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Heather F. Crow

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Riding the Fence on Collective Scier: Allowing Plaintiffs to Clear the PSLRA Pleading Hurdle

“Law school taught me one thing;
how to take two situations that are exactly the same
and show how they are different.”¹

When federal circuits split on a point of law, two situations that are exactly the same may, in fact, be different. A split in the courts results in uncertainty in the law and encourages forum shopping.² This is the current situation for plaintiffs who plead securities fraud in the federal courts. A securities fraud class action claim against a publicly held corporation in the United States has historically resulted in an expensive proposition for corporations and shareholders, especially before 1995.³ At that time, plaintiffs could file a claim and hope to unearth ammunition through discovery.⁴ Consequently, meritless claims were a serious problem.⁵

In 1995, Congress passed the Private Securities Litigation Reform Act (PSLRA) in order to stem the tide of frivolous litigation.⁶ One principal change that the PSLRA made to securities law was to heighten the pleading standards that a plaintiff must meet—stricter requirements meant that surviving a defendant’s motion for dismissal was more difficult.⁷ To validly plead securities fraud, plaintiffs are required to plead, among other things, both a misstatement and scienter, or fraudulent intent, by the defendant.⁸ Plaintiffs may allege liability for securities fraud against individual defendants, such as corporate officers, or the corporation itself.⁹

The PSLRA changed securities law so that the misstatement and intent elements of a claim are pled with particularity, rather

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1. *Hart Pomerantz Quotes*, FAMOUS QUOTES & AUTHORS, http://www.famousquotesandauthors.com/authors/hart_pomerantz_quotes.html (last visited Nov. 6, 2009). Hart Pomerantz is a lawyer and Canadian television comedian.

2. Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 947–48.

3. H.R. REP. NO. 104-369, at 31–32 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 730–31.

4. *Id.*

5. *Id.*

6. *Id.*

7. Adam Pritchard, *Should Congress Repeal Securities Class Action Reform?*, POL’Y ANALYSIS (Cato Inst., Wash., D.C.), Feb. 27, 2003, at 6–8, available at <http://www.cato.org/pubs/pas/pa471.pdf>.

8. *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 341–42 (2005).

9. Securities Exchange Act of 1934 § 3(a)(9), 15 U.S.C. § 78c(a)(9) (2006).

than simply inferred.¹⁰ In other words, before discovery ever begins, a plaintiff must have sufficient factual detail to adequately allege fraud.¹¹ As plaintiffs strive to meet the heightened pleading requirements, varying pleading theories and doctrines have developed.¹² One of the most controversial is the theory of collective scienter.¹³

Collective scienter permits the aggregation of one person's misstatement with the intent of another in a single pleading in order to attribute an allegation of scienter to the corporation, rather than pinpoint a single actor who intentionally misspoke.¹⁴ The issue of whether to accept collective scienter as a pleading theory resulted in a split among federal circuits.¹⁵ Consequently, the same set of facts may result in a different outcome in different circuits. Consider three scenarios.

Scenario #1:

A publicly traded pharmaceutical company discovers a revolutionary new drug. During the company's quarterly conference call report, the CEO makes a statement about the drug's positive results in clinical trials. Predictably, the company's stock price receives an upward jolt. Unbeknownst to the CEO, company scientists discover that the drug has a terrible side effect that could render it unusable. However, the scientists operate in a small lab in a foreign country and decide not to tell anyone.

Under a pure collective scienter theory, pleading fraud here is viable by aggregating the unknowing false statement of the CEO with the knowledge and intent of the scientists.¹⁶ While this may be the only option for a plaintiff to meet the pleading requirements, this scenario illustrates the primary argument for rejection of the theory of collective scienter. The liability claim is too broad, impeaching those who made statements in good faith and extending beyond what Congress intended with the passage of the PSLRA.¹⁷

10. 15 U.S.C. § 78u-4(b)(1) (2006).

11. *Id.*

12. Patricia S. Abril & Ann Morales Olazabal, *The Locus of Corporate Scienter*, 2006 COLUM. BUS. L. REV. 81, 86.

13. *Id.*

14. *Id.*

15. *See infra* Part III.

16. Kevin M. O'Riordan, *Clear Support or Cause for Suspicion? A Critique of Collective Scienter in Securities Litigation*, 91 MINN. L. REV. 1596, 1597 (2007).

17. *Id.* at 1621.

Scenario #2:

The CEO makes the same statements. Although the information about the drug's side effect is not public, the CFO is informed of these effects through lower level employees. He asks them to sit on the information. Later, the information is leaked to the press, and the company's stock price plummets. Again, there is a potential claim of corporate fraud for the non-knowing misleading statements made by the CEO while the CFO intentionally withheld the information. Under a strict reading of the PSLRA by federal circuit courts that reject the pleading theory of collective scienter, the case faces dismissal because the person who actually made the misleading statement, the CEO, had no knowledge that the information was false and had no intent to lie.¹⁸ On the other hand, a circuit court that has not rejected the theory may allow aggregation of the misstatement of the CEO with the intent of the CFO to allege corporate scienter,¹⁹ which allows the claim to survive under the theory of collective scienter.²⁰

Scenario #3:

The CEO knows that the drug is dangerous and a public revelation of this information will cause the stock price to plummet. He makes no public statements. The public relations department issues statements that are eventually revealed to be false. Although the CEO took no part in making these statements, he deliberately failed to prevent them. Under a pure rejection of collective scienter, the CEO's actions may enable the company to skate on a dismissal because there is no intersection between the individual, the misstatement itself, and the intent to defraud.²¹ Under this rule, only when all three elements collide in one actor is a corporate liability claim adequately pled.²²

This is the scenario that proponents of the collective scienter theory warn against. A company may use its separate parts to avoid liability by ensuring that the person *with the knowledge and intent* is not the one who *makes misleading statements*.²³ After Congress

18. *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353 (5th Cir. 2004); *see also Phillips v. Scientific-Atlanta, Inc.*, 374 F.3d 1015 (11th Cir. 2004).

19. Corporate scienter is concerned with attributing the intent element to the corporation, rather than an individual actor.

20. *City of Monroe Emps. Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651 (6th Cir. 2004).

21. *Southland Sec.*, 365 F.3d at 366.

22. *Id.*

23. Charles W. Murdock, *Sarbanes-Oxley, Corporate Corruption, and the Complicity of Courts and Legislatures* 43-46 (Sept. 7, 2006) (unpublished manuscript), available at <http://ssrn.com/abstract=1012970>.

passed the PSLRA, the controversial pleading theory became especially troublesome.²⁴ Under the PSLRA's stricter pleading requirements, the use of the theory of collective scienter may offer the only avenue that plaintiffs in certain situations can take to avoid immediate dismissal. For that reason, this Comment recommends that courts accept the use of collective scienter as a pleading theory in securities fraud claims, but only in very narrow circumstances. These narrow circumstances would require plaintiffs to allege clear knowledge on the part of a corporate officer or director, even if that individual was not the speaker of the fraudulent information, as opposed to simply aggregating non-knowing statements by one person with the intent or knowledge of another employee.

Part I of this Comment explains the background of the relevant underlying securities legislation governing corporate disclosure and fraud, and the later-enacted PSLRA, which sets forth the heightened pleading requirements for securities fraud plaintiffs. Part II discusses the policy and jurisprudential theory surrounding corporate actions and collective scienter, as well as the specific intent requirement of a fraud claim. Part III outlines the split among the federal circuits and examines the factual situation present in each decision. Part IV analyzes the varying degrees of acceptance of the theory of collective scienter by the courts, recommending a solution that entails a narrow application based on the facts of the situation that show knowledge on the part of a corporate officer or director.

I. THE SECURITIES EXCHANGE ACT OF 1934 AND THE PRIVATE LITIGATION SECURITIES REFORM ACT OF 1995

In the wake of the 2007–2008 financial market meltdown, litigation concerning securities fraud, in particular fraudulent corporate misstatement claims, mushroomed.²⁵ When these

24. A collective scienter theory was attempted in other earlier cases that did not involve the pleading requirements of the PSLRA. *See Nordstrom, Inc. v. Chubb & Son, Inc.*, 54 F.3d 1424 (9th Cir. 1995); *see also Caterpillar, Inc. v. Great Am. Ins. Co.*, 62 F.3d 955 (7th Cir. 1995). Collective scienter was considered by these courts as a theory of liability rather than a pleading theory, but faced resistance nonetheless. These cases contributed to further uncertainty among district and circuit courts as collective scienter emerged as a pleading theory.

25. PRICEWATERHOUSECOOPERS LLP, 2008 SECURITIES LITIGATION STUDY (2009), available at <http://10b5.pwc.com/PDF/NY-09-0894%20SECURITIES%20LIT%20STUDY%20FINAL.PDF>.

lawsuits are meritless, a host of problems result.²⁶ Foremost, discovery in a securities fraud claim—regardless of the merits—is extremely expensive; and it costs corporations, shareholders, and the American economy millions of dollars each year.²⁷ Frivolous claims clog the judicial system and have a chilling effect on free and open disclosure by publicly traded companies, which securities laws were originally meant to encourage.²⁸

An obvious tension exists between the need to protect corporate America from wasteful claims and the need to protect shareholders from fraud by corporate actors. Before exploring pleading theories of securities fraud claims, it is essential to understand the relevant underlying legislation and regulations governing publicly traded corporations and the changes that the PSLRA made to these laws.

A. The Securities Exchange Act of 1934

Congress passed the Securities Exchange Act of 1934 (the “’34 Act”) in the aftermath of the Great Depression to regulate secondary trading in the financial markets.²⁹ It governs a number of activities, including transactions by officers and directors, reporting and information dissemination, and promotion of a fair and open market system.³⁰ The ’34 Act was designed to advocate an attitude of full disclosure by publicly traded corporations, rather than a philosophy of *caveat emptor* for securities buyers.³¹

1. Section 10(b) and Rule 10b-5—The Prohibition of Fraud

Section 10(b) of the ’34 Act is the root of the fraud prohibition rules in securities law.³² It not only prohibits the use of fraudulent means through “interstate commerce or . . . the mails,” but authorizes the Securities and Exchange Commission (SEC) to promulgate rules governing fraudulent activities, which include the

26. H.R. REP. NO. 104-369, at 31–32 (1995) (Conf. Rep.), reprinted in 1995 U.S.C.C.A.N. 730, 730–31.

27. *Id.* The report stated that “discovery costs account for roughly 80% of total litigation costs in securities fraud cases.” *Id.* at 37.

28. *Id.* at 31–32. The report further noted that “discovery in securities class actions often resembles a fishing expedition.” *Id.* at 37.

29. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a to 78nn (2006)).

30. *How the SEC Protects Investors, Maintains Market Integrity*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/about/laws.shtml#secexact1934> (last visited Nov. 10, 2009).

31. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

32. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2006).

use of manipulative and deceptive devices.³³ As a result, the SEC is empowered with broad authority over all aspects of the securities industry, including disciplinary rights.³⁴

Under the authority granted by Congress, the SEC set forth rules governing trading activities, including Rule 10b-5, which forbids the use of manipulative devices or other means of fraud.³⁵ According to Section 10(b) and Rule 10b-5, purchasers or sellers of securities have a private (civil) right of action in addition to any disciplinary action the SEC may take against market participants.³⁶

2. Necessary Components of a Securities Fraud Claim

Although the statute and SEC rules set forth broad guidelines for what constitutes fraud, jurisprudence requires six specific components that a plaintiff must allege in a securities fraud pleading in order to defeat a motion to dismiss. These elements include a material misrepresentation or omission; scienter, i.e., a wrongful state of mind or intent; a connection with the purchase or sale of a security; reliance by the plaintiff on that information; economic loss; and causation.³⁷

This Comment will focus on the relationship between the first requirement of misstatement and the second requirement of scienter and how these elements interact under the pleading requirements of the PSLRA. Without one, the other is insufficient;

33. *Id.* § 10, 15 U.S.C. § 78j.

34. *How the SEC Protects Investors, Maintains Market Integrity*, *supra* note 30.

35. SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2010) (“It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.”).

36. This private right of action was implicit in a series of federal court decisions. *See* *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353 (1982). The private right of action was later strengthened through the congressional passage of the PSLRA. *See also* *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196–97 (1976) (summarizing this body of jurisprudential development).

37. *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 341 (2005). It should be noted that “omissions” as used in this context is not omission as negligence, but rather purposeful omission of material facts. In *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), the Supreme Court discusses the key factors in silence versus a statement made with deliberate omission of material facts.

but how the two elements are pled determines whether a claim is sufficient to clear the PSLRA pleading hurdle.

B. The Private Securities Litigation Reform Act of 1995

1. Purpose and Background of the PSLRA

Congress passed the PSLRA in response to a perceived abuse of the legal system with regard to publicly traded securities.³⁸ In the House Conference Report that accompanied the passage of the PSLRA, the Joint Statement of the Managers of the Committee, who submitted the bill, explained the necessity of such reform.³⁹ The statement detailed evidence of abuses of the private securities litigation system and explained that the financial markets needed to have confidence restored in them from an investor standpoint.⁴⁰ Moreover, this legislation was a means to stem the exorbitant costs to corporations and shareholders.⁴¹

The report explained that under then-current pleading requirements, abusive or frivolous lawsuits were frequently filed without specific allegations; later, during the discovery process, plaintiffs hoped to expose some plausible cause of action, preferably against a “deep pocketed defendant.”⁴² The report indicated that in addition to the monetary cost of meritless lawsuits, the financial community suffered because many well-qualified businesspeople refused to serve on boards of directors as a result of the fear of groundless and extortionate securities lawsuits.⁴³ In reaction to these concerns, the PSLRA implemented a number of changes in securities laws, including rules on discovery, lead plaintiffs, changes in proportionate liability, and heightened pleading requirements.⁴⁴

Prior to the passage of the PSLRA, only about 20% of fraud claims were dismissed.⁴⁵ Post-PSLRA, the number of cases

38. H.R. REP. NO. 104-369, at 31–32 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 730–31. The PSLRA was controversial from its inception and passed over the veto of then-President Bill Clinton. *See also* Pritchard, *supra* note 7, at 2.

39. H.R. REP. NO. 104-369, at 31–32.

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.*

44. *Id.*

45. STEPHANIE PLANCICH & SVETLANA STARYKH, NERA ECONOMIC CONSULTING, RECENT TRENDS IN SECURITIES CLASS ACTION LITIGATION: 2009 MID-YEAR UPDATE 15 (2009), *available at* http://www.nera.com/ext/image/Recent_Trends_Report_07_09.pdf.

resulting in dismissal has more than doubled to almost 44%.⁴⁶ Because nearly 56% of cases settled, less than 1% of suits went to trial.⁴⁷ Although settlement is often a preferable alternative to litigation for corporate defendants, reducing the number of meritless cases that settle is important for financial markets because the average settlement is nearly \$29 million.⁴⁸ Because the vast majority of cases that survive dismissal result in settlement rather than trial, stringent pleading requirements are the necessary gatekeeper to prevent frivolous lawsuits.⁴⁹

Moreover, because the most expensive part of securities litigation is the discovery process,⁵⁰ the PSLRA altered the pleading threshold to make it more difficult to pass muster under a Federal Rule of Civil Procedure 12(b)(6) motion to dismiss.⁵¹ To that end, the PSLRA included a mandate that both plaintiff and defendant stay discovery while a dismissal motion is pending.⁵² This rule can dramatically decrease the expense of a frivolous lawsuit because the claim may be dismissed before the expensive process of discovery begins.⁵³

2. *The Heightened Pleading Requirements*

Prior to the passage of the PSLRA, pleadings were governed by Federal Rule of Civil Procedure 9(b).⁵⁴ This rule set the standard for the level of particularity necessary in averments of fraud and required that the surrounding facts constituting fraud be stated with particularity.⁵⁵ In contrast, a general averment of

46. *Id.*

47. *Id.*

48. This figure does not include settlements over \$1 billion. John E. Black, Jr., *D&O Litigation Trends in 2007–2008*, IRMI.COM, <http://www.irmi.com/expert/articles/2009/black01-directors-officers-insurance.aspx#7> (last visited July 3, 2010). Note that these settlement figures necessarily include both those that would have succeeded on the merits and those that simply settle regardless of the merits, based on nuisance value.

49. Pritchard, *supra* note 7, at 13; *see also* Perino, *supra* note 2, at 919–21 (discussing incentive for corporations to settle regardless of merit of claim, due to expense of discovery and harm to reputation).

50. H.R. REP. NO. 104-369, at 31–32 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 730–31.

51. *Id.*

52. 15 U.S.C. § 78u-4(b)(3)(B) (2009).

53. H.R. REP. NO. 104-369, at 31–32.

54. *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1095 (10th Cir. 2003). There is some debate about the particularity requirement pre-PSLRA among various circuit courts. Post-PSLRA, this debate is largely irrelevant. *See* Perino, *supra* note 2, at 926–27.

55. *Id.*

malice, intent, knowledge, and other condition of mind was sufficient.⁵⁶

The PSLRA made changes in the pleading threshold of a securities claim in several ways. The most restrictive changes for plaintiffs are found in 15 U.S.C. § 78u-4(b)(1) and (2). It is not enough to make generalizations in the pleadings. These provisions require that each allegedly false or misleading statement be pled “with particularity, all facts on which that belief is formed.”⁵⁷ Furthermore, with respect to each act or omission, the plaintiff must plead “with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”⁵⁸ The pleadings must indicate intent. The requirement that scienter be pled with particularity stands in strong contrast to former Rule 9(b), under which scienter needed to be alleged only *generally*.⁵⁹

It is this new set of requirements that led to the development of the collective scienter pleading theory and caused a split among federal circuit courts and a disagreement among scholars and financial market players. For instance, securities market organizations such as the Securities Industry and Financial Markets Association (SIFMA) take a firm stance, advocating a full-out rejection of collective scienter.⁶⁰ As part of SIFMA’s strong position against the use of collective scienter, it joined with the U.S. Chamber of Commerce and the Business Roundtable to submit an amicus brief in a Seventh Circuit case in which plaintiffs in a securities fraud class action lawsuit unsuccessfully attempted recovery on a theory of collective scienter.⁶¹

On the other hand, some scholars believe that this legislation is a bar to plaintiffs actually harmed by fraudulent activities.⁶² Others advocate a move to a pure agency theory, under which a *respondeat superior* theory is utilized via the employment

56. *Id.*

57. 15 U.S.C. § 78u-4(b)(1) (2009).

58. *Id.* § 78u-4(b)(2).

59. *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1095 (10th Cir. 2003).

60. According to its website, the Securities Industry and Financial Markets Association (SIFMA) “brings together the shared interests of hundreds of securities firms, banks and asset managers.” *Welcome to SIFMA.org*, SIFMA.ORG, <http://www.sifma.org/about/about.html> (last visited July 3, 2010).

61. Brief for Securities and Financial Markets Association et al. as Amici Curiae Supporting Defendants-Appellants, *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190 (2d Cir. 2008) (No. 06-2902-CV), 2007 WL 6376443 [hereinafter SIFMA Brief].

62. *Murdock*, *supra* note 23.

relationship.⁶³ Whatever the opinion of commentators, the federal courts are largely riding the fence on the issue, with only the United States Court of Appeals for the Fifth and Eleventh Circuits adopting a bright-line rule and clearly rejecting the pleading theory of collective scienter.⁶⁴ Of the remaining circuits, one has permitted the theory in pleading,⁶⁵ and still others have left the door open.⁶⁶

II. POLICY, THEORY, AND JURISPRUDENCE: CORPORATE ACTION AND INTENT—COMPONENTS OF CORPORATE SCIENTER

Before a court will impute liability to a corporate entity for securities fraud, both an action (the misstatement) and intent must be present.⁶⁷ How these are alleged as corporate action, rather than individual officer action, is important when analyzing the usefulness and inherent fairness of a collective scienter pleading.

A. The Total is Greater than the Sum of its Parts—A Corporation and its Agent

The composition of a corporation as a separate legal entity owned by its shareholders and employing executive officers is an important element in the analysis of corporate liability.⁶⁸ This creates the issue of whether a corporation is an individual entity or a collection of persons. Obviously, in a sense it is both, but a corporation as a separate entity cannot act alone.⁶⁹ Because a corporation may not act independently, it acts through its agents.⁷⁰ The elements of common-law agency often exist in the relationship

63. O’Riordan, *supra* note 16, at 1623. *Respondeat superior* is Latin for “let the master answer.”

64. See *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353 (5th Cir. 2004); see also *Phillips v. Scientific-Atlanta, Inc.*, 374 F.3d 1015 (11th Cir. 2004).

65. See *City of Monroe Emps. Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651 (6th Cir. 2004).

66. See, e.g., *Glazer Capital Mgmt., LP v. Magistri*, 549 F.3d 736 (9th Cir. 2008).

67. *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 341 (2005).

68. “A basic tenet of American corporate law is that the corporation and its shareholders are distinct entities.” *Dole Food Co. v. Patrickson*, 538 U.S. 468, 474 (2003).

69. See *Bank of the U.S. v. Dandridge*, 25 U.S. (12 Wheat.) 64, 91 (1827). Chief Justice Marshall’s dissent offers a noteworthy summation of these legal axioms, detailing the creation of a corporation, the distinction between the corporate entity and its members, and its acts through members.

70. *Id.*

between employer and employee—in the corporate context, between the corporation and its officers.⁷¹ This principle is an inherent key to determine corporate scienter.

The agency doctrine naturally brings into play potential corporate liability for the acts of an agent. Agency, a common-law principle, encompasses the theory of *respondeat superior*, which makes an employer vicariously liable for torts committed by its employees while acting within the scope of their employment.⁷² *Respondeat superior* is based on the status that is created by the employment relationship.⁷³

Consequently, when a corporate officer commits fraud, the company may be liable for those acts.⁷⁴ Notably, the liability of the corporate employer under the doctrine of *respondeat superior* cannot exceed that of the employee or servant.⁷⁵ As a result, if the employee is not individually culpable, neither is the employer.⁷⁶ This doctrine creates an apparent tension with the theory of collective scienter because collective scienter attempts to aggregate the various elements of a claim—misstatements and intent—to create the greater corporate liability when an individual agent is not singularly responsible. In other words, it would make the corporation liable for a claim greater than that of the employee's individual culpability.

B. Scienter: What Constitutes Intent under Securities Law?

A securities fraud claim requires not only a misstatement or omission, but also intent.⁷⁷ To succeed, the plaintiff must prove that the defendant acted with scienter.⁷⁸ The mental state of scienter is an intent to deceive, manipulate, or defraud.⁷⁹ The

71. *Id.* at 70–71 (recapping the basic tenets of the corporate entity and agency).

72. 27 AM. JUR. 2D *Employment Relationship* § 387 (2004).

73. *Gleason v. Seaboard Air Line Ry. Co.*, 278 U.S. 349, 354 (1929).

74. *Meyer v. Holley*, 537 U.S. 280 (2003).

75. *Employment Relationship*, *supra* note 72; see also Robert Malonek & Joseph Salama, “Collective Scienter”: Nixed by the Second Circuit in *Dynex?*, N.Y. L.J., Aug. 22, 2008, at 4 (“Can a corporation have a more culpable state of mind than any one of its agents? Can a corporation commit fraud when no single agent does?”).

76. *Employment Relationship*, *supra* note 72.

77. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). Note that recklessness has been found sufficient as well. See *infra* notes 89–90 and accompanying text.

78. *Id.*

79. *Id.* Interestingly, although private securities claims are civil actions, the scienter requirement analogizes the intent aspect more similarly to the criminal law

United States Supreme Court set forth the standard to allege scienter in Section 10(b) and 10b-5 claims in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*⁸⁰ This standard requires a strong inference of scienter.⁸¹

First, for a pleading to indicate a “strong inference” of scienter, the Supreme Court explained that the inquiry is “whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter.”⁸² The Court then held that a trier of fact must consider competing inferences.⁸³ Put simply, plausible explanations must be taken into account. Second, the Court explained that the inference of scienter “must be more than merely plausible or reasonable—it must be cogent and . . . compelling.”⁸⁴

In addition, it is important to recognize how the federal courts have shaped the standard for scienter and made several helpful findings that delineate what may or may not constitute scienter for purposes of a securities fraud claim. First, it is well settled that negligence is insufficient for a finding of scienter.⁸⁵ The United States Court of Appeals for the Third Circuit expounded on this, stating, “[N]egligence whether gross, grave or inexcusable cannot serve as substitute for scienter.”⁸⁶

A significant step beyond mere negligence is recklessness, which courts generally agree is sufficient for a showing of scienter.⁸⁷ The Seventh Circuit, in the oft-cited case *Sundstrand Corp. v. Sun Chemical Corp.*, held that “a reckless omission of material facts”⁸⁸ was actionable under Section 10(b) and Rule 10b-5.⁸⁹ Moreover, the

version of *mens rea*, rather than the more common, and more easily proved, tort of negligence. *Id.* at 200–01 (“It is thus evident that Congress fashioned standards of fault in the express civil remedies in the 1933 and 1934 Acts on a particularized basis.”); *see also* Abril & Olazabal, *supra* note 12, at 98–101 (discussing analogous element of criminal law to intent element of securities fraud).

80. 551 U.S. 308, 322–23 (2007).

81. *Id.*

82. *Id.* at 323.

83. *Id.* at 323.

84. *Id.* at 314.

85. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 210 (1976).

86. *McLean v. Alexander*, 599 F.2d 1190, 1198 (3d Cir. 1979).

87. *See Makor*, 551 U.S. at 319 (noting that the Supreme Court had not previously considered recklessness as sufficient for a finding of scienter, but acknowledging that every Court of Appeals to consider the question has found recklessness sufficient, although those courts differ on the degree of recklessness required).

88. *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044–45 (7th Cir. 1977).

89. *See generally* William H. Kuehnle, *On Scienter, Knowledge, and Recklessness Under the Federal Securities Laws*, 34 HOUS. L. REV. 121 (1997)

Second Circuit implicated willful blindness as sufficient for scienter, holding that no defendant “can escape liability for fraud by closing his eyes to what he saw and could readily understand.”⁹⁰ Keeping these principles in mind helps one appreciate why a narrow application of collective scienter is necessary.

Specific actions by corporate officers are another issue. In the past, plaintiffs have repeatedly attempted to utilize signatures on key documents (such as Sarbanes–Oxley⁹¹ certifications) as proof of scienter when information in the document is later deemed false.⁹² This argument was soundly rejected by the Fifth, Ninth, and Eleventh Circuits.⁹³ The Eleventh Circuit explained, “Sarbanes–Oxley certification is only probative of scienter if the person signing the certification was . . . reckless in certifying the accuracy of the financial statements.”⁹⁴ A number of courts have also held that violations of Generally Accepted Accounting Principles (GAAP) are insufficient, without more, to show scienter.⁹⁵ Finally, although hindsight is generally said to be 20/20, “fraud by hindsight” is insufficient to show scienter.⁹⁶ These various findings underscore the significance that knowledge and intent are both basic requirements of a valid fraud claim.

C. The Doctrine of Collective Scienter

One of the most challenging hurdles for a plaintiff who attempts to adequately plead securities fraud is pleading facts, with particularity, sufficient to raise an inference of scienter.⁹⁷ Collective scienter uses a theory of collectivity to meet the

(thoroughly discussing what constitutes “scienter” under federal securities laws and noting that recklessness is subject to varying interpretations by courts).

90. SEC v. Frank, 388 F.2d 486, 489 (2d Cir. 1968).

91. 15 U.S.C. § 7201 (2009).

92. Glazer Capital Mgmt., LP v. Magistri, 549 F.3d 736 (9th Cir. 2008); Ind. Elec. Workers’ Pension Trust Fund IBEW v. Shaw Group, Inc., 537 F.3d 527 (5th Cir. 2008); Garfield v. NDC Health Corp., 466 F.3d 1255 (11th Cir. 2006).

93. See *supra* note 92.

94. Garfield, 466 F.3d at 1266–67.

95. *In re Ceridian Corp. Sec. Litig.*, 542 F.3d 240 (8th Cir. 2008); PR Diamonds, Inc. v. Chandler, 364 F.3d 671 (6th Cir. 2004). *But see In re Daou Systems, Inc.*, 411 F.3d 1006, 1022 (9th Cir. 2005) (noting that while GAAP violations alone are insufficient, significant violations of GAAP can provide *evidence* of scienter if they are pleaded with particularity).

96. *San Leandro Emergency Med. Grp. Profit Sharing Plan v. Philip Morris Companies, Inc.*, 75 F.3d 801, 812 (1996).

97. Pritchard, *supra* note 7, at 7–8.

pleading particularity requirements of the PSLRA.⁹⁸ This theory aggregates the misstatements or omissions by one corporate player with the intent or knowledge of another that the statements were fraudulent. The controversial theory has caused courts to reach varying results, with critics landing on both sides of the fence.⁹⁹ Proponents of collective scienter argue that without the availability of this pleading theory, corporate officers with fraudulent knowledge may be able to skirt liability by allowing others to make the misstatements or omissions.¹⁰⁰ Furthermore, many argue that without the benefit of discovery, attributing misstatements and omissions to specific individuals is too great a burden on plaintiffs.¹⁰¹

98. This notion of collectivity in pleading securities fraud is not isolated. The theme of collectivity or aggregation appears in other doctrines as well, including the group pleading doctrine and fact aggregation used when making an allegation of a strong inference of scienter. The group pleading doctrine is a jurisprudential theory that came out of the Ninth Circuit in *Wool v. Tandem Computers Inc.*, 818 F.2d 1433 (9th Cir. 1987). The theory allows authorship of a group published document, such as an annual report or prospectus, to be attributed to the collective actions of officers, thus assigning responsibility for the statement to those officers. Although the group pleading doctrine has a different aim (group pleading assigns responsibility for a corporate, group-published document to an individual; collective scienter works in reverse, aggregating knowledge and misstatements by different actors and assigning responsibility of various individuals to the corporation), the majority of courts have held that the group pleading doctrine does not survive the PSLRA, for similar reasons that collective scienter would not. Because the PSLRA requires pleading with particularity, the courts rejecting group pleading find the theory fails to allege that the particular misstatement was made by the particular officer. However, a minority of courts have stated the doctrine is still alive and well. The concept of collectivity is also used in pleading securities fraud to create an inference of strong scienter as required by the PSLRA. This is the only universally accepted notion of collectivity in this respect. The Supreme Court has recognized that an inference of scienter may be created by aggregating facts and looking at the picture as a whole to determine if an inference of strong scienter exists. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 322–23 (2007) (acknowledging this aggregation of facts by the federal circuit courts); see *supra* notes 82–86 and accompanying text. Any further discussion of collectivity and the group pleading doctrine is beyond the scope of this Comment.

99. See *infra* Part III.

100. Murdock, *supra* note 23, at 43–46.

101. In his Veto Message regarding the PSLRA, President Clinton stated: “I am not . . . willing to sign legislation that will have the effect of closing the courthouse door on investors who have legitimate claims. . . . I believe that the pleading requirements . . . impose an unacceptable procedural hurdle to meritorious claims” 141 CONG. REC. 36, 207–08 (1995); see also Perino, *supra* note 2, at 924–26.

This is a potential pitfall of an outright rejection of collective scienter. If a corporate executive intentionally allows fraudulent information to be made public, then wrong-doing occurs. Likewise, if the executive is willfully blind, but is not the direct speaker, fraud takes place. However, a plaintiff has little chance of getting past the pleading stage to prove it.¹⁰²

On the other hand, those courts that reject the theory require that the individual with the requisite scienter must make the misstatement.¹⁰³ Simply stated, to survive a dismissal claim under the PSLRA in those courts, three elements must collide: (1) an individual, (2) who makes a misstatement, (3) with fraudulent intent.¹⁰⁴

Scholars and commentators who favor an outright rejection of the theory fear that it casts too wide a net.¹⁰⁵ They argue that the theory would allow knowledge held by every employee, including lower level employees, to be imputed to the corporation, even though the executive officer has no knowledge or intent that any statements he made may be fraudulent.¹⁰⁶ Opponents of the theory also argue that the use of collective scienter chills or slows corporate communications.¹⁰⁷ Furthermore, those on this side of the fence argue that Congress intended scienter to be a primary requirement of a securities fraud claim; a collective scienter theory allows a claim to become something more akin to negligent liability or even strict liability, neither of which requires intent.¹⁰⁸

Finally, the courts that reject the use of collective scienter reason that it simply does not work under the framework set up in

102. It should be noted that some scholars discussing the theory have characterized the theory as operating in a “weak version” or “strong version.” See O’Riordan, *supra* note 16, at 1606–07; see also Jonathan W. Miller & Lyle Roberts, *Outside Counsel: “Collective Scienter” in Securities Fraud Cases*, N.Y. L.J., Feb. 8, 2008, at 4 (referring to collective scienter as “broad” or “narrow”). Others have distinguished versions of the theory in terms of “collective knowledge” versus “collective action.” See Malioneck & Salama, *supra* note 75; see also Abril & Olazabal, *supra* note 12, at 86 (referring to collective knowledge). For purposes of this Comment, the pleading theory as a whole will be considered.

103. *Phillips v. Scientific-Atlanta, Inc.*, 374 F.3d 1015, 1017–18 (11th Cir. 2004).

104. *Id.*

105. SIFMA Brief, *supra* note 61.

106. *Id.*

107. Miller & Roberts, *supra* note 102.

108. *Id.*; see also Edward J. Fuhr, Terence J. Rasmussen & Steven M. Haas, *Second Circuit Addresses Collective Scienter: Court Raises the Bar for Plaintiffs in Securities Suits Filed in the Wake of a Market Collapse*, CORP. COUNS., Oct. 2008, at 1. The Supreme Court has clearly rejected negligence as insufficient. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 210 (1976).

the PSLRA. These courts, notably the Fifth and Eleventh Circuits, read the language regarding pleading requirements very strictly, finding that scienter must be alleged with respect to each defendant and each alleged misstatement.¹⁰⁹ This strict statutory interpretation, however, is overly limiting in some situations. This split in the circuit courts raises questions and uncertainty among plaintiffs and defendants as appellate courts interpret the PSLRA requirements differently.

III. LANDING ON DIFFERENT SIDES OF THE FENCE ON COLLECTIVE SCIENTER—AN EXAMINATION OF THE FEDERAL CIRCUIT COURTS' SPLIT

A split has developed among the federal circuit courts over the use of collective scienter in order to meet the heightened pleading requirements of the PSLRA. Two circuits have rejected a collective theory of scienter.¹¹⁰ Others have yet to sanction a plaintiff's use of the theory, but have left the door open for possible use in the right circumstances.¹¹¹ Only the Sixth Circuit, although not explicitly using the term "collective scienter," has permitted this type of theory in order to allow plaintiffs to adequately plead scienter.¹¹²

A. Two Circuits' Outright Rejection of Collective Scienter

Within a span of a few months in 2004, the issue of collective scienter appeared in courtrooms in the Fifth, Sixth, and Eleventh Circuits with widely divergent results. The Fifth Circuit led the charge against collectivity and addressed the issue in *Southland Securities Corp. v. Inspire Insurance Solutions, Inc.*¹¹³ In *Southland*, the defendant provided software and other services.¹¹⁴ The plaintiff alleged that the defendant engaged in securities fraud through several actions, including pushing software with major

109. *Phillips v. Scientific-Atlanta, Inc.*, 374 F.3d 1015 (11th Cir. 2004); *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353 (5th Cir. 2004).

110. *See supra* note 109.

111. *See Glazer Capital Mgmt., LP v. Magistri*, 549 F.3d 736 (9th Cir. 2008); *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190 (2d Cir. 2008); *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702 (7th Cir. 2008).

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

113. 365 F.3d 353 (5th Cir. 2004).

114. *Id.* at 359.

design flaws and issuing inaccurate revenue and earnings statements in press releases and other corporate documents.¹¹⁵ The court first flatly rejected any use of the group pleading doctrine, explaining that it did not survive the PSLRA.¹¹⁶ Next, the court reasoned, to determine if a corporate statement was made with the requisite scienter, the court must “look to the state of mind of the individual corporate official or officials who make or issue the statement (or order or approve it . . .) rather than generally to the collective knowledge of all the corporation’s officers and employees.”¹¹⁷ By disallowing an aggregation of one individual’s knowledge with the misstatement of another employee or officer, the court rejected the pleading theory of collective scienter.

The Eleventh Circuit was the next court given the opportunity to address the issue.¹¹⁸ The question asked was whether “allegations that standing alone do not give rise to a ‘strong inference’ of scienter under the PSLRA may nevertheless be aggregated to create such a finding.”¹¹⁹ Drawing from the reasoning of the Fifth Circuit, the court held, “[s]cienter must be found with respect to each defendant and with respect to each alleged violation of the statute.”¹²⁰ Again, a collective set of misstatements and intent failed to suffice when both elements did not reside in the same actor. For both the Fifth and Eleventh Circuits, the plain statutory language of the PSLRA does not allow for this pleading theory.¹²¹ The PSLRA pleading standard refers to “*the defendant*,” a phrase which led these courts to conclude that the PSLRA may only be interpreted in a manner that requires a single actor and thus cannot support collective scienter.¹²²

B. The Sixth Circuit Takes a Different Approach

Although the court did not expressly use the term, the Sixth Circuit addressed the collective scienter issue in *City of Monroe*

115. *Id.* at 360.

116. *Id.* at 364–65. The court refused to allow responsibility for a group-published document to be imputed to an individual corporate officer merely on the basis of his or her title. *See supra* note 99 and accompanying text.

117. *Southland Sec.*, 365 F.3d at 366.

118. *Phillips v. Scientific-Atlanta, Inc.*, 374 F.3d 1015 (11th Cir. 2004). The appellate court addressed the issue in a certified question from the United States District Court for the Northern District of Georgia.

119. *Id.* at 1016.

120. *Id.* at 1017–18.

121. *Id.* at 1018.

122. *Id.*

*Employees Retirement System v. Bridgestone Corp.*¹²³ Bridgestone, a Japanese company, and Firestone, its United States-based subsidiary, began to have tire quality issues.¹²⁴ Firestone was accused of manufacturing faulty tires that caused numerous accidents.¹²⁵ In addition to naming both corporations as defendants, the plaintiffs also named Masatoshi Ono, who was both Executive Vice-President of Bridgestone and CEO of Firestone.¹²⁶ The plaintiffs alleged that the defendants made a number of material public misrepresentations concerning the safety and performance of the company's products.¹²⁷ Later, after severe safety issues came to light resulting in massive recalls and a number of lawsuits, the price of Bridgestone stock took a major dive.¹²⁸ The facts in this case proved to be of utmost importance to demonstrate a need for the pleading theory of collective scienter in certain situations.

A number of significant events surrounded the *Bridgestone* decision. According to the court's narrative, Firestone management was clearly aware of a number of issues.¹²⁹ Firestone's problems began with poor tire quality problems, primarily those tires produced at the Decatur, Illinois plant.¹³⁰ Furthermore, Firestone's own internal and external quality control tests repeatedly indicated high failure rates.¹³¹

As a result, a number of major incidents occurred. These included a demand from State Farm Insurance to pay the costs

123. 399 F.3d 651 (6th Cir. 2005). This case was originally heard in 2004. *City of Monroe Emps. Ret. Sys. v. Bridgestone Corp.*, 387 F.3d 468 (6th Cir. 2004), *modified*, 399 F.3d 651 (6th Cir. 2005). The court later amended its ruling, but there were no significant changes regarding collective scienter.

124. *Bridgestone*, 399 F.3d at 656. Although Firestone was a foreign-owned corporation and did not trade on any United States stock exchange, shares were traded in the form of American Depositary Receipts ("ADRs") in the over-the-counter market. *Id.* at 655–56. Each ADR represented ten shares of Bridgestone common stock. These ADRs had been purchased by the Monroe Retirement Fund. *Id.*

125. *Id.* at 656.

126. *Id.* at 655. Kaizaki, the CEO of Bridgestone, was also named but was dismissed as a defendant for lack of personal jurisdiction.

127. *Id.* at 659.

128. *Id.* at 663.

129. *Id.* at 656–63.

130. *Id.* at 657. Firestone, in response to pressure to cut costs and increase production, ramped up manufacturing at an Illinois-based factory, which resulted in a labor strike. Firestone's response by staffing the production lines with untrained workers, in combination with using a pellet-rubber material later shown to be substandard, resulted in a very large number of poor-quality tires being produced. The tread on these tires began to separate, resulting in tire failure and a large number of vehicle accidents and rollovers. *Id.*

131. *Id.*

attributable to accidents of its clients resulting from faulty tires.¹³² Firestone reimbursed State Farm without public disclosure.¹³³ Next, several governmental investigations began.¹³⁴ The State of Arizona notified Firestone of tire issues;¹³⁵ Firestone responded by replacing the tires on the state's fleet without public disclosure.¹³⁶ The Venezuelan government, responding to an inordinate number of deaths resulting from tire failure accidents, demanded a tire redesign.¹³⁷ Firestone complied in exchange for a promise of no public disclosure.¹³⁸ Following soon after, the Saudi Arabian government, responding to a refusal to issue a recall, banned Firestone tire importation.¹³⁹ Furthermore, several thousand individual complaints and a number of lawsuits were filed in a short time period.¹⁴⁰ In short, the company was under fire. Despite these events, Firestone and Bridgestone continued to stonewall and publicly stated that "objective data" indicated that the tires were safe.¹⁴¹

The plaintiffs' hurdle in this case resulted from the PSLRA particularity pleading requirements. Ono, the CEO of Firestone, was not the speaker of the fraudulent statements that were made in the corporation's annual reports and in press releases.¹⁴² When analyzing the facts, the court first pointed to several specific statements that it held fraudulent.¹⁴³ The next element, of course, was to link the intent to defraud with the speaker.¹⁴⁴ Because none of the statements could be directly attributed to CEO Ono, a theory

132. *Id.* at 658.

133. *Id.*

134. *Id.*

135. *Id.*

136. *Id.*

137. *Id.*

138. *Id.* The Venezuelan government made this demand after Firestone refused a demand by Ford (which was the primary customer of the troubling tires on its Explorer). When Firestone refused to respond to Ford, the Venezuelan government stepped in. *Id.*

139. *Id.* at 662. An internal memo at Firestone indicated that the refusal to institute a recall in the Persian Gulf was based in large part on the fear that the U.S. National Highway Traffic Safety Administration would have to be notified because the same product was sold in the United States. *Id.* at 659.

140. *Id.* at 657.

141. *Id.* at 661. The "objective data" statement was a key statement held by the court to be misleading information.

142. *Id.* at 661-63, 690.

143. *Id.* at 670.

144. *See supra* Part I.A.2 (discussing the elements of a securities fraud claim).

of collective scienter was the only way that the plaintiffs could meet the pleading requirements under the PSLRA.¹⁴⁵

In a well-reasoned analysis, the court explained why Firestone could be found liable.¹⁴⁶ The court used a totality-of-the-circumstances test to determine that there existed a strong inference of scienter with respect to Bridgestone and Firestone, in part by imputing Ono's knowledge to Firestone.¹⁴⁷ The court allowed the plaintiffs to aggregate two key elements: the misleading statements made in the corporate-issued statements and the knowledge (scienter) of Ono (attributable to Firestone via an agency theory).¹⁴⁸ In so doing, the plaintiffs made a sufficient pleading to survive a motion to dismiss.¹⁴⁹

C. *The Fence Riders*

The collective scienter issue came before the Second, Seventh, and Ninth Circuit courts in 2008. Each of these circuits failed to find the theory viable on the facts before them, yet indicated that they were open to the possibility under different facts.¹⁵⁰ In light of this uncertainty, the disparity between the Sixth Circuit and the Fifth and Eleventh Circuits continues to underscore the reality that the same situation may indeed be different in different courtrooms.

1. *The Ninth Circuit's Stance Evolves*

The Ninth Circuit took a seemingly ambiguous position. First, the court decided *Nordstrom, Inc. v. Chubb & Son, Inc.* in 1995.¹⁵¹ Chubb, the plaintiff, was the parent company of Federal, the Error

145. *Bridgestone*, 399 F.3d at 689–90. The court rejected use of the group pleading doctrine, which meant none of the fraudulent statements could be attributed directly to Ono; whether he had the requisite scienter therefore became irrelevant for him as an individual defendant. The court explained that although *respondeat superior* allowed his actions and intent to be attributable to the company, liability does not flow the other way, from corporation to individual. *Id.* at 690 n.34.

146. *Id.* at 690.

147. *Id.* at 690 n.34.

148. *Id.*

149. *Id.* at 690–91. After a remand and a variety of other procedural issues in the district court, Bridgestone and Firestone eventually settled for approximately \$30 million in 2008.

150. *Glazer Capital Mgmt., LP v. Magistri*, 549 F.3d 736 (9th Cir. 2008); *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190 (2d Cir. 2008); *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702 (7th Cir. 2008).

151. 54 F.3d 1424 (9th Cir. 1995).

and Omissions policy insurer of Nordstrom's officers and directors.¹⁵² Nordstrom was accused of securities fraud in a class action suit that ultimately settled.¹⁵³ Chubb, via Federal, was responsible for the indemnification of the six officers and directors who committed the fraud.¹⁵⁴ Federal filed its claim because the insurance policy covered liability of individual officers and directors, but not liability of the corporation itself.¹⁵⁵ Federal argued that fault under the settlement should be allocated between individual liability (of the officers) and corporate liability.¹⁵⁶ Under such an allocation, Federal would have been responsible only for the amount directly attributable to the individuals, while the corporation's liability would have been covered by Nordstrom itself.¹⁵⁷

The court began the analysis by explaining that allocation could only be made "if there is some amount of corporate liability that is both independent of and not duplicated by liability against the directors and officers."¹⁵⁸ Federal argued that the corporation could be solely liable for "certain acts and omissions of the directors and officers, because it is possible that only the corporation, under a theory of 'collective scienter,' would have had the intent required to establish liability."¹⁵⁹ The court explained, first, that at that time there was no case law that would support an independent theory of collective scienter.¹⁶⁰ Second, there was "no evidence in this case to support 'collective scienter' without a concurrent finding that a defendant director or officer also had the requisite intent."¹⁶¹ Therefore, the Ninth Circuit refused to find collective scienter.¹⁶² This decision set the stage for subsequent misinterpretations within the circuit.

In 2002, the Northern District Court of California addressed the issue of collective scienter as well.¹⁶³ The district court cited the *Nordstrom* holding, concluding that "[t]he Ninth Circuit has

152. *Id.* at 1427.

153. *Id.* at 1428.

154. *Id.* at 1428–29.

155. *Id.*

156. *Id.* at 1430.

157. *Id.*

158. *Id.* at 1433.

159. *Id.*

160. *Id.* at 1435. This case was decided in 1995, before any court had allowed or condoned the use of a collective scienter theory.

161. *Id.*

162. *Id.* at 1435–36.

163. The Northern District Court of California is located in the Ninth Circuit Court of Appeals and is bound by its holdings.

rejected the concept of collective scienter.”¹⁶⁴ Clearly, the district court interpreted *Nordstrom* as an across-the-board rejection.¹⁶⁵ However, six years later, *Glazer Capital Management, LP v. Magistri* was appealed, and the Ninth Circuit once again took up the issue.¹⁶⁶ The court attempted to clarify its position, this time taking a more moderate stance regarding collective scienter.

In *Glazer*, shareholders filed a securities fraud claim against InVision Technologies.¹⁶⁷ InVision had announced a merger agreement with General Electric.¹⁶⁸ A few months later, InVision, via press release, announced that internal investigations had uncovered possible violations of the Foreign Corrupt Practices Act, which put the merger in jeopardy.¹⁶⁹ Immediately after the press release was issued, stock prices fell, which resulted in the filing of the claim against InVision and its CEO, Sergio Magistri.¹⁷⁰ The claims centered on statements made in the merger agreement assuring compliance with all laws, which Magistri signed.¹⁷¹

Plaintiffs alleged that because the merger agreement contained statements assuring compliance with all laws, the company knowingly made fraudulent statements.¹⁷² Although the court found three statements were false, the scienter element was in question.¹⁷³ The court clarified the district court’s decision in *Apple*, stating, it “appears to have overstated our holding in *Nordstrom*. We had at that time not categorically rejected the concept of ‘collective scienter.’”¹⁷⁴ The Ninth Circuit explained that in *Nordstrom*, it merely was not present “on the facts of the case.”¹⁷⁵

Even so, the Ninth Circuit once again refused to accept a pleading of collective scienter.¹⁷⁶ The court held that Glazer must

164. *In re Apple Computer, Inc. Sec. Litig.*, 243 F. Supp. 2d 1012, 1023 (N.D. Cal. 2002).

165. *See McCasland v. Formfactor Inc.*, No. 07-5545, 2008 U.S. Dist. LEXIS 60544, at *23 (N.D. Cal. July 25, 2008) (similarly rejecting collective scienter a scant few months before *Glazer* was handed down, thus modifying the Ninth Circuit’s stance on the theory).

166. 549 F.3d 736 (9th Cir. 2008).

167. *Id.*

168. *Id.* at 739.

169. *Id.* The merger was ultimately consummated, in spite of the violations.

170. *Id.*

171. *Id.*

172. *Id.* at 739. The validity of the violations was not in doubt, particularly in light of InVision’s agreement to pay a fine to the Department of Justice and a settlement with the SEC. *Id.* at 740.

173. *Id.* at 742–44.

174. *Id.* at 744.

175. *Id.*

176. *Id.* at 745.

plead individual scienter with respect to Magistri because Magistri made the statements. Simply because a different employee knew of the violations while not knowing of the misstatement was insufficient.¹⁷⁷ Factually important in this case, the employees who were aware of the violations were located overseas, in Asian sales, which made it next to impossible for Magistri to have been aware of the violations at the time of the statements.¹⁷⁸ Although once again rejecting the use of collective scienter, the court continued to leave the door slightly ajar by stating in dicta, “[T]here could be circumstances in which a company’s public statements were so important and so dramatically false that they would create a strong inference that at least *some* corporate officials knew of the falsity upon publication.”¹⁷⁹

2. *The Seventh Circuit’s Take*

The Seventh Circuit first addressed such an issue in *Caterpillar, Inc. v. Great American Insurance Co.*¹⁸⁰ Decided in 1995, the problem was not a pleading sufficiency issue under PSLRA, but an insurance allocation issue much like that in *Nordstrom*, which was decided the same year in the Ninth Circuit.¹⁸¹ The Seventh Circuit followed a similar analysis, ultimately rejecting the plaintiffs’ call for a finding of collective scienter, but once again leaving on the table the possibility for the theory’s usage under certain circumstances.¹⁸²

The Seventh Circuit had another chance to consider scienter under the PSLRA when the court faced *Makor* for a second time

177. *Id.*

178. *Id.* at 745–47. A signature assuring compliance with all laws in all states is impossible to guarantee; to do so would impute a strong liability for even minute infractions. These signatures tend to operate more as a warranty than a guarantee, in that if a problem occurs, the company will make itself whole by paying damages.

179. *Id.* at 744.

180. *Caterpillar, Inc. v. Great Am. Ins. Co.*, 62 F.3d 955 (7th Cir. 1995).

181. In a completely un-analytical observation, the author notes that courts tend to be less sympathetic toward insurance companies who attempt to use a controversial theory and invoke a liberalization of the rules to defray indemnity expenses, compared to shareholders who may have been defrauded, as in the Sixth Circuit decision in *Bridgestone*. Neither insurance allocation case (*Nordstrom* or *Caterpillar*) raised PSLRA issues, but simply argued for collective scienter in order to avoid indemnifying a settlement; both were decided in 1995, the same year PSLRA was passed, so arguably were in the best position to get the go-ahead with such a theory, judicial lack of sympathy notwithstanding.

182. *Caterpillar*, 62 F.3d at 962–63.

after a remand by the Supreme Court in 2008.¹⁸³ In *Makor*, the Seventh Circuit discussed corporate liability under Rule 10b-5.¹⁸⁴ The court stated,

To establish corporate liability . . . requires [the court] “look[ing] to the state of mind of the individual[s] . . . who make or issue the statement . . . rather than generally to the collective knowledge of all the corporation’s officers and employees acquired in the course of their employment.”¹⁸⁵

The court went on to give an example, hypothesizing that a low-level employee guilty of embezzlement could deliberately conceal the information.¹⁸⁶ He could then feed false communications to his superiors, which would result in misleading public statements.¹⁸⁷ This would not create liability that could be imputed to his employer unless the acts were on behalf of the corporation.¹⁸⁸

In the wake of this hypothesis, however, the court made another observation:

But it is possible to draw a strong inference of corporate scienter without being able to name the individuals who concocted and disseminated the fraud. Suppose General Motors announced that it had sold one million SUVs in 2006, and the actual number was zero. There would be a strong inference of corporate scienter, since so dramatic an announcement would have been approved by corporate officials sufficiently knowledgeable about the company to know that the announcement was false.¹⁸⁹

Therefore, once again, a federal circuit court left open the door for the possible use of collective scienter in pleading securities fraud.

183. 513 F.3d 702, 708–09 (7th Cir. 2008).

184. *Id.* at 708.

185. *Id.* (second alteration in original) (quoting *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 366 (5th Cir. 2004)).

186. *Id.*

187. *Id.*

188. *Id.*

189. *Id.* at 710. This type of inference borders on a *res ipsa loquitur* theory, in which although it could not be alleged with particularity which corporate officer had knowledge of the issue, clearly someone in this position *had* to know. In other words, the facts simply speak for themselves. *See infra* notes 210–15 and accompanying text.

3. *The Second Circuit Joins the Fray*

Also in 2008, the closely watched Second Circuit took up the issue when it decided *Teamsters Local 445 Freight Division Pension Fund v. Dynex Capital Inc.*¹⁹⁰ The Teamsters pension fund alleged that Dynex misrepresented the reason for the financial losses and concealed defective underwriting practices.¹⁹¹

Teamsters' complaint alleged scienter on the part of the corporation yet failed to plead scienter against any individual defendant.¹⁹² The court explained that under the PSLRA "the pleaded facts must create a strong inference that someone whose intent could be imputed to the corporation acted with the requisite scienter."¹⁹³ The court noted that the simplest route would be to plead intent for an individual defendant.¹⁹⁴ Here, however, the court found that the plaintiffs failed to allege scienter sufficiently and remanded the case allowing plaintiffs to amend the pleading.¹⁹⁵

Moreover, like the Seventh and Ninth Circuits, the Second Circuit refused to reject the notion of collective scienter as a matter of law, once again leaving the door open with this statement: "Congress has imposed strict requirements on securities fraud pleading, but we do not believe they have imposed the rule urged by defendants, that in no case can corporate scienter be pleaded in the absence of successfully pleading scienter as to an expressly named officer."¹⁹⁶ The court quoted the Seventh Circuit's observation of a possibility of its use in the remand of *Makor*, which also left the door open to such a case.¹⁹⁷

IV. SPANNING THE USAGE SPECTRUM

The federal circuit courts seem to have taken positions along a spectrum of approval. The Fifth and Eleventh Circuits rejected the

190. 531 F.3d 190 (2d Cir. 2008).

191. *Id.* at 193. Shareholders in a class action suit alleged Dynex Capital made risky loans to unworthy borrowers yet failed to disclose these practices; as a result, when the financial markets began to slide, a large number of loans failed. *Id.*

192. *Id.*

193. *Id.* at 195.

194. *Id.*

195. *Id.* at 196.

196. *Id.*

197. *Id.* at 195–96; *see supra* note 189 and accompanying text. The court quoted the General Motors SUV hypothetical from the Seventh Circuit's opinion in *Makor*.

pleading theory of collective scienter across the board.¹⁹⁸ Only the Sixth Circuit has accepted it,¹⁹⁹ while other circuit courts insinuate that they would consider the theory, but only in certain circumstances. The careful refusal to slam the door on collective scienter by the Second, Seventh, and Ninth Circuits indicates that a situation in which a strong inference of corporate scienter exists is possible.²⁰⁰ This occurrence would be based on a special situation in which there is no possible way corporate officials, who may not have been the actual speakers of false information, could not have known of the falsity. This situation is exactly what occurred in the Sixth Circuit in *Bridgestone*.

Bridgestone was decided in 2005,²⁰¹ three years before *Glazer*, *Teamsters*, or *Makor* in the three fence-riding circuits. Notably, all three courts—the Ninth, Seventh, and Second Circuits—did not acknowledge *Bridgestone*'s holding in their respective opinions. This obvious omission seems to indicate a reluctance to take a firm stance and openly reject or condone the theory in these circuits in the absence of an appropriate set of facts. However, all three circuits clearly had a situation such as *Bridgestone* in mind when ruling in 2008 and, although failing to find collective scienter on the instant facts of each case, were careful to leave sufficient legal wiggle room for the use of the theory in the right situation. The following section examines the facts of *Bridgestone* under the analyses used by other circuits when considering collective scienter in pleadings. This analysis demonstrates why the theory should not be rejected out of hand due to the danger of an overbroad dismissal policy.

A. The Fifth Circuit's Analysis

The Fifth Circuit set the standard for a hard-line rejection of collective scienter, and this standard was closely adopted by the Eleventh Circuit as well.²⁰² Under the Fifth Circuit's analysis, even the fact pattern in *Bridgestone* would have resulted in a rejection of collective scienter. For the Fifth Circuit to accept a pleading alleging corporate scienter, Ono, the only corporate officer named as a defendant, would have had to directly make the fraudulent

198. See *supra* Part III.A.

199. See *supra* Part III.B.

200. See *supra* Part III.C.

201. *Bridgestone* first came before the Sixth Circuit in 2004 and was later reconsidered and amended in 2005. *City of Monroe Emps. Ret. Sys. v. Bridgestone Corp.*, 387 F.3d 468 (6th Cir. 2004), *modified*, 399 F.3d 651 (6th Cir. 2005).

202. See *supra* Part III.A.

statement, or the pleading would have had to allege that Ono knowingly ordered the statement or furnished the information, rather than utilize any collective knowledge, to infer scienter.²⁰³

Although information that would suffice may have been uncovered during discovery, this strict approach on the facts of *Bridgestone* would block potentially valid plaintiffs' claims from progressing past the pleading stage. This stance is overly limiting for plaintiffs, creating a hard-line position that prevents plaintiffs with legitimate claims from surviving a dismissal motion.

B. The Circuits Still on the Fence

The Ninth Circuit, in *Glazer*, was quick to correct the Northern District of California's misinterpretation of *Nordstrom*, noting the circuit had not "categorically rejected the concept of 'collective scienter.'"²⁰⁴ The Ninth Circuit rejected the pleadings in *Glazer*, but under the court's analysis, the fact pattern presented in *Bridgestone* would have passed muster and survived a motion to dismiss. The court quoted the hypothetical posed by the Seventh Circuit in *Makor*, stating that "there could be circumstances in which a company's public statements were so important and so dramatically false that they would create a strong inference that at least *some* corporate officials knew of the falsity upon publication."²⁰⁵

This was the case in *Bridgestone*—the plaintiffs alleged that Ono participated in meetings in which the multitude of incriminating facts, lawsuits, and quality test failures were discussed.²⁰⁶ According to the Ninth Circuit, the plaintiff would need to allege the corporate officer was "personally aware . . . or actively involved."²⁰⁷ Although the *Glazer* court was clear that a "should have known" allegation was insufficient,²⁰⁸ the *Bridgestone* plaintiffs alleged that Ono *did know* of the fraudulent statements.²⁰⁹ Therefore, under the analysis used by the Ninth Circuit, the *Bridgestone* facts would have reached the same result as the Sixth Circuit and allowed collective scienter as a pleading

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

204. *Glazer Capital Mgmt., LP v. Magistri*, 549 F.3d 736, 744 (9th Cir. 2008).

205. *Id.* at 744.

206. *City of Monroe Emps. Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 659 (6th Cir. 2005).

207. *Glazer*, 549 F.3d at 745.

208. *Id.* at 748.

209. *Bridgestone*, 399 F.3d at 659.

theory. The Second and Seventh Circuits used similar analyses and would likely reach the same conclusion under the holdings in *Teamsters* and *Makor*.

By overlaying the circumstances presented in the *Bridgestone* case with the varying federal circuit analyses, the distance between the positions of the courts becomes clear. Further complicating the picture and demonstrating a need for a clear ruling is the apparent leaning of some influential courts toward a *res ipsa loquitur* type of argument. In *Makor*, the Seventh Circuit utilized an oft-cited hypothetical regarding General Motors and SUVs.²¹⁰ In this argument, the court insinuated that the facts could speak for themselves and that in such a situation, even if an individual could not be identified, surely *someone* had to know of the misstatements.²¹¹ To date, only one such court has directly addressed a PSLRA claim premised on this type of ground. In *In re Parametric Technology Corp. Securities Litigation*,²¹² the plaintiffs did not rely on specific factual allegations; rather, the pleadings attempted what the court termed a “*res ipsa loquitur* rationale,” noting that the plaintiffs claimed that the defendants “*must have known*.”²¹³ The court admitted that in the past, these allegations would likely have been adequate.²¹⁴ However, the court held these arguments insufficient to comply with the PSLRA’s more strenuous demands.²¹⁵

The complication of the issue is demonstrated through such a disparity in courts’ reasonings, outcomes, and “what ifs.” These inconsistencies magnify the need for clarity within the federal court system, even as federal district courts continue to struggle with the possibility of collective scienter as a sufficient pleading theory.²¹⁶ The solution must be both equitable and reasonable and must, *most importantly*, remain within the parameters set by the PSLRA.

210. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702, 708–09 (7th Cir. 2008); *see supra* note 189.

211. *Id.*

212. 300 F. Supp. 2d 206 (D. Mass. 2001).

213. *Id.* at 223.

214. *Id.*

215. *Id.*

216. *See In re Cadence Design Sys., Inc. Sec. Litig.*, 654 F. Supp. 2d 1037 (N.D. Cal. 2009); *In re Faro Tech. Sec. Litig.*, 534 F. Supp. 2d 1248 (M.D. Fla. 2007); *Roth v. OfficeMax, Inc.*, 527 F. Supp. 2d 791 (N.D. Ill. 2007). All of these cases debate the viability of a collective scienter theory of pleading under the PSLRA.

V. BRIDGING THE DIVIDE: THE SOLUTION—A NARROW USAGE
WITH OBVIOUS KNOWLEDGE

Some scholars reject collective scienter in favor of a pure *respondeat superior* requirement.²¹⁷ Such an argument fails, however, because it would not suffice in the same type of narrow circumstances demonstrated by the examination of the Fifth Circuit's holdings. Although *respondeat superior* is an integral part of the analysis, the doctrine alone is insufficient to prevent loopholes created by corporate executives who deliberately avoid making false statements while allowing others to do so. Other scholars recommend a complicated set of rules that would consider the corporate agents, not by their status within the corporation, but by their level of involvement in the issue.²¹⁸ This set of rules would also examine corporate personality, including corporate culture and common knowledge, and scrutinize them in a context similar to criminal culpability.²¹⁹

Absent a ruling by the Supreme Court or a statutory clarification by Congress, the most reasonable and equitable rule for federal courts to adopt in considering securities fraud pleadings is one similar to that adopted by the Sixth Circuit. This rule allows collective scienter as a pleading theory in securities fraud claims only in very narrow circumstances. This means that a narrow usage of the theory would be acceptable only in those rare cases when a corporate executive is not the speaker of the misinformation but has clear knowledge that the information is false or misleading, in tandem with an awareness that the statements were made.

When Congress passed the PSLRA in 1995, the accompanying report outlined the purpose of the Act, which included protecting investors and issuers from abusive securities litigation, and put in place procedural protections to discourage such suits.²²⁰ The House Report that accompanied the passage of the PSLRA noted that “[t]he PSLRA protects outside directors, and others who may be sued for non-knowing securities law violations, from liability for damage actually caused by others.”²²¹ The “non-knowing” language indicates that a broad usage of the collective scienter theory would not and should not alone suffice. Likewise, a *res ipsa loquitur* type of theory is insufficient because the particularity

217. O’Riordon, *supra* note 16.

218. Abril & Olazabal, *supra* note 12.

219. *Id.* at 153–59.

220. H.R. REP. NO. 104-369, at 31–32 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 730–31.

221. *Id.* at 41.

requirement is simply written out of the equation. However, a narrow usage of collective scienter upon an allegation of patent awareness of the misinformation by a corporate officer bridges the gap between overly strict requirements and a liberal pleading theory.

Simply by its nature, the collective scienter doctrine has the potential to be abused if broadly implemented, as demonstrated in the *Glazer* case.²²² Furthermore, an overly broad use would abrogate the purpose of the PSLRA. Therefore, its use necessarily should be limited to very narrow circumstances where the plaintiffs can show a big picture charging clear fraud on behalf of a corporation with knowing action or inaction by executive officers, even though the distinct connection between an individual actor and the misstatement may not be immediately evident.

This rule necessitates a fact-intensive analysis, taking into account the knowledge of misinformation by a corporate officer, and considers his position, responsibilities, and actions. A lower level employee's knowledge, without more, is not enough. Moreover, as the Supreme Court indicated, a negligence or "should have known" standard is patently insufficient.²²³ Under this rule, a valid complaint must charge that the corporate officers *were aware of the misinformation and the inconsistent corporate statement, even though they themselves did not make the statement, and failed to act*. Anything less would violate the particularity requirements of the PSLRA.

Furthermore, a narrow usage clearly creates a more equitable result. Consider Scenario #1 referred to earlier, in which a CEO makes a non-knowing misstatement.²²⁴ To aggregate his statement with the knowledge of low-level scientists operating in a foreign country is not only unfair, but it is clearly not what Congress intended under the PSLRA.

Consider Scenario #2.²²⁵ A CEO makes a non-knowing statement, while another high-ranking executive, the CFO, has knowledge of its falsity. This type of scenario would require sufficient allegations to indicate intent on behalf of the corporation by charging knowledge of the CFO. This is arguably the type of scenario in which a collective scienter pleading allowance is the most useful. Whether the executive with the scienter was acting in

222. *Glazer Capital Mgmt., LP v. Magistri*, 549 F.3d 736 (9th Cir. 2008). If the court had allowed the theory of collective scienter to be utilized based only on the strength of a CEO signature, these signatures would have become similar to a strict liability.

223. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 210 (1976).

224. See the introductory hypotheticals to this Comment, *supra*.

225. See the introductory hypotheticals to this Comment, *supra*.

a manner that could be imputed to the corporation through a *respondeat superior* theory is a situation that perhaps may only be determinable upon discovery, yet a use of collective scienter in the pleadings is the only way a valid claim by the plaintiffs will survive a dismissal.

Finally, consider Scenario #3.²²⁶ The CEO intentionally avoids making the statements himself. He knows the information being disseminated is untrue, yet deliberately refuses to act. A collective scienter pleading would avoid the overly strict, loophole situation created by a Fifth Circuit type of analysis, producing a far more equitable result by allowing such a pleading to survive a dismissal.

Examining the theory in such scenarios demonstrates how a limited availability of the theory for use only in very narrow circumstances would meet the demanding pleading standards under the PSLRA yet still prevent the fear that opponents have of trapping unknowing corporate officers who make statements in good faith that later turn out to be false. This limited usage also prevents the chilling effect on corporate disclosure that results from a pervasive fear of inadvertent misstatements.

CONCLUSION

A narrow usage of the theory of collective scienter in pleading securities fraud will accomplish what Congress originally intended: to stem the tide of frivolous lawsuits on “fishing expeditions,”²²⁷ hoping to uncover ammunition during discovery yet not advocating such a stringent usage as to block plaintiffs who can show that corporate awareness was clearly evident from the totality of the circumstances. The fear of being held liable for non-knowing violations is not implicated by a narrow rule that allows a collective scienter pleading when plaintiffs can allege that the corporate officers possessed obvious knowledge. A narrow usage, occurring strictly in the face of obvious knowledge of corporate officers, would also allay the fears that collective scienter converts Rule 10b-5 into a mere negligence or strict liability statute.²²⁸ By advocating such a rule, equity and fairness are satisfied, while remaining within the parameters and purpose Congress intended by

226. See the introductory hypotheticals to this Comment, *supra*.

227. H.R. REP. NO. 104-369, at 37 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 736. The House Report specifically refers to “fishing expedition[s]” in the context of plaintiffs with frivolous claims who are searching for any “shred of evidence.” *Id.*

228. Fuhr, Rasmussen & Haas, *supra* note 108. As noted previously, negligence is insufficient for a holding of scienter. *See supra* note 86 and accompanying text.

passage of the PSLRA. Furthermore, the uncertainty that is created by circuit courts riding the fence is removed, and forum shopping fails to result in a bargain for plaintiffs. In other words, two things that are exactly the same, are in fact, exactly the same.

*Heather F. Crow**

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