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Robert W. Brownlie

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FEDERAL PREEMPTION AS A POSSIBLE RESPONSE

TO A NEW CHALLENGE:

SECURITIES CLASS ACTIONS IN STATE COURT

ROBERT W. BROWNLIE*

I. INTRODUCTION

Securities class action litigation is a veritable petri dish for studying creative lawyering and problem solving in action. Because the stakes are high—damage exposure in a single case typically runs in the hundreds of millions of dollars—both sides of the bar are driven toward innovation, leaving the law in a constant state of evolution. The most recent round of parries and thrusts has been driven by Congressional intervention.

In December 1995, Congress overrode a presidential veto and the Private Securities Litigation Reform Act of 1995 (“Reform Act”) became law. Congress enacted the Reform Act to address a perceived threat posed to the national securities markets by the proliferation of securities class action lawsuits. In theory, the Reform Act would address this issue by discouraging the filing of unmeritorious securities class action lawsuits, and by providing a means for their early dismissal through various mechanisms.

After its first two years, the Reform Act has fallen far short of its promise. Various studies concerning the Reform Act’s effectiveness, including a report by the Securities Exchange Commission to the President, show that the overall rate of case filings has remained constant, and early dismissals have been few. Perhaps the most surprising result, however, has been a shift of case filings from claims under federal law brought in federal courts to claims under state law in state courts—where the changes in fed-

* Robert W. Brownlie, J.D., University of California at Davis, is a member of the California State Bar and a partner in the firm of Gray Cary Ware & Freidenrich LLP. His practice focuses on defending corporate and securities litigation cases. Mr. Brownlie has been involved with several notable cases under the Private Securities Litigation Reform Act of 1995, including *Zeid v. Kimberley*, 973 F. Supp. 910 (N.D. Cal. 1997); *Zeid v. Kimberley*, 930 F. Supp. 431 (N.D. Cal. 1996); *Steckman v. Hart Brewing, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 99,420 (S.D. Cal. Dec. 24, 1996); *Powers v. Eichen*, 961 F. Supp. 233 (S.D. Cal. 1997); and *Powers v. Eichen*, Fed. Sec. L. Rep. (CCH) ¶ 99,483 (S.D. Cal. Mar. 13, 1997).

eral law have not been embraced. Prominent plaintiffs' securities class action lawyer, William S. Lerach, states that this shift is the result of the "law of unintended consequences."¹

In response, two bills have been introduced in the House and one in the Senate calling for further reforms through express federal preemption of state laws in securities class action suits.² However, while this legislation would be welcomed by the securities industry, it may not be necessary. Through creative lawyering by the defense bar to meet the ingenuity of the plaintiffs' bar, a strong case can be made for federal preemption under the existing law.

This article will briefly discuss the history of innovation within securities class action litigation, the 1995 Reform Act, the response by the plaintiffs' bar—and the defense bar's case for federal preemption.

II. BACKGROUND

On the heels of the Great Stock Market Crash of 1929, Congress enacted the Securities Act of 1933 as part of the New Deal reforms. The following year, Congress enacted the Securities Exchange Act of 1934. By the authority granted to it by Section 10(b) of the Exchange Act, the Securities and Exchange Commission adopted Rule 10b-5 in 1942. As interpreted by the courts to provide an implied private right of action, Rule 10b-5 provides the now classic remedy for alleged acts of securities fraud.

Section 10(b) provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentalities of interstate commerce or of the mails, or of any facility of any national securities exchange . . .

(b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.³

Rule 10b-5 provides:

It 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 securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

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1. Karen Donovan, *Class Action War Heats Up*, NAT'L L.J., Dec. 22, 1997, at A1.
 2. See Karen Donovan, *Full Stop for Fraud Suits in States?*, NAT'L L.J., Mar. 23, 1998, at A1 [hereinafter *Full Stop for Fraud*].
 3. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (1997).

- (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.⁴

To state a claim under Section 10(b) and Rule 10b-5, courts used common law fraud as a model for the implied private right of action, and required plaintiffs to prove reliance on the allegedly false or misleading statement.⁵

The reliance element of the Section 10(b) claim proved to be a stumbling block for pursuing securities cases as class actions. Securities class action litigation did not come of age until the courts embraced the “fraud on the market theory.”

The fraud on the market theory represents a convergence of economic theory and the rule of law. The fraud on the market theory allowed the proliferation of the most common type of securities claim asserted today—a violation of the anti-fraud provisions of Section 10(b) and Rule 10b-5 of the Exchange Act. Proving reliance, by a large group of individuals making independent decisions to buy or sell securities on a national stock exchange, made certification of securities class actions a challenge until the fraud on the market theory.⁶

Fraud on the market embraces a theory of financial economics known as the efficient capital markets hypothesis. Under this hypothesis, in an efficient market, the price of a company’s securities reflects all of the information available about that company at any given point in time. Consequently, the dissemination of false or materially incomplete information about a company to the market will necessarily affect the market price of that company’s stock. As a result, the purchasers (and in some cases the sellers of the affected securities) will be the harmed whenever they purchase or sell in reliance on the integrity of the market.⁷ This major innovation made class certification of alleged securities fraud cases routine. Securities class action litigation has now become a ubiquitous part of our legal landscape.

The pursuit of securities claims on a class-wide basis is an extremely powerful tool as the damage exposure often runs in the hundreds of millions of dollars.⁸ It is so powerful that it invited abuse by lawyers interested in

4. Securities Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (1997).

5. See *Stack v. Lobo*, 903 F. Supp. 1361, 1368 (N.D. Cal. 1995).

6. See FREDERICK DUNBAR & VINITA JUNEJA, MAKING SECURITIES CLASS ACTIONS MORE RESPONSIVE TO THE MODERN SHAREHOLDER, SECURITIES CLASS ACTIONS: ABUSES AND REMEDIES 198-99 (1994).

7. See *Basic Inc. v. Levinson*, 485 U.S. 224, 248 (1988); *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975).

8. See FREDERICK DUNBAR, RECENT TRENDS IN SECURITIES CLASS ACTION SUITS, tbl. 2 (1992).

using the in terrorem effect of class allegations to force settlements regardless of the merits of their claims.⁹

Defendants in securities fraud suits historically relied on Rule 9(b) of the Federal Rules of Civil Procedure to defend against the filing of securities fraud class action suits.¹⁰ Defendants attempted to use Rule 9(b) to force would-be plaintiffs to establish the merits of their alleged claims at the pleading stage or face dismissal. The aggressive use of Rule 9(b) in securities class actions has caused litigants and the courts to eschew the basic tenets of notice pleading, and to require plaintiffs to allege evidentiary facts at the outset.¹¹

Before the Reform Act, arguably, the most aggressive applications of Rule 9(b) were found in securities class action cases, especially in cases out of the Second Circuit. While Rule 9(b) required that fraud be plead with particularity, it relaxed the particularity requirement for allegations involving state of mind, which could be alleged generally. The Second Circuit Court of Appeal, however, virtually eliminated that exception to Rule 9(b). In the Second Circuit, plaintiffs were allowed to plead "state of mind" generally, so long as they also alleged with particularity facts giving rise to a strong inference of fraud.¹²

Despite this aggressive application of Rule 9(b), securities class actions continued to be filed in large numbers.

III. LEGISLATIVE RESPONSE: THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

In December 1995, Congress overrode the President's veto and the Private Securities Litigation Reform Act of 1995 became law. Legislative history explains that Congress was prompted to act by significant evidence of abuse in private securities lawsuits.¹³ Such evidence included "the routine filing of lawsuits against issuers of securities and others whenever there

9. See *Ross v. A.H. Robins Co.*, 607 F.2d 545, 557 (2d Cir. 1979). See also Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991).

10. FED. R. CIV. P. 9(b) provides that: "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally."

11. See *Fecht v. Price Co.*, 70 F.3d 1078, 1082 (9th Cir. 1995) ("GlenFed requires a plaintiff to plead evidentiary facts and the court to consider what inferences these facts will support—despite the pitfalls and inefficiencies of such an analysis at the pleading stage . . . and whether they are sufficient to satisfy the specificity requirement of Rule 9(b) . . ."). See also *Warshaw v. Xoma Corp.*, 74 F.3d 955, 960 (9th Cir. 1996) ("a plaintiff must plead evidentiary facts"); *In re Herbalife*, CV 95-400, 1996 U.S. Dist. LEXIS 11484, at *16 (C.D. Cal. 1996) ("plaintiffs must plead evidentiary facts").

12. See *Shields v. Citytrust Bancorp*, 25 F.3d 1124, 1128 (2d Cir. 1994). But see *In re Glenfed, Inc. Sec. Litig.*, 42 F.3d 1541 (9th Cir. 1994).

13. See H.R. Conf. Rep. No. 104-369, at 31(1995), reprinted in 1995 U.S.C.C.A.N. 679, 730.

is a significant change in an issuer's stock price."¹⁴

Congress further recognized that "because of the volatility of their stock prices [technology companies] are particularly vulnerable to securities fraud lawsuits when projections do not materialize."¹⁵ The conference report for the Reform Act explains that if a company fails to meet earnings projections "perhaps because of changes in the economy or the timing of an order or new product the company is likely to face a lawsuit."¹⁶ However, the House Commerce Committee was more blunt:

Today, our litigation system allows, indeed encourages, abusive "strike suits"—class actions typically brought under the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. Strike lawsuits are lawsuits filed by class action attorneys on behalf of shareholders whose once attractive stock purchases have failed to live up to their expectations. Volatile stock prices, rapid product development, and technological changes make growing companies a target. As a result, high technology, biotechnology, and other growth companies are hardest hit.

* * *

A typical case involves a stock, usually of a high-growth, high-tech company, that has performed well for many quarters, but ultimately misses analysts' expectations:

Whenever there is any sudden change in stock prices, there is, by definition some surprise (e.g., a disappointing earnings announcement or an adverse product development). Securities class action lawyers can then file a complaint . . . claiming that some group of defendants "knew or should have known" about the negative information and disclosed it earlier.

* * *

The driving force behind many of these suits are not angry investors, but entrepreneurial trial lawyers . . .¹⁷

Congress' goal was clearly to reduce the amount of securities class action litigation through the Reform Act. Congress sought to achieve this goal in part through the establishment of uniform and more stringent standards for pleading securities fraud claims.¹⁸ By reducing the volume of frivolous securities litigation, Congress sought to protect the national securities mar-

14. *Id.*

15. *Id.* at 43.

16. *Id.*

17. H.R. REP. NO. 104-50, pt. 1 (1995).

18. *See id.* at 41 ("The House and Senate hearings on securities litigation reform included testimony on the need to establish uniform and more stringent pleading requirements to curtail the filing of meritless lawsuits.").

kets:

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

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

Congress has been prompted by significant evidence of abuse in private securities lawsuits to enact reforms to protect investors and maintain confidence in our capital markets. . . .¹⁹

The Reform Act's provisions went into effect immediately. Among the more notable reforms were: (1) a statutory safeharbor for forward looking statements;²⁰ (2) an automatic stay of discovery upon the filing of motion to dismiss;²¹ and (3) the requirement that scienter be pled with particularity.²²

IV. THE SHIFT TO STATE COURT

In the wake of the Reform Act, state courts have emerged as a new battleground for securities class actions. The number of new filings of securities class action complaints in state courts throughout the United States increased dramatically during 1996.²³ From the Reform Act's passage through June 1997, there were seventy-seven securities cases filed against publicly-traded companies.²⁴ This increase was dramatic as only six cases were filed between January 1, 1992 and December 31, 1994.²⁵ Some cases involved

19. *Id.* at 31.

20. *See* Reform Act § 102, 15 U.S.C. §§ 77z-2; 78-u-5 (1997).

21. *See* Reform Act § 101, 15 U.S.C. §§ 77z-1(b); 78u-4(b)(1) (1997).

22. *See id.* § 78u-4(b)(1)(B) (1997).

23. *See* Mike France, *Bye, Fraud Suits, Hello, Fraud Suits*, BUS. WEEK, June 24, 1996, at 127.

24. *See What We Know and Don't Know About the Private Securities Litigation Reform Act of 1995: Hearings Before the Subcomm. on Finance and Hazardous Materials of the Committee on Commerce*, 105th Cong. (1997) (written statement of Michael A. Perino, Stanford Law School). *But see* Donovan, *Full Stop for Fraud*, *supra* note 2 (The author states that while there is conflicting information, some statistics suggest the number of state filings in 1997 was down thirty percent compared to 1996).

25. *See id.*

parallel complaints—one in federal court, one in state court—with similar or identical factual allegations but separate theories of relief.²⁶ With a parallel complaint, plaintiffs potentially have the opportunity to seek discovery in the state court action (which would otherwise be prohibited in the federal action while a motion to dismiss is pending).²⁷

V. THEORIES OF RELIEF ADVANCED IN STATE COURT

The shift in forums from federal court to state court required the plaintiffs' class action bar to change the theories of relief through which they pursued remedies. Plaintiffs could not rely on Section 10(b) or Rule 10b-5 of the Securities Exchange Act of 1934 because the federal courts have exclusive jurisdiction over those claims.²⁸ As a result, plaintiffs have attempted to adapt state law remedies to nationwide securities class action suits.

A. Common Law Fraud

An obvious vehicle for securities fraud class actions in state court is common law fraud. However, where required by state law, the element of actual reliance may be a significant roadblock to the use of fraud in complaints asserted as a class action. In 10b-5 cases, the "fraud on the market" doctrine of presumptive reliance makes proof of actual reliance by every class member on each misrepresentation unnecessary.²⁹ For common law fraud under state law to succeed as a weapon in securities fraud class actions, the fraud on the market doctrine is a vital element. Some state courts have rejected the concept of presumptive reliance and have required the traditional element of actual reliance, making it nearly impossible to plead a fraud claim on behalf of a broad class. For example, in *Mirkin v. Wasserman*, the California Supreme Court rejected the fraud on the market presumption in a securities fraud class action asserted under California Civil Code Section 1709-10, California's codification of common law fraud.³⁰

26. For example, in *Powers v. Eichen*, 977 F. Supp. 1031 (S.D. Cal. 1997), a 10b-5 claim was asserted in the U.S. District Court for the Southern District of California; a separate complaint with virtually identical factual allegations on behalf of the same class was filed in California Superior Court. See *Stielau Family Trust v. Eichen*, No. 702845 (S.D. Super. Ct. filed Aug. 15, 1996).

27. See, e.g., *Howard Gunty, Inc. v. Quantum Corp.*, No. 760370 (Santa Clara Sup. Ct. filed Oct. 29, 1997). Judge Fogel refused to stay discovery in accordance with the Reform Act, but imposed an ethical wall to prevent the use of material discovered in a state court action in a parallel federal action.

28. See Securities Exchange Act of 1934 § 27, 15 U.S.C. § 78aa (1997).

29. See *Basic Inc. v. Levinson*, 485 U.S. 224, 250 (1988).

30. *Mirkin v. Wasserman*, 858 P.2d 568 (Cal. 1993). See also *Kahler v. E.F. Hutton*, 558 So. 2d 144, 145 (Fla. Dist. Ct. App. 1990) (rejecting "fraud on the market" under Florida common law fraud); *Gaffin v. Teledyne*, 611 A.2d 467, 474-75 (Del. 1992) (rejecting "fraud on the market" under Delaware common law fraud).

B. State Securities Laws

The migration to state court has resulted in a revival of previously dormant state securities or Blue Sky statutes. Given the broad sweep of Rule 10b-5, these state statutes were infrequently litigated in the past. Consequently, relatively few published opinions have analyzed their meaning and scope. Given the rise in litigation under these statutes at the trial court level, there is no doubt that significant appellate decisions will clarify the landscape in the future.

The securities laws of almost every state impose civil liability for false and misleading statements; Rhode Island and New York are exceptions. Thirty-nine states have adopted the Uniform Securities Acts of 1956 or 1985.³¹ The remaining states have developed their own securities laws. However, the most significant is California. California's statutory liability is broader than that found in the Uniform Act states, and several of the new state court filings have occurred in California since the Reform Act.

C. Uniform Securities Acts of 1956 and 1985

The Uniform Act of 1956 is a compliment to, not a replacement for, the federal statutory scheme.³² The 1956 Act creates statutory liability for making false or misleading statements when selling securities.³³ The 1985 Act largely incorporates the civil liability scheme of the 1956 Act and adds a new claim for market manipulation (but only in securities which are not traded on national market systems).³⁴ Liability under Section 410(a)(2) of the 1956 Act and Section 501(2), 605(a) - (b) of the 1985 Act occurs where: (1) there was an offer or sale of securities "in this state"; (2) that was made by means of any untrue statement or omission of a material fact; (3) the securities were purchased by the plaintiff; (4) the purchaser did not know of the misrepresentation or omission; and (5) the plaintiff is willing to retain the securities, if they are still owned, or the plaintiff has sold the securities. There is no scienter requirement and no reliance requirement. However, strict privity between the plaintiff buyer and the defendant seller is required.³⁵ Plaintiffs who still own the security are limited to rescission as a measure of damages. These limitations, combined with the jurisdictional

31. The Uniform Act of 1956 has been adopted by Alabama, Alaska, Arkansas, Connecticut, Delaware, District of Columbia, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Hampshire, New Jersey, North Carolina, Oklahoma, Oregon, Pennsylvania, South Carolina, South Dakota, Utah, Virginia, Washington, West Virginia, Wisconsin, and Wyoming. The Uniform Act of 1985 has been adopted by Colorado, Maine, Nevada, New Mexico, Rhode Island, and Vermont.

32. Uniform Securities Act § 415 (1997).

33. *See id.* § 410(a)(2).

34. *See id.* § 605(c).

35. *See id.* §§ 410(a)(2), 605(a).

restrictions noted below, may curtail the usefulness of state Blue Sky laws modeled on the Uniform Acts as a viable alternative to federal claims.

D. Liability Under the California Code

In California, civil liability for securities fraud is codified in the Corporate Securities Law of 1968. Essentially, there are three separate statutory schemes of liability: (1) market manipulation,³⁶ (2) false and misleading statements,³⁷ and (3) insider trading.³⁸ The prohibited practices are defined in Sections 25400-02, and the enforcement/remedy provisions are found in Sections 25500-02. Given the dearth of California appellate decisions analyzing these Sections, litigants on both sides of the bar have resorted to federal cases discussing the Sections, legislative history, analogies to comparable federal statutes, and simple statutory interpretation.

Sections 25400 and 25500 were modeled on Section 9(a) and Section 9(e) of the 1934 Act (15 U.S.C. § 78i(a), (e)).³⁹ Section (d) of 25400 is the closest alternative to Rule 10b-5 under the California statutory scheme.⁴⁰ On the face of the statute, Section 25400 requires that the defendant be engaged in buying or selling securities.⁴¹ The "seller" requirement may demand that defendants' misrepresentations are not actionable unless they are accompanied by market activity during the class period.⁴² Plaintiffs argue that the enforcement provision, Section 25500, opens liability to anyone who "willfully participates" in a violation of Section 25400(d), extending secondary liability to those who were not actual sellers.

The scienter standard for Sections 25400 and 25500 violators may require actual intent rather than mere negligence or recklessness. Section 25400 requires the plaintiff to show that the defendant acted "for the purpose of inducing the purchase or sale," and the enforcement provision, Section 25500, demands that the defendant "willfully" participate in the viola-

36. See CAL. CORP. CODE §§ 25400, 25500 (Deering 1997).

37. See *id.* §§ 25401, 25501.

38. See *id.* §§ 25402, 25502.111.

39. See 1 HAROLD MARSH, JR. & ROBERT H. VOLK, PRACTICE UNDER THE CALIFORNIA SECURITIES LAWS § 14.05(1).

40. CAL. CORP. CODE § 25400(d) (Deering 1997). The code provides:

It is unlawful for any person, directly or indirectly, in this state . . . [i]f such person is a broker-dealer or other person selling or offering for sale or purchasing or offering to purchase the security, to make, for the purpose of inducing the purchase or sale of such security by others, any statement which was, at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or which omitted to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, and which he knew or had reasonable ground to believe was so false or misleading.

41. See MARSH & VOLK, *supra* note 39, § 14.05(4).

42. See *In re Activision Sec. Litig.*, 621 F. Supp. 415, 422 (N.D. Cal. 1985).

tion.⁴³ However, Section 25400 merely states that actionable representations are ones which the defendant “knew or had reasonable ground to believe [were] false or misleading.”⁴⁴ Thus, without clarification by California courts, plaintiffs have an opportunity under the statutory language to argue for a lower scienter standard. If successful, such a standard may make Sections 25400 and 25500 preferable for plaintiffs to federal securities laws given the elevated scienter requirement under the Reform Act.

Sections 25401 and 25501 are parallel statutory schemes which prohibits the sale and purchase of securities by means of a communication that contains a misrepresentation or omission. These sections are modeled after Section 12(2) of the 1933 Act.⁴⁵ Significantly, Sections 25401 and 25501 require strict privity between plaintiff and defendant, severely restricting the potential class.⁴⁶ Section 25504 extends liability to control persons.⁴⁷

Insider trading liability is covered by Sections 25402 and 25502. The defendant must be “an issuer or any person who is an officer, director or controlling person of an issuer or any other person whose relationship to the issuer gives him access, directly or indirectly, to material information about the issuer.”⁴⁸ Actual knowledge is required.⁴⁹

E. Jurisdictional Limits: “In This State”

Regardless of the scope of any state’s Blue Sky liability scheme, jurisdictional constraints may limit the ability of plaintiffs to successfully shift nationwide securities fraud class actions from federal to state courts. Perhaps the most significant language in the California securities statute is the phrase “in this state.” Section 25400, 25401, and 25402 all contain this jurisdictional language. A definitional provision, Section 25008, sets forth when a transaction is deemed to be “in this state” under the California Corporations Code. This section states that “an offer or sale of securities is made in this state when an offer to sell is made in the state, or an offer to buy is accepted in this state, or (if both seller and the purchaser are domiciled in this state), the security is delivered to the purchaser in this state.” The “in this state” limitation is also included in Section 414 of the Uniform Securities Act of 1956 and Section 810 of the Uniform Securities Act of 1985.

43. See MARSH & VOLK, *supra* note 39, § 14.05(3)(a) (negligent misrepresentations are not actionable under § 25400).

44. See CAL. CORP. CODE § 25400.

45. See MARSH & VOLK, *supra* note 39, § 14.03(1).

46. See *Victor v. White* [1989 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 94,548, at 93,509-10 (N.D. Cal. 1989); *In re Disonics Sec. Litig.*, 599 F. Supp. 447, 458-59 (N.D. Cal. 1984).

47. See *Victor*, Fed. Sec. L. Rep. (CCH) at 93,509-10; *In re Disonics Sec. Litig.*, 599 F. Supp. at 458-59.

48. CAL. CORP. CODE § 25402 (Deering 1997).

49. See MARSH & VOLK, *supra* note 39, § 14.04(3)(a)(c).

No reported California decision has addressed the jurisdictional limits of the Corporations Code. However, virtually every federal decision on the issue has refused to certify a nationwide class of purchasers in securities class actions under the California Corporations Code.⁵⁰ If courts in California and elsewhere enforce the "in this state" language as a jurisdictional limit barring certification of a nationwide class, the attractiveness of state Blue Sky laws as a vehicle for securities class actions may be restricted.

VI. CREATIVE LAWYERING: FEDERAL PREEMPTION OF STATE LAWS THROUGH THE REFORM ACT

The emergence of the state courts as a forum for litigating nationwide securities class actions, and the adaptation of state law remedies to those lawsuits, are fine examples of ingenious lawyering by the plaintiffs' bar. However, the next round of creative lawyering calls for an effort by the defense bar to bring the cases back to federal court and the Reform Act.

Traditionally, federal and state regulation of the securities industry were thought to coexist in a dual regulatory scheme.⁵¹ Indeed, Section 28(a) of the Securities Exchange Act of 1934 provides that the remedies under the Exchange Act are in addition to any and all other remedies that may exist in law and equity.⁵² Section 28(a) further provides that the Exchange Act does not affect the jurisdiction of any securities commissioners of any state or the rules or regulations of any state insofar as they do not conflict with any provisions of the Act.⁵³ This concept of dual state and federal regulation of the securities industry has caused many to discount the possibility of a preemptive effect of the Reform Act.⁵⁴

However, federal law preempts state law whenever "the state law stands as an obstacle to the accomplishment of the full purposes and objectives of Congress. . . ."⁵⁵ The consequences of applying state law in light of the policies and goals of the otherwise applicable federal law must be examined to determine whether state law stands as an obstacle to the accomplishment

50. See *In re Activision Sec. Litig.*, 621 F. Supp. 415, 432 (N.D. Cal. 1985); *Scholes v. Tomlinson*, 145 F.R.D. 485, 492 (N.D. Ill. 1992); *In re Victor Tech. Sec. Litig.*, 102 F.R.D. 53, 60 (N.D. Cal. 1984). See also MARSH & VOLK, *supra* note 39, § 1.06(1).

51. See *Matsushita Elec. Indus. Co. v. Epstein*, 516 U.S. 367 (1996) ("Congress plainly contemplated the possibility of dual litigation in state and federal courts relating to securities transactions.").

52. Securities Exchange Act of 1934, 15 U.S.C. § 78bb(a) (1997).

53. See *id.*

54. There are currently three bills before Congress that seek to impose express federal preemption of state laws in class actions involving companies whose stocks trade on the national securities exchanges: H.R. 1653, 105th Cong. (1997); H.R. 1689, 105th Cong. (1997); and S. 1260, 105th Cong. (1997).

55. *Schneidewind v. ANR Pipeline Co.*, 485 U.S. 293, 299-300 (1988); *Pacific Gas & Elec. Co. v. State Energy Resources Conservation & Dev. Comm'n*, 461 U.S. 190, 204 (1983).

of federal policies.⁵⁶ Thus, where a provision of state law would “run counter to the basic policy of federal securities laws” or would “frustrate the basic enforcement of federal securities laws,” preemption of state law claims is proper.⁵⁷

The United States Supreme Court has found that federal securities laws will preempt a state securities law where the state regulation “stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.”⁵⁸ The determination of whether state causes of action conflict with the purposes of the Reform Act will be left to lower courts—because the Reform Act did not amend Section 28(a) of the Securities Exchange Act of 1934.⁵⁹ Further, unless the cases are removed, these initial determinations will be made by the state trial courts.⁶⁰ In deciding whether a state law stands as an obstacle to the full implementation of the Reform Act, a court must determine if the state law in question interferes with the methods by which the federal statute was designed to reach its goal.⁶¹ Where state law has “run counter to the basic policy of federal securities laws” or would “frustrate the basic enforcement of federal securities laws,” federal preemption of state law claims is proper.⁶²

56. See *Westmarc Communications, Inc. v. Connecticut Dep't of Pub. Util. Control*, 807 F. Supp. 876, 884 (D. Conn. 1990).

57. *Baker, Watts & Co. v. Miles & Stockbridge*, 876 F.2d 1101, 1108 (4th Cir. 1989) (preempting state law claims for indemnification which would frustrate the policy of the 1933 and 1934 Acts to deny indemnification). See also *Golden Nugget, Inc. v. American Stock Exch., Inc.*, 828 F.2d 586, 588 (9th Cir. 1987) (the federal securities laws preempt state laws when the state laws “stand as an obstacle to the full accomplishment of federal regulatory objectives”).

58. *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 78-79 (1987); *Edgar v. MITE Corp.*, 457 U.S. 624, 630 (1984).

59. See *Edgar*, 457 U.S. at 631.

60. The author has been involved with three demurrers to state court securities class action suits in which federal preemption was argued. Each time, the state trial courts sustained the demurrers without reaching the issue of preemption.

61. See *International Paper Co. v. Ouellette*, 479 U.S. 481, 494 (1986).

62. See, e.g., *American Agric. Movement v. Board of Trade*, 977 F.2d 1147, 1156 (7th Cir. 1992) (state law claims preempted by Commodities Exchange Act where it would frustrate intent of Congress); *Baker, Watts & Co. v. Miles & Stockbridge*, 876 F.2d 1101, 1108 (4th Cir. 1989) (state law claims for indemnification preempted so as not to frustrate the basic enforcement of federal securities laws); *Gilman v. BHC Sec., Inc.*, 104 F.3d 1418, 1423 (2d Cir. 1995) (New York statutory and common law causes of actions dismissed where court's determination of plaintiff's claims would stand as an obstacle to the full purposes and objectives of Congress); *Luxottica Group v. United States Shoe Corp.*, 919 F. Supp. 1085, 1085-90 (S.D. Ohio 1995) (state statute preempted by Williams Act because compliance would frustrate Congressional purpose of undue delay); *Chanoff v. U.S. Surgical Group*, 857 F. Supp. 1011, 1017 (D. Conn. 1994) (state law claims preempted where to enforce would undermine Congressional objectives for the federal securities scheme); *Batus, Inc. v. McKay*, 684 F. Supp. 637, 640 (D. Nev. 1988) (Nevada statute preempted because it frustrates objectives of the Williams Act); *Gelco v. Coniston Partners*, 652 F. Supp. 829, 844 (D. Minn. 1986) (Minnesota Control Shares Acquisition Act preempted by Williams Act objective of neutrality); *Dahl v. Charles Schwab & Co., Inc.*, 545 N.W.2d 918, 925 (Minn. 1996) (Minnesota state law preempted where compliance could frustrate the

The roots for arguing federal preemption can be found in the Reform Act's legislative history.⁶³ As quoted above, the Conference Report explains the purpose of the federal securities laws is to protect investors and maintain confidence in our national securities markets.⁶⁴ The clear intent of Congress was to create uniform national standards for the private enforcement of the securities laws by elevating the pleading standards, staying discovery during the pendency of dismissal motions, and providing a safe harbor for forward looking statements.

Congress particularly focused on securities fraud lawsuits based upon "forward-looking statements" of future events. The Reform Act was premised in part on Congress' manifest concern that "[f]ear that inaccurate projections will trigger the filing of securities class action lawsuit[s] has muzzled corporate management."⁶⁵ Congress was especially concerned that "[t]echnology companies—because of volatility of their stock prices—are particularly vulnerable to securities fraud lawsuits when projections do not materialize."⁶⁶ When a company "fails to satisfy its announced earnings projections—perhaps because of changes in the economy or the timing of an order or new product—the company is likely to face a lawsuit."⁶⁷

Everything that Congress sought to achieve would be lost if disgruntled investors are permitted to simply cross the street and file their cases in state court. The Seventh Circuit recently held that allowing non-traders to bring state common law claims where they could not bring federal law claims under the Commodities Exchange Act ("CEA") would frustrate congressional intent to bring the market under a uniform set of regulations.⁶⁸ The court stressed that a "contracts market could not operate efficiently . . . if varying and potentially contradictory legal standards governed its duties to investors" ⁶⁹ This was the case even though the CEA contains a "savings clause" that is similar to Section 28(a) of the Exchange Act.⁷⁰

State court litigation of securities class actions seeks to stretch state law remedies to cover federally-registered securities that are traded nationwide on national markets. Clearly, it is also a direct attempt to evade Congress' intent to protect "the integrity of American capital markets" by creating a

objectives of the SEC and Congress); *Buckley v. Chicago Bd. Options Exch., Inc.*, 109 Ill. App. 462, 469-70 (1982) (state action for specific performance dismissed where court determination of exchange membership would stand as obstacle federal act's intent to let SEC decide).

63. See H.R. Conf. Rep. No. 104-369, at 31, 43(1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 730.

64. See H.R. REP. NO. 104-50, pt. 1, at 31 (1995).

65. *Id.* at 43.

66. *Id.*

67. *Id.*

68. See *American Agric. Movement v. Board of Trade*, 977 F.2d 1147, 1156 (7th Cir. 1992).

69. *Id.*

70. See *id.* at 1155.

uniform national standard for the private enforcement of securities laws. For example, when an employee attempted to circumvent the application of the Federal Arbitration Act ("FAA") to a contract evidencing a transaction involving interstate commerce, the Supreme Court reversed the California Court of Appeals and held that the FAA preempted the California Labor Code.⁷¹ In *Perry v. Thomas*, the Court explained that the FAA embodied Congressional intent to provide for the enforcement of arbitration agreements unless the agreement is not part of a contract evidencing interstate commerce.⁷² The Court held that the California statutory requirement that litigants be provided a judicial forum for resolving wage disputes placed it in conflict with the purpose of the FAA. Thus, under the Supremacy clause, the state law must give way.⁷³

Litigation of nationwide class actions under state legal standards and procedures that conflict with the Reform Act would seriously compromise the purposes of the Reform Act. State causes of action would create substantial uncertainties on the part of investors and issuers, and could chill issuer disclosures regarding future plans and projections. Congress intended to encourage these disclosures in order to maintain confidence in the market. If a state action's effect is to discourage conduct that federal legislation specifically seeks to encourage, then the state action is preempted.⁷⁴ A uniform standard for the private enforcement of securities laws is the method Congress chose to reach its goal of protecting investors and maintaining confidence in the market. Because litigation under state law causes of action operates to interfere with this method, it thwarts the purposes and objectives of Congress. Thus, an argument for implied federal preemption exists under the Reform Act. It remains to be seen, however, whether or not courts and the bar will seize these arguments and find that preemption exists.⁷⁵

VII. CONCLUSION

Our common law system of jurisprudence—with lawyers acting as competing advocates—allows our laws to be responsive to changing needs and conditions. These competitive forces are not unlike the forces that

71. See *Perry v. Thomas*, 482 U.S. 483 (1987).

72. See *id.* at 489.

73. See *id.* at 490-91.

74. See *Morgan City v. South La. Elec. Coop. Assoc.*, 31 F.3d 319, 322 (5th Cir. 1994) (state law authorizing condemnation of property would conflict with the Rural Electrification Administration's purpose of encouraging the maintenance of low cost electric service to rural areas).

75. In written testimony before Congress, Professors Grundfest and Perino recently expressed their views that the Reform Act preempts state law under the doctrine of implied preemption. See *Ten Things We Know and Ten Things We Don't Know About the Private Securities Litigation Reform Act of 1995: Before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs*, 105th Cong. (1997) (joint written statement of Joseph A. Grundfest and Michael A. Perino, Stanford Law School).

shape our free market economy. It should then come as no surprise that the forces of advocacy are especially vibrant in litigation involving our national securities exchanges. The plaintiffs' bar stepped in with innovative remedies for defrauded investors. When the pendulum swung too far in favor of the investors, the defense bar pushed back. Most recently, in response to Congressional intervention, the plaintiffs' bar began migrating to the state courts. Creative lawyering by the defense bar may push their cases back to the federal courts. On balance, perhaps, this teeter-tottering creates a level playing field for investors and securities issuers.

