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INTRODUCTION

To establish liability under § 10(b) and Rule 10b-5, a plaintiff must prove that the defendant acted with scienter, "a mental state embracing intent to deceive, manipulate, or defraud."[1] A plaintiff is required to allege at the pleading stage facts creating a "strong inference" of scienter, which must then be proven by a "preponderance of the evidence."[2] This endeavor is relatively straightforward when the defendant is an individual. The analysis becomes more complicated when a corporate defendant is involved, however, because a corporation, though a "person" under the law, can only act through its agents. A corporation has no "single mind of its own,"[3] so "its scienter is necessarily derived from its employees."[4] Reflecting this complexity, courts have evolved three different approaches to address corporate scienter in the securities fraud context: strong-form corporate scienter, weak-form corporate scienter, and semi-strong-form corporate scienter.

The most rigorous of the three standards is *strong-form corporate scienter*, which requires plaintiffs to show that the same agent who made a misrepresentation on a company's behalf also possessed the requisite scienter. At the other end of the spectrum lies *weak-form corporate scienter*. The weak-form approach does not require the agent who made a misstatement on the company's behalf to have acted with scienter. Moreover, no individu-

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1. *Ernst & Ernst v. Hochfelder*, 25 U.S. 185, 193 n.12 (1976).

2. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 328-329 (2007) ("We emphasize, as well, that under our construction of the 'strong inference' standard, a plaintiff is not forced to plead more than she would be required to prove at trial. A plaintiff alleging fraud in a § 10(b) action, we hold today, must plead facts rendering an inference of scienter *at least as likely as* any plausible opposing inference. At trial, she must then prove her case by a 'preponderance of the evidence.' Stated otherwise, she must demonstrate that it is *more likely* than not that the defendant acted with scienter.") (emphasis in original; internal citation omitted).

3. *In re Monster Worldwide, Inc. Sec. Lit.*, 549 F.Supp.2d 578, 583 (S.D.N.Y. 2008) (citing *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 101 (2d Cir. 2001)).

4. *In re Monster*, 549 F. Supp. 2d at 583 (internal quotation omitted).

al agent is required to possess scienter. Instead, courts may aggregate the knowledge of multiple corporate agents, none of whom possesses scienter individually, to establish collective corporate scienter. There is no requirement that any of these agents be connected to the misstatement. *Semi-strong-form corporate scienter* occupies the middle ground. The semi-strong-form standard requires proof that one agent committed a reprehensible act with scienter in connection with a misrepresentation, but does not demand that the agent possessing scienter be the maker of the misstatement.

This Essay argues that semi-strong-form corporate scienter provides the best approach, because it strikes a balance between several countervailing public policy concerns.

I. STRONG-FORM CORPORATE SCIENTER

The Northern District of California best articulated the theory of strong-form corporate scienter in *Apple Computer*.[5] The plaintiffs brought claims against Apple and its CEO Steve Jobs, alleging that Jobs made material misrepresentations regarding sales projections for a new product. Apple was unable to meet the projections because of production problems. The plaintiffs presented evidence establishing that other Apple agents were aware of the problems. They did not, however, present sufficient evidence that Jobs himself, the maker of the misstatements, had knowledge of the production problems when he made the misrepresentations. Accordingly, the court held that the plaintiffs' allegations were insufficient to create an inference that Jobs acted with scienter. In refusing to aggregate Jobs' misstatements with the knowledge of other Apple agents, the court further determined that Apple could not have acted with scienter:

> It is not enough to establish fraud on the part of a corporation that one corporate officer makes a false statement that another officer knows to be false. A defendant corporation is deemed to have the requisite scienter for fraud only if the individual corporate officer making the statement has the requisite level of scienter, *i.e.*, knows that the statement is false, or is at least deliberately reckless as to its falsity, at the time that he or she makes the statement.

The Ninth Circuit affirmed the Northern District's dismissal of claims against Jobs and Apple, holding in regard to Apple: "A corporation is deemed to have the requisite scienter for fraud only if the individual corporate officer making the statement has the requisite level of scienter at the time that he or she makes the statement."[6]

Courts have also employed strong-form corporate scienter at the summary judgment stage to extinguish claims against corporate defendants. In *Tyson Foods*, the plaintiffs asserted claims based on alleged misrepresentations in a press release regarding Tyson's termination of its plans to merge

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5. *In re Apple Computer, Inc., Sec. Litig.*, 243 F. Supp. 2d 1012 (N.D. Cal. 2002).

6. *In re Apple Computer, Inc.*, 127 Fed. Appx. 296, 303 (9th Cir. 2005) (internal citation omitted).

with another entity.[7] The trial court granted summary judgment in favor of the individual defendants and Tyson, stating:

> For a corporation to have primary liability under § 10(b) and Rule 10b-5, scienter must be present with respect to at least one of the officers or agents who made a false or misleading statement. Having concluded that each of the individual defendants is entitled to summary judgment under § 10(b) and Rule 10b-5, as a matter of law, Tyson Foods can not be primarily liable and is entitled to summary judgment.

The Third Circuit affirmed this decision: "Having concluded that there is no primary liability on the part of any of the individual officers, the District Court properly held that Tyson Foods could not itself be primarily liable under the facts of this case."[8]

At first glance, public policy appears to support the theory of strong-form scienter, because its use curbs abusive litigation. Congress enacted the Private Securities Litigation Reform Act to check perceived abuses of private § 10(b) securities litigation, including "nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests and manipulation by class action lawyers."[9] Limiting private securities fraud actions to only those instances where plaintiffs can show that an agent who made a misrepresentation on behalf of a company possessed scienter would help to ensure that only the strongest claims are brought.

Unfortunately, while furthering the goal of preventing strike suits, the strong-form theory also allows malfeasant corporations to skirt securities laws by simply compartmentalizing information, *i.e.*, by separating the "mouth" of the operation from the "brain." Under this approach, a company wishing to commit fraud could escape liability by shielding agents who speak on its behalf from knowledge of facts contradicting their public statements. Such tactics could result in a company clearly and intentionally misleading its investors, yet allowing the investors no legal recourse because they are unable to tie evidence of scienter to a specific agent who made a misstatement on its behalf.

II. WEAK-FORM CORPORATE SCIENTER

In *Bridgestone*, the Sixth Circuit endorsed the use of weak-form corporate scienter at the pleading stage.[10] The plaintiffs brought claims under § 10(b) and Rule 10b-5 against Bridgestone, its subsidiary Firestone, Bridgestone's former CEO Yoichiro Kaizaki, and Masatoshi Ono, Bridgestone's former Executive VP and Firestone's former CEO. Although the court upheld the dismissal of claims against the individual defendants Kaizaki and Ono, it allowed claims to proceed against the corporate defendants: "[W]e conclude under the totality of the circumstances that the facts argued collectively give rise to a strong inference of at least recklessness." Thus, the

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7. *In re Tyson Foods, Inc. Sec. Litig.*, Civ. A. No. 01-425-SLR, 2004 U.S. Dist. LEXIS 11122 (D. Del. June 17, 2004).

8. *In re Tyson Foods, Inc.*, 155 Fed. Appx. 53, 57 (3d Cir. 2005).

9. *Tellabs*, 551 U.S. at 320.

10. *City of Monroe Employees Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651 (6th Cir. 2005).

Bridgestone court held that scienter can be pled against a corporate defendant by looking to its collective knowledge, regardless of whether scienter is alleged against an individual agent.

Likewise, the Southern District of New York relied on weak-form scienter to deny a corporate defendant's motion for summary judgment in *WorldCom*.[11] The defendant accounting firm Arthur Andersen argued that it was entitled to summary judgment because the plaintiffs "failed to demonstrate that a particular Andersen auditor acted with scienter." The court disagreed: "To carry their burden of showing that a corporate defendant acted with scienter, plaintiffs in securities fraud cases need not prove that any one individual employee of a corporate defendant also acted with scienter. Proof of a corporation's collective knowledge and intent is sufficient." As such, the court held that the plaintiffs were "entitled to show reckless misconduct through a cumulative pattern of decisions and inaction by several Andersen auditors," *i.e.*, that "Andersen as a firm was reckless." The court, relying on the First Circuit's analysis in *Bank of New England*, reasoned that modern corporate structure necessitated the use of this approach. As the First Circuit aptly stated:

> Corporations compartmentalize knowledge, subdividing the elements of specific duties and operations into smaller components. The aggregate of those components constitutes the corporation's knowledge of a particular operation. It is irrelevant whether employees administering one component of an operation know the specific activities of employees administering another aspect of the operation: A corporation cannot plead innocence by asserting that the information obtained by several employees was not acquired by any one individual who then would have comprehended its full import. Rather the corporation is considered to have acquired the collective knowledge of its employees and is held responsible for their failure to act accordingly.[12]

Allowing claims founded on weak-form corporate scienter does prevent delinquent companies from avoiding liability by compartmentalizing knowledge. Yet any positive influence the use of weak-form scienter might have on corporate policy is drastically overshadowed by its inconsistency with the federal securities laws, the inefficient incentives it creates, and its negative impact on the dissemination of information.

The weak-form approach, which pegs liability to a corporate entity's failure to parse together the knowledge of its agents, is akin to a negligence standard.[13] Moreover, this theory is clearly at odds with Congress' intention to discourage unmeritorious litigation under the PSLRA. Weak-form scienter makes it exceedingly easy for overzealous plaintiffs to advance past the motion to dismiss stage, at which point they can use the leverage of discovery to extort settlements from corporate defendants.

Reliance on weak-form scienter would also cause the inefficient allocation of corporate resources and stymie communications. Under this

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11. *In re WorldCom, Inc. Sec. Litig.*, 352 F. Supp. 2d 472 (S.D.N.Y. 2005).

12. *United States v. Bank of New England, N.A.*, 821 F.2d 844, 856 (1st Cir. 1987) (internal quotation omitted).

13. *See Ernst & Ernst*, 425 U.S. at 193 (holding that a cause of action under § 10(b) and Rule 10b-5 does not lie for mere negligence).

approach, a risk-averse corporation would have to spend undue amounts of human and monetary capital to determine that each piece of information communicated to investors had been thoroughly vetted to ensure that none of the corporation's agents possesses any information which, in combination with information possessed by other agents, could be construed as being inconsistent with the company's public statements. These costs would be substantial. It is doubtful that even the most earnest companies could comply with this unduly burdensome requirement, which would dampen communications between companies and their investors, a primary objective of the Securities Exchange Act of 1934.[14]

III. SEMI-STRONG-FORM CORPORATE SCIENTER

The Fifth Circuit discussed the standard of proof required under semi-strong-form corporate scienter in *Southland*:

> For purposes of determining whether a statement made by the corporation was made by it with the requisite Rule 10(b) scienter we believe it appropriate to look to the state of mind of the individual corporate official or officials who make or issue the statement (*or order or approve it or its making or issuance, or who furnish information or language for inclusion therein, or the like*) rather than generally to the collective knowledge of all the corporation's officers and employees acquired in the course of their employment.[15]

Since the plaintiffs did not allege that any particular employee other than the named executive defendants acted with scienter in connection with any of the misstatements, the *Southland* court held that the plaintiffs were limited to this pool of named individual defendants in pleading that the corporate defendant acted with scienter. In other words, in order to prove that a corporate defendant acted with scienter, a plaintiff must provide evidence showing that an individual agent who is connected to—but not necessarily the maker of—the misstatement at issue had scienter.

Judge Richard Posner applied the semi-strong-form standard in *Tellabs* to reverse the lower court's grant of a motion to dismiss: "That no member of the company's senior management who was involved in authorizing or making public statements . . . knew that they were false is very hard to credit, and no plausible story has yet been told by the defendants that might dispel our incredulity."[16]

Similarly, the District of Columbia utilized semi-strong-form scienter in *Johnson*, an action brought by the SEC.[17] The defendant, Christopher Benyo, a former Senior Vice President for Marketing and Network Development at PurchasePro.com, was found liable for aiding and abetting PurchasePro's violations of the securities laws. Benyo argued in his motion for judgment as a matter of law or in the alternative for a new trial that the

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14. *Randall v. Loftsgaarden*, 478 U.S. 647, 664 (1986).

15. *Southland Sec. Corp v. INSpire Ins. Solutions Inc.*, 365 F.3d 353, 366 (5th Cir. 2004) (emphasis added).

16. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702, 708-709 (7th Cir. 2008).

17. *SEC v. Johnson*, 565 F. Supp. 2d 82 (D.D.C. 2008).

SEC had not presented sufficient evidence to establish a primary violation by PurchasePro, because the SEC did not show that PurchasePro's president (the party who acted on its behalf) possessed scienter. The court disagreed and denied Benyo's motions:

> [M]ultiple PurchasePro officers, including Layne and Boeth, could have provided the requisite scienter. Both Layne and Boeth furnished information or language for inclusion in the earnings statement, and each admitted that they knew claiming the AuctioNet revenue in the First Quarter of 2001 was fraudulent at the time in question. Given the evidence presented regarding Boeth and Layne's role in the earnings announcement and their scienter, the jury had sufficient probative evidence to find that PurchasePro had engaged in a Section 10(b) or Rule 10b-5 violation.

Demanding that plaintiffs show scienter by an individual management-level employee, who is concretely connected to but not necessarily the maker of a misrepresentation, prevents corporate bad actors from avoiding liability by compartmentalizing information. But it does so without heaping unrealistic expectations on corporations making a good faith effort to comply with the law. Rather than requiring a company to undertake the nearly impossible task of synthesizing the knowledge of its agents prior to making a public statement, semi-strong-form scienter simply requires those executives responsible for the statement to ensure the statement does not contain information which contradicts what they know to be true. This is a reasonable expectation.

Furthermore, semi-strong-form scienter discourages trivial litigation without forcing wronged shareholders to comply with overly stringent requirements on the types of claims they may bring. This theory requires plaintiffs to show that a specific individual employee possessed scienter—which ensures that plaintiffs cannot bring a claim lacking a fully-developed theory of liability—but does not limit plaintiffs to only those individuals responsible for making the alleged misstatements.

CONCLUSION

How to attribute the mental state of scienter to a corporate entity has far-reaching implications. Strong-form scienter—limiting the imputation of scienter to only those instances in which the maker of a misstatement possessed intent—would stifle legitimate claims that do not satisfy this narrow criterion. It also would prompt companies seeking to evade the securities laws to erect barriers between those who speak on their behalf from those possessing knowledge. Weak-form scienter—taking an aggregative approach to corporate scienter—would result in unmeritorious claims, economic inefficiency, and degraded corporate communications. The semi-strong-form standard, on the other hand, provides the right blend of incentives. The approach encourages companies to be thorough in their compliance with securities laws without making unreasonable demands. It also sets the bar just high enough to weed out shoddy claims while allowing valid claims to pass. Perhaps the strongest evidence that semi-strong-form scienter is the right choice is that it is the approach which most closely aligns the interests of corporations and their shareholders by encouraging

the most efficient allocation of corporate resources while adequately protecting shareholder rights.