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Interpreting the Heightened Pleading of the Scienter Requirement in Private Securities Fraud Litigation: The Tenth Circuit Takes the Middle Ground

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INTERPRETING THE HEIGHTENED PLEADING OF THE SCIENTER REQUIREMENT IN PRIVATE SECURITIES FRAUD LITIGATION: THE TENTH CIRCUIT TAKES THE MIDDLE GROUND

INTRODUCTION

> *You can't get discovery unless you have strong evidence of fraud, and you can't get strong evidence of fraud without discovery.*[1]

Recent revelations of corporate and individual malfeasance, fraud, and accounting irregularities[2] suggest that Congress may revisit, and possibly revise,[3] certain provisions of the Private Securities Litigation Reform Act of 1995 ("PSLRA").[4] While private securities litigation actions augment the enforcement activities of the Securities and Exchange Commission ("SEC"),[5] critics of private securities actions claim that the threat of strike suits[6] creates enormous, unfair burdens on targeted companies.[7] Congress enacted the PSLRA, in large part, to rein in what it, as

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1. Robert S. Greenberger, *Questioning the Books: Panel, in Enron's Wake, to Review Lawsuit Curbs*, WALL ST. J., Feb. 6, 2002, at A8 (quoting Columbia University law professor Jack Coffee).

2. *See* Eugene Spector, *Fraud Made Easy*, NAT'L L.J., Sept. 23, 2002, at A17 ("The equity bubble has burst, revealing vast accounting fraud, falsified profits, inflated assets and shyster executives the likes of which this country has rarely seen"); *see also* Carl M. Cannon, *Letter from Washington; Suits vs. Suits. Learning to Love Those "Legal Leeches,"* FORBES, Oct. 7, 2002, at 18 ("[A] few of us . . . warned that underneath this veneer of prosperity and profit actually lay widespread accounting rot, falsified profits, inflated asset values, and executive chicanery which would collapse the system " (quoting from an address that securities litigator William S. Lerach gave at Stanford Law School)), *available at* 2002 WL 23192442.

3. *See* Spector, *supra* note 2 (arguing for repeal of the Private Securities Litigation Reform Act of 1995 (PSLRA)). *But see* Charles H. Dick, Jr., *Going Overboard on Securities Law Reform*, SAN DIEGO UNION-TRIB., July 19, 2002, at B7 (arguing that additional legislation is unnecessary and will impose economic burdens on "America's honest businesses"), *available at* 2002 WL 4615199; Patricia J. Villareal, *Enron's Impact on the PSLRA*, TEX. LAW., Apr. 29, 2002, at 31 (arguing that even with the many Enron-inspired bills before it, Congress should not change the PSLRA). Congress responded to public outcries in the wake of the collapse of Enron by enacting the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 15 U.S.C. and 18 U.S.C.). See Barton S. Sacher et al., *The Public Company Accounting Reform and Protection Act, The Changing Landscape of Public Corporations and the Accounting and Law Firms who Provide Them Services*, FLA. B. NEWS, Sept. 1, 2002, at 24, for a discussion of the Sarbanes-Oxley Act's provisions. "The new law is designed to crack down on corporate criminals and to help restore confidence in the honesty, integrity, and fundamental strength of the American economy and . . . marketplace." *Id.*

4. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.).

5. *See* Spector, *supra* note 2 ("Securities litigation is a powerful deterrent against corporate fraud."); *see also* H.R. REP. NO. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730.

6. The term "strike suit" is defined as "a suit (esp. a derivative action), often based on no valid claim, brought either for nuisance value or as leverage to obtain a favorable or inflated settlement." BLACK'S LAW DICTIONARY 1448 (7th ed. 1999).

7. *See* H.R. REP. NO. 104-369, at 31-32, *reprinted in* 1995 U.S.C.C.A.N. 730, 730-31.

well as many members of the business and legal communities, believed to be abusive or unfounded securities lawsuits.[8]

In order to protect defendants from the costs associated with frivolous suits, the PSLRA halts any discovery during the pendency of a motion to dismiss.[9] To survive such a motion, the PSLRA places plaintiffs in the unenviable position of having to present a very strong and compelling case at the pleading stage, without the benefit of discovery.[10] On the other hand, the PSLRA arguably provides corporations and other defendants with better protection from "vexatious litigation"[11] because a motion to dismiss will likely defeat a weak or poorly pled case.

During the survey period, September 2001 to August 2002, the United States Court of Appeals for the Tenth Circuit, in *City of Philadelphia v. Fleming Cos.*,[12] interpreted the PSLRA's new "strong inference" standard for pleading scienter[13] under the anti-fraud provisions.[14] The Tenth Circuit's holding in *Fleming* is significant. In a well-reasoned and common sense analysis, the court aligned itself with other "middle ground" circuits when it held that, in the Tenth Circuit, courts will apply a "totality of the pleadings" test.[15] A plaintiff must show that the defendant possessed information, the intentional or reckless nondisclosure of which likely misled investors.[16] Motive and opportunity to commit fraud are relevant to proving scienter, but not sufficient alone.[17] The court will examine the plaintiff's allegations in their entirety to determine whether,

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8. *Id.* at 32, *reprinted in* 1995 U.S.C.C.A.N. 730, 731. Among the abuses noted by Congress were: 1) strike suits; 2) targeting "deep pocket" defendants; 3) abuse of discovery to try to force settlement; 4) filing of "cookie-cutter" lawsuits whenever a company's share price dropped; and 5) attorney manipulation of clients in class action suits. *Id.* at 31, *reprinted in* 1995 U.S.C.C.A.N. 730, 731; *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739-44 (1975) (discussing "vexatious litigation" under SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2003)).

9. 15 U.S.C. § 78u-4(b)(3)(B) (2000). Unless a stay would create "undue prejudice," or the plaintiffs can convince the court that "particularized discovery is necessary to preserve evidence," the filing of a motion to dismiss automatically stays "all discovery and other proceedings." *Id.*; *see also* Dan Carney, *Why the Little Guy Can't Win*, BUS. WK., Oct. 14, 2002, at 132 (noting that three months prior to WorldCom, Inc.'s disclosure of accounting irregularities, a Mississippi federal judge dismissed a fraud class action against the company, and that a court dismissed thirty-eight suits against Tyco International, Ltd. in February of 2002).

10. *But see, e.g.*, Alan R. Friedman & Michael Tremonte, *Halting Discovery in Securities Cases Rulings Explore Potential Exceptions to Mandatory Stays Under the Reform Act*, N.Y.L.J., Apr. 15, 2002 (exploring recent decisions interpreting the PSLRA stay provision).

11. *Blue Chip Stamps*, 421 U.S. at 740.

12. 264 F.3d 1245 (10th Cir. 2001). In addition to *Fleming*, the focus of this article, the Tenth Circuit also addressed certain aspects of materiality and the duty to disclose in *McDonald v. Kinder-Morgan, Inc.*, 287 F.3d 992 (10th Cir. 2002).

13. The word "scienter" is defined as "a degree of knowledge that makes a person legally responsible for the consequences of his or her act or omission." BLACK'S LAW DICTIONARY 1347 (7th ed. 1999). Scienter in the context of securities fraud includes a requirement that the act was intentional. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976) (defining scienter in the securities fraud context as "a mental state embracing intent to deceive, manipulate or defraud").

14. *See Fleming*, 264 F.3d at 1248-49.

15. *Id.* at 1261-62.

16. *Id.* at 1261.

17. *Id.* at 1263.

taken as a whole, the pleadings "give rise to a strong inference of scienter."[18]

This survey focuses on the Tenth Circuit's "middle ground" analysis of the scienter pleading requirement of the PSLRA. Part I gives a brief history of securities law prior to the enactment of the PSLRA and the subsequent apparent split among the United States courts of appeals in the way that courts in different circuits implement the scienter pleading requirement. Part II presents the Tenth Circuit's decision in *Fleming* and discusses *Fleming*'s impact as evidenced by two current district court cases decided in the Tenth Circuit. Part III reviews selected recent cases from other circuits. Part IV compares the Tenth Circuit's analysis with the analyses of the other circuits. The Tenth Circuit's "middle ground" approach appears to represent an emerging consensus for *all* of the circuits, diminishing the significance of the previous "circuit split."

I. BACKGROUND

A. The Securities Acts

Congress enacted the securities laws[19] in response to the market crash of 1929 and the Great Depression.[20] Collapsed share prices and disclosures of fraud and stock price manipulations seriously eroded investor confidence.[21] Congress sought to restore faith in the exchanges, thereby stimulating wealth formation, creating jobs, and enhancing economic growth.[22] The Securities Act of 1933 regulated the registration and offering of securities and imposed civil and criminal penalties for violations.[23] In addition, the Securities Exchange Act of 1934 regulated secondary trading, and instituted reporting requirements for corporations listing stock on the national exchanges and the over-the-counter markets.[24]

The Exchange Act contained strong prohibitions on fraud. Section 10(b) of the Exchange Act made it "unlawful for any person . . . [t]o use

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18. *Id.*

19. Securities Act of 1933, ch. 38, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. § 77a-77aa); Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. § 78a-78mm).

20. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976) (discussing the rationale behind federal securities regulation). *See generally* Janine C. Guido, *Seeking Enlightenment from Above: Circuit Courts Split on the Interpretation of the Reform Act's Heightened Pleading Requirement*, 66 BROOK. L. REV. 501, 503-13 (2000) (providing historical and legislative background of securities law).

21. *See Hochfelder*, 425 U.S. at 194-95.

22. *See, e.g.*, JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE ch. 2 (rev. ed. 1995) (discussing the rationale for the Securities Act of 1933).

23. *See Hochfelder*, 425 U.S. at 195; *see also* 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1.2[3][A] (4th ed. 2002).

24. *See* 2 HAZEN, *supra* note 23, § 9.2. Section 12g, which covers over-the-counter markets, was added to the Exchange Act in 1964. *See id.* at n.8.

or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of [the rules prescribed by the SEC]."[25] The SEC implemented this prohibition in Rule 10b-5, making it unlawful to disseminate untrue statements of material fact, or to fail to disclose material facts, if, by so doing, investors might be misled as to the value of a company's stock.[26] Even though § 10(b) does not explicitly create any private right of action (nor did the SEC or Congress necessarily intend such a remedy),[27] the courts have determined that litigants may pursue a private right of action when they allege that they have been the victims of securities fraud.[28]

B. Standard for Pleading Prior to the PSRLA

Courts adopted a wide variety of interpretations of the substantive and procedural foundations of actions under Rule 10b-5.[29] In order to bring a Rule 10b-5 or § 10(b) action in the Tenth Circuit, "a plaintiff [had to] allege: (1) a misleading statement or omission of a material fact; (2) made in connection with the purchase or sale of securities; (3) with intent to defraud or recklessness; (4) reliance; and (5) damages."[30] The pleading of the third element, intent, has engendered much controversy. The Supreme Court defined scienter in the securities fraud context as "a mental state embracing intent to deceive, manipulate, or defraud."[31] Although this definition covered intentional behavior, the Court did not specifically address whether scienter also included recklessness.[32] All of the circuit courts, however, accepted a showing of recklessness to support scienter.[33]

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25. 15 U.S.C. § 78j (2000).

26. *See* 17 C.F.R. § 240.10b-5 (2003).

27. *Hochfelder*, 425 U.S. at 196.

28. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975).

29. *Compare* Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1127-28 (2d Cir. 1994), *and In re* Time Warner, Inc. Sec. Litig., 9 F.3d 259, 269 (2d Cir. 1993), *with In re* GlenFed, Inc. Sec. Litig., 42 F.3d 1541, 1545-47 (9th Cir. 1994), *and* Shapiro v. UJB Fin. Corp., 964 F.2d 272, 284-85 (3d Cir. 1992). *See also* S. REP. NO. 104-98, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683 ("The lack of congressional involvement has left judges free to develop conflicting legal standards.").

30. Grossman v. Novell, Inc., 120 F.3d 1112, 1118 (10th Cir. 1997) (governed by pre-PSLRA law). To survive either a motion to dismiss or a motion for summary judgment a plaintiff had to allege facts that supported these five elements. *See Grossman*, 120 F.3d at 1118.

31. *Hochfelder*, 425 U.S. at 193 n.12.

32. *Id.* at 193. The Court disallowed negligence as a basis for liability. *See id.*

33. Scott H. Moss, Comment, *The Private Securities Litigation Reform Act: The Scienter Debacle*, 30 SETON HALL L. REV. 1279, 1280 (2000). The Tenth Circuit defined recklessness as "conduct that is an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." City of Philadelphia v. Fleming Cos. 264 F.3d 1245, 1258 (10th Cir. 2001) (quoting Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1232 (10th Cir. 1996)). This is also the Seventh Circuit articulation of recklessness, *see* Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977), and it is used by the majority of circuit courts, *see Fleming*, 264 F.3d at 1259.

Prior to the PSLRA, the circuits divided over the degree of factual support needed in the pleadings to support allegations of scienter.[34] The Ninth Circuit employed a lenient pleading standard.[35] In contrast, the Second Circuit, considered the most stringent, required plaintiffs to provide a "strong inference" of scienter by either (1) sufficiently alleging facts showing "strong circumstantial evidence of conscious misbehavior or recklessness," or (2) alleging facts sufficient to infer the defendant's opportunity and motive to commit securities fraud.[36]

C. *New Pleading Standard After Passage of the PSLRA and the Circuit "Split"*

Reacting to this lack of uniformity in the circuits' application of Rule 9(b), and in response to the intense criticism by participants in the industry and others regarding perceived abuse by litigants of § 10(b) and Rule 10b-5, Congress revised the securities laws by passing the PSLRA.[37] The PSLRA did a number of things. The more important changes included the addition of statutory "safe harbor" provisions;[38] substitution of proportionate liability for joint and several liability in cases where the defendants acted non-knowingly;[39] as well as various provisions governing lead plaintiffs and counsel in class action suits.[40]

In addition, the PSLRA included a new, heightened, statutory pleading requirement regarding a defendant's state of mind.[41] Specifically,

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34. *See generally* Note, *Pleading Securities Fraud Claims with Particularity Under Rule 9(b)*, 97 HARV. L. REV. 1432 (1984) (discussing the courts' inability to "resolve the conflict between the philosophy of notice pleading . . . and the heightened pleading standard of rule 9(b).").

35. *See, e.g.*, *GlenFed, Inc.*, 42 F.3d at 1545-47. Federal Rule of Civil Procedure 9(b) requires plaintiffs to plead the factual circumstances surrounding any alleged fraud with particularity in order to survive a 12(b)(6) motion to dismiss. *See id.* at 1545. "[Rule] 9(b) . . . states, 'In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally.'" *Id.* (quoting FED. R. CIV. P. 9(b)). Because Rule 9(b) only requires general allegations of intent, "[i]n the Tenth Circuit, [such] general averments of intent or other conditions of mind, unaccompanied by supporting facts, [were] adequate" to satisfy the particularity requirement. *In re* Storage Tech. Corp. Sec. Litig., 804 F. Supp. 1368, 1373 (D. Colo. 1992) (citing Phelps v. Wichita Eagle-Beacon, 886 F.2d 1262, 1270 n.5 (10th Cir. 1989)); *see also In re* Stat-Tech Sec. Litig., 905 F. Supp. 1416, 1421 (D. Colo. 1995); *In re* Exabyte Corp. Sec. Litig., 823 F. Supp. 866, 869 (D. Colo. 1993).

36. Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 537-38 (2d Cir. 1999) (discussing the Second Circuit's pre-PSLRA pleading standard).

37. *See* H.R. REP. NO. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730. Congress enacted the PSLRA over President Clinton's veto. Dick, *supra* note 3.

38. The PSLRA added section 27A to the 1933 Act and section 21E to the 1934 Act, which codified the "bespeaks caution" doctrine whereby "sufficient cautionary language may preclude misstatements from being actionable." 2 HAZEN, *supra* note 23, § 12.9[8].

39. *See id.* § 7.12[1].

40. *See id.* § 12.15[1][A]-[B].

41. *See* Brent Wilson, Comment, *Pleading Versus Proving Scienter Under the Private Securities Litigation Reform Act of 1995 in the Ninth Circuit After In re* Silicon Graphics *and* Howard v. Everex*: Meet the Pleading Standard and the Fat Lady has Already Sung*, 38 WILLAMETTE L. REV. 321, 324-25 (2002). *See generally* Moss, *supra* note 33 ("[A]nalyzing the various interpretations of the PSLRA's scienter standard.").

Congress attempted in the PSLRA to insure a uniform and heightened pleading standard,[42] requiring that:

> [i]n any private action arising under this title . . . in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title . . . , state with *particularity* facts giving rise to a *strong inference* that the defendant acted with the required state of mind.[43]

Should the plaintiff fail to satisfy this requirement, the court may dismiss her claim.[44]

The PSLRA neither defined "required state of mind"[45] nor prescribed any particular method for showing a strong inference of scienter.[46] The legislative history does not clearly indicate what Congress intended.[47] Congress declined to enunciate an unambiguous standard.[48] Unfortunately, contrary to Congress' intent, passage of the Reform Act has not significantly affected the number of securities fraud cases filed each year.[49] Its enactment fueled a firestorm of litigation to resolve various ambiguities in the statute and clarify many of the Act's procedural requirements.[50] In particular, the circuits have struggled in the seven

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42. H.R. REP. NO. 104-369, at 41, *reprinted in* 1995 U.S.C.C.A.N. 730, 740 (Rule 9(b) "ha[d] not prevented abuse of the securities laws by private litigants.").

43. 15 U.S.C. § 78u-4(b)(2) (2000) (emphasis added).

44. *Id.* § 78u-4(b)(3)(A).

45. *See In re* Comshare, Inc. Sec. Litig., 183 F.3d 542, 549 (6th Cir. 1999).

46. *See* Nathenson v. Zonagen, 267 F.3d 400, 411 (5th Cir. 2001).

47. *See, e.g.*, Greebel v. FTP Software, Inc., 194 F.3d 185, 195 (1st Cir. 1999) ("The legislative history is inconclusive on whether the Act was meant to either embody or to reject the Second Circuit's pleading standards.").

48. *Greebel*, 194 F.3d at 192 ("[A]ll sides find . . . some support for their positions. . . . [T]here was agreement [in Congress] on the words of the statute and little else."). The PSLRA explicitly uses the Second Circuit's pre-PSLRA language of "strong inference;" however, the Conference Committee stated that it did not intend to "codify the Second Circuit's case law interpreting this pleading standard." H.R. REP. NO.104-369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740.

49. Since Congress passed the PSLRA, over 1,700 class action securities fraud cases have been filed in federal district courts. *See* Stanford Law School & Cornerstone Research, *Securities Class Action Clearinghouse, at* http://securities.stanford.edu (last visited Feb. 15, 2003) [hereinafter Class Action Litigation] (showing 1,703 federal cases since 1996). Of the roughly 1,300 shareholder class action suits filed between December of 1995 and May of 2002, approximately one-fourth were dismissed, with another one-fourth settled. Kevin P. Roddy, *Seven Years of Practice and Procedure Under the Private Securities Litigation Reform Act of 1995*, SH013 ALI-ABA 397, 499, 502 (2002). In the five years preceding the enactment of the PSLRA, approximately 200 cases per year were filed. *See* Class Action Litigation, *supra*. The dollar amount of settlement has greatly increased over the years, averaging $16 million in 2001. *See* Stanford Law School & Cornerstone Research, *Federal Securities Class Action Cases Filed and Defendant Market Cap Losses Surge in 2001* (Mar. 15, 2002), *at* http://securities.stanford.edu/scac_press/20020315_CR_SCAC.pdf.

50. *See* Roddy, *supra* note 49, at 405 ("[I]t cannot be disputed that since [the PSLRA was passed] the procedural skirmishing . . . has been more intense and time-consuming than that experienced under the prior statutory scheme").

years since the passage of the PSLRA with the interpretation and application of the heightened pleading standard.[51]

Three potentially divergent approaches arose as to exactly what a plaintiff must allege in order to support a "strong inference" of scienter.[52] Courts generally agree that recklessness will suffice.[53] The basic disagreement concerns whether a showing of motive and opportunity by itself remains sufficient to satisfy the scienter requirements of the PSLRA.

1. The Second Circuit's Motive and Opportunity Test

The Second and Third Circuits have held that a showing of motive and opportunity remains sufficient to prove scienter after the passage of the PSLRA.[54] Motive entails a showing of "concrete benefits that could be realized by one or more . . . false statements."[55] Opportunity requires pleading facts showing "the means and likely prospect of achieving concrete benefits by the means alleged."[56] In other words, the defendants must have had the ability to profit from the alleged fraud.

The Third Circuit, in *In re Advanta Corp. Securities Litigation*,[57] reviewed both the legislative history and the plain language of the PSLRA.[58] After finding the legislative history contradictory and inconclusive, the court held that to plead scienter sufficiently, plaintiffs need

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51. *Cf. Fleming*, 264 F.3d at 1257-63 (discussing the circuit court split over the pleading standard). *See generally* Moss, *supra* note 33 (discussing the courts' varying interpretations of the PSLRA's effect on the scienter pleading requirements).

52. *See Fleming*, 264 F.3d at 1259-63; *see also* Dale E. Barnes, Jr. & Elizabeth Ybarra, *Testing a Complaint Under the Private Securities Litigation Reform Act*, 1320 PLI CORP. 135 (2002); Lewis J. Liman, *Selected Topics Under the Private Securities Litigation Reform Act (PSLRA), Pleading Scienter, Pleading Particularity (Anonymous Sources) and Document Preservation*, 1320 PLI CORP. 35, 37-40 (2002); Moss, *supra* note 33; Roddy, *supra* note 49, at 435-57; Tower C. Snow, Jr. & Stephen M. Knaster, *The Diverging Circuit Court Standards for Pleading Scienter under the Private Securities Litigation Reform Act of 1995*, 1332 PLI CORP. 261 (2002).

53. *See, e.g.*, Roberta S. Karmel, *"Wharf," the Reform Act and Scienter*, N.Y.L.J., Dec. 26, 2001, at 3 ("[A]ll of the circuits have gleaned the idea that recklessness can constitute the necessary intent to violate § 10(b) and Rule 10b-5"); *see also In re* Advanta Corp. Sec. Litig., 180 F.3d 525, 535 (3d Cir. 1999) (reaffirming that recklessness "remains a sufficient basis for liability"). This might not be true in the Ninth Circuit. *See* discussion *infra* Part IV.

54. Novak v. Kasaks, 216 F.3d 300, 311 (2d Cir. 2000) (reaffirming that previous Second Circuit case law remains the standard by which scienter must be pled); *Advanta*, 180 F.3d at 534-35; *Press*, 166 F.3d at 537-38.

55. *Shields*, 25 F.3d at 1130.

56. *Id.*

57. 180 F.3d 525 (3d Cir. 1999). Advanta, a credit card issuer, used aggressive "teaser rates" to attract new customers, and would, after a limited time, raise the cards' interest rate to a higher, permanent level. *Advanta*, 180 F.3d at 528. Investors alleged the company and its officers knowingly made false and misleading statements and omissions regarding the company's earnings potential and stock value. *Id.* The Circuit Court dismissed the complaint because it determined that several statements were "forward-looking" within the safe harbor provision of the PSLRA; that the plaintiffs had failed to plead specific facts supporting an inference that the company had actual knowledge of its statements' falsity; and that optimistic statements characterized as "puffery" are generally not material. *See id.* at 535-36, 538. According to the court, stock sales by some officers did not rise to the level permitting an inference of fraudulent intent. *See id.* at 540-41.

58. *Id.* at 531.

only allege facts establishing a motive and opportunity to commit fraud or "facts that constitute circumstantial evidence of either reckless or conscious behavior."[59] The court emphasized, however, that plaintiffs must support such allegations with particular facts allowing a strong inference of scienter.[60]

2. The Ninth Circuit: *In re Silicon Graphics, Inc. Securities Litigation*[61]

The Ninth Circuit held that allegations of "mere 'motive and opportunity' or 'recklessness'" fail to meet the PSLRA's heightened pleading standard, stating that "the PSLRA requires plaintiffs to plead, at a minimum, particular facts giving rise to a strong inference of *deliberate or conscious recklessness.*"[62] The Ninth Circuit's pronouncement of an apparently new recklessness standard, "deliberate recklessness," elicited much criticism; however, its actual application has been comparable to the recklessness standards of the other circuits.[63]

3. Other Circuits: Emergence of "The Middle Ground"[64]

The First, Sixth, and Eleventh Circuits have held that while allegations of motive and opportunity alone will not meet the scienter requirement, the courts will consider these allegations relevant to the scienter analysis when based upon supporting facts.[65] *In re Comshare, Inc. Securities Litigation*[66] illustrates this principle. In that case, the plaintiffs alleged that they were induced to purchase Comshare stock at an artificially inflated price by the defendants' public misrepresentations of revenue, which resulted from a knowing or reckless disregard of accounting errors.[67] Plaintiffs further alleged that the defendants violated "Generally Accepted Accounting Principles ('GAAP')," as well as the company's established accounting standards, because they claimed that Comshare prematurely recognized revenue based upon conditional sales.[68] The Sixth Circuit agreed that the plaintiffs' allegations that the employment compensation of individual defendants were tied to the

59. *See id.* at 534-35.
60. *Id.* at 535.
61. 183 F.3d 970 (9th Cir. 1999).
62. *Silicon Graphics*, 183 F.3d at 979 (emphasis added).
63. *See* discussion *infra* Part IV.B.
64. Besides the First, Sixth and Eleventh Circuits, the Fourth, Fifth and Eighth Circuits should likely also be considered "middle ground." *See infra* Parts III., IV.
65. *See* Helwig v. Vencor, Inc., 251 F.3d 540, 550, 552 (6th Cir. 2001) (en banc) (reaffirming the proposition that the PSLRA requires particularized pleadings that raise a "strong inference of scienter"), *cert. dismissed*, 536 U.S. 935 (2002); Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1285-87 (11th Cir. 1999) (holding that "severe recklessness" satisfies the scienter requirement and requiring plaintiffs to plead scienter with particularity); *Greebel*, 194 F.3d at 188 (holding that the PSLRA requires particularized pleadings that "raise a 'strong' inference of scienter").
66. 183 F.3d 542 (6th Cir. 1999).
67. *See Comshare*, 183 F.3d at 546-47.
68. *Id.*

price of the company's stock and that individual defendants benefited by selling personally held stock at the inflated prices provided the motive and opportunity of the defendants to commit fraud.[69] The court, however, held that, without more, this did not give rise to a strong inference that the defendants acted with recklessness.[70] Because the complaint did not allege any facts that showed that the defendants knew, or could of known, of the accounting errors, the court held that a mere "failure to follow GAAP," even if knowing or reckless, could not alone support scienter.[71]

The Eleventh Circuit agreed with what it viewed as the Sixth Circuit's position in *Comshare*; specifically, that pleading motive and opportunity could not alone sustain a complaint of fraud.[72] The Sixth Circuit, however, in a later case, stated that the Eleventh Circuit's "reading of *Comshare* [was] unduly rigid" and that "[w]hile it is true that motive and opportunity are not substitutes for a showing of recklessness, they can be catalysts to fraud and so serve as external markers to the required state of mind."[73] The Sixth Circuit reiterated that plaintiffs must plead facts and not rely on the "mantra" of motive and opportunity.[74] Asserting that "Congress was concerned with the quantum, not type, of proof,"[75] the Sixth Circuit went on to endorse the First Circuit's "fact-specific" approach, whereby "inferences of scienter survive a motion to dismiss only if they are both reasonable and strong inferences."[76] In order to create a strong inference, plaintiffs must propose facts that most plausibly support a conclusion that misconduct occurred in the face of competing inferences.[77] Thus, according to the Sixth Circuit, the PSLRA significantly strengthened the prior standard, which had given plaintiffs "the benefit of *all* reasonable inferences."[78]

Against this backdrop of confusion about implementing the new PSLRA pleading requirements, the Tenth Circuit weighed in.

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69. *Id.* at 553.
70. *Id.*
71. *Id.*
72. *Bryant*, 187 F.3d at 1283.
73. *Helwig*, 251 F.3d. at 550.
74. *Id.*
75. *Id.* at 551.
76. *Id.* (quoting *Greebel*, 194 F.3d at 195-96).
77. *See id.*
78. *Id.* at 553 (quoting Cameron v. Seitz, 38 F.3d 264, 270 (6th Cir. 1994)).

II. PLEADING SCIENTER IN THE TENTH CIRCUIT

A. City of Philadelphia v. Fleming Cos.[79]

1. Facts

Plaintiffs brought a class action lawsuit on behalf of purchasers of Fleming Companies, Inc. ("Fleming") stock.[80] The plaintiffs alleged that defendant Fleming and four current or former executives of the company violated federal securities laws by issuing materially misleading statements and omitting material information in filings with the SEC and in communications with investors.[81]

Fleming, a publicly traded company, specialized in the food distribution business and supplied food to more than 10,000 supermarkets and retail food stores.[82] In addition, Fleming owned and operated approximately 335 supermarkets.[83] Fleming's pricing arrangements included a "cost-plus" contract under which Fleming purportedly charged customers its actual cost for the items it supplied plus an agreed percentage markup.[84] Customers could expect to receive lower prices through this arrangement due to Fleming's volume discounts from its own suppliers.[85] David's Supermarkets, Inc. ("David's"), a chain of Texas grocery stores, filed suit against Fleming in August 1993, alleging that, contrary to the companies' "cost-plus" contract, Fleming kept for itself the incentives and other discounts given by its suppliers.[86] David's sought damages of approximately $110 million, an amount it eventually raised to almost $450 million.[87] In 1993 and 1994, $110 million represented approximately 10% of Fleming's total net worth and about 3% of its total assets.[88]

Fleming did not disclose the lawsuit until March 14, 1996, when it filed its 1995 Annual Report, the same day the jury announced its "ver-

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79. 264 F.3d 1245 (10th Cir. 2001).

80. *Fleming*, 264 F.3d at 1248-49.

81. *Id.* For the purposes of § 10b and Rule 10b-5, materiality is established by showing "a substantial likelihood that a reasonable shareholder would consider [the information] important." Basic, Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (adopting the materiality standard defined for proxy-solicitation issues in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). To be materially misleading, the statement or information must be significantly inaccurate or obfuscating. *See* 2 HAZEN, *supra* note 23, § 12.9.

82. *Fleming*, 264 F.3d at 1249.

83. *Id.*

84. *Id.* at 1250.

85. *Id.*

86. *Id.*

87. *Id.* at 1250-51.

88. *Id.* at 1250. The court found troubling the fact that it could not ascertain from the facts given in the *Fleming* pleadings what percentage of Fleming's total net worth or total assets was represented by the later, amended damage claims. *See id.* at 1251, 1266. The court's decision about whether to consider the David's litigation material was based in part on these percentages. *See infra* text accompanying notes 105, 115.

dict of liability against Fleming."[89] Following this disclosure, Fleming's stock suffered a substantial drop in value.[90] Even though the court set aside the verdict for David's in May 1996 and Fleming eventually settled the dispute for approximately $20 million, the plaintiffs in the instant case alleged that Fleming's stock price never recovered.[91] The plaintiffs alleged (1) that the individual defendants, as senior officers of Fleming, either had actual knowledge of the David's litigation and its significance[92] or acted with reckless indifference to the significance of the litigation; (2) that the defendants had an "affirmative duty" to stay informed of any "potentially material litigation against the company" and a duty to disclose such litigation to the public; and (3) that the defendants had explicitly disclosed pending litigation involving equivalent damage claims while not disclosing the David's litigation.[93] The plaintiffs also noted that several internal company memoranda supported their claim that the defendants must have known of the Fleming pricing policies at the heart of the David's lawsuit.[94]

The complaint gave five possible motives for the defendants not to disclose the David's litigation, which the defendants allegedly knew to be material: (1) to insure the success of notes offered for sale during the class period; (2) to avoid hampering the success of the new "cost-plus" sales marketing plan; (3) to avoid future, similar lawsuits; (4) to protect their positions and reputations within the company; and (5) to increase the value of their personal investments in Fleming stock.[95] The trial court found these allegations of scienter insufficient to meet the pleading requirements of Rule 10b-5, and that they supported, at most, "a finding of simple negligence."[96] The plaintiffs appealed to the Tenth Circuit.[97]

2. Decision

Since this was the first case that required the Tenth Circuit to interpret the scienter pleading requirements of the PSLRA, the court first reviewed the legislative history of the Act, and then examined other circuits' interpretations of the PSLRA.[98] The court agreed with the position five other circuits took, and stated, "[P]laintiffs can adequately plead scienter by setting forth facts raising a 'strong inference' of intentional or

89. *Fleming*, 264 F.3d at 1251, 1253-54. Four days later, the jury assessed punitive damages, increasing the damage award to "approximately $200 million plus attorney's fees and costs." *Id.* at 1251.

90. *Id.* at 1251-52.

91. *See id.* at 1252.

92. Several of the defendants had previously been deposed as part of the David's litigation. *See id.* at 1255 & n.14.

93. *Id.*

94. *Id.*

95. *See id.* at 1256-57.

96. *Id.* at 1257.

97. *Id.* at 1248-49.

98. *Id.* at 1258-63.

reckless misconduct."[99] The court enunciated a two-part test applicable to allegations of nondisclosure of material facts.[100] The plaintiff must first show that "the defendant knew of the potentially material fact[(s)]," and second, that the defendant knew that investors would likely be misled by "the failure to reveal the potentially material fact[(s)]."[101] The court then explicitly stated its adoption of the "middle ground" standard whereby "motive and opportunity pleadings are relevant to a finding of scienter, but . . . do not constitute a separate, alternative method of pleading scienter."[102] Courts in the Tenth Circuit must examine a plaintiffs' allegations of scienter to see if, "taken as a whole," they support "a strong inference of scienter."[103]

The court reviewed the plaintiffs' complaint using this newly enunciated standard and upheld the trial court's dismissal.[104] The court found that the plaintiffs had failed to plead particular facts sufficient to infer that the individual defendants knew of the David's litigation, or the relevant business practices regarding "cost-plus" contracts, or even the potential materiality of the lawsuit: "[T]he mere fact that the individual Defendants occupied senior positions in the company, and that two of them knew of the litigation at least by early 1995 is *not sufficient to imply knowledge of the specific fact of materiality*."[105] Even if the court accepted as true the plaintiff's allegations that the defendants knew of the David's litigation, the court emphasized that knowledge of the underlying facts does not establish scienter; rather, defendants must have *actual knowledge* of the potentially harmful effects of misleading investors by nondisclosure.[106] Alternatively, plaintiffs may plead facts that show that it would be obvious to reasonable people that harm was likely.[107] The court also rejected as merely conclusory the plaintiffs' claims that the defendants acted with reckless disregard of the "true facts misrepresented or omitted in Fleming's public statements and filings."[108] The simple fact that the defendants held senior positions in the company did not justify a finding that they had actual knowledge of the facts: "Plaintiffs . . . never

99. *Id.* at 1259.
100. *Id.* at 1261. See *supra* note 81, for the definition of "materiality."
101. *Fleming*, 264 F.3d at 1261.
102. *Id.*
103. *Id.* at 1263.
104. *Id.* at 1249.
105. *Id.* at 1264 (emphasis added). Commentators have faulted *Fleming* for possibly "creat[ing] a more difficult barrier than other circuits in pleading state of mind." 3C HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW § 16:37.1 (2d ed. 2002). They argue that the Tenth Circuit, in focusing on whether the defendants knew or should have known of the materiality of the David's litigation, changed the yardstick of materiality into a subjective standard. *Id.*
106. *See Fleming*, 264 F.3d at 1264.
107. *See id.*
108. *Id.* at 1254-55.

name any specific report defendants may have received or identify specific advice defendants may have given or received. . . ."[109]

The court next evaluated the plaintiffs' argument that the defendants should have known, or actually knew, of the importance to investors of the David's lawsuit because of the large damages claims and because it had the potential to engender additional, similar lawsuits.[110] The plaintiffs had failed to provide financial data that would allow the court to evaluate the percentage of Fleming's assets that were actually at risk in the David's litigation.[111] In addition, the plaintiffs failed to plead specific facts as to other potential lawsuits, such as the number of customers or volume attributable to the "cost-plus" contracts at issue.[112] Without a showing of additional threatened or pending lawsuits, the court found that such suits were merely "potential risks."[113]

Furthermore, even assuming that the defendants knew they might be subjected to an adverse judgment in the David's litigation, the court could not find the possibility of this event significant enough to consider the defendants reckless for not disclosing the litigation.[114] The court referred to various SEC reporting requirements relating to the materiality of suits against a company, noting that it "could not impute knowledge of the higher damage claims to Defendants . . . and . . . [it] could not determine the potential materiality under [17 C.F.R.] § 229.103 . . . because Plaintiffs [did] not provide[] the [necessary] financial information."[115] The court pointed to both the likelihood that plaintiffs seeking to force a settlement would make inflated claims and the fact that Fleming disclosed the David's litigation within one month of the amended damages claim requesting approximately $450 million as further indications that the defendants did not act recklessly or negligently.[116]

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109. *Id.*
110. *Id.* at 1264.
111. *Id.* at 1264-65.
112. *Id.* at 1265.
113. *Id.* at 1267.
114. *Id.* at 1265-66.
115. *Id.* at 1266. Instruction number two to 17 C.F.R. § 229.103 states: "No information need be given with respect to any proceeding that involves primarily a claim for damages if the amount involved, exclusive of interest and costs, does not exceed 10 percent of the current assets of the registrant and its subsidiaries on a consolidated basis." 17 C.F.R. § 229.103 (2003). Some have criticized the *Fleming* Court's apparent acceptance of the SEC's reporting requirements as determinative of materiality. *See* 3C BLOOMENTHAL & WOLFF, *supra* note 105, § 16:37.1. By accepting the 10 percent current asset test, the court essentially foreclosed the plaintiffs' allegations that the defendants should have disclosed the pending David's litigation. *Id.* Nevertheless, even if one takes the position that the court should not have considered this SEC requirement, the plaintiffs still did not provide facts supporting an inference that the defendants knew investors might be misled by nondisclosure. *Fleming*, 264 F.3d at 1264. The Tenth Circuit standard does not differ appreciably from that of the other "middle ground" circuits. *See* discussion *infra* Part IV.
116. *Fleming*, 264 F.3d at 1268.

Of the five motives that the plaintiffs alleged,[117] the court concluded that four represented "generalized motives shared by all companies" and, as such, could not alone provide a strong inference of scienter.[118] In order to support an assertion that a defendant had a motive predicated on a desire to increase the value of stock holdings or otherwise profit from a relationship with a company, a plaintiff must show that a defendant benefited from insider trading or sold stock that the defendant held personally.[119] Here, however, the plaintiffs made no concrete showing of such activities.[120] Since all companies and executives presumably desire to keep a high bond rating or stock price and to avoid potential lawsuits, allegations of such motives alone "cannot . . . sustain a claim of securities fraud."[121]

The court agreed that the plaintiffs' second alleged motive, Fleming's desire to convert all of its customers to "cost-plus" contracts, might have suffered harm if customers learned of the David's litigation.[122] Nevertheless, because of the alleged history of customer complaints that Fleming did not pass on discounts, the court found that disclosure of the David's litigation would likely have had little impact on the success of the "cost-plus" marketing plan.[123] Thus, Fleming's desire for the plan to succeed could not provide a sufficient motive to demonstrate either recklessness or intent to defraud.[124] The court concluded that the plaintiffs' pleadings "taken as a whole" failed to provide, with enough particularity, facts sufficient to support a "strong inference" that the defendants acted with the necessary scienter.[125]

B. Recent District Court Cases in the Tenth Circuit

Two recent decisions highlight the impact of *Fleming* on the pleading of securities fraud complaints in the Tenth Circuit.[126]

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117. *See supra* text accompanying note 95.

118. *Fleming*, 264 F.3d at 1269-70.

119. *Id.* at 1270.

120. *Id.*

121. *Id.* at 1269-70.

122. *Id.* at 1268. The court noted that such a motive would not normally support an inference of fraud because a "desire not to jeopardize a company's business plan is a motive shared by most companies." *Id.* Here, however, the alleged motive was "specifically and directly related to the underlying facts." *Id.*

123. *Id.* at 1269.

124. *Id.*

125. *Id.* at 1270. Fleming now faces an "uncertain future." Ann Zimmerman, *Fleming Has Doubts About Financing*, WALL ST. J., Mar. 31, 2003, at B8, *available at* 2003 WL-WSJ 3963305. The SEC is investigating the company's accounting practices and one of its largest customers, Kmart Corp., has ended its contract with Fleming. *Id.* News of Fleming's likely restatement of earnings caused its stock to drop 46% on Friday, March 28, 2003, to 61 cents. *Id.* This was in addition to the more than 90% loss in share value suffered over the previous year. *See id.*

126. Other cases also demonstrate the effect that *Fleming* has had. *See In re* Sprint Corp. Sec. Litig., 232 F. Supp. 2d 1193, 1224-25 (D. Kan. 2002) (distinguishing *Fleming* and finding plaintiffs' allegations of motive compelling where defendants stood to exercise $1.7 billion in stock options; other motives as to optimistic statements failed to raise strong inference of scienter); Precision

1. *In re Sun Healthcare Group, Inc. Securities Litigation*[127]

Plaintiffs claimed that Sun Healthcare Group, Inc. ("Sun"), a large healthcare provider, made false representations in many public statements and financial disclosures concerning its capacity to react to imminent Medicare reimbursement decreases.[128] The plaintiffs alleged that Sun should have known it could not combat the negative impact of the new reimbursement schedule because of Sun's experiences in operating nursing home facilities reimbursed under a similar payment regime.[129] Sun experienced a marked decrease in its reimbursement revenues and petitioned for bankruptcy in 1999.[130]

Despite the uncertainty surrounding the effects of the new reimbursement schedule, Sun claimed it would offset any negative effects through its "early and intensive preparation[s]" for cost reductions and through the efficiency of Sun's operating model.[131] Because Sun made these allegedly misleading statements prior to the government actually implementing the new payment arrangements, the United States District Court for the District of New Mexico viewed the plaintiffs' claims as assertions of "fraud by hindsight"—a type of claim specifically disallowed in *Fleming*.[132] The court found that the "Defendants could not possibly have known the transition's effect on the company with certainty before [the government's conversion to the new reimbursement regime]."[133] In particular, the plaintiffs failed to provide any specific evidence of possible financial harm to Sun that the defendants did not disclose in their public statements.[134] The court faulted the plaintiffs for not providing details that would allow the court to make a meaningful comparison and to "discern Defendants' alleged scienter."[135]

The court also stated that it found "it particularly noteworthy that [the plaintiffs] . . . utterly failed to present a logical motive for Defen-

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Vascular Sys., Inc. v. Sarcos L.C., 199 F. Supp. 2d 1181, 1187 (D. Utah 2002) (finding a lack of specific facts that would allow a strong inference of scienter in allegations of misrepresentations that allegedly induced investors to transfer five million shares to an affiliated corporation); Pirraglia v. Novell, Inc., 195 F. Supp. 2d 1304 (D. Utah 2002) (dismissing a complaint alleging that defendants issued materially false financial statements and business performance and prospect statements due to the lack of particularity and failure to allege requisite scienter); Gower v. IKON Office Solutions, Inc., 177 F. Supp. 2d 1224, 1232 (D. Kan. 2001) (citing *Fleming* for rules on the sufficiency of evidence to satisfy the scienter requirement in state wrongful discharge and breach of contract suit).

127. 181 F. Supp. 2d 1283 (D. N.M. 2002).

128. *Sun Healthcare*, 181 F. Supp. 2d at 1286. Passage of the Balanced Budget Act of 1997 spurred the Health Care Financing Administration to issue new reimbursement rates for Medicare services. *Id.* at 1285.

129. *Id.* at 1295-96.

130. *Id.* at 1286.

131. *See id.* at 1295.

132. *Id.* (quoting *Fleming*, 264 F.3d at 1260).

133. *Id.*

134. *Id.*

135. *Id.* at 1296.

dants' alleged fraud."[136] The court rejected as "baseless" the plaintiffs' allegations that the defendants were motivated by insider trading and by Sun's desire to successfully acquire another company as a subsidiary.[137] The plaintiffs provided no facts to support an inference that insiders had engaged in "unusual" stock activity.[138] In addition, the court found the second motive totally illogical because it wondered why the defendants would seek to acquire a company that would only cause Sun to suffer increased losses under the new payment schedule.[139] Thus, the plaintiffs failed to establish Sun's motive to commit the alleged fraud.[140] Finally, relying on *Fleming*, the court also viewed the plaintiffs' allegations that the defendants violated GAAP, without more, as insufficient to support their claims that the defendants intended to mislead investors.[141]

2. *Spiegel v. Tenfold Corp.*[142]

Tenfold Corporation ("Tenfold") and several of its directors allegedly published materially false statements regarding Tenfold's ability to perform certain of its contractual obligations.[143] These statements included repeated "on time guarantees" while the defendants knew that the company had missed several similar previous deadlines,[144] along with knowing misstatements of Tenfold's technological capabilities.[145] Also, the plaintiffs claimed that the defendants improperly recognized revenues in violation of GAAP.[146] The complaint asserted that the defendants knew or should have known of the company's inability to successfully meet its obligations, and further, that the defendants must have known that their statements would likely mislead investors.[147]

The United States District Court for the District of Utah faulted the complaint for not providing facts that would allow an inference that the defendants had actual knowledge of the company's inability to perform.[148] Nor did the complaint show that the defendants knew that the statements "posed a substantial likelihood of misleading a reasonable investor in light of the total mix of information."[149] The court applied *Fleming*'s "totality of the pleadings" test to find that the complaint, viewed "as a whole," failed "to give rise to a strong inference . . . [of] the

136. *Id.*
137. *Id.*
138. *Id.* (quoting Acito v. IMCERA Group, Inc., 47 F.3d 47, 54 (2d Cir. 1995)).
139. *Id.* at 1296-97.
140. *Id.* at 1297.
141. *Id.*
142. 192 F. Supp. 2d 1261 (D. Utah 2002).
143. *Spiegel*, 192 F. Supp. 2d at 1263.
144. *Id.* at 1264.
145. *Id.* at 1267.
146. *Id.*
147. *Id.* at 1265.
148. *Id.*
149. *Id.* (citing *Fleming*, 264 F.3d at 1265).

requisite mental state."[150] Also, as in *Sun Healthcare*,[151] the court noted that the plaintiffs' allegations of accounting irregularities, without more, did not create the necessary strong inference of scienter.[152]

III. SCIENTER IN OTHER CIRCUITS

As discussed in Part I, several circuits had already addressed the PSLRA's scienter requirement prior to the Tenth Circuit's *Fleming* decision.[153] In order to facilitate the comparison given in Part IV between the different circuits' views of the requirements for pleading scienter, this section presents recent cases from the First, Second, and Ninth Circuits—circuits that had already expressed their opinions. This section will also briefly review the positions presently taken by the Fourth, Fifth, and Eighth Circuits.[154]

A. *First Circuit:* Aldridge v. A.T. Cross Corp.[155]

1. Facts

The A.T. Cross Corporation ("Cross"), a maker of writing utensils, began selling a new product line in early 1998.[156] Cross had "high hopes" for its personal electronic devices, the CrossPad and CrossPad XP, having publicly stated in September 1997 that it expected at least "$25 million in profitable sales."[157] Instead, Cross suffered a $24.3 million loss in 1999 and subsequently discontinued sales of its pen-based computing products.[158]

Aldridge, a shareholder, filed a putative class action in April 2000 on behalf of people who purchased stock in Cross during the class period, September 17, 1997, to April 22, 1999.[159] Aldridge specifically alleged that Cross employed various sales strategies including "channel stuffing,"[160] take backs,[161] and extending price protection to retailers.[162] Aldridge contended that these practices affected the company's reported

150. *Id.* at 1266.
151. *Sun Healthcare*, 181 F. Supp. 2d at 1298.
152. *Id.* at 1267 (quoting *Fleming*, 264 F.3d at 1261).
153. *See* discussion *supra* Part I.C.
154. See *Annual Review of Federal Securities Regulation*, 58 BUS. LAW. 747, 820-89 (2003) [hereinafter *Annual Review*], for a review and analysis of recent PSLRA-related cases.
155. 284 F.3d 72 (1st Cir. 2002).
156. *Aldridge*, 284 F.3d at 75.
157. *Id.*
158. *Id.*
159. *Id.*
160. *Id.* at 81 ("'Channel stuffing' means inducing purchasers to increase substantially their purchases before they would, in the normal course, otherwise purchase products from the company. It has the result of shifting earnings into earlier quarters, quite likely to the detriment of earnings in later quarters." (quoting Greebel v. FTP Software, Inc., 194 F.3d 185, 202 (1st Cir. 1999))).
161. *Id.* ("A 'take back' is a promise to take back goods from customers who have been unable to sell them.").
162. *Id.* at 80 ("Price protection is a retailer's or distributor's right to reimbursement in the event of post-sale price reductions.").

sales of CrossPads and, thus, constituted material information[163] that Cross failed to disclose to investors despite its obligation to do so.[164] Also, in light of these sales tactics and resulting accounting practices, Aldridge alleged that Cross's management made certain fraudulent and misleading statements.[165] In the period from September 1997 to June 1988, Cross made various optimistic statements in press releases, in its 10-K report with the SEC, in *Barron's*, and in *Value Line* that sales of the CrossPad would significantly add to the company's profitability.[166] Aldridge contended that subsequent statements by company officials in 1999 showed that Cross had in fact offered its customers price protection as early as 1998.[167] In a February article in the *Providence Journal*, a company official claimed that the February 1999 price cut of up to 30% in CrossPad products had been planned from the "get go" and that retailers were aware of these planned price reductions.[168] Company officials also seemed to indicate in a conference call with investors and analysts on April 22, 1999, that the price protection program was part of the company's original strategy.[169] The district court dismissed Aldridge's claims, finding no support for the allegations that the defendants knowingly made misleading statements.[170]

2. Decision

The First Circuit Court of Appeals reversed the lower court's dismissal, holding that Aldridge had sufficiently supported his allegations of fraud, and that his pleadings allowed a strong inference that Cross and its management "consciously intended to defraud, or . . . acted with a high degree of recklessness," when making the allegedly false statements.[171] Three facts and circumstances alleged in the complaint, taken together, established a strong inference of scienter: (1) evidence indicated that the Defendants knowingly published arguably inaccurate or misleading statements regarding Cross's price protection and take back policies; (2) evidence showed that Cross did not properly account for the contingent nature of sales in company reports and financial statements; and (3) Cross's corporate officers had particular financial incentives to exaggerate earnings that were different from other firms' standard corporate compensation methods.[172] The court emphasized that the PSLRA did not change the standard of review for a motion under Federal Rule of Civil Procedure 12(b)(6), and "[t]he district court did not 'giv[e] plaintiff[] the

163. *Id.* at 82. See *supra* note 81, for the definition of "materiality."
164. *Aldridge*, 284 F.3d. at 77.
165. *Id.*
166. *Id.* at 76.
167. *See id.* at 79.
168. *Id.*
169. *Id.* at 80.
170. *Id.* at 77.
171. *See id.* at 82 (citing *Greebel*, 194 F.3d at 198-201).
172. *See id.* at 82-84.

benefit of all reasonable inferences' as it should have on a motion to dismiss."[173]

B. Second Circuit: In re Scholastic Corp. Securities Litigation[174]

1. Facts

In December 1996, Scholastic Corporation ("Scholastic"), a book publisher and distributor, changed its sales strategy by expanding distribution of its best-selling product, the "Goosebumps" series of children's books, to include mass merchandisers.[175] Scholastic publicly described this expansion of distribution "as a significant positive development."[176] The complaint alleged that Scholastic did not communicate to investors that sales of Goosebumps significantly decreased in the fall of 1996, and that Scholastic afforded retailers and distributors a full right of return.[177]

In December 1996, Scholastic announced a 24% increase in net second quarter income over the previous year.[178] While Scholastic had earlier expressed "comfort" with security analysts' third quarter income estimates of 64 to 73 cents per share, Scholastic announced an expected third quarter loss of 70 to 80 cents per share in February 1997.[179] Scholastic then announced that it "would take a $13 million pre-tax special charge" to create "a reserve for anticipated additional book returns," which triggered an immediate 40% decline in Scholastic's stock price.[180]

The plaintiffs alleged that one of Scholastic's vice presidents, defendant Raymond Marchuk, had a motive to influence Scholastic's dissemination of false and misleading statements in order to keep the price of Scholastic stock high, since he realized $1.25 million from the sale of his personal stock.[181] The plaintiffs also identified several other purportedly false and misleading material statements made to securities analysts and published in a supplement to a company prospectus.[182]

2. Decision

The Second Circuit Court of Appeals concluded that the plaintiffs had alleged facts in sufficient detail to support an inference that the defendants knew of the potentially material sales declines, and next turned to the plaintiffs' allegations of scienter.[183] Since the complaint listed only

173. *Id.* at 78-79 (alterations in original) (quoting *Greebel*, 194 F.3d at 201).
174. 252 F.3d 63 (2d Cir.), *cert. denied*, 534 U.S. 1071 (2001).
175. *Scholastic*, 252 F.3d. at 68.
176. *Id.*
177. *See id.* at 68-69.
178. *Id.* at 68.
179. *Id.* at 68-69.
180. *Id.* at 69.
181. *Id.* at 74.
182. *Id.* at 70.
183. *Id.* at 70-74.

one individual defendant, Marchuk, the court considered motive with respect to Marchuk alone and did not examine whether other Scholastic officers had sold any stock during the class period.[184] The complaint alleged that Marchuck had not sold any Scholastic shares since 1995, yet starting in late 1996, he "sold [80%] of his holdings within a matter of days for a not insignificant profit."[185] Because of his access to private company information, Marchuk was in a position to manipulate the release of information to the public.[186] Thus, the plaintiffs sufficiently pled motive and opportunity to commit fraud.[187]

The court also found that the plaintiffs had adequately alleged that the defendants had knowledge of information that contradicted their public statements such as to constitute "an extreme departure from the standards of ordinary care" and allow an inference that the defendants exhibited conscious misbehavior or recklessness.[188] In particular, the plaintiffs pled that the defendant (1) knew investors relied on information pertaining to sales and returns of Goosebumps books; (2) publicly represented, contrary to Scholastic's own data, "that returns were not increasing;" (3) told stock analysts that returns remained at normal levels; (4) disregarded retailers' warnings that "the newer Goosebump books were too 'scary;'" and (5) failed to follow Scholastic's own announced policy regarding book return accounting procedures.[189]

C. Fourth Circuit

The Fourth Circuit has not yet ruled on the new pleading standards of the PSLRA,[190] but it appears from various dicta that the court would likely agree with the middle ground courts. In *Phillips v. LCI International, Inc.*,[191] the court discussed the other circuits' PSLRA strong inference standards, but found that it did not have to select a standard because the plaintiffs in that case had failed to meet even what it characterized as the "most lenient standard possible under the PSLRA, the two-pronged Second Circuit test."[192] More recently, in *In re Trex Co. Securities Litigation*,[193] one district court within the Fourth Circuit stated that it was persuaded by reasoning that "reject[s] the mechanical application of any judicial test,"[194] and instead applied a "totality of the circumstances" test to decide whether allegations supported a "cogent and persuasive . . .

184. *Id.* at 75.
185. *Id.* at 69, 75.
186. *Id.* at 75-76.
187. *Id.* at 76.
188. *See id.* (quoting Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 47 (2d Cir. 1978)).
189. *See id.* at 76-77.
190. Phillips v. LCI Int'l, Inc., 190 F.3d 609, 621 (4th Cir. 1999).
191. 190 F.3d 609.
192. *Id.* at 620-21.
193. 212 F. Supp. 2d 596 (W.D. Va. 2002).
194. *Trex*, 212 F. Supp. 2d at 607 n.7.

inference" of scienter.[195] In that case, the plaintiffs alleged that several officers of a manufacturer of non-wood decking material sought to increase their year-end bonuses by issuing misleading sales statements and engaging in channel stuffing.[196] The court cited *Fleming*, among other cases, for the proposition that motivations common to company officials do not substantiate motive for securities fraud.[197] It also distinguished the facts before it regarding channel stuffing from those in *Aldridge* because the plaintiffs did not make specific allegations that would show how the purported sales practice affected revenues and, thus, the officers' bonuses.[198]

D. Fifth Circuit

Shortly after the Tenth Circuit decided *Fleming*, the Fifth Circuit addressed the PSLRA pleading requirements.[199] The court agreed with other circuits that "[i]t seems clear . . . the PSLRA has not generally altered the substantive scienter requirement . . . and therefore severe recklessness . . . remains a basis for such liability."[200] Pointing out that "[t]he PSLRA neither mandated nor prohibited *any* particular method of establishing a strong inference of scienter,"[201] the court cited with approval the approach taken by the Sixth Circuit in *Comshare*.[202] Most importantly, the court stated: "What must be alleged is not motive and opportunity as such but particularized facts," but "[a]ppropriate allegations of motive and opportunity may meaningfully enhance the strength of the inference of scienter."[203]

E. Eighth Circuit

The Eighth Circuit "[v]iew[s] [a plaintiff's] . . . complaint to determine whether [the plaintiff] set forth facts that give a *strong* reason to believe there was reckless or intentional wrongdoing," yet it does not impose any particular criteria or method for meeting this standard.[204] In *Florida State Board of Administration v. Green Tree Financial Corp.*,[205]

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195. *Id.* (quoting *In re* MicroStrategy, Inc. Sec. Litig., 115 F. Supp. 2d 620, 633-34 (E.D. Va. 2000)).

196. *See id.* at 599-600.

197. *Id.* at 607-08 (citing City of Philadelphia v. Fleming Cos., 264 F.3d 1245, 1268-70 (10th Cir. 2001)).

198. *See id.* at 608-12.

199. Nathenson v. Zonagen, Inc., 267 F.3d 400 (5th Cir. 2001) (allowing allegations of false and misleading statements regarding extent of company's patent coverage to support a strong inference of scienter but cautioning that they might be "barely" sufficient).

200. *Nathenson*, 267 F.3d at 408.

201. *Id.* at 411.

202. *Id.* at 410 ("The most sensible approach [to pleading a strong inference of scienter] appears to us to be the one first generally articulated by the Sixth Circuit in *Comshare*.").

203. *Id.* at 412.

204. *In re* Navarre Corp. Sec. Litig., 299 F.3d 735, 745 (8th Cir.), *vacated by* 2002 WL 1760770 (8th Cir. July 31, 2002).

205. 270 F.3d 645 (8th Cir. 2001) (finding a heightened showing of motive to commit fraud where the magnitude and timing of an executive's compensation was unusual, and that a strong

the court stated that sufficient complaints typically include a showing of "unusual or heightened" motive, and a plaintiff's showing of motive and opportunity can support a belief that a defendant made knowing or reckless misrepresentations.[206] If a complaint makes neither of these showings, then it must include other particularly strong allegations in order for the court to infer scienter.[207]

F. Does the Ninth Circuit Stand Alone? Lipton v. PathoGenesis Corp.[208]

1. Facts

PathoGenesis Corporation ("PathoGenesis") developed TOBI (tobramycin solution for inhalation), an inhaled antibiotic used to treat cystic fibrosis.[209] The U.S. Food and Drug Administration granted PathoGenesis approval to market TOBI in December 1997.[210] After one year of sales to wholesalers and mail-order pharmacies, PathoGenesis announced a 7% price increase, but told its wholesalers, in a letter, that "they could purchase TOBI at the lower pre-increase price during a two-week 'buy-in' period."[211] The "buy-in" period began December 11, 1998, and generated a large volume of sales, which gave rise to a strong fourth quarter with sales of $17.8 million.[212] These fourth quarter sales represented a 20% growth from the previous quarter, and corporate statements allegedly led investors to expect increased sales of TOBI during the first quarter of 1999.[213] Instead, PathoGenesis announced near the end of the first quarter of 1999 that TOBI sales would be closer to $10 million.[214] Since sales of TOBI accounted for almost 98% of PathoGenesis' annual sales, value of its stock dropped sharply.[215] The plaintiffs brought a securities fraud suit on behalf of all purchasers of PathoGenesis stock during the class period of January 15, 1989, to March 22, 1999.[216]

The plaintiffs claimed that PathoGenesis sought to create an impression of increasing patient demand for TOBI, specifically listing three allegedly false or misleading statements made by the company or its officers.[217] The plaintiffs further alleged that in December 1998, Patho-

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inference of scienter was supported when the facts pled showed knowledge of or access to information contradicting public statements).

206. *Green Tree*, 270 F.3d at 660.

207. *Id.* The Eighth Circuit recently reinforced these holdings in *In re K-Tel International, Inc. Securities Litigation*, 300 F.3d 881, 893 (8th Cir. 2002), where it confirmed that general allegations of GAAP violations are insufficient to support scienter as are motives common to corporations or corporate officers.

208. 284 F.3d 1027 (9th Cir. 2002).

209. *PathoGenesis*, 284 F.3d at 1030.

210. *Id.* at 1031.

211. *Id.*

212. *Id.*

213. *See id.* at 1031-32.

214. *Id.* at 1031.

215. *See id.* at 1031 & n.2.

216. *See id.* at 1031.

217. *Id.*

Genesis knew that demand for TOBI had leveled and developed the "buy-in" program to artificially boost fourth quarter sales.[218] PathoGenesis purportedly wanted to show strong sales because it sought to expand foreign distribution and needed to obtain favorable financing arrangements.[219] Finally, the plaintiffs pointed to two stock sales made by PathoGenesis' Chairman and C.E.O. during the class period as another motive to mislead investors.[220] The district court judge dismissed the complaint, holding, in part, that the "plaintiffs had not pleaded detailed and particular facts giving rise to a strong inference of scienter."[221]

2. Decision

Because the plaintiffs failed to identify any internal company documents or reports that showed a decline in sales of TOBI, the Ninth Circuit Court of Appeals could not infer that PathoGenesis officers had knowledge, either actual or constructive, of flat or declining patient demand.[222] The court explained that the plaintiffs needed to provide specific references to the contents of any reports purportedly utilized by the defendants in order to support their allegations that the company had consciously made misleading representations.[223] The court also discounted the insider stock transactions as not probative of scienter.[224] Here, the court noted that (1) the sales constituted a small percentage of the Chairman's holdings; (2) the timing of the sales, even considering that they followed announcement of positive earnings, was not suspicious; and (3) no other insiders sold stock during this period.[225] Furthermore, the court characterized the allegations that PathoGenesis sought to conceal knowledge of moderating patient demand while seeking a line of credit and increased foreign sales as "ordinary and appropriate corporate business objectives."[226] Without more, the court could not consider such motives fraudulent.[227] Finally, the court considered whether, even though individually insufficient, the allegations *taken as a whole* could give rise to a strong inference of conscious or deliberate recklessness.[228] Because

218. *Id.*
219. *Id.*
220. *Id.* at 1032. The CEO sold 10,000 personally held shares within two weeks of the company's fourth quarter earnings announcement. *See id.* Prior to this time, he had not sold any of his PathoGenesis stock. *Id.* The complaint further alleged that the CEO had planned to sell up to 50,000 shares. *Id.*
221. *Id.* at 1034.
222. *Id.* at 1035-36 (citing *In re* Silicon Graphics, Inc. Sec. Litig., 183 F.3d 970, 985 (9th Cir. 1999)).
223. *See id.*
224. *Id.* at 1036-38.
225. *See id.* at 1037. The 10,000 shares represented only 1.4% of the CEO's holdings. *Id.*
226. *Id.* at 1038.
227. *Id.*
228. *Id.*

of what it viewed as a lack of critical details and particularized facts, the court affirmed the lower court's dismissal.[229]

IV. ANALYSIS

As circuit courts have considered the issue, a common standard is emerging.[230]

A. *Commonality of the Middle Ground*

The First, Fifth, Sixth, Tenth, Eleventh, and arguably the Fourth and Eighth Circuits appear to share a common "middle ground"[231] approach in their analysis of the PSLRA's heightened pleading of scienter. These courts view plaintiffs' claims in their "entirety" to determine whether the allegations "taken as a whole" compel a strong inference of scienter.[232] They place emphasis on three factors when addressing the sufficiency of the pleading of scienter.

First, plaintiffs must support allegations that defendants made, or failed to make, statements of material fact with fact-based reasons that the statements were misleading at the time they were made.[233] General claims such as allegations of misleading sales practices or GAAP or other accounting violations will not suffice.[234] Second, plaintiffs must provide particular facts that constitute compelling circumstantial evidence of defendants' knowing or reckless misbehavior.[235] Plaintiffs cannot make claims characterized as "fraud-by-hindsight."[236] Third, while motive and opportunity are important considerations, generalized allegations of motive common to many corporations or corporate officers will not prevail.[237] In addition, since a court will evaluate each securities fraud case based on its specific facts, plaintiffs cannot rely on a magic pleading formula.[238]

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229. *Id.*

230. Gerard Pecht & Glen Banks, *Standard for Scienter*, NAT'L L.J., Dec. 3, 2001, at A19; *see also* Karmel, *supra* note 53 ("[T]he gap in interpretations of PSLRA in the circuits has been narrowing.").

231. City of Philadelphia v. Fleming Cos., 264 F.3d 1245, 1261 (10th Cir. 2001).

232. *See Fleming*, 264 F.3d at 1263.

233. *See id.* at 1260.

234. *See id.* at 1261.

235. *See id.* at 1260.

236. *See id.* (quoting Novak v. Kasaks, 216 F.3d 300, 309 (2d Cir. 2000)).

237. *See id.* at 1262.

238. *See* Jeffrey A. Berens, *Pleading Scienter Under the Private Securities Litigation Reform Act of 1995*, 31 COLO. LAW. 39, 43 (2002) ("[A] case specific analysis is always necessary"). *See generally* S. Michael Pack, Jr., *Securities Law-* Philadelphia v. Fleming Cos.: *Determining Pleading Standards in Securities Fraud Case Under the PSLRA*, 25 AM. J. TRIAL ADVOC. 671 (2002) (discussing the Tenth Circuit's analysis of the PSLRA pleading standard).

B. An Emerging Consensus

1. What is "Deliberate Recklessness?"

When the Ninth Circuit first announced its interpretation of the PSLRA pleading requirements in *In re Silicon Graphics, Inc. Securities Litigation*,[239] commentators and other courts viewed the holding as evincing a particularly stringent and unique take on the scienter standard.[240] Many understood the court's "deliberate recklessness" as implicitly changing the substantive level of proof needed to show scienter.[241] Additionally, critics took issue with the court's seemingly categorical denial of the sufficiency of motive and opportunity to support allegations of scienter.[242]

Nevertheless, the Ninth Circuit has retreated from this so-called extreme interpretation in recent cases and there may very well be less to these perceived changes to the standard than commentators have argued. The Ninth Circuit's "deliberate recklessness" standard is arguably essentially the same as the Sixth Circuit's "akin to conscious disregard,"[243] which both the First and Eleventh Circuits adopted.[244] Similarly, it is difficult to discern where the Tenth Circuit's "extreme departure from the standards of ordinary care . . . known to the defendant"[245] test would lead to a different result than the Ninth Circuit's test.

Interestingly, in both *Lipton v. PathoGenesis Corp.*, and in another Ninth Circuit case, *Gompper v. VISX, Inc.*,[246] the Ninth Circuit appeared to downplay any differences between its interpretation of the PSLRA and that of its sister circuits. In particular, the court emphasized the need to view a complaint in its "entirety," directing district courts to apply a balancing test in considering an allegation, "together with any reasonable inferences."[247] Thus, it would seem that the Ninth Circuit views motive and opportunity as useful indicators for ascertaining a defendant's intent.

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239. *In re* Silicon Graphics, Inc. Sec. Litig., 183 F.3d 970, 985 (9th Cir. 1999).

240. *See, e.g.*, Moss, *supra* note 33, at 1316-19 ("In addition to forming a new and uncertain standard of scienter under the PSLRA, the Ninth Circuit established a seemingly impossible barrier to private individuals bringing a securities fraud claim under § 10(b) and Rule 10(b)-5.").

241. *See id.* at 1317-18.

242. *See, e.g.*, Guido, *supra* note 20, at 534-46.

243. *In re* Comshare, Inc. Sec. Litig., 183 F.3d 542, 550 (6th Cir. 1999).

244. *See supra* text accompanying notes 65-78.

245. *Fleming*, 264 F.3d at 1258.

246. 298 F.3d 893 (9th Cir. 2002). The plaintiffs in *Gompper* alleged that VISX, a maker of laser vision-correction devices, knew, or should have known, that its patents were invalid. *Gompper*, 298 F.3d at 895. The complaint further alleged that the defendants' optimistic growth and earnings statements were thus recklessly or intentionally misleading. *Id.* The circuit court concluded that the plaintiffs had failed to plead facts showing that the defendants had knowledge, at the time the statements were made, of the likelihood of the patents' invalidity. *Id.* at 896.

247. *Id.* at 897. *But see Annual Review*, *supra* note 154, at 844 (stating that one aspect of the First Circuit's analysis in *Aldridge* was "almost directly contrary to the Ninth Circuit's decision in *Gompper*").

2. Are the Second and Third Circuits Less Strict?

Though both the Second Circuit, in *Press v. Chemical Investment Services Corp.*,[248] and the Third Circuit, in *In re Advanta Securities Litigation*,[249] held that allegations of motive and opportunity alone may establish scienter, subsequent cases suggest otherwise. Cases that have survived a motion to dismiss have had further elements constituting strong evidence of conscious behavior or recklessness.[250] In *Novak v. Kasaks*, the Second Circuit emphasized that plaintiffs must allege with sufficient particularity the facts that support their claim.[251] In another Second Circuit case, *In re Scholastic Corp. Securities Litigation*,[252] the court determined that those Plaintiffs had adequately pled both motive and opportunity *and* conscious misbehavior.[253] The allegations in the *Scholastic* pleadings likely would also be sufficient under *Fleming*'s "taken as a whole" test.[254]

Despite their rhetoric, the Second and Third Circuits actually apply a fact-specific "taken as a whole" test. As in the Tenth Circuit, not all motives matter. Certain motives are more indicative of scienter than are others. Plaintiffs must supplement or support the "opportunity" portion of "motive and opportunity" with fact-based allegations of intentional or reckless behavior.[255]

3. Strong Inference

All of the circuits that have addressed the issue have incorporated the "strong inference" requirement in scienter pleading mandated by the PSLRA. Irrespective of the exact details of the pleading standard they claim to have adopted, the preceding anlaysis shows the courts apply some form of heightened scrutiny test to allegations of scienter in pleadings under Rule 10b-5. None of these tests appears to differ in any substantial way from that used by the Tenth Circuit in *Fleming*.[256]

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248. 166 F.3d 529, 538 (2d Cir. 1999).

249. 180 F.3d 525, 534-35 (3d Cir. 1999).

250. *See* Ann Morales Olazabal, *The Search for "Middle Ground:" Towards a Harmonized Interpretation of the Private Securities Litigation Reform Act's New Pleading Standard*, 6 STAN. J.L. BUS. & FIN. 153, 167-74 (2001).

251. *Novak*, 216 F.3d at 311.

252. 252 F.3d 63 (2d Cir. 2001).

253. *Scholastic*, 252 F.3d at 76.

254. *Fleming*, 264 F.3d at 1263.

255. *See id.* at 1261-63.

256. Many commentators have argued that the Supreme Court needs to resolve what these commentators see as a circuit split. *See* Guido, *supra* note 20, at 502; Erin Brady, Comment, *Determining the Proper Pleading Standard Under the Private Securities Litigation Reform Act of 1995 After In re* Silicon Graphics, 28 PEPP. L. REV. 471, 510-12 (2001); Karmel, *supra* note 53 (speculating that the Supreme Court would likely maintain severe or deliberate recklessness as a basis for scienter); David E. Rovella, *Securities Reform Spawns Discord*, NAT'L L.J., July 23, 2001, at A1. The Eighth Circuit noted that the split may be "more apparent than real." Fla. State Bd. of Admin. v. Green Tree Fin. Corp., 270 F.3d 645, 659 (8th Cir. 2001). Some differences still exist between the circuits' interpretations of the PSLRA's requirement of a strong inference of scienter as to the

C. *Plaintiffs' Plight*

1. Criticism of the Scienter Pleading Requirement

The dissent in a recent Eighth Circuit case articulated a major point of contention[257] that applies to the approaches of all the circuits. The dissent disagreed with the majority's application of its scienter standard because "[m]any relevant facts in securities cases may not be discoverable at the pleading stage because they are known only by key insiders."[258] Even though the PSLRA strengthened pleading standards, "it does not require that a case be proven in the complaint."[259] This problematic requirement that plaintiffs provide particular facts in their complaints, however, should not be attributed to the PSLRA's scienter standard. The heightened scienter standard arguably deters poorly pled, boilerplate complaints and forces plaintiffs to present and factually-support a cogent and well thought out argument in their pleadings. Because of this deterrence, even should Congress choose to revisit the PSLRA, it appears doubtful that Congress will revise the scienter requirement. It seems more likely that Congress might change other PSLRA provisions, such as the mandatory stay of discovery, or possibly include some type of fee-shifting mechanism in an effort to further discourage unfounded securities fraud suits.[260]

2. Indicators of Fraud

In order to survive a motion to dismiss, plaintiffs' counsel must put together a *detailed* and *highly specific* recitation of *facts* in the pleadings that support a strong inference that a defendant had both motive and opportunity, as well as indicia of either conscious behavior or recklessness. The following factors represent some of the strongest indicators of potential fraud: (1) sudden, large drops in stock price; (2) suspicious restatements of revenue, announcements about financial irregularities, or changes in, or replacement of, management or accounting firms; (3) unusual insider trading or executive compensation strongly impacted

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amount and kind of factual detail required at the pleading stage. However, the Supreme Court may agree with the Eighth Circuit because it has, to date, declined to address these perceived discrepancies. *See In re* Scholastic Corp. Sec. Litig., 252 F.3d 63 (2d Cir.), *cert. denied*, 534 U.S. 1071 (2001); Helwig v. Vencor, Inc., 251 F.3d 540 (6th Cir. 2001) (en banc), *cert. dismissed*, 122 S. Ct. 2616 (2002); Novak v. Kasaks, 216 F.3d 300 (2d Cir.), *cert. denied*, 531 U.S. 1012 (2000).

257. *See In re* K-Tel Int'l, Inc., Sec. Litig., 300 F.3d 881, 900 (8th Cir. 2002) (Murphy, J., dissenting).

258. *K-Tel*, 300 F.3d at 900 (Murphy, J., dissenting).

259. *Id.* (Murphy, J., dissenting); *see* Wilson, *supra* note 41, at 334-36 (arguing that the PSLRA does not contain a provision that controls motions for summary judgment and that in the Ninth Circuit, if a plaintiff manages to survive a motion to dismiss, he is very likely to have substantially proven his case).

260. *See* Lyle Roberts, *Reforming Litigation Reform Act Bush Should Back Fee-Shifting Plan that Targets Meritless Class Actions*, FULTON COUNTY DAILY REP., Feb. 8, 2001, at 7 ("Plaintiffs law firms appear to be offsetting the effect of having a higher percentage of their cases dismissed under the Reform Act's stricter pleading standards by filing more cases.").

by company performance; and (4) suspect sales and accounting practices.[261]

CONCLUSION

When the Tenth Circuit decided *City of Philadelphia v. Fleming Cos.*,[262] a case of first impression in the circuit, the court made its stance on the PSLRA's heightened pleading of scienter quite clear. Since the court joined the other "middle ground" circuits, plaintiffs in the Tenth Circuit cannot plead motive and opportunity alone.[263] The court categorically held that allegations of motives attributable to most companies or corporate officers are not sufficient.[264] To survive a motion to dismiss, a plaintiff's allegations, "taken as a whole" and in the context of the totality of the pleadings, must support a strong inference of scienter.[265] This "totality" of the pleadings test requires a highly individualized and fact-specific analysis.[266]

Plaintiffs' attorneys practicing within the Tenth Circuit jurisdiction must endeavor to structure the totality of their pleadings so as to tell a compelling story that will convince the court that hears the case that the defendants likely perpetrated fraud. Most importantly, the plaintiffs must provide persuasive factual support for their allegations. On the other hand, defendants' attorneys, in a motion to dismiss, should focus on any factual weaknesses, inadequacies, or lack of support in plaintiffs' pleadings. A defendant's attorney should explore any opportunity to characterize those pleadings as merely conclusory. Because the circuits employ similar tests, attorneys should carefully scrutinize relevant court decisions from all circuits.

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261. Sherrie R. Savett, *Securities Class Actions Since the 1995 Reform Act: A Plaintiff's Perspective*, SG091 ALI-ABA 459, 491-97 (2002). See Elliot J. Weiss, *Complex Litigation at the Millennium: Pleading Securities Fraud*, 64 LAW & CONTEMP. PROBS. 5 (2001), for a cogent analysis of the requirements for pleading a strong inference of scienter.

262. 264 F.3d 1245 (10th Cir. 2001).

263. *Fleming*, 264 F.3d at 1262-63.

264. *Id.* at 1269.

265. *Id.* at 1261-63.

266. *See id.* at 1263.

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