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Circuits Split Over the Reform Act's Impact on Scienter Requirement in Securities Fraud Cases

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Your client, the president of a publicly held company, calls to tell you that he and his company have just been served with a class-action complaint alleging securities fraud. You review the complaint's allegations and they seem rather vague, especially on the issue of whether the defendants acted with an intent to defraud.

You recall that Congress recently passed legislation designed to deter unfounded securities class-action suits and that the statute dealt specifically with the issue of what state of mind must be plead to state a cognizable securities cause of action. You locate and review a copy of the law the Private Securities Litigation Reform Act of 1995 but are still unclear on the state of mind that must be plead in securities cases.

Join the club.

Four years following the passage of the Reform Act, courts remain sharply divided on that critical issue. This disagreement has become even more pronounced during the last few months as the first four U.S. Circuit Courts of Appeals decisions on the topic have been handed down. This article will compare how the circuit courts have addressed the state-of-mind question that has arisen in securities fraud cases.

History

Congress enacted the Reform Act to remedy perceived problems regarding the filing of meritless securities suits. The consensus among legal analysts and members of Congress was that securities plaintiffs were abusing the class-action device by filing claims against public companies in response to any significant change in their stock price, regardless of the company's culpability.

Following the filing of the complaint, such plaintiffs routinely would use the threat of costly and time-consuming discovery to persuade the company to settle the case, even where there the claims alleged were unfounded. In passing the Reform Act, Congress crafted a series of measures designed to alter the balance of power in securities class-action cases. Foremost among those measures were heightened pleading requirements and a stay of discovery pending the filing of a motion to dismiss.

On the specific issue of state of mind that must be plead in securities cases, the Reform Act provides that: [T]he 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. 15 U.S.C. Sec. 78u-4(b)(2) (1998).

On its face, that provision does not define what the requisite state of mind is in federal securities cases, but rather addresses the more procedural issue of the manner in which that state of mind must be plead. Courts have struggled in attempting to apply that procedural directive. In addition, the directive apparently has begun to cause a drift in the substantive (in addition to procedural) content of the state of mind that securities plaintiffs are being required to plead and prove.

Since the mid-1970s, the law had been fairly consistent and clear on the question of what state of mind must be proven to prevail on a claim brought under the primary antifraud provision of the federal securities laws, Sec. 10(b) of the Securities Exchange Act of 1934. Specifically, a private plaintiff bringing a section 10(b) suit must prove that the defendant acted with scienter.

The scienter requirement may be satisfied through proving that the defendant acted knowingly or intentionally in committing the alleged misconduct. Courts also agreed that, although the U.S. Supreme Court has never resolved the issue, reckless conduct could be seen as a type of scienter and therefore sufficient. The Supreme Court has made clear, however, that more than mere negligent conduct is needed to prevail on a section 10(b) claim.

Even before Congress passed the Reform Act in 1995, courts, following the dictates of Federal Rule of Civil Procedure 9(b) which requires that claims of fraud be plead with particularity generally had not permitted Sec. 10(b) plaintiffs to pursue their claims of fraud simply by making the bald allegation that the defendant acted with scienter.

While courts took varying approaches, the Second Circuit had adopted the most rigorous standard, holding that the plaintiff

must plead factual allegations [giving] rise to a strong inference that the defendants possessed the requisite intent. *Beck v. Manufacturers Hanover Trust Co.*, 820 F.2d 46, 50 (2d Cir. 1987).

To satisfy that standard, a plaintiff could either (1) allege facts to show that the defendant had both motive and opportunity to commit fraud; or (2) allege facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness. See *Shields v. Citytrust Bancorp. Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994); Beck, 820 F.2d at 50.

The crux of the debate among courts since the passage of the Reform Act concerns whether Congress intended to codify the Second Circuit's standard or enact an even more rigorous pleading standard. The conclusions of the four federal appellate courts that have addressed the issue may be summarized as follows:

Second and Third Circuits: Codification of Second Circuit procedural standard/No alteration of substantive standard. Plaintiff may plead scienter by alleging facts establishing motive and opportunity to commit fraud, or by setting forth facts that constitute circumstantial evidence of either reckless or conscious misconduct.

Sixth Circuit: More rigorous procedural standard/No alteration of substantive standard. Plaintiff may plead scienter by alleging facts giving rise to a strong inference of reckless, knowing or intentional conduct. Pleading facts establishing motive and opportunity to commit fraud is not sufficient.

Ninth Circuit: More rigorous procedural standard/Apparent heightening of substantive standard as well. Plaintiff may plead scienter by alleging particular facts giving rise to a strong inference of deliberate recklessness or conscious misconduct.

Second Circuit Avoids the Controversy

The Second Circuit was the first appellate court to assess the Reform Act's impact on this area of the law. See *Press v. Chemical Investment Services Corp.*, 166 F.3d 529 (2d Cir. 1999). By the time the Second Circuit decided *Press* in February 1999, federal district courts already had embraced a variety of different post-Reform Act approaches to the scienter question.

For example, courts in Washington, Texas and New York had applied the traditional Second Circuit standard. Meanwhile, courts in Florida, Colorado and Washington had applied a heightened Second Circuit standard, rejecting motive and opportunity but accepting allegations giving rise to a strong inference of recklessness.

Finally, courts in Pennsylvania, California, Massachusetts and New York had proceeded even further and held that only allegations giving rise to a strong inference of *conscious* misconduct would be cognizable. Despite the then-active debate concerning the impact of the statutory language and legislative history of the Reform Act, the *Press* court's discussion of the issue was brief.

The court succinctly observed that by enacting the Reform Act, Congress heightened the requirement for pleading scienter to the level used by the Second Circuit. Id. at 538. Thus, while the brevity of the court's discussion is notable, the bottom line for litigants is that the Second Circuit continues to apply the pleading standards that it has long employed in this area.

Third Circuit Adopts the Second Circuit Test

The Third Circuit was the first appellate court to provide meaningful definition to the procedural and substantive elements of the Reform Act's pleading requirements. See *In re: Advanta Corp. Securities Litigation*, 180 F.3d 525 (3d Cir. 1999). The court observed that the Reform Act's drafters copied language from the Second Circuit standard concerning plaintiffs' need to plead facts giving rise to a strong inference that the defendant acted with the requisite state of mind.

In the view of the *Advanta* court, Congress's use of the Second Circuit language compels the conclusion that the Reform Act establishes a pleading standard approximately equal to that of the Second Circuit. Id. at 534. The court therefore proceeded to apply the Second Circuit's test.

The defendants in *Advanta* had urged that the legislative history concerning the Reform Act revealed that Congress actually had intended to enact a standard more rigorous than the Second Circuit test. For example, a proposed Senate amendment to the act that would have codified the Second Circuit two-part test for demonstrating the requisite strong inference did not make it into the final version of the bill.

The conference committee report on the bill noted that it had declined to codify that two-part test because the Committee intends to strengthen existing pleading requirements. Id. at 532 (quoting H.R. Conf. Rep. No. 104-369, at 37 (1995)). In addition, President Bill Clinton stated in vetoing the hill (his veto was subsequently overridden by Congress): I am prepared to support the high pleading standards of the Second Circuit. But the conferees make crystal clear their intent to raise the standard even beyond that level. I am not prepared to accept that. Id. at 533 (quoting 141 Cong. Rec. H15214 (daily ed. Dec. 20, 1995)).

Nonetheless, *Advanta* found the act's legislative history to be contradictory and inconclusive and held fast to the Second Circuit standard. Id. The *Advanta* court also rejected the notion that the Reform Act had altered substantive scienter standards, as several district courts had concluded. In response to one such district court opinion, the Third Circuit stated:

[T]he *Silicon Graphics* court interpreted the Reform Act to eliminate allegations of motive, opportunity, and non-deliberate recklessness as independent bases for scienter. But if Congress had desired to eliminate motive and opportunity or recklessness as a basis for scienter, it could have done so expressly in the text of the Reform Act. In our view, the fact that Congress considered inserting language directly addressing this line of cases, but ultimately chose not to do so, suggests that it intended to leave the matter to judicial interpretation. *Advanta*, 180 F.3d 525 at n.8 (citing *In re Silicon Graphics Inc. Securities Litigation*, 970 F.Supp. 746 (N.D. Cal. 1997)).

Therefore, *Advanta* essentially adopt-

ed the entirety of the Second Circuit's approach, although it emphasized that allegations of scienter must now be supported by facts stated with particularity and that those facts must give rise to a strong inference of scienter. *Advanta*, 180 F.3d at 535.

Ninth Circuit Adopts Strictest Standard

One month after the *Advanta* decision, the Ninth Circuit issued an opinion that set forth the most defendant-friendly standard of any of the relevant circuit court opinions. See *In re Silicon Graphics Inc. Securities Litigation*, 97-16204, 97-16240, 1999 WL 595194 (9th Cir. Aug. 4, 1999).

The court began by reviewing the substantive aspect of the scienter issue. The decision analyzed the relevant pre-Reform Act cases and concluded that the term recklessness, as used in those cases, was merely a lesser form of intentional conduct. Id. at *3. Viewing the recklessness term used in Sec. 10(b) cases as a form of intent as opposed to a heightened form of negligence, the court stated that a Sec. 10(b) plaintiff must establish that the defendant acted with at a minimum deliberate recklessness. Id. at *4.

The *Silicon Graphics* court found further support for that conclusion in the legislative history of the Reform Act. Relying on the same legislative history that the *Advanta* court had discounted, the Ninth Circuit determined that Congress in enacting the Reform Act adopted a standard more stringent than the Second Circuit standard. *Silicon Graphics*, 1999 WL 595194, at *7. The court explained:

It follows that plaintiffs proceeding under the [Reform Act] can no longer aver intent in general terms of mere motive and opportunity or recklessness but rather, must state specific facts indicating no less than a degree of recklessness that strongly suggests actual intent. [T]he [Reform Act] requires plaintiffs to plead, at a minimum, particular facts giving rise to a strong inference of deliberate or conscious recklessness. We believe that this deliberate recklessness standard best reconciles Congress' adoption of the Second Circuit's so-called strong inference standard with its express refusal to codify that circuit's two-prong motive and opportunity and recklessness test. Id.

Thus, the *Silicon Graphics* court saw the Reform Act as altering both substantive and procedural aspects of the scienter issue.

However, a vigorous dissenting opinion in *Silicon Graphics* took issue with the court's apparent alteration of the substantive scienter standards. The dissent noted that pre-Reform Act cases uniformly had concluded that simple recklessness satisfied the scienter requirement. The dissent further observed that the court's deliberate recklessness formulation was not found in the text of the act or its legislative history.

The dissent also noted that the Securities and Exchange Commission (SEC), the administrative agency charged with oversight of the Reform Act, had urged the court not to limit recklessness as a basis for scienter. Specifically, the SEC argued that do so would convert what was intended to be a procedural provision into a substantive change. Id. at *4 (Browning, J., dissenting) (quoting Brief of Amicus SEC at 18-19).

As the *Silicon Graphics* dissent confirmed, the Ninth Circuit's introduction of the deliberate recklessness standard will no doubt continue to be the most controversial aspect of the *Silicon Graphics* ruling.

Sixth Circuit Rejects Motive and Opportunity as a Basis To Prove Scienter

The most recent circuit court decision concerning the scienter issue is the Sixth Circuit's ruling in *In re: Comshare Inc. Securities Litigation*, 97-2098, 1999 WL 460917 (6th Cir. July 8, 1999).

The Comshare court agreed with the Third Circuit that by its own terms, the [Reform Act] pleading standard does not purport to change the substantive law of scienter, or the required state of mind, for securities fraud actions. Before the passage of the Reform Act, virtually every circuit to consider the issue held that recklessness could amount to scienter. Id. at *7. Thus, the court found no reason to back away from the Second Circuit standard permitting plaintiffs to plead scienter by alleging particular facts giving rise to a strong inference of recklessness. Id.

The court rejected, however, the other prong of the Second Circuit's test: the motive and opportunity standard. The court's discussion of the issue was brief. It appears, however, that the court viewed the mere pleading of motive and opportunity to be incompatible with the Reform Act's directive that a securities plaintiff must plead particular facts giving rise to a strong inference of reckless or knowing misconduct. As a result, the court dropped that prong of the Second Circuit standard as a possible basis for pursuit of a Sec. 10(b) claim.

Conclusion

Unfortunately, the recent spate of circuit court decisions on the scienter issue has muddied rather than clarified the waters of securities litigation. Divergent legal standards have made predicting resolution of questions of scienter, which always has been difficult, even more treacherous. That state of affairs is somewhat frustrating for the securities litigator and, more fundamentally, it flies in the face of Congress's Reform Act efforts to inject a degree of stability and uniformity into this area of the law.

Ultimately, the scienter question is one that the Supreme Court will have to resolve. Until that time, however, securities practitioners' successful navigation of this topic will require familiarity with the divergent legal authorities.

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