Litigation

Reform Act Under Attack?

By Richard H. Zelichov

Congress enacted the Private Securities Litigation Reform Act of 1995 (the "Reform Act") to reduce the volume of abusive securities litigation filed by private plaintiffs. After its passage, courts throughout the country, including the U.S. Supreme Court, raised the standards necessary to allege securities fraud.

Despite this trend, a number of courts stepped back from strict application of the Reform Act immediately after the corporate scandals involving Enron and WorldCom. With the stock market in a tailspin in 2008, the courts in which most private securities cases are filed seemingly made it easier for plaintiffs to assert claims of securities fraud by reviving once rejected theories of liability known as "collective scienter" and "core operations."

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In the typical private securities action, a shareholder will sue a company and certain senior officers who allegedly made false statements on behalf of the company. The shareholder will attempt to establish that the senior officers making the statements acted with *scienter* (intent to deceive) that will be imputed to the company. In certain cases, the shareholder cannot establish that the senior officers acted with scienter, but will argue that the company can nonetheless be held liable. The shareholder will claim that, even if the senior officers did not know of any wrongdoing, other individuals at the company did and that the company is charged with the collective knowledge of all of its employees. This is *collective scienter.*

Collective scienter had been rejected for the most part as inconsistent with the Reform Act and general agency principles. Recently, however, the federal Courts of Appeals with jurisdiction over cases brought in Illinois, Indiana, Wisconsin, Connecticut, New York, Vermont, Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, and Washington have either ruled or suggested that plaintiffs may be able to rely on collective scienter. These decisions improperly divorce the act of fraud from the intent to commit it. Only certain individuals at a company have authority to make statements on the company's behalf and the intent of any other person at the company should be irrelevant to whether the company acted with scienter.

The core operations theory also makes it easier for a shareholder to state a claim of securities fraud. It rests on the assumption that a company's most senior officers know all the facts concerning the company's core operations and therefore cannot claim lack of knowledge if they or the company make misleading statements concerning such operations. In 2008, courts struggled with the applicability, breadth, and scope of the doctrine.

One federal Court of Appeals (with jurisdiction over Illinois, Indiana, and Wisconsin) seemingly adopted the theory by ruling that it was "exceedingly unlikely" that senior management did not have information concerning the company's "most important products," while another Court of Appeals (with jurisdiction over Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, and Washington) wavered back and forth. It initially rejected the theory, then adopted it, and then rejected it again before trying to rationalize all of its decisions by ruling that the core operations theory can be used in conjunction with other particularized facts to allege scienter, that the core operations theory alone will usually fall short of the Reform Act standard, and that "in some unusual circumstances, the core operations inference, without more, may raise the strong inference required by the" Reform Act.

While the first two parts of this rationalization are consistent with the Reform Act, the third part—that there are times when the core operations theory alone is enough—seems inconsistent with the Reform Act's insistence on specificity. The court explained that "it would be 'absurd' to suggest that management was without knowledge of the matter," but "absurdity" does not serve as a substitute for particularized facts.

There continues to be diversity in application of the Reform Act in the 14 years since its passage. Indeed, while the decisions might be thought by some to undermine the Reform Act, there are others that further its purpose of reducing the volume of abusive private securities litigation.

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