UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 99-5153

A. CARL HELWIG, On Behalf of Himself and All Others Similarly Situated; GARY BARNES; MEREDITH WILSON BROWN; ROBERT BROWN; S. KAY LUTES; SYBIL R. MEISEL; BARBARA E. SCHUSTER,

Plaintiffs-Appellants,

v.

VENCOR, INC.; W. BRUCE LUNSFORD; W. EARL REED, III; MICHAEL R. BARR; THOMAS T. LADT; JILL L. FORCE; JAMES H. GILLENWATER, JR.,

Defendants-Appellees.

On Appeal from the United States
District Court for the Western District of Kentucky

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION
AS AMICUS CURIAE ON REHEARING EN BANC
IN SUPPORT OF APPELLANTS ON THE ISSUES SPECIFIED

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INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

This case concerns the proper interpretation of the state of mind pleading standard that was enacted in the Private Securities Litigation Reform Act of 1995 ("Reform Act" or "Act"), Pub. L. No. 104-67, 109 Stat. 737, codified at Section 21D of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. 78u-4. The Reform Act establishes a requirement for pleading state of mind in private actions under Section 10(b) of the Exchange Act, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5. See 15 U.S.C. 78u-4(b)(2). This Court's interpretation of that requirement will have a significant impact on the federal securities laws' protection of investors. Congress recognized that the Securities and Exchange Commission, the agency principally responsible for the administration and enforcement of the federal securities laws, would play an active role in the Reform Act's interpretation. See 141 Cong. Rec. S19,149 (1995) (Sen. Bradley). For these reasons, the Commission submits this brief as amicus curiae.

The Commission has long stated that private antifraud actions are an essential supplement to its own enforcement efforts and provide a means of compensating injured investors. It has also recognized that investors are ill-served by frivolous lawsuits. The Reform Act attempts to balance these interests. It adopts a rigorous standard for pleading fraud in order to exclude non-meritorious

cases at an early point. Congress did not intend, however, to bar meritorious claims. Setting the pleading threshold too high would have precisely that effect.

The Reform Act requires that a complaint in a private action "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. 78u-4(b)(2). The "strong inference" pleading standard was developed by the Second Circuit. See, e.g., Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1128, 1130 (2d Cir. 1994). That court has construed (id.) its rigorous standard as being met, in the absence of direct evidence of intent, by particularized allegations of either (a) facts to show that the defendant had both a concrete motive and a clear opportunity to commit fraud or (b) facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness.

In this case, the panel majority found that "plaintiffs' complaint does not allege sufficient facts to establish * * * a strong inference that the defendants had the state of mind required by the statute." Helwig v. Vencor, Inc., 210 F.3d 612, 620 (6th Cir. 2000). The majority found that plaintiff did not show that "the defendants knew that [certain alleged statements] were false when made, nor that they were reckless," and rejected plaintiff's allegations of motive and opportunity as "not establish[ing] a strong inference of recklessness." Id. at 622, 623. For its

interpretation of the Act's scienter pleading provision, the majority relied on the panel decision in In re Comshare, Inc. Sec. Litig., 183 F.3d 542 (6th Cir. 1999). The Commission, which was amicus curiae in Comshare, believes that this Court generally should adopt Comshare's holdings, but with an important clarification of one of them. 1/

Comshare rejected the erroneous contention of the defendants there (and here, see appellees' panel brief at 39-40) that the Reform Act's state of mind pleading provision altered the substantive law and therefore heightened the state of mind requirement in Section 10(b), which is scienter and encompasses recklessness. 183 F.3d at 549-53. Comshare's well-reasoned holding that recklessness continues to be a basis for liability is in accord with decisions of at least four other circuits, and should be adopted here.

On the separate question of the standard for pleading scienter, Comshare likewise correctly held that "plaintiffs may plead scienter in § 10b or Rule 10b-5 cases by alleging facts giving rise to a strong inference of recklessness." Id. at 549.

1/ Comshare, one of the first appeals involving the Reform Act, was briefed and argued before there was court of appeals authority interpreting it. This brief provides the Court with an analysis of the full range of authority that now exists. It also provides a fuller discussion of the legislative history than did our amicus brief in Comshare.

This holding, too, is in accord with decisions of at least four other circuits, and should be adopted by this Court en banc.

With regard to whether motive and opportunity also can be a basis for pleading scienter under the Reform Act -- and, contrary to defendants' position, the Commission believes that it can -- the Comshare court stated that "facts regarding motive and opportunity may be `relevant to pleading circumstances from which a strong inference of fraudulent scienter may be inferred,' and may, on occasion, rise to the level of creating a strong inference of reckless or knowing conduct." Id. at 551 (citation omitted). Plaintiffs may not, the court explained, "establish a `strong inference' of scienter merely by alleging facts demonstrating motive and opportunity where those facts do not simultaneously establish that the defendant acted recklessly or knowingly." Id.; accord Vencor, 210 F.3d at 623.

The Commission believes that this description is consistent with the Second Circuit's pre-Reform Act scienter pleading standard, which Congress adopted in the Act. Second Circuit law already limited motive and opportunity pleading to particularized allegations that created a "strong inference" of scienter. As Comshare recognized, the Second Circuit standard was "the most stringent test as to how a plaintiff may plead scienter under § 10(b) or Rule 10b-5." Id. at 549.

Once the true stringency of that standard is appreciated, the seemingly disparate decisions of courts of appeals on motive and opportunity pleading under the Act can be reconciled, especially the decisions of the at least four circuits that have now held that such pleading can satisfy the Act.

Certain language in Comshare, however, suggests that the Court may have believed that it was "[s]etting aside" the Second Circuit standard with "a somewhat different interpretation of the role of 'motive and opportunity'" than a Reform Act case adopting the Second Circuit standard. Id. at 549, 551 n.8 (citing In re Advanta Corp. Sec. Litig., 180 F.3d 525 (3d Cir. 1999)). For the reasons set forth below, the Commission urges this Court to clarify or depart from Comshare on this point. This Court should hold that the Act does not limit allegations of motive and opportunity any more than the Second Circuit standard already did.

STATEMENT OF ISSUES

1. Whether, contrary to Comshare, the Reform Act's state of mind pleading provision alters the well-established substantive law of this and every other circuit to have considered the issue that recklessness satisfies the state of mind requirement under Section 10(b) and Rule 10b-5.

2. Whether, despite Comshare's determination that allegations of recklessness and of motive and opportunity can give rise to a "strong inference" of scienter under the Reform Act, the Act heightens the rigorous standard for pleading a "strong inference" of scienter that was developed in a long line of Second Circuit cases, under which a private plaintiff may allege either (a) facts to show that the defendant had both a motive and an opportunity to commit fraud or (b) facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness.

SUMMARY OF ARGUMENT

1. The Reform Act's scienter pleading standard does not change the substantive law and therefore does not eliminate recklessness as a basis for liability. The Act requires that private plaintiffs "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind," but does not define that state of mind. Thus, the "required state of mind" language leaves untouched the well-established body of law in this and other courts that the state of mind required under § 10(b) and Rule 10b-5 includes recklessness.

2. The Reform Act likewise does not eliminate recklessness as a basis for pleading scienter. Furthermore, substantial and particularized allegations of motive

and opportunity give rise to a "strong inference" of scienter and thus are a basis for pleading scienter.

The Act uses the term "strong inference," which was developed as a scienter pleading standard in a long line of Second Circuit decisions. It may be presumed, absent contrary evidence, that Congress intended to adopt the judicial definition of that well-established standard.

The Second Circuit standard is satisfied by strong circumstantial evidence of conscious misbehavior or recklessness, and thus is consistent with pleading and proving recklessness. Under the Second Circuit standard, a strong inference of scienter can also be shown by allegations of motive and opportunity to commit the fraud. The Second Circuit tests are proven, sound, widely used, and consistent with the Reform Act's purposes. Nothing in the Act shows that the Act deviates from these established means of pleading a "strong inference." Indeed, authoritative legislative history of the Reform Act confirms that in using the "strong inference" language Congress adopted that standard. In fact, when the President vetoed the bill over concerns that the standard had not been adopted, the bill's managers, in the debate leading to a veto override, made clear their endorsement of that standard.

ARGUMENT

I. THE REFORM ACT'S STATE OF MIND PLEADING PROVISION DOES NOT DISPLACE THE LONG-STANDING JUDICIAL RULE THAT RECKLESSNESS SUFFICES TO SHOW SCIENTER UNDER SECTION 10(b) OF THE EXCHANGE ACT AND RULE 10b-5 THEREUNDER.

In Comshare, 183 F.3d at 548-51, a panel of this Court correctly held that the Reform Act's state of mind pleading provision does not change the well-settled law in this and all other circuits to consider the issue that recklessness suffices to show the required state of mind under Section 10(b) and Rule 10b-5. At least four other circuits have so held. See Greebel v. FTP Software, Inc., 194 F.3d 185, 198-201 (1st Cir. 1999); Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1281-84 (11th Cir. 1999); Advanta, 180 F.3d at 534-35; Novak v. Kasaks, 216 F.3d 300, 306 (2d Cir. 2000); Rothman v. Gregor, __ F.3d __, 2000 WL 959484, at *7 (2d Cir. July 11, 2000); see also Phillips v. LCI Int'l, Inc., 190 F.3d 609, 620 (4th Cir. 1999) (holding that Reform Act does not change existing § 10(b) liability standard that "may perhaps" include recklessness). 2/ This Court should reject defendants'

2/ The Ninth Circuit has agreed that some form of recklessness suffices for liability and held that the Reform Act's pleading standard does not change the liability standard, but stated that the recklessness must be "deliberate" or "conscious." See In re Silicon Graphics, Inc. Sec. Litig., 183 F.3d 970, 974-75 & n.3 (9th Cir. 1999). The panel majority's use of these terms has been criticized not only by a well-reasoned dissent, see id. at 991-96, but by other (continued...)

argument that the Reform Act narrowed the scienter requirement to "conscious misbehavior" or "'knowing misrepresentation,'" see panel brief at 39-40 & n.10, and reaffirm Comshare on this point.

This holding is based on the "plain," "unambiguous" language of the Reform Act, 15 U.S.C. 78u-4(b)(2) & (b)(3)(A). Comshare, 183 F.3d at 551, 552; accord, e.g., Advanta, 180 F.3d at 534. "By its own terms, the [Act's] pleading standard does not purport to change the substantive law of scienter." Comshare, 183 F.3d at 549. The Act's "required state of mind" language necessitates reference to the substantive law to determine what state of mind is "required." Id., at 549-50.

In the substantive case law under Section 10(b), it is "well-settled" that recklessness "constitutes scienter." Id. at 550 & n.7 (citing Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1024 (6th Cir. 1979)); accord, e.g., Novak, 216 F.3d at 306 (meaning of scienter "has been firmly established for at least a generation"); Bryant, 187 F.3d at 1284. 3/

2/ (...continued)
courts, see Bryant, 187 F.3d at 1284 n.21; Greebel, 194 F.3d at 199-201.

3/ The Supreme Court has explicitly reserved the issue, while noting that "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193-94 n.12 (1976).

Following Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1044-45 (7th Cir. 1977), courts have adopted a "stringent formulation of the term 'recklessness'" in this context. Comshare, 183 F.3d at 550. They have required "an extreme departure from the standards of ordinary care," which "presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." Id. The Reform Act's pleading provision leaves this established body of law undisturbed. Id.

The failure to specify a state of mind was hardly an oversight. In other parts of the Reform Act, concerning joint and several liability and liability for forward-looking statements, 4/ where Congress wanted to modify or eliminate the existing recklessness standard, it knew how to do so expressly; and where it did so, the provision was carefully circumscribed. See Comshare, 183 F.3d at 550 n.5; Greebel, 194 F.3d at 200-201; Bryant, 187 F.3d at 1284.

Finally, recklessness is essential to the effective functioning of Section 10(b), as courts have recognized both before and after the Reform Act. See, e.g.,

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4/ See 15 U.S.C. 78u-4(f)(1) & (2)(A) (generally only person who "knowingly committed a violation of the securities laws" will be subject to joint and several liability in a private action; "standard for liability" unaffected); 15 U.S.C. 78u-5(c)(1)(B) (safe harbor does not apply to statements plaintiff proves defendant "made with actual knowledge" that false or misleading).

Mansbach, 598 F.2d at 1024; Advanta, 180 F.3d at 535. The Commission itself often relies on recklessness in its own law enforcement cases. Liability for recklessness is essential to investor protection and plays a critical role in the integrity of corporate disclosure and quality of corporate governance.

II. THE REFORM ACT ADOPTS, OR AT LEAST LEAVES IT TO THE COURTS TO ADOPT, THE SECOND CIRCUIT'S PLEADING TESTS, UNDER WHICH "MOTIVE AND OPPORTUNITY" AND "STRONG CIRCUMSTANTIAL EVIDENCE OF RECKLESSNESS" ARE SUFFICIENT TO PLEAD SCIENTER.

The Reform Act adopts the "strong inference" standard for pleading scienter in private securities actions. 15 U.S.C. 78u-4(b)(2). The Second Circuit created the "strong inference" standard, and, in a long line of decisions, developed the "motive and opportunity" and "strong circumstantial evidence of conscious misbehavior or recklessness" analytical tests for applying it. See, e.g., Shields, 25 F.3d at 1128 (citing cases). Courts of appeals have been unanimous in holding that strong circumstantial evidence of recklessness (in at least some form, see p. 8, supra) can give rise to a "strong inference" of scienter under the Act. See, e.g., Comshare, 183 F.3d at 550; Bryant, 187 F.3d at 1283-84; Advanta, 180 F.3d at 535; Novak, 216 F.3d at 308, 311. But there is some confusion on the role of

motive and opportunity. Through clarification or reevaluation of the panel decision in Comshare, this Court can bring needed clarity to this area.

As discussed, see pp. 3-5, supra, this Court should make clear that Comshare, 183 F.3d at 549, 551, adopted a scienter pleading standard Act that is essentially the same as the Second Circuit standard. If Comshare did not, then this Court should depart from Comshare on this point because there is no justification for rejecting the Second Circuit standard under the Reform Act.

The Act's pleading standard rejects neither recklessness nor motive and opportunity as bases for pleading scienter. Rather, the Act adopts, or at least leaves it to the courts to adopt, the "motive and opportunity" and "strong circumstantial evidence" tests.

It may be presumed from the Act's "strong inference" language, absent contrary evidence, that Congress intended to adopt the judicial definition of the well-established Second Circuit pleading standard, including its two analytical tests. See Advanta, 180 F.3d at 534 ("Congress's use of the Second Circuit's language compels the conclusion that the Reform Act establishes a pleading standard approximately equal in stringency to that of the Second Circuit"); Novak,

216 F.3d at 310 (same); see generally Cottage Savings Ass'n v. Commissioner, 499 U.S. 554, 562 (1991); Lorillard v. Pons, 434 U.S. 575, 581 (1978). 5/

At a minimum, however, the Reform Act leaves it to the courts to decide whether to adopt those tests. As the body of precedent applying the Second Circuit standard shows, pleading strong circumstantial evidence of recklessness or pleading motive and opportunity is clearly consistent with pleading a "strong inference" of scienter, the Act's language.

Moreover, those tests are consistent with the Act's purposes. Adopting the Second Circuit's approach allowed Congress to assess the standard it was enacting and to satisfy itself that the standard properly balanced concerns about weeding out non-meritorious cases with leaving the courts open to investors who have been defrauded, establishing a basis for uniformity in pleading standards, and leaving workable guidance in place for litigants and the courts.

Congress sought to weed out meritless claims at an early stage, but also wanted meritorious claims to proceed. See Joint Explanatory Statement of the Committee of Conference ("Statement of Managers"), Conference Report on

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5/ As discussed in Argument III, the presumption that Congress intended to adopt the Second Circuit standard is supported, not overcome, by the legislative history.

Securities Litigation Reform, H.R. Conf. Rep. No. 104-369, at 31 (1995) ("1995 Conf. Rep."). Furthermore, Congress was concerned that "courts of appeals have interpreted Rule 9(b)'s requirement in conflicting ways, creating distinctly different pleading standards among the circuits," and sought to create a "uniform" national pleading standard, id. at 41, not "a new and untested pleading standard that would generate additional litigation," S. Rep. No. 104-98, at 15 (1995).

The Second Circuit's tests strike the right balance and provide a basis for uniformity. As explained in Press v. Chemical Inv. Servs. Corp., 166 F.3d 529, 538 (2d Cir. 1999), the Second Circuit "has resisted accepting general allegations of scienter" while declining "to create a nearly impossible pleading standard when the `intent' of a corporation is at issue." The motive and opportunity test applies where fraud is most likely to have occurred, such as where the misrepresentation was allegedly made to induce an investment, or where inflation of revenues is accompanied by unusual, large-scale insider trading. See Cohen v. Koenig, 25 F.3d 1168, 1174 (2d Cir. 1994); Rubinstein v. Collins, 20 F.3d 160, 169-70 (5th Cir. 1994). Thus, it allows the most credible claims of fraud to proceed.

At the same time, the Second Circuit tests are exacting. In 1995, pleading standards varied widely among the circuits. In the Ninth Circuit, scienter could be

pled "`simply by saying that [it] existed.'" In re Silicon Graphics Sec. Litig., 183 F.3d 970, 991 (9th Cir. 1999) (dissent). At the other extreme, the Second Circuit developed the "strong inference" standard and the two analytical tests. At the time of the Act, the Second Circuit standard was "the most stringent test as to how a plaintiff may plead scienter under § 10(b) or Rule 10b-5." Comshare, 183 F.3d at 549; accord, e.g., Advanta, 180 F.3d at 534; Silicon Graphics, 183 F.3d at 979.

Under this standard, conclusory allegations that defendants were attempting to inflate the stock price because they held shares in the company, to boost their compensation, to retain their positions, or to secure fees do not suffice. See, e.g., Acito v. IMCERA Group, Inc., 47 F.3d 47, 54 (2d Cir. 1995); Shields, 25 F.3d at 1130; Melder v. Morris, 27 F.3d 1097, 1102-03 (5th Cir. 1994). The plaintiff must plead a motive consistent with "informed economic self-interest" and an opportunity to "achiev[e] concrete benefits by the means alleged." Shields, 25 F.3d at 1130. Where motive is not apparent, "the strength of the circumstantial allegations must be correspondingly greater." Tuchman v. DSC Communications Corp., 14 F.3d 1061, 1068 (5th Cir. 1994) (citing Beck v. Manufacturers Hanover Trust Co., 820 F.2d 46, 50 (2d Cir. 1987)). See Phillips, 190 F.3d at 621-24 (stringently applying Second Circuit tests); In re Burlington Coat Factory Sec.

Litig., 114 F.3d 1410, 1423 n.12 (3d Cir. 1997) (same). The Second Circuit's tests for showing a "strong inference" of scienter are proven, sound, widely used, and consistent with the Act's language and purposes.

As noted, it is widely accepted among the courts that strong circumstantial evidence of recklessness suffices under the Reform Act. And it is now common ground among at least four circuits that motive and opportunity can also give rise to a "strong inference" of scienter under the Act.

Specifically, Comshare stated that facts regarding motive and opportunity "may, on occasion, rise to the level of creating a strong inference of reckless or knowing conduct." 183 F.3d at 550, 551. In Novak, 216 F.3d at 307, 310, the Second Circuit held that the Act "did not change the basic pleading standard for scienter in this circuit," and identified motive and opportunity pleading as among the "basic patterns in our case law." Accord Rothman, 2000 WL 959484, at *7.

In Advanta, 180 F.3d at 534-35, the Third Circuit held that "it remains sufficient [under the Act] for plaintiffs to plead scienter by alleging facts `establishing a motive and an opportunity to commit fraud, or by setting forth facts that constitute circumstantial evidence of either reckless or conscious behavior.'" And in Greebel, 194 F.3d at 197, the First Circuit rejected the "argument that facts

showing motive and opportunity can never be enough to permit the drawing of a strong inference of scienter," permitting "use of motive and opportunity type pleading if it raises a strong inference."

Consistent with pre-Act Second Circuit law, all of these cases made clear that general averrals of "motive and opportunity" are not sufficient. Comshare stated that plaintiffs may not "establish a `strong inference' of scienter merely by alleging facts demonstrating motive and opportunity where those facts do not simultaneously establish that the defendant acted recklessly or knowingly." 183 F.3d 551; accord Greebel, 194 F.3d at 197. 6/ Advanta rejected "blanket assertions" and "catch-all allegations" of motive and opportunity, and noted that the Reform Act makes clear that plaintiffs must state facts constituting a strong inference of scienter "with particularity." 180 F.3d at 535.

Similarly, Novak warned that merely reciting "magic words such as `motive and opportunity'" is insufficient, and "described the type of motive and opportunity

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6/ This does not mean that the Act's pleading standard is, as defendants contend, higher than any previously in existence. The Second Circuit developed the motive and opportunity test as a means of determining whether a "strong inference" of recklessness or conscious misbehavior had been pled. A plaintiff could not plead the one without the other, unless the test were misapplied. That it might be misapplied in an individual case, see Bryant, 187 F.3d at 1286, however, does not mean that the test is unsound.

required to plead scienter," namely, that the defendant "benefitted in a concrete and personal way" from the fraud. 216 F.3d at 307-08, 311 (citing Acito, 47 F.3d at 52 and Shields, 25 F.3d at 1130). The Novak court described this position as a "middle ground," one that was neither "wedded" to generalized motive and opportunity "concepts" nor one that "rejected" motive and opportunity pleading. Id. at 309-10; accord Rothman, 2000 WL 959484, at *7 (requiring "an allegation of facts showing the type of particular circumstances that our case law has recognized will render motive and opportunity probative of a strong inference of scienter").

In fact, it is unclear whether any appellate court has adopted defendants' untenable position that, as a matter of law, allegations of motive and opportunity -- no matter how strong and fact-specific -- can never, in themselves, give rise to a "strong inference" of scienter. In Bryant, 187 F.3d at 1287, an Eleventh Circuit panel majority stated "that a showing of mere motive and opportunity is insufficient to plead scienter" under the Reform Act. But the majority appeared to be referring to generic allegations that would be insufficient under the Second Circuit standard: "`Greed is a ubiquitous motive, and corporate insiders and upper management always have opportunity to lie and manipulate.'" Id. at 1286. And the majority acknowledged, id., that "`[m]otive and opportunity will ordinarily be

relevant, and often highly relevant,'" and noted, id. at 1283, that it was "in basic agreement with" Comshare, which stated that motive and opportunity can suffice.

Similarly, although a Ninth Circuit panel majority stated that the Reform Act "raise[d] the pleading standard above that in the Second Circuit," it misdescribed the Second Circuit standard on both recklessness and motive and opportunity. Silicon Graphics, 183 F.3d at 979 (asserting, without analysis or support, that Second Circuit standard is based on "simple recklessness" and allows plaintiffs to "aver intent in general terms of mere `motive and opportunity'"). 7/ Moreover, elsewhere in the opinion, the majority indicated that stock trading by company insiders – traditional motive and opportunity evidence – could "create [the] strong inference" the Act requires if it were "dramatically out of line with prior trading practices or otherwise suspicious enough." Id. at 987.

To the extent that any of the foregoing cases purport to limit motive and opportunity pleading any more than it was already limited under the Second Circuit

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7/ The Second Circuit, like other courts, uses the Sundstrand definition of recklessness. See Novak, 216 F.3d at 308 (citing Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 46-47 (2d Cir. 1978)). And, as discussed, it does not permit general averrals of "motive and opportunity."

standard, the cases contain no convincing rationale for doing so. This Court should clarify that Comshare is not one of these cases, and, if it is, depart from Comshare.

As discussed above, the statutory language supports adoption of the Second Circuit standard. With respect to liability as opposed to pleading, the Comshare court did properly "assume that Congress was aware of the `contemporary legal context' surrounding the state of mind requirement for § 10(b) and Rule 10b-5 liability and, by its silence, left it undisturbed in the [Reform Act]." 183 F.3d at 550 (quoting Cottage Savings, 499 U.S. at 561-62). But it failed to apply the same principle to the statute's "strong inference" pleading language, which had a well-developed meaning in the case law that included the motive and opportunity and strong circumstantial evidence tests.

Simply because motive and opportunity is not "scienter itself," and is not referenced in the statute's "required state of mind" language, Comshare, 183 F.3d at 551, does not mean that it is not a sound basis for pleading a "strong inference" of scienter and is not referenced by the "strong inference" language. Moreover, nothing in the Act indicates any departure from the Second Circuit standard.

The argument that Congress could have expressly included "motive and opportunity" and "strong circumstantial evidence" language in the statute, see

Silicon Graphics, 183 F.3d at 978, ignores "the fact that Congress considered" doing precisely that. Advanta, 180 F.3d at 534 n.8. But doing so presented the problem of capturing, to everyone's satisfaction, the terms of a nuanced, well-developed body of case law in a single formulation of statutory language. Inclusion of unqualified "motive and opportunity" and "strong circumstantial evidence" language in the statute could have weakened the true Second Circuit standard and required time-consuming and contentious continuing refinement of the statutory language. See pp. 27-32, infra.

It does not appear that Comshare relied for its analysis of the scienter pleading issue on legislative history. See 183 F.3d at 549-51 (adopting "a plain interpretation" of the Act). The opinion does state in passing, however, that certain "indicia of legislative purpose support the notion that courts are not to interpret the [Act] as having adopted the Second Circuit pleading standard." Id. at 552.

Far closer to the mark is the statement elsewhere in Comshare that the legislative history is at best ambiguous. Id. at 552 n.10. Three other circuits have expressly so determined, see Advanta, 180 F.3d at 533; Greebel, 194 F.3d at 192, 195; Novak, 216 F.3d at 310-11, and the Eleventh Circuit did not even see fit to mention the history in Bryant. Only Silicon Graphics relied on it in interpreting the

Act. As discussed below, the legislative history supports adoption of the Second Circuit standard.

III. THE LEGISLATIVE HISTORY CONFIRMS THAT THE REFORM ACT DOES NOT REJECT RECKLESSNESS OR MOTIVE AND OPPORTUNITY.

The "indicia of legislative purpose" cited in Comshare, 183 F.3d at 552, are not a valid basis for rejecting the Second Circuit standard under the Reform Act. Authoritative legislative history of the Act confirms the import of the Act's language: recklessness and motive and opportunity are sufficient to show scienter.

The Reform Act's "strong inference" language originated in S. 240, known as the Domenici-Dodd bill, a precursor to the final bill. As reported by the Senate Banking Committee, S. 240 mandated that the complaint "specifically allege facts giving rise to a strong inference that the defendant acted with the required state of mind." The report accompanying S. 240 explained:

> The Committee does not adopt a new and untested pleading standard that would generate additional litigation. Instead, the Committee chose a uniform standard modeled upon the pleading standard of the Second Circuit.

S. Rep. No. 104-98 at 15 (1995).

Senator Specter attempted to make this reliance on the Second Circuit standard even more explicit by offering a floor amendment that proposed to add certain language to the bill's pleading standard:

> a strong inference that the defendant acted with the required state of mind may be established either --
> (A) by alleging facts to show that the defendant had both motive and opportunity to commit fraud; or
> (B) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness by the defendant.

141 Cong. Rec. S9,222 (1995).

The Senate adopted the Specter amendment, id. at S9,200, but the Conference Committee omitted it, returning the pleading provision to the one that was reported out of the Senate Banking Committee. The Conference Committee also amended the provision from "specifically allege" to "plead with particularity" based on the Judicial Conference's recommendation to conform it to the language of Federal Rule of Civil Procedure 9(b). Id. at S19,066-67.

In the subsequent floor debate, Senator Domenici, one of the Conference Committee Managers, stated that "the conference report adopts the pleading standard utilized by the second circuit court of appeals." 141 Cong. Rec. S17,969 (1995). Senator Dodd, another manager, agreed that the Conference Committee

had "adopt[ed] the Second Circuit Court of Appeals standard," id. at S17,959, as did Senate managers D'Amato and Grams, see id. at S17,934, S17,993.

Notwithstanding these statements by the bill's managers of their intent to adhere to the Second Circuit standard, the President, who supported that standard, vetoed the bill. In his view, certain language in the bill's Statement of Managers and the deletion of the Specter amendment suggested an intent to depart from that standard. Id. at H15,214. 8/

8/ In relevant part, the Statement of Managers stated:

> The Conference Committee language is based in part on the pleading standard of the Second Circuit. The standard also is specifically written to conform the language to Rule 9(b)'s notion of pleading with "particularity."
>
> Regarded as the most stringent pleading standard, the Second Circuit requirement is that the plaintiff state facts with particularity, and that these facts, in turn, must give rise to a "strong inference" of the defendant's fraudulent intent. Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard.

1995 Conf. Rep. at 41. Footnote 23 then stated:

> For this reason, the Conference Report chose not to include in the pleading standard certain language relating

(continued...)

In the post-veto floor debate, Congress rejected the President's arguments. Senator Dodd stated that the President had "reversed course on the pleading standards," which were substantively identical to S. 240's provision before addition of the Specter amendment and which the President had previously endorsed. 141 Cong. Rec. S19,067 (1995). Senator Dodd reported that the Conference Committee had omitted the amendment because it "did not really follow the guidance of the second circuit." Id. at S19,068. He explained that the amendment "omits that where a motive is not apparent, the strength of circumstantial allegations must be correspondingly greater." Id. He stated that the pleading provision, contrary to the President's view, "met [the Second Circuit] standard. We have left out the guidance. That does not mean you disregard it." Id.

Senator Domenici reiterated that the bill's pleading standard "is the Second Circuit's pleading standard" and was a "codification of the Second Circuit rule." Id. at S19,150. He noted that the President's reliance on the language from the Statement of Managers was misplaced because "[a] statement of managers is not law, everyone knows that." Id. at S19,045. Representative Tauzin, another

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8/ (...continued)
to motive, opportunity, or recklessness.

manager, also faulted the President for addressing "[n]ot the bill, [but] the statement of the managers." Id. at H15,214; accord id. at H15,217. Representative Eshoo, another manager, agreed, and stressed that the bill's proponents had "worked to satisfy the concerns [of the Commission and others] * * * on pleading and second circuit language." Id.

These floor statements by the bill's managers, which are consistent with those made by other members of Congress during the debates on the bill, 9/ are highly persuasive evidence of Congress' intent. See NLRB v. Robbins Tire & Rubber Co., 437 U.S. 214, 235 (1978) (rejecting interpretation in veto message where bill's supporters disagreed with it during post-veto debate). 10/ They are reinforced, moreover, by the legislative history of the related Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227. 11/

9/ See, e.g., 141 Cong. Rec. S17,983 (Sen. Dole), S17,966 (Sen. Hatch), S17,984 (Sen. Moseley-Braun), H15,218 (Rep. Moran), H15,219 (Rep. Lofgren), H15,220 (Rep. Deutsch), S19,084 (Sen. Reid), S19,149 (Sen. Bradley) (1995). We know of no statement in the debates by any proponent of the legislation that it rejected the Second Circuit standard.

10/ Accord, e.g., National Endowment for the Arts v. Finley, 524 U.S. 569, 581-82 (1998); Green v. Bock Laundry Machine Co., 490 U.S. 504, 522, 523 (1989); Red Ball Motor Freight, Inc. v. Shannon, 377 U.S. 311, 318 (1964).

11/ See Schlagel v. Learning Tree Int'l, No. CV 98-6384 ABC(Ex), 1998 U.S. (continued...)

Defendants' entire argument against recklessness and motive and opportunity essentially depends on an at best ambiguous sentence and footnote in the Reform Act Statement of Managers. Read with a sentence in the text, the footnote states that because the Conference Committee "intends to strengthen existing pleading standards" and "does not intend to codify the Second Circuit's case law interpreting this pleading standard," it "chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness." 1995 Conf. Rep. at 41 & 48 n.23. The text also states that the pleading standard "is based in part on the pleading standard of the Second Circuit." Id. at 41.

Much of this can be explained by Senator Dodd's statement that "we are trying to hold to that [standard that] came out of the second circuit, not on a case-by-case basis where they differed in some degree in interpretation." 141 Cong. Rec. S17,960 (1995); accord, e.g., id. at S19,149 (1995) (Sen. Bradley). The Conference Committee did not intend to codify each and every word of the Second

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11/ (...continued)
Dist. LEXIS 20306, at *43-48 (C.D. Cal. Dec. 29, 1998); David M. Levine & Adam C. Pritchard, The Securities Litigation Uniform Standards Act: The Sun Sets on California's Blue Sky Laws, 54 Bus. Law. 1, 32-38 (1998); see generally Almendarez-Torres v. United States, 523 U.S. 224, 237 (1998).

Circuit's case law because of the view that some cases did not apply the Circuit's pleading standard in a sufficiently stringent manner. This does not mean that Congress rejected the standard. 12/

Similarly, the Conference Committee "chose not to include certain language" in the bill because of a number of potential problems with that language. The footnote does not refer to "recklessness" in general but to "certain language relating to * * * recklessness." Nor does the footnote state that the Committee discarded the motive and opportunity test, but merely that it omitted "certain language relating to motive [and] opportunity." This is a shorthand description of the Specter amendment, which also included "conscious misbehavior" but was deleted in its entirety. 13/ Certain problems with the amendment readily explain its

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12/ The "based in part" sentence is further explained by the fact that the scienter pleading requirement is only part of the Reform Act's pleading standard. The Statement of Managers describes the bill's "pleading standard" as including not only the scienter pleading requirement (§ 78u-4(b)(2)), which adopts the Second Circuit's distinctive "strong inference" language, but other particularity requirements (§ 78u-4(b)(1)). Indeed, the sentence after the "based in part" sentence states, "The [pleading] standard also is specifically written to conform the language to Rule 9(b)'s notion of pleading with particularity."

13/ That Congress did not use the word "recklessness" in the pleading standard cannot mean that it intended to eliminate pleading of recklessness. Congress (continued...)

rejection, without assuming an intent to overturn the well-established propositions that recklessness and motive and opportunity are bases for showing scienter. 14/

First, the amendment was thought to inaccurately codify the Second Circuit's "strong circumstantial evidence" test. As Senator Dodd explained during the floor debate, the amendment "omits that where a motive is not apparent, the strength of circumstantial evidence must be correspondingly greater." 141 Cong. Rec. S19,068 (1995). Although Senator Specter seemed to believe that the amendment's general reference to "strong circumstantial evidence" was sufficient, Senator Dodd reported the Conference Committee's view that the amendment did not properly state that legal test. See 141 Cong. Rec. S17,960 (1995).

Congress thus believed that it was important to retain the greater burden that Second Circuit decisions impose on plaintiffs who cannot adequately allege

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13/ (...continued)
also declined to include "conscious misbehavior" in the standard, but no one would suggest that conscious misbehavior no longer suffices for pleading scienter under the Reform Act.

14/ See Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 187 (1994) (failed proposals are "'a particularly dangerous ground'" for statutory interpretation because "'several equally tenable inferences may be drawn from [Congressional] inaction, including the inference that the existing legislation already incorporated the offered change'").

motive. By failing to reflect that higher burden, the amendment could have opened the door for claims of fraud based purely on hindsight, weakening significantly the Second Circuit standard. Thus, by omitting the amendment, Congress preserved the true Second Circuit standard, "the most stringent pleading standard," and "strengthened existing pleading requirements" by raising all circuits to that level.

Second, the omission of the "language relating to motive [and] opportunity" is explained by the Conference Committee's apparent belief that the codification offered by Senator Specter would have watered down the Second Circuit standard, and thus, that the more general formulation adopted in the Reform Act would provide a more effective barrier for screening out non-meritorious lawsuits.

Under the Specter amendment's unqualified "motive and opportunity" language, any speculative allegation of motive and opportunity conceivably could suffice to plead scienter, a result that would weaken the pleading standard in those circuits that previously had adopted a demanding test. This was a real concern because Congress knew that even within the generally stringent Second Circuit, cases "differed in some degree in interpretation," 141 Cong. Rec. S17,960 (1995) (Sen. Dodd). There were cases that did not appear to apply a demanding motive and opportunity test. See Advanta, 180 F.3d at 534; In re Time Warner Sec. Litig.,

9 F.3d 259, 274 (2d Cir. 1993) (dissent argues that majority allowed test to be satisfied where concrete benefits unlikely).

Weakening the requirements of those cases that applied a demanding test (see pp. 14-15, supra) would not have served Congress's goals in adopting the pleading standard. Thus, by omitting the Specter amendment, Congress established as the general federal standard a motive and opportunity test applied in a sufficiently rigorous manner that it truly constitutes a "strong inference" of scienter.

Third, the amendment failed to reflect that recklessness was no longer sufficient for liability under certain circumstances. The Reform Act did not eliminate recklessness liability generally under Section 10(b) and Rule 10b-5, but it did do so in cases based on forward-looking statements. A recklessness pleading standard that would apply in all cases would be inconsistent with the forward-looking statements provision, which requires actual knowledge in certain cases.

Finally, the Specter amendment's statement of the strong circumstantial evidence test, which explicitly incorporated recklessness as a pleading standard, could have been read as independently establishing recklessness as a liability standard. Although all courts of appeals to address the issue have concluded that recklessness liability exists under Section 10(b), the Supreme Court has not yet

decided that issue. Congress appears to have preferred to leave it to final resolution by the Supreme Court.

CONCLUSION

For the foregoing reasons, the Commission urges the Court to hold that recklessness remains a basis for liability under Section 10(b) and Rule 10b-5 and that a private plaintiff can plead scienter under the Reform Act by alleging either that the defendant had a motive and an opportunity to commit the fraud or by alleging strong circumstantial evidence of conscious misbehavior or recklessness.

Respectfully submitted,

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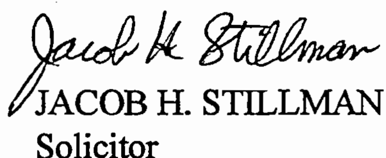

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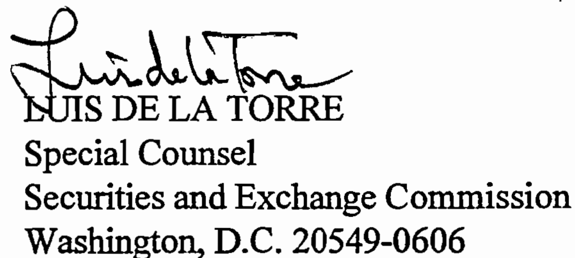

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August 2000

CERTIFICATE OF COMPLIANCE

Pursuant to Fed. R. App. P. 32(a)(7)(C) and 6th Cir. R. 32(a), the undersigned certifies that this Brief of the Securities and Exchange Commission, Amicus Curiae, complies with the type-volume limitations of Fed. R. App. P. 32(a)(7)(B).

1. Exclusive of the exempted portions in Fed. R. App. P. 32(a)(7)(B)(iii) and 6th Cir. R. 28(b), the brief contains 6,997 words of text according to the word processing system used in preparing it.

2. The brief has been prepared in proportionally spaced typeface using WordPerfect 8.0 in Times New Roman font, 14-point type.

3. If the Court so requests, the undersigned will provide an electronic version of the brief and/or a copy of the word or line printout.

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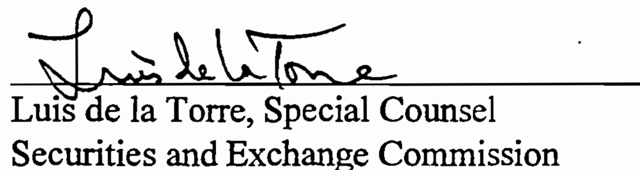

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CERTIFICATE OF SERVICE

I hereby certify that on this 17th day of August 2000, I caused to be served by Federal Express overnight delivery service the original and 26 copies of the Brief of the Securities and Exchange Commission as Amicus Curiae on Rehearing En Banc, on the Clerk of Court and 2 copies on each of the following counsel:

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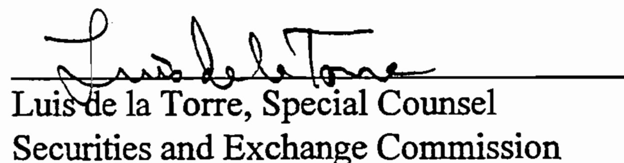

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