult to forge a consensus."

Full text copies and frequently updated status reports on H.R. 1653, H.R. 1689, S. 1260 are available on the Internet at [http://thomas.loc.gov].