S020465

IN THE SUPREME COURT OF

THE STATE OF CALIFORNIA

GERALD D. MIRKIN, et al.,

Plaintiffs and Petitioners,

v.

FRED W. WASSERMAN, et al.,

Defendants and Respondents.

2d Civil No. B048705
Superior Ct. No. CA001122
County Of Los Angeles
The Honorable Barnet M. Cooperman, Judge

AMICUS CURIAE BRIEF OF THE AMERICAN CORPORATE COUNSEL ASSOCIATION IN SUPPORT OF DEFENDANTS/RESPONDENTS

PETER D. ZEUGHAUSER
Vice President and General Counsel
The Irvine Company
550 Newport Center Drive
Newport Beach, CA 92660
(714) 720-2286

Attorney for *Amicus Curiae*
American Corporate Counsel Association

TABLE OF AUTHORITIES

Cases — Page

Blackie v. Barrack,
524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976) 14

Bowden v. Robinson,
67 Cal. App. 3d 705, 136 Cal. Rptr. 871 (1977) 2, 5, 10, 12

Blue Chip Stamps v. Manor Drug Stores,
421 U.S. 723 (1975) 17

Committee on Children's Television, Inc. v. General Foods Corp.,
35 Cal. 3d 197, 197 Cal. Rptr. 783 (1983) 19

Fine v. American Solar King Corp.,
919 F.2d 290 (5th Cir. 1990), *petition for cert. filed*,
59 U.S.L.W. 3615 (Mar. 12, 1991) (No. 90-1372) 14

Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilberston,
111 S. Ct. 2773 (1991) 11

Schneider v. Howard,
183 Cal. App. 3d 1340, 228 Cal. Rptr. 800 (1986) 10

TSC Indus., Inc. v. Northway, Inc.,
426 U.S. 438 (1976) 17

Vasquez v. Superior Court,
4 Cal. 3d 800, 94 Cal. Rptr. 796 (1971) 18, 20

Statutes and Regulations

California Corporations Code
Section 25400 .... passim
Section 25401 .... 7, 12, 13
Section 25402 7
Section 25500 .... passim
Section 25501 .... 7, 10, 13
Section 25502 7
Section 25506 10
Section 25510 .... 3, 6, 12, 13
Section 25530 9

California Civil Code
Section 1709 9
Section 1710 9

Page

Section 3294 10
Section 3343 10

California Code of Civil Procedure
Section 338 10

Securities Exchange Act of 1934
Section 10(b), 15 U.S.C. § 78j(b) 11
Rule 10b-5, 17 C.F.R. § 240.10b-5 .... 6, 9, 12, 13
Item 303 of Regulation S-K, 17 C.F.R. § 229.303 18

Miscellaneous

Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497 (1991) 14, 15, 16

Black, *Fraud on the Market: A Criticism of Dispensing With Reliance Requirements in Certain Open Market Transactions*, 62 N.C.L. Rev. 435 (1984) 9

Coffee, *The Unfaithful Champion: The Plaintiff As Monitor In Shareholder Litigation*, 48 Law & Contemp. Probs. 5 (Summer 1985) 14, 15

Jones, *An Empirical Examination of the Resolution of Shareholder Derivative Suits and Class Action Lawsuits*, 60 B.U.L. Rev. 542 (1980) 15

Kennedy, *Securities Class and Derivative Actions in the United States District Court for the Northern District of Texas: An Empirical Study*, 14 Hous. L. Rev. 769 (1977) 15, 16

H. Marsh & R. Volk, *Practice Under the California Corporate Securities Law of 1968* (1969) .... passim

O'Brien, *The Class-Action Shakedown Racket*, Wall St. J., Sept. 10, 1991, at A20 16

Olson, *The California Corporate Securities Law of 1968*, 9 Santa Clara Law. 75 (1968) 6, 7

23 Sec. Reg. & L. Rep. 669 (BNA) (May 3, 1991) 20

23 Sec. Reg. & L. Rep. 167 (BNA) (Feb. 8, 1991) 20

22 Sec. Reg. & L. Rep. 156 (BNA) (Feb. 2, 1990) 20

21 Sec. Reg. & L. Rep. 512 (BNA) (April 7, 1989) 21

Page

20 Sec. Reg. & L. Rep. 9 (BNA) (Jan. 8, 1988) 20

Tucker, *Shakedown?*, Forbes, Aug. 19, 1991, at 98 9

S020465

IN THE SUPREME COURT OF

THE STATE OF CALIFORNIA

GERALD D. MIRKIN, et al.,

Plaintiffs and Petitioners,

v.

FRED W. WASSERMAN, et al.,

Defendants and Respondents.

2d Civil No. B048705
Superior Ct. No. CA001122
County Of Los Angeles
The Honorable Barnet M. Cooperman, Judge

AMICUS CURIAE BRIEF OF
THE AMERICAN CORPORATE COUNSEL ASSOCIATION
IN SUPPORT OF DEFENDANTS/RESPONDENTS

I.

INTEREST OF *AMICUS CURIAE*

Pursuant to Rule 14(b) of the California Rules of Court, the American Corporate Counsel Association ("ACCA") respectfully submits this brief of *amicus curiae* in support of the defendants/respondents. ACCA is a national bar association, with 35 local chapters across the country, that is devoted exclusively

to the professional activities of attorneys on the legal staffs of corporations and other business entities in the private sector. ACCA has approximately 8000 members employed as corporate counsel by some 3700 organizations. Approximately 900 of its members are employed in the State of California. Many members of ACCA are the chief legal officers of their client corporations. As the primary providers of legal advice to their corporate employers, members of ACCA typically are responsible for formulating their companies' disclosure policy and for advising management on pending litigation. They are therefore intimately familiar with the issues raised by this case.

Although not parties to these proceedings, the many public companies represented by ACCA members, particularly those doing business in the State of California, have vital interests that stand to be significantly affected by the Court's decision in this case. ACCA appreciates this opportunity to submit its views to the Court.

II.

SUMMARY OF ARGUMENT

When the California Legislature enacted the Corporate Securities Law of 1968, it expanded on the remedies available at common law for securities disclosure violations by specifically providing a remedy for any "person who purchases or sells any security at a price which was affected by" a material misrepresentation. Cal. Corp. Code §§ 25500, 25400(d). The Legislature did not require that a plaintiff actually have relied on the alleged misrepresentation to recover damages. *See Bowden v. Robinson*, 67 Cal. App. 3d 705, 714, 136 Cal. Rptr. 871 (1977). To balance this substantial benefit for plaintiffs, however, the Legislature limited the scope of the remedy in several other crucial respects. For example, the statutory cause of action imposes liability only on specified market

participants, requires scienter, limits damages, and adopts a shorter statute of limitations than for common law fraud. In addition, the Legislature explicitly limited the authority of the judiciary to expand upon the express remedy it had created by providing that "[e]xcept as explicitly provided in this chapter, no civil liability in favor of any private party shall arise against any person by implication from or as a result of the violation of any provision of this law * * *." Cal. Corp. Code § 25510.

Unsatisfied with the statutory remedy, Petitioners have requested this Court to ignore the clear mandate of the Legislature and to create another California remedy for plaintiffs who purchase or sell a security at a price affected by an alleged misrepresentation. By engrafting the federal fraud-on-the-market theory onto an action for common law fraud, the resulting new cause of action would substantially reduce the pleading requirements of plaintiffs and dramatically shift the dynamics of securities disclosure class actions in favor of plaintiffs. The shift would occur long before the litigation process has even begun to determine whether plaintiffs' allegations have any merit, and, unlike the Legislature's cause of action, the new remedy would not include any corresponding limitations to protect against abuses. As evidenced by recent studies of federal securities class actions, Petitioners' requested cause of action would further divorce the merits of plaintiffs' claims from the results in securities disclosure class actions and thereby go far toward creating a system of investor insurance in California that would be incredibly expensive and inefficient. California's public companies would be the primary victims of the ill-advised public policy advocated by Petitioners.

Ironically, while Petitioners justify their request for a new cause of action by asserting that protecting the public from fraud in securities transactions is "the public policy of this State" (Petitioners' Brief at 3), they have not made one

reference in their brief to the Corporate Securities Law of 1968, the direct legislative statement of policy on securities remedies. Petitioners therefore would have this Court ignore other important public policies, such as fundamental fairness to litigants and promotion of an efficient economic environment, that were considered by the drafters of the Corporate Securities Law. Creating a new cause of action that will punish fraud is a simple task as long as one is unconcerned about also punishing any innocent parties that happen to fall within its net. Responsible law-making, however, demands much more; it demands that the interests of all affected parties be considered and that all of the often competing policy considerations involved with creating new civil liabilities be recognized and balanced.

The only empirical evidence that Petitioners have offered this Court to support their contention that a new remedy is needed for securities violations is an anecdotal reference to a high-profile fraud (Petitioners' Brief at 12), remedies for which are being pursued under existing law in pending proceedings, and outdated newspaper articles on the budget of the U.S. Securities and Exchange Commission. Petitioners' Brief at 11 n.9. Clearly, the major change in public policy sought by Petitioners demands more serious inquiry. The extent to which there is merit, if any, in Petitioners' arguments can be adequately evaluated only through the legislative process, which provides an opportunity for a full and fair presentation of views and for reconciliation of competing interests.

This Court should reject Petitioners' request for an uninformed and ill-advised change in the public policy established by the Legislature when it last considered the issues raised by this case. The judgment of the Court of Appeal should be affirmed.

III.

ARGUMENT

A. Petitioners' Attempt To Engraft The Federal Fraud-On-The-Market Theory Onto An Action For Common Law Fraud Directly Contradicts The Will Of The California Legislature As Expressed In the Corporate Securities Law Of 1968.

One of the purposes of the California Legislature in enacting the Corporate Securities Law of 1968 was to provide new and liberalized remedies for the victims of corporate disclosure violations. *Bowden*, 67 Cal. App. 3d at 714-15. In furtherance of this goal, the Legislature specifically provided a remedy for an investor "who purchases or sells any security at a price which was affected by" a material misrepresentation. Cal. Corp. Code §§ 25400(d), 25500.[1] That remedy does not require the investor to prove actual reliance. *Bowden*, Cal. App. 3d at 714 ("Section 25400, subdivision (d), and 25500 establish a statutory cause of action for fraud, however, conspicuously avoiding the requirement of 'actual reliance.'"). Petitioners obviously are dissatisfied with the Legislature's work and have

---

[1]Section 25400(d) provides as follows:

> It is unlawful for any person, directly or indirectly, in this state: If 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 statement 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.

Section 25500 provides as follows:

> Any person who willfully participates in any act or transaction in violation of Section 25400 shall be liable to any other person who purchases or sells any security at a price which was affected by such act or transaction for the damages sustained by the latter as a result of such act or transaction. Such damages shall be the difference between the price at which such other person purchased or sold securities and the market value which such securities would have had at the time of his purchase or sale in the absence of such act or transaction, plus interest at the legal rate.

requested this Court to create another remedy for purchasers of stock at a price affected by a material misrepresentation that also does not require such purchasers actually to have relied on the misrepresentation. Petitioners' requested remedy, however, would not include a number of important limitations that the Legislature thought necessary to place on the scope of the statutory remedy. *See* pages 8-11, *infra*.

Because the drafters of the Corporate Securities Law were concerned about just this type of attempt to incorporate federal Rule 10b-5 theories into a common law fraud action, *see* pages 11-13, *infra*, the Legislature explicitly limited the authority of the judiciary to expand upon the remedies for securities violations contained in the Corporate Securities Law. Cal. Corp. Code § 25510. Petitioners' request therefore directly contradicts the will of the Legislature and should be unequivocably rejected by this Court.

1. Petitioners Have Requested A New Remedy For Securities Disclosure Violations That Would Dwarf Remedies Provided By The Corporate Securities Law Of 1968 And Override Significant Policy Determinations Made By The Legislature.

In 1967, after several unsuccessful attempts to enact the Uniform Securities Act to replace an outdated corporate securities statute, the California Commissioner of Corporations, Robert H. Volk, appointed a committee to study the issue and to draft legislation specifically designed for the State of California. *See generally* H. Marsh & R. Volk, *Practice Under the California Corporate Securities Law of 1968* 32 (1969) ("Marsh & Volk");[2] Olson, *The California*

[2]Robert H. Volk was Commissioner of Corporations during the consideration and enactment of the Corporate Securities Law of 1968 and was its primary sponsor. Professor Harold Marsh, Jr. was head of a committee appointed by Volk to develop the new statute and was its chief drafter. The purpose of the treatise was to prevent the legislative history of the law and the intent of its drafters from being "lost completely or at best left to vague and hazy recollection," and the treatise's discussion of these topics was endorsed by the Commissioner of Corporations at the time of its publication. *See* Marsh & Volk at i-ii (Introduction by Anthony R. Pierno, Commissioner of Corporations, State of California). As evidenced by Petitioners' request in this case, the fear that the purpose of the statute would be lost over time was well justified.

Corporate Securities Law of 1968, 9 Santa Clara Law. 75, 75-76 (1968). The scheme of civil liability enacted in the Corporate Securities Law (other than liability for qualification-related violations not relevant to this case) is made up of three pairs of statutory provisions:

(1) Sections 25400 and 25500 address misrepresentations and acts that are intended to affect the market price for a security;

(2) Sections 25401 and 25501 address misrepresentations in connection with a specific purchase or sale of a security; and

(3) Sections 25402 and 25502 address insider trading violations.

For each pair, the first section specifies the unlawful acts and the second section specifies the remedy for such acts.

In creating this comprehensive scheme of civil liability for securities violations, the drafters were informed by more than thirty years of experience under the federal securities laws. Their goal was "to provide a scheme of liability in the light of this experience which will adequately protect the investing public without undue hardship upon persons who might be potential defendants in such actions. It also establishes rules that are not so extreme as to impede legitimate business transactions." Marsh & Volk at 444. Significantly, the drafters clearly understood the policies underlying the fraud-on-the-market theory advocated by Petitioners, and they decided to accept them -- by dispensing with actual reliance as an element of the cause of action -- only in carefully limited circumstances. In describing the remedy created by the Legislature in Sections 25400(d) and 25500, the drafters made plain their understanding of the fraud-on-the-market theory (including its elimination of reliance as an element of the cause of action) as follows:

> There is no requirement under these sections that the plaintiff have relied upon the statements or acts of the defendant or even that he be

> aware that the defendant made them or engaged in them. All that is required is that the plaintiff establish that the price which he paid or received was affected by the defendant's conduct or statements, which would of course assume that someone acted on the basis of the defendant's wrongful conduct. However, it is not necessary that the plaintiff prove that he personally was influenced by such conduct.

Marsh & Volk at 478.

At the same time that the Legislature provided a remedy in Sections 25400(d) and 25500 specifically for persons who purchase or sell a security at a price "affected" by a material misrepresentation, however, the Legislature also carefully limited the scope of that remedy by restricting the class of potential defendants to market participants, requiring scienter, limiting damages, and imposing a shorter statute of limitations than the one applicable to common law fraud actions. Only in these narrowly-tailored circumstances did the Legislature believe that actual reliance should be eliminated as an element of the cause of action.

Petitioners are dissatisfied with this statutory remedy, however, and have requested this Court to create an entirely new remedy that would circumvent the limitations adopted by the Legislature. The new remedy would be so favorable to securities plaintiffs that California likely would become the forum of first resort for nationwide securities litigation. A comparison of the differences between the Legislature's remedy and Petitioners' requested remedy graphically demonstrates the extent to which Petitioners would have this Court override significant policy decisions of the Legislature by expanding the scope of the statutory remedy.

An extremely important limitation adopted by the Legislature was restricting liability to broker-dealers and other persons who are participating in the market for a security and who would therefore stand to benefit from an alleged violation. Cal. Corp. Code § 25400(d). Under Petitioners' proposed cause of action,

a company could be repeatedly sued for its periodic disclosures, even though it was not conducting an offering or otherwise benefitting from the alleged misconduct. As the drafters noted, the unlimited liability that would be imposed in these circumstances simply penalizes other innocent shareholders of the company, even though they received no benefit from the alleged misconduct. Marsh & Volk at 477.[3]

Petitioners have studiously avoided telling this Court whether or not they are requesting that the fraud-on-the-market theory apply to an action for negligent misrepresentation.[4] They therefore may have abandoned this element of their case, which was advanced before the Court of Appeal. *See* Opinion at 4. If not, however, the requirement of willfulness in Section 25500 was specifically intended to foreclose actions for damages based on negligent misrepresentation, although negligent misrepresentation would provide a basis for an injunctive action by the Commissioner of Corporations under Section 25530 of the Corporate Securities Law. *See* Marsh & Volk at 476; Olson, 9 Santa Clara Law. at 99. Assuming Petitioners' request encompasses negligent misrepresentations, the resulting cause of action would be a dramatic expansion of the remedies provided by both Section 25500 and federal Rule 10b-5. One could only imagine the extent to which securities litigation plaintiffs would be attracted to the California courts.

---

[3]The drafters' concerns about the potential for a fraud-on-the-market type of theory to generate repeated lawsuits and indeterminate liability appears to have been well founded. *See* Tucker, *Shakedown?*, Forbes, Aug. 19, 1991 at 98 (reporting repeated securities class actions filed against high technology firms with volatile earnings); Black, *Fraud on the Market: A Criticism of Dispensing With Reliance Requirements in Certain Open Market Transactions*, 62 N. Car. L. Rev. 435, 460 (1984) ("There can be little doubt that, in fraud on the market cases, computation of damages can be an incredibly complex process, with no greater assurance of reasonable accuracy. This, coupled with the fact that virtually all these cases are settled before a determination of liability, lends support to the argument that securities fraud litigations result in haphazard, arbitrary, and potentially ruinous recoveries.") (footnote omitted).

[4]The word "negligent" does not appear in Petitioners' brief, but they have requested a ruling under Sections 1709 and 1710 of the California Civil Code, and paragraph (2) of Section 1710 encompasses negligent misrepresentations.

Another important distinction would be the much greater damages recoverable under the remedy requested by Petitioners than under the remedy provided by the Legislature. The Legislature specifically limited a plaintiff's recovery under Section 25500 to the difference in market price attributable solely to the wrongful act. This is in sharp distinction to the damages available under Section 25501 only against persons in privity with a defrauded purchaser or seller, which include rescission or its equivalent in damages. Even this measure of damages pales, however, in comparison to the remedy requested by Petitioners. In an action for common law fraud, plaintiffs are permitted to seek not only all damages attributable to the transaction, including out-of-pocket and consequential damages, but also punitive damages. *See* Cal. Civ. Code. §§ 3294, 3343; *Schneider v. Howard*, 183 Cal. App. 3d 1340, 1348-49, 228 Cal. Rptr. 800 (1986). Again, one can only imagine the attraction this would provide to securities litigation plaintiffs.

Finally, the Legislature was particularly concerned about the opportunity for speculative behavior created by the expanded remedies in the Corporate Securities Law and imposed shorter limitations periods to address this problem. Section 25506 of the Corporate Securities Law requires plaintiffs to file their suits within one year of discovery of a violation, but in no event more than four years after the violation. In contrast, the limitations period for a common law fraud action is three years from discovery of the violation. Cal. Code Civ. Proc. § 338(d). *See Bowden*, 67 Cal. App. 3d at 714-15 ("Recognizing that dispensing with the 'actual reliance' requirement of common law fraud eases the plaintiff's burden, the Legislature provided that such actions must be brought * * * [within the earlier of one year of discovery or four years of violation]. Again, the Legislature is expressing an intent to provide new and liberalized actions and remedies for

the victims of corporate security violations while, at the same time, preventing speculation by the alleged victim at the expense of innocent parties.").

Under Petitioners' requested cause of action, plaintiffs therefore would have at least two additional years after discovery in which to watch their investment and decide whether to file suit. Moreover, there would be no statute of repose, and plaintiffs conceivably could bring an action 10, 15, or 20 years after the violation was alleged to have occurred. Petitioners' attempt to avoid the Legislature's one year/four year limitations period is particularly ironic in view of their argument to this Court (Petitioners' Brief at 12-13) that a new California remedy is necessary because of the United States Supreme Court's recent decision in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 111 S. Ct. 2773 (1991), which applies a statutory one year/three year limitations period to the judicially implied right of action under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b). While Petitioners assert that "California law is different" in this respect from federal law, in fact the California Legislature has adopted a statute of limitations for securities actions that is patterned on the federal statute of limitations.

Consequently, the remedy provided by the Legislature for material misrepresentations that affect market price would not even begin to approach the expansive remedy that Petitioners would have this Court create for them. As discussed next, the Legislature expressly foreclosed this kind of attempt to circumvent the statutory scheme.

2. The Legislature Explicitly Limited The Authority Of The Judiciary To Expand Upon The Remedies For Securities Disclosure Violations Contained In The Corporate Securities Law Of 1968.

The Legislature enacted civil liability provisions that clearly were intended to provide broader remedies than those available for common law fraud. ***See***

Bowden, 67 Cal. App. 3d at 714-15.[5] But based on their experience with the judicially created remedy under Rule 10b-5, the drafters of the Corporate Securities Act were most concerned that the Legislature, and not the judiciary, specify the limits of civil liability for securities violations: "The first and perhaps the most fundamental decision made in drafting the new California statute was that the Legislature should specify in reasonable detail what the elements of a statutory cause of action in this area should be. Also, that it should make it clear that the judiciary is not authorized to invent causes of action inconsistent with or additional to those provided in the statute." Marsh & Volk at 444-45. The Legislature endorsed this decision of the statute's drafters by enacting Section 25510 of the Corporate Securities Law, which provides as follows:

> Except as explicitly provided in this chapter, no civil liability in favor of any private party shall arise against any person by implication from or as a result of the violation of any provision of this law or any rule or order hereunder. Nothing in this chapter shall limit any liability which may exist by virtue of any other statute or under common law if this law were not in effect.

Granting Petitioners' request in these proceedings would constitute a direct violation of Section 25510. Section 25400(d) prohibits broker-dealers and other market participants from making false and misleading statements or omissions. Section 25401 generally prohibits untrue statements or omissions in connection with the purchase or sale of a security. Petitioners have requested that this Court fundamentally alter the long-established elements of an action for common law fraud in order to impose civil liability on the defendants in this case for alleged

[5]The holding in *Bowden* serves to highlight the impropriety of Petitioners' request in the instant case. The court held that the Corporate Securities Law had not abolished pre-existing common law fraud actions based upon representations that the stock being offered for sale was properly qualified in the State of California. 67 Cal. App. 3d at 711. The court based its holding on a determination that "the Corporate Securities Act of 1968 clearly indicates a legislative intent to provide for actions and remedies for corporate securities victims far less burdensome than those available under common law." *Id*. at 716. Petitioners would have this Court create a "common law" remedy for corporate securities victims far less burdensome than those provided by the Legislature, thereby turning the legislative intent on its head.

misrepresentations made in connection with the sale of a security. Under Section 25510, however, the Legislature has declared that the sole source of expanded civil liability for such an act is Sections 25500 and 25501 (the companions to Sections 25400 and 25401).

Petitioners may argue that the second sentence of Section 25510 covers their request, but their attempt to have this Court dramatically expand civil liability for securities violations under the guise of an action for common law fraud clearly would contradict the Legislature's purpose. With remarkable prescience, the drafters of the Corporate Securities Law predicted Petitioners' attempt to circumvent the Legislature by incorporating Rule 10b-5 theories into an action for common law fraud:

> By using this approach, a court conceivably could incorporate all of the extreme decisions by the Federal courts under Rule 10b-5 into the California common law of "fraud". It could then say that all such actions were preserved by the second sentence of Section 25510, preserving any action which would exist at common law if the Corporate Securities Law of 1968 were not in effect. Any such decision would be completely contrary to the Legislative intent. It is difficult to believe that the California courts would exhibit the contempt for the Legislature which would be involved in such a sophistical argument. Therefore, we believe that the provision will be given effect in accordance with its intent and that any cause of action for misrepresentation in connection with a securities transaction, other than strict common law fraud or an action for rescission based on traditional equitable principles, will have to brought under these provisions of the Corporate Securities Law of 1968.

Marsh & Volk at 446 (emphasis added).

Petitioners have urged this Court to exhibit just such contempt for the California Legislature through their sophistical arguments that twist the long-established meaning of reliance in an action for common law fraud. This Court should unequivocably reject Petitioners' attempt to circumvent the will of the Legislature.

B. **By Reducing Plaintiffs' Pleading Requirements In Securities Disclosure Class Actions Without Any Evaluation Of The Merits Of Plaintiffs' Claims, Adoption Of The Fraud-On-The Market Theory Would Greatly Increase The Exposure Of Public Companies To Coerced Settlements That Are Divorced From The Merits Of Plaintiffs' Claims.**

Petitioners have attempted to convince this Court that the fraud-on-the-market theory does not really eliminate the well-established requirement of reliance in an action for common law fraud, but merely "satisfies that requirement by an evidentiary presumption which is subject to rebuttal by the defendants." Petitioners' Brief at 8 (emphasis in original). It is very clear, however, that fraud-on-the-market "reliance" is a toothless concept that, at the very least, eliminates reliance as a pleading requirement and, in any event, is virtually unrebuttable at trial. *See Blackie v. Barrack*, 524 F.2d 891, 906-07 n.22 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976) (court "doubt[ed]" that presumption of reliance could be rebutted "in many instances to a jury's satisfaction"); *Fine v. American Solar King Corp.*, 919 F.2d 290, 299 (5th Cir. 1990), *petition for cert. filed*, 59 U.S.L.W. 3615 (Mar. 12, 1991) (No. 90-1372) (district court's finding that plaintiffs, in making their investment decision, relied on information other than documents containing defendant's misrepresentation was not sufficient to rebut fraud-on-the-market presumption of reliance).

Consequently, the practical effect of this mere "evidentiary presumption" on the dynamics of securities disclosure class actions is enormous. Legal scholars who have studied federal securities and corporate class actions repeatedly have noted the high settlement rate of such actions. *See, e.g.*, Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497, 526 (1991) (all securities class actions included in precisely limited study were settled; at time of study, not one securities class action in the United States District Court for the Northern District of California had ever gone through trial); Coffee, *The Unfaithful Champion: The Plaintiff As*

Monitor In Shareholder Litigation, 48 Law & Contemp. Probs. 5, 14 (Summer 1985) ("Once an action survives the preliminary motions to dismiss, there is a strong probability that it will be settled, even though plaintiffs' verdicts remain statistical rarities."); Jones, *An Empirical Examination of the Resolution of Shareholder Derivative Suits and Class Action Lawsuits*, 60 B.U.L. Rev. 542, 544-45 (1980) (246 of 275 shareholder lawsuits included in study that proceeded past the pleadings stage were settled); Kennedy, *Securities Class and Derivative Actions in the United States District Court for the Northern District of Texas: An Empirical Study*, 14 Hous. L. Rev. 769, 810-11 (1977) (29 of 31 securities class actions included in study that proceeded past the pleadings stage were settled). Powerful forces, most of which have nothing to do with the merits of plaintiffs' claims, compel companies to settle securities class actions. Particularly important are the great disparity in costs for plaintiffs and defendants during the discovery process, the risk-averse nature of individual defendants, such as officers and directors who, for this reason, are always named in such suits, and the availability of director and officer insurance and indemnification for settlements but not for adjudications. *See* Alexander, 43 Stan. L. Rev. at 528-57; Coffee, 48 Law & Contemp. Probs. at 17-20.

The success of class action plaintiffs in extracting monetary settlements in cases that are allowed to proceed beyond the pleadings contrasts sharply with their lack of success when their claims are actually judged by a trier of fact. Studies have found that an extremely low number of corporate and securities class actions that actually are litigated result in a verdict in favor of the plaintiff, resulting in a success rate that is far below plaintiffs' success rate at trial in other types of class actions. *See* Coffee, 48 Law & Contemp. Probs. at 14 n.35 (studies indicate that plaintiffs win litigated verdicts in 1% of shareholder lawsuits compared with 60% in accident cases); Jones, 60 B.U.L. Rev. at 545 (plaintiffs in

shareholder derivative and class actions successful in only two of fifteen trials); Kennedy, 14 Hous. L. Rev. at 810-11 (out of 35 securities actions in study, 29 were settled, 4 were dismissed, and 2 were tried to verdict for defendant).

A recent study has produced persuasive evidence that the disparity between settlements and trial outcomes in federal securities class actions is explained by the distressing fact that the merits are irrelevant in the settlement process. Alexander, 43 Stan. L. Rev. 497. The study included every computer-related company in Northern California that made an initial public offering prior to the market price collapse for the stocks of such companies in 1983. The author found that federal securities class actions were filed against every one of the companies with sufficient allegeable damages (as determined by sufficient drop in stock price) to make it worthwhile for plaintiffs' attorneys to file an action. Each of these class action suits was settled. Most were settled for an amount, approximately 25% of the damages alleged, that appeared to remain the same regardless of the merits of the plaintiffs' claims. Based on the experience of these California companies, the author concluded that the merits no longer mattered in federal securities class actions and that the process was therefore "more akin to no-fault insurance against market losses than to judicial enforcement of substantive law" and "considered as a system of insurance, it is almost unbelievably expensive and inefficient." 43 Stan. L. Rev. at 570-71.[6]

These scholarly studies demonstrate why pleading requirements have such a dramatic effect on the dynamics of securities disclosure class actions. Despite their high rate of success on the merits at trial, companies generally are unable to

[6]Alexander's results are substantially supported by the results of another recently reported study. *See* O'Brien, *The Class-Action Shakedown Racket*, Wall St. J., Sept. 10, 1991, at A20, col. 3. The study included 330 federal securities class actions involving common stock that had been filed within the past three years. The study found that 96% of such cases were resolved through settlements and that there was little variation in settlement amounts, suggesting that such amounts were not related to the merits of the cases.

obtain merit-based adjudications prior to trial because of the fact-intensive nature of many critical issues in corporate disclosure litigation, such as scienter and materiality. *See, e.g., TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976) (materiality determination requires "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact"). By eliminating the only pleading requirement of a common law fraud action that focuses on the conduct of the plaintiff -- actual reliance -- adoption of the fraud-on-the-market theory would make it even less likely that a company could obtain a merits-based adjudication and thereby exacerbate the forces that have divorced the results in federal securities class actions from the merits of plaintiffs' claims.[7] The result would be a dramatic increase in the vulnerability of public companies to warrantless and wasteful litigation in the California courts. California's public companies would be the primary victims of this ill-advised public policy advocated by Petitioners.

---

[7]The United States Supreme Court recognized this significant problem with securities class actions in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 742-43 (1975):

> Obviously there is no general legal principle that courts in fashioning substantive law should do so in a manner which makes it easier, rather than more difficult, for a defendant to obtain a summary judgment. But in this type of litigation, where the mere existence of an unresolved lawsuit has settlement value to the plaintiff not only because of the possibility that he may prevail on the merits, an entirely legitimate component of settlement value, but because of the threat of discovery and disruption of normal business activities which may accompany a lawsuit which is groundless in any event, but cannot be proved so before trial, such a factor is not to be totally dismissed.

The Court expressed this concern prior to the findings of scholarly studies that discovery costs, disruption of business activities, and other non-merits factors appear to have eclipsed entirely the "legitimate component of settlement value."

C. Adoption Of The Fraud-On-The-Market Theory In Actions For Common Law Fraud Would Eliminate An Important Element Of Transaction Causation Between A Plaintiff's Alleged Injury And A Defendant's Allegedly Misleading Disclosure.

Contrary to Petitioners' arguments, adopting the fraud-on-the-market theory would eliminate an important element of the essential causal link between a plaintiff's alleged injury and a defendant's alleged wrongdoing that has long been required in actions for common law fraud. Actual reliance provides evidence that a company's alleged misrepresentation was at least a substantial factor in inducing a <u>transaction</u> in the company's stock. *See Vasquez v. Superior Court*, 4 Cal. 3d 800, 814 n.9, 94 Cal. Rptr. 796 (1971) (misrepresentation must be a substantial factor in inducing the plaintiff to act). Before an investor can be "defrauded" by the market for a security, the investor must have made an investment decision to enter the market for that security. The fraud-on-the-market theory assumes that exposure to a company's public disclosures will never affect this determination. This assumption will often be invalid.

One result of the comprehensive federal disclosure system has been that a company's public disclosure documents, even those alleged to be misleading, generally will contain quite frank discussions of the specific risk factors associated with a company's stock.[8] While *amicus curiae* in support of Petitioners may believe "there is no point" for investors to read a company's disclosures, Brief of California Public Employees' Retirement System in Support of Plaintiffs/Appellants at 5, there are major differences in risk between the stocks of different companies, for example between an AT&T and a developing company. It is far from certain that reading a discussion of the high risks associated with a

---

[8]For example, Item 303 of Regulation S-K, 17 C.F.R. § 229.303, "Management's Discussion and Analysis of Financial Condition and Results of Operation," lists several specific types of information that companies are required to include in registration statements and periodic reports. These include any known trends or uncertainties that may affect a company's liquidity, capital resources, and results of operations.

developing company will never cause an investor to decide that the stock is not suitable for him and to choose another investment.

Contrary to Petitioners' arguments (Petitioners' Brief at 36 n.29), this Court's decision in *Committee on Children's Television, Inc. v. General Foods Corp.*, 35 Cal. 3d 197, 197 Cal. Rptr. 783 (1983), does not indicate that the causal connection in a child/parent context is exactly the same as in a securities market/investor context. Rather, the facts of *Children's Television* serve to highlight the missing element of transaction causation under the fraud-on-the-market theory. The distinction between actual reliance and fraud-on-the-market "reliance" is the distinction between parents standing in a supermarket aisle with their child begging them to buy a specific cereal and an investor opening *Barrons* and looking at charts containing thousands of stock prices. While the child's appeals are undoubtedly the inducing cause of the parents' decision to purchase a specific brand of cereal, the thousands of stock prices are far less likely to single out and induce a transaction in any particular stock.

Moreover, also contrary to Petitioners' arguments (Petitioners' Brief at 24-25), materiality is not a complete substitute for actual reliance in proving causation. Rather, materiality is a much broader concept that produces a correspondingly broader base of liability than actual reliance. Determining materiality -- what information a reasonable investor would consider important in making an investment decision -- is a theoretical exercise that is sure to encompass a great deal of information that would not necessarily induce an actual investment decision by any particular person. Proof that a plaintiff actually was aware of a defendant's alleged misrepresentations, however, provides a concrete, factual link between defendant's alleged misconduct and plaintiff's decision to purchase the stock, and it thereby provides a much stronger basis to hold the defendant responsible for any loss that the plaintiff may have

realized on his investment. This link is lost when actual reliance is replaced by the fraud-on-the-market theory.[9] Few things are more frustrating for a company than to bear the enormous expense and effort of compliance with the comprehensive U.S. corporate disclosure scheme, only to be subjected to the enormous expense and effort of defending its disclosures in civil litigation against plaintiffs who were uninterested in the company's disclosures before they invested.

D. Petitioners' Arguments That A New Securities Disclosure Remedy Is Needed Can Be Properly Evaluated Only Through The Legislative Process, Which Provides An Opportunity For A Full And Fair Exchange Of Views And For Reconciliation of Competing Interests.

Petitioners have requested this Court simply to drop a long-established element of a cause of action that they cannot plead, without any corresponding change in the other elements of the cause of action. In support of their request, they offer only anecdotal evidence of a high-profile fraud (Petitioners' Brief at 12), remedies for which are being sought under existing law in multiple pending proceedings, and newspaper articles on the SEC's budget (Petitioners' Brief at 11 n.9), which has increased dramatically since 1988, the date of the most recent article cited by Petitioners.[10] Clearly, the major change in public policy sought by

[9]Petitioners imply that this Court's decision in *Vasquez*, 4 Cal. 3d 800, indicates that materiality alone can create an inference of reliance. Petitioners' Brief at 36 n.29. *Vasquez*, however, merely reiterates the well-established rule that proof of <u>both</u> materiality and awareness raises such an inference: "If [plaintiffs] can establish without individual testimony that the representations were made to each plaintiff and that they were false, it should not be unduly complicated to sustain their burden of proving reliance thereon as a common element. * * * It is sufficient for our present purposes to hold that if the trial court finds material misrepresentations were made to the class members, at least an inference of reliance would arise as to the entire class." 4 Cal. 3d at 814 (emphasis added).

[10]The SEC budget in fiscal 1988 was $135 million. 20 Sec. Reg. & L. Rep. 9 (BNA) (Jan. 8, 1988). For fiscal 1992, which begins on October 1, 1991, the Bush Administration has requested $225 million for the SEC, 23 Sec. Reg. & L. Rep. 167 (BNA) (Feb. 8, 1991), and the SEC has requested $241 million, 23 Sec. Reg. & L. Rep. 669 (BNA) (May 3, 1991). These requests represent increases of 66% and 77%, respectively, over the fiscal 1988 budget. Congress' inclination in recent years has been to grant requests for substantial increases in the SEC budget. *See* 23 Sec. Reg. & L. Rep. at 167 (SEC budget in fiscal 1991 was $187 million); 22 Sec. Reg. & L. Rep. 156 (BNA) (Feb. 2, 1990) (SEC

Petitioners demands more serious inquiry. Moreover, even if the Legislature were to agree with Petitioners that a new remedy is appropriate, it is most unlikely that the Legislature would simply grant Petitioners' one-sided request and drop actual reliance without any corresponding changes in other elements of the cause of action to protect against abuse and to balance the interests of plaintiffs, defendants, and society.

Plainly, evaluating the need for new remedies and balancing the elements in a cause of action are peculiarly the province of the Legislature. The opportunity for hearings, empirical study, a process of give and take between interest groups and lawmakers, and, ultimately, the Legislature's capacity to fashion compromises that reflect the general will of society make it the appropriate governmental forum to evaluate the issues and to make the policy judgments that Petitioners have submitted to this Court. This Court should affirm its proper role as an adjudicator and reject Petitioners' attempt to override the policy decisions of the Legislature when it last considered the issues raised by this case.

budget in fiscal 1990 was $166 million); 21 Sec. Reg. & L. Rep. 512 (BNA) (April 7, 1989) (SEC budget in fiscal 1989 was $142 million).

IV.

CONCLUSION

For the foregoing reasons, the judgment of the Court of Appeal should be affirmed.

Respectfully submitted,

/s/ Peter D. Zeughauser
PETER D. ZEUGHAUSER
Vice President and General Counsel
The Irvine Company
550 Newport Center Drive
Newport Beach, CA 92660
(714) 720-2286

Attorney for *Amicus Curiae*
American Corporate Counsel Association

September 23, 1991

DECLARATION OF SERVICE BY MAIL

I am over the age of eighteen years and not a party to the within action. My business address is 550 Newport Center Drive, Newport Beach, California 92660.

I served the foregoing:

AMICUS CURIAE BRIEF OF
THE AMERICAN CORPORATE COUNSEL ASSOCIATION
IN SUPPORT OF DEFENDANTS/RESPONDENTS

dated September 23, 1991, by depositing true copies thereof in the United States mail in Newport Beach, California, on September 23, 1991, enclosed in sealed envelopes with first-class postage thereon fully prepaid, addressed as follows:

See Attached List

Executed on September 23, 1991, in the City of Newport Beach, Orange County, State of California.

I declare under penalty of perjury that the foregoing is true and correct.

/s/ Sandra Boulin
Sandra Boulin

Honorable Barnet M. Cooperman
Superior Court for the County of Los Angeles
Department 59
111 North Hill Street
Los Angeles, CA 90012

Court of Appeal
Second Appellate District
Division Two
300 South Spring Street
Los Angeles, CA 90013

William S. Lerach
Leonard B. Simon
Blake M. Harper
Eric A. Isaacson
Milberg Weiss Bershad Specthrie & Lerach
225 Broadway, Suite 2000
San Diego, CA 92101

Edward M. Gergosian
Barrack, Rodos & Bacine
225 Broadway, Suite 2000
San Diego, CA 92101

Leonard Barrack
Barrack, Rodos & Bacine
1845 Walnut Street, Suite 2100
Philadelphia, PA 19103

Dianne Nast
Barbara Podell
Robert Kitchenoff
Kohn, Savett, Klein & Graf, P.C.
One Reading Center
1101 Market Street, Suite 2400
Philadelphia, PA 19107

Daniel W. Krasner
Jeffrey G. Smith
Francis M. Gregorek
Wolf Haldenstein Adler Freeman & Herz
270 Madison Avenue
New York, NY 10016

Alvin Ivers
Law Office of Alvin Ivers
4 Penn Center Plaza, Suite 700
Philadelphia, PA 19103

Stuart D. Wechsler
Wechsler, Skirnick, Harwood, Halebian & Feffer
555 Madison Avenue, 18th Floor
New York, NY 10022-3489

Morgan Chu
Marjorie N. Neufeld
Irell & Manella
1800 Avenue of the Stars, Suite 900
Los Angeles, CA 90067-4276

William H. Ginsburg
Wood, Lucksinger & Epstein
1900 Avenue of the Stars, Suite 1700
Los Angeles, CA 90067

Todd E. Gordinier
Elizabeth W. Sachs
Paul, Hastings, Janofsky & Walker
555 South Flower Street, 23rd Floor
Los Angeles, CA 90071

Richard P. Levy
Donald J. Schmid
Gibson, Dunn & Crutcher
333 South Grand Avenue
Los Angeles, CA 90071-3197

Lawrence H. Nagler
Nagler & Schneider
9100 Wilshire Boulevard, 5th Floor
Beverly Hills, CA 90212

Michael D. Dempsey
Cooper & Dempsey
2049 Century Park East, Suite 4010
Los Angeles, CA 90067