NOTE

PLEADING SCIENTER AFTER THE PRIVATE SECURITIES LITIGATION REFORM ACT: OR, A TEXTUALIST REVENGE

Michael B. Dunn†

INTRODUCTION .......................................................... 194
I. BACKGROUND .................................................................. 199
   A. Section 21D(b)(2): The Heightened Pleading Standard for Scienter .............................................. 199
   B. The Pre-Reform Act Legal Landscape .......... 203
      1. Substantive Versus Procedural Law ............... 203
      2. The Substantive Element of Scienter .......... 204
      3. The Second Circuit's "Strong Inference" Pleading Standard .................................................. 205
II. THE DEVELOPMENT OF THE HEIGHTENED PLEADING STANDARD FOR SCIENTER IN CONGRESS .......... 207
   A. The House of Representatives ...................... 207
   B. The Senate ................................................. 211
      1. Floor Discussion and the Senate Report .......... 211
      2. The Specter Amendment .............................. 213
   C. The House Conference Report, Presidential Veto, and Congressional Override ...................... 215
III. CONFUSION AMONG THE DISTRICT COURTS .............. 221
   A. Framing the Issues ...................................... 221
   B. The Standards ........................................ 222
      1. Standard #1: A Rough Codification of the Second Circuit Standard .................................. 223
      2. Standards #2 and #3: More Stringent Than the Second Circuit Standard .................. 228
         a. Standard #2: No Presumption That Pleading Motive and Opportunity Gives Rise to a Strong Inference of Scienter .......... 228
         b. Standard #3: Elimination of Recklessness as a Substantive Basis for Securities Fraud .......... 231
            i. Silicon Graphics I and II .................... 231
            ii. Friedberg, Norwood Venture, and In Re Comshare .................................................. 235

† Candidate for J.D. 1999, Cornell Law School; B.A. 1993, University of Richmond. The author is an Article Editor and Symposium Editor of the Cornell Law Review.
IV. ANALYSIS ................................................................. 237
   A. Interpretive Methodology ...................................... 237
   B. Deducing the Pleading Standard ............................. 239
      1. Section 21D(b)(2) Does Not Eliminate Liability for
         Recklessness ................................................... 239
         a. The Text of the Reform Act ............................ 239
         b. The Legislative History ............................... 241
         c. History and Policy Considerations .................... 246
      2. As to Whether Section 21D(b)(2) Creates a Pleading
         Standard More Stringent Than That of the Second
         Circuit: The Text of the Statute Must Control .......... 248

CONCLUSION ............................................................... 250

INTRODUCTION

On December 22, 1995, Congress enacted the Private Securities
Litigation Reform Act of 19951 ("Reform Act") in a bipartisan effort to
curb abusive securities litigation. The Reform Act introduced major
revisions to the Securities Act of 19332 and the Securities Exchange
Act of 19343 ("1934 Act") in an effort to achieve an optimal balance4
between protecting investors from fraud and preventing the increase

---
U.S.C. (Supp. II 1996)).
77aa (1994 & Supp. II 1996)). Congress enacted the Securities Act of 1933
and the Securities Exchange Act of 1934 during the Great Depression in order to "pro-
mote investor confidence in the United States securities markets and thereby to encourage
the investment necessary for capital formation, economic growth, and job creation." S.
sion was marked by many deceptive practices by issuers against investors. See LOUIS LOSS &
JOEL SELIGMAN, FUNDamentals OF SECURITIES REGULATION 7-8 (3d ed. 1995). For a good
summary of the history and variety of these deceptive practices, see id. at 1-54 (1995);
securities laws attempt to prevent the use of such devices and the resulting fraud by ensuring
that all material information pertaining to a security or issuing company is fully disclosed
to investors. See LOSS & SELIGMAN, supra, at 54. The Securities Act of 1933 is concerned
with the initial distribution of securities, whereas the 1934 Act deals primarily with the
subsequent trading of securities. See id.
that the purpose behind the Reform Act is to "lower the cost of raising capital by combat-
ing [securities litigation] abuses, while maintaining the incentive for bringing meritorious
actions"); 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,
Defend-
ants and Lawyers, 51 BUS. LAW. 1009, 1009 (1996). Phillips and Miller suggest that
[a] properly balanced system would give appropriate weight to two competing
interests: the interest in deterring securities fraud and remedying it
when it occurs, and the interest in assuring that the litigation process is not
used for abusive purposes and does not unfairly target defendants who are
guilty of no wrongdoing.
4 Id.
in the cost of capital that results from the now infamous "strike suit."\(^5\)

A strike suit occurs when a plaintiffs' attorney files a class-action lawsuit\(^6\) on behalf of a corporation's shareholders following a sudden decline in the value of the company's stock. The attorney brings the suit not as a faithful representative of the plaintiff class, but primarily for its settlement value.\(^7\) According to proponents of the Reform Act, strike suits ultimately benefit the plaintiffs' lawyer at the expense of both the corporate defendant and the plaintiff-shareholder class.\(^8\)

The Reform Act seeks to curb these abusive lawsuits by making it more difficult for plaintiffs' lawyers to take advantage of the general antifraud provision of the federal securities laws—section 10b of the 1934 Act\(^9\) and Rule 10b-5\(^10\) promulgated thereunder.

---


7. The Reform Act congressional committee hearings and floor debates abound with tales of abuse via the "strike suit." For a good summary of the typical "strike suit" see H.R. Rep. No. 104-50 (1995), reprinted in James D. Cox et al., *Securities Regulation* 724-26 (2d ed. 1997). The complaints filed in strike suits are typically based on only minimal investigation and plead the most general allegations. See id. at 725. Having initiated a suit, the plaintiffs' lawyer typically uses numerous scare tactics unrelated to the underlying merits of the case, such as initiating extensive and costly discovery requests or raising the specter of huge judgment awards and negative publicity, to force the defendant company to settle. See id.

With relatively little specific evidence other than a drop in stock price, the plaintiffs have succeeded in filing a lawsuit, triggering the costly discovery process, and imposing massive costs on the defendant who possesses the bulk of the relevant information. . . .

As the costs of discovery rise, the pressure to settle becomes enormous. Many cases settle before the completion of discovery.

---

8. See H.R. Rep. No. 104-50 (1995), reprinted in Cox et al., *supra* note 7, at 725 ("The plaintiffs' lawyers take one third of the settlement, and the rest is distributed to the members of the class, resulting in pennies of return for each individual plaintiff.").


   It shall be unlawful for any person . . .

   (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

---

10. 17 C.F.R. § 240.10b-5 (1998). Securities and Exchange Commission ("SEC") Rule 10b-5 was promulgated by the SEC in 1948 and further refines the phrase "manipulative and deceptive device" contained in section 10b. Rule 10b-5 provides in relevant part:

   It shall be unlawful for any person . . .
The mainstay provision of the Reform Act, section 21D(b) (2), attempts to deter strike suits at the pleading stage of litigation. This

(a) To employ any device, scheme, or artifice to defraud,
(b) 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 were made, not misleading, or
(c) 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.

Id. The Supreme Court has described Rule 10b-5 as a "catch-all" provision. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1976). Rule 10b-5 "properly proscribes all fraud that touches on the purchase or sale of a security," and "stands as the centerpiece antifraud provision under the federal securities laws." Cox et al., supra note 7, at 682.

To establish a valid claim under Rule 10b-5, a plaintiff must prove that the defendant:
(1) made a material misrepresentation or omission, (2) in connection with the purchase or sale of a security, (3) with scienter, (4) that the plaintiff relied on this misrepresentation or omission, and (5) that this reliance caused the plaintiff's injury. See, e.g., Pits, Ltd. v. American Express Bank Int'l, 911 F. Supp. 710, 715-16 (S.D.N.Y 1996).

The Reform Act includes provisions designed to thwart the strike suit at every stage of litigation. In order to slow the "race to the courthouse," and to prevent the use of professional plaintiffs, Congress enacted a provision that requires the court to appoint "the most adequate plaintiff" as lead plaintiff. See 15 U.S.C. §§ 77z-1(a) (3) (B), 78u-4(a) (3) (B) (Supp. II 1996). The Reform Act creates further disincentives for plaintiffs' lawyers by limiting the lead plaintiff's recovery to his pro rata share of any final judgment or settlement, see 15 U.S.C. §§ 77z-1(a) (4), 78u-4(a) (4), and by prohibiting persons other than institutional investors from serving as lead plaintiff more than five times in three years, see 15 U.S.C. §§ 77z-1(a) (3) (B) (vi), 78u-4(a) (3) (B) (vi). Whereas prior to the Reform Act sanctions under Rule 11 of the Federal Rules of Civil Procedure were at the judge's discretion, see Fed. R. Civ. P. 11 (c), the Reform Act makes judicial review and imposition of sanctions for frivolous complaints mandatory. See 15 U.S.C. §§ 77z-1(c), 78u-4(c). With regard to forward-looking statements contained in prospectuses, primary targets for class action securities suits, Congress eliminated liability for recklessness, see 15 U.S.C. §§ 77z-2(c) (1) (B) (i), 78u-5(c) (1) (B) (i), and further enacted a provision codifying the "bespeaks caution" doctrine, which extends a "safe harbor" for both written and oral forward-looking statements accompanied by "meaningful cautionary statements." 15 U.S.C. §§ 77z-2(c) (1) (A) (i), 78u-5(c) (1) (A) (i). See generally Phillips & Miller, supra note 4, at 1015-16 (discussing the changes implemented by the Reform Act to curb speculative class action suits). For a study surveying the current state of judicial reception with regard to each of these provisions, see TEN THINGS WE KNOW AND TEN THINGS WE DON'T KNOW ABOUT THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 (1997) (testimony of Joseph A. Grundfest and Michael A. Perino), reprinted in, 1 29TH ANNUAL INSTITUTE ON SECURITIES REGULATION, at 301, 307-08 (PLI Corp. L. & Practice Course Handbook Series No. B-1022, 1997) [hereinafter TEN THINGS].
provision, the subject of extensive and heated congressional debate,\textsuperscript{14} heightens the requirements for pleading the scienter, or mental state, element of a securities fraud action brought under Rule 10b-5, thereby making it more difficult for a complaint to survive a motion to dismiss under Rule 12(b)(6) of the \textit{Federal Rules of Civil Procedure} ("FRCP").\textsuperscript{15} Aply comparing the reform legislation to "wet clay," Professor John Coffee observed that the ultimate fate of the Reform Act lies with the federal courts, "the master sculptor . . . that will spell the difference between high art and merely competent mediocrity."\textsuperscript{16} Thus far, the federal district courts' nonuniform treatment of section 21D(b)(2) has more closely resembled an art student's midterm than a Michelangelo.\textsuperscript{17}

The current confusion among the federal district courts centers on exactly how stringent Congress intended section 21D(b)(2)'s "strong inference" pleading standard to be. The thirty-one\textsuperscript{18} federal district courts that have interpreted section 21D(b)(2) to date have employed various interpretive strategies, contradictory Supreme Court precedent on statutory interpretation, and different pieces of the Reform Act's circuitous legislative history.\textsuperscript{19} As a result, the courts have arrived at, not one, but three distinct pleading standards. Approximately half of the courts to interpret section 21D(b)(2) have held that it roughly codified the Second Circuit's "strong inference" pleading standard in its entirety.\textsuperscript{20} The remaining courts have interpreted section 21D(b)(2) to have borrowed the "strong inference" language from the Second Circuit, but view the language as having modified the tests\textsuperscript{21} developed therein for determining whether a "strong inference" has been successfully pled.\textsuperscript{22} As a result, these courts have created a more stringent standard than that of the Second Circuit. Of these courts, one group has interpreted section 21D(b)(2) to have eliminated the presumption that satisfying one of the Second Circuit's two tests—the "motive and opportunity"—creates a strong inference of scienter.\textsuperscript{23} Even more disconcerting, the second group of these courts has interpreted section 21D(b)(2) both to have eradi-

\textsuperscript{14} For an in depth discussion of the legislative history leading to the enactment of the Reform Act, see \textit{infra} Part II.
\textsuperscript{15} See \textit{Fed. R. Civ. P.} 12(b)(6).
\textsuperscript{16} John C. Coffee, Jr., \textit{The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung}, 51 \textit{Bus. Law.} 975, 975 (1996).
\textsuperscript{17} See \textit{TEN THINGS}, supra note 11, at 301.
\textsuperscript{18} This number is based upon the Note writer's research as of September 1, 1998.
\textsuperscript{19} As Professor Coffee noted, "the more closely that one examines the legislative history on this point, the murkier the issue gets." Coffee, supra note 16, at 980.
\textsuperscript{20} See \textit{infra} Part III.B.1.
\textsuperscript{21} The Second Circuit's two alternative tests are laid out in detail \textit{infra} Part I.B.3.
\textsuperscript{22} See \textit{infra} Part III.B.2.
\textsuperscript{23} See \textit{infra} Part III.B.2(a).
cated the Second Circuit's motive and opportunity test and, by misconstruing the Second Circuit's second possible test, to have eliminated securities fraud liability for recklessness.\textsuperscript{24} By holding that a complaint must now plead facts establishing that the defendant acted with "conscious knowledge," these courts have modified not only the pleading requirements but also the substantive requirements of Rule 10b-5 securities fraud actions.

This Note explores how the federal district courts have interpreted one provision of the Reform Act to radically transform the pleading and scienter standards for federal securities litigation, and it attempts to clarify the present confusion concerning this provision. Part I provides a detailed introduction to the three different standards that the district courts have derived from section 21D(b)(2), clarifies the distinction between procedural and substantive law that has eluded several district courts, and describes the pre-Reform Act pleading requirements for the scienter element of securities fraud under Rule 10b-5. Part II discusses the legislative history behind section 21D(b)(2), and seeks to present a comprehensive guide for judges and legal practitioners faced with section 21D(b)(2) in the future. Part II closely tracks the development of the heightened standard for pleading scienter from the introduction of the Reform Act bill in each house of Congress to floor discussion preceding the congressional override of President Clinton's veto. Part III surveys the thirty-one district court cases that have interpreted section 21D(b)(2) to date. This Part identifies the three distinct pleading standards the courts have developed and analyzes the main interpretive arguments that each court has employed. Part IV evaluates the district courts' interpretive arguments in light of the text of both section 21D(b)(2) and related Reform Act provisions, in light of the legislative history behind section 21D(b)(2), and in light of the larger policy goals of both the Reform Act and the federal securities laws. Part IV concludes that section 21D(b)(2) does not alter the substantive scienter requirements for securities fraud and that, as to the precise stringency of section 21D(b)(2)'s pleading standard, the text of the provision must ultimately control.

\textsuperscript{24} \textit{See infra} Part III.B.2(b). It is crucial to understand the analytical distinction between a procedural and a substantive requirement. To restate the point: one group of courts has interpreted section 21D(b)(2) to have altered not simply what a complaint must plead with regard to the defendant's state of mind in order to survive a FRCP 12(b)(6) motion to dismiss for failure to state a claim, but also what a plaintiff must prove at trial with respect to the defendant's state of mind in order to succeed on the merits. For further clarifying remarks, see \textit{infra} Part I.B.1.
I

BACKGROUND

A. Section 21D(b)(2): The Heightened Pleading Standard for Scienter

A complaint alleging securities fraud under the federal securities laws must comply with the requirements of FRCP Rule 9(b).25 Prior to the passage of the Reform Act, the federal courts of appeals had applied widely divergent interpretations of FRCP Rule 9(b)'s requirement that, in fraud actions, "[m]alice, intent, knowledge, and other condition of mind of a person may be averred generally."26 The greatest divergence in application of FRCP Rule 9(b) was between the Ninth and the Second Circuits.27 Under pre-Reform Act Ninth Circuit law, in order to survive a FRCP Rule 12(b)(6) motion to dismiss, a plaintiff could plead the scienter element of a Rule 10b-5 securities fraud action with mere conclusory allegations.28 By contrast, Second Circuit law required a plaintiff's complaint to plead specific facts sufficient to establish a "strong inference" of scienter.29

In an attempt to create uniformity among the circuits30 and to "establish . . . more stringent pleading requirements to curtail the filing of meritless lawsuits,"31 the Reform Act added section 21D(b)(2) to the 1934 Act, which provides:

25 FRCP 9(b) provides: "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally." FED. R. Civ. P. 9(b). SEC Chairman Arthur Levitt characterized FRCP 9(b), during Senate Subcommittee hearings, as follows:

This . . . provision recognizes that, while it is fair to require a plaintiff to allege with some specificity what a defendant did and why it was fraudulent, 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.


27 See Senate Hearings, supra note 25, at 248-49 (testimony of Arthur Levitt, Chairman, SEC).

28 See In re GlenFed, Inc. Sec. Litig., 42 F.3d 1541, 1545-47 (9th Cir. 1994); see also Fecht v. Price Co., 70 F.3d 1078, 1082 n.4 (9th Cir. 1995) (noting that under the GlenFed standard a plaintiff "need 'simply . . . say[] that scienter existed' to satisfy the requirements of Rule 9(b)" (quoting Glenfed, 42 F.3d at 1547)).

29 See In re Time Warner Inc. Sec. Litig., 9 F.3d 259, 268 (2d Cir. 1993). Approximately three other circuits have followed the Second Circuit's approach. See Tuchman v. DSC Comm. Corp., 14 F.3d 1061, 1068 (5th Cir. 1994); Greenstone v. Cambex Corp., 975 F.2d 22, 25 (1st Cir. 1992); DiLeo v. Ernst & Young, 901 F.2d 624, 629-30 (7th Cir. 1990).


31 Id.
REQUIRED STATE OF MIND.—In any private action arising under this chapter 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 chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.32

According to the House Conference Report on the Reform Act, Congress wrote section 21D(b)(2) to conform to the “with particularity” language found in the first sentence of FRCP Rule 9(b),33 and also based the section’s language, “in part,” on the scienter pleading standard developed in the Second Circuit.34 The current confusion among the district courts stems from uncertainty over exactly how stringent Congress intended section 21D(b)(2)’s “strong inference” standard to be. The statutory language of section 21D(b)(2) neither sets out a definition of the term “strong inference,” nor provides any guidance as to precisely what a plaintiff must plead in order to establish a strong inference of scienter. Although the provision borrows language from the Second Circuit’s strong inference pleading standard, the text of section 21D(b)(2) does not explicitly incorporate the tests for establishing a strong inference developed in Second Circuit case law. According to the Second Circuit’s tests, a plaintiff may plead a “strong inference” by alleging either “facts establishing a motive to commit fraud and an opportunity to do so,”35 or, alternatively, “facts constituting circumstantial evidence of either reckless or conscious behavior.”36

Explanatory language in the House Conference Report, the starting point for a majority of the court decisions that this Note discusses, is indicative of the equivocal nature of the legislative history and has proven to be a primary source of the confusion surrounding section 21D(b)(2):

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. Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit’s case law interpreting this pleading standard.37

33 For the text of FRCP Rule 9(b), see supra note 25.
35 See In re Time Warner, 9 F.3d at 268-69.
36 Id. Part I.B.3 infra discusses in detail the Second Circuit’s “strong inference” standard, and the two alternative tests developed in that Circuit’s case law.
In the footnote accompanying this statement, the Conference Report states: "For this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness." This passage and the accompanying footnote, in combination with several other key parts of the Reform Act's legislative history, have raised several related questions. Did Congress intend the stringency of section 21D(b)(2)'s strong inference pleading standard to be roughly equivalent to the Second Circuit's standard, as measured by the alternative tests developed in Second Circuit case law? Alternatively, by adopting the "strong inference" language from the Second Circuit's pleading standard without expressly codifying Second Circuit case law, did Congress intend the provision to be more stringent than the Second Circuit's standard? Moreover, if Congress did indeed intend section 21D(b)(2) to be more stringent than the Second Circuit's strong inference pleading standard, as interpreted in Second Circuit case law, exactly how stringent is it to be? In enacting section 21D(b)(2), did Congress intend to raise the scienter pleading standard by eliminating the Second Circuit's first test for establishing a strong inference, such that a complaint alleging "motive and opportunity" would no longer necessarily be sufficient? Or did Congress intend not only to eliminate the first test but also to modify the Second Circuit's second possible test by prohibiting the pleading of recklessness, in effect changing the substantive requirements of securities fraud?

The courts are roughly split as to the first question. Of the thirty-one cases this Note examines, courts in sixteen of the cases have interpreted section 21D(b)(2) to be more or less a codification of the Second Circuit standard and have concluded that satisfaction of either Second Circuit test per se establishes a "strong inference." Courts in the remaining fifteen cases have interpreted section 21D(b)(2) to be more stringent than the Second Circuit standard. Eight of these fifteen courts have taken a middle ground and have held that the Reform Act simply eliminated the presumption that satisfying the "motive and opportunity" test suffices to establish a strong inference of scienter. Another case, Novak v. Kasaks, 997 F. Supp. 425 (S.D.N.Y. 1998), though arriving at a standard that closely resembles that of the second line of cases, in fact arrives at a standard that shares aspects of both the second and third lines of cases. Novak is discussed supra note 201.

cornucopia . . . on which courts of every appetite can feed." In re Baesa Sec. Litig., 969 F. Supp. 258, 242 n.2 (S.D.N.Y. 1997).
38 Id. at 4 n.23 (emphasis added).
39 Part III.B.1 infra discusses this line of cases.
40 Part III.B.2(a) infra discusses this line of cases. Another case, Novak v. Kasaks, 997 F. Supp. 425 (S.D.N.Y. 1998), though arriving at a standard that closely resembles that of the second line of cases, in fact arrives at a standard that shares aspects of both the second and third lines of cases. Novak is discussed supra note 201.
10b-5 liability for reckless conduct. In other words, these courts have held that section 21D(b)(2) changed not only the pleading requirement for the scienter, or mental state, element of securities fraud but also the underlying substantive mental state requirement itself.\textsuperscript{41}

Determining the exact stringency of the new scienter pleading standard is important for several reasons. As Senator John Kerry (D-Mass.) acknowledged in floor debate, procedure is an area of law in which "minor word changes can produce major consequences."\textsuperscript{42} This concern becomes magnified when such a change involves a pleading requirement regarding a state of mind, which is subjective by definition and thus provable only by circumstantial evidence. Because parties cannot obtain such evidence in the vast majority of cases until they have conducted discovery proceedings, erecting too high a pleading standard might prevent any complaint from surviving a FRCP Rule 12(b)(6) motion to dismiss.\textsuperscript{43} Further, because the Reform Act amended the 1934 Act to include an automatic stay of discovery\textsuperscript{44} pending motions to dismiss, the Reform Act prohibits a common plaintiff strategy—amending the complaint\textsuperscript{45} to reflect evidence uncovered in discovery. Hence, an extremely strict scienter pleading standard, coupled with the Reform Act's discovery stay, can make it virtually impossible for plaintiffs to sufficiently plead the requisite

\textsuperscript{41} Part III.B.2(b) \textit{infra} discusses this line of cases.

\textsuperscript{42} 141 Cong. Rec. S9204 (daily ed. June 28, 1995) (statement of Sen. Kerry). An observation, along similar lines, by Senator Specter, proves to have been particularly relevant:

\begin{quote}
The rules which govern court procedure . . . . are complicated on matters such as how pleadings are formulated, how specific you have to be, and what to say to get in court before you are entitled to discovery . . . .

. . . . It is not the kind of a matter which is customarily brought before the Banking Committee.
\end{quote}


\textsuperscript{43} See \textit{id.} at S8916 (daily ed. June 22, 1995) (statement of Sen. Bryan). Senator Bryan noted:

\begin{quote}
Under current law, fraud plaintiffs are not required to state specific facts establishing the defendant's intent. That is a subjective state of mind . . . .

It is a pretty onerous burden to be able to allege with particularity what the subjective thought process would be of a defendant.

The reason for that is because such facts are normally only uncovered later during a deposition or discovery process when there is a chance to examine the defendant or defendants under oath.
\end{quote}

\textit{Id.}

\textsuperscript{44} See 15 U.S.C. § 78u-4(b)(3)(B) (Supp. II 1996). Section 78u-4(b)(3)(B) amended the 1934 Act to include new section 21D(b)(1), which reads:

\begin{quote}
In any private action arising under this subchapter, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds, upon the motion of any party, that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.
\end{quote}

state of mind. As a result, the function of securities fraud suits in promoting full corporate disclosure could be severely impaired.

B. The Pre-Reform Act Legal Landscape

1. Substantive Versus Procedural Law

Pleading standards, particularly the pleading standard for the mental-state requirement of securities fraud actions brought under Rule 10b-5, tend to be surprisingly technical and complicated. Several areas of uncertainty in Second Circuit case law, upon which Congress at the very least modeled section 21D(b)(2)'s strong inference pleading standard, further complicate matters. The first area of potential confusion arises out of the fact that a pleading requirement for the scienter element of securities fraud lies at the intersection of procedural and substantive law. Several courts have failed to recognize the conceptual distinction between these two aspects of law.

A pleading requirement is a matter of procedural law and dictates the allegations, and the stringency of allegations, that a complaint must contain in order to establish a prima facie case and survive a FRCP Rule 12(b)(6) motion to dismiss for failure to state a claim. The scienter requirement of securities fraud, however, is a matter of substantive law. It pertains to the mental state that a plaintiff must prove the defendant acted with in order to win on the merits. Naturally, both a pleading requirement and an underlying mental-state requirement are formulated along continuums: a pleading requirement may be extremely stringent, somewhat stringent, or not at all stringent; and a scienter requirement may impose, or excuse, liability for conscious knowledge, recklessness, gross negligence, or negligence. Although the stringency of a pleading requirement for the scienter element of securities fraud depends, to a certain extent, upon the stringency of the underlying scienter standard (e.g., if the underlying scienter standard requires reckless behavior, a complaint cannot

47 See Brief of Securities Exchange Commission, Amicus Curiae, Concerning Defendants' Motion to Dismiss the Amended Complaint at 3, In re Silicon Graphics, Inc. Sec. Litig., 970 F. Supp. 746 (N.D. Cal. 1997) (C96-0390 FMS) [hereinafter SEC Amicus Brief].
49 On the distinction between substantive and procedural law, see Walter Wheeler Cook, "Substance" and "Procedure" in the Conflict of Laws, 42 YALE L.J. 333 (1933).
50 See infra Part III.B.2(b).
51 Three cases, namely Friedberg v. Discroet Logic Inc., 959 F. Supp. 42 (D. Mass. 1997), Norwood Venture Corp. v. Converse Inc., 959 F. Supp. 205 (S.D.N.Y. 1997), and Queen Uno Ltd. Partnership v. Coeur D'Alene Mines Corp., 2 F. Supp. 2d 1345 (D. Colo. 1998), by misunderstanding the "one way" relationship between substantive and procedural requirements, have interpreted section 21D(b)(2) to have raised the pleading requirement for securities fraud by heightening the underlying substantive scienter requirement. See infra Part III.B.2(b) (discussing Friedberg and Norwood Venture).
plead allegations of mere negligence), a pleading requirement and the underlying substantive requirement are analytically distinct.

2. The Substantive Element of Scienter

Several of the district court opinions discussed below have interpreted section 21D(b)(2) to have heightened both the pleading requirement and, by eliminating liability for reckless behavior, the substantive scienter requirements for Rule 10b-5 securities fraud. Thus, one must place the concepts of "scienter" and "recklessness," as they pertain to securities fraud, in context. The requirement that a plaintiff bringing an action under Rule 10b-5 must establish that the defendant acted with a particular state of mind was established in the touchstone case of Ernst & Ernst v. Hochfelder.53 In Ernst & Ernst, the Supreme Court held that merely negligent conduct does not give rise to liability for securities fraud.54 The court instead required a showing of scienter, which it described as "a mental state embracing intent to deceive, manipulate, or defraud."55 While the Court acknowledged in a famous footnote that "certain areas of the law" considered "recklessness" intentional conduct,56 it left unanswered the question of whether reckless behavior gives rise to liability under section 10(b) and Rule 10b-5.57 The vast majority of circuits subsequently have held that Rule 10b-5's scienter element does indeed include recklessness.58

Notwithstanding the nearly uniform acceptance of recklessness as a form of scienter, the precise definition of recklessness varies greatly

52 See infra Part III.B.2(b).
54 See id. at 214.
55 Id. at 195 n.12. The Court reached this conclusion through an interpretation of language in 1934 Act section 10(b), see id. at 195-96, which makes it unlawful for any person "to use or employ ... any manipulative or deceptive device," 15 U.S.C. § 78j(b) (1994), and language in Rule 10b-5, which states that "It shall be unlawful for any person ... to employ any device, scheme, or artifice to defraud," 17 C.F.R. § 240.10b-5 (1998). See Ernst & Ernst, 425 U.S. at 195-96.
56 Ernst & Ernst, 425 U.S. at 193 n.12.
57 See id.
among the district courts. More importantly for this Note's concerns, in interpreting section 21D(b)(2) at least one court, In re Silicon Graphics, Inc. Securities Litigation, has ignored the bulk of Second Circuit case law and has questioned whether the Second Circuit definitively has held that recklessness constitutes a form of scienter. Further complicating the issue, the court in Silicon Graphics identified three distinct lines of cases in the Second Circuit's case law that pertain to the scienter element of securities fraud and concluded that in modeling section 21D(b)(2) upon the Second Circuit's standard, Congress intended to codify a line of cases holding that scienter does not include recklessness.

3. The Second Circuit's "Strong Inference" Pleading Standard

Pleading requirements also present conceptual difficulties. As mentioned above, although the complaints in claims brought under the federal securities laws must comply with the Federal Rules of Civil Procedure, the circuits have applied varying interpretations to the requirements of FRCP Rule 9(b) with respect to pleading the scienter element of fraud. Because Congress focused on the Second Circuit's standard as a point of reference in drafting section 21D(b)(2), and because the level of stringency that the district courts have afforded section 21D(b)(2) has hinged, to a large degree, upon the extent to which the courts have adopted the two tests developed in Second Circuit case law, the following discussion is limited to the Second Circuit's pleading standard. Under Second Circuit law, in order to successfully plead the defendant's mental state in a complaint alleging securities fraud under Rule 10b-5, and thereby survive a defendant's motion to dismiss, the complaint must plead "specific facts" leading to a strong inference of the requisite scienter. Because direct knowledge of a defendant's state of mind is virtually impossible,

---


60 970 F. Supp. 746 (N.D. Cal. 1997).


62 See In re Silicon Graphics, 970 F. Supp. at 754-57. For further consideration of these three lines of cases, see infra Part III.B.2(b); infra note 311.

63 See supra text accompanying notes 25-29.


65 In re Time Warner Inc. Sec. Litig., 9 F.3d 259, 268-69 (2d Cir. 1993) (citing Beck v. Manufacturers Hanover Trust Co., 820 F.2d 46, 50 (2d Cir. 1987)).
and because plaintiffs may initiate discovery proceedings only after they file a complaint, the Second Circuit has developed two tests that provide alternative means for plaintiffs to plead strong inference. As stated in In re Time Warner Inc. Securities Litigation, "[t]he first approach is to allege facts establishing a motive to commit fraud and an opportunity to do so. The second approach is to allege facts constituting circumstantial evidence of either reckless or conscious behavior." However, Second Circuit case law contains a split concerning the precise formulation of these two alternative tests. In Beck v. Manufacturers Hanover Trust Co., the court states the tests somewhat differently by adding the following qualification: "[w]here 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."

Thus, the legal landscape upon which Congress enacted, and the judiciary has sought to interpret, section 21(D)(b)(2) is much more complicated, and much less definite, than either branch realized. To summarize: First, the intersection of procedural and substantive requirements intrinsic to a scienter pleading requirement has been a source of confusion. Second, though the substantive requirements of the scienter element of Rule 10b-5 securities fraud are quite settled—a majority of the circuits include recklessness as a basis for securities fraud liability—two issues still persist: (1) one court purportedly has uncovered a split within the Second Circuit's case law, suggesting that the circuit has yet to resolve conclusively the recklessness question; and (2) those circuits that definitively hold that reckless conduct constitutes scienter have employed a wide range of definitions for reck-

---

67 See In re Time Warner, 9 F.3d at 268-69.
68 Id. at 269. "Motive" and "Opportunity" are defined in Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124 (2d Cir. 1994). "Motive would entail concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged. Opportunity would entail the means and likely prospect of achieving concrete benefits by the means alleged." Id. at 1130.
69 See Douglas M. Parker, Fraud Under Section 10(b) of Securities Exchange Act, N.Y.L.J., Apr. 11, 1994, at 1. This split within the Second Circuit's case law was uncovered in congressional floor discussion, in exchanges between Senators Specter and Dodd surrounding the House Conference Report, see infra text accompanying notes 149-54, and preceding congressional override of President Clinton's veto, see infra text accompanying notes 158-64.
70 820 F.2d 46 (2d Cir. 1987).
71 At this point, the reader need only focus on the procedural differences between In re Time Warner and Beck. In re Time Warner and Beck formulate the two alternative tests differently in that Beck includes the following qualification: when a plaintiff does not pursue the first possible test (i.e., the motive and opportunity prong), the circumstantial evidence required in the second test must be "correspondingly greater." Beck, 820 F.2d at 50. For arguments against interpreting the term "conscious knowledge," as found in Beck, to exclude liability for recklessness, see infra note 311.
72 Beck, 820 F.2d at 50 (citations omitted) (emphasis added).
lessness. Finally, although the Second Circuit's pleading standard certainly requires the allegation of specific facts leading to a strong inference of scienter, a second split within the Second Circuit's case law indicates two distinct formulations of the two alternative tests for establishing a strong inference.

II
THE DEVELOPMENT OF THE HEIGHTENED PLEADING STANDARD FOR SCIENTER IN CONGRESS

This Part attempts to organize the legislative history pertaining to section 21D(b)(2), from its introduction in the House of Representatives in early January of 1995 to its enactment over presidential veto in late December of that year. The goal is to better understand the general import of the provision and to provide a point of reference for Part III, which maps judicial interpretation of this legislative history. This Part traces the development of the scienter pleading standard provision chronologically within each house of Congress and considers every version of the scienter pleading standard as it appeared in the bills of the Senate and the House of Representatives. It further analyzes the suggested and rejected amendments surrounding the Senate Committee and House Conference Committee Reports, President Clinton's veto of the Reform Act, and all significant congressional floor discussion that accompanied the congressional override of the presidential veto.

A. The House of Representatives

The first version of the Private Securities Litigation Reform Act of 1995, introduced in the House of Representatives as Title II of The Common Sense Legal Reform Act of 1995—House Bill 1075—proposed to reform abusive litigation practices in the tort liability system as a whole.76 House Bill 10 contained provisions that altered both the pleading and the substantive requirements of the scienter element of securities fraud. It required that a complaint alleging securities fraud

73 One should note at the outset that the House of Representatives and the Senate approached the issue of heightening the pleading standard for scienter in slightly different ways. When the Reform Act bill first developed in the House, it included provisions that altered both procedural aspects (i.e., pleading requirements) and substantive aspects (i.e., elements of a cause of action) of securities fraud actions. However, the relevant provisions in the Senate bill were always tightly circumscribed to the pleading stage of securities fraud. Thus, while the House spent significant time discussing the exact definition of the scienter element of securities fraud, whether to include recklessness, and if so, how to define recklessness, this type of discussion is completely absent from Senate debate.


76 See Avery, supra note 74, at 347-48.
plead "specific facts" demonstrating that the defendant had acted with the required scienter.\textsuperscript{77} By explicitly requiring that a defendant act knowingly, and thus eliminating liability for recklessness, House Bill 10 also altered the mental state requirement for Rule 10b-5 actions:

In any action under section 10(b), a defendant may be held liable for money damages only on proof—

\begin{itemize}
  \item [(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 statement made at the time they were made.\textsuperscript{78}
\end{itemize}

The House Subcommittee on Telecommunications and Finance ("House Subcommittee") held hearings on Title II of House Bill 10 on January 1979 and February 10,\textsuperscript{80} 1995. During these hearings Securities Exchange Commission ("SEC") Chairman Arthur Levitt testified as to the SEC's opposition to House Bill 10's elimination of recklessness as a basis of liability for securities fraud.\textsuperscript{81} The House Subcommittee passed Title II of House Bill 10 on February 14, 1995,\textsuperscript{82} and on February 16, 1995, the House Committee on Commerce ("Commerce Committee") marked up and reported the bill.\textsuperscript{83} This version included significant changes to the requirements for securities fraud, which now included and defined recklessness.\textsuperscript{84}

On February 27, 1995, Chairman Bliley introduced a revised version of Title II of House Bill 10, redesignated as House Bill 1058.\textsuperscript{85} House Bill 1058's requirements for securities fraud generally followed those of the version reported out of the Commerce Committee. Notably, it included recklessness as grounds for securities fraud liability.\textsuperscript{86} It also included a definition of "reckless behavior," modeled on *Sundstrand Corp. v. Sun Chemical Corp.*,\textsuperscript{87} and provided an example of reck-

\begin{footnotes}
\item[77] See H.R. 10, 104th Cong. § 204 (1995) (proposing addition to section 10 of the 1934 Act).
\item[78] Id. (emphasis added).
\item[80] See id. at 157-598.
\item[81] See id. at 191-221 (statement, prepared statement, and testimony of Arthur Levitt).
\item[83] See id. at D208 (daily ed. Feb. 16, 1995).
\item[84] See Avery, supra note 74, at 549-50.
\item[85] H.R. 1058, 104th Cong. (1995).
\item[86] See id. at § 4 (proposing new section 10A(a) of the 1934 Act). This part of the provision read: "Requirements for Securities Fraud Actions. (a) Scienter—... In any private action arising under this title based on a fraudulent statement, liability may be established only on proof that..., the defendant made such fraudulent statement knowingly or recklessly." Id. (proposing new section 10A(a)(1)(C) of the 1934 Act).
\item[87] 553 F.2d 1033, 1045 (7th Cir. 1977) (quoting Franke v. Midwestern Okla. Dev. Auth., 428 F. Supp. 719 (W.D. Okla. 1976)). The definition of "recklessness" formulated in *Sundstrand* is the most widely followed among the circuits. See Loss & Seligman, supra note
\end{footnotes}
less behavior. However, House Bill 1058 added language to House Bill 10’s pleading requirement, making it more stringent than House Bill 10. Rather than merely requiring that the complaint make "specific allegations" regarding the requisite scienter, it required that the "complaint . . . make specific allegations which, if true, would be sufficient to establish scienter as to each defendant at the time the alleged violation occurred." The House debated House Bill 1058 on March 7 and March 8, 1995. The debate regarding the substantive requirements for securities fraud did not center on the reinclusion of recklessness as a substantive ground for liability, but on House Bill 1058’s definition of recklessness. An amendment offered by Representative Anna Eshoo (D-Cal.), which the House eventually rejected, would have stricken the second line of House Bill 1058’s definition of recklessness. This line of House Bill 1058 provided by way of example that "a defendant who genuinely forgot to disclose, or to whom disclosure did not come to mind, is not reckless." Representative Christo-


88 The provision reads:

[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.

H.R. 1058 § 4 (proposing new section 10A(a)(4) of the 1934 Act).

89 Id. (emphasis added) (proposing new section 10A(b) of the 1934 Act). The provision also provided 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." Id.


91 See id. at H2818 (daily ed. Mar. 8, 1995).

92 There in fact seems to have been general approval for what would have been the first codification of a definition of recklessness. See, e.g., 141 Cong. Rec. H2761 (daily ed. Mar. 7, 1995) (statement of Rep. Fields) ("For the first time in the securities laws, a standard for reckless conduct is defined"). The next day, Representative Ganske added:

[A] for the definition of recklessness, the current law is vague and uncertain [and] . . . has led to a great deal of inconsistency, confusion, and unfairness . . . .

I think all of us would agree that by creating consistency we can increase fairness and decrease the probability of injustice in our legal system.

Id. at H2764 (daily ed. Mar. 8, 1995) (statement of Rep. Ganske). Note that the Reform Act did not ultimately include a definition of "recklessness."

93 See id. at H2818 (daily ed. Mar. 8, 1995).

pher Cox (R-Cal.) also offered an amendment to this sentence of the recklessness definition. He proposed to replace the sentence in an attempt to distinguish more precisely between recklessness and gross negligence on the one hand and between recklessness and intentional conduct on the other. The House ultimately passed this amendment, which appears in the final version of House Bill 1058.95

The procedural requirement for pleading the scienter element of securities fraud was also the subject of contention on the floor of the House. The Representatives were primarily concerned that the pleading standard’s requirement that a complaint “make specific allegations . . . sufficient to establish [s]cienter”96 was impossibly strict. As Representative Edward Bryant (R-Tenn.) argued in favor of his proposed amendment, House Bill 1058’s pleading requirement for scienter would require a plaintiff to include these specific allegations “prior to discovery when it is virtually impossible for [the] plaintiff to establish [such] facts.”97 Representative Bryant’s proposed amendment lessened the scienter pleading requirement to require only that the plaintiff “allege in its complaint facts suggesting that the defendant acted with [the required state of mind].”98 The House ultimately rejected this amendment99 and retained the original language of House Bill 1058’s pleading requirement when the bill passed by a vote of 325 to ninety-nine on March 8, 1995.100

---

95 This amendment read: “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 reckless.” 141 CONG. REC. H2820 (daily ed. Mar. 8, 1995).


97 141 CONG. REC. H2848 (daily ed. Mar. 8, 1995); see also id. at H2849 (statement of Rep. Dingell) (“[T]his legislation, as now drawn, makes it impossible [for a plaintiff to survive a Rule 12(b)(6) motion to dismiss] without having both an attorney, a psychiatrist, and probably a psychic.”).

98 Id. at H2848 (emphasis added).

99 See id. at H2852.

100 See id. at H2863-64. Thus, the requirements for securities fraud, as they appeared in the final version of House Bill 1058 adopted by the House read:

**SECTION 10A. REQUIREMENTS FOR SECURITIES FRAUD ACTIONS.**

(a) Scienter.—

(1) In General.—In any private action arising under this title based on a fraudulent statement, liability may be established only on proof that . . .
PLEADING SCIENTER

B. The Senate

1. Floor Discussion and the Senate Report

On January 18, 1995, Senators Christopher Dodd (D-Conn.) and Pete Domenici (R-N.M.) introduced the Senate's version of the Reform Act.\(^{101}\) Senate Bill 240.\(^{102}\) The Senate never purported to alter the substantive requirements for securities fraud. The pleading requirement for scienter in the original version of the bill erected a standard identical to that required of a complaint when pleading the "circumstances constituting fraud" under the first sentence of FRCP Rule 9(b). Thus, the standard was significantly higher than the "general averment" pleading standard set out in the second sentence of FRCP Rule 9(b).\(^{103}\) Though Senator Domenici explained that the new provision simply required "specificity in pleading securities fraud,"\(^{104}\) several Senators argued that the standard was more stringent than any that the federal courts of appeals currently employed.\(^{105}\) The provision read as follows: "In [securities fraud actions brought under Rule 10b-5], the plaintiff's complaint shall allege specific facts demonstrating the state of mind of each defendant at the time the alleged violation occurred."\(^{106}\)

(c) The defendant made such fraudulent statement knowingly or recklessly.

(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. Deliberately refraining from taking steps to discover whether one's statements are false or misleading constitute recklessness, but if the failure to investigate was not deliberate, such conduct shall not be considered reckless.

(b) Requirements for Explicit Pleading of Scienter.—... [T]he complaint shall... make specific allegations which, if true, would be sufficient to establish scienter as to each defendant at the time the alleged violation occurred.

\(^{101}\) See 141 CONG. REC. S1075 (daily ed. Jan. 18, 1995).
\(^{103}\) For the text of FRCP Rule 9(b), see supra note 25.
\(^{105}\) See 141 CONG. REC. S8916 (daily ed. June 22, 1995) (statement of Sen. Bryan) ("[T]he original S. 240 tried to block cases... through impossible pleading standards requiring plaintiffs to state specific acts demonstrating the state of mind of each defendant. Witness after witness indicated that this would prevent, for all practical purposes, many fraud victims from recovering their money.").
\(^{106}\) S. 240 § 104 (proposing new section 39(a) of the 1934 Act). An analysis document introduced with Senate Bill 240 supports Senator Domenici's description of the proposed addition of section 39(a) to the 1934 Act: "Section 39(a)... requires the plaintiff to allege in its complaint specific facts demonstrating why the plaintiff believes that each such defen-
The Senate's Subcommittee on Securities ("Senate Subcommittee") held hearings on March 2, March 22, and April 6, 1995. During his April 6 testimony, SEC Chairman Levitt expressed the Commission's views on both the Senate and House bills. Acknowledging House Bill 1058's concern with the substantive liability aspect of scienter and its definition of recklessness, Chairman Levitt advised Congress to codify the *Sundstrand Corp. v. Sun Chemical Corp.* definition of recklessness. With regard to the pleading requirement, Chairman Levitt urged Congress to adopt the Second Circuit's strong inference standard. The Senate Bill, as reported out of the Senate Committee on Banking, Housing, and Urban Affairs ("Senate Banking Committee") on June 19, 1995, codified the Second Circuit's strong inference pleading standard, but it did not add language pertaining to the substantive scienter requirement. The relevant provision read: "In any private action arising under this title ... 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." The Committee Report accompanying the bill contained a paragraph, which a large number of courts have relied on, explaining how the Committee arrived at this pleading standard:

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 caselaw interpreting this pleading standard, although courts may find this body of law instructive.*
The Senate Bill was debated on the floor for five days in June 1995. Senators expressed general approval and disapproval regarding the actual text of Senate Bill 240's pleading standard. Most of the debate, however, centered around an amendment proposed by Senator Arlen Specter (R-Pa.) that approved of Senate Bill 240's codification of the Second Circuit's strong inference standard, but sought further to codify Second Circuit case law interpreting the standard—in particular the two alternative tests for establishing a strong inference of scienter. Because much of the disagreement among the district courts has revolved around the binding effect and pre- emptional value of the tests developed in the Second Circuit, this Note considers in detail the arguments Senator Specter made in support of his amendment.

2. The Specter Amendment

The Specter amendment attempted to codify the two alternative tests developed in the Second Circuit. The amendment, which added language explaining how plaintiffs may establish a strong inference, read in pertinent part:


115 See, e.g., id. at S8892 (daily ed. June 22, 1995) (statement of Sen. D'Amato) ("S. 240 creates a uniform pleading standard that will help to weed out frivolous complaints before companies must pay heavy legal bills [because it] . . . codifies the pleading standard of the second circuit in New York . . . "). Senator Dodd added: The bill clarifies current requirements that lawyers should have some facts to back up their assertion of securities fraud by adopting the reasonable standards established by the Second Circuit Court of Appeals . . . This is not some arbitrary standard pulled out of a hat or crafted in committee; it follows the Federal courts. Id. at S8895 (statement of Sen. Dodd).

116 Senator Specter described his proposed amendment as follows:

What this amendment does is to accept the very stringent standard of the second circuit on pleading to show state of mind, and then it adds to the legislation the way the second circuit says you can allege the necessary state of mind.

The bill, quite properly, tightens up the pleading standards by establishing the most stringent rule of any circuit. Id. at S9200 (daily ed. June 28, 1995) (statement by Senator Specter).

117 Although Senator Specter stated explicitly that he based his formulation on the two alternative tests in Beck v. Manufacturers Hanover Trust Co., 820 F.2d 46, 50 (2d Cir. 1987), it more closely resembled the formulation of the test as it appears in In re Time Warner Inc. Securities Litigation, 9 F.3d 259, 268-69 (2d Cir. 1993). In re Time Warner is the case upon which, at SEC Chairman Levitt's suggestion, see supra note 110 and accompanying text, the Senate Committee based S.240's "strong inference" language. That Beck and In re Time Warner in fact formulate the Second Circuit's two alternative tests differently is only explicitly discussed in two exchanges between Senators Specter and Dodd. See infra text accompanying notes 149-54, 158-62.
For purposes of paragraph (1), 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.\footnote{118}

Senator Specter offered two arguments for the inclusion of these tests. First, he argued that the codification of the Second Circuit's strong inference pleading standard without guidance as to how a complaint might satisfy that standard was unfair to plaintiffs.\footnote{119} Senator Specter's second concern, and an issue which is at the center of the current debate in the district courts,\footnote{120} pertained to the seemingly contradictory intent evidenced in the Senate Report. The Senate Report states that Senate Bill 240's heightened pleading requirement is modeled on the Second Circuit's strong inference standard and not a "new and untested pleading standard."\footnote{121} However, argued Specter, by failing to incorporate the two alternative tests into the statute and choosing instead merely to allow the courts to consult the tests for guidance, the Senate Report in effect advocates a new and untested pleading standard.\footnote{122} It follows, Specter pointed out, that if the two alternative tests developed in Second Circuit case law are not codified, "then this bill allows courts to interpret this tougher pleading stan-

\footnote{118} \textit{CONG. REC.} S9170 (daily ed. June 27, 1995). After introducing his amendment, Senator Specter went on to discuss the Second Circuit's standard:

Judge John Newman, who established this standard in the case of \textit{Beck v. Manufacturers Hanover Trust Co.}, said:

\ldots

"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."

\textit{Id.} at S9171 (daily ed. June 27, 1995) (statement of Sen. Specter) (quoting \textit{Beck}, 820 F.2d at 50). As discussed below, the precise formulation of this test becomes a topic of contention in floor debate surrounding the Senate Report, the House Conference Report, and President Clinton's veto. \textit{See infra} Part II.C.

\footnote{119} Senator Specter stated:

This is just basic fundamental fairness that if you take the second circuit standard, you ought to take the entire standard . . . . How do you get into somebody else's head? [By codifying the second circuit test, you] at least . . . let the plaintiff know . . . they are going to be able to plead . . . the way the second circuit itself permits.


\footnote{120} \textit{See infra} Part III.


\footnote{122} \textit{See 141 CONG. REC.} S9171 (daily ed. June 27, 1995) (statement of Sen. Specter) ("[T]he one thing for the committee to say that they are not adopting a new and untested pleading standard, but it is only halfway [true] if it . . . leaves open the question of how you meet this standard.").
standard anyway they choose, and courts may impose some standards which go far beyond what the second circuit . . . had in mind in imposing this tough pleading standard."123

Senator Specter’s logic did not persuade all of his colleagues, and Senator Robert Bennett (R-Utah) provided first-hand insight into the Senate Committee’s reasons for not codifying the Second Circuit’s case law. Senator Bennett made it clear that the Committee purposely decided to leave the Second Circuit tests uncodified:

[T]he committee 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.

. . . They felt that with the second circuit 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.124

Senator Alfonse D’Amato (R-N.Y.), also a member of the Senate Committee, opposed the Specter amendment because he believed that codification of the Second Circuit tests would, in effect, “straight-jacket” the courts and would upset the “balanced” approach the Committee had intended.125 Despite these objections, the Senate accepted the Specter amendment,126 and it appears in the final version of Senate Bill 240, which the Senate passed on June 28, 1995 by a vote of seventy to twenty-nine.127

C. The House Conference Report, Presidential Veto, and Congressional Override

On November 28, 1995, after several months of negotiations, a Committee of Conference reconciled the differences between the

123 Id.
124 Id. at S9172 (statement of Sen. Bennett).
125 Id. at S9201 (daily ed. June 28, 1995) (statement of Sen. D’Amato) (“This amendment goes too far, however, because it actually tells the court how to interpret S. 240’s pleading standards.”).
126 See id. (passing amendment by a vote of 57 to 42).
127 See id. at S9219. Thus, the scienter pleading standard as it appeared in the final version of the Senate Bill 240 bill adopted by the Senate read:

(b) REQUIRED STATE OF MIND.—

(1) In General.—In any private action arising under this title . . . the 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.

(2) Strong Inference of Fraudulent Intent.—For purposes of paragraph (1), 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.

Id. at S9222.
The Committee filed the final version of the Reform Act bill, together with a "Statement of Managers" describing the Committee's intent, in House Conference Report 104-369. The pleading standard for scienter in the final version of the Reform Act bill adopted the strong inference language of the Senate bill, but dropped the two alternative tests contained in the Specter amendment. Further, the Committee omitted from the final version of the Reform Act bill any provision purporting to alter the substantive requirements of securities fraud. Thus, the House Conference Report dropped House Bill 1058's explicit inclusion of recklessness as a basis of liability and its definition of recklessness. Ultimately enacted as section 21D(b)(2) of the 1994 Act, the final version of the pleading requirement reads:

**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.

According to the House Conference Report's Statement of Managers, the conferees adopted the heightened pleading standard to create uniformity among the circuits, which had thitherto interpreted the requirements of FRCP Rule 9(b) in conflicting ways. The Statement of Managers explicitly states that the language of the heightened pleading provision was written "to conform . . . to Rule 9(b)’s notion of pleading with particularity," and also was based, "in part," on the Second Circuit's pleading standard. The Statement of Managers then describes, in somewhat cryptic fashion, the conferee's reasoning for dropping the language that the Specter amendment had added to the Senate bill:

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. Because the Conference Committee in-

---

131 For the text of the final House Bill 1058, with respect to the pleading standard, see supra note 100.
134 Id.
tends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard.135

Then, in the appended footnote 23, the Statement of Managers adds: "For this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness."136 According to a statement Senator Dodd made during floor discussion, the pleading standard in the revised bill struck a "balance" between the pleading standards found in the Senate and House bills.137 The Conference Committee appears to have opted against the House bill's extremely stringent pleading requirement, but strengthened the Senate bill's standard by dropping the Specter amendment's two alternative tests and by replacing Senate Bill 240's "specifically allege" language with the requirement that a complaint must state "with particularity" facts giving rise to a strong inference of the required scienter.138 The language of the Statement of Managers suggests that the Committee intended to codify the Second Circuit's strong inference standard, but then states that the Committee's intention was to "strengthen existing pleading requirements."139 The Committee sought to accomplish this goal, according to the Statement of Managers, by not codifying the Second Circuit's case law interpreting the strong inference pleading standard.140 Moreover, the "motive, opportunity, or recklessness" language in footnote 23 presumably refers to Second Circuit case law, particularly the two alternative tests developed in Beck v. Manufacturers Hanover Trust Co.,141 In re Time Warner Inc. Securities Litigation,142 and the Specter amendment.143 However, as the courts have recognized, this explanation raises as many questions as it answers.144

Floor discussion continued in each house prior to the passage of the bill in the Senate on December 5, 1995,145 and in the House of Representatives on December 6, 1995.146 The Reform Act bill's heightened pleading requirement received only minimal attention in

---

135 Id. (emphasis added).
136 Id. at 48 n.23, reprinted in 1995 U.S.C.C.A.N. 730, 747 n.23
138 Compare the text of the House Conference Report, see supra text accompanying note 135, with the final version of Senate Bill 240, see supra note 127. Note that this "with particularity" language was in neither the Senate nor the House bill.
139 H.R. CONF. REP. No. 104-369, at 41.
140 See id.
141 820 F.2d 46, 50 (2d Cir. 1987).
142 9 F.3d 259, 268-69 (2d Cir. 1993).
143 See 141 CONG. REC. S9170 (daily ed. June 27, 1995). That Beck and In re Time Warner in fact formulate the Second Circuit's two alternative tests differently is only explicitly discussed in two exchanges between Senators Specter and Dodd. See infra text accompanying notes 149-54, 158-62.
144 See infra Part III.
146 See id. at H14,055 (daily ed. Dec. 6, 1995).
the House of Representatives.\footnote{See, e.g., id. at H14,041 (statement of Rep. Dingell) ("The bill’s elevated pleading standard for scienter . . . will require average investors . . . to know and state facts in pleadings that are only knowable after discovery.").} By contrast, the heightened pleading standard received considerable attention in the Senate.\footnote{Statements made by different Senators reflect various understandings of the pleading standard contained in the House Conference Report. \textit{Compare} id. at S17,999 (daily ed. Dec. 5, 1995) (statement of Sen. Grams) ("Codification of the pleading standard adopted by the second circuit court of appeals."), \textit{id.} at S17,969 (statement of Sen. Domenici) ("[The] conference report adopts the pleading standard utilized by the second circuit court of appeals."), \textit{id.} at S17,983 (statement of Sen. Dole) ("[The House Conference Report] adopts the second circuit’s pleading standard."), \textit{and id.} at S17,984 (statement of Sen. Moseley-Braun) ("In the area of pleading, the House bill adopted a standard that was significantly higher than the second circuit standard, which was the standard adopted in the Senate bill. The Senate position prevailed at conference.")., with \textit{id.} at S17,980 (statement of Sen. Heflin) ("[T]he proponents have retained an extremely difficult pleading requirement[,] . . . [t]he report not only adopts [the 'strong inference'] language but raises the requirement even more.")., \textit{id.} at S17,992 (statement of Sen. Biden) ("Another of the troubling provisions in this bill, is the one which adopts a higher pleading standard than was in the Senate bill—higher in fact than the standard adopted by the second circuit.")., \textit{and id.} at S17,938 (statement of Sen. Sarbanes) ("The draft conference report deleted the Specter amendment, leaving investors without the protection of the additional second circuit holdings.").} The most heated exchange arose between Senators Dodd and Specter. As one might expect, the Conference Committee’s elimination of the Second Circuit’s two alternative tests concerned Senator Specter because it left plaintiffs without guidance as to what a complaint must allege in order to plead a strong inference of scienter.\footnote{See \textit{id.} at S17,959 (statement of Sen. Specter).} This change, along with the Conference Committee’s replacement of the requirement that a complaint “specifically allege facts,” as found in the final version of Senate Bill 240, with the requirement that a complaint state the facts “with particularity,” led Specter to assert that the committee created an “impossible pleading standard.”\footnote{\textit{Id.} at S17,960-61. \textit{Compare supra} note 127 (quoting the final version of Senate Bill 240), \textit{with supra} text accompanying note 132 (quoting the final version of the comparable provision in the House Conference Report).} In response to Senator Specter’s protests, Senator Dodd, a member of the Conference Committee, attempted to clarify the committee’s intention. In so doing, Senator Dodd brought to light the confusion over the exact formulation of the Second Circuit’s tests. Senator Dodd stated that the Conference Committee eliminated the Specter amendment because the version of the Second Circuit’s two alternative tests contained therein was but one of several formulations of the test and “omit[ted] a critical qualification in the case law.”\footnote{141 \textit{CONG. REC.} S17,960 (daily ed. Dec. 5, 1995) (statement of Sen. Dodd).} According to Senator Dodd, the Specter amendment ignored the fact that a number of Second Circuit cases had “held that ‘where motive is not apparent, a plaintiff may plead scienter by identifying circumstances’ indicating wrongful behavior, but ‘the strength of the circumstantial alle-
gations must be correspondingly greater." Senator Dodd explained that the Conference Committee intended to codify the Second Circuit's strong inference standard but, because of the varied interpretations of that standard in Second Circuit case law, also intended to let the courts decide what a plaintiff's complaint must plead in order to meet that standard.

President Clinton also realized that the Statement of Managers could be construed as creating a standard stricter than that of the Second Circuit and expressed his reservations in the message accompanying his veto of the Reform Act bill, which he issued on December 19, 1995. In his veto message, the President specifically objected to what he construed to be the House Conference Report's overly stringent pleading requirement. The President stated 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 Cir-

---


153 Senator Specter challenged the assertion that the Specter amendment's formulation of the Second Circuit's test, itself drawn from Beck, 820 F.2d at 50, failed to take into account the qualification to which Senator Dodd drew attention. See 141 Cong. Rec. S17,960 (daily ed. Dec. 5, 1995) (statement of Sen. Specter). Senator Specter argued that because his amendment required that the plaintiff's complaint establish the required scienter by alleging either "motive and opportunity," or "strong circumstantial evidence" of the required scienter, the amendment "tracked the second circuit's language directly." Id. (emphasis added).

154 See id. at S17,960 (statement of Sen. Dodd). In attempting to explain whether the Conference Committee intended the courts to look solely to Second Circuit case law, Senator Dodd become somewhat convoluted:

[W]hat we are attempting to do here, again, I think, is instead of trying to take each case that came under the second circuit, we are trying to get to the point where we would have well-pleaded complaints. We are using the standards in the second circuit in that regard, then letting the courts—as these matters will—test. They can then refer to specific cases, the second circuit, otherwise, to determine if these standards are based on facts and circumstances in a particular case.

Id.

cuit 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.156

Debate in the Senate and House of Representatives preceding congressional override of President Clinton's veto was marked by varying responses to the President's veto message. On December 20, 1995, the House of Representatives overrode the President's veto (319 to 100)157 with minimal discussion of the heightened pleading standard.158 The Senate, however, addressed President Clinton's concerns more thoroughly. The Senators divided into two camps on the heightened pleading requirement.159 The first camp, spearheaded by Senators Specter and Paul Sarbanes (D-Md.), agreed with President Clinton that the pleading standard, by dropping the Specter amendment and by adding the "state with particularity" language, erected a standard more stringent than that of the Second Circuit.160 The second camp, led by Senator Dodd, took the position that the President had incorrectly interpreted the Statement of Managers, and that the House Conference Report, while not codifying the Second Circuit's case law, did not create a more stringent pleading standard.161 Senator Dodd reiterated that the Committee rejected the Specter amendment because it articulated the Second Circuit's two alternative tests

156 Id. at 1912. President Clinton further stated that he would sign the bill if Congress "adopt[ed] the Second Circuit pleading standards and reinsert[ed] the Specter amendment." Id.
158 See, e.g., id. at H15,222 (statement of Rep. Berman) ("No one seems to want to address the specific points of the veto, I suggest, because there [are] no good answers to those specific points... We want a pleading standard that matches the Second Circuit."); id. at H15,216 (statement of Rep. Markey) ("[T]he codification of the second circuit's standard is something... that we should be debating out here on the floor."); id. at H15,219 (statement of Rep. Lofgren) ("The President says he supports the second circuit standard for pleading. So do I. That is what is included in this bill."); id. at H15,218 (statement of Rep. Moran); id. at H15,220 (statement of Rep. Deutsch).
160 See id. at S19,046 (daily ed. Dec. 21, 1995) (statement of Sen. Specter); id. at S19,070-71 (statement of Sen. Sarbanes). Interestingly, Senator Sarbanes quotes the letters of the following eminent scholars in support of his position: Professor Arthur Miller of Harvard Law School (stating that the pleading standard "effectively will destroy the private enforcement capacities that have been given to investors to police our Nation's marketplace"); Dean John Sexton of New York University School of Law (stating that "[i]t simply will be impossible for the plaintiff, without discovery, to meet the standard inserted by the conference committee at the last minute"), and Dean Joel Seligman of the University of Arizona School of Law (stating that the pleading standard would "prevent a significant number of meritorious lawsuits from going forward"). Id. at S19,038 (statement of Sen. Sarbanes).
161 See id. at S19,067-68 (statement of Sen. Dodd).
inaccurately. Senator Dodd also denied that the phrases "specifically allege" and "state with particularity" created different pleading standards. Notwithstanding the President's and the Specter/Sarbanes camp's objections to the heightened pleading standard for scienter, the Senate overrode the veto on December 22, 1995 (sixty-eight to thirty).

III

CONFUSION AMONG THE DISTRICT COURTS

This Part identifies the three standards that the district courts have interpreted section 21D(b)(2) to have created and the main interpretive arguments that each court has employed. Because the courts reach different outcomes depending on subtle differences in their interpretive strategy—interpretations which depend, in turn, upon emphasizing or de-emphasizing different pieces of the legislative record—this Part begins by examining the related issues that the courts have attempted to resolve before proceeding to a discussion and analysis of the three lines of cases.

A. Framing the Issues

The easiest way to frame the central issues of concern in the district courts is to identify the questions that the House Conference Re-

---

162 See id. at S19,068 (statement of Sen. Dodd). Senator Dodd stated that the House Conference Committee opted not to include the correct formulation of the Second Circuit's two alternative tests (i.e., the Beck v. Manufacturers Hanover Trust Co., 820 F.2d 46, 50 (2d Cir. 1987), formulation), with its qualification that it is necessary for a plaintiff to plead a stronger showing of circumstantial evidence when defendant's motive can not be shown, because "by codifying guidance you get into an area where you can get some differences of opinion[,] . . . the decision was to take [the language of the Specter amendment] out on the assumption that courts will look to the guidance." Id. Senator Dodd further stated that "[w]e have left out the guidance . . . [but] [t]hat does not mean you disregard it." Id.

Senator Dodd relied heavily on a memorandum written by Joseph A. Grundfest, professor at Stanford Law School and former Commissioner of the SEC, that understood the language of the House Conference Report to be "faithful to the Second Circuit's test," and that "concur[red] with the decision to eliminate the Specter amendment language, which was an incomplete and inaccurate codification of case law in that circuit." Id. (memorandum from Professor Grundfest inserted in the Congressional Record at the request of Senator Dodd).

163 See id. at S19,067 (statement of Sen. Dodd). Senator Dodd also stated that the technical change inserting the "with particularity" language was at the request of the Judicial Conference of the United States Federal Judiciary, for the sole reason that "'particularity' already [had] a meaning under law and 'specifically allege' [did] not. Id. at S19,067.


165 Although the courts that have thus far interpreted section 21D(b)(2) seem to have settled upon three distinct standards, several courts have arrived at identical standards through dissimilar interpretive arguments and use of the legislative history, and several have arrived at different standards despite a similar analysis of the legislative history. Thus, while the central interpretive strategies behind a given standard will be discussed in detail, slightly divergent interpretive arguments propounded by courts will be addressed in passing.
port raised. Most questions stem from the Statement of Manager's explanation for dropping the Specter amendment. How should a court interpret the conferees' reasoning? Did the conferees intend to create a more stringent pleading standard than that of the Second Circuit by adopting the strong inference language from the Second Circuit case law while overruling the motive and opportunity test for meeting that standard? Or did the conferees intend to adopt the strong inference language while leaving to the court's discretion the decision of what a complaint must allege to meet that standard?

Footnote 23, which accompanied the Statement of Manager's cryptic message, poses additional questions. How should the courts interpret this footnote? Does it refer solely to the two alternative tests offered in the Specter amendment, which the Committee deleted from the final version of section 21D(b)(2), or does the reference to recklessness allude to the House's early proposals to codify a definition of the recklessness standard? If footnote 23 does refer solely to the Specter amendment, does it refer inadvertently to only one key word—reckless—from the second test that the Second Circuit uses, even though it specifically refers to the two key words from the first test? Or, was the Committee attempting to "strengthen existing pleading requirements" by eliminating recklessness as a substantive basis for securities fraud liability?

B. The Standards

The thirty-one district courts that have ruled on the meaning of section 21D(b)(2) fall into three groups, each creating a distinct standard. The first line of cases has concluded that satisfaction of either of the Second Circuit's two alternative tests per se suffices to establish the required strong inference. This line of cases thus has concluded that Congress intended section 21D(b)(2) to create a standard of approximately the same stringency as the Second Circuit's strong inference standard as interpreted by the two alternative tests developed in that circuit's case law. The second and third lines of cases have con-

---


168 See supra note 127 (quoting final version of Senate Bill 240, as amended by the Specter amendment).

169 See supra text accompanying note 132 (quoting final version of Reform Act bill, as amended by the Committee on Conference).

170 See supra note 87 and accompanying text (quoting House Bill 1058's early formulation of the pleading requirements).

171 See supra Part I.B.3 for a discussion of the Second Circuit's two alternative tests.

172 One should note that the district courts discussed below gave no consideration to section 21D(b)(2)'s requirement that a complaint state facts "with particularity," or that this language creates an impossible pleading standard.
cluded that section 21D(b)(2) established a more stringent standard than the Second Circuit's strong inference standard, as interpreted under that circuit's case law. The second line of cases has concluded that the motive and opportunity test no longer suffices to presumptively raise a strong inference of scienter. The third line of cases has rejected the motive and opportunity test outright and has boldly interpreted section 21D(b)(2) to eliminate recklessness as a substantive basis for securities fraud liability. This Part discusses these standards in order of stringency, from least to most stringent.\textsuperscript{173}

1. Standard #1: A Rough Codification of the Second Circuit Standard

To date, sixteen district courts have found that section 21D(b)(2) codifies the Second Circuit's pleading standard for pleading scienter and that Congress intended this standard to be equally as stringent as the Second Circuit's standard.\textsuperscript{174} These courts have adopted both

\textsuperscript{173} It is important to note that, in discussing the Second Circuit's two alternative tests, the courts in the first two lines of cases, see infra Part III.B.1-2(a), focus primarily on the first, "motive and opportunity" test. Apparently, these courts understood the second test, the pleading of facts "constituting circumstantial evidence of either reckless or conscious behavior," to be the default test for pleading a strong inference, the elimination of which would literally prevent all complaints from pleading facts sufficient to establish a "strong inference."


tests developed in the Second Circuit's case law, meaning that a complaint may establish the requisite strong inference by pleading either motive and opportunity or by alleging facts constituting "circumstantial evidence of either reckless or conscious behavior." Of these sixteen courts, nine courts did not find the language of section 21D(b)(2) ambiguous and looked to Second Circuit case law as the natural starting point for interpreting the words "strong inference." These courts applied the Second Circuit's two alternative tests without so much as discussing the Reform Act's legislative history.

The remaining seven courts concluding that the Second Circuit's tests survived the enactment of section 21D(b)(2) all discussed, to at least some extent, the legislative history of the Reform Act. For example, in Zeid v. Kimberley, the court recognized the inconsistencies between the language of section 21D(b)(2) and the legislative record and engaged in an in-depth consideration of the Reform Act's legislative history. The Zeid court considered several pieces of legislative history, but found congressional intent "equivocal" and concluded that the statutory language should control. Focusing on the text of section 21D(b)(2), the court reasoned that Congress's adoption of the strong inference language from the Second Circuit, and its failure to codify an alternative interpretation to the Second Circuit's tests, demonstrated "some approval" of that Circuit's case law and "militate[d] against completely dispensing" with the two alternative tests. The court also reasoned that Congress's failure to explicitly incorporate the two tests into section 21D(b)(2) meant that Congress intended the reviewing courts to have "significant leeway"

(S.D.N.Y. Feb. 6, 1997) (misapplying Reform Act because complaint was filed prior to December 21, 1995).

175 In re Time Warner Inc. Sec. Litig., 9 F.3d 259, 269 (2d Cir. 1993).
177 See Zeid, 973 F. Supp. at 915-18. The court stated that "[e]ven though the Reform Act makes use of the 'strong inference' language, the statute's legislative history creates some uncertainty as to whether Congress intended to adopt all, some or none of the Second Circuit case law interpreting the standard." Id. at 916.
178 See id. at 915-17. The Zeid court considered several pieces of legislative history, including the Senate Report, the Specter Amendment, the House Conference Report, President Clinton's veto message, and statements made by Senator Dodd preceding congressional override of the President's veto. See id. at 916. For a discussion of this legislative history, see supra Part II.
179 See Zeid, 975 F. Supp. at 917 ("Congress did not provide any clear answers for interpreting the 'strong inference' standard.").
180 Id.
when interpreting the standard. The court explained that "courts can and should modify, or in some instances, reject, any case law that is inconsistent with the letter or spirit of the Reform Act." Applying this interpretive strategy, the court found that the Second Circuit's two alternative tests accorded with the language of section 21D(b)(2).

The remaining six courts employed reasoning similar to that of the ZEID court. These courts reached the same conclusion: while Second Circuit case law does not bind the courts, the stringency of the Reform Act's pleading standard is equivalent to the Second Circuit's interpretation, and the two alternative tests therefore satisfy section 21D(b)(2). In fact, three courts—In re Health Management, Inc. Securities Litigation, Marksman Partners, L.P. v. Chantal Pharmaceutical

181 Id. Interestingly, the ZEID court did find inconsistencies between the Reform Act's pleading standard and the "strong inference" standard as it was applied in the Second Circuit, though unrelated to the two alternative tests. The court found that section 21D(b)(2)'s requirement that a complaint "state with particularity" facts giving rise to a strong inference of scienter is inconsistent with the Second Circuit's application of the "strong inference" standard, in which that circuit both "had stated that scienter need not be pled with 'great specificity'" and held that plaintiffs need only provide a "minimal factual basis for their conclusory allegations of scienter." Id. (quoting Connecticut Nat'l Bank v. Fluor Corp., 808 F. 2d 957 (2d Cir. 1987)).

182 See id. at 917.


184 Though these courts did interpret the stringency of section 21D(b)(2) to be approximately identical to the Second Circuit standard, as developed in that circuit's case law, none of these courts found that judges are bound by the Second Circuit's case law. It is important to clarify that these courts are dealing in terms of case law as a whole, that is, whether the Second Circuit's two alternative tests are consistent with the language of the Reform Act. The courts in the first line of cases answer this question in the affirmative. See, e.g., In re Health Management, 970 F. Supp. at 201 ("A plaintiff can satisfy this burden by pleading motive and opportunity, conscious misbehavior, recklessness or by impressing upon the court a novel legal theory."); REHMB, 954 F. Supp. at 1252 ("We find that [section 21D(b)(2)] adopts the Second Circuit standard but declines to bind courts to the Second Circuit's interpretation of its standard.").

CORNELL LAW REVIEW

Corp.,\(^{186}\) and Rehm v. Eagle Finance Corp.\(^{187}\)—went further than Zeid and specifically concluded that section 21D(b)(2) did not overturn Second Circuit case law interpreting the strong inference standard.\(^{188}\)

The Rehm and Marksman opinions, in particular, demonstrate the various routes by which this conclusion can be reached. To begin with, both the Rehm and Marksman courts found that Congress’s verbatim incorporation of the Second Circuit’s strong inference language into section 21D(b)(2) provided particularly persuasive evidence that Congress intended to enact “a pleading standard of approximately the same specificity.”\(^{189}\) In reaching this conclusion, the Marksman court further argued that there was no basis to conclude that Congress overturned the Second Circuit’s motive and opportunity test because Congress was silent on the matter.\(^{190}\) Both courts bolster their reasoning by considering the larger policy goals of the federal securities laws, which lead them to conclude that Congress did not intend to create a scienter pleading standard more stringent than that found in the Second Circuit. The Rehm court noted that:

Ratcheting up the standard to conform with the stringent Second Circuit test satisfies Congress’ goal of curtailing abusive securities litigation while still leaving room for aggrieved parties to bring valid securities fraud claims. To impose a higher pleading standard would make it extremely difficult to sufficiently plead a 10b-5 claim—an outcome which would certainly be contrary to the broad remedial purposes of the federal securities laws.\(^{191}\)

---

\(^{186}\) 927 F. Supp. 1297 (C.D. Cal. 1996). In finding that section 21D(b)(2) was of the same stringency as the “strong inference” pleading standard as interpreted by Second Circuit case law, the Marksman court dealt thoroughly with the argument that Congress intended to eliminate recklessness as a substantive basis for liability for securities fraud. See id. at 1309-10. The court’s argument against such an interpretation is discussed with the cases holding that section 21D(b) (2) indeed eliminated liability for recklessness. See infra note 272 and accompanying text.


\(^{188}\) See In re Health Management, 970 F. Supp. at 200-01; Rehm, 954 F. Supp. at 1252; Marksman, 927 F. Supp. at 1311.

\(^{189}\) Rehm, 954 F. Supp. at 1252; accord Marksman, 927 F. Supp. at 1310 (“It is worthy of note that the language used by the [Reform Act] to articulate its scienter pleading standard . . . mirrors language traditionally employed by the Second Circuit . . .”).

\(^{190}\) See Marksman, 927 F. Supp. at 1311-12 (“There is no basis to conclude that Congress eradicated, sub silentio, the well-established ‘motive and opportunity’ test . . .”). In INS v. Cardoza-Fonesca, 480 U.S. 421, 442-43 (1987), the Supreme Court propounded a similar principle, albeit for the opposite conclusion regarding congressional intent: “Few principles of statutory construction are more compelling than the proposition that Congress does not intend sub silentio to enact statutory language that it has earlier discarded in favor of other language.” Id. (quoting Nachman Corp. v. PBGC, 446 U.S. 359, 392-93 (1980)).

\(^{191}\) Rehm, 954 F. Supp. at 1252 (citation omitted). The Marksman court advanced a similar, though not as overtly policy oriented, argument: “[T]he conference committee emphasized that the Second Circuit’s pleading standards were the most stringent of any circuit’s, and thus it is reasonable to assume that Second Circuit jurisprudence comes closest to approximating the [Reform Act’s] new requirements.” Marksman, 927 F. Supp. at 1310.
In a similar vein, the *Marksman* court assessed the stringency of the Second Circuit test and concluded that it clearly achieved Congress’s "purpose of making scienter allegations more difficult to plead."\(^{192}\) The court found that the test imposed an "exacting analysis" and that its "analytical framework" was consistent with a more stringent pleading requirement.\(^{193}\)

Lastly, both the *Marksman* and *Rehm* courts engaged in a thorough consideration of the Reform Act’s legislative history.\(^{194}\) Both courts limited their discussion primarily to the Senate Report\(^ {195}\) and the House Conference Report.\(^ {196}\) Interestingly, both courts ultimately found the House Conference Report to be consistent with the Senate Report. Although the courts focused on the language in the House Conference Report which stated that section 21D(b)(2) is "based in part on the pleading standard of the Second Circuit,"\(^ {197}\) neither court accorded any weight to the sentence stating that the committee "intends to strengthen existing pleading requirements"\(^ {198}\) or to the explanatory language in footnote 23.\(^ {199}\) Consequently, the courts had little difficulty reconciling the House and Senate Reports as the authoritative expression of legislative intent. Both courts relied upon language in the Senate Report which they believed indicates that the Senate Committee did not "adopt a new and untested pleading standard," but rather a "uniform standard modeled upon the pleading standard of the Second Circuit," and which they thought explains that courts may find that Circuit's case law "instructive."\(^ {200}\)

\(^{192}\) *Marksman*, 927 F. Supp. at 1311.

\(^{193}\) *Id.*

\(^{194}\) See also Epstein v. Itron, Inc., 993 F. Supp. 1314, 1323-24 (E.D. Wash. 1998) (considering the legislative history behind section 21D(b)(2) in detail, but finding it unnecessary to resolve the issue of whether Congress intended to adopt the Second Circuit's two test approach).

\(^{195}\) See supra text accompanying note 113 (quoting the relevant language of the Senate Report). The *Rehm* court addressed President Clinton's veto message only in passing. See *Rehm*, 954 F. Supp. at 1252 n.3.

\(^{196}\) See supra Part II.C.


\(^{198}\) *Id.*

\(^{199}\) See *Rehm*, 954 F. Supp. at 1251-53; *Marksman*, 927 F. Supp. at 1310-11. The *Rehm* court did not specifically address this language at all. The *Marksman* court did address this language but was "unimpressed" with the argument that the "oblique reference to 'motive, opportunity and recklessness'" in the footnote abrogated the Second Circuit's two alternative tests. *Marksman*, 927 F. Supp. at 1311. In reaching this conclusion, the *Marksman* court downplayed the importance of the footnote and reasoned that "when Congress wishes to supplant a judicially-created rule it knows how to do so explicitly, and in the body of the statute." *Id.*

\(^{200}\) *Marksman*, 927 F. Supp. at 1311; *Rehm*, 954 F. Supp. at 1251-52; see supra text accompanying note 113 (quoting the relevant portion of the Committee Report).
2. Standards #2 and #3: More Stringent Than the Second Circuit Standard

The two lines of cases surveyed in this section have found that although Congress modeled the strong inference language of 21D(b)(2) on the Second Circuit's pleading standard, Congress actually intended the pleading standard to be higher than the Second Circuit case law's interpretation of that standard.

a. Standard #2: No Presumption That Pleading Motive and Opportunity Gives Rise to a Strong Inference of Scienter

One line of cases has held that Congress intended section 21D(b)(2) to be more stringent than the Second Circuit's pleading standard, but did not intend to alter the substantive scienter requirements for securities fraud. More precisely, the eight courts that fall into this category have held that allegations of motive and opportunity are relevant, but do not presumptively satisfy section 21D(b)(2)'s strong inference requirement.

As with the courts adopting standard one, the courts that arrived at standard two employed various interpretive strategies. The court in OnBank & Trust Co. v. FDIC used reasoning similar to those courts that concluded that the Second Circuit's two alternative tests per se satisfy section 21D(b)(2). The OnBank court found that the House Conference Report's treatment of the Second Circuit's case law and its comment in footnote were "ambiguous," and the court remained unconvinced that Congress's failure to explicitly codify the case law meant that it intended to overrule the two tests developed.

---


203 See id. at 88-89.

204 See supra text accompanying notes 135-36.
therein. The OnBank court concentrated on the strong inference language in the text of section 21D(b)(2) and in the Senate Report’s language that courts may find the Second Circuit’s case law “instructive.” The court stated that while “allegations of motive, opportunity, or reckless behavior may still be relevant,” a deciding court must consider whether such allegations establish a strong inference of scienter on a case-by-case basis.

The court in Havenick v. Network Express, Inc. found that the language in both the House Conference Report, stating that the “Conference Committee intends to strengthen existing pleading requirements,” and in footnote 23 “directly refuted” the plaintiff’s argument that allegations of motive and opportunity presumptively establish a strong inference of scienter.

The Havenick court bolstered its reliance on the House Conference Report by citing Supreme Court cases which held that congressional committee reports are “the most reliable and authoritative source for Congressional intent.” In arriving at its conclusion the court also accorded considerable weight to President Clinton’s veto message, in which the President interpreted the House Conference Report to have “‘raise[d] the standard even beyond’” the Second Circuit’s standard.

Although the court in Queen Uno Ltd. v. Coeur D’Alene Mines Corp. found the key passages in the House Conference Report and the Senate Report contradictory and “ambivalent” on the whole, it concluded that “Congress’s unequivocal intention, as noted in both reports, to ‘raise existing pleading requirements’ precludes a per se rule that allegations of motive and opportunity necessarily raise a

---

205 OnBank, 967 F. Supp. at 88 n.4.
206 See id.
207 See id. at 88.
210 Havenick, 981 F. Supp. at 527.
211 Id. (citing Garcia v. United States, 469 U.S. 70, 76 (1984)); see also Garcia, 469 U.S. at 76 (“The authoritative source for finding the Legislature’s intent lies in the Committee Reports on the bill, which ‘represen[t] the considered and collective understanding of those Congressmen involved in drafting and studying proposed legislation” (quoting Zuber v. Allen, 396 U.S. 168, 186 (1969))); Landgraf v. USI Film Products, 511 U.S. 244, 262 n.15 (1994) (“[A] court would be well advised to take with a large grain of salt floor debate and statements placed in the Congressional Record which purport to create an interpretation for the legislation that is before us.”) (quoting 137 CONG. REC. S15,325 (Oct. 29, 1991) (statement of Sen. Danforth)); Resolution Trust Corp. v. Gallagher, 10 F.3d 416, 421 (7th Cir. 1993) (stating that the Conference Report “is the most persuasive evidence of congressional intent besides the statute itself”); Zolb v. Kelly (In re Kelly), 841 F.2d 908, 912 n.3 (9th Cir. 1988) (commenting on how committee reports, not “[s]tray comments by individual legislators,” provide the best expression of legislative intent).
212 For a discussion of this veto message along with excerpted portions of the relevant text, see supra notes 155-56 and accompanying text.
213 Havenick, 981 F. Supp. at 528 (quoting the president’s veto message).
strong inference . . . of scienter." Nonetheless, the court did not rule out the possibility that a court occasionally might draw the requisite inference "solely from motive and opportunity allegations," and it stated that such allegations may be "relevant in determining whether the totality of the allegations permits a strong inference of fraud."

The remaining five courts gave considerably less weight to the legislative history and based their decisions primarily on plain meaning arguments. The court's reasoning in In re Baesa is illustrative:

The statute, however, while adopting the "strong inference" requirement, makes no mention whatever of "motive and opportunity," nor singles out any other special kind of particulars as presumptively sufficient. The conclusion follows from the plain language of the statute that the mere pleading of motive and opportunity does not, of itself, automatically suffice to raise a strong inference of scienter.

The In re Baesa court supported its reliance on the statutory text by quoting Supreme Court precedent on statutory interpretation which held that "[w]hen the statutory text is so plain, resort to legislative history is neither necessary nor prudent.

---

215 Id. at 1359.
216 Id.
217 Id.
219 See In re Baesa, 969 F. Supp. at 242; see also Glenayre, 982 F. Supp. at 298 ("[T]he law in this district . . . is that 'motive and opportunity' alone will no longer suffice to meet the required pleading standard."); Press, 1997 WL 458666, at *2 ("Under the plain language of the Reform Act, even if motive and opportunity are adequately plead, facts must still be alleged that give rise to a strong inference of fraudulent intent."). The In re Baesa court also considered in detail, and ultimately dismissed, the argument that Congress intended to eliminate recklessness as a substantive basis for securities fraud liability. See In re Baesa, 969 F. Supp. at 240-42; see also infra note 272 and accompanying text (discussing the In re Baesa court's reasoning).

Interestingly, the In re Baesa and Press courts each found that their interpretation of section 21D(b)(2)—that allegations of "motive and opportunity" do not presumptively establish a "strong inference"—was, in fact, in accordance with Second Circuit precedent. See In re Baesa, 969 F. Supp. at 242 n.3 ("Even under prior Second Circuit precedent . . . it is not entirely clear that the Court of Appeals always accepted mere allegations of motive and opportunity as sufficient to establish scienter."); Press, 1997 WL 458666, at *2 n.2 ("The scienter requirement of the Reform Act does not appear to depart from Second Circuit precedent in that the Second Circuit has similarly required that the allegations of motive and opportunity to commit fraud give rise to the strong inference of fraudulent intent."). These two cases reflect, as did the congressional debate between Senators Specter and Dodd, see supra text accompanying notes 148-54, confusion over the precise formulation of
b. Standard #3: Elimination of Recklessness as a Substantive Basis for Securities Fraud

Six courts\(^{221}\) have ruled that Congress did not restrict its reforms to the pleading stage of securities fraud litigation; instead, these courts have found that Congress intended to heighten both the pleading and substantive standards for securities fraud. The courts in these cases have interpreted section 21D(b)(2) to have both eliminated the pleading of motive and opportunity as a sufficient basis for establishing a strong inference of scienter and altered the underlying mental state requirement of which a strong inference must be shown. In short, these courts have held that the Reform Act eliminates liability for recklessness in Rule 10b-5\(^{222}\) actions.

i. Silicon Graphics I and II

*In re Silicon Graphics, Inc. Securities Litigation* ("Silicon Graphics I") was the first case to conclude that section 21D(b)(2) eliminated recklessness as a basis for securities fraud liability.\(^{223}\) The court in *Silicon Graphics I* engaged in the most thorough interpretation of the Reform Act's legislative history to date. Because *Silicon Graphics I* is the only case involving the interpretation of section 21D(b)(2) that a court has reheard on appeal\(^{224}\) and because the SEC filed an amicus brief in that appeal, it is a particularly important case.

The court in *Silicon Graphics I* began its analysis of section 21D(b)(2) with the House Conference Report.\(^{225}\) Based on the language stating that the "Conference Committee intend[ed] to strengthen existing pleading requirements"\(^{226}\) and on footnote 23 of the Report,\(^{227}\) the court reasoned that the Conference Committee in-

---


\(^{226}\) See id. at 41, reprinted in 1995 U.S.C.C.A.N. 730, 740; see also supra text accompanying note 135 (quoting relevant portion of the Conference Report).

\(^{227}\) See H.R. CONF. REP. No. 104-369, at 48 n.23; see also supra text accompanying note 136 (reprinting footnote 25).
tended to "strengthen" the Second Circuit standard both by abrogating the motive and opportunity test and by narrowing the second test to exclude recklessness—thereby confusing the distinction between procedural and substantive law. Thus, the court concluded that a plaintiff must allege specific facts that "create a strong inference of knowing misrepresentation on the part of defendants." In support of its conclusions, the court emphasized the Conference Committee's decision to drop the Specter amendment and President Clinton's veto message but accorded minimal weight to comments made by members of both houses during floor discussion before and after the President's veto.

The court supported its reliance on these pieces of the legislative history with Supreme Court precedent on statutory interpretation. After referring to the House Conference Report as "the most definitive part" of the legislative history, the court cited Supreme Court precedent to explain that "the authoritative source for finding the Legislature's intent lies in the Committee Reports on the bill, which "represen[t] the considered and collective understanding of those Congressmen involved in drafting and studying proposed legislation." The court then justified relying on the Conference Committee's failure to retain the Specter amendment by quoting Supreme Court precedent which stated that reason "strongly militates against a judgment that Congress intended a result that it expressly declined to enact." Finally, the court reasoned that its interpretation of section 21D(b) (2) was consistent with the Reform Act's larger policy objective of "discourag[ing] frivolous litigation" by implementing "needed procedural protections."

The confusion among the district courts regarding the proper interpretation of section 21D(b) (2) and the dramatic effect that the elimination of recklessness as a substantive basis for securities fraud

---

229 Id. at *7.
231 See id.
232 Id. at *6 n.4.
234 Id. (quoting Gulf Oil Corp. v. Copp Paving Co., 419 U.S. 186, 200 (1974)).
would have on the U.S. securities markets\textsuperscript{236} prompted the SEC to file an amicus curiae brief in the rehearing of \textit{In re Silicon Graphics, Inc. Securities Litigation} ("Silicon Graphics II").\textsuperscript{237} The SEC argued that the Reform Act did not eliminate recklessness as a substantive basis for liability and drew attention to the fact that section 21D(b)(2), "by its express terms," applies only to the pleading stage of Rule 10b-5 actions.\textsuperscript{238} The SEC noted, "In determining that section 21D(b)(2) required the pleading of conscious behavior, the court drew from a purely procedural provision the incorrect conclusion that Congress had eliminated a well established substantive standard."\textsuperscript{239} The SEC rejected \textit{Silicon Graphics I}'s determination that footnote 23 implied a narrower interpretation of the second test that the Second Circuit had developed and pointed to an inconsistency between the footnote and the final version of the pleading standard as it appeared in the House Conference Report. The SEC argued that the court's "conclusion was reached in spite of the fact that in deleting the [Specter] amendment, the Conference Committee deleted not only the language regarding motive, opportunity, and recklessness, but also the language regarding conscious misbehavior."\textsuperscript{240} According to the SEC, footnote 23 explains the Conference Committee's "decision not to codify the Second Circuit's case law interpreting the standard[,] . . . preferring to leave to the courts the discretion to create their own standards for determining whether" the plaintiff has established a strong inference.\textsuperscript{241}

The court in \textit{Silicon Graphics II} brushed aside the SEC's argument that the Reform Act intended to heighten only the pleading, and not the substantive, requirements for securities fraud. The court instead chose to engage in a lengthy discussion of the development and current state of the substantive scienter requirement.\textsuperscript{242} The \textit{Silicon Graphics II} court ultimately concluded that section 21D(b)(2) was intended both to abrogate the Second Circuit's motive and opportunity test and to narrow the second test to include "deliberate recklessness" but to exclude "non-deliberate recklessness."\textsuperscript{243} Although the court offered a less extreme interpretation than it did in \textit{Silicon Graphics I}, in that it expressly accepted some form of recklessness as a basis for se-

\textsuperscript{236} See SEC Amicus Brief, \textit{supra} note 47, at 3. The SEC argued that a "higher scienter standard would lessen the incentives for corporations to conduct a full inquiry into potentially troublesome or embarrassing areas[, would encourage] . . . deliberate ignorance . . . [,] and would greatly erode the deterrent effect of Section 10(b) actions." \textit{Id.}

\textsuperscript{237} 970 F. Supp. 746 (N.D. Cal. 1997).

\textsuperscript{238} SEC Amicus Brief, \textit{supra} note 47, at 8.

\textsuperscript{239} \textit{Id.}

\textsuperscript{240} \textit{Id.} at 12.

\textsuperscript{241} \textit{Id.} at 12-13.

\textsuperscript{242} See Silicon Graphics \textit{II}, 970 F. Supp. at 754-56.

\textsuperscript{243} \textit{Id.} at 757.
In reaching this conclusion, the *Silicon Graphics II* court failed to distinguish between two conceptually distinct standards—the scienter pleading standard (what a complaint must allege to successfully withstand a motion to dismiss) and the substantive scienter requirement (the mental state that a plaintiff must prove at trial). Conflating these substantive and procedural requirements, the *Silicon Graphics II* court interpreted the language in both the House Conference Report, which states that section 21D(b)(2) was based on the Second Circuit’s strong inference standard, and related footnote 23 as pertaining to Second Circuit case law interpreting the underlying substantive scienter requirements for securities fraud. Thus, the court all but ignored Second Circuit case law interpreting the strong inference pleading standard and instead identified three distinct lines of cases defining scienter in Second Circuit case law. After considering each of these three lines of cases, the court adopted the *Weschler v. Steinberg* line, which requires a plaintiff to establish “actual intent” to satisfy the scienter element of securities fraud. The *Silicon Graphics II* court based this approach on the Conference Committee’s failure to codify “motive, opportunity or recklessness” in footnote 23 of

244 See id. at 754.

245 The relevant portions of the House Conference Report and related footnote are reprinted * supra* text accompanying notes 135-36.

246 See *Silicon Graphics II*, 970 F. Supp. at 755-57. Though misdirected, the court’s inquiry does uncover a subtle issue that no other court identified: in order for section 21D(b)(2) to “establish uniform and more stringent pleading requirements,” a stated purpose of the Reform Act, the definition of scienter must be uniform. *Id.* at 755-56 (quoting H.R. CONF. REP. No. 104-369, at 41 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 740). Put another way, there cannot be uniformity among the circuits if the underlying definition of scienter differs, even if the pleading requirements for the scienter element of securities fraud are identical. This is because pleading standards are dependent upon substantive standards in that a complaint must plead facts that tend to establish (according to the stringency of the standard) the substantive requirement.

247 See *Silicon Graphics II*, 970 F. Supp. at 755. The court identified three lines of cases: (1) the *Lanza* line of cases, see *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973), under which “unqualified allegations of recklessness suffice to establish scienter,” *Silicon Graphics II*, 970 F. Supp. at 755; (2) the *Rolf* line of cases, see *Rolf v. Blythe*, Eastman Dillon & Co., 570 F.2d 38 (2d Cir.) amended by 1978 WL 4098 (2d Cir. May 22, 1978), aff’d in part and rev’d in part, 637 F.2d 77 (2d Cir. 1980), which “allows recklessness to support scienter only if the defendant had a fiduciary duty to the plaintiff,” *Silicon Graphics II*, 970 F. Supp. at 755; and (3) the *Wechsler* line of cases, see *Wechsler v. Steinberg*, 733 F.2d 1054 (2d Cir. 1984), which according to the court “require[s] actual intent or circumstances implying actual intent before finding scienter,” *Silicon Graphics II*, 970 F. Supp. at 755. See Vanyo et al., * supra* note 61, at 75-78 (identifying these same three lines of cases).

248 733 F.2d 1054 (2d Cir. 1984).

249 See *Silicon Graphics II*, 970 F. Supp. at 755; see also id. at 756 ("In excluding from the [Reform Act’s] pleading standard language relating to motive, opportunity, or recklessness, Congress appears to have rejected the *Lanza* and *Rolf* lines of cases in favor of the *Wechsler* approach that is more consistent with Supreme Court precedent regarding [Rule 10b] scienter.").
the House Conference Report. The court then defined "actual intent" to include "deliberate recklessness." The court supported its argument that Congress intended to eliminate liability for recklessness in the fact that both an early version of the House bill and the Specter amendment included definitions of recklessness and ultimately were dropped from the Reform Act bill. The Silicon Graphics II court further supported this interpretation by pointing to Congress's override of President Clinton's veto, which had objected to the Reform Act bill's "crystal clear" intent to create a pleading standard more stringent than that of the Second Circuit.

ii. Friedberg, Norwood Venture, and In Re Comshare

The courts in Friedberg v. Discreet Logic Inc., Norwood Venture Corp. v. Converse Inc., and In re Comshare, Inc. Securities Litigation tightly circumscribed their analyses to the pleading stage of securities fraud. These courts concluded that section 21D(b)(2) heightened the scienter pleading standard by no longer permitting a complaint that alleged recklessness to satisfy the strong inference of scienter requirement. In reaching this conclusion, all three courts failed to grasp fully the division, or the relationship, between procedural and substantive rules. None of these courts expressly recognized that disallowing a complaint alleging recklessness to satisfy the pleading requirement effectively eliminates recklessness as a ground for substantive liability. Thus, the Friedberg, Norwood Venture, and In re Comshare courts eliminated recklessness as a substantive basis for securities fraud by implication.

All three courts focused primarily on the House Conference Report. However, the Norwood Venture and In re Comshare courts considered the legislative history only cursorily. Relying on the language in the House Conference Report (stating that the Conference Commit-

250 See id. at 756.
251 Id. at 757.
252 See supra text accompanying notes 83-87.
253 The Specter amendment did not, in fact, define "recklessness." See supra text accompanying note 118.
255 The relevant text of the President's veto message is reprinted supra text accompanying note 156.
261 The only other possible option would be to require a plaintiff to plead more than she would have to prove at trial—a preposterous result.
tee sought to "strengthen existing pleading requirements","footnote 23,263 and President Clinton’s veto message (stating that the Conference Committee had intended to "raise the [pleading] standard even beyond that level [of the Second Circuit]"264) these two courts concluded that section 21D(b)(2) required a plaintiff to "plead specific facts that ‘create a strong inference of knowing misrepresentation on the part of the defendants.’"265

By contrast, the Friedberg court considered the legislative history more carefully. Finding that the text of the Reform Act does not offer a clear interpretation of the words “strong inference,” the court turned to the legislative history for guidance.266 The Friedberg court first considered the House Conference Report and deduced from it that the conferees intended to create a pleading standard “even stronger than the existing Second Circuit standard.”267 In addition, because the court believed that the Specter amendment contained the “Second Circuit standard and case law,” it found the rejection of the amendment by the Conference Committee dispositive.268 In support of this reasoning, the court cited Supreme Court precedent to explain that “‘Congress does not intend sub silentio to enact statutory language that it has earlier discarded in favor of other language.”269 The Friedberg court parsed the House Conference Report language and concluded that the Conference Committee’s reference to “motive, opportunity and recklessness” in footnote 23 indicated that the Second Circuit case law’s development of these approaches was insufficiently stringent.270 The court then applied deductive logic and retained what remained of the Second Circuit test, namely the pleading of “conscious behavior,” which the Friedberg court defined as “intent to defraud or knowledge of... falsity.”271 In this way, the Friedberg court

263 See H.R. Conf. Rep. No. 104-369, at 48 n.23; see also supra text accompanying note 136 (reprinting footnote 23).
264 Veto Message, supra note 155, at 1912; see also supra text accompanying note 156 (reprinting relevant portion of the veto message).
267 Id. at 48. In reaching this conclusion, the Friedberg court analyzed the language of the House Conference Report in more detail than any other district court. The court pointed out that the conferees considered the Second Circuit standard to be the “most stringent pleading standard” of all the circuits. Id. (quoting H.R. Conf. Rep. No. 104-369, at 41, reprinted in 1995 U.S.C.C.A.N. 730, 740). The court then concluded that the word “existing” in the sentence reading “intends to strengthen existing pleading requirements” necessarily referred to the Second Circuit’s standard. See id.
268 Id. at 48-49.
269 Id. at 49 (quoting INS v. Cardoza-Fonseca, 480 U.S. 421, 442-43 (1987)).
270 Id.
271 Id. at 49 n.2.
felt it had implemented congressional intent as evidenced in the House Conference Report. As the court summarized:

The Conference Committee Report retained the “conscious behavior” pleading approach and under Second Circuit case law the strength of the evidence needed to constitute conscious behavior is greater than that required for the motive and opportunity or reckless behavior approaches. . . .[T]his Court rules that the plaintiff must set forth specific facts that constitute strong circumstantial evi-
dence of conscious behavior by defendants.272

IV
ANALYSIS

A. Interpretive Methodology

Except for the handful of courts that ceased their inquiry with the statutory language of section 21D(b)(2)—taking what can be labeled as a “textualist” interpretive approach—none of the district courts discussed above explicitly identified the interpretive methodology they used to decipher the meaning of section 21D(b)(2). Rather, these courts, as a group and individually, employed a mixture of interpretive arguments, including arguments based upon the statutory text of section 21D(b)(2) and the Reform Act, arguments grounded in the


The Marksman court acknowledged that the House of Representatives had eliminated recklessness as a substantive basis of liability in its early version of the bill, see supra notes 77-78 and accompanying text, but recognized that House Bill 1058, as adopted by the House, see supra text accompanying note 99, “expressly provided for liability based on reckless conduct.” Marksman, 927 F. Supp. at 1309 n.9. The Marksman court used a portion of the House Conference Report which stated that “the Conference Committee explicitly deter-
dined that the legislation should make no change to the state of mind requirements of existing law,” H.R. CONF. REP. NO. 104-369, at 38 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 737, to support its conclusion that the substantive requirements of securities fraud have not been altered. See Marksman, 927 F. Supp. at 1309 n.9. For further support, the court invoked the interpretive argument that “[l]egislative silence . . . does not give the court grounds to conclude that recklessness is no longer an adequate basis to establish scienter.” Id.

The court in In re Baesa briefly traced the judicial history of the scienter element of securities fraud, from the Supreme Court’s decision in Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 n.12 (1976), to reserve ruling on whether recklessness qualifies as scienter, to the near universal acceptance of recklessness as a form of scienter in the circuit courts, and concluded that “nothing in the Reform Act purports” to overrule recklessness as being sufficient under the Hochfelder definition of scienter. In re Baesa, 969 F. Supp. at 241. Interest-

ingly, the In re Baesa court interpreted the decisions in Silicon Graphics I, Friedberg, and Norwood “as simply reinforcing the requirement that recklessness . . . includes a conscious component.” In re Baesa, 969 F. Supp. at 241 n.1.
traditional canons of statutory construction, arguments based upon the larger policy goals of the Reform Act, and arguments drawn from the legislative history of section 21D(b)(2).

Despite this somewhat ad hoc approach, the district courts primarily engaged in the latter "contextualist" approach. Contextualist methodology stands diametrically opposed to textualist methodology and considers the meaning of an ambiguous statutory provision within the context of legislative intent, as evidenced by legislative history. By contrast, the textualist approach urges courts to restrict themselves to the text and structure of the statute in question when interpreting the meaning of an ambiguous or vague provision. By focusing on "plain meaning" arguments rooted in the "text," textualists, most notably Justice Antonin Scalia, demonstrate a skepticism for legislative history and seek to avoid it altogether.

In analyzing the meaning of section 21D(b)(2), this Note does not restrict itself to any one interpretive methodology. Instead, it

---

273 The canons of statutory construction are the traditional starting points for a court. See Robert A. Katzmann, Courts And Congress 48 (1997). For an exhaustive study of the different types of interpretational arguments, see Robert S. Summers, Statutory Interpretation in the United States, in Interpreting Statutes 407 (D. Neil MacCormick & Robert S. Summers eds., 1991). For general studies of the traditional approaches to statutory construction, see Norman J. Singer, Statutes and Statutory Construction (5th ed. 1992); David L. Shapiro, Continuity and Change in Statutory Interpretation, 67 N.Y.U. L. Rev. 921 (1992). According to Katzmann, the canons of statutory construction include the principles that "the starting point is the language of the statute; if the language is plain, construction is unnecessary; ... the expression of one thing is the exclusion of another; ... and every word of a statute must be given significance." Katzmann, supra, at 49.

274 Very generally, contextualist interpretive methodology holds that legislative history can be used in a number of circumstances, such as to clarify the meaning or purpose of technical or nontechnical words or phrases, or "to promote fidelity to congressional meaning and coherence in the law" when a controversial statute is silent on a contested issue. Katzmann, supra note 273, at 62. See generally Stephen Breyer, On the Uses of Legislative History in Interpreting Statutes, 65 S. Cal. L. Rev. 845, 847 (1992) (defending the use of legislative history); George A. Costello, Average Voting Members and Other "Benign Fictions": The Relative Reliability of Committee Reports, Floor Debates, and Other Sources of Legislative History, 1990 Duke L.J. 39, 61-72 (discussing new approaches when relying on legislative history); William N. Eskridge, Jr., Dynamic Statutory Interpretation, 135 U. Pa. L. Rev. 1479, 1481-82 (1987) (arguing that statutes should be interpreted dynamically in their current context); Abner J. Mikva, A Reply to Judge Starr's Observations, 1987 Duke L.J. 380, 382 (arguing for the use of legislative history in interpreting statutes); Stephen F. Ross, Where Have You Gone, Karl Llewellyn? Should Congress Turn Its Lonely Eyes to You?, 45 Vand. L. Rev. 561, 594-77 (1992) (examining actions Congress can take to control judicial abuse of statutory interpretation). As several of the district courts duly noted, committee reports are generally understood to be the most definite expressions of legislative intent. See Havenick v. Network Express, Inc., 981 F. Supp. 480, 527 (E.D. Mich. 1997); In re Silicon Graphics, Inc. Sec. Litig., 970 F. Supp. 746, 757 (N.D. Cal. 1997) (citing Garcia v. United States, 469 U.S. 70, 76 (1984), for the proposition that committee reports are the authoritative expression of legislative intent, but arriving at separate interpretations of that intent); Katzmann, supra note 273, at 63.

275 See Katzmann, supra note 273, at 59.

276 See id. at 62.

277 See id.

278 See id. at 59-62.
adopts a mixed approach and interprets section 21D(b)(2) in light of the statutory text, the legislative history, and the larger policy goals of the Reform Act and the federal securities laws. This Note concludes that section 21D(b)(2) did not alter the substantive scienter element of Rule 10b-5 securities fraud by eliminating liability for reckless conduct. With regard to the question of whether section 21D(b)(2) creates a pleading standard more stringent than that of the Second Circuit, this Note demonstrates that even after thorough consideration of the legislative history, the related policy concerns, and the uneven legal landscape upon which Congress legislated, the evidence weighs fairly evenly in favor of both conclusions. Thus, as the next section demonstrates, the text of section 21D(b)(2) must ultimately control.

B. Deducing the Pleading Standard

1. Section 21D(b)(2) Does Not Eliminate Liability for Recklessness

The argument that section 21D(b)(2) altered the substantive requirements for securities fraud by eliminating liability for recklessness suffers from serious weaknesses. The text of the Reform Act, a preponderance of the legislative history, and the history and larger policy goals of the federal securities laws dictate that section 21D(b)(2) only heightened the requirements of pleading scienter.

a. The Text of the Reform Act

The text of section 21D(b)(2) offers the most conclusive evidence that Congress did not intend to alter the substantive requirements for securities fraud actions by enacting the Reform Act. Once again, the text of section 21D(b)(2) bears repeating:

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.\(^{279}\)

Although Congress placed section 21D(b)(2) under the title "Requirements for securities fraud actions,"\(^{280}\) and thus did not specifically refer to the pleading stage of litigation, all the other provisions under this title pertain solely to procedural requirements.\(^{281}\) Further-


\(^{280}\) Id. § 78u-4(b). The title section to section 21D(b)(2) was, in fact, worded after the title section in the House bill. See H.R. 10, 104th Cong. § 204 (1995).

\(^{281}\) See 15 U.S.C. § 78u-4(b)(1) (requiring complaints to state with specificity all alleged misleading statements); id. § 78u-4(b)(3)(B) (staying discovery pending motions to dismiss); id. § 78u-4(b)(4) (placing the burden of proving the causation element of securities fraud upon the plaintiff).
more, the language of section 21D(b)(2) refers to the requirements of a "complaint" and is directed solely at the procedural requirements of pleading securities fraud. Moreover, by including the language "acted with the required state of mind," section 21D(b)(2) carefully brackets the issue of the substantive scienter requirement of securities fraud. Two versions of the House bill did include provisions pertaining to the underlying scienter requirements of securities fraud, and in fact, referred specifically to liability for reckless misconduct. The initial version of the House bill eliminated liability for recklessness, and the final version explicitly included and defined liability for recklessness. However, the House's inclusion of language pertaining to liability for recklessness and use of the term "recklessness" itself in the early versions of the bill support the conclusion that in ultimately remaining completely silent on the issue, Congress did not intend to eliminate liability for recklessness.

The language of other Reform Act provisions and the language in the House Conference Report explaining those provisions provide indirect support for the proposition that section 21D(b)(2) heightens only the pleading requirements for securities fraud. For example, a separate Reform Act provision, new section 21D(g), does in fact heighten the substantive scienter requirement with respect to the damages aspect of securities fraud, but leaves liability standards untouched. To the contrary, in requiring a defendant to have acted "knowingly" in order to be subject to joint and several damages, section 21D(g) explicitly states 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." Additionally, language in the House Conference Report explaining the new damages provision, reinforces this point: in eliminating joint and several liability for 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;... [Section 21D(g)] further provides that the standard of liability in any such action should be determined by the pre-existing, unamended statutory provision that creates the cause of action, without regard to this provision, which applies solely to the allocation of damages.

282 See supra text accompanying note 78.
283 See supra note 88 and accompanying text.
286 Id. § 78u-4(g)(1).
Although somewhat strained, the courts in *Silicon Graphics I* and *II* did provide a counterargument to this point. The courts argued that the absence of similar language in yet another provision pertaining to substantive mental state requirements undermines the explanatory language in section 21D(g) and the House Conference Report.\(^\text{288}\)

The courts pointed to new section 21E(c),\(^\text{289}\) which explicitly excludes a "safe harbor" for defendants who have made "forward-looking"\(^\text{290}\) statements with "actual knowledge . . . that the statement[s were] false or misleading"\(^\text{291}\) but which nowhere explicitly limits changes to substantive scienter requirements to this subsection. However, this asymmetry—section 21D(g) includes limiting language which section 21E does not—can be easily explained. Section 21E pertains only to the safe harbor for forward-looking statements, whereas section 21D pertains to many different procedural provisions,\(^\text{292}\) making it more necessary to be explicit about how changes to one subsection affect other subsections.

### b. The Legislative History

As Parts II and III demonstrated, a thorough investigation of the Reform Act's legislative history permits more than one interpretation of section 21D(b)(2)'s meaning. In attempting to divine legislative intent, the district courts, though ultimately coming to three distinct conclusions, relied on similar principles of statutory interpretation.\(^\text{293}\)

As two courts\(^\text{294}\) correctly identified, congressional committee reports are traditionally understood as the most reliable sources of legislative intent.\(^\text{295}\) If one reads the House Conference Report, in particular the sentence stating that the "Conference Committee intends to

---


\(^{290}\) For a definition of forward-looking statements, see id. § 78u-5(c)(I)(A).

\(^{291}\) See id. § 78u-5(c)(1)(B).

\(^{292}\) Compare id. § 78u-4(g) (dealing with "proportionate liability"), with id. § 78u-4(c) (dealing with "sanctions for abusive litigation").

\(^{293}\) See supra text accompanying notes 190, 205, 219, 269.


\(^{295}\) See Garcia v. U.S., 469 U.S. 70, 76 (1984) ("The authoritative source for finding the Legislature’s intent lies in the Committee Reports on the bill, which ‘represen[t] the considered and collective understanding of those Congressmen involved in drafting and studying proposed legislation’" (quoting Zuber v. Allen, 369 U.S. 168, 186 (1969))); see also Costello, supra note 274, at 41 (explaining that "[t]he case for considering floor debates as inherently more reliable than committee reports is weak"); William N. Eskridge Jr., *The New Textualism*, 37 UCLA L. Rev. 621, 636 (1990) (providing a chart of the most and least authoritative pieces of legislative history); Mikva, supra note 274, at 385 (explaining that "I always find that the committee report is the most useful device."). *But see* Wisconsin Pub. Intervenor v. Mortier, 501 U.S. 597, 621 (1991) (Scalia, J., concurring) ("[W]e are a Government of laws, not of committee reports.").
strengthen existing pleading requirements," in conjunction with the language in footnote 23 that states "for this reason, the Conference Report chose not to include in the pleading standard certain language relating to . . . recklessness," one can make several arguments that the Committee intended to eliminate liability for recklessness. After all, Congress certainly considered the idea: the first version of the House bill had eliminated liability for recklessness. In fact, the Reform Act, as enacted, did alter the substantive scienter requirement for joint and several liability and created a safe harbor for forward-looking statements precisely by eliminating liability for recklessness. Strictly speaking, as the courts in *Friedberg* and *Norwood Venture* demonstrated, perhaps unwittingly, one may heighten a pleading requirement by altering the requirements of the substantive element to be pled.

At first blush, the three-way split in Second Circuit case law that *Silicon Graphics II* identified also supports an interpretation that the House Conference Report intended to eliminate liability for recklessness. As the *Silicon Graphics II* court accurately discovered, the Wechsler v. Steinberg line of cases has never defined "scienter" to include reckless conduct for purposes of Rule 10b-5 securities fraud—despite the near universal acceptance among the circuits of recklessness as a form of scienter. If a court knew about the Wechsler line of cases, it could point to the language in the House Conference Report which states that Congress based section 21D(b)(2) "in part on the pleading standard of the Second Circuit to show Congress intended to eliminate liability for recklessness." Therefore, according to this argument, the Second Circuit's Wechsler line of cases is more stringent than the Second Circuit's pleading requirement (i.e., *In re Time*...
Warner Inc. Securities Litigation precisely because it does not include reckless conduct as grounds for securities fraud liability.

These arguments, however, ultimately fail. First, the Committee specifically entitled the portion of the House Conference Report that explains section 21D(b)(2) "Heightened pleading standard." The House Conference Report refers to FRCP Rule 9(b) throughout this explanatory section, which pertains solely to the pleading stage of litigation. Furthermore, nowhere in the legislative history, not even in a single stray comment on the House or Senate floor, is there evidence that Congress either misunderstood the distinction between the substantive and procedural requirements of securities fraud or sought to heighten the pleading standard for the scienter element of securities fraud by fusing these two notions. Similarly, neither the Wechsler line of cases nor the existence of a three-way split in Second Circuit case law was ever the topic of congressional debate. The three-way split in Second Circuit case law pertains solely to the substantive requirements of scienter and therefore has no bearing on either section 21D(b)(2) or the language of the House Conference Report. Thus, Silicon Graphics II's conclusion that section 21D(b)(2) eliminated liability for recklessness is founded on a forced interpretation of three sentences in the House Conference Report, read in the false context of an intracircuit split that relates to a nongermane area of law.

To conclude that Congress intended to eliminate securities fraud liability for recklessness also requires one to ignore the great bulk of

308 9 F.3d 259 (2d Cir. 1993); see discussion supra Part I.B.3.
310 See id.; supra Part I.A.
311 The Silicon Graphics II decision, see supra notes 236-54 and accompanying text, and the Vanyo article, see Vanyo et al., supra note 61, reflect conceptual confusion regarding the Second Circuit's case law. Both the court in Silicon Graphics II and the Vanyo article identify the Wechsler v. Steinberg, 733 F.2d 1054 (2d Cir. 1984), line of cases as defining scienter to exclude recklessness, and a second line of cases as specifically including recklessness. See Silicon Graphics II, 970 F. Supp. at 755; Vanyo et al., supra note 61, at 76-77. The Silicon Graphics II court identifies the second line as the Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973), line. See Silicon Graphics II, 970 F. Supp. at 755. As noted earlier, Wechsler and Lanza form opposing lines of case law with respect to the substantive scienter requirements of securities fraud. See supra note 247. The Vanyo article identifies the second line of cases to include In re Time Warner Inc. Securities Litigation, 9 F.3d 259 (2d Cir.1993). See Vanyo et al., supra note 61, at 76-77. In so doing, the article sets up a false opposition between case law pertaining to the substantive requirements of securities fraud (i.e., the Wechsler line), and a line of cases pertaining to the pleading requirements of securities fraud (i.e., the In re Time Warner line). The Vanyo article makes another conceptual mistake by including Beck v. Manufacturers Hanover Trust Co., 820 F.2d 46 (2d Cir. 1987), among the Wechsler line of cases. See Vanyo, supra note 61, at 94 n.1. The article fits Beck into the Wechsler line of cases by reading Beck's requirement that the defendant act with "conscious knowledge" to exclude recklessness. In so doing, it ignores the fact that many courts, including courts in the Second Circuit, have interpreted "conscious knowledge" to include "recklessness," just as they have interpreted "scienter" to include "recklessness." See Johnson, supra note 59, at 685.
other aspects of the Reform Act's legislative history. Both the Senate Report\textsuperscript{312} and key exchanges between Senators Specter and Dodd\textsuperscript{313} indicate that Congress focused solely on the pleadings. A majority of the courts also relied upon President Clinton's veto message\textsuperscript{314} to rule that section 21D(b)(2) eliminated liability for recklessness. However, courts must keep the President's interpretation of section 21D(b)(2) distinct from the legislature's intent.\textsuperscript{315} Not only might the President's political orientation influence his interpretation, which would warrant giving it minimal weight, but also the veto message itself, in decrying the stringency of section 21D(b)(2),\textsuperscript{316} nowhere implies that the President understood the Conference Committee to have altered substantive requirements.

The Supreme Court's latest rulings on statutory interpretation also weigh against interpreting section 21D(b)(2) to have eliminated securities fraud liability for recklessness. \textit{Shannon v. United States}\textsuperscript{317} presented the Supreme Court with a statute that was ambiguous as to what jury instructions courts should give in connection with the insanity defense.\textsuperscript{318} The Senate Report accompanying the statute specifically endorsed the procedure used by the D.C. Circuit, but the statute itself contained no language that reflected this procedure.\textsuperscript{319} The Court ruled that a statement made in the legislative history of a statute will not receive interpretive weight if it is "in no way anchored in the text of the statute."\textsuperscript{320} Although \textit{Shannon} dealt with a single statement made in the legislative history of a statute, the principle laid down in \textit{Shannon} clearly applies to any "snippet of legislative history."\textsuperscript{321}

The two or three statements contained in the House Conference Report for the Reform Act which support the interpretation that section 21D(b)(2) eliminated liability for recklessness are, at most, mere "snippets" of legislative history. Indeed, these two statements are arguably less than snippets. The statement at issue in \textit{Shannon} was a clear endorsement of D.C. Circuit procedure, whereas only a strained reading of the statement and related footnote in the Reform Act's House Conference Report supports a congressional intention to eliminate liability for recklessness. Moreover, and as previously discussed,\textsuperscript{312-321}}
no language in section 21D(b)(2) purports to alter the substantive scienter requirements for securities fraud; in fact, the term “recklessness” does not even appear. Thus, the proposition that section 21D(b)(2) eliminated liability for recklessness is not “anchored” in the text and therefore must be rejected.

The principle that courts should defer to the statutory interpretation of the administrative agency that administers the statute, as enunciated in *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*,\(^\text{322}\) also weighs against a finding that section 21D(b)(2) eliminated liability for recklessness.\(^\text{323}\) Admittedly, one can apply arguments grounded in the *Chevron* doctrine to the issue at hand only by analogy. Strictly speaking, the *Chevron* doctrine applies only to judicial review of an administrative agency’s judicial ruling\(^\text{324}\) and thus arguably does not extend to the SEC’s interpretation of section 21D(b)(2) in an amicus curiae brief. Moreover, under the *Chevron* doctrine, a court accords judicial deference only when the agency “administers” the statute in question,\(^\text{325}\) and the Reform Act, which is primarily concerned with court procedure, pertains to an area of law “where the SEC has neither primary jurisdiction nor special expertise.”\(^\text{326}\) However, the substantive requirements of Rule 10b-5 securities fraud are certainly an area of the SEC’s expertise. Thus, the extreme interpretation that section 21D(b)(2) eliminated liability for recklessness converts at least this aspect of the Reform Act into a subject of SEC jurisdiction. According to *Chevron*, when the text of the statute is “silent or ambiguous with respect to the specific issue, the question for the court is whether the agency’s [interpretation] is based on a permissible construction of the statute.”\(^\text{327}\) The SEC’s thorough analysis and interpretation\(^\text{328}\) of section 21D(b)(2) is clearly a more permissible construction of both the statute and the Reform Act’s legislative history than a district court’s construction that section 21D(b)(2) eliminated liability for recklessness. It follows that courts should seriously consider the SEC’s position that section 21D(b)(2) in no way alters the substantive requirements of securities fraud.\(^\text{329}\)

\(^\text{323}\) See *Coffee*, supra note 16, at 518 (arguing that because of the *Chevron* doctrine of deference to agencies, the SEC “could have an even more decisive role than the courts in shaping the [Reform Act]”).
\(^\text{324}\) See *Chevron*, 467 U.S. at 842.
\(^\text{325}\) See id. at 843-44.
\(^\text{326}\) *Coffee*, supra note 16, at 518.
\(^\text{327}\) *Chevron*, 467 U.S. at 843.
\(^\text{328}\) See SEC Amicus Brief, supra note 47.
\(^\text{329}\) See id. The SEC recently reaffirmed its position that the Reform Act did not eliminate securities fraud liability for reckless conduct during the legislative debate surrounding the newly passed Securities Litigation Standards Act of 1998 (“Uniform Standards Act”), Pub. L. No. 105-353, 112 Stat. 3227 (to be codified in scattered sections of 15 U.S.C.), which preempts plaintiffs from bringing securities fraud class actions under state law. In March 1998, Chairman Arthur Levitt and several SEC commissioners agreed to support the
c. History and Policy Considerations

Both the history of the scienter element of securities fraud and policy considerations argue against the conclusion that section 21D(b)(2) eliminated securities fraud liability for reckless misconduct. After the Supreme Court decided in *Ernst & Ernst v. Hochfelder*\(^3\) not to explicitly define the scienter element of Rule 10b-5 securities fraud to include recklessness, nearly every circuit has held that some level of recklessness gives rise to liability for securities

preemption legislation in return for assurances made by several senators that the legislative record would include statements to the effect that Congress had not intended section 21D(b)(2) to eliminate recklessness as a substantive basis for securities fraud. *See* Letter from Arthur Levitt, Chairman, Isaac C. Hunt, Jr., Commissioner, and Laura S. Unger, Commissioner, to Sen. Alfonse D'Amato, Sen. Phil Gramm, and Sen. Christopher J. Dodd (Mar. 24, 1998), *reprinted in* 144 Cong. Rec. S4780 (daily ed. May 13, 1998); Letter from Sen. Alfonse M. D'Amato, Sen. Phil Gramm, and Sen. Christopher J. Dodd to Arthur Levitt, Chairman, SEC (Mar. 24, 1998) (stating that "our clear intent in 1995 . . . was that the [Reform Act] did not in any way alter the scienter standard . . . [and] [w]e intend to restate these facts . . . in both the legislative history and the floor debate that will accompany [the preemption bill]"). The Clinton administration also predicated its support for the preemption legislation on congressional clarification that it had not intended to eradicate securities fraud liability for reckless conduct. *See* Letter from Bruce Lindsey, Assistant to the President and Deputy Counsel, and Gene Sperling, Assistant to the President for Economic Policy, to Chairman D'Amato, Chairman Graham, and Sen. Dodd (Apr. 28, 1998), *reprinted in* 144 Cong. Rec. S4781 (daily ed. May 13, 1998) (stating that "it is particularly important to the President that [Congress] be clear that federal law to be applied includes recklessness as a basis for pleading and liability in securities fraud class actions").

A prearranged colloquy between Senators Dodd and D'Amato, in which both clarified their previous intentions that the Reform Act was not meant to eliminate liability for recklessness, took place on the Senate floor on May 13, 1998. *See* 144 Cong. Rec. S4798 (daily ed. May 13, 1998) (floor debate on Senate Bill 1260). Language to the same effect also was included in the Statement of Managers of the Conference Report on the Uniform Standards Act. *See* H.R. Conf. Rep. No. 105-803, at 15 (1998), *reprinted in* 144 Cong. Rec. H11,020-21 (daily ed. Oct. 15, 1998) ("Congress did not, in adopting the Reform Act, Intend to alter the standards of liability under the [1934] Act."). In light of "the Supreme Court's hostility toward using subsequent legislative history in interpreting section 10(b) of the 1934 Act, this colloquy and the entire 'quid pro quo' . . . may be meaningless." Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 Cornell L. Rev. 1, 55-56 (1998) (footnote omitted). Interestingly, several paragraphs of the Statement of Managers which further clarified that Congress had not intended the Reform Act to alter the substantive basis for securities fraud were initially omitted from the Congressional Record. *See* 144 Cong. Rec. H10,270 (daily ed. Oct. 9, 1998). When these paragraphs were later printed in the Congressional Record, *see* 144 Cong. Rec. H11,021 (daily ed. Oct. 15, 1998), they were followed by a reproduction of a well-known speech by Representative Bliley, Chairman of the Conference Committee for the Reform Act, stating that "it is our view that non-intentional conduct can never be sufficient for liability under section 10(b) of the [1934] Act." *Id.* As Professor Painter aptly observes, "at least some individual members of Congress clearly intend[ ] that the legislative history be as confusing as possible on the question of whether Congress" intended section 21D(b)(2) to eliminate liability for recklessness. Painter, *supra*, at 58 n.323.

For an excellent discussion and analysis of the federal preemption debate, see Painter, *supra* (concluding that Congress acted prematurely in enacting the Uniform Standards Act).

\(^3\) 425 U.S. 185 (1976).
fraud. In fact, liability for recklessness "is an inherent aspect of fraud" and has origins in early common law extending as far back as the English case of Derry v. Peek. Thus, to eliminate securities fraud liability for reckless misconduct would not only require overturning the settled case law of every circuit, but also would uproot securities fraud from its very foundation.

Eliminating securities fraud liability for recklessness also would upset the guiding policy objectives of the federal securities laws, which Congress intended the Reform Act to reestablish. The elimination of liability for recklessness would upset the delicate balance between deterring securities fraud and reducing the cost of capital formation by eliminating abusive securities suits. As the SEC argued, because it is extremely difficult to establish that a defendant acted with "knowledge" or "conscious intent," such a standard would give corporations less of an incentive "to conduct . . . full inquiries into potentially troublesome or embarrassing areas." This lack of incentive would "greatly erode the deterrent effect" of Rule 10b-5 actions. Lastly, eliminating securities fraud liability for reckless misconduct would leave both courts and plaintiffs in a state of confusion. Plaintiffs would have no guidance as to precisely what a complaint must plead or what they must prove at trial with regard to the scienter element of securities fraud. Courts, in turn, would have to redevelop criteria by which to judge both the pleading and substantive aspects of securities fraud.

331 See In re Baesa Inc. Sec. Litig., 969 F. Supp. 238, 241 (S.D.N.Y. 1997) (collecting cases); SEC Amicus Brief, supra note 49, at 5 n.4 (same); LOSS & SELIGMAN, supra note 3, at 843 n.320 (same).
332 Kuehnle, supra note 59, at 127; see also RESTATEMENT (SECOND) OF TORTS § 526(b) cmt.e (1977) (stating that "fraud is prove[n] if it is shown that a false representation has been made without belief in its truth or recklessly, careless of whether it is true or false"); W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 107, at 741-42 (5th ed. 1984) (explaining that courts will find an intent to mislead when "a representation is made . . . with reckless disregard whether it be true or false").
333 14 App. Cas. 337, 374, 58 L.J. Ch. 864 (1889); see Kuehnle, supra note 59, at 153-59.
334 See Johnson, supra note 59, at 736 (eliminating recklessness would be "a clear . . . deviation from well-settled common law jurisprudence").
335 See S. REP. No. 104-98, at 4 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 683 (stating that the purpose behind the Reform Act is to "lower the cost of raising capital by combating securities litigation abuses, while maintaining the incentive for bringing meritorious actions"). Commentators have described the goals of securities laws similarly. For example, Phillips and Miller have said:

A properly balanced system would give appropriate weight to two competing interests: the interest in deterring securities fraud and remedying it when it occurs, and the interest in assuring that the litigation process is not used for abusive purposes and does not unfairly target defendants who are guilty of no wrongdoing.

Phillips & Miller, supra note 4, at 1009.
336 SEC Amicus Brief, supra note 47, at 3.
337 Id.
2. As to Whether Section 21D(b)(2) Creates a Pleading Standard More Stringent Than That of the Second Circuit: The Statute Must Control

The question of whether section 21D(b)(2) creates a pleading standard more stringent than the standard developed by Second Circuit case law is much more difficult. As previously discussed, a line of cases has interpreted section 21D(b)(2) to have created a pleading standard of approximately the same stringency as the Second Circuit's strong inference standard. This line of cases adopted the Second Circuit's two alternative tests without alteration. A second line of cases interpreted section 21D(b)(2) to have created a pleading standard more stringent than that of the Second Circuit and concluded that the motive and opportunity test no longer presumptively gives rise to a strong inference of scienter. The legislative history behind section 21D(b)(2) provides equal support for both interpretations of the provision.

The language of the Senate Report and several comments made in floor discussions surrounding the House Conference Report and congressional override of President Clinton’s veto suggest that Congress intended courts to look to Second Circuit case law for guidance in construing section 21D(b)(2). Language in the House Conference Report suggesting that the intent of the heightened pleading requirement was to “strengthen existing pleading requirements,” footnote 23, and President Clinton’s veto message all support the proposition that Congress intended section 21D(b)(2) to be more stringent than the Second Circuit standard as interpreted in that circuit’s two alternative tests. Supreme Court precedent and tradition dictate that the committee reports comprise the most definitive expression of legislative intent, but both interpretations of section 21D(b)(2) find support in a committee report: the Senate Report on the one hand and the House Conference Report on the other. Furthermore, the Supreme Court’s Shannon decision, which requires that congressional intent gleaned from statements made in the legislative record must be “anchored” in the text of the statute before they are given interpretive weight, offers no guidance either—the relevant

338 See supra Part III.B.1.
339 See supra Part III.B.2(a).
341 See supra notes 148-64 and accompanying text.
344 For the relevant portion of the veto message, see supra text accompanying note 156.
345 See sources cited supra note 295.
PLEADING SCIENTER

statements in both the Senate Report and the House Conference Report are equally "anchored" in the strong inference language of section 21D(b)(2).

Arguably, the House Conference Report, as the embodiment of the views of both houses of Congress, is a more reliable source of congressional intent than the Senate Report. As a result, courts should interpret section 21D(b)(2) to have created a pleading standard more stringent than that of Second Circuit case law, as indicated by the language the conferees used in the House Conference Report. But, an alternative interpretation of the House Conference Report, stemming from the split in Second Circuit case law over the exact formulation of the two alternative tests, undermines this argument. As highlighted in the congressional floor debate between Senators Dodd and Specter, two distinct formulations of the Second Circuit's two alternative tests exist: the In re Time Warner Inc. Securities Litigation, Inc. formulation and the Beck v. Manufacturers Hanover Trust Co. formulation. The latter includes qualifying language stipulating that when motive is not apparent, the plaintiff must plead correspondingly stronger circumstantial evidence of reckless behavior or knowledge. In light of this split, one can read the crucial language in the House Conference Report as intending to strengthen existing pleading requirements by overruling the In re Time Warner formulation, but not the Beck formulation, of the Second Circuit's tests.

Policy considerations also weigh evenly in favor of both interpretations of section 21D(b)(2)'s pleading requirements. The difference between the two standards is arguably so slight that it will have little negative impact on either the objectives of the Reform Act or the larger policy objectives of the federal securities laws. Moreover, the stability argument—interpreting section 21D(b)(2) to have effectively codified Second Circuit case law creates greater coherence in the law—is not dispositive. It is true that adopting the competing interpretation—the Reform Act's heightened pleading provision creates a more stringent standard than that developed in Second Circuit case law—certainly will require courts to start from a "blank slate." How-

347 See supra notes 149-54 and accompanying text.
349 See Beck v. Manufacturers Hanover Trust Co., 820 F.2d 46, 50 (2d Cir. 1987).
350 See discussion supra Part I.B.3; see also Parker, supra note 69, at 4 (identifying In re Time Warner and Beck split).
351 See Paul H. Dawes, Pleading Motions Under the Private Securities Litigation Reform Act of 1995, in Securities Litigation 1996, at 69-70 (PLI Corp. L. & Practice Course Handbook Series No. B-958, 1996). A central reason why determining the precise stringency of section 21D(b)(2) might have only minimal ramifications for complaints pleading securities fraud is that the application of sciente pleading requirements to a very large degree turns on the precise facts of each case. For a study of what fact patterns have been held to establish a "strong inference" of sciente, see Elliot J. Weiss, The New Securities Fraud Pleading Requirement: Speed Bump or Road Block?, 38 ARIZ. L. REV. 675, 683-90 (1996).
ever, the already present confusion over the precise formulation of
the Second Circuit test arguably will lead to identical results: neither
plaintiffs nor courts will have guidance as to precisely what a com-
plaint must plead in order to allege sufficiently a strong inference of
scienter.

Thus, the text of section 21D(b)(2)\textsuperscript{352} must control. Nothing in
the text of section 21D(b)(2) refers or directs courts to the Second
Circuit's case law for guidance in interpreting the provision. Accord-
ingly, although reviewing courts may look to the Second Circuit’s case
law, and to the two alternative tests developed therein, as a natural
starting point when interpreting the terms “strong inference,” that
body of law need not be considered the only starting point. Further,
because this provision should not necessarily be interpreted in rela-
tion to Second Circuit case law, section 21D(b)(2) should not be
thought of as more (or less) stringent than the Second Circuit stan-
dard. This conclusion particularly speaks to those courts that have
interpreted section 21D(b)(2) to be more stringent than the Second
Circuit by holding that it eliminated one of the tests developed in that
circuit’s case law—namely, the presumption that pleading motive and
opportunity suffices to establish a "strong inference" of scienter.

Deciding courts are to have significant discretion in interpreting
the precise requirements of section 21D(b)(2): they may equate it
with the Second Circuit’s “strong inference” standard and apply both
of that circuit’s tests unaltered; they may look to Second Circuit case
law but modify the tests developed therein by eliminating the pre-
sumption that pleading motive and opportunity suffices to establish a
strong inference and measure the weight of such evidence on a case-
by-case basis; or alternatively, they may develop novel requirements
and tests by which to satisfy the strong inference pleading standard.
Thus, the text of section 21D(b)(2) in a sense works a revenge on the
legislature, with its months of drafting and debate, the judiciary, with
its painstaking scrutiny of the resulting legislative history, and to a cer-
tain extent, the bulk of this Note, which tracks both: for this interpre-
tive discretion is the baseline assumption of any court faced with the
text of a new provision.

CONCLUSION

In enacting section 21D(b)(2) of the Private Securities Litigation
Reform Act of 1995, Congress sought to achieve a balance between
preventing securities fraud and preventing abusive securities litigation
by heightening the pleading standard for the scienter element of Rule
10b-5 securities fraud actions. The ambiguous language of section
21D(b)(2), the extensive and confusing legislative history, the concep-

\textsuperscript{352} See supra text accompanying note 132.
tual confusion regarding the Second Circuit’s case law, and the relationship between substantive and procedural requirements generally have led the district courts to arrive at three distinct pleading standards. A comprehensive evaluation of the interpretive arguments of the district courts against a thorough analysis of the Reform Act’s legislative history leads to the conclusion that section 21D(b)(2) did not abrogate securities fraud liability for reckless conduct. As for the precise stringency of the strong inference pleading requirement contained in section 21D(b)(2), however, the text of the statute must ultimately control.