Mercer Law Review

Volume 48
Number 4 *Annual Eleventh Circuit Survey*

Article 14

7-1997

Securities Regulation

John L. Latham

Jenna L. Fruechtenicht

Securities Regulation

by John L. Latham[*]
and
Jenna L. Fruechtenicht[**]

This Article surveys significant cases decided by the United States Court of Appeals for the Eleventh Circuit during 1995 and 1996 in the field of securities regulation. This Article also examines select Supreme Court decisions and Congressional enactments during this survey period that affect Eleventh Circuit precedent.

The most significant development during this survey period was the enactment of the Private Securities Litigation Reform Act of 1995. Because the legislation affects a number of historical precedents and implements substantial changes in the area of securities regulation, this survey must begin with that Act.

I. THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

On December 22, 1995, the Private Securities Litigation Reform Act of 1995 ("PSLRA") became law.[1] The PSLRA was enacted to combat "strike" suits and other litigation abuses "while maintaining the

* Partner in the firm of Alston & Bird, L.L.P., Atlanta, Georgia. University of Toledo (B.A., cum laude with honors, 1976); Emory University (J.D., 1979). Member, State Bar of Georgia.

** Associate in the firm of Alston & Bird, L.L.P., Atlanta, Georgia. Wake Forest University (B.A., magna cum laude, 1992; J.D., cum laude, 1995). Member, State Bars of Georgia and North Carolina.

1. The PSLRA was not easily enacted. After being approved by the Senate on December 5, 1995, by a vote of 65 to 30, and by the House of Representatives on December 6, 1995, by a vote of 320 to 102, the Act was vetoed by President Clinton. The House voted to override the President's veto on December 20, 1995, by a vote of 319 to 100, and the Senate voted to override the veto on December 22, 1995, by a vote of 65 to 30. 141 CONG. REC. S17997 (daily ed. Dec. 5, 1995); 141 CONG. REC. H14055 (daily ed. Dec. 6, 1995); 141 CONG. REC. D1496 (daily ed. Dec. 20, 1995); 141 CONG. REC. H15224 (daily ed. Dec. 20, 1995); 141 CONG. REC. S19180 (daily ed. Dec. 22, 1995).

incentive for bringing meritorious actions."[2] As one of the most significant pieces of legislation enacted in the private securities area this half of the century, the PSLRA will substantially impact the manner in which the securities laws are litigated.

Because the PSLRA applies only to those actions originally filed after December 22, 1995,[3] few cases have been fully litigated under its new provisions.[4] Nonetheless, much could be and has been written about this momentous legislation.[5] This Article, however, is meant to serve only as a brief overview of the latest developments in this circuit; thus, these authors will merely touch upon the primary areas of reform implemented by the PSLRA and leave a more thorough discussion of the Act for another day and another article.[6]

---

2. S. REP. NO. 98, 104th Cong., 1st Sess. 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683.

3. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, §§ 108-109, 202 Stat. 737 (1995).

4. Although many cases are now progressing under the PSLRA's new provisions, few published opinions can be found addressing disputes arising thereunder. *But see*, Medhekar v. United States District Court for the Northern District of California, 99 F.3d 325 (9th Cir. 1996); Medical Imaging Ctrs., Inc. v. Lichtenstein, 917 F. Supp. 717 (S.D. Cal. 1996); Zeid v. Kimberley, 930 F. Supp. 431 (N.D. Cal. 1996); Greebel v. FTP Software, Inc., 939 F. Supp. 57 (D. Mass. 1996); Edge Partners, L.P. v. Dockser, 944 F. Supp. 438 (D. Md. 1996); *In re* Silicon Graphics, Inc. Sec. Litig., No. C96-0393, 1996 WL 664639 (N.D. Cal. Sept. 25, 1996).

5. *See, e.g.*, JOSEPH A. GRUNDFEST & MICHAEL A. PERINO, SECURITIES LITIGATION REFORM: THE FIRST YEAR'S EXPERIENCE, (Cornerstone Research Release No. 97.1, February 27, 1997) [hereinafter "Cornerstone Research"]; Jay B. Kasner, Stephen W. Hamilton, & Nancy J. McGlynn, *The Safe Harbor for Forward-Looking Statements Under the Private Securities Litigation Reform Act of 1995, in* SECURITIES LITIGATION 1996, at 89 (PLI Corp. Law & Practice Course Handbook Series No. B4-7165, 1996) [hereinafter "Safe Harbor"]; Joel W. Sternman & Garrett L. Gray, *The Origins & Implications of the Joint and Several Liability & Proportionate Fault Provisions of § 21D of the Private Securities Litigation Reform Act of 1995, in* SECURITIES LITIGATION 1996, at 757 (PLI Corp. Law & Practice Course Handbook Series No. B4-7165, 1996) [hereinafter "Origins & Implications"]; Symposium, *The Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 1 (Aug. 1996).

6. For a discussion of the impact of the PSLRA after one year, see U.S. SECURITIES & EXCHANGE COMMISSION, OFFICE OF THE GENERAL COUNSEL, REPORT TO THE PRESIDENT AND THE CONGRESS ON THE FIRST YEAR OF PRACTICE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 (April 1997). Found at www.sec.gov/news/studies/lreform.txt.

A. Provisions of the PSLRA Applicable to Both the Securities Act and the Exchange Act

1. Safe Harbor Provisions. One of the most important aspects of the PSLRA is the protection from civil liability afforded by the safe harbor provisions of sections 27A and 21E. Section 102 of the PSLRA amends the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act") by inserting section 27A into the Securities Act and section 21E into the Exchange Act. These identical provisions provide a safe harbor from civil liability for both written and oral forward-looking statements that project, explain, or estimate future events.[7] The safe harbor provisions reflect the chilling effect the threat of litigation has had on corporate America's willingness to assess its own future and are intended "to enhance market efficiency by encouraging companies to disclose forward-looking information."[8]

The protection afforded by the safe harbor provisions is extended to forward-looking statements expressly identified as such and "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the

7. A forward-looking statement is defined as:

> (A) a statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure, or other financial items;
> (B) a statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer;
> (C) a statement of future economic performance, including any such statement contained in a discussion and analysis of financial condition by the management or in the results of operations included pursuant to the rules and regulations of the Commission;
> (D) any statement of the assumptions underlying or relating to any statement described in subparagraph (A), (B), or (C);
> (E) any report issued by an outside reviewer retained by an issuer, to the extent that the report assesses a forward-looking statement made by the issuer; or
> (F) a statement containing a projection or estimate of such other items as may be specified by rule or regulation of the Commission.

Private Securities Litigation Reform Act of 1995 § 102 (codified at 15 U.S.C. §§ 77z-2(i)(1), 78u-5(i)(1) (Supp. 1997)).

8. H. R. CONF. REP. NO. 369, 104th Cong., 1st Sess. 43 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 742. The Senate Report also notes, "Fear that inaccurate projections will trigger the filing of a securities fraud lawsuit has muzzled corporate management. One study found that over two-thirds of venture capital firms were reluctant to discuss their performance with analysts or the public because of the threat of litigation." S. REP. NO. 98, 104th Cong., 1st Sess. 16 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 695.

forward-looking statement."[9] In addition, the safe harbor provisions protect against liability for forward-looking statements deemed to be immaterial[10] and statements the plaintiff fails to show were made with actual knowledge of the statement's falsity or tendency to mislead.[11] Oral forward-looking statements are protected to the same extent as written statements as long as the forward-looking statement is identified as such, accompanied by a cautionary statement explaining "that the actual results could differ materially from those projected," and, if the oral statement references additional information contained in a readily available written document, the document is identified and also fulfills the statutory requirements for written materials.[12]

The PSLRA's safe harbor provisions are not of unlimited applicability, however, for they extend only to the statements of specifically identified individuals. The individuals protected by the safe harbor are issuers subject to the reporting requirements of sections 13(a) or 15(d) of the Exchange Act, persons acting on behalf of such issuers, outside reviewers retained by such issuers to make a statement on behalf of that issuer, or underwriters with respect to information provided by or derived from such issuers.[13] Quite a few transactions are also expressly excluded from the protection of the safe harbor provisions—financial statements prepared according to generally accepted accounting principles, initial public offerings, tender offers, and a variety of other transactions.[14]

---

9. 15 U.S.C. §§ 77z-2(c)(1)(A), 78u-5(c)(1)(A).

10. *Id.*

11. *Id.* §§ 77z-2(c)(1)(B), 78u-5(c)(1)(B). If the statement is made by a business entity, then the PSLRA protects against liability for statements made by or approved by an executive officer if the plaintiff fails to prove the officer had actual knowledge of the statement's falsity or tendency to mislead. *Id.*

12. 15 U.S.C. §§ 77z-2(c)(2), 78u-5(c)(1)(B).

13. *Id.* §§ 77z-2(i)(1), 78u-5(i)(1).

14. *Id.* §§ 77z-2(b), 78u-5(b). The safe harbor also does not extend to an issuer who was convicted of a felony or misdemeanor during the three-year period preceding the date of the statement or an issuer who was the subject of a judicial decree or order arising out of certain governmental action. *Id.* These provisions state:

> (b) Exclusions
>
> Except to the extent otherwise specifically provided by rule, regulation, or order of the Commission, this section shall not apply to a forward-looking statement—
>
> (1) that is made with respect to the business or operations of the issuer, if the issuer—
>
> (A) during the 3-year period preceding the date on which the statement was first made—
>
> (i) was convicted of any felony or misdemeanor described in clauses (i) through (iv) of section 15(b)(4)(B) of the Securities Exchange Act of 1934; or
>
> (ii) has been made the subject of a judicial or administrative decree or order arising out of a governmental action that—

However, the legislative history of the Act suggests that the Securities Exchange Commission ("SEC") should consider adopting regulatory safe harbors for those forward-looking statements not protected by the PSLRA.[15] Additionally, the PSLRA itself grants the Commission the authority to "provide exemptions from or under any provision of this title . . . if and to the extent that any such exemption is consistent with the public interest and the protection of investors."[16]

Prior to the enactment of the PSLRA, most circuits, including the Eleventh Circuit in *Saltzberg v. TM Sterling/Austin Associates, Ltd.*,[17] recognized the need to protect certain forward-looking statements and consequently adopted some form of the "bespeaks caution" doctrine to do

---

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

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

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

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

(C) issues penny stock;

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

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

(2) that is—

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

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

(C) made in connection with a tender offer;

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

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

(F) made in a disclosure of beneficial ownership in a report required to be filed with the Commission pursuant to section 13(d) of the Securities Exchange Act of 1934.

Id.

15. S. REP. NO. 98, 104th Cong., 1st Sess. 17 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 696; H. R. CONF. REP. NO. 67, 104th Cong., 1st Sess. 46 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 745 ("The committee intends for its statutory safe harbor provisions to serve as a starting point and fully expects the SEC to continue its rulemaking proceedings in this area.").

16. 15 U.S.C. §§ 77z-2(g), 78u-5(g).

17. 45 F.3d 399 (11th Cir. 1995). The prevailing parties in the *Saltzberg* appeal were represented by Alston & Bird.

so.[18] The bespeaks caution doctrine generally places importance upon the context within which a statement is made.[19] Thus, "[w]hen an offering document's projections are accompanied by meaningful cautionary statements and specific warnings of the risks involved, that language may be sufficient to render the alleged omissions or misrepresentations immaterial as a matter of law."[20] Although the bespeaks caution doctrine was essentially codified by section 102 of the PSLRA,[21] the legislative history states that the safe harbor provisions are not intended to entirely replace the bespeaks caution doctrine "or to foreclose further development of that doctrine by the courts."[22] Thus, the PSLRA should not be interpreted as precluding the judiciary from further molding the bespeaks caution doctrine to supplement the limited applicability of the new safe harbor provisions.

The need to provide protection for forward-looking statements has been recognized for some time. Prior to widespread acceptance of the bespeaks caution doctrine, the SEC, in Rule 175, extended safe harbor protection to certain forward-looking statements made by issuers in quarterly (10-Q) and annual (10-K) reports to shareholders.[23] The adoption of the bespeaks caution doctrine by the circuits and the enactment of the safe harbor provisions of the PSLRA evidence the view

---

18. The First, Second, Third, Sixth, Eighth, Ninth, and Eleventh Circuits are among those adopting a version of the bespeaks caution doctrine. *See, e.g.*, Romani v. Shearson Lehman Hutton, 929 F.2d 875, 879 (1st Cir. 1991); Luce v. Edelstein, 802 F.2d 49, 56 (2d Cir. 1986); I. Meyer Pincus & Assocs., P.C. v. Oppenheimer & Co., 936 F.2d 759, 763 (2d Cir. 1991); Kline v. First W. Gov't Sec., Inc., 24 F.3d 480 (3d Cir. 1994); Krim v. BancTexas Group, Inc., 989 F.2d 1435 (5th Cir. 1993); Sinay v. Lamson & Sessions Co., 948 F.2d 1037, 1040 (6th Cir. 1991); Polin v. Conductron Corp., 552 F.2d 797 (8th Cir. 1977); Moorhead v. Merrill Lynch, 949 F.2d 243 (8th Cir. 1991); *In re* Convergent Technologies Sec. Litig., 948 F.2d 507, 516 (9th Cir. 1991); Saltzberg v. TM Sterling/Austin Assocs., Ltd., 45 F.3d 399 (11th Cir. 1995).

19. *Saltzberg*, 45 F.3d at 400.

20. *Id.*

21. The safe harbor provision "is based on aspects of SEC Rule 175 and the bespeaks caution doctrine." S. REP. NO. 98, 104th Cong., 1st Sess. 17 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 695-96. SEC Rule 175 provides, in part:

> A statement within the coverage of paragraph (b) of this section which is made by or on behalf of an issuer or by an outside reviewer retained by the issuer shall be deemed not to be a fraudulent statement . . . unless it is shown that such statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith.

17 C.F.R. § 230.175 (1997). Subsection (b) of Rule 175 sets forth the types of forward-looking statements protected, and subsection (c) provides the definition of forward-looking information adopted by Congress in the PSLRA. *Id.*

22. H. R. CONF. REP. NO. 67, 104th Cong., 1st Sess. 46, *reprinted in* 1995 U.S.C.C.A.N. 679, 745.

23. *See id.*

that the protection of certain forward-looking statements should be extended even further.

The SEC should give serious consideration to extending safe harbor protection to forward-looking statements made in connection with tender offers. Although the approach is subject to potential abuse, a target company should be able to avail itself of the safe harbor protection when providing forward-looking statements to shareholders to demonstrate that it has chosen to reject a hostile tender offer because the target believes it can create greater value for the shareholders through its business plan.[24]

2. Class Action Reforms. Another area of the securities practice strongly impacted by the enactment of the PSLRA is that of class actions.[25] Implementing class action reforms, section 101 of the PSLRA amends the Securities Act by adding section 27(a) and amends the Exchange Act by adding section 21D(a). These class action provisions apply to any private action brought by a plaintiff class pursuant to the securities laws and are intended to curb class action abuses such as "the use of professional plaintiffs and the race to the courthouse to be the first to file the complaint."[26] Congress also enacted the provisions to prevent counsel for the class from receiving a disproportionate share of any award and to require that more meaningful information be provided to class members.[27]

a. Certification Filed with the Complaint. Sections 27(a)(2) of the Securities Act and 21D(a)(2) of the Exchange Act set forth new requirements for plaintiffs seeking to serve as a class representative. Each

24. In Paramount Communications, Inc. v. QVC Networks, Inc., 637 A.2d 34, 44 n.13 (Del. 1994), the Delaware Supreme Court indicated that a board may "just say no" under the appropriate circumstances to an unsolicited takeover proposal, but did not identify the circumstances that would justify this approach. The Delaware federal court appeared to sanction the "just say no" defense in Moore Corp. v. Wallace Computer Servs., Inc., 907 F. Supp. 1545 (D. Del. 1995), in which the court refused to require Wallace to redeem its poison pill in the face of a tender offer which had attracted holders of more than 73% of Wallace's outstanding shares. The board's refusal to redeem the pill was based on its belief that Moore's offer was inadequate in light of the potential payoff of Wallace's business strategy. Extension of the safe harbor provision to tender offers could have provided the Wallace board with protection for disclosure to its shareholders of the projections upon which the board based its rejection of the Moore offer.

25. *See* Richard M. Phillips & Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers*, 51 BUS. LAW. 1009 (Aug. 1996).

26. S. REP. NO. 98, 104th Cong., 1st Sess. 10, *reprinted in* 1995 U.S.C.C.A.N. 679, 689.

27. *Id.* at 12, *reprinted in* 1995 U.S.C.C.A.N. 679, 691.

plaintiff seeking to serve as a representative must provide with the complaint a sworn certification, personally signed by the plaintiff, stating "that the plaintiff has reviewed the complaint and authorized its filing," that the plaintiff did not purchase the security involved in the lawsuit at the direction of counsel or in order to participate in the lawsuit, and "that the plaintiff is willing to serve as a representative party on behalf of a class, including providing testimony at deposition and trial, if necessary."[28]

Additionally, the certification filed with the complaint must set forth all the plaintiff's transactions in the security during the relevant time period, identify all other actions brought pursuant to the securities laws within three years of the date of the certification in which the plaintiff sought to serve as a class representative, and state "that the plaintiff will not accept any payment for serving as a representative party on behalf of a class beyond the plaintiff's pro rata share of any recovery, except as ordered or approved by the court."[29]

b. Appointment of Lead Plaintiff. The class action provisions of the PSLRA also require that the first plaintiff to file a complaint publish notice to class members within twenty days of filing.[30] The court is then to consider motions for appointment as lead plaintiff not later than ninety days after the date the notice is published.[31] Courts are to

---

28. 15 U.S.C. §§ 77z-1(a)(2)(A)(i)-(iii), 78u-4(a)(2)(A)(i)-(iii) provide:

(A) In general

Each plaintiff seeking to serve as a representative party on behalf of a class shall provide a sworn certification, which shall be personally signed by such plaintiff and filed with the complaint, that—

(i) states that the plaintiff has reviewed the complaint and authorized its filing;

(ii) states that the plaintiff did not purchase the security that is the subject of the complaint at the direction of plaintiff's counsel or in order to participate in any private action arising under this title;

(iii) states that the plaintiff is willing to serve as a representative party on behalf of a class, including providing testimony at deposition and trial, if necessary.

Id.

29. 15 U.S.C. §§ 77z-1(a)(2)(A)(iv)-(vi), 78u-4(a)(2)(A)(iv)-(vi).

30. *Id.* §§ 77z-1(a)(3)(A), 78u-4(a)(3)(A). This notice must be published in a widely circulated national business-oriented publication or wire service and must advise members of the purported class "of the pendency of the action, the claims asserted therein, and the purported class period." The notice must also advise purported class members that any member may move to serve as lead plaintiff within sixty days of publication. If more than one complaint is filed asserting substantially the same claim or claims, only the plaintiff or plaintiffs involved in the first action to be filed are required to publish notice. The notice required by the PSLRA is in addition to any notice required by the Federal Rules of Civil Procedure. *Id.* §§ 77z-1(a)(3)(A)(i)-(iii), 78u-4(a)(3)(A)(i)-(iii).

31. *Id.* §§ 77z-1(a)(3)(B)(i), 78u-4(a)(3)(B)(i).

presume that the most adequate plaintiff, and therefore the plaintiff who should be appointed to be the lead plaintiff, is the plaintiff or group of plaintiffs who possess "the largest financial interest in the relief sought by the class."[32] However, to be appointed as the lead plaintiff, a plaintiff must either file a complaint or file a motion to serve as the lead plaintiff.[33]

The presumption that the most adequate plaintiff is the one with the largest financial interest may be rebutted with evidence that the plaintiff "will not fairly and adequately protect the interests of the class" or is subject to unique defenses thereby rendering such plaintiff incapable of adequately representing the rest of the class.[34] However, discovery aimed at rebutting the most adequate plaintiff presumption may only be conducted if the plaintiff challenging the presumption first demonstrates a reasonable basis for the challenge.[35] Once a lead plaintiff is chosen, that plaintiff selects and retains class counsel, subject to the approval of the court.[36] A person may not serve as lead plaintiff in more than five securities class actions during any three-year period.[37]

While the approach taken by the PSLRA for selection of the lead plaintiff may eliminate certain historic class action abuses, the presumption that the plaintiff with the largest claim should be the lead plaintiff presents the potential for substantial litigation. For instance, litigation will undoubtedly arise over whether the lead plaintiff bought or sold based on the same information available to the public and whether the claims are otherwise typical of the class.[38]

---

32. *Id.* §§ 77z-1(a)(3)(B)(iii), 78u-4(a)(3)(B)(iii). This provision is meant "to increase the likelihood that institutional investors will serve as lead plaintiffs." S. REP. NO. 98, 104th Cong., 1st Sess. 11 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 690.

33. 15 U.S.C. §§ 77z-1(a)(3)(B)(iii), 78u-4(a)(3)(B)(iii).

34. *Id.*

35. *Id.* §§ 77z-1(a)(3)(B)(iv), 78u-4(a)(3)(B)(iv).

36. *Id.* §§ 77z-1(a)(3)(B)(v), 78u-4(a)(3)(B). This provision was included "to permit the plaintiff to choose counsel rather than have counsel choose the plaintiff." S. REP. NO. 98, 104th Cong., 1st Sess. 11 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 690.

37. 15 U.S.C. §§ 77z-1(a)(3)(B)(vi), 78u-4(a)(3)(B)(vi).

38. The theoretical concern raised by this portion of the PSLRA has already become a reality in an action filed in the United States District Court for the Northern District of Texas against Cellstar Corporation and KPMG Peat Marwick. Gluck v. Cellstar Corp., 96CV-1353-H. *See* Bruce Rubenstein, *Pension Fund Picks Bargain-Priced Firm; Finds Milberg Weiss Too Pricey*, 2 U.S. BUSINESS LITIG. (Jan. 1997). In *Cellstar*, the State of Wisconsin Investment Board ("SWIB"), the tenth largest pension fund in the United States, petitioned the court for lead plaintiff status in July of 1996. This petition was granted on October 1, 1996. *Id.* Although Milberg Weiss filed a detailed complaint on behalf of individuals with substantial investments in Cellstar, SWIB chose the less-experienced

c. Other Class Action Provisions. Other provisions of the PSLRA relating to class actions prevent representative plaintiffs from recovering a larger percentage of the final judgment or settlement than the other members of the class[39] and preclude settlements from being filed under seal, except upon motion of a party showing publication would cause direct and substantial harm.[40] Additionally, certain restrictions are placed upon payment of attorney fees;[41] courts are required to determine whether an attorney who represents a class should be disqualified if the attorney owns or has a beneficial interest in the securities that are the subject of the litigation;[42] and any disclosure of settlement terms to class members must include specific statements and identify representatives of plaintiffs' counsel who will be available to answer questions from class members.[43]

Blank, Rome, Comisky & McCauley to represent it as lead counsel. *Id.* Blank, Rome agreed to a fee that was quite a bit less than that sought by Milberg Weiss. *Id.* In addition to the now brewing fight over lead counsel status, the involvement of SWIB raises other more troubling issues such as SWIB's typicality and adequacy. These issues will undoubtedly be hotly contested at the pending Rule 23 hearing.

39. 15 U.S.C. §§ 77z-1(a)(4), 78u-4(a)(4). These sections provide:

> (4) Recovery by plaintiffs
>
> The share of any final judgment or of any settlement that is awarded to a representative party serving on behalf of a class shall be equal, on a per share basis, to the portion of the final judgment or settlement awarded to all other members of the class. Nothing in this paragraph shall be construed to limit the award of reasonable costs and expenses (including lost wages) directly relating to the representation of the class to any representative party serving on behalf of the class.

Id.

40. *Id.* §§ 77z-1(a)(5), 78u-4(a)(5). These sections provide:

> (5) Restrictions on settlements under seal
>
> The terms and provisions of any settlement agreement of a class action shall not be filed under seal, except that on motion of any party to the settlement, the court may order filing under seal for those portions of a settlement agreement as to which good cause is shown for such filing under seal. For purposes of this paragraph, good cause shall exist only if publication of a term or provision of a settlement agreement would cause direct and substantial harm to any party.

Id.

41. *Id.* §§ 77z-1(a)(6), 78u-4(a)(6).

42. *Id.* §§ 77z-1(a)(8), 78u-4(a)(9).

43. *Id.* §§ 77z-1(a)(7), 78u-4(a)(7). These sections provide:

> (7) Disclosure of settlement terms to class members
>
> Any proposed or final settlement agreement that is published or otherwise disseminated to the class shall include each of the following statements, along with a cover page summarizing the information contained in such statements:
>
> (A) Statement of plaintiff recovery

3. Reforms Applicable to Both the Securities Act and the Exchange Act

a. Stay of Discovery. Another important provision of the PSLRA, applicable to all actions filed under the securities laws, imposes a stay on discovery and other proceedings 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."[44] This provision applies to any private

---

The amount of the settlement proposed to be distributed to the parties to the action, determined in the aggregate and on an average per share basis.

(B) Statement of potential outcome of case

(i) Agreement on amount of damages

If the settling parties agree on the average amount of damages per share that would be recoverable if the plaintiff prevailed on each claim alleged under this title, a statement concerning the average amount of such potential damages per share.

(ii) Disagreement on amount of damages

If the parties do not agree on the average amount of damages per share that would be recoverable if the plaintiff prevailed on each claim alleged under this title, a statement from each settling party concerning the issue or issues on which the parties disagree.

(iii) Inadmissibility for certain purposes

A statement made in accordance with clause (i) or (ii) concerning the amount of damages shall not be admissible in any Federal or State judicial action or administrative proceeding, other than an action or proceeding arising out of such statement.

(C) Statement of attorneys' fees or costs sought

If any of the settling parties or their counsel intend to apply to the court for an award of attorneys' fees or costs from any fund established as part of the settlement, a statement indicating which parties or counsel intend to make such an application, the amount of fees and costs that will be sought (including the amount of such fees and costs determined on an average per share basis), and a brief explanation supporting the fees and costs sought.

(D) Identification of lawyers' representatives

The name, telephone number, and address of one or more representatives of counsel for the plaintiff class who will be reasonably available to answer questions from class members concerning any matter contained in any notice of settlement published or otherwise disseminated to the class.

(E) Reasons for settlement

A brief statement explaining the reasons why the parties are proposing the settlement.

(F) Other Information

Such other information as may be required by the court.

Id.

44. 15 U.S.C. §§ 77z-1(b), 78u-4(b)(3)(B). *See* John F. Olson, David C. Mahaffey & Brian E. Casey, *Pleading Reform, Plaintiff Qualification and Discovery Stays Under the*

action filed under either the Securities Act or the Exchange Act and was implemented to reduce the likelihood that even unmeritorious and abusive securities class actions would be settled because of the high cost of discovery to defendants.[45] The stay is also intended to prevent plaintiffs from filing frivolous lawsuits simply as a means of conducting discovery "in the hopes of finding a sustainable claim not alleged in the complaint."[46]

To prevent relevant evidence from being lost during the pendency of any stay imposed pursuant to the PSLRA, parties with actual notice of the allegations in the complaint are required to treat "all documents, data compilations . . ., and tangible objects that are in the custody or control of such person and that are relevant to the allegations, as if they were the subject of a continuing request for production of documents from an opposing party under the Federal Rules of Civil Procedure."[47] Sanctions may be imposed for a willful violation of this provision.[48]

b. Sanctions for Abusive Litigation and Elimination of Certain Abusive Practices. In an attempt "to reduce the economic incentive to file meritless claims," the PSLRA explicitly provides for the imposition of sanctions for abusive litigation.[49] Pursuant to section 27(c) of the Securities Act and section 21D(c) of the Exchange Act, a court must conduct a mandatory review upon final adjudication of an action as to whether each party and each attorney complied with Rule 11(b) of the Federal Rules of Civil Procedure. If the court finds a violation of Rule 11(b), the court must impose sanctions in accordance with Rule 11. If sanctions are imposed for failure of a responsive pleading or dispositive motion to comply with Rule 11(b), the court must presume the appropriate sanction "is an award to the opposing party of the reasonable attorneys' fees and other expenses incurred as a direct

---

Reform Act, 51 BUS. LAW. 1101 (Aug. 1996).

45. S. REP. NO. 98, 104th Cong., 1st Sess. 14 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 693.

46. *Id.* The PSLRA simply uses the term "motion to dismiss." The stay provision is therefore arguably not limited to motions to dismiss filed pursuant to Rule 12(b)(6). Additionally, the use of the phrase "discovery and other proceedings" has led one court to find that the initial disclosure requirements of Rule 26(a) are stayed under this provision. Medhekar v. United States Dist. Ct. for the N. Dist. of Cal., 99 F.3d 325 (9th Cir. 1996). *See also* Powers v. Eichen, 1997 WL 217571 (S.D. Cal. 1997) (finding third-party subpoenas subject to PSLRA's stay provisions); Novak v. Kasaks, 1996 WL 467534 (S.D.N.Y. 1996) (same).

47. 15 U.S.C. §§ 77z-1(b)(2), 78u-4(b)(3)(c)(i).

48. *Id.* §§ 77z-1(b)(3), 78u-4(b)(3)(C)(ii).

49. S. REP. NO. 98, 104th Cong., 1st Sess. 13 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 692.

result of the violation."[50] Likewise, the court must presume the appropriate sanction for the substantial failure of a complaint to comply with Rule 11(b) "is an award to the opposing party of the reasonable attorneys' fees and other expenses incurred in the action."[51] However, these presumptions may be rebutted.[52]

Additionally, in an attempt to cure other abusive practices, section 103 of the PSLRA amends section 15(c) of the Exchange Act to prohibit brokers, dealers, and persons associated with brokers or dealers who refer cases to an attorney from soliciting or receiving fees for providing such assistance.[53] In addition, section 20 of the Securities Act and section 21(d) of the Exchange Act are amended to prohibit distribution of "funds disgorged as the result of an action brought by the Commission in Federal court, or as a result of any Commission administrative action" as payment for attorney fees or other similar types of expenses.[54]

c. *Jury Interrogatories.* A final provision applicable to both the Securities Act and the Exchange Act is a provision on jury interrogatories. When requested by a defendant in an action requiring proof that a defendant acted with a particular state of mind, a court must submit written interrogatories to the jury on the issue of each defendant's state of mind at the time of the alleged violation.[55] This provision does not preclude the submission of interrogatories "concerning the mental state or relative fault of the plaintiff and of persons who could have been joined as defendants."[56]

---

50. 15 U.S.C. §§ 77z-1(c)(3)(A)(i), 78u-4(c)(3)(A)(i).

51. *Id.* §§ 77z-1(c)(3)(A)(ii), 78u-4(c)(3)(A)(ii).

52. *Id.* §§ 77z-1(c)(3)(B), 78u-4(c)(3)(B). The presumptive sanctions may be rebutted upon a showing by the party or attorney against whom the sanctions are imposed that the sanction will impose an unreasonable burden and would be unjust, and that the failure to make the presumptive award would not impose a greater burden on the party in whose favor sanctions are to be imposed, or that the violation of Rule 11(b) was de minimis. *Id.* If the presumption is successfully rebutted, "the court shall award the sanctions that the court deems appropriate pursuant to Rule 11 of the Federal Rules of Civil Procedure." *Id.* §§ 77z-1(c)(3)(C), 78u-4(c)(3)(C).

53. *Id.* § 78o(8) (Supp. 1997). Although only the Exchange Act is amended, the prohibition on referral fees also applies to any private action arising under the Securities Act. *Id.*

54. *Id.* §§ 77t(f), 78u(d)(4).

55. *Id.* §§ 77z-1(d), 78u-4(d).

56. S. REP. NO. 98, 104th Cong., 1st Sess. 18 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 697-98. The report states as an example that "interrogatories may be appropriate in contribution proceedings among defendants or . . . when some of the defendants have entered into settlement." *Id.* See text accompanying *supra* notes 66-82 for a discussion of the use of interrogatories in establishing joint and several liability.

B. Provisions of the PSLRA Applicable Solely to Claims Under the Exchange Act

1. Uniform Pleading Requirements and Loss Causation. In an attempt "to establish a uniform and stringent pleading requirement to curtail the filing of abusive lawsuits,"[57] section 101(b) of the PSLRA amends the Exchange Act to require any complaint predicated upon the Exchange Act's fraud provisions to "specify each statement alleged to have been misleading . . . [and the] reasons why the statement is misleading."[58] Additionally, if the plaintiff must prove the defendant acted with a particular state of mind, "the complaint shall, with respect to each act or omission alleged to violate [the Act], state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[59]

A complaint failing to allege fraud or scienter with the required specificity may be dismissed and "all discovery and other proceedings

---

57. S. REP. NO. 98, 104th Cong., 1st Sess. 15, *reprinted in* 1995 U.S.C.C.A.N. 679, 694.

58. 15 U.S.C. § 78u-4(b)(1). Section 21D(b)(1) provides:

> (1) Misleading statements and omissions
>
> In any private action arising under this title in which the plaintiff alleges that the defendant—
>
> (A) made an untrue statement of a material fact; or
>
> (B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading; the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which the belief is formed.

Id. This provision is modeled on the pleading standard of the Second Circuit, but is not intended "to codify the Second Circuit's case law interpreting this pleading standard, although courts may find this body of law instructive." S. REP. NO. 98, 104th Cong., 1st Sess. 15 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 694.

59. 15 U.S.C. § 78u-4(b)(2). Section 21D(b)(2) provides:

> (2) Required state of mind
>
> In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

Id. A few district courts have recently published opinions discussing the PSLRA's heightened pleading standards. *See* Fugman v. Aprogenex, Inc., No. 96C5817, 1997 WL 136323 (N.D. Ill., Mar. 17, 1997); *In re* Silicon Graphics, Inc. Secs. Litig., No. C96-0393 FMS, 1997 WL 285057 (N.D. Cal., May 23, 1997); Rehm v. Eagle Finance Corp., 954 F. Supp. 1246 (N.D. Ill. 1997); Marksman Partners, L.P. v. Chantal Pharmaceutical Corp., 927 F. Supp. 1297 (C.D. Cal. 1996); Zeid v. Kimberley, 930 F. Supp. 431 (N.D. Cal. 1996).

shall be stayed during the pendency of any motion to dismiss, unless the court finds . . . that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party."[60] Additionally, plaintiffs must prove that the act or omission alleged to violate the Exchange Act's fraud provisions actually caused the loss for which the plaintiff seeks to recover damages.[61]

2. Limitation on Damages. Recognizing that "[t]he current method of calculating damages in 1934 Act securities fraud cases is complex, with no statutory guidance to provide certainty,"[62] the PSLRA attempts to limit such damages to only those losses actually caused by the fraud as opposed to other market conditions. The PSLRA seeks to accomplish this by providing a "bounce back" period for the calculation of damages when a plaintiff seeks to establish loss by reference to the market price of a security.[63] In such a case, the plaintiff may not receive more than

> the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.[64]

An exception to this rule is applied if the plaintiff sells or repurchases the security prior to the expiration of the ninety-day period. In that case,

> the plaintiff's damages shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the security and the mean trading price of the security during the period beginning immediately after dissemination of information correcting the misstatement or omission and ending on the date on which the plaintiff sells or repurchases the security.[65]

---

60. 15 U.S.C. § 78u-4(b)(3).
61. *Id.* § 78u-4(b)(4).
62. S. REP. NO. 98, 104th Cong., 1st Sess. 19 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 698.
63. *Id.*
64. 15 U.S.C. § 78u-4(e)(1). *See* Jonathon C. Dickey & Marcia Kramer Mayer, *Effect on Rule 10b-5 Damages of the 1995 Private Securities Litigation Reform Act: A Forward Looking Assessment*, 51 BUS. LAW. 1203 (Aug. 1996).
65. 15 U.S.C. § 78u-4(e)(2). The "mean trading price" of a security is defined as the "average of the daily trading price of that security, determined as of the close of the market each day during the 90-day period." *Id.* § 78u-4(e)(3).

3. Proportionate Liability and Contribution. To remedy "[o]ne of the most manifestly unfair aspects of the current system of securities litigation,"[66] section 201 of the PSLRA eliminates joint and several liability for nonknowing violations of the Exchange Act and nonknowing violations by outside directors under section 11 of the Securities Act.[67] In place of joint and several liability, section 21D(g) imposes a "fair share" system of proportionate liability by which a defendant who is found liable, but who did not engage in a knowing securities violation, is only held accountable for its share of the judgment as apportioned by the fact finder.[68] Joint and several liability remains applicable to a defendant who engages in a knowing securities violation.[69] To impose joint and several liability, however, the defendant must have had actual knowledge—reckless conduct will not suffice.[70]

A nonknowing defendant may also be held jointly and severally liable in two specifically enumerated instances. If one or more of the defendants is not able to pay its full share of the amount of liability attributed to it, and the jointly and severally liable defendants are not able to cover the difference, then the proportionately liable defendants

66. H.R. CONF. REP. NO. 369, 104th Cong., 1st Sess. 37 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 736.

67. 15 U.S.C. § 78u-4(g). A knowing violation of the securities laws occurs when:

> (i) with respect to an action that is based on an untrue statement of material fact or omission of a material fact necessary to make the statement not misleading, if—
>
> (I) that covered person makes an untrue statement of a material fact, with actual knowledge that the representation is false, or omits to state a fact necessary in order to make the statement made not misleading, with actual knowledge that, as a result of the omission, one of the material representations of the covered person is false; and
>
> (II) persons are likely to reasonably rely on that misrepresentation or omission; and
>
> (ii) with respect to an action that is based on any conduct that is not described in clause (i), if that covered person engages in that conduct with actual knowledge of the facts and circumstances that make the conduct of that covered person a violation of the securities laws.

Id. § 78u-4(g)(10)(A). The definition also expressly states that reckless conduct does not constitute a knowing violation. *Id.* § 78u-4(g)(10)(B). Throughout section 21D(g) the term "covered persons" is used. A covered person is defined in section 21D(g)(10)(C) as a defendant in any private action arising under the Exchange Act or a defendant in any private action arising under section 11 of the Securities Act who is an outside director. 15 U.S.C. § 78u-4(g)(10)(C).

68. 15 U.S.C. § 78u-4(g)(2)(B); S. REP. NO. 98, 104th Cong., 1st Sess. 22 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 701.

69. 15 U.S.C. § 78u-4(g)(2)(A).

70. *Id.* § 78u-4(g)(10)(B).

are jointly and severally liable for the uncollectible share if the plaintiff establishes (1) "the plaintiff is an individual whose recoverable damages under the final judgment are equal to more than 10 percent of the net worth of the plaintiff;" and (2) "the net worth of the plaintiff is equal to less than $200,000."[71] Additionally, if one or more of the defendants is unable to pay, but the plaintiff fails to establish the foregoing, then each proportionately liable defendant is liable for the uncollectible share in proportion to the percentage of responsibility imposed on that defendant, but the total liability of any defendant may not exceed fifty percent of that defendant's proportionate share.[72] Any defendant who is required to make an additional payment under the uncollectible share provision may seek contribution from other enumerated parties.[73]

Importantly, contribution may not be sought from a defendant who settles at any time before the final verdict or judgment. Section 21D(g)(7) expressly discharges such settling defendants from all claims for contribution and requires that "[u]pon entry of the settlement by the court, the court shall enter a bar order constituting the final discharge of all obligations to the plaintiff of the settling covered person arising out of the action."[74] The PSLRA also imposes a uniform method of judg-

---

71. *Id.* § 78u-4(g)(4)(A)(i).

72. *Id.* § 78u-4(g)(4)(A)(ii).

73. *Id.* § 78u-4(g)(5). To the extent a defendant is required to make an additional payment pursuant to the uncollectible share provision, that defendant may recover contribution

> (A) from the covered person originally liable to make the payment;
> (B) from any covered person liable jointly and severally pursuant to [the joint and several liability provision for knowing violations]; (C) from any covered person held proportionately liable pursuant to this paragraph who is liable to make the same payment and has paid less than his or her proportionate share of that payment; or (D) from any other person responsible for the conduct giving rise to the payment that would have been liable to make the same payment.

Id.

74. *Id.* § 78u-4(g)(7). This sections provides, in part:

> (7) Settlement discharge
> (A) In general
> A covered person who settles any private action at any time before final verdict or judgment shall be discharged from all claims for contributions brought by other persons. Upon entry of the settlement by the court, the court shall enter a bar order constituting the final discharge of all obligations to the plaintiff of the settling covered person arising out of the action. The order shall bar all future claims for contribution arising out of the action—
> (i) by any person against the settling covered person; and
> (ii) by the settling covered person against any person, other than a person whose liability has been extinguished by the settlement of the settling covered person.

Id.

ment reduction in the event one or more defendants settle. Any verdict or judgment against the remaining defendants must be reduced by the greater of an amount corresponding to the percentage of responsibility of the settling defendant or the amount of the settlement paid by that defendant to the plaintiff.[75] A defendant who becomes jointly and severally liable may nonetheless "recover contribution from any other person who, if joined in the original action, would have been liable for the same damages."[76]

Because this proportionate liability section of the PSLRA is dependent upon the distinction between a knowing and nonknowing violation of the Exchange Act or section 11 of the Securities Act, juries in cases involving such claims must answer special interrogatories, or the court must make findings, "with respect to each covered person and each of the other persons claimed by any of the parties to have caused or contributed to the loss incurred by the plaintiff, including persons who have entered into settlements."[77] These interrogatories or findings must answer three questions: "(i) whether such person violated the securities laws; (ii) the percentage of responsibility of such person, measured as a percentage of the total fault of all persons who caused or contributed to the loss incurred by the plaintiff; and (iii) whether such person knowingly committed a violation of the securities laws."[78]

Interestingly, although the third interrogatory above requires a finding as to a defendant's actual knowledge, the proportionate liability subsection of the PSLRA is not intended to "be construed to create, affect, or in any manner modify, the standard for liability associated with any action arising under the securities laws."[79] Most courts since

---

75. 15 U.S.C. § 78u-4(g)(7)(B). Subsection (B) provides:

> (B) Reduction
>
> If a covered person enters into a settlement with the plaintiff prior to final verdict or judgment, the verdict or judgment shall be reduced by the greater of— (i) an amount that corresponds to the percentage of responsibility of that covered person; or (ii) the amount paid to the plaintiff by that covered person.

Id.

76. *Id.* § 78u-4(g)(8). The claim for contribution is to be determined according to the percentage of responsibility of the claimant and each person against whom a claim for contribution is made, *id.*, and any action for contribution must be brought within six months after entry of the final judgment unless the action involves a payment made pursuant to the uncollectible share provision. *Id.* § 78u-4(g)(9). In that case the action for contribution must be brought not later than six months after the date the payment is made. *Id.*

77. 15 U.S.C. § 78u-4(g)(3)(A).

78. *Id.* § 78u-4(g)(3)(A)(i)-(iii).

79. *Id.* § 78u-4(g)(1).

Ernst & Ernst v. Hochfelder[80] have ruled that recklessness satisfies the scienter element in a Rule 10b-5 action and that section 11 typically requires no proof of actual knowledge.[81] Thus, in requiring plaintiffs seeking to hold a defendant jointly and severally liable to prove the defendant actually knew its representations were false, the PSLRA's proportionate liability provisions impose a stricter liability standard for joint and several liability than is required to prove liability by itself.[82]

4. Auditor Disclosure Under PSLRA. Although most of the PSLRA's provisions are designed to curb litigation abuses by plaintiffs, certain aspects are regarded as directed toward enhanced enforcement of the federal securities laws. One such provision requires auditors of public companies to blow the whistle on illegal acts committed by their clients.[83] The PSLRA requires the auditor to advise its client of any illegal act discovered by the auditor. If the company fails to take the necessary corrective action, the auditor may be forced to resign or report the misconduct to the SEC.[84] Although the PSLRA does not create a private right of action against the auditor for failing to discharge its whistle blower duties, the auditor may be subject to SEC administrative sanctions if it does not do so.[85]

C. Final Comments on the Reforms Implemented by the PSLRA

The foregoing discussion of the PSLRA touches upon the major areas of reform implemented by the PSLRA. Additional measures include section 104, which amends section 20 of the Exchange Act to allow the SEC to prosecute aiding and abetting.[86] Also, section 105 amends

---

80. 425 U.S. 185 (1976). The Eleventh Circuit has held that proof of severe recklessness is sufficient to sustain a Rule 10b-5 cause of action. Woods v. Barnett Bank of Ft. Lauderdale, 765 F.2d 1004, 1010 (11th Cir.), *reh'g denied*, 772 F.2d 918 (11th Cir. 1985).

81. Section 11 is essentially a strict liability offense, imposing liability without requiring proof that the defendant knew the registration statement contained an untrue statement or omitted a material fact. 15 U.S.C. § 78u-4(g)(10).

82. Lack of proof of intent would not preclude a finding of liability, it would simply preclude a finding of joint and several liability. If the plaintiff fails to prove intent, the defendant could still be held proportionately liable.

83. 15 U.S.C. § 78j-l. The audit disclosure provisions are found in Title III of the PSLRA. Phillips & Miller, *supra* note 25.

84. 15 U.S.C. § 78j-l(b)(1)-(3).

85. *Id.* 78j-1(d).

86. 15 U.S.C. § 78t(f) (Supp. 1997). The adoption of section 104 ends the debate over the ability of the SEC to prosecute actions for aiding and abetting following the Supreme Court's decision in Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994), in which the Court held there was no private cause of action for aiding and

section 12 of the Securities Act to preclude the recovery of damages not actually caused by the misrepresentation or omission in the prospectus or oral communication that formed the basis for the defendant's liability.[87] Section 107 amends 18 U.S.C. § 1964(c) to prevent a noncriminal securities violation from serving as a predicate act under the Racketeer Influenced Corrupt Organizations Act.[88]

Congress was prompted to enact these and the other provisions of the PSLRA by significant evidence of abuse in the private securities practice area. As noted by the Senate Report and the Joint Explanatory Statement of the Conference Committee, the filing of abusive and unmeritorious lawsuits is both costly to our national economy and a disservice to all but those who thrive on such techniques.[89] Not only is corporate America now unwilling to discuss publicly any matters of substance with any amount of depth, but those investors who are legitimately harmed by fraudulent conduct often recover only a small portion of their losses due to the self-interested manipulations of some class counsel. The PSLRA was enacted to curb these and other abuses and to regain investor confidence in the integrity and efficiency of the United States securities markets.[90]

Although the long-term effects of the PSLRA remain to be seen, the impact of the Act is necessarily limited because it does not presently alter securities litigation under common law or state blue sky provisions. Consequently, one anticipated result of the PSLRA is an increase in the number of securities-related actions filed in state court. In fact, it appears this trend has already begun.[91] State court filings serve as a means of avoiding the stricter pleading requirements under the PSLRA and of evading the stay on discovery. Additionally, individual investors who turn to state court proceedings are able to avoid a fight with institutional investors over class representation. Thus, if the PSLRA is to truly have the far-reaching effects Congress intended, the states must

---

abetting under Rule 10b-5. For a discussion of the applicability of *Central Bank* to SEC enforcement actions prior to the PSLRA, see Edward C. Brewer, III & John L. Latham, SEC v. Central Bank: *A Draft Opinion for the Court's Conference*, 50 BUS. LAW. 19 (Nov. 1994); Simon M. Lorne, Symposium, *The Central Bank Decision: The Demise of Aiding and Abetting?* Central Bank of Denver v. SEC, 49 BUS. LAW. 1467 (Aug. 1994). *See also* SEC v. Fehn, 97 F.3d 1276 (9th Cir. 1996).

87. 15 U.S.C. § 77l(b) (Supp. 1997).

88. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 107, 202 Stat. 737 (1995) (amending 18 U.S.C. § 1964(c)).

89. *Id.*

90. S. REP. NO. 98, 104th Cong., 1st Sess. 8 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 687.

91. *See, e.g.*, Dominic Bencivenga, *Litigation Re-Formed: Lawyers Report on 'Year 1' Under Securities Act*, N.Y.L.J. (Jan. 16, 1997).

adopt provisions similar to those of the PSLRA or the PSLRA must be found to preempt state law altogether.

II. THE SECURITIES ACT OF 1933

A. *Scope of Section 12(2)*

Section 12(2) of the Securities Act prohibits the sale of a security through the use of a false or misleading prospectus. Specifically, it provides, in part:

> Any person who . . . offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statement, in the light of the circumstances under which they were made, not misleading . . . shall be liable to the person purchasing such security from him.[92]

In *Gustafson v. Alloyd Co.*,[93] the Supreme Court declined to extend the remedies provided by section 12(2) to private or secondary market transactions, concluding instead that "[t]he intent of Congress and the design of the statute require that [section] 12(2) liability be limited to public offerings."[94]

Gustafson involved the sale of Alloyd, Inc., a plastic packaging and automatic heat sealing equipment manufacturer. The contract of sale included assurances that Alloyd's financial situation had not changed materially in the time between the date of the last balance sheet and the date the agreement was executed. The contract also provided that if Alloyd's final year-end audit and financial statements showed its actual value was not as high as the estimated value, the disappointed party would receive an adjustment.[95] When the year-end audit showed Alloyd's actual earnings were lower than what was estimated, the buyers, rather than seeking the adjustment to which they were entitled, sought to rescind the contract under section 12(2) of the Securities Act.[96] The buyers claimed the statements made by the sellers regarding the financial data of the company were inaccurate and untrue and that because the contract of sale was a "prospectus," they were entitled to rescission under section 12(2).[97]

92. 15 U.S.C. § 77l.
93. 115 S. Ct. 1061 (1995).
94. *Id.* at 1071.
95. *Id.* at 1065.
96. *Id.*
97. *Id.*

The district court granted summary judgment for the sellers, finding section 12(2) to be applicable only to claims involving initial stock offerings.[98] On appeal, the Seventh Circuit vacated the district court's judgment and remanded for further consideration in light of its decision in *Pacific Dunlop Holdings, Inc. v. Allen & Co.*[99] In *Pacific Dunlop*, the Seventh Circuit had defined the term prospectus broadly to include all written communications offering the sale of a security.[100]

In reversing the Seventh Circuit, the Supreme Court assumed the stock purchase agreement involved in *Gustafson* contained material misstatements of fact.[101] Thus, if those misstatements were made "by means of a prospectus or oral communication," the buyer would have a right to rescission under section 12(2).[102] The disposative question was therefore "whether the contract . . . [was] a 'prospectus' as the term is used in the 1933 Act."[103] In addressing the issue of whether the contract was a prospectus, the Court focused on three sections of the Securities Act: sections 2(10), 10, and 12.

Section 10 of the Securities Act sets forth the type of information a prospectus must contain. Section 10 provides, in pertinent part, "Except to the extent otherwise permitted or required pursuant to this subsection or subsections (c), (d), or (e) . . . a prospectus relating to a security . . . shall contain the information contained in the registration statement."[104] In examining the definition provided by section 10, the Court determined, "whatever else 'prospectus' may mean, the term is confined to a document that, absent an overriding exemption, must include the 'information contained in the registration statement.'"[105] The Court further noted that "[b]y and large, only public offerings by an issuer of a security, or by controlling shareholders of an issuer, require the preparation and filing of registration statements."[106] There was no dispute that the contract at issue in *Gustafson* was not required under any provision of the Securities Act to contain information from a registration statement, nor was a statutory exemption required to take the contract outside the purview of section 10.[107] The Court therefore

---

98. *Id.*
99. 993 F.2d 578 (7th Cir. 1993).
100. 115 S. Ct. at 1065.
101. *Id.* at 1066.
102. *Id.*
103. *Id.*
104. *Id.* (citing 15 U.S.C. § 77j).
105. *Id.* at 1067.
106. *Id.*
107. *Id.*

concluded the contract for sale in *Gustafson* was not a prospectus under section 10.[108]

Having defined the term prospectus under section 10, the Court next determined the term could not be given different meanings under sections 10 and 12.[109] The Court pointed to the structure of the 1933 Securities Act, stating, "Nowhere in the statute . . . do the terms 'formal prospectus' or 'informal prospectus' appear. Instead, the Act uses one term—'prospectus'—throughout."[110] The Court also noted that when the term prospectus is read in conjunction with the definition contained in section 2(10),[111] "it is apparent that the list refers to documents of wide dissemination . . . [and] not face-to-face or telephonic conversations."[112] Additionally, the Court found that "[t]he use of the term prospectus to refer to public solicitation explains as well Congress' decision to start in [section] 12(2) to grant buyers a right to rescind without proof of reliance."[113]

In conclusion, the Court stated in *Gustafson* that "the word 'prospectus' is a term of art referring to a document that describes a public offering of securities by an issuer or controlling shareholder."[114] Consequently, because the contract of sale in *Gustafson* and its recitations were not held out to the public and were not a prospectus under the Securities Act, the buyers had no right to rescind the contract.[115] This decision is therefore in accord with the Eleventh Circuit's decision in *First Union Discount Brokerage Services, Inc. v. Milos*.[116] In *First Union*, the Eleventh Circuit determined section 12(2) does not apply to aftermarket securities transactions.[117]

---

108. *Id.*

109. *Id.*

110. *Id.* at 1068.

111. Section 2(10) states, "[t]he term 'prospectus' means any prospectus, notice, circular, advertisement, letter or communication, written or by radio or television which offers any security for sale or confirms the sale of any security." *Id.* at 1069.

112. 115 S. Ct. at 1070.

113. *Id.* (citing H.R. REP. NO. 85, 73d Cong., 1st Sess. 10 (1933)). The Court found it understandable that Congress would allow a buyer to rescind, without proof of fraud or reliance, "as to misstatements contained in a document prepared with care, following well-established procedures relating to investigations with due diligence and in the context of a public offering by an issuer or its controlling shareholders." *Id.* at 1071. However, the Court did not find it "plausible to infer that Congress created this extensive liability for every casual communication between buyer and seller in the secondary market." *Id.*

114. *Id.* at 1073-74.

115. *Id.*

116. 997 F.2d 835 (11th Cir. 1993).

117. *Id.* at 843-44. For a thorough discussion of First Union, see John Latham & Jay Sloman, *Securities Regulation*, 46 MERCER L. REV. 1463, 1463-67 (1995).

III. THE SECURITIES EXCHANGE ACT OF 1934

A. *Limitations Period for Section 10(b) Causes of Action*

In *Plaut v. Spendthrift Farm, Inc.*,[118] the Supreme Court resolved a split among the circuits concerning the constitutionality of section 27A(b) of the Exchange Act. Section 27A(b) allowed cases instituted prior to the Supreme Court's decision in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*,[119] but subsequently dismissed as time-barred pursuant to *Lampf*, to be reinstated if the claim would have been timely under the limitation period that existed prior to *Lampf*.[120]

Plaut arose because section 10(b) of the Exchange Act does not provide a limitations period for securities fraud actions brought pursuant to its provisions or Rule 10b-5[121] promulgated thereunder. Thus, prior to June 20, 1991, the limitations period for section 10(b) and Rule 10b-5 actions varied from one to five years, depending upon which law, federal or state, each circuit determined was applicable to such actions.[122] The Eleventh Circuit applied the period of limitations prescribed by the most analogous state statute.[123] On June 20, 1991, however, the United States Supreme Court announced a uniform limitations period for all claims brought pursuant to section 10(b) or Rule 10b-5.[124] In *Lampf*, the Court decided that all claims "instituted pursuant to [section] 10(b) and Rule 10b-5 . . . must be commenced within one year after the discovery of the facts constituting the violation and within three years after such violation."[125]

---

118. 115 S. Ct. 1447 (1995).

119. 501 U.S. 350 (1991).

120. 115 S. Ct. at 1450-51.

121. Rule 10b-5, promulgated pursuant to 15 U.S.C. § 78j, provides:

> [I]t shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national security exchange, (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.

17 C.F.R § 240.10b-5 (1992).

122. For a thorough discussion of limitations periods for section 10(b) actions prior to *Plaut*, see John Latham & James Shuchart, *Securities Regulation*, 44 MERCER L. REV. 1281, 1288-95 (1993).

123. Smith v. Duff & Phelps, Inc., 891 F.2d 1567, 1570 (11th Cir. 1990).

124. *Lampf*, 501 U.S. at 362.

125. *Id.* at 364. For a discussion of *Lampf*, *see* Latham & Shuchart, *supra* note 122.

On the same day the Supreme Court decided *Lampf*, the Court also decided *James B. Beam Distilling Co. v. Georgia*.[126] In *Beam*, the Court stated that new rules of federal law made applicable to the parties in the case in which the rule is announced must also be applied to all cases pending on direct review.[127] Thus, the *Lampf* decision, which was made applicable to the *Lampf* parties, was applicable to all cases pending on direct review.[128] The combined effect of *Lampf* and *Beam* was therefore to provide a uniform statute of limitations for section 10(b) and Rule 10b-5 causes of action in all cases decided subsequent to or reviewed subsequent to June 19, 1991.

Six months after *Lampf* and *Beam* were decided, Congress responded to the controversy surrounding the retroactive effect of the *Lampf* decision by enacting section 27A of the Exchange Act.[129] Section 27A provides:

> (a) Effect on pending causes of action
> The limitation period for any private civil action implied under section 10(b) of this Act that was commenced on or before June 19, 1991, shall be the limitation period provided by the laws applicable in the jurisdiction, including principles of retroactivity, as such laws existed on June 19, 1991.
> (b) Effect on dismissed causes of action
> Any private civil action implied under section 10(b) of this Act that was commenced on or before June 19, 1991—
> (1) which was dismissed as time barred subsequent to June 19, 1991, and
> (2) which would have been timely filed under the limitation period provided by the laws applicable in the jurisdiction, including principles of retroactivity, as such laws existed on June 19, 1991, shall be reinstated on motion by the plaintiff not later than 60 days after [December 19, 1991].[130]

Thus, in section 27A, Congress attempted to overrule the combined effect of *Lampf* and *Beam*. In *Plaut*,[131] however, the Supreme Court determined section 27A(b) violates the Constitution's separation of powers

---

126. 501 U.S. 529 (1991).
127. *Id.* at 543-44.
128. 501 U.S. at 364.
129. Section 27A was enacted as part of the Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, § 476, 105 Stat. 2236 (codified at 15 U.S.C. § 78aa-1).
130. *Id.*
131. 115 S. Ct. 1447 (1995)

doctrine to the extent it requires federal courts to reopen final judgments.[132]

In *Plaut*, the United States District Court for the Eastern District of Kentucky relied on section 27A to reinstate a dismissed action originally brought pursuant to section 10(b) and Rule 10b-5. The petitioners' action was first filed in 1987, but became caught up in pretrial proceedings until June 20, 1991, when the Supreme Court decided *Lampf* and *Beam*. The district court subsequently dismissed petitioners' section 10(b) and Rule 10b-5 actions as untimely pursuant to the statute of limitations established in *Lampf*. Petitioners did not appeal the court's ruling and the judgment became final thirty days later.[133]

Shortly after the *Plaut* dismissal became final, section 27A of the Exchange Act was signed into law. Petitioners therefore returned to the district court seeking reinstatement of their action. Because their action had been dismissed as time barred on August 13, 1991, but would have been timely under the applicable limitations period as it existed prior to June 19, 1991, the district court determined the conditions set out in section 27A had been met. Thus, under the terms of the statute, petitioners' motion should have been granted. The court nonetheless denied petitioners' motion for reinstatement, concluding section 27A(b) was unconstitutional.[134] The Court of Appeals for the Sixth Circuit affirmed, and certiorari was granted on June 6, 1994.[135] The Supreme Court subsequently affirmed the Sixth Circuit.[136]

In affirming the Sixth Circuit, the Court issued a lengthy opinion heavily entrenched in historical references predating the Constitution. The gravamen of this opinion was the Court's determination that "there is no reasonable construction on which [section] 27A(b) does not require federal courts to reopen final judgments in suits dismissed with prejudice by virtue of *Lampf*."[137] The Court concluded that section 27A(b) therefore offended the "deeply rooted postulate of Article III" that the judicial department is vested with the "'province and duty . . . to say what the law is' in particular cases and controversies."[138] By requiring courts to reopen final judgments, the Court found that section 27A(b) impermissibly invaded the exclusive power of the judicial

---

132. *Id.* at 1459. *Plaut* therefore overrules the Eleventh Circuit case of Henderson v. Scientific-Atlanta, Inc., 971 F.2d 1567 (11th Cir. 1992) (determining section 27A was constitutional and applying it to the case at bar).

133. 115 S. Ct. at 1451.

134. *Id.*

135. 114 S. Ct. 2161 (1994).

136. 115 S. Ct. at 1452.

137. *Id.*

138. *Id.* at 1453 (quoting Marbury v. Madison, 1 Cranch 137, 177 (1803)).

branch "not merely to rule on cases, but to *decide* them, subject to review only by superior courts in the Article III hierarchy—with an understanding, in short, that 'a judgment conclusively resolves the case' because 'a "judicial Power" is one to render dispositive judgments.'"[139] Thus, section 27A(b) was found to be unconstitutional.[140]

The Court rejected as irrelevant petitioners' argument that section 27A(b) was constitutional because the final judgments reopened by the statute involved statute of limitations provisions which are "mere creatures of Congress."[141] The Court stated that the issue involved in *Plaut* was "not the validity or even the source of the legal rule that produced the Article III judgments, but rather the immunity from legislative abrogation of those judgments themselves."[142] The Court also rejected petitioners' comparison of section 27A(b) to Rule 60(b) of the Federal Rules of Civil Procedure.[143] The Court stated that Rule 60(b) does not impose a legislative mandate to reopen final judgments as in section 27A(b), but instead serves as a reflection and confirmation of "the courts' own inherent and discretionary power . . . to set aside a judgment whose enforcement would work inequity."[144]

The Court emphasized that the problem perpetuated by section 27A(b) was that it nullified prior authoritative judicial action[145] and deprived judicial judgments of the conclusive effect they had when they were announced.[146] Thus, the Court found section 27A(b) to embody the very sort of risk the separation of powers doctrine was intended to avoid.[147] The Court described the separation of powers doctrine as a structural safeguard and "a prophylactic device, establishing high walls and clear distinctions because low walls and vague distinctions are not judicially defensible in the heat of interbranch conflict."[148] Thus, the Court concluded, "[t]o the extent that it requires federal courts to reopen

139. *Id.* (emphasis added) (quoting Easterbrook, *Presidential Review*, 40 CASE W. RES. L. REV. 905, 926 (1990)).

140. *Id.*

141. *Id.* at 1458.

142. *Id.*

143. Federal Rule of Civil Procedure 60(b) allows a court to "relieve a party . . . from a final judgment, order, or proceeding" for reasons such as mistake, newly discovered evidence, or "any other reason justifying relief." FED. R. CIV. P. 60(b).

144. 115 S. Ct. at 1460.

145. *Id.* at 1462-63.

146. *Id.* at 1457.

147. *Id.* at 1463.

148. *Id.*

final judgments entered before its enactment," section 27A(b) was unconstitutional.[149]

The issue raised by *Plaut* was also recently visited by the Eleventh Circuit in *Raven v. Oppenheimer & Co.*[150] In *Raven*, plaintiffs' section 10(b) and Rule 10b-5 claims had been dismissed as time barred on October 16, 1991, in accordance with *Lampf*. Following the enactment of section 27A, plaintiffs filed a motion to reinstate their claims pursuant to section 27A(b) or, in the alternative, under the authority of section 27A(a) and Rule 60(b). The United States District Court for the Northern District of Georgia ruled section 27A was constitutional in its entirety and granted plaintiffs' motion to reinstate their claims.[151] The court also found merit in plaintiffs' arguments under Rule 60(b) and granted that motion independently.[152] *Plaut* was decided shortly thereafter.

On appeal, the plaintiffs conceded subsection (b) of section 27A was unconstitutional based on *Plaut*, but maintained reinstatement was permissible pursuant to Rule 60(b)(6).[153] The Eleventh Circuit determined the district court's application of Rule 60(b)(6) was premised upon the court's perception that section 27A(a) established a new statute of limitations for all section 10(b) actions filed on or before June 19, 1991.[154] The Eleventh Circuit concluded this was an incorrect interpretation of the statute, noting that when subsection (a) was read in conjunction with subsection (b) it was clear the term "any" in subsection (a) was not designed to include lawsuits dismissed as time-barred after June 19, 1991, since such actions were governed by subsection (b).[155] Thus, the Eleventh Circuit held that the district court abused its discretion in granting Rule 60(b)(6) relief premised upon the applicability of section 27A(a).[156] The lower court's order was therefore vacated.[157]

B. *Effect of Class Settlements in State Court Proceedings*

In *Matsushita Electric Industrial Co. v. Epstein*,[158] the Supreme Court confronted the issue of whether a federal court was required to

149. *Id.*
150. 74 F.3d 239 (11th Cir. 1996).
151. *Id.* at 240.
152. *Id.* at 241.
153. *Id.* at 242.
154. *Id.*
155. *Id.*
156. *Id.* at 243.
157. *Id.*
158. 116 S. Ct. 873 (1996).

afford full faith and credit to a state court judgment approving a class-action settlement when the state court settlement purported to release claims within the exclusive jurisdiction of the federal courts. The Full Faith and Credit Act, 28 U.S.C. § 1738, states in pertinent part, "judicial proceedings . . . [of any state] shall have the same full faith and credit in every court within the United States . . . as they have by law or usage in the courts of such State . . . from which they are taken."[159]

Matsushita arose after two class actions were filed following a tender offer by Matsushita for the common stock of MCA, Inc.[160] The first class action was filed in the Delaware Court of Chancery against MCA for breach of fiduciary duty and waste of corporate assets and against Matsushita for conspiracy. Shortly after the state action was filed, another class action was filed in California federal court. This action involved claims brought under SEC Rules 10b-3[161] and 14d-10,[162] promulgated pursuant to provisions of the Exchange Act of 1934. Claims brought pursuant to the Exchange Act are under the exclusive jurisdiction of the federal courts.[163]

The California district court declined to certify the federal class and dismissed the action. The plaintiffs subsequently appealed the dismissal to the Court of Appeals for the Ninth Circuit. Before the Ninth Circuit delivered its opinion, however, the class in the state court action negotiated a settlement.[164] The Delaware court subsequently certified the class for purposes of settlement and approved notice of the proposed settlement in accordance with Delaware Court of Chancery Rule 23, which is modeled after Federal Rule of Civil Procedure 23.[165] Both the notice distributed to class members and the order and final judgment of the Delaware court provided that any member of the settlement class who did not validly request exclusion from the class released all rights to bring further causes of action for acts arising out of the MCA tender

159. 28 U.S.C. § 1738 (1994).

160. 116 S. Ct. at 876.

161. 17 C.F.R. § 240.10b-3. Rule 10b-3 provides that it is unlawful for any broker or dealer or any municipal securities dealer to use or employ "any act, practice, or course of business defined by the Commission to be included within the term 'manipulative, deceptive, or other fraudulent device or contrivance,' as such term is used in section 15(c)(1) of the [Exchange Act]." *Id.*

162. 17 C.F.R. § 240.14d-10. Rule 14d-10 provides for equal treatment of security holders when a tender offer is made. *Id.*

163. 15 U.S.C. § 78aa. Claims brought under the Securities Act may be filed in either state or federal court. *Id.*

164. 116 S. Ct. at 876.

165. *Id.*

offer.[166] The California federal action was specifically referenced in this portion of the notice.[167]

Following confirmation of the settlement by the Delaware Court of Chancery, Matsushita argued in the Ninth Circuit that pursuant to the Full Faith and Credit Act the state court judgment barred any further prosecution of the federal action. The Ninth Circuit rejected this argument, stating that the Full Faith and Credit Act was limited to claims that "could . . . have been extinguished by the issue preclusive effect of an adjudication of the state claims."[168] The Supreme Court reversed the Ninth Circuit, determining as an initial matter that the fact the judgment at issue was the result of a class action did not undermine the applicability of the Full Faith and Credit Act, nor was the Act "irrelevant simply because the judgment in question might work to bar the litigation of exclusively federal claims."[169]

In concluding the Full Faith and Credit Act was applicable to the judgment confirming the settlement of the Delaware action, the Court relied on its previous decision of *Marrese v. American Academy of Orthopedic Surgeons*[170] to formulate a two-part test to be used by federal courts in determining the preclusive effect to be given a state court judgment.[171] In accordance with this test, the Court first looked to the law of the state rendering the judgment to ascertain the effect of the judgment in the courts of that state.[172] The Court concluded the Delaware settlement in *Matsushita* would have served as a bar to any subsequent pursuit of the federal claims in the Delaware courts, notwithstanding the fact that such claims could not have been raised in the state court action initially.[173] Thus, because respondents did not deny they were part of the plaintiff class in the Delaware settlement, nor did they deny they failed to opt out of the class, the Court determined the settlement judgment "would be res judicata under Delaware law."[174]

The Court next considered "whether [section] 27 of the Exchange Act, which confers exclusive jurisdiction upon the federal courts for suits

166. *Id.*
167. *Id.*
168. Epstein v. MCA, Inc., 50 F.3d 644, 665 (9th Cir. 1995).
169. 116 S. Ct. at 878.
170. 470 U.S. 373 (1985).
171. 116 S. Ct. at 878.
172. *Id.*
173. *Id.* at 879-80. The Court noted that in Nottingham Partners v. Dana, 564 A.2d 1089 (Del. 1989), the Delaware Supreme Court approved a class action settlement "that released claims then pending in federal court." *Matsushita*, 116 S. Ct. at 879.
174. 116 S. Ct. at 880-81.

arising under the Act, partially repealed [section] 1738."[175] The Court ultimately rejected this argument, stating,

> [w]hile [section] 27 prohibits state courts from adjudicating claims arising under the Exchange Act, it does not prohibit state courts from approving the release of Exchange Act claims in the settlement of suits over which they have properly exercised jurisdiction, *i.e.*, suits arising under state law or under federal law for which there is concurrent jurisdiction.[176]

The Court noted, "As an historical matter, we have seldom, if ever, held that a federal statute impliedly repealed [section] 1738."[177] The Court further noted that although the Exchange Act confers exclusive jurisdiction upon the federal courts for the adjudication of claims arising thereunder, the language of the Exchange Act does not prohibit the release of such claims in a settlement achieved in a different forum.[178]

Additionally, the Court noted it had already determined in a prior decision that parties could waive the right to bring their Exchange Act claims in federal court by agreeing to arbitrate instead.[179] The Court therefore concluded, "state court litigants ought also to be able to waive, or 'release,' the right to litigate Exchange Act claims in a federal forum as part of a settlement agreement."[180] Accordingly, the Court held that although federal courts are the only forum in which such claims may be adjudicated, "there is no 'universal right to *litigate* a federal claim in a federal district court.'"[181] The state court settlement in *Matsushita* was therefore granted preclusive effect in the federal court action.[182]

---

175. *Id.* at 881.

176. *Id.*

177. *Id.*

178. *Id.* "[A] statute confirming exclusive federal jurisdiction for a certain class of claims does not necessarily require resolution of those claims in a federal court." *Id.* at 883.

179. *Id.* at 883 (discussing Shearson/American Express Inc. v. McMahon, 482 U.S. 220 (1987)).

180. *Id.*

181. *Id.* (emphasis added).

182. *Id.* In its conclusion, the Court also clarified why the lack of subject matter jurisdiction exception to the Full Faith and Credit Act was not applicable to the case before it. *Id.* at 884. The Court distinguished *Matsushita*, where the state court clearly possessed jurisdiction over the subject matter of the underlying suit, from a case in which the complaint alleges violations of the Exchange Act and the state court impermissibly renders a judgment on the merits of those claims. *Id.* In the first instance, the subject matter jurisdiction exception is not applicable, whereas in the second instance, the exception precludes application of the Act because the state court would improperly rule on a matter for which it lacks jurisdiction. *Id.*

C. Control Person Liability Under Section 20(a)

Section 20(a) of the Exchange Act of 1934 provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable . . . .[183]

Although regulations promulgated under the Exchange Act define control as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person,"[184] the circuits are not in agreement "on exactly how a plaintiff is to meet [its] burden" to show that a defendant is a controlling person.[185] In *Brown v. Enstar Group, Inc.*,[186] the Eleventh Circuit set forth the test to be followed in this circuit in determining control person liability under section 20(a).

In devising the control person test to be followed in this circuit, the Eleventh Circuit combined the requirements outlined in two decisions of the former Fifth Circuit.[187] The Eleventh Circuit first paraphrased the Fifth Circuit's holding in *Pharo v. Smith*,[188] stating, "a defendant who did not have the power to control the management of a company or the company itself could not be liable as a controlling person under Section 20(a)."[189] The court next looked to a subsequent Fifth Circuit decision imposing liability on a defendant as a control person because the defendant "had the requisite power to directly or indirectly control or influence corporate policy."[190] In combining these two Fifth Circuit decisions, the Eleventh Circuit concluded,

> a defendant is liable as a controlling person under Section 20(a) if he or she "had the power to control the general affairs of the entity primarily liable at the time the entity violated the securities laws . . . [and] had the requisite power to directly or indirectly control or

183. 15 U.S.C. § 78t(a).
184. 17 C.F.R. § 230.405 (1995).
185. Brown v. Enstar Group, Inc., 84 F.3d 393, 396 (11th Cir. 1996), *cert. denied*, 117 S. Ct. 950 (1997).
186. 84 F.3d at 393.
187. *Id.* at 396.
188. 621 F.2d 656 (5th Cir. 1980).
189. 84 F.3d at 396.
190. G.A. Thompson & Co. v. Partridge, 636 F.2d 945, 958 (5th Cir. 1981).

> influence the specific corporate policy which resulted in the primary liability."[191]

The court further noted, "Of course, the plaintiff must also establish that the controlled person violated the securities laws."[192]

This test for controlling person liability developed by the Eleventh Circuit in *Enstar* is different in one important aspect from the test established by the Eighth Circuit and cited approvingly by the Fifth, Sixth, Seventh, and Tenth Circuits.[193] The Eighth Circuit, in *Metge v. Baehler*,[194] stated that in order to establish control person liability, a plaintiff must show (1) that the defendant actually participated in the operations of the corporation, and (2) that the defendant had the power to control the specific action upon which liability is predicated.[195] The plaintiff in *Metge* was required to show the defendant actually exercised power over the entity it purportedly controlled.[196] In *Enstar*, the Eleventh Circuit did not reach the issue of "whether 'power to control the general affairs of the entity primarily liable' means simply abstract power to control, or actual exercise of the power to control."[197] Thus, the Eleventh Circuit test does not yet preclude liability based on abstract rather than actual power to control.

IV. THE INVESTMENT ADVISORS ACT

In addressing an issue of first impression under the Investment Advisors Act, the Eleventh Circuit determined in *United States v. Elliott*[198] that an adviser-client relationship was not necessary for the imposition of liability under the Investment Advisors Act. In *Elliott*, a group of investment companies owned and managed by Charles Elliott

---

191. 84 F.3d at 396 (quoting Brown v. Mendel, 864 F. Supp. 1138, 1145 (M.D. Ala. 1994)).

192. *Id.* at 396-97. In *Enstar*, plaintiffs asserted claims against Perry Mendel ("Mendel"), the founder of Kinder-Care, Inc., as a control person for allegedly material omissions and fraud in the dissemination of a prospectus issued to Kinder-Care's shareholders in connection with a new restructuring plan. *Id.* at 394-95. In applying its new control person test, the Eleventh Circuit found no evidence that Mendel had any power over Kinder-Care at the time the prospectus was issued. *Id.* at 397.

193. Metge v. Baehler, 762 F.2d 621, 631 (8th Cir. 1985); Abbott v. Equity Group, Inc., 2 F.3d 613, 619-20 (5th Cir. 1993); Sanders Confectionary Prods., Inc. v. Heller Fin., Inc., 973 F.2d 474, 486 (6th Cir. 1992); Harrison v. Dean Witter Reynolds, Inc., 974 F.2d 873, 887 (7th Cir. 1992); First Interstate Bank v. Pring, 969 F.2d 891, 898 (10th Cir. 1992).

194. 762 F.2d 621 (8th Cir. 1985).

195. *Id.* at 631.

196. *Id.*

197. 84 F.3d at 396 n.6.

198. 62 F.3d 1304 (11th Cir. 1995).

("Elliott") with the help of William Melhorne ("Melhorne") lost millions of dollars over a seven-year period. Elliott and Melhorne managed to attract new investors and retain old investors in spite of poor performance through a ponzi scheme.[199] Elliott and Melhorne were eventually indicted on twenty-two counts of fraud under the Investment Advisors Act.[200] They were also indicted on six counts of securities fraud, ten counts of mail fraud, and one count of conspiracy, all stemming from misrepresentations allegedly made by them regarding the financial position of their collection of investment companies. At trial, a jury returned a verdict of guilty on all but two charges of mail fraud, and both Elliott and Melhorne were sentenced to prison.[201]

On appeal, Elliott and Melhorne contended that the district court improperly excluded evidence of satisfied customers, and that such an exclusion was improper because the testimony was relevant to show lack of intent to defraud.[202] The Eleventh Circuit upheld the district court's ruling excluding the evidence, stating that the impact of the appellants' misrepresentations was less important than the substance of their misrepresentations.[203] Thus, the testimony of satisfied customers would not have negated the testimony concerning appellants' continuous concealment of millions of dollars of losses.[204]

Elliott and Melhorne also contended they could not be convicted of investment advisor fraud because they did not have an advisor-client relationship with the alleged victims of their actions. The Eleventh Circuit rejected this argument, relying on an SEC interpretive release that clarified the application of the Investment Advisors Act to financial planners, pensions consultants, and other financial service providers.[205]

---

199. *Id.* at 1306.

200. *Id.* at 1307. The defendants were indicted under (15 U.S.C. §§ 80b-3 and 80b-6).

201. *Id.*

202. *Id.* at 1308.

203. *Id.*

204. *Id.*

205. *Id.* at 1309-10. Applicability of the Investment Advisors Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisors Act Release No. IA-1092, 52 Fed. Reg. 38400, 38401-02 (1987). This release states:

> [W]hether a person providing financially related services of the type discussed in this release is an investment advisor within the meaning of the Advisors Act depends upon all the relevant facts and circumstances .... A determination as to whether a person providing financial planning, pension consulting, or other integrated advisory services is an investment advisor will depend upon whether such person: (1) provides advice, or issues reports or analyses, regarding securities; (2) is in the business of providing such services; *and* (3) provides such services for compensation.

Id. (emphasis added).

The court also relied on section 80b-2(a)(11) of the Act itself, which states that an investment advisor is

> any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.[206]

The court found that both Elliott and Melhorne had clearly provided investment advice, were "in the business of advising others, and did so 'for compensation.'"[207] The court further found that both Elliott and Melhorne held Elliott out as an investment advisor, received compensation clearly definable as being transaction-based compensation, and provided investment advice on more than a few rare or isolated occasions.[208] Thus, the Eleventh Circuit concluded both Elliott and Melhorne were "in the business" of advising others and were compensated for such investment advice.[209]

The court also rejected Elliott and Melhorne's contention that even if they were investment advisors, they could not be held liable under the Act because there was no advisor-client relationship.[210] The court quoted section 80b-6(4) of the Act,[211] stating that subsection (4) is "a general prohibition against certain conduct by an investment advisor."[212] The Eleventh Circuit therefore concluded the Investment Advisors Act did not require the victim to be in an advisor-client relationship with the purported advisor and affirmed both Elliott and Melhorne's convictions under the terms of the Act.[213]

206. 62 F.3d at 1309 (citing 15 U.S.C. § 80b-2(a)(11)).

207. *Id.* at 1310.

208. *Id.* *See* SEC Release, *supra* note 205, at 38402.

209. 62 F.3d at 1311.

210. *Id.* at 1311-12.

211. *Id.* at 1311. Section 80b-6(4) of the Act provides: "It shall be unlawful for any investment advisor, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly— . . . (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative". *Id.*

212. 62 F.3d at 1311-12.

213. *Id.* at 1314. The court in *Elliott* also concluded that "restitution must be limited to the losses attributable to the 19 victims named in the government's amended indictment." *Id.* (citing Hughey v. United States, 495 U.S. 411 (1990)). The restitution was not governed by the 1990 amendment to the Victim and Witness Protection Act because defendants had completed their offenses prior to the effective date of the Act. *Id.*

V. ARBITRATION

In the years since the Supreme Court's 1987 decision in *Shearson/American Express, Inc. v. McMahon*[214] and 1989 decision in *Rodriguez de Quijas v. Shearson/American Express, Inc.*,[215] which overruled *Wilko v. Swan*,[216] customer agreements requiring disputes to be submitted to arbitration have become standard in the securities industry.[217] Consequently, the number of securities-related matters submitted to arbitration has been steadily rising.[218] Yet in spite of the ever-increasing popularity of arbitration, very little case law exists to guide the securities practitioner in asserting or defending a claim in the arbitration forum.[219] Additionally, although arbitration decisions are now subject to minimum content criteria,[220] these opinions rarely provide the type of substantive guidance found in some court opinions. Thus, the arbitration of a securities dispute is a relatively undeveloped area of the law. Recently, however, both the United States Supreme Court and the Eleventh Circuit have faced important questions of first impression in this area of emerging importance to the securities practitioner.

---

214. 482 U.S. 220 (1987) (ruling that claims arising under Rule 10b-5 and RICO could be the subject of a binding arbitration agreement).

215. 490 U.S. 477 (1989) (ruling that claims arising under the Securities Act could be arbitrated).

216. 346 U.S. 427 (1953). In *Wilco*, the Supreme Court held that agreements to submit disputes to arbitration were void for claims brought pursuant to section 12(2) of the Securities Act. *Rodriguez* overruled *Wilco*, finding such agreements enforceable under the Federal Arbitration Act.

217. Harold S. Bloomenthal & Holme Roberts & Owen, Securities Law Handbook 1997; Class and Derivative Litigation in the Reform Era at 1646 (Glasser LegalWorks Seminars, Sixth Ann. Institute 1996). *See also* Deborah Masucci, *Securities Arbitration—A Success Story: What Does the Future Hold?*, 31 WAKE FOREST L. REV. 183, 188-89 (Spring 1996); Karen Kupersmith, *A Perspective on the Role of the Arbitrator in Securities Arbitration*, 31 WAKE FOREST L. REV. 297 (Spring 1996).

218. For example, the number of arbitrations filed with the National Association of Securities Dealers has increased from 4,150 cases filed in 1991 to 6,056 filed in 1995. These statistics were acquired from the NASD Economic Research Department, 1735 K Street, NW, Washington, D.C., 20006. *See also* Masucci, *supra* note 217, 188-89.

219. *See* James E. Beckley, Equity & Arbitration, in SECURITIES ARBITRATION 1996, at 31 (PLI Corp. Law & Practice Course Handbook Series No. B4-7147, 1996).

220. Masucci, *supra* note 217, at 190.

A. *Arbitrating Arbitrability*

In *First Options of Chicago, Inc. v. Kaplan*,[221] the Supreme Court addressed two issues arising under the Federal Arbitration Act ("FAA").[222] First, the Court addressed the manner with which a district court should review an arbitrator's decision as to whether parties have agreed to arbitrate a dispute.[223] Second, the Court addressed the manner with which a court of appeals should review a district court's decision confirming or refusing to vacate an arbitration award.[224]

First Options arose when a stock clearing firm sought arbitration against an investment company, and the husband and wife owners of the investment company, for debts incurred following the stock market crash of 1987.[225] The husband and wife (the "Kaplans") never personally signed any documents containing an arbitration clause and therefore "forcefully" objected to the arbitrators' jurisdiction over them individually.[226] Rather than seeking a court order enjoining the arbitration, the Kaplans objected by filing a written memorandum with the arbitrators.[227] The arbitrators determined the Kaplans were subject to arbitration and ruled against them on the merits of the underlying dispute. The Kaplans subsequently asked the district court to vacate the arbitration award. The district court confirmed the award, but the Third Circuit reversed. The Third Circuit was later affirmed by the Supreme Court.[228]

In affirming the Third Circuit, the Supreme Court divided the arbitrability issue into three "disagreements."[229] The first disagreement was whether the individuals were personally liable for the

221. 115 S. Ct. 1920 (1995)

222. *Id.* at 1922.

223. *Id.*

224. *Id.*

225. *Id.* at 1923.

226. *Id.* at 1925. First Options attempted to argue that the Kaplans clearly agreed to arbitration by submitting the arbitrability issue to the arbitrators. The Court dismissed this argument, stating the Kaplans' actions showed the opposite, *i.e.*, that they clearly objected to the arbitrators' jurisdiction over their dispute. The Court bolstered this conclusion by noting (1) there was "an obvious explanation for the Kaplans' presence before the arbitrators (*i.e.*, that MKI, Mr. Kaplan's wholly owned firm, was arbitrating workout agreement matters); and (2) Third Circuit law . . . suggest[s] that the Kaplans might argue arbitrability to the arbitrators without losing their right to independent court review." *Id.* (citing Teamsters v. Western Pa. Motor Carriers Ass'n, 574 F.2d 783, 786-88 (3d Cir. 1978)).

227. 115 S. Ct. at 1925.

228. *Id.* at 1925-26.

229. *Id.* at 1925.

investment company's debt to the claimant. This disagreement concerned the merits of the dispute. The second disagreement was whether the parties agreed to arbitrate the first dispute. This disagreement was the arbitrability dispute. The third disagreement was "who should have the primary power to decide the second matter."[230] The Court considered only the third question.[231] The Court framed the issue of who should decide whether the parties agreed to arbitrate as a question concerning the type of review a district court should exercise over an arbitrability decision by arbitrators.[232] The Court noted that if the district court reviewed the decision deferentially, then the arbitrability decision was essentially left to the arbitrators, whereas de novo review would allow the courts to draw their own conclusions.[233]

The Court began its analysis in *First Options* by noting that the arbitrability question turned upon "the fact that arbitration is simply a matter of contract between the parties."[234] Thus, the arbitrability of the dispute was found to be dependent upon the parties' agreement regarding the submission of the arbitrability question itself to arbitration.[235] The Court next determined that in deciding whether there was an agreement to arbitrate arbitrability, "courts generally . . . should apply ordinary state-law principles that govern the formation of contracts . . . [but] should not assume that the parties agreed to arbitrate arbitrability unless there is 'clear and unmistakable' evidence that they did so."[236]

In stating that courts should not assume parties have agreed to arbitrate arbitrability, the Court recognized it was treating the question of whether the parties agreed to arbitrate the arbitrability dispute in a different manner than it generally treated the question of whether a particular dispute was arbitrable.[237] The presumption in the first instance, as to whether there was an agreement to arbitrate arbitrability, is that parties do not generally agree to arbitrate the issue of arbitrability.[238] In contrast, the presumption in the second instance, as to whether the merits of a particular dispute are within the scope of an otherwise valid arbitration agreement, is to be resolved in favor of

230. *Id.* at 1923.
231. *Id.* at 1923-24.
232. *Id.*
233. *Id.*
234. *Id.* at 1924.
235. *Id.*
236. *Id.* (quoting AT&T Techs., Inc. v. Communications Workers, 475 U.S. 643, 649 (1986); citing Mastrobuono v. Shearson Lehman Hutton, Inc., 115 S. Ct. 1212 (1995)).
237. *Id.*
238. *Id.*

arbitration.[239] The Court supported this variant treatment by stating it was necessary in light of the substantial rights given up when a party is required to arbitrate.[240] "The latter question arises when the parties have a contract that provides for arbitration of some issues. In such circumstances, the parties likely gave at least some thought to the scope of arbitration."[241] On the other hand, when individuals do not clearly agree to submit the question of arbitrability to arbitration, it is doubtful the parties thought about the significance of having arbitrators decide the scope of their agreement.[242] Thus, because "a party can be forced to arbitrate only those issues it specifically has agreed to submit to arbitration," the Court concluded the arbitrability of the parties' dispute was subject to the independent review of the courts.[243]

The Supreme Court next addressed in *First Options* the standard with which a court of appeals should review a district court's decision confirming or refusing to vacate an arbitration award.[244] The Court adopted the Third Circuit's de novo approach, expressly disagreeing with the Eleventh Circuit's policy of applying a particularly lenient "abuse of discretion" standard to both questions of law and fact when a district court confirms, but not when it sets aside, an arbitration award.[245] The Court stated that ordinary standards of review should be applied when reviewing a district court decision upholding an arbitration award. Thus, findings of fact that are not "clearly erroneous" should be accepted, but questions of law should be decided de novo.[246]

An issue similar to that addressed by the Supreme Court in *First Options* was recently addressed by the Eleventh Circuit in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cohen.*[247] In *Merrill Lynch*, an arbitration claim was filed with the National Association of Securities Dealers ("NASD") for alleged violations of Florida Blue Sky provisions,

---

239. *Id.* (citing Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614 (1985)).

240. *Id.* at 1923-24. ("[W]ho—court or arbitrator—has the primary authority to decide whether a party has agreed to arbitrate can make a critical difference to a party resisting arbitration.").

241. *Id.* at 1924.

242. *Id.* at 1925.

243. *Id.* at 1925-26. The Court's conclusion is in accordance with the Eleventh Circuit's decision in Wheat, First Securities, Inc. v. Green, 993 F.2d 814, 815 (11th Cir. 1993). For a discussion of *Wheat*, see John Latham & Jay Sloman, *Securities Regulation*, 46 MERCER L. REV. 1463, 1485-88 (1995).

244. 115 S. Ct. at 1926.

245. *Id.* (citing Robbins v. Day, 954 F.2d 679, 681-82 (11th Cir.), *cert. denied sub nom.*, Robbins v. PaineWebber, Inc., 506 U.S. 870 (1992)).

246. *Id.*

247. 62 F.3d 381 (11th Cir. 1995).

common-law fraud, breach of fiduciary duty, and other similar torts. The claimants had purchased limited partnership interests from a financial consultant at Merrill Lynch, at which time they entered into standard customer agreements requiring all disputes to be resolved by NASD arbitration.

Merrill Lynch responded to the statement of claim by filing an action in Florida state court to enjoin the arbitration on the ground that the claims were time-barred by section 15 of the NASD Code.[248] The claimants then removed the action to federal court, moved to compel arbitration, and filed a motion to stay the federal action pending arbitration. The district court granted the claimants' motion to compel, ruling that the question of whether the claims were time-barred was a question for the arbitrators. On appeal, the Eleventh Circuit reversed the decision, finding section 15 to be a "substantive eligibility requirement" requiring determination by the district court.[249]

In ruling that courts rather than arbitrators should address limitations disputes, the Eleventh Circuit rejected the argument that *Belke v. Merrill Lynch, Pierce, Fenner & Smith*[250] or section 35 of the NASD Code[251] demanded a contrary result. Recognizing a split in the circuits on the issue,[252] the court reiterated that arbitration is essentially a creature of contract.[253] Thus, the court looked to the parties' agree-

---

248. *Id.* at 382. Former NASD Code section 15, now Rule 10304, provides:

> No dispute, claim, or controversy shall be eligible for submission to arbitration under this Code where six (6) years have elapsed from the occurrence or event giving rise to the act or dispute, claim, or controversy. This section shall not extend applicable statutes of limitations, nor shall it apply to any case which is directed to arbitration by a court of competent jurisdiction.

Id.

249. 62 F.3d at 383.

250. 693 F.2d 1023 (11th Cir. 1982) (holding that where an arbitration agreement required notice of intent to arbitrate, the issue of whether failure to serve notice barred arbitration was a procedural question to be resolved by the arbitrators).

251. Former NASD Code section 35, now Rule 10324, provides:

> The arbitrators shall be empowered to interpret and determine the applicability of all provisions under this Code and to take appropriate action to obtain compliance with any ruling by the arbitrator(s). Such interpretations and actions to obtain compliance shall be final and binding upon the parties.

252. 62 F.3d at 383. The court noted, "Our sister circuits have grappled with this issue and reached conflicting results." *Id.* (citing the Third, Sixth, and Seventh Circuits as holding section 15 must be applied by the courts, PaineWebber Inc. v. Hofmann, 984 F.2d 1372, 1374 (3rd Cir. 1993); Dean Witter Reynolds, Inc. v. McCoy, 995 F.2d 649, 651 (6th Cir. 1993); Edward D. Jones & Co. v. Sorrells, 957 F.2d 509, 512 (7th Cir. 1992), and the Fifth and Eighth Circuits as holding section 15 is an issue to be addressed by the arbitrators, Smith Barney Shearson, Inc. v. Boone, 47 F.3d 750, 754 (5th Cir. 1995); FSC Sec. Corp. v. Freel, 14 F.3d 1310 (8th Cir. 1994)).

253. 62 F.3d at 383.

ment to determine their intentions.[254] Additionally, because the agreement incorporated the NASD Code, the court looked to the Code for guidance, finding the plain language of section 15 to support the conclusion "that [section] 15 is a jurisdictional prerequisite to arbitration."[255]

The Eleventh Circuit also cited the Supreme Court's decision in *First Options*[256] for the proposition that the "presumption in favor of arbitration is not applicable when the question to be resolved is who decides arbitrability."[257] The court concluded that based on *First Options* it could not assume the parties in the case at bar agreed to arbitrate arbitrability absent clear and unmistakable evidence that they had done so.[258] The court noted that section 35 of the NASD Code did not qualify as clear and unmistakable evidence, finding, "at most, section 35 creates an ambiguity as to who determines arbitrability."[259] Such ambiguity was not sufficient to overcome the presumption that the courts should determine the arbitrability issue.[260] The Eleventh Circuit therefore concluded the district court, as opposed to the arbitrators, should determine whether the dispute was time-barred under section 15 of the NASD Code.[261]

B. *Punitive Damage Awards*

"One of the most frequently litigated issues in the realm of securities arbitration has been the ability of arbitrators to award punitive damages."[262] In *Mastrobuono v. Shearson Lehman Hutton, Inc.*,[263]

---

254. *Id.* at 384.

255. *Id.*

256. 115 S. Ct. 1920 (1995).

257. 62 F.3d at 384.

258. *Id.*

259. *Id.* For the text of NASD Code section 35, *see supra* note 251.

260. 62 F.3d at 384.

261. *Id.* at 385. The Eleventh Circuit also determined in *Merrill Lynch* that the actual purchase date of the securities involved did not necessarily control the limitations period. The court ruled that if the claimants could prove Merrill Lynch reported false values, then the act of sending these false statements, as opposed to the initial purchase of the investments, could be considered the "occurrence or event" giving rise to the claimants' claims. *Id.* The court therefore remanded the action, stating that the district court should examine each claim to determine which act was the "occurrence or event" and to determine whether more than six years had elapsed from that event. *Id.* The Eleventh Circuit recognized its holding "may compel federal courts to hold 'mini-trials' on timeliness, which may be followed by full arbitration if the claims are not deemed time-barred," but concluded judicial economy should not interfere with a binding agreement to arbitrate. *Id.* (citing Goldberg v. Bear, Stearns & Co., 912 F.2d 1418, 1422 (11th Cir. 1990)).

262. *Annual Review of Federal Securities Regulation*, 51 BUS. LAW. 511, 541 (1996).

the Supreme Court addressed this subject in the context of a New York choice-of-law provision, an issue that had split the circuits.[264] Under New York law, punitive damages may only be awarded by courts and not by arbitrators.[265] The issue before the Court in *Mastrobuono* was whether a standard agreement to arbitrate, executed by a customer and containing a New York choice-of-law provision, prevented the arbitral forum handling the dispute from awarding punitive damages. The Supreme Court determined such a provision, in and of itself, does not prevent arbitrators from awarding punitive damages.[266] The decision is therefore consistent with the 1988 Eleventh Circuit decision in *Bonar v. Dean Witter Reynolds, Inc.*[267]

In *Mastrobuono*, husband and wife customers (the "Mastrobuonos") of Shearson Lehman Hutton ("Shearson") signed a standard client agreement when they opened a trading account.[268] This agreement contained both a choice-of-law provision and an arbitration provision. The choice-of-law provision appeared in one of the agreement's standard paragraphs and provided that the entire agreement was governed by the laws of the State of New York.[269] The arbitration provision was also standard, stating that "any controversy" arising out of the parties' transactions was to be settled by arbitration in accordance with the rules of the National Association of Securities Dealers ("NASD"), the Board of Directors of the New York Stock Exchange, or the Board of Directors of

---

263. 115 S. Ct. 1212 (1995).

264. *Id.* The Court noted that it granted certiorari "because the Courts of Appeals have expressed differing views on whether a contractual choice-of-law provision may preclude an arbitral award of punitive damages that otherwise would be proper." *Id.* at 1215 (citing Barbier v. Shearson Lehman Hutton Inc., 948 F.2d 117 (2d Cir. 1991); Pierson v. Dean Witter Reynolds, Inc., 742 F.2d 334 (7th Cir. 1984); Bonar v. Dean Witter Reynolds, Inc., 835 F.2d 1378, 1386-88 (11th Cir. 1988); Raytheon Co. v. Automated Bus. Sys., Inc., 882 F.2d 6 (1st Cir. 1989); Lee v. Chica, 983 F.2d 883 (8th Cir. 1993)).

265. 115 S. Ct. at 1215.

266. *Id.*

267. 835 F.2d 1378 (11th Cir. 1988). In *Bonar*, the Eleventh Circuit rejected Dean Witter's argument that the arbitrators lacked the authority to award punitive damages. *Id.* at 1386. The customer agreement in *Bonar*, like the agreement in *Mastrobuono*, contained a New York choice-of-law provision. *Id.* The Eleventh Circuit, citing Willoughby Roofing & Supply Co. v. Kajima Int'l, Inc., 598 F. Supp. 353, 359 (N. D. Ala. 1984), *aff'd*, 776 F.2d 269 (11th Cir. 1985), stated, "a choice of law provision in a contract governed by the Arbitration Act merely designates the substantive law that the arbitrators must apply in determining whether the conduct of the parties warrants an award of punitive damages; it does not deprive the arbitrators of their authority to award punitive damages." *Bonar*, 835 F.2d at 1387.

268. 115 S. Ct. at 1214-17.

269. *Id.* at 1216-17.

the American Stock Exchange.[270] The agreement did not expressly reference punitive damages.[271]

When the Mastrobuonos asserted claims against Shearson in federal court, Shearson invoked the arbitration provision. The NASD arbitrators subsequently awarded the Mastrobuonos both compensatory and punitive damages. Shearson paid the compensatory portion of the award but filed a motion to vacate the award of punitive damages. The district court granted Shearson's motion, and the Seventh Circuit affirmed.[272] Both courts found that the arbitration panel did not have the power to award punitive damages because the New York rule precluding arbitrators from awarding punitive damages was incorporated by the New York choice-of-law provision.[273] The Supreme Court granted certiorari to resolve the split in the circuits on the issue.[274]

In reversing the Seventh Circuit, the Supreme Court noted its earlier decision in *Allied-Bruce Terminix Cos. v. Dobson*[275] and reiterated that "Congress passed the FAA [Federal Arbitration Act] 'to overcome Courts' refusals to enforce agreements to arbitrate.'"[276] The Court stated that in *Mastrobuono* the petitioners sought a similar result in that they were asking the court to hold that the FAA preempts New York's prohibition against punitive damage awards by arbitrators.[277] However, the Court avoided the issue of whether the FAA preempts New York's prohibition on punitive damages, finding that New York procedural law regarding the award of punitive damages was not incorporated by the New York choice-of-law provision.[278]

In concluding the New York choice-of-law provision did not incorporate New York's prohibition on the award of punitive damages by arbitrators,

---

270. *Id.* at 1217.
271. *Id.*
272. *Id.* at 1214-15.
273. *Id.* at 1215.
274. *Id.* *See supra* note 264.
275. 115 S. Ct. 834 (1995).
276. 115 S. Ct. at 1215.
277. *Id.* Petitioners also relied on the Court's 1989 decision in Volt Info. Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ., 489 U.S. 468 (1989), in arguing that parties to a contract may lawfully agree to waive any claim for punitive damages. The Court rejected this application of *Volt*, stating, "[I]f contracting parties agree to include claims for punitive damages within the issues to be arbitrated, the FAA ensures that their agreement will be enforced according to its terms even if a rule of state law would otherwise exclude such claims from arbitration." 115 S. Ct. at 1216. Justice Thomas's dissent in *Mastrobuono* is based on his contention that "the choice-of-law provision here cannot reasonably be distinguished from the one in *Volt*." *Id.* at 1219 (Thomas, J., dissenting).
278. *Id.* at 1220.

the Court first looked to the language of the agreement itself.[279] The Court found that the choice-of-law provision, "when viewed in isolation," was merely a substitute for the conflict-of-laws analysis a court would otherwise go through to determine what law to apply to the dispute arising out of the contractual relationship.[280] "It is not, in itself, an unequivocal exclusion of punitive damages claims."[281]

The Court next turned to the arbitration provision of the contract, noting that the arbitration provision, "when read separately . . . strongly implies that an arbitral award of punitive damages is appropriate."[282] The Court pointed out that the NASD Code of Arbitration Procedure states that arbitrators may award "'damages and other relief,'"[283] and an NASD arbitrators' manual states that arbitrators may consider punitive damages as a remedy.[284] Thus, the Court determined, "[a]t most, the choice-of-law clause introduces an ambiguity into an arbitration agreement that would otherwise allow punitive damages awards."[285]

Because the arbitration provision in the Mastrobuono's customer agreement was found to be at best ambiguous, the Court applied the common-law rule "that a court should construe ambiguous language against the interest of the party that drafted it,"[286] and the "cardinal principal of contract construction: that a document should be read to give effect to all its provisions and to render them consistent with each other."[287] Consequently, the Court found that "the best way to harmonize the choice-of-law provision with the arbitration provision" was to read the choice-of-law provision as encompassing only substantive principles, and not special rules limiting the authority of arbitrators.[288] "Thus, the choice-of-law provision covers the rights and duties of the parties, while the arbitration clause covers arbitration."[289] Therefore, if a party wishes to preclude an arbitral forum from awarding punitive damages, it must now expressly exclude punitive damages from the purview of the arbitrators or explicitly incorporate New York substantive law into their agreement to arbitrate.

---

279. *Id.* at 1220-21.
280. *Id.* at 1217.
281. *Id.*
282. *Id.* at 1218.
283. *Id.* (citing NASD Code of Arbitration Procedure ¶ 3741(e) (1993)).
284. *Id.*
285. *Id.*
286. *Id.* at 1219.
287. *Id.*
288. *Id.*
289. *Id.*

C. *Due Process Concerns*

The Eleventh Circuit recently adopted the *Mastrobuono* holding in *Davis v. Prudential Securities, Inc.*,[290] rejecting as "meritless" petitioner's argument that *Mastrobuono* was not applicable to claims arbitrated before the American Arbitration Association ("AAA").[291] In *Prudential*, an arbitration panel awarded both compensatory and punitive damages against Prudential Securities, Inc. ("PSI"). PSI contended the arbitrators lacked the authority to award punitive damages because the arbitration agreement contained a New York choice-of-law provision.[292] PSI also contended the confirmation of the punitive damages award by the district court violated PSI's due process rights.[293] The claimant cross-appealed, asserting that the district court erred in confirming the arbitrators' ruling that each party should bear its own attorney fees and costs.[294]

In confirming the arbitration panel's award of punitive damages, the Eleventh Circuit first noted that in accordance with the Supreme Court's decision in *First Options of Chicago, Inc. v. Kaplan*,[295] the court would review findings of fact according to a clearly erroneous standard, but decide questions of law de novo.[296] The court recognized that such a standard was contrary to the Eleventh Circuit's prior approach in reviewing confirmation awards,[297] but rejected the former standard as contrary to *First Options*.[298] The court also found that because *Mastrobuono v. Shearson Lehman Hutton, Inc.*[299] was directly on point, petitioner's argument that the New York choice-of-law provision prevented the arbitrators from awarding punitive damages was no longer valid.[300] Thus, the primary issue before the court was PSI's contention that the district court's confirmation of the punitive damages award violated the due process clause of the Fifth and Fourteenth Amendments.

---

290. 59 F.3d 1186 (11th Cir. 1995).
291. *Id.* at 1189.
292. *Id.* at 1187.
293. *Id.*
294. *Id.*
295. 115 S. Ct. 1920 (1995).
296. 59 F.3d at 1188.
297. *See* Robbins v. Day, 954 F.2d 679, 681-82 (11th Cir.), *cert. denied sub nom.* Robbins v. PainWebber, Inc., 506 U.S. 870 (1992).
298. 59 F.3d at 1188.
299. 115 S. Ct. 1212 (1995).
300. 59 F.3d at 1188-89.

PSI contended that the district court's confirmation of the damages award violated due process because arbitration "lacks the procedural protections and meaningful judicial review required for the imposition of punitive damages."[301] In disagreeing with PSI's contention, the Eleventh Circuit noted, "it is axiomatic that constitutional due process protections 'do not extend to "private conduct abridging individual rights."'"[302] The court followed the inquiry set forth by the Supreme Court in *National Collegiate Athletic Ass'n v. Tarkanian*[303] to determine whether the requisite state action existed, concluding "the state action element of a due process claim is absent in private arbitration cases."[304]

The court also rejected PSI's contention that the district court's confirmation of the award violated due process concerns pursuant to "the *Shelley v. Kraemer*[305] theory that a court's enforcement of a private contract constitutes state action."[306] The court noted that subsequent cases have interpreted state action narrowly and "have rejected the argument that the limited state action inherent in the confirmation of private arbitration awards mandates compliance with the Due Process Clause."[307] The court distinguished *Honda Motor Co. v. Oberg*[308] on the basis that *Honda* involved an award of punitive damages by a jury rather than a panel of arbitrators.[309] The court also noted that federal policy favors arbitration and that arbitration lacks "the bias and runaway punitive awards prevalent in the jury context."[310] Additionally, the court found that as a voluntary participant in the arbitration, "PSI may not require customers to arbitrate under the terms of an account agreement that PSI drafted and later complain about the

301. *Id.*

302. *Id.*

303. 488 U.S. 179 (1988).

304. 59 F.3d at 1191. This conclusion is in agreement with other courts that have decided the issue. *See, e.g.*, Federal Deposit Ins. Corp. v. Air Florida Sys., Inc., 822 F.2d 833, 842 n.9 (9th Cir. 1987); Elmore v. Chicago & Ill. Midland R.R., 782 F.2d 94, 96 (7th Cir. 1987); International Ass'n of Heat & Frost Insulators & Asbestos Workers Local Union 42 v. Absolute Envtl. Servs., Inc., 814 F. Supp. 392, 402-03 (D. Del. 1993); Austern v. Chicago Bd. of Options Exch., Inc., 716 F. Supp. 121, 125 (S.D.N.Y. 1989).

305. 334 U.S. 1, 19020 (1948) (holding that a court order enforcing a racially restrictive covenant constitutes state action).

306. 59 F.3d at 1191.

307. *Id.*

308. 512 U.S. 415 (1994) (finding due process concerns mandate that some degree of judicial review of punitive damage awards be imposed in state court actions).

309. 59 F.3d at 1193.

310. *Id.* The court cited no authority for this statement.

adequacy of the procedures afforded by the forum of its own choosing."[311] Thus, the punitive damages award was upheld.[312]

The court next considered the claimant's cross-appeal on the issue of attorney fees, ruling that an arbitrator can only bind the parties on issues they have agreed to submit to arbitration. The court determined that although the statement of claim requested costs and general damages were to be argued before the arbitrators, "these actions [do not] amount to a submission of the issue of attorney fees for determination."[313] Thus, because the attorney fees issue was not properly submitted to the arbitrators, the court held they exceeded their powers in ordering that each side pay their own fees.[314] Consequently, the court vacated the district court's judgment to the extent it confirmed the arbitrators' attorney fees determination.[315]

VI. SEC PROCEEDINGS

In *Sheldon v. SEC*[316] the former president of two securities brokerage firms appealed an SEC finding that he had violated federal securities laws and regulations and failed to adequately supervise his firms.[317] The Eleventh Circuit affirmed the SEC's order barring petitioner from associating with any securities broker or dealer, finding that the SEC's factual findings were supported by substantial evidence.[318] The court also found that various criticisms against the SEC's general operating procedures were without merit.[319] In particular, the court "join[ed] the Second and Ninth Circuits in rejecting the contention that the SEC's Rule 2(e) is improper or otherwise taints the fairness of proceedings before the SEC."[320]

---

311. *Id.* The court also noted that in *Mastrobuono*, the Supreme Court upheld an arbitration award of punitive damages in an amount greater than the award at issue in *Prudential*. *Id.*

312. *Id.*

313. *Id.* at 1195.

314. *Id.*

315. *Id.*

316. 45 F.3d 1515 (11th Cir. 1995).

317. *Id.* at 1516-17.

318. *Id.* at 1517.

319. *Id.*

320. *Id.* at 1518. *See* Touche Ross & Co. v. SEC, 609 F.2d 570, 579 (2d Cir. 1979); Davy v. SEC, 792 F.2d 1418, 1421-22 (9th Cir. 1986). Rule 2(e) provides:

> The Commission may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice of an opportunity for hearing in the matter (i) not to possess the requisite qualifications to represent others, or (ii) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct or (iii)

The court also disagreed with petitioner's contention that the Administrative Law Judge ("ALJ") proceedings violated the separation of powers doctrine and denied broker-dealers due process of law.[321] Citing *Elliott v. SEC*,[322] the court noted, "[a]n agency may combine investigative, adversarial, and adjudicative functions, as long as no employees serve in dual roles."[323] The court therefore determined that because in *Sheldon* "SEC employees gathered and presented the evidence, while the ALJ, an independent adjudicator, heard that evidence," the SEC had not acted improperly.[324]

VII. PENDING CASES

On January 17, 1997, the Supreme Court granted certiorari[325] in *United States v. O'Hagan*,[326] a case rejecting the applicability of the misappropriation theory as a basis of liability for fraudulent insider trading. The application of the misappropriation theory in the securities context had caused a split among the circuits. The Second, Third, Seventh, and Ninth Circuits adopted the misappropriation theory,[327] whereas the Fourth and Eighth Circuits found that section 10(b) and Rule 10b-5 should not be read so broadly.[328] The Eleventh Circuit does not appear to have addressed the issue.

Only days before this Article was published, the Supreme Court handed down its decision in *O'Hagan*.[329] In an opinion authored by Justice Ginsburg, the Court reversed the Eighth Circuit and ruled that criminal liability under section 10(b) may be predicated upon the misappropriation theory. The indictment in *O'Hagan* alleged that "O'Hagan, in breach of a duty of trust and confidence he owed to his law firm . . . and to his client . . . traded on the basis of nonpublic informa-

---

> to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws . . . or the rules and regulations thereunder.

17 C.F.R. § 201.2(e)(1) (1994). Petitioner contended the rule intimidated attorneys. 45 F.3d at 1518.

321. *Id.*

322. 36 F.3d 86 (11th Cir. 1994).

323. 45 F.3d at 1519 (quoting *Elliot*, 36 F.3d at 87).

324. *Id.* at 1519.

325. 117 S. Ct. 759 (1997).

326. 92 F.3d 612 (8th Cir. 1996).

327. United States v. Newman, 664 F.2d 12 (2d Cir. 1981); SEC v. Materia, 745 F.2d 197 (2d Cir. 1984); Rothberg v. Rosenbloom, 771 F.2d 818 (3d Cir. 1985); SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991); SEC v. Clark, 915 F.2d 439 (9th Cir. 1990).

328. United States v. Bryan, 58 F.3d 933 (4th Cir. 1995); United States v. O'Hagan, 92 F.3d 612 (8th Cir. 1996).

329. United States v. O'Hagan, No. 96-842, 1997 WL 345229 (June 25, 1997).

tion regarding [his client's] planned tender offer."[330] The Court found that O'Hagan's conduct, as defined in the indictment, constituted a fraudulent device in connection with the purchase and sale of securities.[331] O'Hagan's convictions pursuant to section 10(b) were therefore upheld.[332]

VIII. CONCLUSION

The most significant development during the survey period was the enactment of the Private Securities Litigation Reform Act, which imposes a number of substantial changes in the securities area. Although it is still too soon to tell whether the PSLRA will fulfill the intentions of its drafters, it clearly presents a number of new issues to be dealt with by those practicing under its provisions. It is therefore anticipated that future articles for this Eleventh Circuit Survey will include much discussion of decisions rendered under the PSLRA.

---

330. *Id.* at 6.

331. *Id.*

332. The Court also determined in *O'Hagan* that the Securities and Exchange Commission had not exceeded "its rulemaking authority by adopting Rule 14e-3(a), which proscribes trading on undisclosed information in the tender offer setting, even in the absence of a duty to disclose." *Id.* at 3.