

RESTORING THE BALANCE AFTER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

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I. INTRODUCTION

*“Instead of trying to discourage private litigation, reforms should strive to make it work.”*¹

For the past several decades, Congress has struggled to develop a system of private litigation that works for securities fraud claims. Most notably, Congress passed the Private Securities Litigation Reform Act (the Reform Act) of 1995 in response to complaints that plaintiffs were abusing the litigation process.² Specifically, many individuals alleged that plaintiffs were excessively filing frivolous claims, or strike suits, hoping the corporations they sued would succumb to the pressures of litigation and settle.³ Accordingly, the Re-

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1. Shannon Rose Selden, *(Self-)Policing the Market: Congress's Flawed Approach to Securities Law Reform*, 33 J. LEGIS. 57, 96 (2006).

2. Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, 109 Stat. 737 (1995).

3. S. REP. NO. 104-98, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683; *see also* Richard M. Phillips & Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers*, 51 BUS. LAW. 1009 (1996). Strike suits are suits “based on no valid claim,

form Act established certain procedural barriers, including a heightened pleading standard and mandatory stay on discovery, aimed at preventing plaintiffs from bringing such claims.⁴ As a result, courts began to dismiss more securities fraud cases, finding they did not comply with the Reform Act's new procedural requirements.⁵

However, the Reform Act has failed to truly "make it work." While the Reform Act has successfully screened out more frivolous claims, the increased dismissal rate, in light of recent corporate fraud and accounting scandals, has exposed an adverse consequence of the legislation. Namely, the strict procedural barriers allow some securities fraud to go undeterred and unpunished.⁶ In short, the Reform Act may preclude plaintiffs with legitimate claims from succeeding in litigation.⁷

This problem may be explained by the principal-agent relationship that exists between investors and corporations. Specifically, private securities litigation embodies what is known as the informed defendant model, a scenario wherein the corporation, but not the investor, knows whether it has violated federal securities law, creating an information asymmetry.⁸ The provisions of the Reform Act further skew this asymmetry in favor of the corporation, creating a defendant-friendly securities litigation regime. Thus, Congress overlooked the need to reach a balance between procedural safeguards that prevent frivolous litigation and devices that deter corporate wrongdoing.⁹ Instead, the Reform Act focused on eliminating the previous hardships felt by corporations at the hands of aggressive plaintiffs. Accordingly, Congress needs to reexamine these competing objectives to provide a workable system where plaintiffs will be unsuccessful if they file frivolous claims and corporations will not only be deterred by the threat of litigation but also punished if they violate federal securities laws.

for nuisance value or as leverage to obtain a favorable or inflated settlement." BLACK'S LAW DICTIONARY 679 (9th ed. 2004).

4. See Phillips & Miller, *supra* note 3, at 1018.

5. Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 969 (2003).

6. Hillary A. Sale, *Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA's Internal-Information Standard on '33 and '34 Act Claims*, 76 WASH. U. L.Q. 537, 564 (1998).

7. See *id.* at 538 (arguing "the Reform Act implements a standard that is outcome determinative and, if strictly applied, virtually impossible to meet").

8. See Robert G. Bone, *Modeling Frivolous Suits*, 145 U. PA. L. REV. 519, 550 (1997).

9. These competing interests were discussed in the Second Circuit case *In re Time Warner Securities Litigation*. The court in that case noted regulation and litigation must balance the "interest in deterring fraud in the securities markets" with the "interest in deterring the use of the litigation process as a device for extracting undeserved settlements as the price of avoiding the extensive discovery costs that frequently ensue once a complaint survives dismissal." *In re Time Warner Inc. Securities Litigation*, 9 F.3d 259, 263 (2d Cir. 1993).

While no standard could achieve the perfect balance, this Note attempts to examine the steps necessary to reach a more auspicious equilibrium. First, Part II of this Note discusses the history and importance of private securities litigation. Additionally, it details the abusive practices of plaintiffs' attorneys that led Congress to seek reform. Part III then discusses Congress's answer to the problem—the Reform Act—and the consequences that followed. Part IV explains the failures of the Reform Act through common notions of game theory. Specifically, this Part frames private securities litigation as a sequential game between principal and agent entrenched with information asymmetries that are only amplified by the provisions in the Reform Act. Most importantly, this Part recognizes that the Reform Act's procedural barriers may be too high, preventing some plaintiffs with meritorious claims from succeeding and allowing securities fraud to remain unpunished. Lastly, Part V suggests certain modifications to the current regime to reduce these information asymmetries and create a more favorable system of private securities litigation. In particular, this Part suggests lowering the procedural barriers under the Reform Act by adopting a lower pleading standard, instituting a judicially managed discovery process, and implementing factors similar to those used by the Securities and Exchange Commission (SEC) to evaluate a motion to dismiss. Additionally, this Part calls Congress to reevaluate the perceived harms of frivolous litigation and recognize its possibility to produce positive externalities.

II. A BRIEF HISTORY OF PRIVATE SECURITIES LITIGATION AND THE EXPLOSION OF ABUSIVE LITIGATION PRACTICES

A. *Background of Federal Securities Law and Private Litigation Under the Fraud Provisions*

Following the events of the Great Depression, Congress sought to improve government intervention in the securities market¹⁰ with the passage of the Securities Act of 1933 (the '33 Act)¹¹ and the Securities Exchange Act of 1934 (the '34 Act).¹² With this legislation, Congress hoped to “increase investor confidence” in the marketplace.¹³ However, the mere presence of these regulations was not enough to prevent another financial disaster. Thus, Congress provided for two separate methods of enforcing the Acts.¹⁴ First, the SEC was given

10. Evan Hill, *The Rule 10b-5 Suit: Loss Causation Pleading Standards in Private Securities Fraud Claims After Dura Pharmaceuticals, Inc. v. Broudo*, 78 FORDHAM L. REV. 2659, 2665 (2010).

11. 15 U.S.C. § 77a, et seq. (2006).

12. *Id.* § 78a, et seq.

13. Brandon C. Helms, *The Supreme Court's Dura Decision Unfortunately Secures a Brighter Future for 10b-5 Defendants*, 56 DEPAUL L. REV. 189, 189 (2006).

14. *Id.*

primary authority to bring enforcement actions against violators.¹⁵ Yet, the SEC has limited resources and is unable to pursue every alleged violation of securities law.¹⁶ Therefore, private securities litigation has been deemed the “necessary supplement” to SEC enforcement action and the second means of enforcing the Acts.¹⁷

Most private class actions are brought under the “catchall” fraud provisions¹⁸—section 10(b) of the Exchange Act and Rule 10b-5—because of their broad scope.¹⁹ Section 10(b) prohibits the use of “manipulative or deceptive device[s]” in violation of any SEC Rule.²⁰ This provision also permits the SEC to promulgate rules necessary for the enforcement of section 10(b),²¹ leading to the adoption of Rule 10b-5.²² Rule 10b-5 makes it unlawful for any person to “employ any device, scheme, or artifice to defraud” or to make misleading statements or omit material facts that would mislead others in “connection with the purchase or sale of any security.”²³ Although these provisions do not explicitly provide investors with the right to sue, courts have consistently implied private rights of action.²⁴ The elements required to establish a securities fraud claim under these provisions include: “(1) a material misrepresentation (or omission) . . . (2) scienter, i.e., a wrongful state of mind . . . (3) a connection with the purchase or sale of a security . . . (4) reliance, often referred to in cases involving public securities markets (fraud-on-the-market cases) as ‘transaction causation’ . . . (5) economic loss . . . and (6) ‘loss causation’”²⁵

Private rights of action, specifically class actions, produce numerous benefits. In particular, they provide an avenue for harmed investors to receive financial recovery.²⁶ They also reduce the negative externalities of securities fraud, such as decreased “investors’ confidence in the economy,” “inaccurate pricing signals,” and “misallocation of capital.”²⁷ Under class actions, individual shareholders who would normally find litigation inefficient and costly are able to com-

15. *Id.*

16. Brian S. Sommer, *The PSLRA Decade of Decadence: Improving Balance in the Private Securities Litigation Arena with a Screening Panel Approach*, 44 WASHBURN L.J. 413, 419 (2005); see also Elizabeth Chamblee Burch, *Securities Class Actions as Pragmatic Ex Post Regulation*, 43 GA. L. REV. 63, 101 (2008) (arguing the SEC is faced with scarce resources and agency capture).

17. See *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964).

18. Hill, *supra* note 10, at 2662.

19. See Phillips & Miller, *supra* note 3, at 1031; see also Hill, *supra* note 10, at 2662.

20. 15 U.S.C. § 78j(b) (2006).

21. *Id.*

22. Hill, *supra* note 10, at 2667.

23. 17 C.F.R. § 240.10b-5 (2010).

24. See, e.g., *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975).

25. *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341-42 (2005) (emphasis omitted).

26. Phillips & Miller, *supra* note 3, at 1029.

27. Robert Allen, *Securities Litigation as a Coordination Problem*, 11 U. PA. J. BUS. L. 475, 493 (2009).

bine their claims with other shareholders in a cost-effective manner.²⁸ Additionally, class actions promote investor confidence in our markets by enforcing a system of disclosure. Punishing those who make false representations ensures most information disclosed to the public is accurate.²⁹ Moreover, private actions deter securities fraud violations³⁰ by increasing the likelihood corporations will be sued for their wrongdoings.³¹

B. *The Explosion of Abusive Litigation Practices*

Beginning in the 1970s, private securities litigation “evolved from a ‘necessary supplement to [SEC] action’ to a state of ‘vexatiousness’ more prevalent and severe than other types of litigation.”³² Plaintiffs began to take advantage of the lax rules of federal procedure in order to pursue abusive tactics. While Rule 8 of the Federal Rules of Civil Procedure only requires plaintiffs to plead a “short and plain statement” of the claim,³³ securities claims are subject to the specialized pleading standard of fraud found in Rule 9(b). Under Rule 9(b), a complaint must “state with particularity the circumstances constituting fraud or mistake”; yet, the complaint can assert generally “[m]alice, intent, knowledge, and other conditions of a person’s mind.”³⁴ However, courts rarely granted motions to dismiss for failing to sufficiently state a securities fraud claim under these standards.³⁵ Courts maintained such motions would only be granted in limited instances where “ ‘it appear[ed] beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief.’ ”³⁶

These lenient rules permitted plaintiffs to file often and file fast without regard to the merits of their claim. For example, class action plaintiffs would often file “stock drop” cases—a lawsuit spawned by an abrupt drop in a company’s stock price almost immediately after

28. Stephen J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 23 J.L. ECON & ORG. 598, 590 (2007).

29. Ryan G. Miest, Note, *Would the Real Scienter Please Stand Up: The Effect of the Private Securities Litigation Reform Act of 1995 on Pleading Securities Fraud*, 82 MINN. L. REV. 1103, 1104 (1998).

30. See Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10B-5*, 108 COLUM. L. REV. 1301, 1318 (2008).

31. Shaun Mulreed, Note, *Private Securities Litigation Reform Failure: How Scienter has Prevented the Private Securities Litigation Reform Act of 1995 From Achieving Its Goals*, 42 SAN DIEGO L. REV. 779, 784 (2005).

32. Sommer, *supra* note 16, at 420 (alteration in original).

33. FED. R. CIV. P. 8.

34. FED. R. CIV. P. 9(b).

35. Phillips & Miller, *supra* note 3, at 1034.

36. *Id.* (quoting *Conley v. Gibson*, 335 U.S. 41, 45-46 (1957) (citations omitted)).

bad news about the company was publicly announced.³⁷ These claims were filed within days and sometimes even hours after the price dropped.³⁸ Accordingly, plaintiffs' attorneys engaged in "fishing expedition[s]," attempting to find evidence supporting their claim after the complaint was filed.³⁹ Such expeditions were possible under broad discovery provisions⁴⁰ and infrequently imposed sanctions.⁴¹ Plaintiffs' attorneys were also able to bring as many suits as possible through a diversification approach. Particularly, plaintiffs' firms would "file many suits, with a minimum investment of resources in each suit, and to develop a stable income stream from their contingent fee arrangements."⁴² Since only a few suits would prove unsuccessful, there was little "downside risk" to filing as many as possible.⁴³

Further, in securities fraud lawsuits, the plaintiff and defendant face asymmetric discovery burdens. While plaintiffs incur minimal costs,⁴⁴ defendants are required to produce numerous records and deponents, making the process extremely "expensive and time-consuming."⁴⁵ These costs ultimately induce corporations to settle without regard to the merits of the plaintiff's claim.⁴⁶ Aware of this, plaintiffs' attorneys engaged in "legalized 'extortion,'"⁴⁷ filing meritless suits as "leverage to obtain a favorable or inflated settlement" from the corporations they sued.⁴⁸

The fraud-on-the-market theory, upheld in *Basic Inc. v. Levinson*,⁴⁹ further alleviated what little obstacles stood in the way of plaintiffs bringing frivolous claims. Among other things, a plaintiff must prove reliance on a material misstatement or omission to recover under a section 10(b) or Rule 10b-5 claim.⁵⁰ However, the fraud-

37. James C. Dugan, *Securities Litigation and the Economic Crisis: Leading Lawyers on Understanding the Current Legal Environment, Developing Litigation Best Practices, and Helping Clients Respond to a Changing Marketplace*, 2009 WL 1615203 (Aspatore), at *1 (Apr. 2009).

38. See Phillips & Miller, *supra* note 3, at 1011 (describing lawsuits that were filed less than five hours after Philip Morris announced a decrease in its earnings in 1993).

39. John F. Olson et al., *Pleading Reform, Plaintiff Qualification and Discovery Stays Under the Reform Act*, 51 BUS. LAW. 1101, 1112 (1996).

40. See FED. R. CIV. P. 26(b).

41. See FED. R. CIV. P. 11.

42. Phillips & Miller, *supra* note 3, at 1036.

43. See *id.* at 1037.

44. Olson et al., *supra* note 39, at 1112.

45. Selden, *supra* note 1, at 75.

46. See Charles M. Yablon, Essay, *A Dangerous Supplement? Longshot Claims and Private Securities Litigation*, 94 NW. U. L. REV. 567, 585 (2000).

47. Richard H. Walker et al., *The New Securities Class Action: Federal Obstacles, State Detours*, 39 ARIZ. L. REV. 641, 645 (1997).

48. Damian Moos, Note, *Pleading Around the Private Securities Litigation Reform Act: Reevaluating the Pleading Requirements for Market Manipulation Claims*, 78 S. CAL. L. REV. 763, 763-64 (2005) (quoting BLACK'S LAW DICTIONARY 679 (2d Pocket ed. 2001)).

49. 485 U.S. 224, 250 (1988) ("It is not inappropriate to apply a presumption of reliance supported by the fraud-on-the-market theory.")

50. *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341-42 (2005).

on-the-market theory precludes the need to prove reliance on misleading statements or disclosures.⁵¹ Instead, a plaintiff may claim the misstatements or omissions “caused her to pay a purchase price that is higher than it would have been but for the misstatement,”⁵² relying on the semi-strong presumption of market efficiency.⁵³ Thus, as long as investors purchase the stock in an efficient market, misleading statements can defraud investors based on the effect it has on the stock price.⁵⁴ While this theory has been subsequently limited by the Supreme Court,⁵⁵ plaintiffs could nevertheless file suits based on misstatements or omissions without ever reading the company’s disclosure documents.⁵⁶

These abusive practices not only harmed innocent corporations but also created negative implications market wide. First, abusive litigation undercuts the integrity of the judicial system.⁵⁷ It also leads to poor public disclosure practices. With the constant possibility of strike suits, corporate managers are less inclined to make public statements for fear what they say could be subsequently used against them.⁵⁸ Additionally, corporations incur costs defending meritless suits, which may be passed along to the shareholders.⁵⁹ The Supreme Court recognized the problems of frivolous securities litigation in *Blue Chip Stamps v. Manor Drug Stores*.⁶⁰ Particularly, the Court noted two separate concerns: (1) the pendency of a meritless lawsuit “may frustrate or delay normal business activity of the defendant,” and (2) the “liberal discovery provisions of the Federal Rules of Civil Procedure” permit plaintiffs with “largely groundless claim[s] to simply take up the time of a number of other people . . . [imposing] a social cost rather than a benefit.”⁶¹ As then SEC Chairman Arthur Levitt noted, “the pendulum had swung too far toward plaintiffs, and it needed to be brought into better balance.”⁶²

51. Rose, *supra* note 30, at 1311.

52. Merritt B. Fox, *Understanding Dura*, 60 BUS. LAW. 1547, 1548 (2005).

53. The semi-strong theory of market efficiency posits that stock prices represent all publicly available information, including material misstatements. *Basic Inc.*, 485 U.S. at 246.

54. *See id.* at 247.

55. *See Dura*, 544 U.S. at 347-48. The Court in *Dura* held the fact a price was inflated by misstatements at the time of purchase is insufficient, standing alone, to establish the loss on the sale after the company disclosed the truth was caused by the misstatement. *Id.* Instead, the plaintiff must plead some additional information indicating a causal connection between misstatements and the loss. *Id.*

56. Rose, *supra* note 30, at 1312.

57. Phillips & Miller, *supra* note 3, at 1027.

58. Allen, *supra* note 27, at 502.

59. *Id.* at 481.

60. 421 U.S. 723 (1975).

61. *Id.* at 740, 741.

62. Arthur Levitt, “*Final Thoughts on Litigation Reform*”: Remarks by Chairman Arthur Levitt United States Securities and Exchange Commission 23rd Annual Securities Regulation Institute San Diego, California, January 24, 1996, 33 SAN DIEGO L. REV. 835, 838 (1996).

III. A CALL FOR REFORM: CONGRESSIONAL ACTION TO CURB VEXATIOUS LITIGATION

A. *The Private Securities Litigation Reform Act*

To combat the problems of vexatious litigation, Congress passed the Private Securities Litigation Reform Act on December 22, 1995.⁶³ The Reform Act was designed to promote voluntary disclosure by issuers, provide investors with primary authority over private litigation, and encourage plaintiffs to bring legitimate claims.⁶⁴ Overall, the legislation sought to balance the interest of deterring securities fraud with the interest of deterring abusive litigation practices.⁶⁵ Accordingly, Congress erected certain procedural hurdles to prevent plaintiffs from engaging in speculative litigation.⁶⁶ These provisions, codified in section 21D of the '34 Act, include: (1) a heightened pleading requirement coupled with a stay on discovery if a motion to dismiss is filed;⁶⁷ (2) the “most adequate plaintiff” rule—requiring courts to select an appropriate lead plaintiff in class action suits;⁶⁸ and (3) mandatory Rule 11 sanctions imposed against attorneys for filing meritless claims.⁶⁹

The heightened pleading standard is considered the most controversial provision of the Reform Act. It requires a complaint alleging a misstatement or omission of material fact 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 complaint shall state with particularity all facts on which that belief is formed.”⁷⁰ While this section does not significantly differ from the pre-Reform Act standard utilized by most courts, the following section establishing the pleading requirements for scienter is considered more of a “wild card.”⁷¹ Specifically, it requires that a “complaint shall . . . state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”⁷²

63. Pub. L. 104-67, 109 Stat. 737; see also Mulreed, *supra* note 31, at 780.

64. S. REP. NO. 104-98, at 4 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 683.

65. Phillips & Miller, *supra* note 3, at 1009.

66. *Id.* at 1018.

67. 15 U.S.C. § 78u-4(b)(3) (2006).

68. *Id.* § 77z-1(a)(3)(B)(i). A detailed discussion of this particular provision is outside the scope of this Note.

69. *Id.* § 77z-1(c).

70. *Id.* § 78u-4(b)(1).

71. John C. Coffee, Jr., *The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady has not Yet Sung*, 51 BUS. LAW. 975, 978 (1996).

72. 15 U.S.C. § 78u-4(b)(2) (2006). Following the passage of the Reform Act, courts were imposing various interpretations of the “strong inference” requirement. One author recognized three different lines of cases that developed. Patricia J. Meyer, *What Congress Said About the Heightened Pleading Standard: A Proposed Solution to the Securities Fraud Pleading Confusion*, 66 FORDHAM L. REV. 2517, 2535 (1998). However, the Supreme Court resolved

While Congress was drafting the legislation, there was much debate surrounding these heightened pleading provisions. The most notable opposition came from President Clinton, who vetoed the Reform Act, arguing the legislation would have the damaging effect of “closing the courthouse door on investors who have legitimate claims.”⁷³ President Clinton was concerned the requirements to plead scienter “impose[d] an unacceptable procedural hurdle to meritorious claims being heard in Federal courts.”⁷⁴ Nevertheless, Congress overrode the veto and passed the legislation.

The Reform Act also includes a provision that imposes a stay on discovery when a motion to dismiss is filed.⁷⁵ This provision sought to eliminate abusive fishing expeditions⁷⁶ and to reduce the high costs of discovery that often compel innocent corporations to settle meritless lawsuits.⁷⁷ The stay will only be excused if discovery is “necessary to preserve evidence or to prevent undue prejudice.”⁷⁸ This provision, when enforced with the heightened pleading standard, ensures only the strongest complaints survive a motion to dismiss.

Further, Congress sought to “give[] teeth” to these provisions by enhancing the sanctions for violations of Rule 11 of the Federal Rules of Civil Procedure.⁷⁹ Under Rule 11, claims must be supported by existing law while factual contentions must be supported by evidence.⁸⁰ Section 21D(c) of the Exchange Act requires the court, upon completion of the case, to determine compliance with Rule 11.⁸¹ If a violation is discovered, the court shall impose sanctions on the violating party, consisting of reasonable attorney’s fees and other costs to be paid to the opposing party.⁸² Ultimately, this provision requires courts to meticulously scrutinize the complaints filed before them and punish those who file meritless claims.

B. *The Consequences of the Reform Act*

The Reform Act failed to achieve its primary goal—preventing plaintiffs from filing frivolous lawsuits. Although the number of com-

this discrepancy in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007). The Court in *Tellabs* required the inference of scienter to be “cogent and at least as compelling as any plausible opposing inference.” *Id.* at 310.

73. William J. Clinton, Veto Message on the Private Securities Litigation Reform Act, H.R. Doc. 140-150, 141 CONG. REC. 37797 (Dec. 19, 1995).

74. *Id.* at 37798.

75. 15 U.S.C. § 78u-4(b)(3)(B) (2006).

76. See Phillips & Miller, *supra* note 3, 1044.

77. Walker et al., *supra* note 47, at 648.

78. 15 U.S.C. § 78u-4(b)(3)(B) (2006).

79. H.R. REP. NO. 104-369, at 39 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 738.

80. FED. R. CIV. P. 11.

81. 15 U.S.C. § 78u-4(c)(1) (2006).

82. *Id.* § 78u-4(c)(2)–(3)(A). Sanctions may be waived only if awarding attorney’s fees will inflict an unreasonable and unjust burden on the violating party. *Id.* § 78u-4(c)(3)(B)(i).

plaintiffs filed initially decreased in 1996, this was mainly because plaintiffs were taking their claims to state court where stricter standards had not been implemented.⁸³ However, the Securities Litigation Uniform Standards Act of 1998 preempted state law causes of action for securities fraud and placed the claims back in federal courts.⁸⁴ Overall, the number of private actions filed increased after the passage of the Reform Act.⁸⁵ One study indicated that the average number of securities issuers sued each year increased by 32% for six years following the Reform Act's enactment.⁸⁶

The Reform Act's inability to curtail frivolous litigation is attributable to the lack of downside risk plaintiffs currently face. Even after the passage of the Reform Act, plaintiffs find it cost-effective to file as many strike suits as possible. Specifically, courts are still reluctant to impose sanctions for Rule 11 violations,⁸⁷ allowing plaintiffs' attorneys to freely carry on with their diversification strategies.⁸⁸ And because the Reform Act has made it more difficult to survive a motion to dismiss, plaintiffs' attorneys have even more incentive to not only bring as many suits as possible but also "throw every available bit of favorable information into the complaint in hopes that the judge will be induced by the sheer number of paragraphs to conclude that the complaint has alleged fraud with specificity."⁸⁹

Yet, the Reform Act was not a complete failure. Specifically, the Act successfully reduced the overall costs associated with frivolous litigation in several ways.⁹⁰ First, federal courts have dismissed more complaints for failing to meet the Reform Act's heightened pleading standard.⁹¹ Following the passage of the Reform Act, the dismissal rate more than doubled.⁹² In addition, the Reform Act has successfully slowed the "race to the courthouse." Plaintiffs' attorneys are now taking more time to investigate actions before they file,⁹³ evi-

83. Perino, *supra* note 5, at 931.

84. Securities Litigation on Uniform Standards Act of 1998, Pub. L. 105-353, 112 Stat. 3227.

85. Perino, *supra* note 5, at 929; *see also* Joel Seligman, *Rethinking Private Securities Litigation*, 73 U. CIN. L. REV. 95, 111 (2004) (noting that "[b]etween 1991 and 1995, an average of 177 federal securities class actions were filed in federal court each year," but "[b]etween 1996 and 2001, an average of 186 federal securities class actions were brought each year").

86. Perino, *supra* note 5, at 930.

87. *Id.* at 938.

88. *See id.* at 937.

89. Geoffrey P. Miller, *Pleading After Tellabs*, 2009 WIS. L. REV. 507, 532 (2009).

90. *See* Perino, *supra* note 5, at 969.

91. *Id.*; *see also* Seligman, *supra* note 85, at 112 (finding the Ninth Circuit dismissed 61% of its claims and the Second Circuit dismissed 37% of its claims after the Reform Act was passed).

92. Helms, *supra* note 13, at 190-91 (noting the dismissal rate increased from 11.2% to 25.1% after the enactment of the Reform Act); *see also* Burch, *supra* note 16, at 79 (noting the dismissal rate as of 2008 was 39.1%).

93. Walker et al., *supra* note 47, at 684.

denced by an increase in the time between a drop in the price of a stock and the filing of a related lawsuit.⁹⁴ Now, additional preparation is necessary to sufficiently state with particularity those facts giving rise to a “strong inference” of fraudulent intent. Attorneys have also modified the types of complaints filed since the passage of the Reform Act. Instead of traditional stock drop cases, plaintiffs now focus on accounting irregularities and insider trading,⁹⁵ rendering the complaints longer and more complicated as they discuss the mechanical nuances of accounting rules.⁹⁶ Thus, the Reform Act imposed obstacles that successfully prevent plaintiffs with frivolous claims from surviving a motion to dismiss.

IV. THE REFORM ACT’S INFLUENCE ON FRAUDULENT ACTIVITY FROM A GAME THEORETIC PERSPECTIVE

A. *A Balancing of Errors*

While it is likely that more frivolous claims are being dismissed, the Reform Act has created consequences insufficiently considered by the enacting Congress—consequences that may have potentially negative implications on the securities market. In particular, by establishing stricter procedural standards, courts are not only screening out frivolous cases but also screening out cases with merit, creating a “climate in which frauds are more likely to occur.”⁹⁷ Thus, it appears Congress preferred some meritorious claims to go unprosecuted rather than allow frivolous lawsuits that may harm corporations.⁹⁸ But given the recent wave of corporate fraud, including the events of Enron and WorldCom, was the trade-off really worth it?

One author has characterized this problem as an imbalance between Type I and Type II errors.⁹⁹ A Type I error, also known as a false positive, results when a defendant is found to have committed securities fraud, when in reality no fraud transpired.¹⁰⁰ This usually occurs when a court allows frivolous claims to proceed to litigation.¹⁰¹

94. Perino, *supra* note 5, at 963 (noting a study that found the average filing delay before the Reform Act was 49 days, compared to an average filing delay of 79 days with a median filing delay of 38 days after the Reform Act).

95. See William S. Lerach, “*The Private Securities Litigation Reform Act of 1995—27 Months Later*”: *Securities Class Action Litigation Under the Private Securities Litigation Reform Act’s Brave New World*, 76 WASH. U. L.Q. 597, 605 (1998) (finding that “67% of the post-Reform Act Section 10(b) complaints involving publicly-traded companies allege accounting fraud as a basis for liability . . . [and that alleged] trading by insiders is particularly important in cases against high technology companies, appearing in 73% of those cases”).

96. Dugan, *supra* note 37, at *2.

97. Perino, *supra* note 5, at 914.

98. Phillips & Miller, *supra* note 3, at 1068.

99. See Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 ARIZ. L. REV. 711, 711 (1996).

100. *Id.*

101. *See id.*

On the other hand, a Type II error, or a false negative, takes place when a court dismisses a meritorious claim or mistakenly determines no fraud has occurred.¹⁰² Congress has overlooked the importance of balancing Type I and Type II errors to reach a viable equilibrium that will both deter corporations from making fraudulent statements while simultaneously deterring plaintiffs from filing frivolous claims. Yet, achieving such a balance is easier said than done. Complications arise from the inherent principle-agent relationship that exists between shareholders and corporate managers.

B. Modeling Private Securities Litigation as a Sequential Game Between Agent and Principle

An agency relationship results when an investor (principle) gives her money to a corporation (agent) to manage.¹⁰³ In this type of agency relationship, the agent possesses information about the corporation the investor does not have.¹⁰⁴ Thus, investors need to protect themselves should the corporation abuse this information asymmetry by making material misstatements or omissions.¹⁰⁵ However, it is costly for a principle to monitor the agent's actions.¹⁰⁶

Threat of litigation is one way to avoid monitoring costs, but a plaintiff must first decide whether to bring suit. This decision can be framed as a multi-player, sequential game between the investor and the corporation. Under the norms of game theory, a sequential game involves a situation where the players make alternating moves.¹⁰⁷ One player's move will depend upon the previous and possible future actions of the other player.¹⁰⁸ Additionally, each player must "anticipate the future decisions" and reason backwards to make the correct choice at earlier points in the game.¹⁰⁹ At the outset, it is important to note corporations in this sequential game are repeat players. They will continue to issue securities and thus will continue to be sued by investors who believe they were injured. Therefore, the corporation's actions should send credible signals to both investors in the current game and the entire market for possible future games.

The decision to bring suit for a section 10(b) or Rule 10b-5 violation begins after the plaintiff believes a manager or executive of a company in which she holds stock has made a misstatement or omis-

102. *Id.*

103. See Frank B. Cross & Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 CARDOZO L. REV. 333, 338 (2006).

104. *Id.* at 339.

105. See *id.*

106. *Id.*

107. AVINASH K. DIXIT & BARRY J. NALEBUFF, *THE ART OF STRATEGY: A GAME THEORIST'S GUIDE TO SUCCESS IN BUSINESS & LIFE* 33 (2008).

108. *Id.*

109. *Id.* at 37.

sion of material fact. The plaintiff must then decide whether or not to file suit. A plaintiff will sue if she knows her suit has merit or if she is unsure of the merits because no preliminary investigation has been performed.¹¹⁰ Additionally, when deciding whether to sue, a rational plaintiff will consider the costs involved. Plaintiffs incur nominal costs when filing a securities fraud claim,¹¹¹ particularly if they aggregate their claim with other plaintiffs in the form of a class action.¹¹² However, the Reform Act requires plaintiffs to engage in backward reasoning when making this initial decision. Specifically, if a plaintiff determines her complaint would not survive a motion to dismiss if one was filed, or if she believes she may be subject to the Reform Act's stricter Rule 11 sanctions, it is likely the plaintiff will decide to not bring suit.

If a plaintiff does file a lawsuit, the corporation must then decide whether to make a settlement offer or litigate the claim.¹¹³ At this point in the sequential game, the corporation may use the information asymmetry between the principle and agent to its advantage. The corporation knows whether it committed securities fraud and, if fraud has occurred, a corporation would prefer to settle instead of proceed to litigation. Litigation is costly and class actions force corporations to redirect their resources from their "best use" to defending allegations of securities fraud.¹¹⁴ Moreover, an adverse judgment against the corporation could damage its reputation and profitability.¹¹⁵

If a corporation offers to settle, the plaintiff must decide whether to accept or reject the offer.¹¹⁶ In most instances, a plaintiff faced with this kind of information inequity would likely accept the settlement offer. For example, assume the plaintiff files suit but has not performed an investigation to determine the merits of her claim. Further assume, as is true in most securities fraud cases, the corporation is unaware whether the plaintiff knows if her claim is meritorious or frivolous.¹¹⁷ A corporation's offer to settle signals to the plaintiff her case may have merit and allows her to free ride off the corporation's actions without undergoing the costs of investigation.¹¹⁸ If the plaintiff rejects the corporation's settlement offer or the corporation re-

110. Bone, *supra* note 8, at 559.

111. See Olson et al., *supra* note 39, at 1112.

112. See Choi, *supra* note 28, at 598.

113. Bone, *supra* note 8, at 559.

114. Moos, *supra* note 48, at 770.

115. See *id.*

116. Bone, *supra* note 8, at 560.

117. *Id.* at 559-60.

118. *Id.* at 560 (discussing that plaintiffs do not investigate the merit of their suits because they can "rely on obtaining information from defendant's settlement offer").

fuses to settle, the plaintiff must then decide whether to litigate or drop the case.¹¹⁹

C. *The Informed Defendant Model: Increasing the Information Gap Between Plaintiff and Defendant*

The sequential game discussed in the previous section is known as the informed defendant model. It represents a scenario where the defendant, but not the plaintiff, knows if a suit is meritless,¹²⁰ creating information asymmetries the defendant may use to its advantage. While the informed defendant model contemplates a corporation faced with a lawsuit will either settle or not, it fails to consider a third option made more viable under the Reform Act. Specifically, corporations may also respond by filing a motion to dismiss. As evidenced by the increased dismissal rates in the post-Reform Act era, this seems to be a popular option.¹²¹ Therefore, plaintiffs, as players in this sequential game, must recognize defendants may file a motion to dismiss when they make the initial decision of whether to bring suit.

The defendant-friendly regime created by the Reform Act coupled with the nature of the informed defendant model makes filing a motion to dismiss an advantageous choice for corporations. Doing so prevents plaintiffs from leveling the informational playing field. Particularly, once a motion to dismiss is filed, the Reform Act mandates a stay on discovery,¹²² preventing plaintiffs from gathering any information on their claim that is not publicly available. The heightened pleading standard, therefore, incorrectly “assumes that in meritorious fraud cases, public information will provide sufficient evidence of intent to enable plaintiffs to meet this high threshold.”¹²³ In actuality, the heightened pleading standard places plaintiffs in a “procedural catch 22.”¹²⁴ Assuming most corporations do not disclose their fraudulent intentions publicly, plaintiffs are unable to uncover sufficient information that meets the Reform Act’s strict standards to survive a motion to dismiss, potentially screening out meritorious claims. These “excessive restrictions to pursuing securities fraud claims . . . insulate fraudfeasors from suit and filter meritorious lawsuits.”¹²⁵ Therefore, the Reform Act allows some violations of federal securities law to remain unpunished.

119. *Id.*

120. *Id.* at 550.

121. See Helms, *supra* note 13, at 190 (noting “the dismissal rate following the enactment of the PSLRA more than doubled”).

122. 15 U.S.C. § 78u-4(b)(3) (2006).

123. Selden, *supra* note 1, at 77.

124. Neil Pandey-Jorin, *A Case for Amending the Private Securities Litigation Reform Act: Why Increasing Shareholder Rights to Sue Will Help Prevent the Next Financial Crisis and Better Inform the Investigating Public*, 5 BUS. L. BRIEF 15, 15 (2009).

125. Sommer, *supra* note 16, at 415.

Moreover, the information asymmetries under the informed defendant model make a motion to dismiss a more attractive option than settlement or litigation. Filing a motion to dismiss sends a signal, although perhaps an inaccurate one, to uninformed plaintiffs that their complaint is frivolous. Plaintiffs normally rely on these signals since they rarely perform initial investigations.¹²⁶ Thus, a plaintiff faced with such motion may drop the case. Additionally, corporations may file a motion to dismiss to prevent plaintiffs from uncovering information that reveals other misdeeds of the corporation.

Additionally, cases decided by the Supreme Court following the passage of the Reform Act only made it more difficult for plaintiffs with legitimate claims to succeed. For example, in 2005, the Supreme Court decided *Dura Pharmaceuticals, Inc. v. Broudo*.¹²⁷ The plaintiffs in *Dura* brought a securities fraud action against managers and directors of the company, claiming the company's false statements about the expected approval of a new device by the Food and Drug Administration inflated the price of the stock.¹²⁸ The Court, however, determined the complaint was "legally insufficient," reasoning the inflated purchase price, by itself, did not prove loss causation.¹²⁹ Instead, a plaintiff must be able to provide "some indication of the loss and the causal connection."¹³⁰ Consequently, *Dura* made it more difficult for plaintiffs to meet the loss causation element for a section 10(b) and Rule 10b-5 claim.

Two years later, the Supreme Court decided a case that would raise the bar for plaintiffs even higher. In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, the Court attempted to establish a uniform interpretation of the Reform Act's pleading requirement for fraudulent intent.¹³¹ While the Court recognized the need to balance the "twin goals" of private securities litigation—preventing frivolous filings while protecting defrauded investors¹³²—it seems the Court ultimately sided with the corporations. Specifically, the Court held an "inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent."¹³³ Together, these cases have diminished the probability plaintiffs with valid claims may "successfully . . . litigate a securities fraud claim."¹³⁴

126. See Bone, *supra* note 8, at 560.

127. 544 U.S. 336 (2005).

128. *Id.* at 339-40.

129. *Id.* at 347-48.

130. *Id.* at 347.

131. 551 U.S. 308 (2007).

132. *Id.* at 309.

133. *Id.* at 314.

134. Dugan, *supra* note 37, at *6.

Accordingly, some have speculated that the Reform Act's effect of screening out meritorious suits is linked to the surge of corporate fraud in the early 2000s, including the Enron and WorldCom scandals.¹³⁵ Although it is unlikely that the Reform Act's severe provisions were the leading cause of this rise in crime,¹³⁶ they may have been a contributing factor. The ease with which meritorious claims may be dismissed has lessened private litigation's deterrence effect on securities fraud. Specifically, the Reform Act has "encouraged aggressive marketplace behavior."¹³⁷ While unconstrained aggressiveness may be beneficial for a corporation's bottom line, it is detrimental to the market as a whole. For example, recent incidents of corporate fraud "have led many ordinary Americans to conclude that our securities fraud deterrence regime is broken."¹³⁸ Ultimately, the Reform Act overcorrected the perceived abuses of frivolous litigation and shifted the pendulum away from plaintiffs and too far in favor of corporations.

V. RESTORING BALANCE BETWEEN PLAINTIFF AND DEFENDANT

While some argue the Reform Act strikes an appropriate balance between Type I and Type II errors,¹³⁹ the above discussion illustrates otherwise. The Reform Act's procedural barriers reduced the occurrence of Type I errors by screening out frivolous litigation. However, the Reform Act has overcorrected by allowing more Type II errors, effectively precluding meritorious claims from reaching settlement or litigation. Therefore, Congress must take curative measures to attain a better balance between these competing errors. Specifically, reforms should work to reduce the procedural obstacles plaintiffs face by requiring a lesser pleading standard and instituting a judicially managed discovery process. Additionally, Congress should require the SEC to promulgate standards that courts may use when ruling on motions to dismiss in private securities fraud cases.

These modifications find some support in the theory that frivolous litigation may actually generate positive externalities that help combat securities fraud. While much literature discusses the downsides of frivolous litigation,¹⁴⁰ Congress should reevaluate these perceived harms and recognize the possible benefits. Society is concerned Americans are "too litigious" and that "frivolous litigation is

135. See Seligman, *supra* note 85, at 112. Although Seligman posits the question of whether the Reform Act led to these recent occurrences of fraud, he does not fully support that proposition. *Id.* at 113.

136. *Id.*

137. Sommer, *supra* note 16, at 434.

138. Amanda M. Rose, *The Multiplier Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2175-76 (2010).

139. See, e.g., Phillips & Miller, *supra* note 3, at 1065.

140. See, e.g., Bone, *supra* note 8; Suja A. Thomas, *Frivolous Cases*, 59 DEPAUL L. REV. 633 (2010).

out of control”;¹⁴¹ however, there is no clear base line of what comprises frivolity.¹⁴² It is arguable frivolous litigation may generate benefits similar to legitimate class actions, such as deterrence, transparency, and accountability.¹⁴³ For example, a plaintiff who brings a meritless section 10(b) or Rule 10b-5 claim may uncover other violations of the corporation. Thus, preventing plaintiffs with even frivolous claims from partaking in discovery could allow other securities fraud violations to remain unexposed and unpunished.

A. Lowering the Pleading Standard

Prior to the Reform Act, circuit courts were split over how scienter under a section 10(b) or Rule 10b-5 claim should be pled.¹⁴⁴ The most noted division existed between the Second and Ninth Circuits. Taking the stricter approach, the Second Circuit required that facts set forth in the complaint “give[] rise to a strong inference of fraudulent intent.”¹⁴⁵ Conversely, the more lenient Ninth Circuit held scienter may be averred generally, “simply by saying that scienter existed.”¹⁴⁶ However, it appears the Reform Act adopted the Second Circuit’s test, as it requires a complaint to “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”¹⁴⁷

Utilizing the Second Circuit’s “strong inference” test, the Reform Act attempted to increase the litigation risks faced by plaintiffs,¹⁴⁸ placing more weight on their initial decision of whether to bring suit. Yet, as previously mentioned, the heightened pleading standard was unsuccessful in this regard. Instead, the “strong inference” test is overinclusive in its impact and, “if strictly applied and interpreted, will eliminate most private securities-fraud lawsuits.”¹⁴⁹ Fraudulent intent is difficult to demonstrate,¹⁵⁰ particularly if plaintiffs are foreclosed from discovery, as corporations would be unwise to reveal their fraudulent intentions publicly. Thus, requiring facts demonstrating a “strong inference” before the opportunity for discovery imposes an excessive burden on plaintiffs.¹⁵¹

141. Bone, *supra* note 8, at 420.

142. *See id.* at 529; *see also* Thomas, *supra* note 140, at 634.

143. *See* Burch, *supra* note 16, at 67.

144. Phillips & Miller, *supra* note 3, at 1042.

145. O’Brien v. Nat’l Prop. Analysts Partners, 936 F.2d 674, 676 (2d Cir. 1991) (internal citations omitted).

146. *In re* GlenFed, Inc. Securities Litigation, 42 F.3d 1541, 1547 (9th Cir. 1994).

147. 15 U.S.C. § 78u-4(b)(2) (2006).

148. Perino, *supra* note 5, at 957.

149. Sale, *supra* note 6, at 579.

150. Miest, *supra* note 29, at 1105 (stating scienter is “typically the most difficult element of a securities fraud claim to plead”).

151. Pandey-Jorin, *supra* note 124, at 18.

Accordingly, Congress should lower the pleading requirements and allow existing law to serve as the initial screening device.¹⁵² Rule 9(b) already requires complaints to “state with particularity the circumstances constituting fraud.”¹⁵³ Moreover, the Supreme Court’s decision in *Tellabs* requires these circumstances be convincing and as “compelling as any opposing inference of nonfraudulent intent.”¹⁵⁴ Expanding upon these requirements in the Reform Act is merely “duplicative and unduly burdensome.”¹⁵⁵ If the complaint is truly frivolous, the corporation will know that fact and can fight to defend the allegations by either filing a motion to dismiss or litigating the claim. Litigating not only allows a corporation to defend against existing frivolous claims but also allows the corporation, as a repeat player in this sequential game, to send signals to future plaintiffs indicating the corporation will not submit to the pressures of frivolous litigation and settle. Furthermore, concerns of abusive litigation can be addressed further down the line with judicially managed discovery and higher thresholds for motions to dismiss that do not focus exactly on the face of the complaint.

B. Judicially Managed Discovery

The Reform Act’s mandated stay on discovery amplifies the information asymmetry between investor and corporation. Preventing investors from obtaining information in support of their securities fraud claims places plaintiffs at a significant disadvantage. Additionally, the stay on discovery allows corporations to exploit the information gap created by the Reform Act by sending plaintiffs false signals about the merits of their claim through filing a motion to dismiss. Plaintiffs are unable to determine the validity of such signals unless verification is available through public information. Therefore, to reduce the information disparity between corporations and investors and to enhance corporate transparency, Congress should eliminate the Reform Act’s stay on discovery provision and implement a modified discovery process.

Instead of prohibiting discovery, courts should partake in the “[j]udicial management” of private securities fraud cases.¹⁵⁶ Under this modified process, a motion to dismiss would trigger judicially managed discovery. The court could then set a time limit for the plaintiff, establishing a certain number of days for permissible discovery. During this time, the court may frame the discovery process as it sees fit—limiting the amount of depositions or document re-

152. *See id.*

153. FED. R. CIV. P. 9(b).

154. *Tellabs, Inc. v. Makor Rights & Issues Ltd.*, 551 U.S. 308, 309 (2007).

155. Pandey-Jorrin, *supra* note 124, at 18.

156. *See Seligman, supra* note 85, at 118.

quests produced by either party. When the allotted time expires, the plaintiff would be allowed to resubmit a complaint pleading any additional factors uncovered during discovery in support of her claim. At this point, the court would analyze the plaintiff's complaint under Rule 9(b) and the *Tellabs* standard, in addition to suggested factors borrowed from the SEC (discussed in the next section), to determine if the motion to dismiss should be granted or denied.

Judicial management can reduce the costs normally imposed on corporate defendants and allows courts to “establish the scope and pace of permissible discovery.”¹⁵⁷ Furthermore, eliminating the stay on discovery encourages plaintiffs to perform their own investigation to determine the merits of their case, instead of free riding on the corporation's actions in the sequential game. Then, if a plaintiff realizes after investigation that her claim is meritless, she is free to drop the case. Furthermore, imposing a modified discovery process would permit more shareholders with valid claims to bring successful suits, combating the negative externalities created by securities fraud. Allowing plaintiffs to uncover facts under the discretion of the judge will lead to more complaints that plead the requisite strong inference of scienter. This, in turn, will increase the successful prosecution of securities fraud. It will also “increase corporate transparency” by exposing the “targeted information about the corporate practices” uncovered in the discovery process.¹⁵⁸

Judicial management of discovery, however, is not without its problems. Plaintiffs may still be enticed to file frivolous claims first and engage in abusive fishing expeditions later to leverage a settlement from the corporation. However, judicial scrutiny over the discovery process should work to reduce this problem. Nevertheless, modified discovery is only one factor necessary to create an appropriate balance between Type I and Type II errors. Assistance from the SEC will also help limit abusive practices.

C. Integration of Securities and Exchange Commission Standards into the Private Realm

Some scholars argue the best approach to balancing Type I and Type II errors is to eliminate private enforcement altogether, providing the SEC with exclusive authority over securities fraud enforcement.¹⁵⁹ While the SEC has specialized knowledge and experience in securities fraud, this approach ignores the reality that the SEC faces

157. *Id.*

158. Pandey-Jorin, *supra* note 124, at 17-18.

159. *See, e.g.,* Rose, *supra* note 138, at 2176 (suggesting to grant the SEC “exclusive authority to prosecute national securities frauds”).

many limitations.¹⁶⁰ Instead, private litigation should borrow from some of the SEC's expertise and practices.

The SEC considers certain factors when deciding whether to impose penalties on a corporation for securities fraud.¹⁶¹ These factors include: "[t]he need to deter the particular type of offense," "[t]he extent of the injury . . . [suffered by] the innocent part[y]," "[t]he level of intent on the part of the perpetrator[]," how difficult it is to detect that type of violation, and the "[p]resence or lack of remedial steps" on behalf of the corporation.¹⁶² Congress should require the SEC to create similar factors to be used by courts when presented with a motion to dismiss. These factors would be considered in addition to whether the complaint satisfies Rule 9(b) and the *Tellabs* standard, thereby establishing a higher threshold to survive a motion to dismiss while effectively transforming the pleading standard into another factor the court would consider.

Whether a complaint meets the strong inference standard under *Tellabs* is important as an initial screening device; however, that standard should not be dispositive in a court's decision to dismiss a complaint. Allowing courts to consider other important factors increases the likelihood meritorious cases will succeed. SEC involvement in this fashion provides an additional, but more lenient, level of screening out frivolous filings, while assisting plaintiffs disadvantaged by the information asymmetries under the informed defendant model. Moreover, as plaintiffs would have had the opportunity to uncover facts in judicially managed discovery, it is more likely those with frivolous complaints would decide to drop their cases, while legitimate claims would survive a motion to dismiss if one were filed.

Nevertheless, some may argue such factors will cause uncertainty in private securities litigation and remove some judicial decisionmaking authority from the court. In particular, it is possible courts will not apply these factors uniformly. Yet, courts are frequently tasked with the responsibility of applying similar factor tests. To assist in this responsibility, courts could receive more assistance from the SEC. Particularly, courts could analyze the proffered factors with regards to a specific case and submit, in writing, its analysis to the SEC for review. Regardless, instituting such factors balances the potentially adverse effects of lowering the pleading standard.

160. See Burch, *supra* note 16, at 101.

161. Rose, *supra* note 138, at 2176.

162. Statement of the Securities and Exchange Commission Concerning Financial Penalties, available at <http://www.sec.gov/news/press/2006-4.htm>.

D. Why Stricter Rule 11 Sanctions Will Not Work

Many have suggested stricter Rule 11 sanctions will reduce abusive litigation practices, particularly if a lower pleading standard has been recommended.¹⁶³ One author has even suggested applying different levels of sanctions based on assorted types of Rule 11 violations.¹⁶⁴ This approach would require Congress to classify different violations and create a corresponding sanctions rubric.¹⁶⁵ Courts would institute a sliding scale approach, imposing lower sanctions for less serious violations that incrementally increase with the severity of the violation.¹⁶⁶ However, while sanctions may deter frivolous litigation in other areas of law, they may not be as effective in private securities litigation.

In an area of law where the underlying crime involves disclosure of information, stricter sanctions may not be an appropriate measure of deterrence. Corporations have incentives to hide adverse information from the public. Particularly, corporations may lie because of “greed, fear, pressure, [and] opportunity.”¹⁶⁷ Moreover, corporations will work to keep the truth hidden from the public. To effectively deter frivolous litigation, sanctions must be high enough that plaintiffs will “internalize the net social costs of the contemplated misbehavior,”¹⁶⁸ yet not so high that it would lead to overdeterrence.¹⁶⁹ Plaintiffs would have to consider the additional factor of Rule 11 sanctions when making the initial decision of whether to bring suit. As a result, strict sanctions imposed on plaintiffs for failure to uncover hidden information would significantly increase their downside risk and potentially dissuade both meritless and meritorious claims from being filed. Thus, Rule 11 sanctions should be left to the discretion of the court so as to not deter investors from bringing legitimate claims.

VI. CONCLUSION

It is clear the Reform Act overcorrected the perceived abuses of private securities litigation. The increased dismissal rates in the post-Reform Act era indicate that while courts were successfully screening out frivolous litigation, they were also preventing meritorious claims from proceeding to trial. Further, the Reform Act has created an even wider information gap between investors and corpora-

163. *See, e.g.*, Pandey-Jorin, *supra* note 124, at 19.

164. *Id.*

165. *Id.*

166. *Id.* (“Thus, the more significant the court determines a Rule 11 violation to be, the more recovery that would be available to the defendant at the plaintiff’s expense.”).

167. Burch, *supra* note 16, at 93.

168. Rose, *supra* note 30, at 1322.

169. *See* Allen, *supra* note 27, at 498.

tions than previously existed under their principle-agent relationship. Corporations may exploit this information asymmetry through the procedural barriers of the Reform Act, allowing some corporate fraud to slip through the cracks that private litigation was originally designed to fill.

Private securities litigation needs to reclaim its responsibility as the necessary supplement to the SEC by effectively deterring and punishing securities fraud. Although finding an appropriate solution is not easy, Congress can take certain steps to “make it work.”¹⁷⁰ By lowering the procedural bar established by the Reform Act, plaintiffs with meritorious claims are more likely to survive a motion to dismiss, particularly if judicially managed discovery is permitted. Additionally, even plaintiffs who may have initially filed frivolous claims should be allowed to perform discovery in the instance they might uncover other violations committed by the corporation. This, in turn, improves corporate transparency and accountability. Further, reducing the initial screening requirements for a section 10(b) and Rule 10b-5 claim allows courts to institute stricter standards after discovery has taken place, applying standards similar to those currently utilized by the SEC. While this method is not guaranteed to achieve the perfect balance, “society must bear the risk that some suits will be brought when fraud has not occurred” if “actual fraud is to be combatted.”¹⁷¹

170. Selden, *supra* note 1, at 96 (emphasis omitted).

171. D. Brian Hufford, *Deterring Fraud v. Avoiding the “Strike Suit”: Reaching an Appropriate Balance*, 61 BROOK. L. REV. 593, 628 (1995).