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ARTICLES

FOREWORD
"FINAL THOUGHTS ON LITIGATION REFORM"
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PROMISES MADE, PROMISES KEPT: THE PRACTICAL
IMPLIED IMPLICATIONS OF THE PRIVATE SECURITIES
LITIGATION REFORM ACT OF 1995

PLEADING SCIENTER UNDER SECTION 21D(b)(2) OF
THE SECURITIES EXCHANGE ACT OF 1934: MOTIVE,
OPPORTUNITY, RECKLESSNESS, AND THE PRIVATE
SECURITIES LITIGATION REFORM ACT OF 1995

LEGISLATING ON A FALSE FOUNDATION: THE
ERRONEOUS ACADEMIC UNDERPINNINGS OF THE
PRIVATE SECURITIES LITIGATION REFORM ACT
OF 1995

DEVELOPMENTS IN DISCLOSURE: SPECIAL
PROBLEMS IN PUBLIC OFFERINGS—FORWARD-
LOOKING INFORMATION, INCLUDING THE
PRIVATE SECURITIES LITIGATION REFORM
ACT OF 1995

NEGOTIATING BUSINESS COMBINATION
AGREEMENTS—THE "SELLER'S" POINT OF VIEW

SECURITIES FRAUD PROSECUTIONS: STILL
VIALE UNDER CALIFORNIA SECURITIES LAW
AFTER SIMON?

COMMENTS

MISPLACED PRIORITIES: THE UTAH DIGITAL SIGNATURE ACT AND LIABILITY
ALLOCATION IN A PUBLIC KEY INFRASTRUCTURE

CALIFORNIA'S SEX OFFENDER NOTIFICATION STATUTE: A CONSTITUTIONAL ANALYSIS

PATENTABLE DISCOVERY?

WILLIAM S. LERACH* & ERIC ALAN ISAACSON**

TABLE OF CONTENTS

I. INTRODUCTION ......................................................... 894
II. THE TEXT AND HISTORY OF SECTION 21D(b) ................................. 900
   A. The Text and Structure of Section 21D(b) and Related Provisions in the PSLRA ........................................... 900
      1. Section 21D(b)(1)'s Standard for Pleading Falsity .......... 901
      2. Section 21D(b)(2)'s Standard for Pleading Scienter .......... 906
      3. Section 21D(b)(2)'s Preservation of Existing Standards of Liability .................................................. 913
III. DOES THE LEGISLATIVE HISTORY OF SECTION 21D(b) CONTRADICT ITS TEXT? ........................................ 918

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A. Legislative History and the Silicon Graphics and Marksman Partners Opinions
B. The Legislative History of Section 21D(b)(2)
   1. The Second Circuit "Strong Inference" Standard and the Conflict Among the Circuits
   2. The Legislative Response
      a. Congressional Hearings and Early Drafts Culminating in Passage of H.R. 1058
      b. The Pleading Standard in Senate Hearings
      c. The "Strong Inference" Provision Enters S. 240's Text
      d. Senator Arlen Specter's Proposed Amendment
      e. The Conference Report Statement of the Managers Adopts the Second Circuit Standard
      f. President Clinton's Veto and the Veto-Override Debate
IV. CONCLUSION

I. INTRODUCTION

The Private Securities Litigation Reform Act of 1995 ("PSLRA"), by enacting the Securities Exchange Act ("Exchange Act") section 21D(b), resolves conflicts among the circuit courts regarding appropriate pleading requirements in securities-fraud actions under section 10(b) of the Exchange Act. Section 21D(b)(1) provides that in any private action under the Exchange Act based on allegedly false or misleading statements, "the complaint shall specify each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading." Section 21D(b)(2) further provides that the complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." Together, these provisions resolve conflicts among the circuits by adopting the Ninth Circuit's requirements for pleading falsity and the Second Circuit's requirements for pleading scienter in securities-fraud cases.

Section 21D(b)(1) effectively codifies Ninth Circuit law interpreting Federal Rule of Civil Procedure 9(b)'s provision requiring circumstances constituting fraud to be alleged with particularity. The Ninth Circuit's en banc opinion in In re GlenFed Securities Litigation held that Rule 9(b) requires plaintiffs alleging fraud to explain how and why allegedly

6. FED. R. CIV. P. 9(b) ("In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity.").
7. 42 F.3d 1541 (9th Cir. 1994) (en banc).
fraudulent statements were false or misleading: “The plaintiff must set forth what is false or misleading about a statement, and why it is false. In other words, the plaintiff must set forth an explanation as to why the statement or omission complained of was false or misleading.”

Section 21D(b)(1) similarly requires plaintiffs to “specify each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading.” GlenFed and section 21D(b)(1) differ somewhat from the prior law in other circuits, which did not always require plaintiffs to specify the content of statements or to allege evidentiary facts showing how and why they were misleading. Section 21D(b)(1) thus strengthens the pleading standard for alleging false or misleading statements by adopting the Ninth Circuit standard for pleading falsity.

Section 21D(b)(2), on the other hand, adopts the Second Circuit’s standard for pleading scienter. Since the late 1970s, Second Circuit decisions have required plaintiffs alleging fraud to raise “a strong inference” of scienter, which can be done by alleging “motive and opportunity” or by alleging “facts constituting circumstantial evidence of either reckless or conscious behavior.” Other courts—including the Ninth Circuit in GlenFed—rejected the Second Circuit’s “strong inference” standard, holding that under Rule 9(b) plaintiffs cannot be required to plead facts to support conclusory allegations of fraudulent intent or recklessness. Section 21D(b)(2) resolves a conflict among the circuits, for Exchange Act cases at least, by requiring plaintiffs to “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”

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8. GlenFed, 42 F.3d at 1548; see also Fecht v. Price Co., 70 F.3d 1078, 1082-83 (9th Cir. 1995).
10. See infra notes 55, 60 and accompanying text.
11. See infra notes 20-28 and accompanying text.
12. See infra note 81 and accompanying text.
14. See infra notes 52-54, and accompanying text. In GlenFed, for example, the Ninth Circuit flatly rejected Second Circuit law, GlenFed, 42 F.3d at 1545-47, holding “that plaintiffs may aver scienter generally, just as the rule states—that is, simply by saying that scienter existed.” Id. at 1547.
Section 21D(b)(2) scrupulously avoids any implication that it alters the standard for what actually constitutes scienter under the Exchange Act, allowing plaintiffs to raise "a strong inference that the defendant acted with the required state of mind." Congress knew that "the required state of mind" for a section 10(b) violation was knowledge of falsity or recklessness. With another section of the PSLRA, it raised the required state of mind to "actual knowledge of falsity" for certain "forward-looking" statements. With a new Exchange Act section 21D(g), Congress imposed limitations on joint-and-several liability for reckless conduct, warning that "[n]othing in this subsection shall be construed to create, affect, or in any manner modify, the standard for liability associated with any action arising under the securities laws." Thus, under section 21D(b)(2), "the required state of mind" is actual knowledge for section 10(b) violations based entirely on specified forward-looking statements, and knowledge or recklessness for all other types of statements or representations.

On its face, then, section 21D(b) imposes a uniform national pleading standard that is stronger than that which had existed in either the Second Circuit or the Ninth Circuit. It adopts GlenFed's approach to pleading falsity with particularity, but opts for the Second Circuit's "strong inference" standard for pleading state of mind, without altering "the required state of mind" for a section 10(b) violation.

Nonetheless, in the first cases filed under the PSLRA, defense counsel invoked the PSLRA's legislative history to argue that section 21D(b) does something very different from what its text says. They argued that, far from adopting the Second Circuit's "strong inference" test for pleading scienter, Congress really intended with section 21D(b)(2) to impose a new and untested standard for pleading scienter that is more demanding than Second Circuit case law and that cannot be satisfied with allegations of motive and opportunity, or with allegations of reckless misconduct. Some have gone so far as to argue that section 21D(b) imposes a new pleading standard that is stronger than that which existed under the PSLRA. Congress knew that "the required state of mind" for a section 10(b) violation was knowledge of falsity or recklessness.
21D(b) implicitly abolishes liability for reckless misconduct in private actions under the Exchange Act, even for non-forward-looking statements.  

The first reported decisions under the PSLRA sensibly rejected such contentions. *Marksman Partners, L.P. v. Chantal Pharmaceutical Corp.* did so explicitly with a scholarly opinion flatly rejecting contentions that section 21D(b) overrides the Second Circuit "strong inference" standard or abolished liability for recklessness. *Zeid v. Kimberly* ignored defendants' arguments that the Second Circuit case law had been superseded and evaluated the complaint under Second Circuit precedents allowing plaintiffs to raise "a strong inference" with allegations of "facts constituting circumstantial evidence of either reckless or conscious behavior" or "facts establishing a motive to commit fraud and an opportunity to do so." Yet a third decision, *In Support of Memo at 14-15 (March 18, 1996), and Reply Mem. in Support of Motion to Dismiss, at 16 n.7 (May 1, 1996), Zeid v. Kimberly, N.D. Cal. No. C-96-20136 SW(PVT); see also Stephen F. Black, et. al., The Securities Litigation Reform Act of 1995: A Preliminary Analysis, 24 SEC. REG. L. J. 117, 134-37 (1996); Walter Reiman, et al., The Private Securities Litigation Reform Act: A User's Guide, 24 SEC. REG. L. J. 143, 163-66 (1996).  


25. Id. at 437-38 (quoting Time Warner, 9 F.3d at 269). Although the district court correctly used Second Circuit standards to evaluate the complaint in Zeid, we believe it erred in holding that the complaint did not meet the standard of the Second Circuit precedents. In another case, this one filed before the PSLRA took effect, a district court cites the PSLRA as "codifying the Second Circuit standard for pleading scienter" that the court proceeds to apply. Sloane Overseas Fund, Ltd v. Sapiens International Corp., No. 95 Civ. 9165 (RPP), 1996 U.S. Dist. LEXIS 12104, at *23 (S.D.N.Y. Aug. 16, 1996).
In her *Silicon Graphics* opinion, Judge Fern M. Smith relies on President Clinton's interpretation of a cryptic sentence and an endnote in the Statement of the Managers accompanying the Conference Report on the PSLRA. Although the decision in *Silicon Graphics* was rendered after this article was accepted for publication, we have tried to take account of it with last-minute revisions. With these revisions we have also added citations to two articles published by academic commentators after this article was accepted for publication. See John C. Coffee, *The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung*, 51 Bus. Law. 975, 977-85 (1996); Michael A. Perrino, *A Strong Inference of Fraud? An Early Interpretation of the 1995 Private Securities Litigation Reform Act*, 1 SEC. REFORM ACT LITIG. REP. 397, 402-05 (1996).


27. *Id.* at 13 n.4 ("The Court respectfully disagrees with the opinions in Zeid v. Kimberly and Marksmen Partners, L.P. v. Chantel Pharmaceutical Corp., which interpret The [PSLRA] as adopting the Second Circuit standard.") (citations omitted).

28. *Id.* at 10-16. Although the decision in *Silicon Graphics* was rendered after this article was accepted for publication, we have tried to take account of it with last-minute revisions. With these revisions we have also added citations to two articles published by academic commentators after this article was accepted for publication. See John C. Coffee, *The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung*, 51 Bus. Law. 975, 977-85 (1996); Michael A. Perrino, *A Strong Inference of Fraud? An Early Interpretation of the 1995 Private Securities Litigation Reform Act*, 1 SEC. REFORM ACT LITIG. REP. 397, 402-05 (1996).


or misleading, and create a strong inference of knowing misrepresentation on the part of the defendants.\textsuperscript{34}

The Silicon Graphics interpretation of section 21D(b) is untenable. Where the text of a statute is clear, courts should not resort to legislative history—much less to the views of opponents of the legislation—in order to contradict it.\textsuperscript{35} The text of section 21D(b) is clear, and nothing in it suggests that when Congress adopted the Second Circuit’s “strong inference” formulation, it really meant to impose an even stronger standard for allegations of scienter. Nor does anything in it suggest that Congress intended to overrule the case law that framed, defined, and interpreted the very words Congress chose to adopt. Further, nothing in section 21D(b) suggests that “the required state of mind” for a section 10(b) always requires knowing, rather than reckless, conduct.

Nonetheless, Silicon Graphics adopts an erroneous interpretation of section 21D(b)’s legislative history, relying on the views of a President who opposed the legislation and imputing them to a Congress that rejected those views when it overrode his veto.\textsuperscript{36} A careful review of the legislative history of section 21D(b)(2) shows that Congress intended to adopt the “strong-inference” pleading standard from Second Circuit case law and to leave courts free to seek guidance from the existing precedents whenever appropriate.\textsuperscript{37} Indeed, the legislative history shows that the bill’s leading proponents intended for allegations of motive, opportunity, and recklessness to raise a strong inference of scienter under section 21D(b)(2).\textsuperscript{38} Congress overrode President Clinton’s veto because it believed he was wrong in thinking the Statement of Managers demanded more than Second Circuit case law required.\textsuperscript{39}

Moreover, nothing in the legislative history suggests that Congress intended to change the scienter standard for section 10(b) violations not involving forward-looking statements. Although initial drafts of the legislation required plaintiffs to plead and prove “that the defendant knew the statement was misleading at the time it was made, or intentionally omitted to state a fact knowing that such omission would

\textsuperscript{34} Id. at 16 (emphasis added).
\textsuperscript{35} See infra notes 328-34 and accompanying text.
\textsuperscript{36} See infra notes 345-67 and accompanying text.
\textsuperscript{37} Id.
\textsuperscript{38} See infra notes 356-67 and accompanying text.
\textsuperscript{39} See infra notes 345-67 and accompanying text.
render misleading the statements made at the time they were made, such a requirement was removed—except with respect to “forward-looking statements.”

In short, section 21D(b) adopts a uniform national standard for pleading securities-fraud claims that is based on existing pleading standards from the Ninth Circuit for pleading falsity, and from the Second Circuit on how plaintiffs may raise “a strong inference” of scienter.

II. THE TEXT AND HISTORY OF SECTION 21D(b)

A. The Text and Structure of Section 21D(b) and Related Provisions in the PSLRA

Enacted as part of the PSLRA, Exchange Act section 21D(b) restates the pleading standards for Exchange Act securities-fraud actions. But the pleading standards are not new. Subsection (b)(1) restates a pleading rule developed under Federal Rule of Civil Procedure 9(b), which the Ninth Circuit construed to require complaints alleging fraud not only to identify the statements alleged to be misleading, but also to explain how or why those statements were misleading. Subsection (b)(2) restates the requirement, developed in the Second Circuit, that a complaint alleging fraud should set forth facts raising a “strong inference” of

41. See infra notes 328-33 and accompanying text.
42. Exchange Act section 21D(b) provides:
(b) Requirements for Securities Fraud Actions. —
(1) Misleading statements and omissions. — In any private action arising under this title in which the plaintiff alleges that the defendant —
(A) made an untrue statement of a material fact; or
(B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading;
the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.
(2) Required state of mind. — In any private action arising under this title in which the plaintiff may recover money 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 title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.
44. See infra notes 48-54 and accompanying text.
scienter. 45 By combining the two rules, Congress created a new, stronger pleading standard that comprises the Second Circuit’s standard for pleading scienter and the Ninth Circuit’s standard for pleading falsity.

1. Section 21D(b)(1)’s Standard for Pleading Falsity

Section 21D(b)(1) states that in any Exchange Act case based on misleading statements, “the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement . . . is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.” 46 This is, undoubtedly, a codification of case law applying Rule 9(b)’s provision that “[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity.” 47 It is, in fact, a codification of the Ninth Circuit standard for pleading falsity which applies Rule 9(b), to require plaintiffs alleging fraud to specify the substance of what was said, along with some explanation of why the statements were misleading. 48

The Ninth Circuit’s Rule 9(b) precedents held that a complaint alleging fraud “must state precisely the time, place, and nature of the misleading statements, misrepresentations, and specific acts of fraud,” and that “the allegations should include the misrepresentations themselves with particularity and, where possible, the roles of the individual defendants in the misrepresentations.” 49 With an en banc decision in In re GlenFed Sec. Litig., 50 the Ninth Circuit clarified its requirement that plaintiffs explain how a statement is false:

The time, place, and content of an alleged misrepresentation may identify the statement or the omission complained of, but these circumstances do not

45. See infra notes 72-85 and accompanying text.
47. FED. R. CIV. P. 9(b).
48. See, e.g., Warshaw v. Xoma Corp., 74 F.3d 955, 960 (9th Cir. 1996); Fecht v. Price Co., 70 F.3d 1078, 1082-83 (9th Cir. 1995); In re GlenFed, Inc. Sec. Litig., 42 F.3d 1541, 1548 (9th Cir. 1994) (en banc); Kaplan v. Rose, 49 F.3d 1363, 1370 (9th Cir. 1994); Moore v. Kayport Package Express, Inc., 885 F.2d 531, 540 (9th Cir. 1989).
49. Kaplan v. Rose, 49 F.3d 1363, 1370 (9th Cir. 1994) (quoting Moore v. Kayport Package Express, Inc., 885 F.2d 531, 540 (9th Cir. 1989)).
50. 42 F.3d 1541, 1548 (9th Cir. 1994) (en banc).
“constitute” fraud. The statement in question must be false to be fraudulent. Accordingly, our cases have consistently required that circumstances indicating falseness be set forth . . . . To allege fraud with particularity, a plaintiff must set forth more than the neutral facts necessary to identify the transaction. The plaintiff must set forth what is false or misleading about a statement, and why it is false. In other words, the plaintiff must set forth an explanation as to why the statement or omission complained of was false or misleading. A plaintiff might do less and still identify the statement complained of; indeed, the plaintiff might do less and still set forth some of the circumstances of the fraud. But the plaintiff cannot do anything less and still comply with Rule 9(b)’s mandate to set forth with particularity those circumstances which constitute the fraud.51

In GlenFed, the court rejected objections that plaintiffs cannot be required to plead evidentiary facts to show falsity, explaining that “Rule 9(b) requires particularity as to the circumstances of the fraud—this requires pleading facts that by any definition are ‘evidentiary’: time, place, persons, statements made, explanation of why or how such statements are false or misleading.”52 Hence, “GlenFed requires a plaintiff to plead evidentiary facts and the court to consider what inferences these facts will support.”53 Under GlenFed, “a plaintiff may ‘draw on contemporaneous statements or conditions’ to demonstrate why statements were false when made,” and “allegations of specific problems undermining a defendant’s optimistic claims suffice to explain how the claims are false.”54

However, other federal courts did not consistently construe Rule 9(b) to demand such particularized pleading of misrepresentations and reasons for falsity.55 Some Second Circuit decisions, such as Cosmas v. Hassett,56 imposed a similar pleading standard, stating that a complaint alleging fraud “must adequately specify the statements it claims were false or misleading and give particulars as to the respect in which plaintiffs contend the statements were fraudulent.”57 But others held that “[t]o pass muster under rule 9(b), the complaint must allege the time, place, speaker, and sometimes even the content of the alleged

51. Id. (emphasis added).
52. Id. at 1547-48 n.7.
53. Fecht v. Price Co., 70 F.3d 1078, 1082 (9th Cir. 1994); see Warshaw v. Xoma Corp., 74 F.3d 955, 960 (9th Cir. 1996) (“In GlenFed we explained that a plaintiff must plead evidentiary facts that support inferences sufficient to meet the specificity requirements of Rule 9(b).”); Fecht, 70 F.3d at 1082.
54. Id. at 1083 (quoting In re GlenFed, Inc. Sec. Litig., 42 F.3d 1541, 1549 (9th Cir. 1994)); see Warshaw v. Xoma Corp., 74 F.3d 955, 960 (9th Cir. 1996).
55. Compare Seville Indus. Mach. Corp. v. Southmost Mach. Corp., 742 F.2d 786, 791 (3d Cir. 1984) (“It is certainly true that allegations of ‘date, place or time’ fulfill [Rule 9(b)’s requirements], but nothing in the rule requires them.”)(emphasis added).
56. 886 F.2d 8 (2d Cir. 1989).
57. Id. at 11; see also Mills v. Polar Molecular Corp., 12 F.3d 1170, 1175 (2d Cir. 1993); McLaughlin v. Anderson, 962 F.2d 187, 191 (2d Cir. 1992); Goldman v. Belden, 754 F.2d 1059, 1069-70 (2d Cir. 1985).
misrepresentation," 58 suggesting that specification of statements’ content, and the reasons why they were misleading, was the exception rather than the rule. 59 There was no clear rule then, even in the Second Circuit, that plaintiffs specify the content of what was said and explain why it was false or misleading.

Even courts that required plaintiffs to set forth the content of the statements alleged to be misleading typically did not require plaintiffs to explain how or why those statements were false. The Seventh Circuit held that under Rule 9(b), “[a]lthough plaintiffs must specifically identify allegedly fraudulent statements, they are not required ‘to plead facts that if true would show that the defendant’s alleged misrepresentations were indeed false.’” 60 The Second Circuit joined most other courts 61 in holding that, with the exception of allegations of scienter, “a complainant

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59. Id.; accord, e.g., IUE AFL-CIO Pension Fund v. Herrmann, 9 F.3d 1049, 1057 (2d Cir. 1993) (“This Court has construed Rule 9(b) to require a complaint alleging fraud to ‘allege the time, place, speaker and sometimes even the content of the alleged misrepresentation.’”) (quoting Ouaknine, 897 F.2d at 79); Update Traffic Sys. v. Gould, 857 F. Supp. 274, 281 (E.D.N.Y. 1994) (“[I]t is sufficient to allege the ‘time, place, speaker, and sometimes even the content of the alleged misrepresentation’”) (quoting Ouaknine, 897 F.2d at 79).

60. Katz v. Household Int’l, 36 F.3d 670, 675 (7th Cir. 1994) (quoting Uni*Quality, Inc. v. Infotronix, Inc., 974 F.2d 918, 923 (7th Cir. 1992)). Judge Posner explained that in the Seventh Circuit:

The reported cases involve misrepresentations, the commonest kind of fraud, and merely require the plaintiff to state in his complaint ‘the identity of the person making the misrepresentation, the time, place, and content of the misrepresentation, and the method by which the misrepresentation was communicated to the plaintiff. . . . They do not require him to plead facts showing that the representation is indeed false.

Bankers Tr. Co. v. Old Republic Ins. Co., 959 F.2d 677, 683 (7th Cir. 1992) (emphasis added)(citations omitted); see also Midwest Commerce Banking Co. v. Elkhart City Centre, 4 F.3d 521, 524 (7th Cir. 1993) (in a case alleging fraud, Rule 9(b) does not require “allegations demonstrating the falsity of any representations or omissions”); Whirlpool Financial Corp. v. GN Holdings, 873 F. Supp. 111, 118 n.11 (N.D. Ill.) (“Rule 9(b) does not require particularized pleading of . . . facts that if true would show that the defendant’s alleged misrepresentations were indeed false.”) (emphasis in original), aff’d 67 F.3d 605 (7th Cir. 1995).

is not required to plead evidence\textsuperscript{62} to satisfy Rule 9(b)'s particularity requirement.\textsuperscript{63} Section 21D(b)(1) adopts the stronger Ninth Circuit rule by providing that "the complaint shall specify each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading."\textsuperscript{64} 

GlenFed's requirement that plaintiffs plead facts explaining how and why a statement is misleading is restated in section 21D(b)(1), moderated by the qualification that "if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."\textsuperscript{65} In many securities cases, of course, there is no need to plead "on information and belief."\textsuperscript{66} Nonetheless, this clause effectively codifies the Ninth Circuit's holding in \textit{Wool v. Tandem Computers, Inc.}\textsuperscript{67} that fraud may be alleged on information and belief "if the allegations are accompanied by a statement of the facts upon which the belief is founded."\textsuperscript{68} In

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\item Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 379 (2d Cir. 1974); see also Ross v. A.H. Robbins Co., 607 F.2d 545, 557 n.20 (2d Cir. 1979). A recent district court decision summarized the Second Circuit's precedents: \textit{The Court of Appeals has indeed held in some circumstances that "[t]o pass muster under rule 9(b), the complaint must allege the time, place, speaker, and sometimes even the content of the alleged misrepresentation." However, it is equally true that "a complainant is not required to plead evidence." In re Blech Sec. Litig., 928 F. Supp. 1279, 1290 (S.D.N.Y. 1996) (quoting Ouaknine, 897 F.2d at 79, and Schlick, 507 F.2d at 379 (citations omitted)).}
\item The Second Circuit did require plaintiffs to plead facts constituting circumstantial evidence of scienter in order to raise a "strong inference" of the required state of mind, but only if allegations of motive and opportunity were absent. \textit{See infra} notes 330-35 and accompanying text.
\item \textit{Id.}
\item Professors Wright and Miller write: \textit{[P]leading on information and belief is not an appropriate form of pleading if the matter is within the personal knowledge of the pleader or "presumptively within his knowledge . . . . Thus, matters of public record or matters generally known in the community should not be alleged on information and belief inasmuch as everyone is held to be conversant with them.}
\item 5 \textit{CHARLES A. WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE} §1224, at 206 (2d ed. 1990). In open-market fraud cases, allegations regarding a publicly-traded issuer's public misrepresentations and omissions often deal with matters that became generally known to the financial community with a negative public disclosure that contradicted the issuer's earlier statements. Other allegations may deal with facts within the knowledge of counsel after careful prefiling investigation, and therefore need not be made "on information and belief."
\item 818 F.2d 1433 (9th Cir. 1987).
\item \textit{Id. at 1439; accord} Moore v. Kayport Package Express, Inc., 885 F.2d 531, 540 (9th Cir. 1989). Rule 11(b) expressly permits allegations on the basis of a "person's knowledge, information, and belief." \textit{Fed. R. Civ. P. 11(b)}. Furthermore, the Supreme Court has held that a complaint alleging fraud on "information and belief" complies with Rule 11, Surowitz v. Hilton Hotels Corp., 383 U.S. 363 (1966), and that nothing in any
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Wool, the Ninth Circuit observed that “[a]llegations of fraud based on information and belief usually do not satisfy the degree of particularity required under Rule 9(b),” but held that “an exception exists where, as in cases of corporate fraud, the plaintiffs cannot be expected to have personal knowledge of the facts constituting the wrongdoing.” An allegation of fraud made on information and belief must be accepted if “[e]ach alleged misstatement is identified by content, date, and the document or announcement in which it appeared, [along with] the manner in which such representations were false and misleading.” Thus, section 21D(b)(1) codifies Ninth Circuit law on pleading statements, and their falsity, with particularity.

of the Federal Rules can be construed to require dismissal of such a complaint. Id. at 373 (emphasis added); see Hirshfield v. Briskin, 447 F.2d 694, 698 (7th Cir. 1971).

69. Id. at 1439 (emphasis added) (quoting Zatkin v. Primuth, 551 F.Supp. 39, 42 (S.D.Cal. 1982)).

70. Id. In such cases, “the allegations should include the misrepresentations themselves with particularity and, where possible, the roles of the individual defendants in the misrepresentations.” Kayport, 885 F.2d at 540 (citing Wool v. Tandem Computers Inc., 818 F.2d 1433, 1440 (9th Cir. 1987)); see Rolex Employees Retirement Trust v. Mentor Graphics Corp., 749 F. Supp. 1042, 1047 (D. Or. 1990). Some Second Circuit decisions recognized a similar rule. See, e.g., Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 379 (2d Cir. 1994).

71. Wool, 818 F.2d at 1440. Wool flatly rejected contentions that allegations made entirely on “information and belief” were defective in all circumstances: “Applying these principles to the complaint filed by Wool, we conclude that the particularity requirement of Rule 9(b) has been met. Although Wool’s complaint is based on the SEC’s allegations, the paragraphs alleging misleading statements, misrepresentations, and specific acts of fraud are very precise.” Id. at 1439-40. The fact that the complaint relied upon the SEC’s allegations, rather than on counsel’s own investigation, apparently was taken to mean that those allegations were based on “information and belief.” Nonetheless, the complaint satisfied Rule 9(b) because the allegedly misleading statements were “identified by content, date, and the document or announcement in which [they] appeared,” and the complaint specified “the manner in which such representations were false and misleading.” Id. at 1440; accord, e.g., Flashman v. Singleton, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,872, at 93,313 (N.D. Cal. 1991); Wegbreit v. Marley Orchards Corp., 793 F. Supp. 957, 961-62 (E.D. Wash. 1991); Rolex Employees Retirement Trust v. Mentor Graphics Corp., 749 F. Supp. 1042, 1047 (D. Or. 1990); In re ZZZZ Best Sec. Litig., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,485, at 93,095 (C.D. Cal. 1989); Cincinnati Microwave, Inc. v. Wilson, 705 F. Supp. 1453, 1457 (D. Nev. 1989); Steiner v. Southmark Corp., 734 F. Supp. 269, 273 (N.D. Tex.), recons. denied, 739 F. Supp. 1087 (N.D. Tex. 1990).
2. Section 21D(b)(2)’s Standard for Pleading Sciente

Section 21D(b)(2) provides that a complaint shall “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” The “strong inference” standard comes from Second Circuit case law, which has long held that plaintiffs alleging fraud should raise a “strong inference” of scienter—with allegations of motive and opportunity, or by pleading facts that suggest either reckless or conscious behavior.

The Second Circuit began to demand that plaintiffs alleging fraud plead facts giving rise to a strong inference of scienter in the late 1970s. Rule 9(b) states that “[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity.” But the rule further states that “[m]alice, intent, knowledge, and other condition of mind of a person may be averred generally.” This was long understood to mean that plaintiffs alleging fraud are not required to plead any facts from which scienter may be inferred. However, in 1979 the Second Circuit held in Ross v. A.H. Robins Co. that plaintiffs who allege that defendants knew statements were false “can be required to supply a factual basis for their conclusory allegations regarding that knowledge.” The court considered it “reasonable to require that the plaintiffs specifically plead those events which they assert give rise to a strong inference that the defendants had knowledge of the facts” allegedly making their statements misleading. Since then, the Second Circuit has regularly held that although “great specificity [is] not required with respect to . . . allegations of . . . scienter,” a plaintiff must nonetheless provide some factual basis raising

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74. Ross, 607 F.2d at 556.
75. FED. R. CIV. P. 9(b).
76. Id.
78. 607 F.2d 545 (2d Cir. 1979).
79. Id. at 558.
80. Id. (emphasis added).
at least a "strong inference" of scienter.\textsuperscript{81} Indeed, "conclusory allegations of scienter are sufficient 'if supported by facts giving rise to a 'strong inference' of fraudulent intent.'\textsuperscript{82}

The required "strong inference" of scienter may be raised through either of two approaches.\textsuperscript{83} "The first approach is to allege facts establishing a motive to commit fraud and an opportunity to do so."\textsuperscript{84} "The second approach is to allege facts constituting circumstantial evidence of either reckless or conscious behavior."\textsuperscript{85}

Under the "motive and opportunity" test, opportunity is often present. When a corporation and its management have allegedly perpetrated a fraud on the market, "no one doubts that the defendants [would have] had the opportunity, if they wished, to manipulate the price of the [company's] stock."\textsuperscript{86} Motive may then be provided by a variety of factors, such as the company's desire to raise money with an offering of

\textsuperscript{81} Cohen v. Koenig, 25 F.3d 1168, 1173 (2d Cir. 1994) (citations omitted); see Turkish v. Kasenetz, 27 F.3d 23, 28 (2d Cir. 1994); In re Time Warner Inc. Sec. Litig., 9 F.3d 259, 268-69 (2d Cir. 1993); IUE AFL-CIO Pension Fund v. Hermann, 9 F.3d 1049, 1057 (2d Cir. 1993); Breard v. Sachnoff & Weaver, 941 F.2d 142, 143-44 (2d Cir. 1991); Goldman v. Belden, 754 F.2d 1059, 1070 (2d Cir. 1985). As the Court explained in Ouaknine v. MacFarlane: Allegations of scienter are not subjected to the more exacting consideration applied to the other components of fraud. They are sufficient where, as here, the allegations lie peculiarly within the opposing parties' knowledge and are accompanied by information that raises a strong inference of fraud. 897 F.2d 75, 81 (2d Cir. 1990) (citations omitted); accord Breard, 941 F.2d at 143 (quoting Ouaknine, 897 F.2d at 81).

\textsuperscript{82} IUE, 9 F.3d at 1057 (quoting Ouaknine, 897 F.2d at 80). The determination must be made "accepting as true the factual allegations in the liberally construed [c]omplaint, and drawing all inferences in favor of the pleader. . ." Id. at 1058; see Cosmas v. Hassett, 886 F.2d 8, 11 (2d Cir. 1989); Yoder v. Orthomolecular Nutrition Institute, Inc., 751 F.2d 555, 562 (2d Cir. 1984); McCoy v. Goldberg, 883 F. Supp. 927, 936 (S.D.N.Y. 1995).

\textsuperscript{83} Time Warner, 9 F.3d at 268-69.

\textsuperscript{84} Id. at 269; accord In re Wells Fargo Sec. Litig., 12 F.3d 922, 931 (9th Cir. 1993) ("allegations of motive and opportunity in the complaint are sufficient to establish a basis for inferring . . . fraudulent intent"), cert. denied, 115 S. Ct. 295 (1994). Such a basis may be shown through allegations of motive to deceive and access to accurate information. Cohen, 25 F.3d at 1173-74.

\textsuperscript{85} Time Warner, 9 F.3d at 269; see Breard, 941 F.2d at 144; Beck v. Manufacturers Hanover Trust Co., 820 F.2d 46, 50 (2d Cir. 1987), cert. denied, 484 U.S. 1005 (1988), overruled in part on other grounds; United States v. Indelicato, 865 F.2d 1370 (2d Cir. 1989) (en banc); In re Network Equipment Technologies Inc. Litig., 762 F. Supp. 1359, 1362-63 (N.D. Cal. 1991).

\textsuperscript{86} Time Warner, 9 F.3d at 269; see also Cohen, 25 F.3d at 1174; RMED Int'l Inc. v. Sloan's Supermarket, Inc., 878 F. Supp. 16, 19 (S.D.N.Y. 1995).
securities. The opportunity for insiders to sell stock at artificially-inflated prices similarly provides a motive that raises "a strong inference" of fraudulent intent. Decisions applying the Second Circuit

87. Time Warner, 9 F.3d at 269-70. In Time Warner, the Second Circuit held that a rights offering provided a motive to manipulate the price of securities, "thereby enabling the company to set the rights offering price somewhat higher than would have been possible without the misleading statements and to lessen the dilutive effect of the offering." Id. at 269. This motive—the desire to obtain a higher price for a securities offering—raises a strong inference of scienter under Second Circuit law. Id. at 269-70. A potential merger or acquisition also provides a recognized motive for securities fraud. Fleet Nat'l Bank v. Anchor Medica Television, 831 F. Supp. 16, 40 (D.R.I. 1993) ("Although a motive to profit is not a necessary prerequisite to a finding of scienter and intent to deceive, the jury was entitled to consider [defendant's] incentive to try and pump up the purchase price as circumstantial evidence of intent to deceive."). (emphasis added); In In re Lotus Development Corp. Sec. Litig., 875 F. Supp. 48, 53 (D. Mass. 1995) ("Plaintiffs make well-pled allegations of motive. They allege that all of the defendants gained heavily from an artificially inflated stock price during the class period: the insiders through sizable sales of their personal stock holdings; and the company through an important stock-financed acquisition."); In re PNC Sec. Litig., [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,865, at 93,523 (W.D. Pa. 1992) (denying denied a motion to dismiss under Rule 9(b) based upon plaintiff's allegations that "PNC and the individual defendants allegedly were motivated by a desire to perpetuate PNC's ability to acquire banks at the lowest possible cost and thus with the minimum dilution to existing shareholders").

88. See Cosmas v. Hassett, 886 F.2d 8, 12 (2d Cir. 1989). In Cosmas, the Second Circuit held that allegations that a section 10(b) violation would permit insiders to sell stock at inflated prices provided a "strong inference that the defendants possessed the requisite fraudulent intent." Id. at 12-13. The court explained that:

[T]he allegations in the amended complaint herein do establish a motive. The amended complaint asserts that the defendants owned shares of Inflight (¶6) and that the allegedly fraudulent statements artificially inflated or maintained the prices of Inflight securities (¶38). As we stated in Goldman, 754 F.2d at 1070: "the . . . implication of the Complaint is that the alleged failure to qualify the bullish statements was intended to permit individual defendants to profit from an inflated market price before the truth became known."


Such holdings find support in precedents from other circuits, which hold that insider stock sales raise an inference of scienter — both at the pleading stage and at later stages when courts hold that insider sales can support a jury verdict of scienter. See, e.g., Rubinstein v. Collins, 20 F.3d 160, 169 (5th Cir. 1994) (insider sales of $760,599 raise an inference of scienter at the pleading stage); In re 3COM Sec. Litig., 761 F. Supp. 1411, 1417-18 (N.D. Cal. 1990) (insider sales of $2 million raise an inference of scienter). The Ninth Circuit, and other courts, have long held that "[i]nsider trading in suspicious amounts or at suspicious times is probative of bad faith and scienter." In re Apple Computer Sec. Litig., 886 F.2d 1109, 1117 (9th Cir. 1989), cert. denied, 496 U.S. 943 (1990); accord Shaw v. Digital Equipment Corp., 82 F.3d 1194, 1224 (1st Cir. 1996); In re Cryomedical Sciences, Inc. Sec. Litig., 884 F. Supp. 1001, 1020 (D. Md. 1995).

In Deutsch v. Flannery, 823 F.2d 1361 (9th Cir. 1987), the Ninth Circuit held that the opportunity to sell options raised an inference of scienter under Second Circuit standards.
standard hold that a professional—such as an auditor—may have a reason to intentionally or recklessly ignore facts that make its professional certification of financial statements misleading, because it desires to maintain a profitable financial relationship or to conceal shortcomings in its own prior work.89

The Second Circuit’s second approach for alleging scienter allows plaintiffs to identify circumstances indicating reckless or conscious behavior.90 The knowledge or recklessness of an individual may be inferred from his or her position within a company, or functions in a particular transaction, and likely access to material information.91

See Deutsch, 823 F.2d at 1365 & n.3; In re GlenFed, Inc. Sec. Litig., 42 F.3d 1541, 1547 n.6 (9th Cir. 1994) (noting that Deutsch applied Second Circuit law). In Kaplan v. Rose, the Ninth Circuit held that scenter may be found on the basis of insider stock sales “in amounts dramatically out of line with prior trading practices at times calculated to maximize personal benefit from undisclosed inside information.” Kaplan v. Rose, 49 F.3d 1363, 1379 (9th Cir. 1994) (quoting Apple Computer Sec. Litig., 886 F.2d at 1117).

More recently, in Fecht v. Price Co., the Ninth Circuit held that a corporate offering of securities and insider stock sales demonstrated knowledge of falsity, 70 F.3d at 1078 (9th Cir. 1995). Plaintiffs alleged that the defendant Price Co. and its officers had made unduly optimistic statements in order to inflate the price of the Company’s securities. Id. at 1084. Two top executives sold stock during the period of the alleged fraud, and the Company itself raised money with an offering of Real Estate Investment Trust (“REIT”) securities. Id. The Ninth Circuit held that “[t]hese sales are circumstantial evidence that the defendants knew or had reason to know that the financial condition of the Company was deteriorating well before they disclosed the problems with the expansion program.” Id.

89. District courts in the Second Circuit explain that under such circumstances, ‘[t]he defendant is motivated not to ‘open his eyes’ to the underlying facts, since this would place him in a position of terminating his profitable financial situation and exposing his association with, or continuing to participate in the fraudulent activity, but now without his cherished modicum of deniability. The combination of this motivation and otherwise unlikely degree of mere carelessness gives rise to an inference of deliberate disregard for the facts.

In re Leslie Fay Companies, Inc. Sec. Litig., 835 F. Supp. 167, 174 (S.D.N.Y. 1993) (quoting In re Fischbach Sec. Litig., 1992 WL 8715, at *6 (S.D.N.Y. Jan. 15, 1992)). In United States v. Simon, 425 F.2d 796 (2d Cir. 1969), the Second Circuit affirmed accountants’ criminal convictions, observing that the jury could have reasonably found that the accountants were motivated by a desire to “conceal the alleged dereliction of their predecessors and themselves in former years.” Id. at 808; see Elliot J. Weiss, The New Securities Fraud Pleading Requirement: Speed Bump or Road Block?, 38 ARIZ. L. REV. 675, 702 & n.164 (1996).

90. See Breard, 941 F.2d at 144; Beck, 820 F.2d at 50; RMED Intl, Inc. v. Sloan’s Supermarkets, Inc., 878 F. Supp. 16, 19-20 (S.D.N.Y. 1995).

91. See, e.g., Breard, 941 F.2d at 144; Cosmas, 886 F.2d at 13; Cohen, 25 F.3d at 1174; In re MTC Electronic Technologies Shareholders Litig., 898 F. Supp. 974, 979-
For example, in *Cosmas v. Hassett*, the complaint alleged that the Inflight Corporation made optimistic statements about revenues and projected sales that were false or misleading because the People’s Republic of China (“PRC”) had imposed new import restrictions that corporate directors must have known would adversely affect the company’s sales to that country. The Second Circuit held that the complaint raised a strong inference of scienter because corporate directors were in a position to know of the import restrictions and their likely effect on the company’s business.

In *Cohen v. Koenig*, the Second Circuit held that a plaintiff raised a strong inference of scienter by pleading facts suggesting that defendants likely knew that their financial representations about the Koenig Group were false. The fact that the defendants “were officers, directors and majority shareholders of the Koenig Group and were active managers and . . . [thus] fully familiar with all aspects of Koenig Group’s business and financial conditions and operations” was sufficient to show that the defendants, more likely than not, knew their financial representations were false—and thus scienter was successfully alleged.

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92. 886 F.2d 8 (2d Cir. 1989).

93. Id. at 10-12.

94. *Cosmas*, 886 F.2d at 13. The Court explained:

[T]he amended complaint herein satisfies the scienter requirement of Rule 9(b).

As already discussed, the amended complaint alleges facts from which one can reasonably infer that sales to the PRC were to represent a significant part of Inflight’s business. These facts give rise to a strong inference that the defendants, who the amended complaint alleges were directors of Inflight, had knowledge of the PRC import restrictions, since the restrictions apparently eliminated a potentially significant source of income for the company. In light of the strong inference that the defendants, at the time the allegedly fraudulent statements were made, had knowledge of the PRC import restrictions, we conclude that the amended complaint alleges sufficient facts from which it can be inferred that the defendants had the requisite fraudulent intent.

Id. (emphasis added).

95. 25 F.3d 1168 (2d Cir. 1994).

96. Id. at 1174.

97. Id.; see also In re MTC Electronic Technologies Shareholder Litig., 898 F. Supp. 974, 979-80 (E.D.N.Y. 1995) (directors’ positions on audit committee and their signatures on a prospectus raise a strong inference of scienter regarding massive accounting fraud).
A professional’s position similarly can raise a strong inference of scienter with respect to material omissions from documents the professional participated in drafting. For example, in *Breard v. Sachnoff & Weaver*, allegations that a law firm participated in drafting an offering memorandum that failed to disclose an individual’s criminal conviction raised a strong inference of scienter because omission of this material information could be considered reckless. The inference of scienter was strengthened by the fact that the law firm then drafted a supplemental offering memorandum which disclosed the fact but tried to minimize it, characterizing it as “immaterial.”

The many kinds of facts that can be relied upon to survive a summary judgment motion or to establish scienter at trial also should be capable of raising “a strong inference” of scienter at the pleading stage. Thus, accounting violations can help to provide a basis for inferring scienter. Violations of specific accounting rules can raise an inference


99. *Id.* at 144 & n.3. “Indeed, Sachnoff’s failure to mention Berg’s conviction in the initial offering memorandum could be considered reckless as a matter of law.” *Id.* at 144. The Second Circuit reversed a district court’s holding that the complaint “failed to allege any fact from which it could be inferred that [Sachnoff] had knowledge or should have had knowledge of the alleged fraud.” *Id.* at 143. It instead held that allegations the law firm “participated in drafting” an offering memorandum, but overlooked material information, did raise a strong inference of recklessness. *Id.* at 144-45. *Compare In re Software Toolworks, Inc. Sec. Litig.,* 50 F.3d 615, 625-29 (9th Cir. 1994) (holding that scienter may be inferred from professionals’ access to undisclosed material information).

100. *Breard*, 941 F.2d at 144. The Second Circuit explained: Moreover, once Sachnoff learned that Berg . . . had just been convicted for mail fraud and conspiracy, Sachnoff should have informed itself of the nature and extent of Berg’s criminal acts, and should have conducted some sort of independent investigation of the facts supplied by Berg. Failure to do so before offering the opinion in the supplemental offering memorandum that Berg’s criminal past was ‘immaterial’ could therefore be considered reckless. See Goldman v. McMahan, Brafman, Morgan & Co., 706 F. Supp. 256, 259 (S.D.N.Y. 1989) (“An egregious refusal to see the obvious, or to investigate the doubtful, may in some cases give rise to an inference of . . . recklessness.”).

*Id.*

of scienter that is strong enough to overcome summary judgment.\(^{102}\) In the Second Circuit, manipulation of accounting rules to report greater revenues and earnings raises an inference of scienter sufficient not just to overcome a motion to dismiss, but to defeat summary judgment as well.\(^{103}\) In the Ninth Circuit, violation of accounting rules can raise an inference of scienter strong enough to support a criminal conviction for securities fraud—beyond a reasonable doubt.\(^{104}\) Even under circumstances where evidence of inaccurate accounting figures, or a misapplication of generally accepted accounting principles, might not by itself necessarily establish scienter, a showing that a corporate defendant violated its own policies to recognize revenue is enough to survive a summary-judgment motion.\(^{105}\)

By using the Second Circuit's "strong inference" formulation, section 21D(b)(2) on its face adopts the Second Circuit standard for pleading scienter. Had Congress intended to abrogate the Second Circuit precedents creating and interpreting the "strong inference" pleading standard, it would not have explicitly adopted the Second Circuit's "strong inference" formulation.\(^{106}\) Nothing in section 21D(b)(2)'s text

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104. United States v. Weiner, 578 F.2d 757, 786 (9th Cir. 1978); see also United States v. Sarno, 73 F.3d 1470, 1494-96 (9th Cir. 1995) (sustaining criminal fraud convictions on the basis of GAAP violations).

105. Provenz v. Miller, Nos. 95-15839, 95-16819, 1996 U.S. App. LEXIS 33085, at *28-*29 (9th Cir. Dec. 18, 1996). The Ninth Circuit also has held that allegations of a scheme to inflate financial statements raise an inference of specific intent to defraud at the pleading stage. E.g., Blake v. Dierdorff, 856 F.2d 1365, 1370 (9th Cir. 1988); Sun Sav. & Loan Ass'n v. Dierdorff, 825 F.2d 187, 195-96 (9th Cir. 1987). To the extent these pleading decisions were overruled by GlenFed's en banc holding that no inference of scienter is required to be pleaded, 42 F.3d 1541, 1545-47 (9th Cir. 1995), they have been revived by the new Act's express requirement of a strong inference of scienter. The same is true of Ninth Circuit district court cases that applied Second Circuit law to find a strong inference of scienter. See, e.g., Network Equipment Technologies Inc. Litig., 762 F. Supp. 1359, 1362-63 (1991); 3COM Sec. Litig., 761 F. Supp. at 1417-18; In re Genentech, Inc. Sec. Litig., [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) 994,960, at 95,372-73 (N.D. Cal. 1989).

suggests that it overrules the Second Circuit case law, whose very language it adopts, on what kind of facts can suffice to raise "a strong inference" of intentional fraud or recklessness. \(^{108}\)

3. **Section 21D(b)(2)'s Preservation of Existing Standards of Liability**

Section 21D(b)(2) requires a plaintiff to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind," \(^{109}\) and the "required state of mind" for Section 10(b) violations has long included recklessness. Section 21D(b)(2) preserves existing law for the state of mind necessary to establish liability—except where Congress has expressly changed the required state of mind, as for certain forward-looking statements. \(^{110}\)

The Supreme Court held in 1976 that scienter is an element of liability under section 10(b), \(^{111}\) observing that "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct." \(^{112}\) Since then, the circuit courts have uniformly held that the required state of mind for a section 10(b) action is knowledge of falsity or reckless disregard. \(^{113}\) One circuit after another adopted the so-called "Sundstrand standard" for recklessness, which was first articulated in

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107. See *supra* note 72 and accompanying text.
110. "Scienter may be satisfied by either proof of actual knowledge or recklessness." Hanon v. Dataproducts Corp., 976 F.2d 497, 507 (9th Cir. 1992) (citing Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990)).
112. *Id.* at 194 n.12.
113. See, e.g., Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 46 (2d Cir. 1978); Sharp v. Coopers & Lybrand, 649 F.2d 175, 193 (3d Cir. 1981); McLean v. Alexander, 599 F.2d 1190, 1197 (3d Cir. 1979); Broad v. Rockwell Int’l Corp., 642 F.2d 929, 960-61 (5th Cir 1981) (en banc); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1024 (6th Cir. 1979); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1044 (7th Cir. 1977); Alpern v. Utilicorp United, Inc., 84 F.3d 1525, 1534 (8th Cir. 1996); Van Dyke v. Coburn Enterprises, Inc., 873 F.2d 1094, 1100 (8th Cir. 1989); Stokes v. Lokken, 644 F.2d 779, 783 (8th Cir. 1981); Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990) (en banc); Anixter v. Home Products, Inc., 77 F.3d 1215, 1232-33 & n.20 (10th Cir. 1996); Hackbart v. Holmes, 675 F.2d 1114, 1117-18 (10th Cir. 1982); Woods v. Barnett Bank, 765 F.2d 1004, 1010 (11th Cir. 1985); SEC v. Steadman, 967 F.2d 636, 641-42 (D.C. Cir. 1991).
Franke v. Mid-Western Oklahoma Development Authority, and adopted by the Seventh Circuit in Sundstrand Corp. v. SunChemical Corp. Under the Sundstrand standard:

'[R]eckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.'

This formulation became a uniform national standard for scienter under section 10(b), explicitly adopted and applied by the First, Second, Third, Fifth, Sixth, Seventh, Eighth, Ninth, Tenth, Eleventh, and District of Columbia Circuits—as well as by district courts in the Fourth Circuit.

Against this background, Congress' choice of "the required state of mind," necessarily preserves recklessness as a basis of liability for most section 10(b) claims. "A fundamental canon of statutory construction is that, unless otherwise defined, words will be interpreted as taking their ordinary, contemporary, common meaning" in use at the time Congress enacted the statute. Because the many decisions holding that recklessness satisfies section 10(b)'s scienter requirement were part of the "contemporary legal context" presumably known to Congress and left undisturbed by the text of section 21D(b)(2), they provide "the

114. 428 F. Supp. 719, 725 (W.D. Okla. 1976), vacated, 619 F.2d 856 (10th Cir. 1980).
115. 553 F.2d at 1033, 1044-45 (7th Cir. 1979).
116. Id. at 1045 (citation omitted).
118. Rolf, 570 F.2d at 47.
121. Ohio Drill & Tool Co. v. Johnson, 625 F.2d 738, 741 (6th Cir. 1980).
122. Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1044-45 (7th Cir. 1977).
125. Hackbart v. Holmes, 675 F.2d 1114, 1118 (10th Cir. 1982).
126. SEC v. Carriba Air, Inc., 681 F.2d 1318, 1324 (11th Cir. 1982).
required state of mind” for the typical section 10(b) cause of action.131 Had Congress intended to overrule the established law and require actual knowledge of falsity with section 21D(b)(2), it would have said so.132

Indeed, when Congress intended, with the PSLRA, to limit liability for reckless conduct, it did say so.133 Congress, in enacting a new section 21(E), chose to provide only a narrow “safe harbor” from recklessness liability.134 The “safe harbor” protects specified defendants from liability for defined “forward-looking statements” unless plaintiff proves that such a statement was made with “actual knowledge” that the statement was false or misleading.135 If a “forward-looking statement” comes within the “safe harbor,” defendants avoid liability if the statement was “identified as a forward-looking statement, and [was] accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement,” or if the plaintiff fails to prove that the statement “was made with actual knowledge” that it was false or

131. See Cottage Savings Ass’n v. Commissioner, 499 U.S. 554, 561-62 (1991) (Congress presumably codified decisions that “were part of the ‘contemporary legal context’ in which Congress enacted” a statute) (quoting Cannon v. University of Chicago, 441 U.S. 677, 698-99 (1979)); Associated General Contractors v. California State Council of Carpenters, 459 U.S. 519, 532 (1983) (“Just as the substantive content of the Sherman Act draws meaning from its common-law antecedents, so must we consider the contemporary legal context in which Congress acted when we try to ascertain the intended scope of the private remedy created by §7.”); Herman & MacLean v. Huddleston, 459 U.S. 375, 385-86 (1983) (assuming Congress acted with knowledge of Section 10(b) precedents when it revised the securities laws in 1975). As the Supreme Court explained in Lorillard v. Pons, 434 U.S. 575, 580-81 (1978):

Congress is presumed to be aware of administrative or judicial interpretation of a statute and to adopt that interpretation when it re-enacts a statute without change . . . . So too, where, as here, Congress adopts a new law incorporating sections of a prior law, Congress normally can be presumed to have had knowledge of the interpretation given to the incorporated law, at least insofar as it affects the new statute.


133. See supra notes 16-19 and accompanying text.


misleading. To establish liability for a statement within the "safe harbor," plaintiffs must show that the statement, "if made by a natural person, was made with actual knowledge by that person that the statement was false or misleading; or... if made by a business entity... was made or approved by [an] officer with actual knowledge by that

136. The "safe harbor" for qualifying forward-looking statements states, in relevant part:

(c) Safe Harbor. —
(1) In general. — Except as provided in subsection (b) [which excludes many statements from the safe harbor], in any private action arising under this title that is based on an untrue statement of a material fact or omission of a material fact necessary to make the statement not misleading, a person referred to in subsection (a) [limited to periodically reporting issuers and their agents] shall not be liable with respect to any forward-looking statement, whether written or oral, if and to the extent that —
(A) the forward-looking statement is —
(i) identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement; or
(ii) immaterial; or
(B) the plaintiff fails to prove that the forward-looking statement —
(i) if made by a natural person, was made with actual knowledge by that person that the statement was false or misleading; or
(ii) if made by a business entity; was —
(I) made with the approval of an executive officer of that entity; and
(II) made or approved by such officer with actual knowledge by that officer that the statement was false or misleading.


The disjunctive text of the statute raises a question as to whether persons defined by subsection (a) are free to lie in a forward-looking statement so long as the statements "identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." 15 U.S.C. §78u-5(e)(1)(A)(i) (Supp. 1996). SEC Chairman Arthur Levitt, Jr. commented that "a person who makes a deliberate lie with the purpose and intent of defrauding investors cannot provide 'meaningful' warnings to investors under the 'bespeaks caution' prong of the safe harbor." Letter from Arthur Levitt and Steven M.H. Wallman to Representatives John D. Dingell and Edward J. Markey, November 27, 1995, at 2 (copy on file with authors). On this basis, the provision's proponents emphatically denied that it could provide any "license to lie." See, e.g., 141 CONG. REC. S17934 (Dec. 5, 1995) ("The safe harbor does not give a license to lie.") (statement of Sen. D'Amato); 141 CONG. REC. S17958 (Dec. 5, 1995) ("The idea that this conference report contains any license to lie is simply and totally untrue . . . .") (statement of Sen. Dodd); 141 CONG. REC. S17970 (Dec. 5, 1995) ("The conference report's balanced safe harbor provision encourages companies to speak by recognizing that predictions are not promises, while prohibiting outright lies by corporate executives.") (statement of Sen. Domenici); 141 CONG. REC. S17911 (Dec. 5, 1995) ("Executives who deliberately lie about their company's prospects would be liable under the compromise.") (statement of Sen. Reid). The Conference Report confirms that "boilerplate warnings will not suffice." H.R. CONF. REP. NO. 104-360, at 43 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 742.
Section 21E's requirement of actual knowledge for certain claims based on forward-looking statements cannot reasonably be extended to cover all other claims under section 10(b). 138 "Expression unius est exclusio alterius." 139 Indeed, section 21E's detailed specifications excluding many persons and statements from the safe harbor would be utterly frustrated if Section 21D were construed to require proof of actual knowledge in every case. 140

Moreover, Exchange Act section 21(g)'s proportionate liability provision limits the extent of defendants' liability for reckless conduct, while carefully preserving the rule that reckless conduct can give rise to liability. 141 The section also provides that it does not affect the basic scienter standards for establishing a violation of Section 10(b): "Nothing in this subsection shall be construed to create, affect, or in any manner modify, the standard for liability associated with any action arising under the securities laws." 142 The PSLRA thus expressly preserves the existing case law holding that recklessness suffices to establish the scienter element for a section 10(b) violation. Finally, when Congress restored the SEC authority to prosecute aiders and abettors, it limited aider-and-abettor liability to "any person that knowingly provides...

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141. 15 U.S.C. § 78u-4(g) (Supp. 1996). Section 21(g) provides that any defendant "against whom a final judgment is entered in a private action shall be liable for damages jointly and severally only if the trier of fact specifically determines that such covered person knowingly committed a violation of the securities laws." 15 U.S.C. § 78u-4(g)(2)(A). This section recognizes that "final judgment" may be entered without such a finding, but will result in joint-and-several liability only upon a finding of knowing conduct, and in less-sweeping "proportionate liability" on a finding of recklessness. U.S.C. § 78u-4(g)(2) (Supp. 1996). Section 21(g)(10) states that "[f]or purposes of this subsection [a defendant] knowingly commits a violation of the securities laws... [only if it acts] with actual knowledge... of [falsity]." 15 U.S.C. § 78u-4(g)(10) (Supp. 1996). It specifies that for this subsection alone "reckless conduct by a covered person shall not be construed to constitute a knowing commission of a violation of the securities laws by that covered person... ." 15 U.S.C. § 78u-4(g)(10)(B) (Supp. 1996).
substantial assistance to another person in violation of this chapter,” although the case law had recognized recklessness as a ground for liability. These specific changes show that Congress did not intend to raise the basic scienter standard for all Section 10(b) actions.

Because “forward-looking statements” within the safe harbor now require proof of actual knowledge of falsity, the “required state of mind” for some section 10(b) claims based on forward-looking statements is more than recklessness. But by using “the required state of mind” in section 21D(b)(2), Congress could require plaintiffs to plead facts raising a strong inference of knowledge only in cases based exclusively on forward-looking statements, while allowing plaintiffs to proceed on the basis of a strong inference of either conscious or reckless behavior in all other section 10(b) cases.

III. DOES THE LEGISLATIVE HISTORY OF SECTION 21(D)(b) CONTRADICT ITS TEXT?

A. Legislative History and the Silicon Graphics and Marksman Partners Opinions

Section 21D(b)(2) says that plaintiffs must “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” No one doubts that the “strong inference” language comes from the Second Circuit case law, or that the “required state of mind” for section 10(b) claims has long included both actual knowledge of falsity and recklessness. Nothing in section 21D(b)(2)’s statutory text appears to overrule Second Circuit “motive and opportunity” precedents on how a “strong inference” of scienter may be pleaded, or to eliminate liability for reckless violations of section 10(b). On the contrary, the statutory text apparently adopts the Second Circuit standard for alleging scienter and preserves knowing or reckless conduct as “the required state of mind” for most section 10(b) actions. Can legislative history be relied on, as it was in Silicon Graphics, to contradict this legislative text? And does the legislative history suggest Congress really intended to overrule precedents accepting allegations of

144. See SEC v. Fehn, 97 F.3d 1276, 1288 n.11 (9th Cir. 1996); Levine v. Diamanthuset, Inc., 950 F.2d 1478, 1483 (9th Cir. 1991).
145. See supra note 137 and accompanying text.
147. See supra notes 131-32 and accompanying text.
motive, opportunity, and recklessness to establish scienter in section 10(b) cases? Both questions must be answered in the negative.

Legislative history cannot be used to contradict unambiguous statutory text adopting the Second Circuit's "strong-inference" standard. The Supreme Court has held that where statutory text "contains a phrase that is unambiguous—that has a clearly accepted meaning in both legislative and judicial practice—we do not permit it to be expanded or contracted by the statements of individual legislators or committees during the course of the enactment process." Thus, a cryptic endnote in the Statement of the Managers cannot overpower the statutory text itself.

Views of the legislation's opponents regarding that endnote's signifi-

148. See Amoco Production Co. v. Village of Gambell, 480 U.S. 531, 552-53 (1987) (holding that "[w]hen statutory language is plain, and nothing in the Act's structure or relationship to other statutes calls into question this plain meaning, that is ordinarily 'the end of the matter.'") (quoting Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842 (1984); accord United States v. Ron Pair Enterprises, 489 U.S. 235, 240-41 (1989) ("[A]s long as the statutory scheme is coherent and consistent, there generally is no need for a court to inquire beyond the plain language of the statute."); Ex parte Collett, 337 U.S. 55, 61 (1949) (holding that "there is no need to refer to the legislative history where the statutory language is clear."); Kenaitze Indian Tribe v. Alaska, 860 F.2d 312, 318 (9th Cir. 1988); Davis v. Michigan Dept. of Treasury, 489 U.S. 803, 808 n.3 (1989) (stating that "[l]egislative history is irrelevant to the interpretation of an unambiguous statute.") (citation omitted); Hearn v. Western Conference of Teamsters Pension Fund, 68 F.3d 301, 304 (9th Cir. 1995) ("Where the statute's language 'can be construed in a consistent and workable fashion,' we must put aside contrary legislative history.") (quoting Valentine v. Mobil Oil Corp., 789 F.2d 1388, 1391 (9th Cir. 1986)).

149. West Virginia University Hospitals, Inc. v. Casey, 499 U.S. 83, 98-99 (1991) (emphasis added; citation omitted); Hearn, 68 F.3d at 304 ("[L]egislative history—no matter how clear—can't override statutory text.").

150. United States v. Oregon, 366 U.S. 643, 648 (1961) (holding that statements in the legislative history "have never been regarded as sufficiently compelling to justify deviation from the plain language of a statute."); see, e.g., Arcadia Ohio v. Ohio Power Co., 498 U.S. 73, 81 n.2 (1990) ("[T]he legislative history is overborne by the text."). Professor Coffee aptly observes:

"In Shannon v. United States, the Court confronted a statute whose conference report specifically "endorsed" a procedure used in one circuit by which the jury was given specific instructions in connection with the insanity defense. As clear and specific as this statement was, the Court still gave no weight to this congressional "endorsement" and instead adopted a very different procedure, stating "[w]e are not aware of any case . . . in which we have given authoritative weight to a single passage of legislative history that is in no way anchored in the text of the statute.""

Coffee, supra note 28, at 981 (quoting Shannon v. United States, 114 S. Ct. 2419, 2426 (1994)). "From Shannon's perspective then, courts should simply focus on the statutory text and ignore the surplusage in the legislative history." Id.
cance—including those stated in the President’s veto message—carry even less weight, for “views of opponents of a bill with respect to its meaning . . . are not persuasive,” 151 even with respect to ambiguous statutory provisions. 152

Nonetheless, in *Silicon Graphics* Judge Smith relied on President Clinton’s interpretation of the Statement of the Managers accompanying the Conference Committee Report 153 on the PSLRA to hold that section 21D(b)(2) abrogates Second Circuit precedents allowing plaintiffs to raise “a strong inference” of scienter with allegations of motive, opportunity or recklessness. 154 As *Silicon Graphics* notes, when he vetoed the PSLRA, President Clinton stated that, although he could accept the Second Circuit “strong inference” pleading standard called for by the text of section 21D(b)(2), he feared “the conferees [made] crystal clear in the Statement of Managers their intent to raise the standard even beyond that level.” 155 That veto was subsequently overridden by Congress. 156 “Based on this legislative history,” Judge Smith in *Silicon Graphics* “[found] that Congress did not intend to codify the Second Circuit standard” for pleading scienter 157 and held that the PSLRA required proof of “knowing misrepresentation” in all cases. 158

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152. Professor Coffee correctly observes that “the President’s characterization of the [PSLRA] cannot determine what Congress itself intended.” Coffee, supra note 28, at 982.

153. The Conference Committee Report or “Conference Report” contains the text of the statute that emerges from the Conference Committee and that, if enacted, is the law. The Statement of the Managers is a commentary by the conferees that accompanies the Conference Committee Report.


158. Id. at 12-13, 16.
Judge Smith expressly rejected the contrary holding of *Marksman Partners*, 159 in which Judge Rea had carefully reviewed the statutory text and its legislative history to conclude that section 21D(b)(2) did not eliminate liability for reckless misconduct. 160 Judge Rea was, moreover, "unimpressed with defendants' enthusiastic reliance on an oblique reference to 'motive, opportunity and recklessness' in a footnote in the Conference Committee Report for their argument that the 'motive and opportunity' test has been jettisoned." 161

In *Silicon Graphics*, however, Judge Smith placed great emphasis on the fact that the Conference Committee chose not to include in section 21D(b)(2) language offered by Senator Specter in an amendment which would have expressly "allowed a plaintiff to use allegations of recklessness or motive and opportunity to establish fraudulent intent," 162 for "[t]he Conference Committee eliminated this amendment from its version of the bill." 163 Judge Smith concluded:

> Because Congress chose not to include that language from the Second Circuit standard relating to motive, opportunity, and recklessness, Congress must have adopted the Conference Committee view . . . . The Court therefore holds that plaintiff must allege specific facts that constitute circumstantial evidence of conscious behavior by defendants. 164

> Thus, in order to state a private securities claim, plaintiff must now allege false or misleading statements, describe how the statements are false or misleading, and create a strong inference of knowing misrepresentation on the part of the defendants. *This standard applies whether the statements in question are forward-looking or not.* 165

Judge Smith wrote that "[t]he Conference Committee's deletion of the Second Circuit standard from the final bill 'strongly militates against a judgment that Congress intended a result that it expressly declined to enact.'" 166 Yet the "strong inference" standard in the statute is drawn from the Second Circuit precedents. 167 The Statement of the Managers

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159. 927 F. Supp. at 1308-12; see *Silicon Graphics*, slip op. at 13 n.4.
161. *Id.* at 1311.
162. *Silicon Graphics*, slip op. at 12.
164. *Id.* at 12-13.
165. *Id.* at 16.
167. *See supra* notes 131-32 and accompanying text.
says that section 21D(b)(2)’s pleading standard “is based in part on the pleading standard of the Second Circuit” regarding allegations of scienter, but “also is specifically written to conform the language to Rule 9(b)’s notion of pleading with ‘particularity.’”\textsuperscript{168} “Regarded as the most stringent pleading standard,” the Managers explained, “the Second Circuit require[s] that the plaintiff state facts with particularity, and that these facts, in turn, must give rise to a ‘strong inference’ of the defendant’s fraudulent intent.”\textsuperscript{169} However, they added that “[b]ecause 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.”\textsuperscript{170} An endnote adds that “[f]or this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness.”\textsuperscript{171}

This does not mean that Congress intended to reject Second Circuit case law or to repudiate motive and opportunity or recklessness as ways of establishing scienter for most section 10(b) actions. The truth is that Congress \textit{could not} simply codify Second Circuit case law on motive, opportunity, and recklessness as a universal pleading standard in section 21D(b)(2) because it also enacted a new Section 21E of the Exchange Act to provide a narrow “safe harbor” protecting specified persons from liability for certain forward-looking statements, \textit{unless those statements are made with “actual knowledge of falsity.”}\textsuperscript{172} Since claims within section 21E’s “safe harbor” require “actual knowledge” rather than recklessness, section 21D(b)(2) \textit{could not codify} case law allowing a strong inference of scienter to be raised from allegations of “motive, opportunity, or recklessness,” as recklessness no longer is the governing standard for some section 10(b) claims. Language in Senator Specter’s proposed amendment of section 21D(b), which said plaintiffs could raise “a strong inference of scienter” with allegations of motive and opportunity or facts suggesting recklessness,\textsuperscript{173} was inconsistent with section 21E’s requirement of actual knowledge for forward-looking statements,\textsuperscript{174} because it would have allowed plaintiffs to proceed on the

\textsuperscript{169} \textit{Id.}
\textsuperscript{170} \textit{Id.}
\textsuperscript{171} \textit{Id.}
\textsuperscript{173} \textit{See infra} notes 289-310 and accompanying text.
\textsuperscript{174} Congress had explicitly rejected recklessness as the standard of liability for a Section 10(b) claims based on qualifying forward-looking statements. \textit{See supra} notes 166-82 and accompanying text.
basis of recklessness in all situations. Not surprisingly, the Conference Committee deleted it from the bill, inserting language that required plaintiffs to raise "a strong inference of the required state of mind," which may be actual knowledge in some cases, and recklessness in others.

In Silicon Graphics, however, Judge Smith observes that section 21E(c)(1)(B) "provides that defendants are not liable for forward-looking statements accompanied by cautionary language unless the plaintiff proves that the statement 'was made with actual knowledge' that it was false or misleading," and extends this narrow, qualified provision to all section 10(b) claims. But by extending this rule to all section 10(b) claims, the Silicon Graphics opinion frustrates Congress' desire to require actual knowledge only for forward-looking statements. Silicon Graphics' holding ignores the fact that early drafts of the legislation expressly required actual knowledge of falsity, and were rejected because legislators did not want to abolish liability for reckless

175. Thus, in the veto-override debate, Senator Dodd criticized the Specter amendment because it would have included recklessness as a universal standard of liability for all section 10(b) claims: "My point simply has been that I do not think the Specter amendment was—I think it was an effort to get recklessness in, which would have changed the standard from the [Second Circuit]." 141 CONG. REC. S19071 (Dec. 21 1995) (statement of Sen. Dodd). See infra notes 289-310 and accompanying text.

Professor Perino observes that section 21D(b)(2)'s "pleading provision applies to other private actions under the 1934 Act besides section 10(b)," to argue that "[t]he Specter Amendment was thus inconsistent with case law holding that recklessness was insufficient to establish liability under these provisions." Perino, supra note 23, at 404. We think that section 21E's requirement of actual knowledge provides for some section 10(b) claims is far more compelling. Perino cites as support a vacated opinion's holding that "recklessness may not be used to fulfill section 9's scienter requirement." Chemetron Corp. v. Business Funds, Inc., 682 F.2d 1149, 1165 (5th Cir. 1982), vacated 460 U.S. 1007 (1983); see Perino, supra note 23, at 404, 410 n.61. Perino indicates that Chemetron was "vacated on other grounds," but Chemetron's holding that section 9 requires more than recklessness appears to us to conflict with section 9's text and with precedent holding that reckless conduct satisfies Rule 9(b)'s willfulness element. See Dlugash v. SEC, 373 F.2d 107, 109 (2d Cir. 1967); SEC v. Resch-Cassin & Co., 362 F. Supp. 964, 978 (S.D.N.Y. 1973), and as a vacated opinion it has no precedential value on the required scienter for liability under section 9. See O'Connor v. United States, 422 U.S. 563, 578 n.2 (1975); Durning v. Citibank, N.A., 950 F.2d 1419, 1424 n.2 (9th Cir. 1991) ("A decision may be reversed on other grounds, but a decision that has been vacated has no precedential authority whatsoever.") (emphasis in original).

176. See infra at notes 252-59 and accompanying text.

177. Silicon Graphics, slip op. at 16.

178. See supra notes 129-32.
conduct. Congress decided that it would require actual knowledge rather than falsity to impose liability for certain narrowly-defined forward-looking statements, and to impose full joint-and-several liability rather than proportionate-fault liability. Otherwise, it chose not to change the scienter standard. Congress provided that the “safe harbor” should apply only to a narrowly-defined group of “forward-looking” statements. It carefully limited the “safe harbor,” providing that it would apply only to forward-looking statements of an issuer subject to reporting requirements under section 13(a) or section 15(d) of the Exchange Act, and to certain persons acting on such an issuer’s behalf, including outside reviewers retained by such an issuer, or such an issuer’s underwriter. Congress provided many exclu-

179. See supra notes 148-61 and accompanying text.
183. Section 21E(i) defines “forward-looking statements” that may qualify for the safe harbor requiring proof of actual knowledge:
(i) Definitions—For purposes of this section, the following definitions shall apply:
(1) Forward-looking statement. — The term forward-looking statement means —
(A) a statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure or other financial items;
(B) a statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer;
(C) a statement of future economic performance, including any such statement contained in a discussion and analysis of financial condition by the management or in the results of operations included pursuant to the rules and regulations of the Commission;
(D) any statement of the assumptions underlying or relating to any statement described in subparagraph (A), (B), or (C);
(E) any report issued by an outside reviewer retained by an issuer, to the extent that the report assesses a forward-looking statement made by the issuer; or
(F) a statement containing a projection or estimate of such other items as may be specified by rule or regulation of the Commissions.
184. Section 21E(a) provides:
(a) Applicability—This section shall apply only to a forward-looking statement made by —
(1) an issuer that, at the time that the statement is made, subject to the reporting requirements of section 78m(a) or section 78o(d) of this title;
(2) a person acting on behalf of such issuer;
(3) an outside reviewer retained by such issuer making a statement on behalf of such issuer; or
sions from protection of the “safe harbor,” exempting many statements from section 21E(c)’s actual-knowledge requirement. All of these provisions are effectively nullified by Silicon Graphics’s apparent holding that a similar actual knowledge requirement applies to all section

(4) an underwriter, with respect to information provided by such issuer or information derived from information provided by such issuer.


185. Section 21E(b) provides:

(b) Exclusions. — Except to the extent otherwise specifically provided by rule, regulation, or order of the Commission, this section shall not apply to a forward-looking statement —

(1) that is made with respect to the business or operations of the issuer, if the issuer —

(A) during the 3-year period preceding the date on which the statement was first made —

(i) was convicted of any felony or misdemeanor described in clauses (i) through (iv) of section 78(b)(4)(B) of this title; or

(ii) has been made the subject of a judicial or administrative decree or order arising out of a governmental action that —

(I) prohibits future violations of the antifraud provisions of the securities laws;

(II) requires that the issuer cease and desist from violating the antifraud provisions of the securities laws; or

(III) determines that the issuer violated the antifraud provisions of the securities laws;

(B) makes the forward-looking statement in connection with an offering of securities by a blank check company;

(C) issues penny stock;

(D) makes the forward-looking statement in connection with a going private transaction; or

(E) makes the forward-looking statement in connection with a going private transaction; or

(2) that is —

(A) included in a financial statement prepared in accordance with generally accepted accounting principles;

(B) contained in a registration statement of, or otherwise issued by, an investment company;

(C) made in connection with a tender offer;

(D) made in connection with an initial public offering;

(E) made in connection with an offering by, or relating to the operations of, a partnership, limited liability company, or a direct participation investment program; or

(F) made in a disclosure of beneficial ownership in a report required to be filed with the Commission pursuant to section 13(d).

10(b) claims, without regard to whether they come within the section 21E's "safe harbor."  

Acknowledging that Congress also distinguished between knowing and non-knowing violations with section 21D(g)(2)'s provision limiting joint-and-several liability, Judge Smith brushed it away with the assertion that "Congress was making the distinction between knowing violators under section 21D of the [PSLRA] and non-knowing control persons under section 78t of the original Act, for example." But section 21D says nothing about "knowing violators;" it speaks only of "the required state of mind," to be supplied by reference to other sections of the statute and the case law interpreting them.

In the end, Judge Smith tried to justify her holding on the ground that "courts should be mindful of . . . policy considerations in construing federal securities law." But the Supreme Court has repeatedly held that policy considerations cannot override the securities laws' text. No doubt, "Congress sought to 'protect investors, issuers, and all who are associated with our capital markets from abusive securities litigation." But neither the statute nor its legislative history indicates that assertion of claims based on reckless misstatements or omissions is "abusive" litigation. Quite to the contrary, when the SEC and others objected that provisions in early drafts of the legislation would eliminate liability for reckless misrepresentation, Congress eliminated them.

Thus, even if one could argue that some of the policy considerations underlying the PSLRA might support a higher scienter standard for all section 10(b) claims, that would provide no ground for ignoring statutory

186. See In re Silicon Graphics Inc. Sec. Litig., No. C96-0393FMS, slip op. at 16 (N.D. Cal. Sep. 25, 1996) ("This standard applies whether the statements in question are forward-looking or not.").
188. Silicon Graphics, slip op. at 15-16.
191. See infra notes 329-35 and accompanying text.
language that clearly embraces existing legal standards. Moreover, the fundamental stated policy underlying the PSLRA, according to the Statement of the Managers, was to ensure effective enforcement of investors' rights, not to frustrate investors' claims by abolishing all liability based on reckless violations of section 10(b).

Far from supporting *Silicon Graphics*, a careful review of the legislative history of section 21D(b)(2) actually confirms that Congress adopted the Second Circuit's "strong inference" pleading standard and that it intended for courts to seek guidance from Second Circuit precedents on how a "strong inference" of scienter may be pleaded. The bill's proponents unquestionably intended to preserve motive, opportunity, and recklessness as means of establishing scienter.

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192. See United States v. Sisson, 399 U.S. 267, 296-98 (1970). In *Sisson*, the Supreme Court interpreted the statutory phrase "decision arresting a judgment" in light of the contemporary legal context at the time of its enactment, rejecting the dissent's contention that the "broad policy" under the act mandated a different interpretation:

Radical reinterpretations of the statutory phrase "decision arresting a judgment" are said to be necessary in order to effectuate a broad policy, found to be underlying the Criminal Appeals Act, that this Court review important legal issues. The axiom that courts should endeavor to give statutory language that meaning that nurtures the policies underlying legislation is one that guides us when circumstances not plainly covered by the terms of a statute are subsumed by the underlying policies to which Congress was committed. Care must be taken, however, to respect the limits up to which Congress was prepared to enact a particular policy, especially when the boundaries of a statute are drawn as a compromise resulting from the countervailing pressures of other policies.

*Id.*

193. According to the Statement of the Managers:

The overriding purpose of our Nation's securities laws is to protect investors and to maintain confidence in the securities markets, so that our national savings, capital formation and investment may grow for the benefit of all Americans.

The private securities litigation system is too important to the integrity of American capital markets to allow this system to be undermined by those who seek to line their own pockets by bringing abusive and meritless suits. Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely on government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and other properly perform their jobs. This legislation seeks to return the securities litigation system to that high standard.


194. See infra notes 295-309 and accompanying text.
B. The Legislative History of Section 21D(b)(2)

1. The Second Circuit "Strong Inference" Standard and the Conflict Among the Circuits

The legislative history of section 21D(b) must begin with the split among the circuits regarding the Second Circuit's "strong inference" pleading standard. Describing the Second Circuit's Ross decision as "contra," the First Circuit in McGinty v. Beranger Volkswagen, Inc., selected to follow "[t]he clear weight of authority . . . that Rule 9[(b)] requires specification of the time, place, and content of an alleged false representation, but not the circumstances or evidence from which fraudulent intent could be inferred." Many courts followed the First Circuit and McGinty in rejecting Second Circuit law on this point.

However, in 1992, with the decision of Greenstone v. Cambex, the First Circuit departed from the rule it set down in McGinty, without so much as citing that decision, to state that "[t]he courts have uniformly held inadequate a complaint's general averment of the defendant's 'knowledge' of material falsity, unless the complaint also sets forth specific facts that make it reasonable to believe that defendant knew that a statement was materially false or misleading." The court affirmed dismissal of a complaint on the ground that "[t]he inferential links are weak.

In 1993, a three-judge panel in the Ninth Circuit followed Second Circuit decisions, holding that "[a]lthough Rule 9(b) allows scienter to be pleaded generally, courts have required that the facts pled provide a
basis for a strong inference of fraudulent intent." 201 "The real inquiry," the court wrote, "must be whether the facts in the amended complaint would give rise to an inference that the Defendants either did not believe the statements or knew that the statements were false." 202

The Ninth Circuit granted rehearing and convened en banc, then issued an opinion vacating the panel opinion and rejecting Second Circuit law as "irreconcilable with the second sentence of Rule 9(b)." 203 To demand any inference of scienter would "conflict[] both with the English rule which was the model for Rule 9(b) and with the second sentence of Rule 9(b) itself, which declares unequivocally that state of mind may be averred generally, and says absolutely nothing about required inferences." 204 Nonetheless, the GlenFed court imposed requirements for pleading falsity that may be more demanding than some Second Circuit decisions. 205

GlenFed placed the Ninth Circuit in direct conflict with the Second Circuit, while decisions in the First, Fifth, and Seventh Circuits appeared to join the Second Circuit in requiring allegations to raise an inference of scienter. 206 Decisions from other courts adhered to the rule stated by the en banc panel in GlenFed. 207

In the summer of 1994, SEC Chairman Arthur Levitt testified before the Subcommittee on Telecommunications and Finance of the House of Representatives Committee on Energy and Finance that "there is a split in the circuits regarding the application of Rule 9(b) in securities fraud

202. Id. at 849.
203. In re GlenFed, Inc. Sec. Litig., 42 F.3d 1541, 1545 (9th Cir. 1994).
204. Id. at 1546. The Ninth Circuit explained:
We are not permitted to add new requirements to Rule 9(b) simply because we like the effects of doing so. This is a job for Congress, or for the various legislative, judicial, and advisory bodies involved in the process of amending the Federal Rules.
205. See supra notes 82-108 and accompanying text.
206. See Greenstone v. Cambex Corp., 975 F.2d 22, 25 (1st Cir. 1992); Tuchman v. DSC Communications Corp., 14 F.3d 1061, 1068 (5th Cir. 1994); DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir. 1990), cert. denied, 498 U.S. 941 (1990).
Chairman Levitt observed that “[a]lthough the particularity requirement of Rule 9(b) does not apply by its terms to allegations regarding a defendants’ state of mind, some courts nevertheless require that plaintiffs plead with some particularity the facts suggesting that a defendant had the requisite scienter.” He testified that “the First, Fifth, and Seventh Circuits have all started to require a similar `inference’ in cases involving scienter, but that other circuits continue to apply the more liberal standard.” Chairman Levitt told Congress that “[i]t would be beneficial to harmonize the differing standards applied by the circuit courts of appeal on this issue, either under the auspices of the Judicial Conference of the United States or through legislation,” after “a careful evaluation of the experience with the Second Circuit’s approach.”

2. The Legislative Response

Congress acted to resolve the conflict among the circuits on the requirements for pleading securities fraud, ultimately adopting the Ninth Circuit approach to pleading falsity with particularity and the Second Circuit approach to pleading scienter. Further, after first considering revisions that might abolish liability for recklessness, Congress decided to eliminate recklessness liability only for certain forward-looking statements.

a. Congressional Hearings and Early Drafts
   Culminating in Passage of H.R. 1058

In early 1995, the bills proposed to address securities litigation matters did not incorporate the Second Circuit’s “strong inference” standard. Proposals that would have eliminated liability for reckless misconduct were considered, but after drawing a hostile response from the SEC, were quickly abandoned.

As introduced on January 4, 1995, Title II of H.R. 10 provided for changes to the federal securities laws and included new provisions regarding both the state of mind required to establish liability, and the

209. Id. at 38.
210. Id.
211. Id.
rules for pleading that state of mind. It would have added a new section 10A(a) to the Exchange Act, apparently abolishing monetary liability for reckless misconduct by requiring proof that a “defendant knew [a] statement was misleading at the time it was made, or intentionally omitted to state a fact knowing that such omission would render misleading the statements made at the time they were made.” It

213. H.R. 10, 104th Cong., 1st Sess. § 204 (1995), would have added a new section 10A which would have provided:

SEC. 10A. REQUIREMENTS FOR SECURITIES FRAUD ACTIONS. (a) SCIENTER. — In any action under section 10(b), a defendant may be held liable for money damages only on proof —

1. that the defendant made an untrue statement of a material fact, or omitted to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading; and
2. that the defendant knew the statement was misleading at the time it was made, or intentionally omitted to state a fact knowing that such omission would render misleading the statements made at the time they were made.

(b) REQUIREMENT FOR EXPLICIT PLEADING AND PROOF OF SCIENTER. — In any action under section 10(b) in which it is alleged that the defendant —

1. made an untrue statement of a material fact; or
2. omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading; the complaint shall allege specific facts demonstrating the state of mind of each defendant at the time the alleged violation occurred. The complaint shall also specify each statement or omission alleged to have been misleading and the reasons the statement or omission is misleading. If an allegation regarding the statement or omission is made on information and belief, the complaint shall set forth with specificity all information on which that belief is formed. Failure to comply fully with this requirement shall result in dismissal of the complaint for failure to state a cause of action.

Id.

214. Id. By imposing liability only for “an untrue statement of a material fact, or omission to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading,” the new section 10A would have effectively eliminated liability for violations of Rule 10b-5(1) and 10b-5(2), which make it unlawful “to employ any device, scheme, or artifice to defraud,” or “to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.” 17 C.F.R. § 240.10b-5(a), (c). This would have effectively limited liability under section 10(b) to violations of Rule 10b-5(2), which makes it unlawful “to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they
also would have added a new Section 10A(b), requiring a section 10(b) complaint to "allege specific facts demonstrating the state of mind of each defendant at the time the alleged violation occurred."\textsuperscript{215} The bill was referred to the House Committee on Commerce, and the Committee on the Judiciary.\textsuperscript{216} The Commerce Committee's Subcommittee on Telecommunications and Finance then held hearings in January and February of 1995.\textsuperscript{217}

As introduced by Senator Domenici on January 18, 1995,\textsuperscript{218} S. 240 would have added a new section 39 to the Exchange Act, providing:

In an implied action arising under this title in which the plaintiff may recover money damages from a defendant only on proof that the defendant acted with some level of intent, the plaintiff's complaint shall \textit{allege specific facts demonstrating the state of mind of each defendant} at the time the alleged violation occurred.\textsuperscript{219}

were made, not misleading." 17 C.F.R. § 10b-5(b). Ultimately, Congress chose not to enact language overruling the many decisions that have recognized liability under section 10(b) for a "device, scheme, or artifice to defraud," or for conduct that "operates as a fraud or deceit." E.g., Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976) (noting that section 10(b)'s phrase prohibiting "any manipulative device or contrivance" by definition includes schemes to defraud) (quoting \textit{WEBSTER'S INTERNATIONAL DICTIONARY} (1934)); Affiliated Ute Citizens v. United States, 406 U.S. 128, 150, 152-53 (1972) (noting that although "the second subparagraph of the rule specifies the making of an untrue statement of a material fact and the omission to state a material fact," nonetheless "[t]he first and third subparagraphs are not so restricted . . ." and impose liability for defendants' conduct which fall "within the very language of one or the other of those subparagraphs, a 'course of business' or a 'device, scheme, or artifice' that operated as a fraud"); Blackie v. Barrack, 524 F.2d 891, 903 n.19 (9th Cir. 1975) ("Rule 10b-5 liability is not restricted solely to isolated misrepresentations or omissions; it may also be predicated on a 'practice, or course of business which operates . . . as a fraud . . .'"), \textit{cert. denied}, 429 U.S. 891 (1976); Competitive Associates, Inc. v. Laventhal, Krekstein, Horwath & Horwath, 516 F.2d 811, 814 (2d Cir. 1975) ("Not every violation of the anti-fraud provisions of the federal securities law can be, or should be, forced into a category headed 'misrepresentations' or 'nondisclosures.' Fraudulent devices, practices, schemes, artifices and courses of business are also interdicted by the securities laws."); \textit{In re ZZZZ Best Sec. Litig.}, 864 F. Supp. 960, 967-72 (C.D. Cal. 1994) (reviewing principles and precedents dealing with "scheme to defraud" liability); \textit{In re Union Carbide Corp. Consumer Products Business Sec. Litig.}, 676 F. Supp. 458, 467-69 (S.D.N.Y. 1987).  

\textsuperscript{216} 141 CONG. REC. H124 (daily ed. Jan. 4, 1995).  
\textsuperscript{218} 141 CONG. REC. S1070, S1075-84 (daily ed. Jan. 18, 1995).  
\textsuperscript{219} S. 240, 104th Cong., 2d Sess. § 104 (1995) (emphasis added). The new section 39 would have provided:

\textbf{SEC. 39. REQUIREMENTS FOR SECURITIES FRAUD ACTIONS}

(a) \textbf{INTENT.} — In an implied private action arising under this title in which the plaintiff may recover money damages from a defendant only on proof that the defendant acted with some level of intent, the plaintiff's complaint shall \textit{allege specific facts demonstrating the state of mind of each defendant} at the time the alleged violation occurred.
It also would have required plaintiffs asserting claims under Rule 10b-5(2) to “specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the plaintiff shall set forth all information on which that belief is formed.”\textsuperscript{220} S. 240 was referred to the Senate Committee on Banking, Housing, and Urban Affairs.\textsuperscript{221} Its Subcommittee on Securities held hearings on the bill in March and April of 1995.\textsuperscript{222}

SEC Chairman Arthur Levitt condemned H.R. 10 in his February 10, 1995 testimony before the Subcommittee on Telecommunications and Finance of the House Committee on Commerce.\textsuperscript{223} He warned that our capital markets “could be seriously harmed by overzealous legislation,” because “private rights of action are fundamental to the success of those markets.”\textsuperscript{224} Among the SEC’s objections to H.R. 10 was the issue of scienter.\textsuperscript{225}

The SEC was “against any proposal to require a plaintiff to prove that the defendant had actual knowledge” that statements were false.\textsuperscript{226} Liability for reckless misconduct was “needed to protect the integrity of
the disclosure process which . . . represents the integrity of the markets." Chair
man Levitt explained:

We really want corporations—we want executives of corporations—to worry
about the accuracy of their disclosures. It is the best way I know to assure the
markets of a continuous stream of reliable, accurate information. Any higher
scienter standard threatens the process that has made our markets what they are.
Indeed, an actual knowledge standard could create a legal incentive to ignore
indications of fraud. The phrase, "Ignorance is bliss," could take on, unhappily,
new meaning.

Chairman Levitt's prepared remarks underscored the SEC's objections
to eliminating liability for reckless misconduct. By "requiring proof
that the defendant acted knowingly and intentionally," H.R. 10 signalled
"a retreat from the recklessness standard [that] would greatly erode the
deterrent effect of private actions." Chairman Levitt explained:

The Commission has consistently supported a recklessness standard because
such a standard is needed to protect the integrity of the disclosure process. The
law should sanction corporations and individuals who act recklessly when
making disclosures, because that is the only way to assure the markets of a
continuous stream of accurate information. Any higher scienter standard would
lesser the incentives for corporations and other issuers to conduct a full inquiry
into areas of potential exposure, and thus threaten the process that has made our
markets a model for nations around the world.

Moreover, because an actual knowledge standard would virtually foreclose
recovery against attorneys, accountants, and financial advisers, it would reduce
the degree to which such professional advisers encourage full and complete
disclosure.

Chairman Levitt's prepared remarks also indicated that "[t]he
Commission believes that it would be beneficial to resolve the split
between the circuits regarding the proper application of Rule (9b)."
Chairman Levitt noted that the Second Circuit "has long required that
plaintiffs pleading securities fraud alleged facts giving rise to a 'strong
inference' of fraudulent intent on the part of the defendants," and
other courts had recently "started to require a similar 'inference of
scienter.'" But H.R. 10 demanded too much. It would "require

227. Id.
228. Id. at 194-95.
229. Id. at 201-02.
230. Id. at 202.
231. Id.
232. Id. at 199 (emphasis added).
233. Id. (emphasis added) (citing Ross v. A.H. Robbins Co., 607 F.2d 545, 558 (2d
Cir. 1979), cert. denied, 446 U.S. 946 (1980)).
234. Id. (citing Greenstone v. Cambex Corp., 975 F.2d 22, 25 (1st Cir. 1992);
Tuchman v. DSC Communications Corp., 14 F.3d 1061, 1068 (5th Cir. 1994); Di Leo
Chairman Levitt noted that other courts of appeal had rejected this approach on the
plaintiffs to plead specific facts ‘demonstrating’ the state of mind of each
defendant—a test which arguably is more severe than that employed in
any of the circuits today.” Chairman Levitt noted that many
plaintiffs would not be able to demonstrate a defendant’s state of mind
without having the chance to conduct discovery.

On February 14, 1995, after hearings on H.R. 10, the Subcommittee
on Telecommunications and Finance approved an amendment to Title II
of H.R. 10 in the form of a substitute, and it then ordered the bill as
amended reported to the full Committee. The substitute’s provision
took a step toward restoring liability for reckless misconduct. Its
ground that it goes beyond the language of Rule 9(b). Id. (citing In re GlenFed, Inc.
Sec. Litig., 42 F.3d 1541 (9th Cir. 1994) (en banc); Phelps v. Wichita Eagle-Beacon, 886
F.2d 1262, 1270 n.5 (10th Cir. 1989); Auslender v. Energy Management Corp., 832 F.2d
354, 356 (6th Cir. 1987)).

236. Id. Specifically, Mr. Levitt stated: “It is likely that there would be many cases
in which plaintiffs with meritorious claims would be unable to make such a demonstra-
tion without an opportunity to conduct discovery.” Id.


238. It did so with a convoluted and confusing text that appeared to require
plaintiffs to prove that fraud was both intentional and reckless. H.R. 10, Committee
Print Showing the Amendment in the Nature of a Substitute to Title II of H.R. 10
Adopted By the Subcommittee on Telecommunications and Finance. (Feb. 14, 1995).
The new Section 204 of H.R. 10 called for adding a new Section 10A(a) to the
Exchange Act, providing:

(a) SCIENTER.—

(1) IN GENERAL.—In any private action arising under this title based on
a misstatement or omission of a material fact, liability may not be
established unless the defendant possessed the intent to deceive,
manipulate, or defraud. The defendant may be found to have acted with
such intent only on proof that—

(A) the defendant directly or indirectly made a fraudulent statement;

(B) the defendant possessed the intention to deceive, manipulate, or
defraud; and

(C) the defendant made such fraudulent statement knowingly or
recklessly.

(2) FRAUDULENT STATEMENT.—For purposes of paragraph (1), a
fraudulent statement is a statement that contains an untrue statement of
a material fact, or omits a material fact necessary in order to make the
statements made, in the light of the circumstances in which they were
made, not misleading.

(3) KNOWINGLY.—For purposes of paragraph (1), a defendant makes
a fraudulent statement knowingly if the defendant knew that the
statement of a material fact was misleading at the time it was made, or
knew that an omitted fact was necessary in order to make the statements
made, in the light of the circumstances in which they were made, not
provision on pleading scienter required plaintiffs to “make specific allegations which, if true, would be sufficient to establish scienter as to each defendant at the time the alleged violation occurred.”

The SEC responded swiftly with a press release on February 15, 1995, expressing concern regarding the amended bill’s provisions—including the “pleading requirements, [and] the standard to establish reckless conduct”—concluding that “[b]ecause of the potential impact on U.S. investors and markets, the Commission cannot support the proposed provisions.” Chairman Levitt sent a letter to Representative Bliley explaining that the SEC opposed the amended bill’s provisions, including those on “the standard to establish recklessness, [and] the pleading requirements,” because “these provisions would adversely affect the interests of U.S. investors.” Chairman Levitt assured Representative Bliley that the SEC supported his “effort to craft balanced legislation,” but warned that “the proposed language approved yesterday does not achieve the balance we would seek.”

The next day, the subcommittee agreed to an amendment submitted by Representative Cox, which further refined the statutory definition of misleading.

(4) RECKLESSNESS. — For purposes of paragraph (1), a defendant makes a fraudulent statement recklessly if the defendant, in making such statement, acted with willful blindness such that the defendant was consciously aware of a high probability that the statement was false, and took deliberate actions in order to avoid ascertaining its truth or falsity. A defendant who actually believed the statement was true is not reckless.

H.R. 10, Committee Print § 204 (Feb. 14, 1995) (emphasis added).


(b) REQUIREMENT FOR EXPLICIT PLEADING AND PROOF OF SCIENTER. — In any private action to which subsection (a) applies, the complaint shall specify each statement or omission alleged to have been misleading, and the reasons the statement or omission is misleading. The complaint shall also make specific allegations which, if true, would be sufficient to establish scienter as to each defendant at the time the alleged violation occurred. It shall not be sufficient for this purpose to plead the mere presence of facts inconsistent with a statement or omission alleged to have been misleading. If an allegation is made on information and belief, the complaint shall set forth with specificity all information on which that belief is formed.

H.R. 10, Committee Print §204 (Feb. 14, 1995).


242. Id.
recklessness.\textsuperscript{243} This definition paralleled the \emph{Sundstrand} standard adopted by the federal courts and endorsed by the SEC.\textsuperscript{244} The SEC responded, stating that "the current version of H.R. 10 represents an improvement over the bill as originally introduced," in part because it now expressly "preserved liability based on reckless conduct."\textsuperscript{245} Still, the SEC objected that the text might inadvertently extend scienter requirements to section 14 and section 18 claims, which required no showing of scienter,\textsuperscript{246} and it recommended revising the definition of recklessness to more closely conform to the \emph{Sundstrand} formulation.\textsuperscript{247}

\begin{verbatim}
243. Representative Cox's amendment revised subsection (4) to read:
(4) RECKLESSNESS. — For purposes of paragraph (1), a defendant makes a fraudulent statement recklessly if the defendant, in making such statement, is guilty of highly unreasonable conduct that (A) involves not merely simple or even gross negligence, but an extreme departure from standards of ordinary care, and (B) presents a danger of misleading buyers or sellers that was either known to the defendant or so obvious that the defendant must have been consciously aware of it. For example, a defendant who genuinely forgot to disclose, or to whom disclosure did not come to mind, is not reckless.

Amendment to the Amendment in the Nature of a Substitute (Feb. 16, 1995) (copy on file with the authors). This provision deviated from the \emph{Sundstrand} standard itself in two respects. First, the word "consciously" does not appear in \emph{Sundstrand}. Second, the final sentence, giving an example of conduct that would not be reckless, is completely new.

244. See supra notes 115-16 and accompanying text.


246. \textit{Id.} at 43. The SEC objected that the text "would have the effect of requiring a showing of scienter in proxy cases brought under Section 14 of the Exchange Act and disclosure cases brought under Section 18, neither of which currently has a scienter requirement, in addition to cases under Section 10(b)." \textit{Id.}

247. \textit{Id.} at 43-44. The SEC explained:
Subsection 10A(a) would provide that liability in a private action may be based on conduct that satisfies a definition of recklessness based generally on the standard enunciated by the Seventh Circuit Court of Appeals in \emph{Sunstrand Corporation v. Sun Chemical Corporation}. The \emph{Sunstrand} definition has been altered by adding the word "consciously" near the end of the first sentence, and by adding the second sentence, which paraphrases a footnote in the \emph{Sunstrand} opinion. The extent to which these amendments would change the result in any particular case is unclear, but the Commission believes that it would be preferable simply to codify the \emph{Sunstrand} definition as currently applied by a majority of the federal circuit courts.

\textit{Id.} The SEC also recommended "that the second part of the three part test in Subsection 10A(a) be deleted as redundant, as a defendant's intent to deceive, manipulate or defraud is established by evidence that the defendant knowingly or recklessly made a fraudulent statement." \textit{Id.}
\end{verbatim}
The SEC also objected to the provision on pleading scienter:

For purposes of pleading scienter, subsection (b) of new Section 10A would require a plaintiff to make specific allegations which, if true, would be sufficient to “establish” that the defendant acted knowingly or recklessly. It then adds that “it shall not be sufficient for this purpose to plead the mere presence of facts inconsistent with a statement or omission alleged to have been misleading.”

As the Commission noted in its testimony, it would be beneficial to resolve the existing split between the circuit courts regarding pleading requirements under Rule 9(b) of the Federal Rules of Civil Procedure. In the Commission’s view, however, the standard in H.R. 10 would place unrealistic demands on plaintiffs. The Second Circuit Court of Appeals currently requires that plaintiffs plead with some particularity facts giving rise to a “strong inference” of fraudulent intent on the part of the defendant. This test is regarded as being the most stringent used today, and the Commission recommends that Congress not enact any pleading requirements that go beyond those used by the Second Circuit.

The SEC’s objections and suggestions were included in the Commerce Committee’s report on the bill. The committee report explained that its restatement of the Sundstrand standard, “particularly as it has been applied in the case law of the Second and Seventh Circuits, will provide the degree of consistency and certainty,” but that “[i]n adopting a standard that includes language from the Sundstrand case . . . the Committee notes that it in no way intends to codify all of the prior case law—indeed, any particular case—purporting to apply that decision.” As to pleading scienter, the Committee explained that the bill would require a plaintiff to “specify each statement or omission alleged to have been misleading and must make specific allegations which, if true, would be sufficient to establish that the defendant acted knowingly or recklessly.”

The text of Title II of H.R. 10, as amended and reported by the Commerce Committee, was introduced by Representative Bliley on February 27, 1995, as a new bill, H.R. 1058. The bill was considered and amended by the House on March 7 and 8, 1995, conforming its language on recklessness more precisely to the Sundstrand standard.

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248. Id. at 44.
250. Id. at 39.
251. Id. (emphasis added).
252. Id. (emphasis added).
The House of Representatives clearly intended to preserve recklessness as a basis of liability.

It did not intend to require proof of scienter in a complaint. On the floor of the House, Representative Cox defended H.R. 1058’s requirement that a complaint must “make specific allegations which, if true, would be sufficient to establish scienter as to each defendant at the time the alleged violation occurred.” He declared that this phrase was not intended to require proof of scienter in the complaint:

First of all, we are talking today about allegations, so we do not need to know that they are true. You simply allege it and you get on with your lawsuit, you go through discovery, you take depositions, you subpoena records, and so on, and see if you can back up those allegations. But you make the allegations in your complaint; you do not put the proof in your complaint.

Second, you can do it on information and belief, so you just state in your pleading that the plaintiff is informed and believes and thereupon alleges that—and that is very, very easy to do. The complaint shall make allegations which, if true, would be sufficient to establish Scienter.

So for purposes of judging the pleading, all the court does is assume all of the allegations are true even before you have actually proved them, and if added together, assuming their truthfulness, they would state a cause of action and you get by judgment on the pleadings, and away you go and you are off with your lawsuit. That is the way it ought to work.

Representative Cox defended his bill’s language against a proposed amendment offered by Representative Bryant, explaining that:

254. 141 CONG. REC. H2749-H2780 (daily ed. March 7, 1995), 141 CONG. REC. H2818-H2864 (daily ed. March 8, 1995). Representative Fields offered an amendment of technical and conforming changes that, among other things, struck the word “consciously” from the definition of recklessness. Id. at H2779. Representative Fields’s amendment also narrowed the scope of the scienter requirement, so that it would apply only to actions under section 10(b), and not to actions under section 14 or Section 18. Id. The amendment was agreed to without dissent on March 7. Id.

On March 8, Representative Eshoo offered an amendment that would strike the following words: “For example, a defendant who genuinely forgot to disclose or to whom disclosure did not come to mind is not reckless.” 141 CONG. REC. H2818 (daily ed. March 8, 1995). Representative Eshoo explained that Congress should delete the “sentence which allows the defendant to escape liability” for reckless fraud, by saying “I forgot to tell the truth.” Id. Representative Cox agreed that the objectionable sentence might be removed, but his substitute inserted the following language in its place: “Deliberately refraining from taking steps to discover whether one’s statements are false or misleading constitutes recklessness, but if the failure to investigate was not deliberate, such conduct shall not be considered to be recklessness.” Id. at H2820. The amendment offered by Representative Cox as a substitute for the amendment offered by Representative Eshoo was agreed to by a roll call vote. Id. at H2826.

[W]e are not asking anyone do anything other than allege. We are asking people to make an allegation. That is[,] they can charge something. They do not have to prove it until later. 257

And he contrasted the House bill with what he believed to be the more demanding alternative text of S. 240, which would require plaintiffs to "allege specific facts demonstrating the state of mind of each defendant," 258 explaining that the House bill required less than this. With these assurances from the bill's leading proponent, H.R. 1058 passed the House on a vote of 325 to 99. 259

b. The Pleading Standard in Senate Hearings

The House bill was received by the Senate and referred to the Senate Committee on Banking, Housing, and Urban Affairs. 260 Its Subcommittee on Securities held hearings on H.R. 1058 and on S. 240 in March and April of 1995. 261

On April 6, 1995, SEC Chairman Arthur Levitt, Jr. testified before the subcommittee, 262 calling S. 240 "a positive step," but urging Congress to revise the legislation's provisions relating to state of mind. 263 He again asked Congress "to work together to make certain

258. Id. The Dodd-Domenici proposal is as follows:

The complaint shall allege specific facts demonstrating the state of mind of each defendant.

Rep. Cox explained that:

[W]e had a lot of complaints about that language on our side because people said, "Well, you would have to be a mind reader in order to demonstrate the state of mind of each defendant." So now our bill no longer says that. It says that the complaint shall specify each statement or omission alleged to have been misleading. Those are objective facts and the reasons that the statement or omission was misleading. That is factual as well, and of course one only has to allege it.

The complaint shall also make specific allegations which, if true, would be sufficient to establish scienter. So one only has to allege things which, if true, if they were proved later, would add up to a case that meets all the requirements of the existing law.

141 CONG. REC. H2850 (daily ed. March 8, 1995).
259. 141 CONG. REC. H2863-64 (daily ed. March 8, 1995).
261. Id. The subcommittee held hearings on March 2, March 22, and April 6, 1995.
262. Id. at 228-36, 247-57 (opening and prepared statements of Arthur Levitt and colloquy).
263. Id. at 230.
improvements in the bill, including the adoption of the Second Circuit’s pleading requirement that plaintiffs plead with particularity . . . facts that give rise to a strong inference of fraudulent intent by the defendant.”

When asked about his primary concerns with the proposed legislation, Chairman Levitt reiterated that “the standards for pleading a defendant’s state of mind should be conformed to the Second Circuit standard . . ..” He urged the senators to use the Sundstrand standard of recklessness, to “avoid the kind of confusion that would result from the present wording.” “Those two areas,” he testified, “are probably the most important.”

Chairman Levitt’s prepared remarks similarly urged the adoption of the Second Circuit’s pleading requirement, that plaintiffs plead with particularity facts giving rise to a “strong inference” of fraudulent intent by the defendant. Chairman Levitt explained:

“T]here is a split between the circuit courts regarding the manner in which Rule 9(b) should be interpreted. The Second Circuit Court of Appeals requires that a plaintiff pleading securities fraud allege facts that give rise to a “strong inference” of fraudulent intent on the part of the defendant. This requirement may be satisfied either by alleging facts that establish a motive to commit fraud and an opportunity to do so, or by alleging facts that constitute circumstantial evidence of either reckless or conscious behavior . . . . Other courts of appeal, however, including most recently the Ninth Circuit, have rejected this approach on the grounds that it goes beyond the plain language of Rule 9(b).”

He further observed:

The pleading provision in the House bill would require a plaintiff “to make specific allegations which, if true, would be sufficient to establish scienter as

264. Id.; see also id. at 235-36 (“I think this notion of state of mind is so vague and open to so many different interpretations, that I really believe that we should conform to the Second Circuit standard that plaintiffs plead with particularity facts that give rise to a strong inference of fraudulent intent. And I think by codifying that, we accomplish pretty much what we intend to accomplish with respect to pleadings.”).

265. Id. at 231.

266. Id.

267. Id.

268. Id. at 247.


271. In re GlenFed Inc. Sec. Litig., 42 F.3d, 1541, 1547 (9th Cir. 1994); Phelps v. Wichita Eagle-Beacon, 886 F.2d 1262, 1270 n.5 (10th Cir. 1989); Auslender v. Energy Management Corp., 832 F.2d 354, 356 (6th Cir. 1987).
to each defendant.” Unless facts giving rise to “a strong inference” of scienter are viewed as sufficient to “establish” scienter, this test is more stringent than even the standards currently imposed by the Second Circuit. The pleading requirement proposed in the Domenici-Dodd bill would require a plaintiff to “allege specific facts demonstrating the state of mind of each defendant.” This test may be less onerous than that provided in the House bill, but the use of the word “demonstrating” may still create a standard more stringent than the Second Circuit standard.

Chairman Levitt then recommended “that the language be amended to conform with the language actually used by the Second Circuit, which has been clarified and refined by the case law and is therefore less likely to generate additional litigation.”

Chairman Levitt warned that “it is unrealistic to expect a plaintiff, at the commencement of an action, to be able to present facts specifically demonstrating that a defendant acted with the requisite state of mind.” “Indeed, in most cases it may be impossible at the pleading stage, before any discovery has been taken, to meet such a burden.”

Chairman Levitt was concerned with any provision that:

“[I]t shall not be sufficient . . . to plead the mere presence of facts inconsistent with a statement or omission alleged to have been misleading.” The contemporaneous existence of facts inconsistent with a defendant’s statement is the type of evidence often relied upon by a plaintiff to establish an inference of scienter. Indeed, it may be the only evidence available to a plaintiff prior to discovery.

To resolve the split between the circuits regarding the proper application of Rule 9(b), the Commission recommended that Congress obtain input from the Advisory Committee on Civil Rules of the Judicial Conference of the United States prior to enacting any legislation. The Commission further recommended “that Congress not enact any pleading requirements that go beyond those used by the Second Circuit, which are regarded as being the most stringent used today.”

c. The “Strong Inference” Provision Enters S. 240’s Text

The Second Circuit’s “strong inference” standard was added by the Senate Banking Committee in order to bring the nation’s other courts

272. Securities Litigation Reform Proposals, at 249.
273. Id.
274. Id. at 248.
275. Id. at 248.
276. Id. at 249 n.9.
277. Id. at 249.
278. Id.
into line with the Second Circuit precedents on pleading scienter. The committee report explained:

The courts of appeals have interpreted Rule 9(b) in different ways, creating distinctly different pleading standards among the circuits.

The Committee does not adopt a new and untested pleading standard that would generate additional litigation. Instead, the Committee chose a uniform standard modeled upon the pleading standard of the Second Circuit. Regarded as the most stringent pleading standard, the Second Circuit requires that the plaintiff plead facts that give rise to a “strong inference” of defendant’s fraudulent intent. The Committee does not intend to codify the Second Circuit’s case law interpreting this pleading standard, although courts may find this body of law instructive. 279

As reported by the Banking Committee, S. 240 would have added a new section 36 substantially similar to the text eventually enacted as section 21D(b):

SEC. 36. REQUIREMENTS FOR SECURITIES FRAUD ACTIONS
   (a) MISLEADING STATEMENTS AND OMISSIONS. — In any private action arising under this title in which the plaintiff alleges that the defendant —
      (1) made an untrue statement of a material fact; or
      (2) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading; the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the plaintiff shall set forth all information on which that belief is formed.
   (b) REQUIRED STATE OF MIND. — In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the plaintiff’s complaint shall, with respect to each act or omission alleged to violate this title, specifically allege facts giving rise to a strong inference that the defendant acted with the required state of mind. 280

According to the Senate Report, the “strong inference of scienter” language came from Second Circuit precedents. 281 From Rule 9(b),

280. S. 240, 104th Cong. (1995). In summary, the Committee report explained: Section 104(b) amends the 1934 Act by adding a new Section 36, establishing pleading standards for Section 10(b) actions alleging untrue statements or omissions of a material fact. The complaint must specifically identify each misleading statement and the reason or reasons why it is misleading. In any private action to recover money damages, the plaintiff must, for each misstatement or omission, specifically allege facts giving rise to a strong inference that the defendant acted with the required state of mind.

and the case law interpreting it, came the GlenFed requirement that "[t]he plaintiff . . . specifically identify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if the allegation is made on information and belief, the plaintiff must set forth all information in plaintiff's possession on which the belief is formed."282

The clear adoption of Second Circuit pleading standards pleased the SEC and the White House. On June 21, 1995, the SEC informed the OMB that "[t]he Commission supports, or does not oppose, the measures set forth in Section 104, 'Requirements for Securities Fraud Actions.'"283 The Executive Office of the President, Office of Management and Budget, on June 23, 1995, issued a Statement of Administration Policy announcing that "S. 240 is now a substantial improvement on H.R. 1058, which the Administration could not support."284 It noted that S.240 "adopts several sensible provisions, including a workable pleading standard taken from the Second Circuit."285 Although the SEC and administration urged other modifications to the bill,286 adoption of the Second Circuit pleading standard met with approval from the executive branch.

d. Senator Arlen Specter's Proposed Amendment

Section 240 was debated by the Senate and amended in June, 1995.287 Although all agreed that S. 240's text drew the "strong inference" standard from the Second Circuit case law, Senator Arlen Specter proposed an amendment intended to further clarify the phrase by

282. Id.
285. Id.
restating other language from Second Circuit case law in the text of the statute. Specifically, Senator Specter proposed adding the following language to expressly define how a “strong inference” of scienter might be raised:

[A] strong inference that the defendant acted with the required state of mind may be established either —

(A) by alleging facts to show that the defendant had both motive and opportunity to commit fraud; or

(B) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness by the defendant. 289

Senator Specter explained that by adding the “strong inference” phrase, “what the draftsmen have done is gone to the Court of Appeals for the [S]econd [C]ircuit, and they have drafted a type of pleading requirement which was articulated by the chief judge of the court of appeals by the name of John Newman.” 290 Senator Specter told his colleagues that the Second Circuit standard is “the toughest standard around and that is fine.” 291 He said the Second Circuit Court of Appeals established guidelines for what would give rise to an inference of scienter so that plaintiffs would not have to guess what the standard meant. 292 In Beck v. Manufacturers Hanover Tr. Co., 293 Judge Newman’s opinion for the court held:

A common method for establishing a strong inference of scienter is to allege facts showing a motive for committing fraud and a clear opportunity for doing so. Where motive is not apparent, it is still possible to plead scienter by identifying circumstances indicating conscious behavior by the defendant, though the strength of the circumstantial allegations must be correspondingly greater. 294

Senator Specter explained that the purpose of his amendment was to incorporate the terminology Judge Newman used in Beck when he “posed this very tough standard [for] pleading.” 295 However, Senator

289. Id.
291. Id.
292. Id.
293. 820 F.2d 46, 50 (2d Cir. 1987).
294. Id. at S9171 (statement of Sen. Specter) (quoting Beck v. Manufacturers Hanover Tr. Co., 820 F.2d 46, 50 (2d Cir. 1987)).
295. Id. (statement of Sen. Specter). Senator Specter further commented: “What I am trying to do in this amendment is simply complete the picture and have in the statute
Specter's amendment failed to indicate that less particularity was required when plaintiffs could allege motive and opportunity. Because the Senate Banking Committee's report stated that the committee had chosen "a uniform standard modeled upon the pleading standard of the [S]econd [C]ircuit," Senator Specter was puzzled by the committee's further assertion that it did not "intend to codify the [S]econd [C]ircuit's case law interpreting this pleading standard." His proposed amendment would "complete the picture . . . so that people know what they are to do on the pleading."

Senator Bennett, who served on the Senate Banking Committee when it adopted the "strong inference" language—and who would later serve as a Manager of the Conference Committee—responded that the Committee did want to codify the Second Circuit standard, but that it "intentionally did not provide language to give guidance on exactly what evidence would be sufficient to prove facts giving rise to a strong inference of fraud." He explained:

[The committee] felt that with the [S]econd [C]ircuit standard being written into the bill, it was best to stop at that point and allow the courts then the latitude that would come beyond that point.

The next day, on June 28, 1995, Senator Specter again urged amendment of the pleading provision, explaining that the amendment accepts "the very stringent standard of the [S]econd [C]ircuit on pleading to show state of mind, and then it adds to the legislation the way the [S]econd [C]ircuit says you can allege the necessary state of mind." Senator D'Amato, who had chaired the Senate Banking Committee and submitted its report on the "strong inference" language—and who would later serve as a Manager of the Conference Committee—argued that Senator Specter's amendment, would "place too great a burden on plaintiffs" by limiting the ways in which scienter could be demonstrated:

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297. Id. at S9171 (statement of Sen. Specter). Specifically, Senator Specter stated: "[I]t is one thing for the committee to say that they are not adopting a new and untested pleading standard, but it is only halfway if it does not put into the statute but leaves open the question of how you meet this standard." Id.
298. See S. Rep. No. 104-98, at II.
299. See H.R. CONF. REP. No. 104-369 at 13699.
301. Id.
303. S. Rep. No. 104-98 at II.
S. 240 codifies the Second Circuit pleading standard, but this amendment goes further, to say precisely what evidence a party may present to show a strong inference of fraudulent intent. I think this straitjackets the court.

Having said that, I could accept referring to the court's interpretation, but I think we are going too far if we adopt the language that the court referred to because it would tie the court's hand by forcing it to ask that plaintiffs prove exactly the delineated facts; alleging facts to show the defendant had both the motive and opportunity to commit fraud and by alleging facts that constitute strong circumstantial evidence.

To be quite candid with you, I think it places too great a burden on the plaintiffs . . . . We tried to be balanced in setting this standard[,] that is why we did not straitjacket the court with the language in this amendment.\textsuperscript{305}

Nonetheless, Senator Specter's amendment passed by a vote of 57 to 42\textsuperscript{306} and became a part of S. 240 as it passed the Senate by a vote of 70 to 29 on June 28, 1995.\textsuperscript{307}

e. The Conference Report Statement of the Managers Adopts the Second Circuit Standard

The legislation's proponents worked on draft conference reports, to reconcile the House and Senate legislation, in the fall of 1995. Draft conference reports began appearing as early as October 23, 1995.\textsuperscript{308}

The language of Senator Specter's amendment already had been dropped.\textsuperscript{309} Moreover, the provision from the House bill, expressly adopting the Sundstrand standard for recklessness, was not included,\textsuperscript{310} undoubtedly because the federal decisions universally applied the standard already.

On October 24, 1995, the House formally appointed its conferees.\textsuperscript{311} A draft conference report dated November 9, 1995 altered the language of the pleading requirements slightly. The requirement that a plaintiff

\textsuperscript{306} 141 CONG. REC. S9201 (daily ed. June 28, 1995).
\textsuperscript{307} 141 CONG. REC. S9219, S9222 (daily ed. June 28, 1995).
\textsuperscript{308} Draft Conference Report, October 23, 1995 (on file with the authors).
\textsuperscript{309} Id. at 31-32. The October draft proposed a new Exchange Act section 36. To see the text of of the proposal, see supra text accompanying note 281.
\textsuperscript{310} See id.
\textsuperscript{311} 141 CONG. REC. H10690 (daily ed. Oct. 24, 1995) (appointing as conferees from the Committee on Commerce, Representatives Bliley, Tauzin, Fields of Texas, Cox of California, White, Dingell, Markey, Bryant of Texas, and Eshoo, and from the Committee on the Judiciary Representatives Hyde, McCollum and Conyers).
alleging fraud on information and belief "shall set forth all information on which that belief is formed,"\footnote{Draft Conference Report, October 23, 1995 at 31.} became "shall state with particularity all information on which that belief is formed."\footnote{Draft Conference Report, November 9, 1995, at 28.} The requirement that plaintiff "specifically allege facts giving rise to a strong inference that the defendant acted with the required state of mind,"\footnote{Draft Conference Report, October 23, 1995, at 31.} became "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."\footnote{Draft Conference Report, November 9, 1995, at 28.} This was done in order to better conform the statutory text to Federal Rule of Civil Procedure 9(b), in response to a letter from Judge Anthony Sirica of the United States Court of Appeals for the Third Circuit writing on behalf of the Judicial Council of the United States.\footnote{See 141 CONG. REC. S19044-45 (remarks of Sen. Domenici and letter of October 31, 1995 from Hon. Anthony Sirica to Ms. Laura Unger and Mr. Robert Giuffra of the Senate Committee on Banking, Housing, and Urban Affairs). A notation to the November 9 draft says the changes were made to "[c]onform language to make the provision consistent with Rule 11." November 9 "Draft Conference Report" at 2. However, the language actually parallels Rule 9(b)'s requirement that circumstances constituting fraud be set forth "with particularity," FED. R. CIV. P. 9(b), and later floor debate makes clear that the effort was to conform the language to Rule 9(b), in accordance with Judge Sirica's recommendation. See, e.g., 141 CONG. REC. S19044-45 (remarks of Sen. Domenici).}

On November 15, 1995, the SEC endorsed the November 9 draft in a letter from Chairman Arthur Levitt and Commissioner Steven M. Wallman to Senator D'Amato: "While the Commission has raised a number of concerns about earlier versions of this legislation, we believe the draft conference report dated November 9th responds to our principal concerns."\footnote{Letter from Chairman Arthur Levitt and Commissioner Steven M. H. Wallman, to Senator Alfonse D'Amato, 1 (Nov. 15, 1995) (on file with authors).} In the SEC's view, this was not a statutory text that could be construed to abolish liability for recklessness, or to raise the standard for pleading scienter above that of the Second Circuit precedents.

Two days later, on November 17, 1996, the Senate conferees were formally appointed.\footnote{141 CONG. REC. S17361 (daily ed. Nov. 17, 1995) (appointing Senators D'Amato, Gramm, Bennett, Grams, Domenici, Sarbanes, Dodd, Kerry and Bryan as conferees on the part of the Senate).} That day a third "Proposed Conference Report" was released,\footnote{Proposed Conference Report, November 17, 1995.} providing that the modified provision on pleading standards would be codified as Exchange Act Section 21D(b).\footnote{See id. at 27-28.} The
With respect to pleading standards, the Conference Committee adopted the Senate Banking Committee's text, codifying certain aspects of the Rule 9(b) jurisprudence and adopting the Second Circuit's "strong inference" standard. The Statement of the Managers explained that "[t]he Conference Committee language is based in part on the pleading standard of the Second Circuit," and "is specifically written to conform the language to Rule 9(b)'s notion of pleading with 'particularity.'" The Managers added that "[b]ecause 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," and endnote twenty-three states that "the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness," which had been proposed for inclusion by Senator Arlen Specter.

Because the "safe harbor" provision requires actual knowledge for some forward-looking statements, section 21D(b)(4) could not simply codify the Second Circuit case law or "include in the pleading standard certain language [from the cases] relating to motive, opportunity, or recklessness." For section 21D(b)(4) to codify a "strong inference of recklessness" pleading standard from Second Circuit case law would have conflicted with section 21E(c)(1)(B)'s increased requirement of "actual knowledge" for certain forward-looking statements. Neither could section 21D(b)(2) codify all of the Second Circuit "motive and opportunity" case law as a single pleading standard for all section 10(b) cases. Sometimes motive and opportunity raise an inference only of recklessness—as where an accountant or corporate officer has reason to recklessly turn a blind eye to wrongdoing, in disregard of actual truth or

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322. H.R. REP. No. 369, 104th Cong., at 41, reprinted in 1995 U.S.C.C.A.N. 730, 740 (Statement of Managers). The Statement adds: "Regarded as the most stringent pleading standard, the Second Circuit requirement is that the plaintiff state facts with particularity, and that these facts, in turn, must give rise to a 'strong inference' of the defendant's fraudulent intent." Id.
323. Id.
falsity. Thus, if section 21D(b)(2) expressly adopted Second Circuit case law that permits a showing of scienter based on "motive, opportunity, or recklessness," it would have undermined the "actual knowledge" requirement for forward-looking statements.

Instead of adopting all of the Second Circuit decisions without regard to the standard of scienter that ultimately must be proved, Congress provided that plaintiffs need only "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 327 That state of mind is "actual knowledge" for cases within section 21(E)(c)(1)(B)'s safe harbor, and recklessness for all others.

Congress did not seek to abolish motive, opportunity, and recklessness as means of establishing scienter in cases where liability is not based exclusively on forward-looking statements, and no one believed the Conference Report eliminated liability for reckless conduct. The Statement of the Managers itself says exactly the opposite: "In applying the 'fair share' rule of proportionate liability to cases involving non-knowing securities violations, the Conference Committee explicitly determined that the legislation should make no change to the state of mind requirements of existing law." 328 The Conference Report provision on proportionate liability under the Securities Act and Exchange Act, the Managers explained, "provides that the standard of liability in any such action should be determined by the pre-existing, unamended provision that creates the cause of action, without regard to this provision, which applies solely to the allocation of damages." 329 For section 10(b) actions, other than those based exclusively on "forward-looking statements," this would include recklessness. 330 Senator Moseley-Braun observed that while "the original House bill abolished liability for reckless conduct[,] the Senate bill did not, and the Senate position prevailed in conference." 331 Representative Bliley, who served as Manager for the House on the Conference Committee, confirmed that with the exception of the safe-harbor and proportionate-liability provisions, "[t]he conference report is careful not to change standards of liability under the securities laws." 332

329. Id. (emphasis added).
330. See supra notes 133-136 and accompanying text.
While some of the legislation's opponents were troubled by the Statement of the Managers—fearing that it might be misinterpreted as calling for a more-demanding pleading standard than the Second Circuit precedents—the Conference Committee Managers themselves uniformly understood the Conference Report to adopt its pleading standard from the Second Circuit case law. Senator Dodd explained that the Committee Managers had “adopt[ed] the Second Circuit Court of Appeals standard.”

The Conference Report therefore contrasted with the earlier House Bill, which had “established pleading standards that were so high . . . that it would have been impossible to bring a suit . . . had the [earlier] House language been adopted.”

“This legislation, therefore, is using a pleadings standard that has been successfully tested . . . in the real world.”

Senator Domenici similarly explained that “the conference report adopts the pleading standard utilized by the [S]econd [C]ircuit [C]ourt of [A]ppeals, where a large number of securities fraud lawsuits are brought.”

Among its advantages was the body of precedent applying the “strong-inference” standard: “This court-tested standard requires plaintiffs to plead facts in their complaint which give rise to a strong inference of securities fraud.” Senators Dodd and Domenici had authored this, “the Dodd-Domenici bill,” they had shepherded it through Congress, and then served as Managers for the Senate on the Conference Committee. Other members of the Conference Committee agreed with them that the statute codified a pleading standard from the Second Circuit case law, even if it did not specifically codify particular decisions.

334. 141 CONG. REC. S17959 (daily ed. Dec. 5, 1995) (statement of Sen. Dodd); see also 141 CONG. REC. S17957 (Dec. 5, 1995) (“The conference report clarifies current requirements that lawyers should have some facts . . . to back up their assertion of security fraud by adopting most of the reasonable standards established by the U.S. Second Circuit Court of Appeals.”) (statement of Sen. Dodd); 141 CONG. REC. S17959 (daily ed. Dec. 5, 1995) (the conferees intended to “adopt the Second Circuit Court of Appeals standard”) (statement of Sen. Dodd).
338. Senator Grams, who served with Dodd and Domenici on the Conference Committee as a Manager for the Senate, confirmed that the legislation provided for “[c]odification of the pleading standard adopted by the [S]econd [C]ircuit [C]ourt of
When Senator Specter asked if the Conference Report repudiated Second Circuit case law, Senator Dodd told him that it did not: "Basically, what we intended to do here was to codify the [S]econd [C]ircuit's pleadings standards, not to indicate disapproval of each individual case that came before it." He added that courts would be free to follow the Second Circuit case law, explaining that, although "the committee does not intend . . . to codify the [S]econd [C]ircuit's case law interpreting this pleading standard, . . . courts may find this body [of] law instructive." Senator Dodd elaborated, explaining:

[Instead of trying to take each case that came under the [S]econd [C]ircuit, we are trying to get to the point where we would have well-pleaded complaints. We are using the standards in the [S]econd [C]ircuit in that regard, then letting the courts—as these matters will—test. They can then refer to specific cases, the [S]econd [C]ircuit, or otherwise, to determine if these standards are [met] based on facts and circumstances in a particular case. That is what we are trying to do here.]

Other legislators took the Managers at their word. Senator Moseley-Braun concluded that although "[i]n the area of pleading, the House bill [had] adopted a standard that was significantly higher than the [S]econd [C]ircuit standard, which was the standard adopted in the Senate bill," it was "[t]he Senate position [that] prevailed at conference." Both Senator Hatch and Senator Dole agreed that "the legislation adopts the Second Circuit pleading standard." Only the bill's opponents doubted that.

f. President Clinton's Veto and the Veto-Override Debate

The Statement of the Managers was not as clear as its authors might have hoped. President Clinton "took the unusual step of citing


340. Id.
341. Id.
nonbinding report language as a reason for his veto” of the bill, fearing that the Statement of the Managers might be construed to impose a more demanding standard for pleading scienter than that adopted by the Second Circuit case law. However, contrary to Silicon Graphics, nothing he said suggested he believed either the bill’s text or the Statement of the Managers abolished liability for reckless misconduct.

Moreover, the veto-override debate confirms that the bill’s proponents did not intend to do away with the Second Circuit standard—they intended to adopt it. Representative Lofgren, for example, explained: “The President says he supports the [S]econd [C]ircuit standard for pleading. So do I. That is what is included in this bill.” Senator Domenici stated: “The President objected to the pleading standard. Yet it is the Second Circuit’s pleading standard.” Whatever it meant, far

345. In his December 19, 1995, veto message, President Clinton explained:
I believe that the pleading requirements of the Conference Report with regard to a defendant’s state of mind impose an unacceptable procedural hurdle to meritorious claims being heard in Federal courts. I am prepared to support the high pleading standard of the U.S. Court of Appeals for the Second Circuit—the highest pleading standard of any Federal circuit court. But the conferees make crystal clear in the Statement of Managers their intent to raise the standard even beyond that level. I am not prepared to accept that.

The conferees deleted an amendment offered by Senator Specter and adopted by the Senate that specifically incorporated Second Circuit case law with respect to pleading a claim of fraud. Then they specifically indicated that they were not adopting Second Circuit case law but instead intended to “strengthen” the existing pleading requirements of the Second Circuit. All this shows that the conferees meant to erect a higher barrier to bringing suit than any now existing—one so high that even the most aggrieved investors with the most painful losses may get tossed out of court before they have a chance to prove their case.

346. See id.
Second [C]ircuit pleading standard becomes the uniform rule. — Same as Senate-passed bill; Senator Specter’s amendment deleted from conference report.

The objective: . . . To codify the requirements in the 2nd Circuit.
from controlling interpretation of section 21D(b)(2), language in the Statement of Managers should not affect the statute’s meaning: “We know we are going to have the Second Circuit standard applied, and that in fact when legislation is at variance with legislative history or report language, that it is the bill itself that prevails.”

Representative Deutsch, as a member of the Conference Committee, rose to declare that “[r]eport language has no effect on the bill.” Senator Domenici agreed: “A statement of the managers is not law, everyone knows that.” The bill’s proponents were mystified that the President would veto a bill on the basis of a legislative history that could not contradict its clear terms:

Now, the Constitution gives the President the authority to veto legislation, but nowhere does it give the President authority to veto legislative history. I think a veto on the grounds of legislative history in this case is extreme, especially in light of the clear language of the bill.

Senator Bradley, in particular, rejected contentions that the Conference Committee Report might impose a higher pleading standard than the Second Circuit precedents:

Now much has been made of the exact specifications surrounding the pleading standard in the bill. A number of critics contend that it goes beyond the already stringent standards of the Second Circuit—and would have the effect of closing the courthouse door for many small plaintiffs. Ambiguities in the statement of managers have served only to heighten these criticisms. In fact, the language of the bill does codify the Second Circuit standard in part—and the statement of managers says so.

But even within the Second Circuit, there are varying interpretations of the standard. That is why the conference report deliberately rejects a complete codification of the Second Circuit and adopts language which is substantially similar to the language of the Senate-passed bill and its report language.

Senator Dodd complained that the Specter amendment, by allowing recklessness to raise a strong inference of scienter in all cases, would undermine the requirement of actual knowledge for some claims: “[T]he

A complaint should outline the facts supporting the lawsuit. . . . Under the Conference Agreement, the complaint must set forth the facts supporting each of the alleged misstatements or omissions and must include facts that give rise to a “strong inference” of scienter or intent. . . . This is a codification of the 2nd Circuit rule.

Specter amendment . . . was an effort to get recklessness in" section 21D(b) as a pleading standard for all section 10(b) claims, "which would have changed the standard from the [S]econd [C]ircuit" as formulated in the Senate Report. But Senator Dodd did not believe the Conference Report changed the Second Circuit standards for raising an inference of scienter from allegations of motive and opportunity or recklessness. Far from it.

According to the bill’s leading proponent, "motive" would provide the necessary “strong inference” of scienter. In debate on the veto override, Senator Dodd quoted Stanford University Professor Joseph Grundfest—a former SEC commissioner—as “one of the most knowledgeable people in this particular area,” for his opinion that under “the securities litigation conference report, the pleading standard is faithful to the Second Circuit’s test.” Dodd and Grundfest assured Congress that this “pleading standard articulated by the Second Circuit of Appeals is intended simply to require the plaintiff to allege facts sufficient to give rise to a strong inference of motive to defraud.” Senator Dodd explained: “We have clearly established the standard of alleging facts with particularity, showing a strong inference of motive.”

Dodd condemned Senator Specter’s amendment, which had sought to insert specific language about motive, opportunity, and recklessness, not for incorporating the guidance of Second Circuit precedents on these points, but for deviating from those precedents. He and Senator Reid both quoted Professor Grundfest’s conclusion that “the Specter amendment language . . . was an incomplete and inaccurate codification of case law in the circuit.” Senator Dodd explained:

360. See 141 CONG. REC. S9170-71 (daily ed. Dec. 21, 1995) (“The Specter amendment said he was codifying the guidance in the [S]econd [C]ircuit and that is not the case.”). Dodd had earlier argued that Senator Specter’s amendment was an incomplete statement of Second Circuit law. See infra note 364 and accompanying text.

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Where motive is apparent, you do not have to make any allegations of a lot of circumstances. If you have a clear motive, you do not have to worry about the circumstances or the alleged strong facts. Where you do not have motive, apparently, and that can be a case where it is hard to get at that motive, then you are going to allege circumstances. There Judge Newman says, “Where motive is not apparent, it is still possible to plead scienter by identifying circumstances indicating conscious behavior by the defendant, though the strength of the circumstantial allegations must be correspondingly greater.” Greater. The Specter amendment does not distinguish at all between when motive is and is not apparent [emphasis added] . . . [He] therefore did not really follow the guidance of the Second Circuit. So that is the reason that amendment was taken out.362

Dodd explained that, far from foreclosing reliance on Second Circuit precedent, the Conference Committee actually expected courts to look to that court’s decisions for guidance:

You could have gone in, I suppose, and said why did you not include the other language [from the Second Circuit precedents] here? The problem was, in a sense, by codifying [judicial] guidance you get into an area where you can get some differences of opinion on this. And arguably it could have, I suppose, gone back and included all of it, but the decision was to take it out on the assumption that the courts will look to the guidance.363

Dodd believed that the Second Circuit’s guidance would be followed because the standard was established in the statute.364 He explained:

We have met the Second Circuit standard here, as indicated by the memorandum from Judge Grundfest . . . . We have met that standard. We have left out the guidance. That does not mean you disregard it.365

Indeed, Senator Dodd observed that “the suggestion that somehow the courts are going to disregard the guidance because it is no longer in the bill itself, it has not been codified, I think overstates the case.”366

IV. CONCLUSION

Exchange Act section 21D(b) combines the Ninth Circuit’s standard for pleading falsity and the Second Circuit’s standard for pleading scienter into a single national standard for pleading securities fraud under the Exchange Act. By requiring plaintiffs to raise “a strong inference of the required state of mind,” Congress did not intend to increase the quoting Professor Grundfest).

required state of mind or to cast doubt on the continued validity of Second Circuit precedents holding that plaintiffs may raise a strong inference of scienter with allegations of motive and opportunity or by pleading facts suggesting conscious wrongdoing or reckless disregard. Congress considered doing away with liability for reckless misconduct, but chose only to limit liability for reckless violations and to require knowing conduct only for certain forward-looking statements.

The Statement of the Managers does not support a contrary conclusion. Although President Clinton believed the Statement of the Managers indicated that the Conference Committee intended to impose a pleading standard more demanding than the Second Circuit's, the legislative history conclusively demonstrates that the bill's proponents did not intend this. The veto-override debate shows that Congress intended, in fact, to enact the Second Circuit standard, and the bill's leading proponents specifically endorsed motive and opportunity as means of establishing scienter.