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Congress Nails Door Shut on State Court Securities Class Action Litigation

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Last month, President Bill Clinton signed the Securities Litigation Uniform Standards Act of 1998, effectively pre-empting all major state court securities class action litigation. This article examines the origins of the Uniform Standards Act, the law's central provisions and the significant and immediate effects that the act will have on securities litigation in New Jersey and elsewhere.

The Uniform Standards Act's purpose is to close loopholes in federal securities laws that allowed firms to file marginal securities class action complaints in state court. The law was seen as a necessary supplement to Congress' efforts less than three years ago with the passage of the Private Securities Litigation Reform Act of 1995. Lawyers using the tactic of filing common law actions in state court made the Reform Act relatively ineffective in providing meaningful relief to public companies.

The Reform Act was Congress' first major attempt at securities reform since federal securities laws were first enacted in the 1930s. It was designed to reduce the number of so-called strike suits. These suits are marginal securities class action claims based on sudden drops in stock prices. They are typically settled on terms that benefit the plaintiffs' class action bar but provide few benefits to shareholders or the public companies involved.

To discourage such suits, the Reform Act provided that there would generally be no liability under federal securities law for a company's forward-looking statements -- such as earnings projections -- so long as they are accompanied by meaningful cautionary language.

The Reform Act also imposed heightened pleading requirements and enabled federal court defendants to seek a stay of discovery during the pendency of a motion to dismiss in a securities case. Although President Clinton vetoed the law out of his concern that it would prevent the prosecution of meritorious claims, Congress overrode the veto.

Unexpected Effect

The Reform Act did not have the effect that either President Clinton or Congress anticipated. Plaintiffs' counsel quickly sought to avoid most of the provisions of the act by bringing claims pursuant to state common law and filing their complaints in state rather than federal courts.

Moreover, attorneys were able to thwart the federal court discovery stay by filing companion complaints in state court and obtaining discovery in that forum during the pendency of a federal court motion to dismiss. The availability of a state court forum also made public companies reluctant to take advantage of the Reform Act's safe harbor for forward-looking statements, for fear that the safe harbor would not be enforced in state court proceedings.

Class action firms also found that in some ways, state common law was more hospitable to securities plaintiffs than federal securities law. For example, unlike most federal securities laws, state law offers securities plaintiffs punitive damages, aiding and abetting liability, long statutes of limitation and the ability to prevail by proving mere negligent misrepresentation instead of fraud. Thus, while the rate of securities-related filings dropped in the federal courts following the enactment of the Reform Act, there was a dramatic increase in the number of state court filings.

In California, for example, the number of securities fraud suits brought in state court increased fivefold in the first six months after the passage of the Reform Act. Likewise, New Jersey state courts experienced a spate of such filings. One case, Kaufman v. I-Stat Corp., A-005838-97-T2, is pending for review before the Appellate Division. Public companies suddenly faced potential liability greater and more expansive than they had confronted before the Reform Act passed.

As a result, public companies, led by high-technology firms from Silicon Valley and backed by the Securities Industry Association, petitioned Congress for relief and the Uniform Standards Act was passed and signed into law by the president on Nov. 3. Designed to close the Reform Act's loopholes, the Uniform Standards Act establishes national standards for securities class actions by providing that no such class action may be maintained in any court if it is based on state law and alleges either: (1) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or (2) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

By mimicking the language of the Securities Act of 1933 and the Securities Exchange Act of 1934, Congress sought to ensure class action complaints that could be brought under those statutes would no longer be brought instead under state law analogues. The effect of that limitation will be significant in New Jersey and elsewhere, as most securities class action suits may no longer be pursued under state law.

The Uniform Standards Act defines covered security as a nationally traded security, such as one listed on the New York Stock Exchange, the American Stock Exchange or the Nasdaq Stock Market. Class actions are defined generally as cases in which damages are sought on behalf of 50 or more people or in which named parties seek to recover damages on behalf of themselves and others similarly situated. If a class action plaintiff alleges fraud in connection with the purchase or sale of a nationally traded security, federal law now offers the sole means of recovery.

In addition to pre-empting state law causes of action, the Uniform Standards Act provides defendants with other procedural safeguards. First, defendants may now remove most securities class actions to federal court. The Uniform Standards Act also empowers federal judges to stay discovery proceedings in state court cases to complement the Reform Act's

federal court discovery stay. The state court stay of proceedings is permitted regardless of whether the state or federal court case was filed first and regardless of the specific type of claim being pursued in the state court case.

The breadth of the Uniform Standards Act is countered by a series of carefully drafted limitations. Securities and Exchange Chairman Arthur Levitt had expressed concern in testimony before Congress about making assessments concerning the Reform Act's impact before appellate courts have an opportunity to interpret the central provisions of the act. Levitt also was concerned about a total broad-based pre-emption of state corporation law.

To address the SEC's concerns, Congress exempted class actions involving fraud in connection with tender offers, the exercise of appraisal rights, or other recommendations made by a company to shareholders relating to a shareholder vote from the Uniform Standards Act. Those types of claims have traditionally been brought under state and not federal law -- indeed, shareholders were pursuing such claims under state law before federal securities laws even existed.

Another carve-out exempts from the Uniform Standards Act's coverage class action suits by states, their political subdivisions and state pension plans, as long as each such plaintiff is named in the complaint and has authorized its participation in the case. Through that provision, Congress enables state entities to bring securities class actions that may recover money for taxpayers. At the same time, those state entities cannot be unwillingly included in a class action by an individual plaintiff attempting to bring suit on behalf of the entity.

Finally, a savings clause in the act makes clear that state securities commissions retain their jurisdiction under state law to investigate and pursue enforcement actions. The act instructs the SEC and state securities commissions to encourage the adoption of state laws that provide that subpoenas issued by such state commissions are enforceable in other states. The SEC must report back to Congress within two years about its progress in this regard.

Destined for Litigation?

One aspect of the Uniform Standards Act that seems destined for litigation is the state of mind that will now be necessary to prove a claim of securities fraud under federal law. Although the text of the new act is silent on this issue, the legislative history suggests that reckless conduct may be sufficient. This is an issue that has been expressly left open in a series of Supreme Court decisions holding that plaintiffs in securities fraud cases must establish that the defendant acted with scienter. See, e.g., Herman & MacLean v. Huddleston, 459 U.S. 375, 378 n.4 (1983); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976).

After the passage of the Reform Act, there was debate in the securities bar over whether Congress had intended to eliminate recklessness as a potential basis for liability under the primary federal securities fraud provisions. See, e.g., Voit v. Wonderware Corp., 977 F. Supp. 363, 373-74 (E.D. Pa. 1997); Norwood Venture Corp. v. Converse Inc., 959 F. Supp. 205, 208 (S.D.N.Y. 1997).

Those holdings led SEC Chairman Levitt to observe that such a result would be tantamount to eliminating manslaughter from the criminal laws. Thereafter, in accordance with an SEC request, congressional leaders debating the Uniform Standards Act made clear that the Reform Act's drafters had not intended to preclude recklessness as a sufficient form of scienter. The point was emphasized in various colloquies on the House and Senate floors, as well as in a report issued by the Senate Banking Committee.

Indeed, President Clinton acknowledged the importance of the scienter point by noting that its inclusion in the congressional record persuaded him to endorse the uniform standards legislation. As a result, courts interpreting either the Reform Act or the Uniform Standards Act will undoubtedly review this legislative history as they attempt to decide whether the statutes permit securities fraud liability to be premised upon reckless conduct.

The new legislation has been met with mixed reactions. Supporters of the bill have argued that it makes sense that public companies selling securities nationwide should be governed by national standards. They have emphasized the need to reduce the number of frivolous securities suits and to enable public companies to provide meaningful earnings projections to investors without fear of liability. Opponents, on the other hand, have contended that it is simply too early to determine how the Reform Act has and has not affected investors and public companies.

Some opponents of the new legislation have gone further, contending that the current securities scheme is not flawed and that the Uniform Standards Act is a solution in search of a problem. Similarly, some plaintiffs' lawyers assert that our concerns should be not with the Reform Act itself but with companies that exaggerate claims of technological breakthroughs to deceive investors. Lastly, some observers would have preferred that state legislatures, instead of Congress, address any state law issues arising as a result of the Reform Act.

In view of the considerable pre-emptive effect that the Uniform Standards Act will have on state securities laws, surprisingly few opponents of the law have claimed that the legislation is unconstitutional. Any such claims have been noticeably less emphatic since Congress added to the bill the various carve-outs preserving state jurisdiction over conduct traditionally regulated by the states. Courts evaluating the constitutionality of the act are likely to be swayed by Congress' stated finding in the act that nationally traded securities should be governed by national standards. In view of that finding and the commerce clause's authorization of this type of legislation, it is doubtful that federalism concerns will bring about the act's downfall.

The effect of the Uniform Standards Act on securities litigants and lawyers will almost certainly be immediate and significant. State court securities filings will likely plummet, as those cases are forced back into federal court. As a result, the securities bar will end its scrambling to determine whether and how various securities concepts that had been formulated in federal court could be applied in state court cases. More generally, securities lawyers may now cease their post-Reform Act attempts to master the substantive and procedural nuances of state securities and class action laws. The features of state law that have been helpful to securities class action plaintiffs, such as the availability of punitive damages, aiding and abetting liability and longer statutes of limitations, are no longer available to them.

As noted, the Uniform Standards Act applies only to class actions, and thus investors will still be able to pursue individual claims in state court or under state law. In many instances, however, it is not economically feasible for securities plaintiffs to proceed individually, and thus the act might effectively preclude recovery for investors who simply find it too onerous to pursue a securities case under the new legal regime. In addition, although efforts to avoid the limitations of the Reform Act have thus far been creative and successful, it is difficult to discern similar openings for plaintiffs' counsel within the Uniform Standards Act. With its latest venture into the area of securities law, Congress seems to have nailed shut more effectively the doors it tried to close three years ago.

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