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NEWSLETTER

Recent Judicial Interpretations of the Pleading Requirements under the PSLRA

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After much anticipation, several federal appellate courts recently have construed the pleading requirements of the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), 15 U.S.C. §§ 78u, et seq. (West 1999). Those seeking clarity regarding the impact of the statute on pleading standards in securities fraud suits will be disappointed. As of this writing, the First, Second, Third, Fifth, Sixth and Ninth Circuits have offered a range of interpretations of the statute. Further, although the time for filing a petition for a writ of certiorari has not run for the decisions by the Third, Sixth and Ninth Circuits, no petitions have yet been filed, which means the pleading requirements will vary by circuit for the foreseeable future. This article discusses the highlights of each ruling.

The Statute and a Brief Overview of the Relevant Legislative History: The recent rulings focus on the meaning of the section of the PSLRA that addresses the facts relating to the scienter that a private plaintiff must allege in order to overcome a motion to dismiss in a securities fraud suit covered by the statute:

In any private action arising under this chapter in which the plaintiff may recover 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.

15 U.S.C. § 78u-4(b)(2). The issue that generates disagreement among the courts is whether Congress intended through this provision to codify the Second Circuit pleading standard in securities fraud suits that existed prior to the enactment of the PSLRA, which widely was regarded as the most stringent standard at the time the legislation was enacted, or whether Congress intended to establish a requirement that exceeds the Second Circuit's test. In that regard, prior to the enactment of the PSLRA, the Second Circuit had allowed a plaintiff to survive a motion to dismiss in a securities fraud suit by either (1) alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness by the defendant, or (2) showing that the defendants had both the motive and opportunity to commit fraud. *See, e.g., Shields v. Citytrust Bancorp, Inc.,* 25 F.3d 1124, 1128 (2d Cir. 1994). The recent decisions grapple with whether the so-called "motive and opportunity test" survived the enactment of the PSLRA.

While the legislative history of the PSLRA is extensive, the recent judicial decisions focus on several key parts of the record. First, the Senate passed a version of the PSLRA that included language offered by Senator Arlin Specter that attempted to codify the Second Circuit test. The Conference Committee deleted the language, and the Statement of the Managers explained that, "because the Conference Committee intends to strengthen existing pleading requirements, *it does not intend to codify the Second Circuit's case law interpreting this pleading standard.*"(1)

Second, President Clinton vetoed the PSLRA, expressing concern, *inter alia*, that while he was "prepared to support the high pleading standards of the U.S. Court of Appeals for the Second Circuit," the Statement of the Managers "make[s] crystal clear . . . their intent to raise the standard even beyond that level. I am not prepared to accept that."(2) Thereafter, several legislators entered statements on the record taking issue with the suggestion that the language of the statute as passed went beyond the Second Circuit standard.(3)

Against this legislative backdrop, six federal appellate courts have now offered their views, with varying degrees of analysis, of the effect of the PSLRA on the pleading requirements in private securities fraud suits.

Second and Fifth Circuits: The PSLRA Adopts the Second Circuit "Motive and Opportunity" Test: In *Press v. Chemical Investment Services Corp.,* 166 F.3d 529 (2d Cir. 1999), the Second Circuit stated, without analysis, that the PSLRA "heightened the requirement for pleading scienter to the level used by the Second Circuit . . .. As a pleading requirement, a plaintiff must either (a) allege facts to show that ?defendants had both motive and opportunity to commit fraud' or (b) allege facts that ?constitute strong circumstantial evidence of conscious misbehavior or recklessness.'" *Id.* at 537-38 (quoting *Shields*, 25 F.3d at 1128). Similarly, in an earlier opinion, the Fifth Circuit opined without analysis that the PSLRA adopted the Second Circuit standard. *Williams v. WMX Techs., Inc.*, 112 F.3d 175, 178 (5th Cir. 1997). Somewhat curiously, it cited to the portion of the Statement of the Managers that suggested that the PSLRA raised the pleading requirements beyond the Second Circuit standard. Because the opinions in these cases evidence no consideration of the competing interpretations of the statute, their precedential value on the issue remains uncertain.

First Circuit: Dicta Suggests "Motive and Opportunity" Not Enough: The First Circuit has opined in dicta that the PSLRA's standard is similar to the First Circuit's pre-PSLRA pleading standard, which called for facts giving rise to a "strong inference" of intent. *Maldonado v. Dominguez* 137 F.3d 1, 9 n.5 (1st Cir. 1998). The same decision declined to adopt the Second Circuit's "motive and opportunity" test and cites with apparent approval an article arguing that the PSLRA strengthened standards beyond those articulated in Second Circuit precedent. *Id.* at 10 n.6.

Third Circuit: Motive and Opportunity Supported by Particularized Facts: In *In re Advanta Corp. Securities Litigation*, ___ F.3d. ___, 1999 U.S. App. LEXIS 13332 (3d Cir. June 17, 1999), the Third Circuit weighed in with the first federal appellate opinion that attempted to analyze the disparate interpretations of the PSLRA advocated by the plaintiffs' and defense bars. Chronicling the legislative history of the statute, the Court ultimately opined that the history is "ambiguous and even contradictory" on the issue of whether the PSLRA codified the Second Circuit standard. *Id.* at 12. Thus, it jettisoned any reliance on the legislative history in favor of an interpretation based on the PSLRA's "plain language." *Id.* at 21.

Comparing the language of the PSLRA with Second Circuit precedent, the Third Circuit found that the reference in the statute to facts supporting a "strong inference" of scienter resonates with prior Second Circuit case law. *See Shields*, 25 F.3d at 1128 (requiring plaintiffs to allege facts that give rise to a "strong inference" of fraudulent intent). Thus, the Court concluded that the PSLRA standard is "approximately equal in stringency to that of the Second Circuit." *In re Advanta Corp.*, 1999 U.S. App. LEXIS 13332 at 22. Nevertheless, the Court determined that the PSLRA's requirement that plaintiffs allege facts relating to scienter "?with particularity' represents a heightening" of the Second Circuit standard. *Id.* "Accordingly, we hold that it remains sufficient for plaintiffs [to] plead scienter by alleging facts ?establishing a motive and an opportunity to commit fraud, or by setting forth facts that constitute circumstantial evidence of either reckless or conscious behavior,'" but that the allegations "must be supported by facts stated ?with particularity' and must give rise to a ?strong inference' of scienter." *Id.* at 25. Finally, the Court emphasized that the PSLRA altered only procedural requirements in securities fraud suits; it did not change the relevant level of scienter required. *Id.* at 23-24.

Sixth Circuit: Mere Motive and Opportunity Insufficient; Plaintiff Must Allege Facts Giving Rise to a Strong Inference of Recklessness: Looking solely to the language of the PSLRA, the Sixth Circuit found, in essence, that the PSLRA requires a plaintiff "to plead facts giving rise to a ?strong inference' of scienter" without changing the standard for the requisite level of scienter. *In re Comshare, Inc. Securities Litig.*, ___ F.3d ___, 1999 U.S. App. LEXIS 15068, at 17 (6th Cir. July 8, 1999). According to the Court, the mere recitation of motive and opportunity, in and of itself, does not give rise to a "strong inference" of knowing or reckless conduct. *Id.* at 21. While such allegations may be relevant to the level of scienter, and may "on occasion" rise to the level of showing reckless or knowing conduct, the "bare pleading of motive of motive and opportunity does not, standing alone, constitute the pleading of a strong inference of scienter." *Id.* at 23.

Like the Third Circuit, the Sixth Circuit was disenchanted with any reliance on the PSLRA's legislative history. "Viewed in its entirety, the legislative history is ambiguous and does little to accurately reveal Congress'[s] intent here." *Id.* at 27 n.10. Also like the Third Circuit, the Sixth Circuit spurned any suggestion that the PSLRA altered the state of mind required to establish a violation of the federal securities laws. "[I]t is clear that Congress changed the pleading, but not the state of mind, requirements applicable to § 10(b) and Rule 10b-5 cases." *Id.* at 26.

Ninth Circuit: PSLRA Requires Detailed Allegations of Fact Constituting Circumstantial Evidence of Deliberate Recklessness: In contrast to other federal appellate courts, the Ninth Circuit recently concluded that the PSLRA raised the level of recklessness that must be plead in order to survive a motion to dismiss in a private securities fraud suit. In a 2-1 decision, the majority in *In re Silicon Graphics Inc. Securities Litigation,* ____ F.3d ____, 1999 U.S. App. LEXIS 14955 (9th Cir. July 2, 1999, as amended, August 4, 1999), concluded that, under the PSLRA, a private plaintiff must plead "particular facts" that give rise to a "strong inference" of "deliberate recklessness." *Id.* at 13.

Looking to the language of the statute, the court found that it did not answer the question "whether motive and opportunity or simple recklessness are sufficient to raise a ?strong inference' of deliberate recklessness." *Id.* at 14. The court therefore turned to the legislative history of the PSLRA. Relying heavily on the Conference Committee report, the majority emphasized the statement that the Committee "intends to strengthen existing

pleading requirements" and therefore "does not intend to codify the Second Circuit's case law interpreting this pleading standard." *Id.* at 17 (quoting H.R. Conf. Rep. No. 104-369, at 41 & n.23). The majority also stressed that Senator Specter's amendment, which endeavored to embody the Second Circuit standard, was not adopted. *Id.* at 16. Finally the *Silicon Graphics* court highlighted President Clinton's veto message, which voiced concern about the statute going beyond the Second Circuit standard, and the subsequent decision by Congress to override the veto. *Id.* at 20. The court concluded:

It follows that plaintiffs proceeding under the PSLRA 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. Thus, we agree with the district court that the PSLRA requires plaintiffs to plead, at a minimum, particular facts giving rise to a strong inference of deliberate or conscious recklessness. Id. at 21.

Judge James Browning dissented from this part of the majority's ruling(4). Arguing that there is no basis in the text of the PSLRA to conclude that "proof of recklessness or motive and opportunity to commit fraud are not sufficient to meet the ?strong inference' standard," *Id.* at 59-60, Judge Browning criticized the majority for resorting to legislative history in the absence of statutory ambiguity. *Id.* at 61. He cited statements in the legislative record suggesting that at least some members of Congress intended to embrace the Second Circuit standard and that the Specter amendment was rejected because it was perceived as not capturing the full scope of Second Circuit precedent. *Id.* at 62-64. In sum, Judge Browning argued strenuously that "[i]f plaintiffs can state with particularity facts given rise to a strong inference that defendants acted recklessly, their complaint is sufficient under the Reform Act." *Id.* at 71.

CONCLUSION

The Third and Sixth Circuits' approaches preserve the ability of plaintiffs to rely on allegations of motive and opportunity to withstand a motion to dismiss, although they now must be supported by "particularized facts" or by additional facts that give rise to a "strong inference" of intent. Both jurisdictions read the PSLRA to alter the procedural pleading requirements in private securities suits, but not the level of intent required to make a showing of a violation. Judge Browning's dissent in *Silicon Graphics* appears to advocate a similar approach.

The majority opinion in *Silicon Graphics* raises the bar with respect to the level of recklessness that a securities fraud plaintiff must allege in order to establish intent. Citing a new standard of "deliberate recklessness," the opinion differs from the reasoning of other courts, which have avoided any suggestion that the statute alters the level of recklessness that a plaintiff must plead. Its heavy reliance on legislative history to reach this conclusion could serve as the focus for critics of its approach.

Finally, of course, the Second and Fifth Circuits have indicated, without significant analysis, that the PSLRA adopts the Second Circuit standard. Given the debate that the issue has generated in other circuits, it is unclear whether these circuits will offer more detailed analyses of the PSLRA in future cases. As of the time of this article, no petitions for a writ of certiorari have been filed for these cases, although the deadline has not run in *Advanta Corp.*, *Comshare, Inc.*, and *Silicon Graphics*. Appellants in *Silicon Graphics* have petitioned for

rehearing, but the extent of further review, if any, remains uncertain. Particularly if the *Silicon Graphics* decision survives further review in the Ninth Circuit, a divergence among the federal courts of appeals clearly has emerged. For litigants and insurers seeking greater certainty regarding the impact of the PSLRA, any such certainty will remain elusive, at least pending further appellate and possible Supreme Court review.

(1) Statement of Managers - The Private Securities Litigation Act of 1995, H.R. Rep. No. 104-369, at 41 (1995) (emphasis added).

(2) 141 Cong. Rec. H15214 (daily ed. Dec. 20, 1995).

(3) See generally Richard H. Walker & J. Gordon Seymour, *Recent Judicial and Legislative Developments Affecting the Private Securities Fraud Class Action*, 40 Ariz. L. Rev. 1003, 1025 (Fall 1998).

(4) This dissent was issued with the original opinion filed on July 2, 1999. Although the August 4, 1999 amended opinion indicates that a dissent will be filed, it has not been issued as of this writing.