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Current Trends in Federal Securities Litigation

By

Jonathan C. Dickey
Daniel Floyd
Paul J. Collins
Gibson, Dunn & Crutcher LLP

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I. DEVELOPMENTS IN LOSS CAUSATION

The Private Securities Litigation Reform Act ("PSLRA") provides that:

> (4) Loss causation In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.

15 U.S.C. § 88u-4(b)(4). The loss causation requirement of the PSLRA had produced disagreement between the circuits as to what was required to plead and prove loss causation. The recent, unanimous opinion of the Supreme Court in *Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 366, 125 S. Ct. 1627 (2005), however, resolved the split between the circuits as to what is required to plead and prove loss causation under the PSLRA.

A. THE CIRCUIT SPLIT OVER THE STANDARD OF PLEADING LOSS CAUSATION

Prior to the Supreme Court's recent opinion in *Dura*, the loss causation requirement of the PSLRA had produced a circuit split over what was necessary to adequately plead loss causation.

The prevailing view was that of the Second, Third, Seventh and Eleventh Circuits that pleading and proving that a plaintiff purchased securities at an artificially inflated price without proof of the impact of the fraud on the price by a decline in value following disclosure of the fraud was insufficient to satisfy the PSLRA. *See, e.g., Robbins v. Koger Properties, Inc.*, 116 F.3d 1441, 1447-8 (11th Cir. 1997) ("proof that a plaintiff purchased securities at an artificially inflated price, without more, [does not] satisf[y] the loss causation requirement."); *Semerenko v. Cendant Corp.*, 223 F.3d 165, 184-5 (2d Cir. 2000), *cert denied,* 531 U.S. 1149 (2001) (holding that loss causation is established only if the value of the security "actually decline[s] as a result of [the] alleged misrepresentation."); *Emergent Capital Investment Mgt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 198 (2d Cir. 2003) (holding that alleging a disparity in investment value at the time of purchase is insufficient to satisfy the loss causation pleading requirement); *Bastian v. Petron Resources Corp.*, 892 F.2d 680 (7th Cir. 1990), *cert. denied* 496 U.S. 906 (1990) (similar).

The Ninth Circuit had held, conversely, that a plaintiff could plead loss causation by pleading that the price of the stock on the date of purchase was inflated because of the misrepresentation.[1] *See, e.g.*, *Broudo v. Dura Pharmaceuticals, Inc.*, 339 F.3d 933 (9th Cir.

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[1] Arguably, the Ninth Circuit had set a higher standard of proving loss causation than pleading loss causation. *See, e.g., Binder v. Gillespie*, 184 F.3d 1059, 1066 (9th Cir. 1999) ("the plaintiff must show that the fraud caused, or at least had something to do

[Footnote continued on next page]

2003) (holding that "[i]n a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation). The Ninth Circuit thus had adopted a theory of loss causation permitting a plaintiff to survive a motion to dismiss if they pled that the fraud "touch[ed] upon" their loss – that is, if they pled that they purchased the stock an inflated price.

B. THE SUPREME COURT'S OPINION IN *DURA*

On April 19, 2005, the United States Supreme Court decided *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 366, 125 S. Ct. 1627 (2005). In *Dura*, the United States Supreme Court reversed the holding of the Ninth Circuit in *Broudo* and clarified what is necessary to *plead* and *prove*[2] loss causation under the PSLRA.

Prior to the Supreme Court's opinion in *Dura*, the law in the Ninth Circuit was that:

> [L]oss causation is satisfied where the plaintiff shows [*i.e.,* proves] that the misrepresentation touches upon the reasons for the investment's decline in value.

Broudo, 339 F.3d at 938 (quotations and citations omitted). Based on this holding, the Ninth Circuit in *Broudo* concluded that loss causation could adequately be pled by pleading inflation of a stock at the time of purchase. The Supreme Court in *Dura*, expressly overruled this holding of the Ninth Circuit, holding that:

> To 'touch upon' a loss is not to *cause* a loss, and it is the latter that the law requires.

Dura, 125 S. Ct. at 1632 (italics in original). The Supreme Court held that loss causation is an element of the claim, and is established based on a showing of loss, *i.e.*, a price decline, upon disclosure of the facts underlying the fraud. *Id.* at 1631, 1632. The Supreme Court in *Dura* made clear that if a party sells "before the truth begins to leak out, the misrepresentation will not have led to any loss." *Id.* at 1631.

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with, the decline in the value of the investment after the securities transaction took place."); *McGonigle v. Combs*, 968 F.2d 810, 819 (9th Cir. 1992) (approving a jury instruction stating that "[t]he plaintiff must also establish loss causation, and that means that the misrepresentations and omissions have to have caused the harm, that is, they have to have impacted the value of the investment.").

[2] While *Dura* involved a Motion to Dismiss, the Supreme Court's holding that the Ninth Circuit's standard of pleading loss causation was wrong was based on *Dura's* conclusion that the Ninth Circuit's standard of proving loss causation was wrong. *Id.* at 1634 ("Our *holding* about plaintiffs' need to *prove* proximate causation and economic loss leads us also to conclude that the plaintiffs' complaint here failed adequately to *allege* these requirements.") (italics in original).

One of the express considerations that the Supreme Court identified in its opinion is that stock price declines, even after fraud is revealed, "may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions or other events . . ." *Dura*, 125 S. Ct. at 1632. The *Dura* court held that "an inflated purchase price will not itself constitute or proximately cause the relevant economic loss" because, "at the moment the transaction takes place, the plaintiff has suffered no loss . . . ." *Id.* This conclusion was based on logic, policy and statutory and common law. As a matter of logic, the Court noted that at the time of purchase, "the inflated purchase payment is offset by ownership of a share that ***at that instant*** possesses equivalent value." *Id.* (italics in original). Further, the "link between the inflated share purchase price and any later economic loss is not invariably strong," *id.*, reinforcing that loss in a securities fraud action is not caused upon purchase of allegedly inflated stock.

As the Supreme Court noted in *Dura*, when a purchaser sells his shares, even at a lower price after disclosure of the fraud, that lower price may not reflect the earlier misrepresentation, but rather will often reflect "changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price."[3] *Id.* at 1632. As a matter of underlying policy, the securities laws are available "not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause." *Id.* at 1633. Allowing plaintiffs to recover based on price declines not caused by the misrepresentations at issue, the Supreme Court recognized, would transform the securities laws into such insurance.

Further, as the *Dura* Court noted, Section 78u-4(b)(4) of the Private Securities Litigation Reform Act ("PSLRA") itself imposes upon plaintiffs "'the burden of proving' that the defendant's misrepresentations 'caused the loss for which the plaintiff seeks to recover.'" *Id.* at 1633. This statute, the Court held, "makes clear Congress' intent to permit private securities fraud actions for recovery where, but only where, plaintiffs adequately allege and prove the traditional elements of causation and loss." *Id.* And the "judicial consensus" of those "traditional elements" is "that a person who 'misrepresents the financial condition of a corporation in order to sell its stock' becomes liable to a relying purchaser 'for the loss' the purchaser sustains 'when the facts . . . become generally known' and 'as a result' share value depreciate[s]." *Id.* (citing Restatement of Torts § 548A, Comment *b* at 107).

Dura makes clear that at least in traditional cases of securities fraud, loss causation requires at least proof of a fraudulently inflated stock price *and* a decline in the value of that stock due to disclosure of the underlying circumstances of the fraud.

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[3] As the Supreme Court also noted, "[o]ther things being equal, the longer time between purchase and sale, the more likely that this is so, *i.e.*, the more likely that other factors caused the loss." *Id.* at 1632.

C. PLEADING AND PROVING LOSS CAUSATION FOLLOWING *DURA*

Following *Dura*, federal courts have been tasked with application of what appears to be a straightforward standard of pleading loss causation. In the many decisions citing *Dura* a few issues have emerged to be resolved by the Circuit Courts..

The first is whether allegations of loss causation must meet the heightened pleading standards of Rule 9(b) or the PSLRA, or whether a "short plain statement" under Rule 8(a)(2). While the *Dura* court evaluated the claim under Rule 8(a)(2), it did not explicitly decide the issue: "[a]nd we assume, at least for argument's sake, that neither the Rules nor the securities statutes impose any special further requirement in respect to the pleading of proximate causation or economic loss." 125 S.Ct. at 1634. A split has emerged in the district courts, with some courts holding that ***all*** elements of fraud must be pled with particularity, including loss causation,[4] but with a majority either simply following the *Dura* court's approach without comment, or determining that the Rule 8(a)(2) standards are properly applied.[5]

The second area the courts have been addressing is what constitutes a disclosure of bad news sufficiently connected to the fraud to satisfy the critical element of loss causation: that the decline in the stock price upon which the claim must be based was "caused" by the fraud. While in many cases, the courts have found the issue simple to resolve, in either direction, some issues have emerged.

There have been several cases where the allegations have been found insufficient. For example, in *Knollenberg v. Harmonic, Inc.*, 2005 WL 2980628 (9th Cir. 2005), the Ninth Circuit held that “a private securities fraud action must include allegations of facts establishing economic loss to the plaintiffs caused by the defendants’ fraud or misrepresentation.” *Id*. at *9. The court there held that the plaintiffs had “failed to properly allege loss causation” where they alleged only that the “named representatives for the putative class purchased stock during the class period and that the stock price then fell,” but did not allege “that any of [the] same [p]laintiffs sold stock at a loss caused by the [d]efendants’ fraud or misrepresentation.” *Id.*

Similarly, in *Mortensen v. Snavely*, 145 Fed. Appx. 218 (9th Cir. 2005), the Ninth Circuit held that the “plaintiffs needed to prove both that the shares were overvalued on the date of purchase and that the misrepresented value which induced their purchase also caused a loss when

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[4] *See, e.g., In re The First Union Corp. Sec. Litig.*, 2006 U.S. Dist. LEXIS 5083 *16 (N.D.N.C. 2006) (citing cases).

[5] *See, e.g., Plumbers & Pipefitters Local 572 Pension fund v. Cisco Systems*, 411 F. Supp. 2d 1172, 1175 (N.D. Cal. 2005) ("Although the Supreme Court also noted that its holding did not affect the applicability of Fed.R.Civ.P. 8(a)(2) to loss causation (i.e., its holding did not create a heightened pleading standard for loss causation) . . ."); *In re Enron Corp. Sec., Derivative and ERISA Litig.*, 2005 U.S. Dist. LEXIS 41240 *61 (S.D. Tex. 2005).

they sold their shares." *Id.* at 220. Because the plaintiffs had not introduced any evidence of the actual value of the shares, the court held that the plaintiffs had proven neither a false statement nor transaction or loss causation. *Id.*

Finally, in *In re Immune Response Sec. Litig.*, 375 F. Supp. 2d 983 (S.D. Cal. 2005), the court held that where the plaintiffs had alleged that the stock price of the defendant corporation was overvalued by fraud during the class period and specifically pled that the stock price fell from approximately $18 a share to $2 a share, the complaint had adequately alleged loss causation. *Id.* at 1025.

But the Ninth Circuit's opinion in *In re Daou Systems, Inc.*, 411 F.3d 1006 (9th Cir. 2005) demonstrates that application of the *Dura* standard is not always so straightforward. In *Daou,* the Ninth Circuit held that "to prove loss causation, the plaintiff must demonstrate a causal connection between the deceptive acts that form the basis for the claim of securities fraud and the injury suffered by the plaintiff." *Id.* at 1025. The Ninth Circuit in *Daou* noted that a "plaintiff is not required to 'show that a misrepresentation was the sole reason for the investment's decline in value' in order to establish loss causation." *Id*. (citing *Robbins v. Koger Props. Inc.*, 116 F.3d 1441, 1447 n. 5 (11th Cir. 1997)). "'[A]s long as the misrepresentation is one substantial cause of the investments decline in value, other contributing forces will not bar recovery under the loss causation requirement' but will play a role 'in determining recoverable damages.'" *Id*. (citing *Robbins*, 116 F.3d at 11447, n. 5).

The *Daou* court addressed a complex loss causation fact pattern. The district court had concluded that the plaintiffs complaint did not "allege that there were any negative public statements, announcements or disclosures at the time the stock price dropped that defendants were engaged in improper accounting practices." *Id.* at 1026. The court held that "if the improper accounting did not lead to the decrease in Daou's stock price, plaintiffs' reliance on the improper accounting in acquiring the stock would not be sufficiently linked to their damages." *Id.* The Ninth Circuit disagreed, holding that:

> An independent assessment of the TAC, however, indicates that the price of Daou's stock fell precipitously after defendants began to reveal figures showing the company's true financial condition.

Id. The Ninth Circuit thus noted that Daou's stock price had fallen after a number of disclosures that were not express disclosures of fraud. The Ninth Circuit concluded that the plaintiffs had adequately alleged loss causation but only with respect to the drop in price following the revelations of Daou's true financial condition.

The Second Circuit in *Lentell v. Merrill Lynch & Co. Inc.*, 396 F.3d 161, 172-177 (2d Cir. 2005), decided before *Dura*, but consistent with its holding, described the standard as follows:

> Thus to establish loss causation, 'a plaintiff must allege . . . that the subject of the fraudulent statement or omission was the cause of the action loss suffered,' *Suez Equity Investors , L.P. v. Toronto-Dominion Bank,* 250 F.3d 87, 95 (2d. Cir. 2001) (emphasis added), i.e., that the misstatement or omission concealed something

> from the market that, when disclosed, negatively affected the value of the security. Otherwise, the loss in question was not foreseeable.

Thus, "loss causation has to do with the relationship between the plaintiff's investment loss and the information misstated or concealed by the defendant." *Id.* at 174. Thus, in *Lentell*, the court found that allegations of false and misleading "buy" and "accumulate" recommendations of certain internet stocks were insufficient to satisfy the loss causation requirements because Merrill Lynch did not misstate any investment risks, and "the subject of the false recommendations," or any "corrective disclosure" regarding the falsity of the recommendations did not cause the decline in the stock value. *Id.* at 175. The Second Circuit ultimately viewed the issue as one of avoidance: that the "misstatements and omissions concealed the circumstances that bear upon the loss suffered such that plaintiffs would have been spared all or an ascertainable portion of that loss absent the fraud." *Id.* Where the stock price decline is on its face attributable to overall market forces, like the bursting of the internet bubble, the requirement of pleading facts tying an ascertainable portion of the decline to the allegedly concealed information is critical to plead and prove loss causation.

In re Unumprovident Corp. Sec. Lit., 396 F. Supp. 2d 858 (E.D. Tenn. 2005), similarly illustrates the difficulty in applying *Dura's* standard where the "revelation" of the true financial condition of a company is not obviously related to the alleged fraud, but ultimately allowed the case to proceed. In *Unumprovident*, the court considered how closely related the revealing disclosures must be to the fraud alleged. The defendants contended in their motion to dismiss that although the plaintiff's complaint referred to the company's stock price, it dud demonstrate "'any causal link between a concrete decline in [the company's] stock price and any particular misstatement or omission ... or the disclosure of some alleged fraud.'" *Id.* at 898.

The *Unumprovident* court noted that:

> One method of pleading loss causation is to allege facts indicating the plaintiff's economic loss was suffered in close temporal proximity to the public disclosure of the alleged fraud. Where a significant stock price decline immediately follows an announcement revealing fraud or prior misinformation to the public, it can reasonably be inferred that decline is fairly attributable to the conduct or information disclosed.

Id. The *Unumprovident* court noted that while the plaintiff had pled stock drops following the issuance of press releases announcing negative media reports, the complaint did not address other stock drops and thus "provide[d] something less than a complete picture."

The court nonetheless held that the plaintiff had "pointed to two sizeable dips in UnumProvident's stock price following disclosures of information which in some marginal way tended to disclose the existence of the alleged underlying fraudulent scheme." *Id.* The court held that the disclosures "reveal[ed] at least some minimal details suggesting the possibility of prior misrepresentations, thus justifying an inference the negative effect on UnumProvident's share price reflected the market's reaction to this acknowledgment." While the court found that the allegations were "by no means compelling," the court noted that "unlike the elements of

pleading an actionable misstatement and scienter, the PSLRA imposes no heightened pleading standard with respect to causation."

The court held that the statements met the minimal requirements of Federal Rule of Civil Procedure 8(a)(2) ("short and plain statement of the claim showing that the pleader is entitled to relief") and provide "some indication of the loss and causal connection the plaintiff has in mind" so as to place the defendants on "fair notice of what the plaintiff's claim is and the grounds upon which it rests."

While neither *Daou* and *Unumprovident* draws the line, both cases illustrate the potential difficulty in assessing whether a plaintiff's allegations of disclosure of the fraud truly relate to the fraud alleged.[6]

Another issue addressed by the courts is whether a plaintiff who sells "before the relevant truth begins to leak out," can, in any circumstance maintain a claim, because in such cases "the misrepresentation will not have led to any loss." *Dura*, 125 S.Ct. at 1631. Thus, in *In re Compuware Sec. Litig.*, the court, relying upon the above-cited language, granted summary judgment where the named plaintiff had "traded out of Defendants' stock long before the alleged inflated price began to leak out of Defendants' stock price." 386 F. Supp. 2d 913, 920 (E.D. Mich. 2005). Notwithstanding the seemingly clear statement of the Supreme Court, some cases have refused to categorically hold that so-called in and out traders cannot prove causation, further eroding the ability of defendants to obtain dismissals on loss causation grounds.[7]

D. PROOF OF LOSS CAUSATION ON A STATEMENT BY STATEMENT BASIS

The PSLRA provides that:

> In any private action arising under this title 15 U.S.C. § § 78a *et seq.*], the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this title [15 U.S.C. § § 78a *et seq.*] caused the loss for which the plaintiff seeks to recover damages.

15 U.S.C. § 78u-4(b)(4). The Supreme Court in *Dura* addressed this language and reinforced that liability and damage under the PSLRA must be evaluated on a statement-by-statement basis:

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[6] *See also In re ESPEED Sec. Litig.,* U.S. Dist. LEXIS 16875 *85-88 (S.D.N.Y. 2006) (Holding allegations of loss causation sufficient under Rule 8(a)(2) notwithstanding no specific reference in later disclosures to the issue causing the loss); *Asher v. Baxter Intl.*, 2006 U.S. Dist. LEXIS 4821 *19-24 (N.D. Ill. 2006) (same).

[7] *In re Bearingpoint, Inc. Sec. Litig.*, 232 F.R.D. 534, 543-544 (E.D. Va. 2006) (holding on class certification, that in and out traders may be able to prove loss causation, and citing cases on both sides of the issue).

> [T]he statute expressly imposes on plaintiffs "the burden of proving" ***that the defendant's misrepresentations "caused the loss*** for which the plaintiff seeks to recover."

Dura, 125 S. Ct. at 1633 (quoting 15 U.S.C. § § 78u-4(b)(4)) (emphasis added) ("In sum, we find the Ninth Circuit's approach inconsistent with the requirement that a plaintiff prove that a defendant's misrepresentation (or other fraudulent conduct) proximately caused the plaintiff's economic loss.").

The Eleventh Circuit opinion in *Robbins*, 116 F.3d 1441 (cited with approval by the Supreme Court in *Dura*) emphasizes the necessity of proving that a particular defendant's misrepresentations caused damages**.** In *Robbins*, the plaintiffs, investors in Koger Properties, Inc. ("KPI"), sued KPI and its outside auditor Deloitte for alleged violations of Section 10(b) and Rule 10b-5. *Id.* at 1443-44. The basis of the plaintiffs' claim for fraud was their allegation that, as a result of KPI's false financial statements (which had been audited by Deloitte), KPI was able, throughout the class period, to continue to pay dividends when its cash flow was insufficient to permit the continued payment of dividends. *Id.* at 1444-45. When KPI eventually announced its dividend cut, the stock price fell precipitously. *Id.* at 1445. There was no allegation or evidence that Deloitte made any statement about KPI's ability to continue to pay dividends. *Id*. at 1444. Yet, the plaintiffs' expert opined that, had true information regarding KPI's cash flow been publicly available, KPI would have been forced to announce a dividend cut much earlier. *Id*. at 1445.

The Eleventh Circuit held that the plaintiffs there had not proven loss causation with respect to Deloitte, stating that "[p]laintiffs here offered no evidence of a connection between Deloitte's misrepresentations and the decline in price of KPI stock throughout the class period or following the October 1990 dividend cut. In fact, the claims presented to the jury do not attempt to link Deloitte's misrepresentations to any decline in the value of plaintiffs' investment." *Id.* at 1448. On the contrary, the court held that the evidence adduced at trial demonstrated that the announcement that KPI would be cutting revenues was a result of KPI's concern of a possible future lack of financing, not over a concern of misstated cash flows on financial statements.

E. LOSS CAUSATION FOR SECTION 11 CLAIMS

In *In re Worlds of Wonder Securities Litigation*, 35 F.3d 1407 (9th Cir. 1994), the Ninth Circuit addressed the parameters of the loss causation defense. The court held that the defendant bears the burden of proof on the loss causation defense to prove that "the depreciation in value [of the stock] resulted from factors other than the [alleged] material misstatement. . . ." *Id.* at 1422. The *Worlds of Wonder* court held that "loss causation exists where 'the misrepresentation *touches upon* the *reasons* for the investment's decline in value.'" *Id.* (citing *McGonigle*, 968 F.2d at 821). The *Worlds of Wonder* court held that an express disclosure of fraud is unnecessary and a requirement of an express disclosure of fraud would "eviscerate the statute." *Id.* It was enough, the court noted, that some disclosure of facts evidencing fraud be shown. *Id.*

Following *Worlds of Wonder,* the court in *In re McKesson HBOC, Inc. Sec. Lit.*, 126 F. Supp. 2d 1248 (N.D. Cal. 2000) held that plaintiffs' pleading had provided defendants with an "absolute 'negative causation' defense" with respect to plaintiffs that sold shares before the only

corrective disclosure alleged. *Id.* at 1261. The court held, however, that the defendants had not met their burden on their defense with respect to plaintiffs that held or sold following corrective disclosures even when those did not expressly disclose fraudulent results. *Id.* at 168. The court held that the disclosure of an ongoing audit process of previous financials was a *dependent*, rather than *independent* supervening cause of a stock price drop. *Id.*

In *McMahan & Co. v. Wherehouse Entertainment, Inc.*, 65 F.3d 1044 (2d Cir. 1995), the court considered how a defendant might bear its burden of proof to establish negative causation. The court noted that, as a general rule, a "'price decline before disclosure may not be charged to defendants.'" *Id.* at 1049 (quoting *Akerman v. Oryx Communications,* 810 F.2d 336, 342 (2d Cir. 1987)). The court noted, however, that the defendant bears the burden of proving that the price decline was not related to the misrepresentations in the registration statement. *Id.*

In *Rebenstock v. Deloitte & Touche*, 907 F. Supp. 1059 (E.D. Mich. 1995), the court stated the rule that, "[t]o establish a 'loss causation' defense under §11(e), [the defendant] needs to prove that the depreciation in the value of [the] stock resulted from factors other than the alleged material misstatement" in the registration statement." *Id*. at 1066. In *Rebenstock*, the defendants moved for summary judgment contending there was no evidence that any misrepresentation caused a loss in value of the stock at issue.

The *Rebenstock* court agreed with the defendants that the stock at issue had lost almost all of its value as a result of earnings estimates that had no relationship to the fraud alleged. *Id*. The *Rebenstock* court analyzed Section 10(b) concepts of loss causation in fraud on the market cases, however, and concluded that the plaintiffs had adduced evidence sufficient to defeat summary judgment that the price of the stock was inflated at the time of purchase. *Id.* at 1067. The court held that there was, at least, a fact issue as to causation. *Id.*

Whether the holding in *Rebenstock* would survive *Dura*, which holds that price inflation at the time of purchase does not establish loss causation, is unclear.

II. RECENT DEVELOPMENTS UNDER SLUSA

On January 11, 2005, the Second Circuit Court of Appeals held that holder's claims under state and common law are not preempted by SLUSA. The plaintiff-appellants in *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 2005 WL 44434 (2d Cir. Jan. 11, 2005), both filed separate actions against Merrill Lynch in federal district court for damages based on alleged biased research provided by Merrill Lynch to its customers who held Merrill Lynch retail brokerage accounts. Each plaintiff sought damages, however, pursuant to state law theories of liability (breach of fiduciary duty and contract) and neither plaintiff actually purchased or sold securities during the relevant period in the case. Thus, after the district court decided that SLUSA preempted plaintiffs' claims, plaintiffs appeals "present[ed] an issue of first impression in [the Second] Circuit: whether [SLUSA], which preempts certain class actions based upon state law brought by private parties alleging a misrepresentation or omission 'in connection with the purchase or sale' of certain nationally traded securities [], preempts claims that do not allege that putative class members purchased or sold particular securities in reliance upon the defendant's alleged misconduct." *Id.* at *1. Despite the Securities & Exchange Commission and Merrill Lynch's position to the contrary, the court held that "the meaning of 'in connection with' under

SLUSA is coterminous with the meaning of the nearly identical language of the [Exchange Act] and its corresponding Rule 10b-5 [] , and [] the purchaser-seller rule of *Blue Chip Stamps* applies as a limit on SLUSA's 'in connection with' requirement such that SLUSA does not preempt claims that do not allege purchases or sales made by the plaintiff or the alleged class members." *Id.* at *1.

The United States Supreme Court granted certiorari to review the Second Circuit's decision and to determine whether SLUSA preempts "holders" claims. The Securities & Exchange Commission submitted an amicus brief, as did various industry and investor groups. The Commission argued that the Second Circuit's holding—that plaintiffs could avoid preemption by "excluding from the class claimants who purchased in connection with the fraud [,]" *Id.* at *46—conflated the issue of standing to sue with the issue of the fraudulent conduct alleged. Additionally, the Commission claims that the Second Circuit's holding would pervert SLUSA, which was created to eliminate abusive and meritless lawsuits: "If any set of plaintiffs were to be exempted from preemption, it would not be those who neither purchased nor sold securities. *Blue Chip* denies standing to such plaintiffs precisely because their suits present an especially high risk of abuse in light of the relative ease of alleging, and difficulty of disproving, that a plaintiff relied on public representations in not purchasing or selling a security." The Commission also explained that "[c]onstruing *Blue Chip* to immunize 'holder' class actions from SLUSA preemption would contravene the intent of Congress and the policies recognized by this Court in *Blue Chip* by permitting a particularly abusive category of state-law class actions to escape SLUSA's reach."

The Supreme Court unanimously agreed with the Commission and Merrill Lynch and reversed and vacated the opinion of the Second Circuit. 126 S. Ct. 1503. Central to the Court's holding was its opinion that the Supreme Court in *Blue Chip Stamps* adopted the purchaser-seller limitation based on "policy considerations" and not on the text of Rule 10b-5 itself. *See id.* at *24. The Court opined that "class actions brought by holders pose a special risk of vexatious litigation." And as a matter of policy, "[i]t would be odd, to say the least, if SLUSA exempted that particularly troublesome subset of class actions from its pre-emptive sweep." Nevertheless, the Court indicated that this policy was also was consistent with the way the Court viewed its prior interpretations of the federal securities laws: "when this Court *has* sought to give meaning to the phrase ["in connection with the purchase or sale"], in the context of § 10(b) and Rule 10b-5, it has espoused a board interpretation."

III. STANDARDS UNDER THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934

Pleading a cause of action under the federal securities laws has become an increasingly complex undertaking as the number of securities cases — and the number of perceived abusive cases — have increased dramatically over the past 30 years. In 1976, in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 n.12 (1976), the Supreme Court held that, to state a claim under Rule 10b-5, a plaintiff must plead and prove that the defendant acted with scienter. Pleading claims under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 immediately became more difficult, as courts concluded that the heightened pleading standard set forth in Rule 9(b) of the Federal Rules of Civil Procedure, rather than the general "notice pleading" standard set forth in Rule 8, applied. As discussed below, in the years that followed, most courts

applied Rule 9(b) not only to claims in which fraud was required to be pled and proved, but also to pleadings in which fraud was alleged, even if fraud was not required to recover.

To remedy the perceived proliferation of abusive private securities class action lawsuits in the 1980s and 1990s, Congress enacted the Private Securities Litigation Reform Act of 1995 ("PSLRA"),[8] which was intended, in part, to prevent weaker cases that might meet the requirements of Rule 9(b) from surviving a motion to dismiss. Although Rules 8 and 9(b) still apply in some instances, the PSLRA largely has displaced the pleading standards set forth in the Federal Rules of Civil Procedure by mandating a uniform heightened pleading standard.

Among the principal procedural reforms of the PSLRA were new and rigorous pleading requirements for securities fraud class actions — beyond what was previously required under Rule 9(b) — and an automatic stay of discovery until the court has evaluated the sufficiency of those pleadings. 15 U.S.C. § 77z-1 & 78u-4. The PSLRA requires, among other things, that plaintiffs "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). The PSLRA also requires that, when a private plaintiff seeks a monetary recovery under Section 10(b), "the complaint shall, with respect to each act or omission alleged to violate [10b-5], state with particularity facts giving rise to a strong inference that the defendant acted with [scienter.]" 15 U.S.C. § 78u-4(b)(2).

A. FALSITY

1. Fraud-By-Hindsight Allegations

Even prior to the passage of the PSLRA, courts were generally unmoved by what Judge Friendly called "fraud by hindsight"— that is, the practice of alleging fraud by claiming that certain sobering disclosures (*e.g.*, of worse-than-expected performance) should have been made earlier (*i.e.*, when prior, more optimistic statements were made).[9] In *Denny v. Barber,* 576 F.2d

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[8] Pub. L. No. 104-67, 109 Stat. 737 (1995).

[9] *See, e.g., Greenstone v. Cambex Corp.*, 975 F.2d 22, 25 (1st Cir. 1992) ("To permit a securities fraud complaint to state, without more, that the corporation's executives 'knew' in 1991 about the likely decline in 1992 sales would sanction what Judge Friendly called 'fraud by hindsight,' a practice that courts have not allowed.") (internal citation omitted); *DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir. 1990) ("The story in this complaint is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud. 'Must be' is the critical phrase, for the complaint offers no information other than the differences between the two statements of the firm's condition. Because only a fraction of financial deteriorations reflects fraud, plaintiffs

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465 (2d Cir. 1978), the plaintiff purportedly relied upon Chase Manhattan's annual reports in 1974 and 1975, which described foreign operations and loans as "risky" and/or "speculative," as the principal basis for his allegation that the company's 1973 report, in which foreign loans and operations generally were "depicted with enthusiasm," were false. Writing for the Second Circuit, Judge Friendly affirmed the trial court's dismissal of the complaint for failure to plead fraud with particularity, holding that:

> In sum, the complaint is an example of alleging fraud by hindsight. For the most part, plaintiff has simply seized upon disclosures made in later annual reports and alleged that they should have been made in earlier ones. While greater clairvoyance in 1973 might have led to a realization that foreign government sand enterprises might encounter difficulties, particularly in consequence of the dramatic increase in petroleum prices; that REITs, including CMART, would run into serious trouble, necessitating a transaction between CMART and the Bank fully described in the 1975 Annual Report (pp. 5, 42); and that New York City would come to the verge of bankruptcy late in that year, failure to make such perceptions does not constitute fraud. Nowhere does the complaint allege with the required particularity transactions about which defendants in fact had such perceptions or were reckless in not having them when the 1973 and early 1974 reports were issued.[10]

The heightened pleading standards of the PSLRA, requiring plaintiffs to "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, [to] state with particularity all facts on which that belief is formed," was intended to curtail such practices as pleading "fraud by hindsight," and post-PSLRA courts have uniformly held that the falsity of a statement cannot be inferred merely from the fact that subsequent disclosures reflect a different (usually less optimistic) view.[11]

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may not proffer the different financial statements and rest. Investors must point to some facts suggesting that the difference is attributable to fraud.").

[10] *Id.* at 470.

[11] *In re Cabletron Systems, Inc.*, 311 F.3d 11, 37 (1st Cir. 2002); *Gross v. Summa Four, Inc.*, 93 F.3d 991 (1st Cir. 1996); *In re Carter-Wallace, Inc. Sec. Litig.*, 220 F.3d 36, 42 (2d Cir. 2000); *CALPERS v. Chubb Corp.*, 294 F.3d 126, 158 (3d Cir. 2004); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 538 (3d Cir. 1999); *Asher v. Baxter Int'l. Inc.*, 277 F.3d 727, 730 (7th Cir. 2004); *In re Navarre Corp. Sec. Litig.*, 299 F.3d 735, 742 (8th Cir. 2002); *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 988 (9th Cir. 1999); *Philadelphia v. Fleming Cos., Inc.*, 264 F.3d 1245, 1260 (10th Cir. 2001).

2. The "Contemporaneous Inconsistent Facts" Standard

Plaintiffs adequately allege falsity if they plead the existence of material contemporaneous facts that are inconsistent with a company's public statements with the level of detail required by Rule 9(b) and/or the PSLRA. To satisfy their burden under Fed. R. Civ. P. 9(b), plaintiffs must "set forth, as part of the circumstances constituting fraud, an explanation as to why the disputed statement was untrue or misleading when made."[12] "This falsity requirement can be satisfied 'by pointing to inconsistent contemporaneous statements or information (such as internal reports) which were made by or available to the defendants.'"[13]

Courts deciding cases under the PSLRA's heightened pleading standards also apply the contemporaneous inconsistent facts standard, but typically have required plaintiffs to plead such facts with greater particularity. Most courts, for example, no longer accept a simple allegation that generic "internal reports" contained facts inconsistent with, or undermining, a company's public disclosures. To satisfy the PSLRA, plaintiffs must specify "the sources of [their] information with respect to the reports, how [they] learned of the reports, who drafted them, or which officers received them . . . [and] an adequate description of their contents.[14] "[A]n unsupported general claim of the existence of confidential company sales reports that revealed [a] larger decline in sales is insufficient to survive a motion to dismiss . . . . [A] plaintiff needs to specify the internal reports, who prepared them and when, how firm the numbers were or which company officers reviewed them" to satisfy the heightened pleading standards of the PSLRA.[15]The Ninth Circuit has specifically stated that "internal reports" reflecting information

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12 *Fecht v. Price Co.,* 70 F.3d 1078, 1082 (9th Cir. 1995).

13 *Yourish v. California Amplifier,* 191 F.3d 983, 993 (9th Cir. 1999) (*quoting In re GlenFed Sec. Litig.,* 42 F.3d 1541, 1545 (9th Cir. 1994)); *see also San Leandro Emergency Med. Group Profit Sharing Plan v. Phillip Morris Cos., Inc.,* 75 F.3d 801, 812 (2d Cir. 1996); *United States v. Morris,* 80 F.3d 1151, 1165 (7th Cir. 1996); *Wallace v. Systems & Computer Tech. Corp.,* 1997 U.S. Dist. LEXIS 14677 (D. Pa. 1997); *McNamara v. Bre-X Minerals, Ltd.,* 57 F. Supp. 2d 396, 404 (D. Tex. 1999) (same); *In re Century Bus. Servs. Sec. Litig.,* 2002 U.S. Dist. LEXIS 26964, 55-56 (D. Ohio 2002) (same); *In re Technical Chems. Sec. Litig.,* 2001 U.S. Dist. LEXIS 4851, 21-22 (D. Fla. 2001) (same).

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

15 *In re Scholastic Corp. Sec. Litig.,* 252 F.3d 63, 72 (2d Cir. 2001) (internal citations omitted); *California Public Employees' Retirement Sys. v. Chubb Corp.,* 394 F.3d 126, 147 (3d Cir. 2004) (same); *Southland Sec. Corp. v. INSpire Ins. Solutions Inc.,* 365 F.3d 353, 370 (5th Cir. 2004) ("An unsupported general claim of the existence of company reports reflecting contrary information is insufficient to survive a motion to dismiss [under the PSLRA]. Such allegations must have corroborating details regarding the contents of allegedly contrary reports, their authors and recipients.") (internal quotations

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inconsistent with a corporate insider's public statements may constitute the sort of inconsistent contemporaneous information necessary to adequately plead falsity under Rule 9(b).[16] However, vague references to inconsistent internal reports generally do not suffice. Allegations of contemporaneous inconsistent information should set forth when such reports were written or information produced, the source of the information, and when the alleged information or reports were received and read.[17] "When plaintiffs rely upon internal reports, plaintiff must allege with requisite particularity: (1) what medium contained the information, *e.g.,* internal reports; (2) when the information was made available to people inside the company; (3) to which of the defendants the information would have been available; and (4) when they were aware of the information."[18]

3. "Temporal Proximity"

Plaintiffs in securities fraud actions frequently rely on the temporal proximity between positive and/or optimistic statements and subsequent bad news as evidence that the earlier, positive statements were false. Although such temporal proximity is, by itself, generally held to

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omitted); *In re Trex Co., Inc. Sec. Litig.,* 212 F. Supp. 2d 596, 610 (D. Va. 2002) (the PSLRA requires a plaintiff relying on internal reports to plead "facts concerning the people who made or received the reports, the content of the reports, the dates of transmissions, the manner in which they were transmitted or the bases for plaintiff's knowledge."); *In re BMC Software Sec. Litig.,* 183 F. Supp. 2d 860, 887 (D. Tex. 2001) (to meet the PSLRA's heightened pleading standards, plaintiffs "need to provide details about alleged negative internal reports, when they were prepared, who prepared them, their content, the sources from whom plaintiffs obtained such information, etc."); *Precision Vascular Sys. v. Sarcos L.C.,* 199 F. Supp. 2d 1181, 1186 (D. Utah 2002) (quoting *Silicon Graphics*).

16 *See Fecht,* 70 F.3d at 1082.

17 *See In re Copper Mountain Sec. Litig.*, 311 F. Supp. 2d 857, 870 (D. Cal. 2004).

18 *In re USA Talks.com, Inc. Sec. Litig.,* 2000 U.S. Dist. LEXIS 14823 (D. Cal. 2000) (denying motion to dismiss because plaintiffs specifically identified an internal memo that a defendant received that "indicated there were significant technical problems with USAT's network"); *see also San Leandro,* 75 F.3d at 812 ("Plaintiffs' unsupported general claim of the existence of confidential company sales reports [that were inconsistent with public statements] is insufficient to survive a motion to dismiss."); *Arazie v. Mullane,* 2 F.3d 1456, 1466 (7th Cir. 1993) (reference to internal reports insufficient where the complaint does not "indicate who prepared the projected figures, when they were prepared, how firm numbers were, or which [defendants] reviewed them.").

be insufficient to allege that the earlier statements were false when made,[19] some courts have accepted temporal proximity as circumstantial evidence of falsity and scienter.[20]

4. Statements Of Opinion

In *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991), the Supreme Court held that a statement of reason or belief may be actionable as a false statement in a securities fraud case. In that case, the minority shareholders of a bank brought an action under Section 14(a) of the Exchange Act and SEC Rule 14a-9 alleging, among other things, *inter alia*, that defendants falsely stated in their Proxy Statement that "[t]he Plan of Merger has been approved by the Board of Directors because it provides an opportunity for the Bank's public shareholders to achieve a high value for their shares." *Id.* at 1090. Appealing from a judgment in plaintiffs' favor, the defendants argued that "statements of opinion or belief incorporating indefinite and unverifiable expressions cannot be actionable as misstatements of material fact within the meaning of Rule 14a-9." *Id.* The Court rejected this argument, finding that "[s]uch statements are factual in two senses: as statements that the directors do act for the reasons given or hold the belief stated and as statements about the subject matter of the reason or belief expressed." *Id.* at 1092. "[S]uch conclusory terms in a commercial context are reasonably understood to rest on a factual basis that justifies them as accurate, the absence of which renders them misleading." *Id.* at 1093.

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19 *See Arazie*, 2 F.3d 1456, 1467-68 (7th Cir. 1993) ("temporal proximity between positive statements stressing a firm's strengths and announcements of poor economic performance do not create an inference that the earlier statements were fraudulent."); *see also Kaplan v. Rose*, 49 F.3d 1363, 1373 (9th Cir. 1994) (rejecting allegation that company's optimistic statements in registration statement and prospectus about market for new medical device was contradicted by statement that the same market was "dead" made three months later).

20 *See Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1224-25 (1st Cir. 1996) ("While the short time frame between an allegedly fraudulent statement or omission and a later disclosure of inconsistent information does not, standing alone, provide a sufficient factual grounding to satisfy Rule 9(b) . . . there is nothing in Rule 9(b) that precludes consideration of such temporal proximity as a circumstance potentially bolstering the complaint's claims of fraud.") (internal citations omitted); *Fidel v. Farley*, 392 F.3d 220, 232 (6th Cir. 2004) ("one factor of a non-exhaustive list that could be indicative of a knowing or reckless misstatement is the 'closeness in time of an allegedly fraudulent statement or omission and the later disclosure of inconsistent information . . . . In this case, however, the class members' allegations rest on nothing more than hindsight."); *Yourish v. California Amplifier,* 191 F.3d 983, 997 (9th Cir. 1999) ("We have allowed the temporal proximity of an allegedly fraudulent statement or omission and a later disclosure to *bolster* a complaint, but we have never allowed the temporal proximity between the two, *without more*, to satisfy the requirements of Rule 9(b).") (emphasis in original) (internal citation omitted); *Ronconi v. Larkin*, 253 F.3d 423, 437 (9th Cir. 2001) (applying holding of *Yourish* in context of PSLRA).

The Court dismissed defendants' argument that the proof or disproof of statements of reasons or belief implicated concerns about "hazy issues of historical fact the proof of which depended almost entirely on oral testimony,"[21] finding that the "[r]easons for directors' recommendations or statements of belief are, in contrast, characteristically matters of corporate record subject to documentation, to be supported or attacked by evidence of historical fact, and that the plaintiffs had indeed adduced such evidence:

> Whereas the proxy statement described the $42 price as offering a premium above both book value and market price, the evidence indicated that a calculation of the book figure based on the appreciated value of the Bank's real estate holdings eliminated any such premium. The evidence on the significance of market price showed that KBW had conceded that the market was closed, thin, and dominated by FABI, facts omitted from the statement. There was, indeed, evidence of a "going concern" value for the Bank in excess of $60 per share of common stock, another fact never disclosed. However conclusory the directors' statement may have been, then, it was open to attack by garden-variety evidence, subject neither to a plaintiff's control nor ready manufacture, and there was no undue risk of open-ended liability or uncontrollable litigation in allowing respondents the opportunity for recovery on the allegation that it was misleading to call $42 "high."[22]

The Court concluded that disbelief alone, without any demonstration that the statement was "false or misleading about its subject," was insufficient to establish falsity. *Id.* at 1096.

In the context of the PSLRA, *Virginia Bankshares* has been interpreted to require plaintiffs to plead with specificity both the *objective* and the *subjective* falsity of a statement of opinion.[23] A statement of opinion is *objectively* false when there is "objective evidence . . . that the statement . . . expressly or impliedly asserted something false or misleading about its subject matter." 501 U.S. at 1096. A statement of opinion is *subjectively* false when the speaker disbelieves the opinion he or she is expressing. Thus, the question of falsity in the case of an opinion is tightly bound up with the question of scienter.

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[21] *Id.* at 1094-95 (quoting *Blue Chip Stamps v. Manor Drug Store*, 321 U.S. 723 (1975)).

[22] 501 U.S. at 1094-95.

[23] *See, e.g. In re Ford Motor Co. Sec. Litig.*, 381 F.3d 563, 571 (6th Cir. 2004); *Nolte v. Capital One Fin. Corp.*, 290 F.3d 311, 315-16 (4th Cir. 2004); *In re Salomon Analyst Level 3 Litig.*, 350 F. Supp. 2d 477, 489 (S.D.N.Y. 2004); *D.E. & J. Ltd. Partnership v. Conaway*, 284 F. Supp. 2d 719, 736 (E.D. Mich, 2003); *In re Real Estate Assocs. Ltd. P'ship Litig.*, 223 F. Supp. 2d 1142, 1148-49 (C.D. Cal. 2002); *Hayes v. Crown Central Petroleum Corp.*, 249 F. Supp. 2d 725, 729-30 (E.D. Va. 2002); *In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d 1248, 1265 (N.D. Cal. 2000); *Freedman v. Value Health, Inc.*, 958 F. Supp. 745, 752-753 (D. Conn. 1997).

B. SCIENTER

1. Debate Over The PSLRA's "Strong Inference" Pleading Standard

The issue of how high the PSLRA raised the standard for pleading scienter continues to be debated by the appellate courts. A number of courts, including the Second Circuit, have held that Congress intended the PSLRA's "strong inference of fraudulent intent" standard to meet the then-existing Second Circuit standard, which at the time was considered to be the most rigorous in the country.[24] In *Shields v. Citytrust Bancorp., Inc.,*[25] the Second Circuit held that under Rule 9(b) "[t]he 'strong inference' of fraud may be established either (a) by alleging facts to show that defendants had both motive and opportunity to conceit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness."[26] Other courts, including the Ninth Circuit, have held that Congress intended to raise the pleading standard beyond the Second Circuit's "motive and opportunities" standard.

The First Circuit. Prior to the PSLRA, the First Circuit had adopted a definition of scienter that encompassed "recklessness," which it defined as "a highly unreasonable omission, involving not merely simple, or even inexcusable, negligence, but 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 the actor must have been aware of it."[27] In 1997, a federal court in Massachusetts held that the PSLRA had "eliminated recklessness" and that "conscious behavior can now only take the form of circumstantial evidence indicating intent to defraud or knowledge of the falsity."[28] In *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 200 (1st Cir. 1999), the First Circuit held that "the PSLRA did not address the substantive definition of scienter," and thus did not change the definition of scienter previously adopted by that Circuit.

The *Greebel* court, moreover, rejected defendants' argument that "facts showing motive and opportunity can never be enough to permit the drawing of a strong inference of scienter." 194 F.3d at 197. Although the court cautioned that "merely pleading motive and opportunity, regardless of the strength of the inferences to be drawn of scienter, is not enough," the court noted that three other circuits (the Second, Third, and Fifth) had interpreted the PSLRA as "permitting use of motive and opportunity type pleading if it raises a strong inference." *Id.* In a

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[24] *See Novak v. Kasaks,* 216 F.3d 300 (2d Cir.), *cert. denied,* 531 U.S. 1012 (2000); *In re Scholastic Corp. Sec. Litig.,* 252 F.3d 63 (2d Cir.), *cert. denied,* 122 S. Ct. 678 (2001).

[25] 25 F.3d 1124, 1128 (2d Cir. 1994).

[26] *See In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 979 (9th Cir. 1999).

[27] *Cook v. Avien,Inc.*, 573 F.2d 685, 692 (1st Cir. 1978) (quoting *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977)).

[28] *Friedberg v. Discreet Logic, Inc.*, 959 F. Supp. 42, 49 n.2 (D. Mass. 1997).

subsequent case, *In re Cabletron Systems, Inc. Securities Litigation,* 311 F.3d 11, 39-40 (1st Cir. 2002), the First Circuit considered allegations of motive and opportunity along with several other allegations that the court found, as a whole, to satisfy the scienter requirement.

The Second Circuit. In *Press v. Chemical Investment Services Corp.*, 166 F.2d 529, 537 (2d Cir. 1999), the Second Circuit announced that the PSLRA "heightened the requirement for pleading scienter to the level used by the Second Circuit." A year later, in *Novak v. Kasaks*, 216 F.3d 300, 310 (2d Cir. 2000), however, the Second Circuit acknowledged that the "with particularity" requirement of the PSLRA did raise the bar somewhat higher than even the Second Circuit's former "motive and opportunity" standard.

In *Novak*, the court also distilled Second Circuit precedent applying the "strong inference" standard into four categories of allegations that may give rise to a "strong inference" of scienter:

(1) defendants "benefited [*sic*] in a concrete and personal way from the purported fraud,"

(2) defendants "engaged in deliberately illegal behavior,"

(3) defendants "knew facts or had access to information suggesting that their public statements were not accurate," or

(4) defendants "failed to check information they had a duty to monitor." *Id.*

The *Novak* court also expressed its belief that "Congress's failure to include language about motive and opportunity suggests that we need not be wedded to these concepts in articulating the prevailing standard," but did not rule on the sufficiency of any "motive and opportunity" allegations.

In *Rombach v. Chang*, 355 F.3d 164 (2nd Cir. 2004) the court addressed — and rejected — three allegations of motive. First, plaintiffs alleged that defendants were motivated to inflate the company's stock price to complete a previously arranged corporate acquisition and to retire debt. The Second Circuit agreed with the district court that "these steps are part of the officers' and directors' financial responsibilities to the Company," and that plaintiffs had not alleged that defendants "engaged in these transactions to secure personal gain." *Id.* at 177. Second, plaintiffs alleged that one of the individual defendants was "affiliated" with a company that leased the issuer its corporate jet. The court noted that there was "no indication that he stood to profit substantially from the arrangement." *Id.* Third, plaintiffs alleged that the individual defendants purchased large amounts of stock after the price collapsed, but the court noted that there was "no explanation as to how defendants' post-collapse purchase of Family Golf stock, which is now worthless, benefited them in any way." *Id.* The Second Circuit affirmed dismissal because "the complaint identified no personal interest sufficient to establish motive."

In *In re Federated Department Stores, Inc. Securities Litigation*, 2004 U.S. Dist. LEXIS 3769 (S.D.N.Y. Mar. 11, 2004), the court held that plaintiffs could not combine allegations of motive and opportunity and allegations of reckless or intentional conduct to establish a strong inference of scienter where neither set of allegations would stand alone to establish that

inference. "The two methods of pleading scienter are separate and distinct," explained the court before holding that the complaint before it failed to plead either method sufficiently, and dismissing with leave to amend. *Id.*

The Third Circuit. In *In re Advanta Corp. Securities Litigation*, 180 F.3d 525, 533 (3d Cir. 1999), the Third Circuit held that the PSLRA's language "closely mirrors language employed by the Second Circuit, particularly as it requires the plaintiff to allege facts supporting a 'strong inference' of scienter. In fact, with the exception of the Act's state with particularity requirement, the two standards are virtually identical." The court noted that "even in jurisdictions already employing the Second Circuit standard, the additional requirement that plaintiffs state facts 'with particularity' represents a heightening of the standard." *Id.* at 534. The court then concluded that, "it remains sufficient for plaintiffs plead scienter by alleging facts 'establishing a motive and an opportunity to commit fraud, or by setting forth facts that constitute circumstantial evidence of either reckless or conscious behavior.'" *Id*. at 534-35 (quoting *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 318 n.8 (3d Cir. 1997)). The court observed that the result of applying the heightened standard of the PSLRA is to make it harder to plead motive and opportunity: "After the Reform Act, catchall allegations that defendants stood to benefit from wrongdoing and had the opportunity to implement a fraudulent scheme are no longer sufficient, because they do not state facts with particularity or give rise to a strong inference of scienter." 180 F.3d at 535.

The court in *Advanta* also held that the substantive standard for scienter in the Third Circuit was not changed by the PSLRA, and that "recklessness . . . remains a sufficient basis for liability":

> Retaining recklessness not only is consistent with the Reform Act's expressly procedural language, but also promotes the policy objectives of discouraging deliberate ignorance and preventing defendants from escaping liability solely because of the difficulty of proving conscious intent to commit fraud. A reckless statement is one "'involving not merely simple, or even inexcusable negligence, but 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.'" *Id.* (citations omitted).

In *GSC Partners CDO Fund v. Washington*, 368 F.3d 228 (3d Cir. 2004), plaintiffs alleged that defendants were motivated to commit fraud because (1) defendants wanted to close a note offering that would allow the corporation to complete a merger transaction; and (2) one individual defendant would profit by receiving lucrative stock options. The court found that such generic allegations were insufficient to establish a strong inference of scienter: "In every corporate transaction, the corporation and its officers have a desire to complete the transaction, and officers will usually reap financial benefits from a successful transaction." *Id.* at 237. The court also rejected as "undoubtedly true but equally unavailing" allegations that CSFB had a motive to commit fraud because it stood to receive underwriting and financial advisory fees. *Id.* at 238.

The Fourth Circuit. The Fourth Circuit has declined to adopt or articulate a specific pleading standard under the PSLRA. In its first post-PSLRA opportunity to address the issue —

Phillips v. LCI International, Inc. the court stated: "We have not yet determined which pleading standard best effectuates Congress's intent." 190 F.3d 609, 621 (4th Cir. 1999). The court found it did not need to do so in that case, as the plaintiffs had "failed to allege facts sufficient to meet even the most lenient standard possible under the PSLRA, the two-pronged Second Circuit test." *Id.* at 621. In *Ottman v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 343-46 (4th Cir. 2003), the Fourth Circuit continued its circumspect approach to the PSLRA's pleading standards, finding that "both the absence of any statutory language addressing particular methods of pleading and the inconclusive legislative history regarding the adoption of Second Circuit pleading standards indicate that Congress ultimately chose not to specify particular types of facts that would or would not show a strong inference of scienter," and that "a flexible, case-specific analysis is appropriate in examining scienter pleadings."

In *LCI*, the Fourth Circuit found that the complaint failed to allege "sufficient specific facts of 'motive and opportunity' to defraud." *LCI*, 190 F.3d at 621. "In order to demonstrate motive, a plaintiff must show 'concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged.' Merely alleging facts that lead to a 'strained and tenuous inference' of motive is insufficient to satisfy the pleading requirement." *Id.* (citations omitted). This standard was repeated in *Ottman*, with the court noting that "generalized motives — which are shared by all companies — [are] insufficient to plead scienter under the PSLRA." *Ottman*, 353 F.3d at 352.

The Fifth Circuit. Noting that the PSLRA "leaves undefined . . . the content of the scienter requirement," and that the "absence of direct guidance on this point, coupled with the statute's stated purpose of winnowing out meritless claims by imposing more stringent pleading requirements on plaintiffs has raised in the minds of some the possibility that the PSLRA may have eliminated the lesser mental state of recklessness as a basis for liability," the Fifth Circuit held that the PSLRA required a standard of "severe recklessness." *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 407 (5th Cir. 2001). As defined by the Fifth Circuit, severe recklessness "is limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it." *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 961-62 (5th Cir. 1981) (quoted in *Nathenson, supra*).

The Fifth Circuit has adopted a "middle ground" approach to motive and opportunity:

> What must be alleged is not motive and opportunity as such but particularized facts giving rise to a strong inference of scienter. Appropriate allegations of motive and opportunity may meaningfully enhance the strength of the inference of scienter, but it would seem to be a rare set of circumstances indeed where those allegations alone are both sufficiently persuasive to give rise to a scienter inference of the necessary strength and yet at the same time there is no basis for further allegations also supportive of that inference. We conclude that simply because motive and opportunity is alleged does not of itself automatically and

> categorically mean that the necessary strong inference of scienter is present. Whether motive and opportunity allegations will ever alone suffice should in most cases be a moot point.[29]

In *Goldstein v. MCI WorldCom*, 267 F.3d at 411, the court found sufficiently plaintiffs' allegations that WorldCom CEO Bernard Ebbers stood to lose millions in compensation if WorldCom's stock price dropped "significantly," and that a "materially adverse" change in his compensation would cause certain personal loans secured by Ebbers' shares in WorldCom stock to become due, "particularized" and that Ebbers had "a strong and unique incentive" to artificially inflate the price of WorldCom's stock. However, the court noted that "our court requires more than allegations of motive and opportunity to withstand dismissal," and concluded that the totality of plaintiffs' allegations of circumstantial evidence of scienter was insufficient to support the strong inference required by the PSLRA. *Id.* at 250.

In *R2 Investments LDC v. Phillips*, 401 F.3d 638, 645 (5th Cir. 2005), the Fifth Circuit noted that because the plaintiff had not alleged a "clear motive" for the alleged misstatements or omissions, "the strength of its circumstantial evidence of scienter must be correspondingly greater." After analyzing the allegations in the complaint, the court concluded that the plaintiff had not raised a strong inference of scienter, in part because it had not made any allegation of motive. *Id.*

The Sixth Circuit. In *In re Comshare, Inc. Securities Litigation,* 183 F.3d 532, 548 (6th Cir. 1999), the Sixth Circuit held that the PSLRA had heightened the pleading standard for scienter, but had not modified the substantive law with respect to whether recklessness or motive and opportunity were sufficient to establish scienter. The court held that recklessness remained sufficient to establish liability under the PSLRA: "Because it is clear that recklessness, understood as a mental state apart from negligence and akin to conscious disregard, may constitute scienter, we conclude that under the PSLRA a plaintiff may survive a motion to dismiss by pleading facts that give rise to a 'strong inference' of recklessness." 183 F.3d at 551. As to motive and opportunity, the court held that plaintiffs may not meet the PSLRA pleading requirements "by alleging facts that illustrate nothing more than a defendant's motive and opportunity to commit fraud." *Id.* As for the definition of recklessness itself, the court adopted an objective standard, holding that, "[w]hile the danger need not be known, it must at least be so obvious that any reasonable man would have known of it." *Id.*

In *Helwig v. Vencor*, 251 F.3d 540 (6th Cir. 2001), the Sixth Circuit clarified its view on "motive and opportunity" allegations:

> While 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 . . . . "[M]otive" and "opportunity" are simply recurring patterns of evidence. We decide cases on facts, not labels . . . . Whether the facts

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29 267 F.3d at 411.

> can be said to establish motive, opportunity, or neither, we are directed only to consider whether they produce a strong inference that the defendant acted at least recklessly. This necessarily involves a sifting of allegations in the complaint. As we have noted, recklessness in securities fraud is an untidy, case-by-case concept . . . . Accordingly, facts presenting motive and opportunity may be of enough weight to state a claim under the PSLRA, whereas pleading conclusory labels of motive and opportunity will not suffice. *Id.* at 550-51 (6th Cir. 2001) (citations omitted).

In *PR Diamonds, Inc. v. Chandler*, 364 F.3d 671 (6th Cir. 2004), the Sixth Circuit addressed "motive and opportunity" allegations in some detail. The plaintiffs in that case alleged that the individual defendants had motives and opportunities to commit fraud and artificially inflate the company's stock price, including:

(1) motivation to engage in improper accounting practices which would help mask the company's deteriorating operating results and forestall an impending default on a bank loan;

(2) motivation to report artificially inflated net income to reduce the impact on quarterly financials of a spike in fuel costs;

(3) motivation to inflate the value of the company's accounts receivable because the terms of the company's credit facility were determined by a formula tiled to accounts receivable;

(4) motivation to protect themselves and their investment in the company;

(5) motivation to protect and enhance their executive positions and the substantial compensation and prestige obtained thereby;

(6) motivation on the part of one defendant to engage in self-dealing from which he would reap profits;

(7) motivation on the part of another defendant to disseminate false financial statements to receive a bonus based on net income before taxes; and

(8) opportunities to participate in fraud due to positions as the "highest ranking officers . . . who controlled the content of the Company's press releases and public filings."[30]

The court found that the opportunity to commit fraud had been plead, but that many of the alleged motives were "motives common to corporations and executives generally," as distinguished from motive to commit fraud. Such common motives include the desire for the

[30] 364 F.3d at 689.

company to appear successful, to protect one's position within the company, or to increase one's compensation. *Id.* at 690. Similarly, the court found that the allegations of self-dealing "suggest no more than a general motive for [the company's] success, not fraud." The court found the allegations concerning the bank loan and credit facility more particularized, and therefore more probative of scienter, "although standing alone they do not establish a strong inference." In the end, the court considered these particularized motive and opportunity allegations "along with all others, in the totality of the circumstances analysis," and concluded that a strong inference of scienter had not been raised. *Id.* at 692-93.

The Seventh Circuit. The Seventh Circuit Court of Appeals has not yet directly interpreted the PSLRA's "strong inference" pleading standard. Some trial courts within the Seventh Circuit have applied the pre-PSLRA "motive and opportunity" standard.[31] Other courts have found it unnecessary to address the debate reflected in the case law of other circuits[32] and others have declined to "set forth generally applicable exclusionary rules with respect to each technical detail of pleading," preferring instead to "appl[y] the PSLRA on a case by case basis in accordance with its plain terms, without resource to fixed formalistic categories.[33]

The Eighth Circuit. The Eighth Circuit addressed the PSLRA's pleading standards in *Florida State Board of Administration v. Green Tree Financial Corp.,* 270 F.3d 645 (8th Cir. 2001). Noting "substantial agreement among the Circuits that have considered the question that 15 U.S.C. § 78u-4(b)(2) was not intended to alter the substantive standard for scienter," the court reaffirmed its pre-PSLRA cases which defined scienter to include recklessness "limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even

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31 *See e.g., In re Spyglass, Inc. Sec. Litig.*, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,607 (N.D. Ill. July 21, 1999) ("The PSLRA 'did not change the substantive standards of the securities laws; it only modified the pleading standards . . . . Thus, the scienter requirement can still be established by a motive and an opportunity to commit fraud, or by establishing facts that constitute circumstantial evidence of reckless or conscious misbehavior.") (internal citations omitted).

32 *See e.g., Zoghlin v. Renaissance Worldwide, Inc.*, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,904 (N.D. Ill. Nov. 4, 1999) (noting the conflicting case law in other circuits regarding the meaning of the PSLRA's "strong inference" standard, but declining to address the issue "because Zoghlin's allegations fail to satisfy even Rule 9(b)'s pleading requirements.").

33 *In re Allied Products Corp., Inc. Sec. Litig.*, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,971 (N.D. Ill. Mar. 13, 2000); *see Waldock v. M.J. Select Global, Ltd.*, 2005 WL 2978895, at *4-7 (N.D. Ill. Nov. 7, 2005); *Davis v. USN Comm., Inc.*, 73 F. Supp. 2d 923, 937 (N.D. Ill. 1999) ("the PSLRA's focus is on whether plaintiffs have plead with particularity facts establishing a 'strong inference" that the defendants acted with scienter. The types of facts they choose to use in this pursuit . . . are of no consequence as long as those facts establish the strong inference of scienter.").

inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it." *Id.* at 653-54.

With respect to motive and opportunity allegations in PSLRA cases, the Eight Circuit has articulated the following guidelines:

(1) Motive and opportunity "are generally relevant to a fraud case, and a showing of unusual or heightened motive will often form an important part of a complaint that meets the Reform Act standard." *Id.* at 660.

(2) In some cases, "the same circumstantial allegations that establish motive and opportunity also give additional reason to believe the defendant's misrepresentation was knowing or reckless . . . . Such allegations may meet the Reform Act standard, but if so it is because they give rise to a strong inference of scienter, not merely because they establish motive and opportunity." *Id.*

In the absence of motive and opportunity allegations "of any sort — either the unusual, heightened motive highlighted in the Second Circuit cases, or even an everyday motive such as keeping one's job — then other allegations tending to show scienter would have to be particularly strong in order to meet the Reform Act standard." *Id.*

The Ninth Circuit.. In *In re Silicon Graphics, Inc. Securities Litigation*, 183 F.3d 970, 979 (9th Cir. 1999), the Ninth Circuit found that Congress had adopted, in the PSLRA, "a standard more stringent than the Second Circuit standard." Under this new, more stringent, standard, the court concluded, a plaintiff "can no longer aver intent in general terms of mere 'motive and opportunity' or 'recklessness,' but rather, must state specific facts indicating no less than a degree of recklessness that strongly suggests actual intent." *Id.* The Ninth Circuit called this heightened degree of recklessness "deliberate recklessness":

> We hold that a private securities plaintiff proceeding under the PSLRA must plead, in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct. Our holding rests, in part, on our conclusion that Congress intended to elevate the pleading requirement above the Second Circuit standard requiring plaintiffs merely to provide facts showing simple recklessness or a motive to commit fraud and opportunity to do so. We hold that although facts showing mere recklessness or a motive to commit fraud and opportunity to do so may provide some reasonable inference of intent, they are not sufficient to establish a strong inference of intent. In order to show a strong inference of intent, plaintiffs must state facts that come closer to demonstrating intent, as opposed to mere recklessness. Accordingly, we hold that a heightened form of recklessness, *i.e.*, deliberate or conscious recklessness, at a minimum, is required to establish a strong inference of intent. *Id.* at 974.

The Tenth Circuit. In *Philadelphia v. Fleming Cos., Inc.*, 264 F.3d 1245, 1259 (10th Cir. 2001), the Tenth Circuit concluded that "the PSLRA heightened the pleading requirements for securities fraud cases generally, and particularly in regard to the scienter element, and the legislative history suggests that Congress specifically intended a pleading standard stricter than

the standard then prevailing in the Second Circuit." The court then addressed each prong of the Second Circuit's pre-PSLRA approach.

With respect to intentional conduct, the court held that, "to establish scienter in a securities fraud case alleging non-disclosure of potentially material facts, the plaintiff must demonstrate: (1) the defendant knew of the potentially material fact, and (2) the defendant knew that failure to reveal the potentially material fact would likely mislead investors. The requirement of knowledge in this context may be satisfied under a recklessness standard by the defendant's knowledge of a fact that was so obviously material that the defendant must have been aware both of its materiality and that its non-disclosure would likely mislead investors." *Id.* at 1261.

With respect to motive and opportunity, the court noted that circuit courts were "split on the question of whether plaintiffs may still use 'motive and opportunity' pleadings to demonstrate scienter under the heightened pleading requirements set forth in the PSLRA," and chose a "totality of the pleadings" approach. *Id.* at 1261-62. "Allegations of motive and opportunity may be important to that totality," the court held, "but are typically not sufficient in themselves to establish a 'strong inference' of scienter." *Id.* at 1262.

In *Pirraglia v. Novell*, 339 F.3d 1182 (10th Cir. 2003), the Tenth Circuit considered allegations that defendants were motivated to commit fraud to increase the company's reported revenue because the company had fired two consecutive executives for failing to improve the company's revenue. The court held that, "[w]hile the desire to protect one's own position is shared by all company executives, the defendants in the instant case had especial cause to think that they would lose their jobs if they failed to produce results," and "[w]hile this evidence of motive and opportunity does not in itself establish a strong inference of scienter, we consider it in reviewing the 'totality of the pleadings.'" *Id.* at 1191.

The Eleventh Circuit. In *Bryant v. Arvado Brands*, 187 F.3d 1271, 1282 (11th Cir. 1999), the Eleventh Circuit rejected the Ninth Circuit's "deliberate recklessness" standard and held that the Eleventh Circuit's own prior standard of "severe recklessness" still applied. The Eleventh Circuit's definition of "severe recklessness" is borrowed from the Fifth Circuit:

> Severe recklessness is limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it.[34]

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[34] *Id.* at 1282 (quoting *McDonald v. Alan Bush Brokerage Co.*, 863 F.2d 809, 814 (11th Cir. 1989), which in turn quoted *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929 at 961-62 (5th Cir. 1981)).

As for motive and opportunity, the court held that the PSLRA's "required state of mind" language: "Clearly refers to a substantive standard, a condition of the mind, like willfulness or recklessness. Motive and opportunity, on the other hand, do not constitute a substantive standard; rather, motive and opportunity are specific kinds of evidence, which along with other evidence might contribute to an inference of recklessness or willfulness." *Bryant*, 187 F.3d at 1282.

2. The "Group Pleading Doctrine" and Pleading "Collective Scienter"

As with the court's interpretation of the PSLRA's "strong inference" pleading standard, the courts do not always agree as to the impact, if any, the PSLRA has on the PSLRA "group published" information doctrine. Prior to the PSLRA, many courts held that

> [i]n cases of corporate fraud, where the false or misleading information is conveyed in prospectuses, registration statements, annual reports, press releases, or other "group published 'information,'" it is reasonable to presume that these are the collective actions of the officers. Under such circumstances, a plaintiff fulfills the particularity requirement of Rule 9(b) by pleading the misrepresentations with particularity and where possible the roles of the individual defendants in the misrepresentations.[35]

Some courts have held that the "group published information" doctrine is fundamentally inconsistent with the PSLRA,[36] while others have concluded that it is a doctrine not specifically relating to scienter, and, therefore, untouched by the PSLRA.[37]

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35 *Wool v. Tandem Computers, Inc*., 818 F.2d 1433, 1440 (9th. Cir. 1987).

36 *See. e.g., In re Lockheed Martin Corp. Sec. Litig*., [2001-2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,298, 91,855 (C.D. Cal. July 22, 2002) ("The group published information doctrine is inconsistent with the PSLRA because it requires courts to accept a plaintiff's belief regarding the individual liability of a corporate officer even when the belief is based on the officer's job title alone. The doctrine is essentially a mechanism for pleading an officer's involvement in the issuance of a corporate statement based on information and belief. The PSLRA permits pleading on information and belief, but only if the complaint states with particularity all facts on which the belief is formed."); *Allison v. Brooktree Corp*., 999 F. Supp. 1342, 1350-51 (S.D. Cal. 1999) (holding that group published information doctrine does not survive the PSLRA because the PSLRA "requires that the untrue statements or omissions be set forth with particularity as to [each] 'defendant' ".); *Coates v. Heartland Wireless Comm., Inc*., 26 F. Supp. 2d 910, 916 (N.D. Tex., 1998) (holding that "it is nonsensical to require a plaintiff specifically to allege facts regarding scienter as to each defendant, but to allow him to rely on group pleading in asserting that the defendant made the statement or omission").

The Second Circuit. In *In re Cross Media Marketing Corp. Securities Litigation*, 2004 U.S. Dist. LEXIS 6777 (S.D.N.Y. Apr. 20, 2004), the court held that the plaintiffs' allegations failed to give rise to a strong inference of scienter because the plaintiffs attributed recklessness to the group of individual defendants without specifying reckless actions of particular defendants.

The Fifth Circuit. In *Southland Securities Corp. v. INSpire Insurance Solutions Inc*., 365 F.3d 353, 364 (5th Cir. Mar. 31, 2004), the Fifth Circuit rejected the "group pleading" doctrine, holding that the Court would not "construe allegations . . . against the 'defendants' as a group as properly imputable to any particular individual defendant unless the connection between the individual defendant and the allegedly fraudulent statement is specifically pleaded." The Court offered examples of "specific facts tying a corporate officer to a statement," including "a signature on the document or particular factual allegations explaining the individual's involvement in the formulation of either the entire document, or that specific portion of the document, containing the statement." *Id.* at 365. Notwithstanding its holding as to individual defendants, "the corporation itself may be treated as making press releases and public statements issued by authorized officers on its behalf, and statements made by its authorized officers to further the interests of the corporation." *Id*.

The Seventh Circuit. In *Caterpillar, Inc. v. Great American Insurance Co.*, 62 F.3d 955, 962 (7th Cir. 1995), an action for reimbursement brought against a D&O insurer, the Seventh Circuit noted, in dicta, that "there are conceivable situations where the individual actors would not be liable but their corporate employer would be, for example, where a case depends on the collective scienter of its employees . . . ." The court then went on to observe that that "there is little case law supporting an independent corporate scienter theory,"[38] but also quoted *In re Warner Communications Securities Litigation*[39] for the proposition that "the requisite degree of scienter is likely to be easier to attribute to the corporation than the individual defendants."

Recently the Northern District of Illinois rejected allegations of collective scienter in a securities fraud case brought under the PSLRA, citing *Caterpillar* as evidence that the Seventh Circuit had "expressed agreement" with the holdings of the Fifth and Ninth Circuits that "the requisite scienter must be held by the corporate employee responsible for issuing the alleged

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37 *See e.g., In re Secure Computing Corp*., 184 F. Supp. 2d 980, 991 (N.D. Cal. 2001); *In re Bank Am. Corp. Sec. Litig*., 78 F. Supp. 976, 988 (E.D. Mo. 1999) (holding that group published pleading doctrine survive PSLRA because it has "nothing to do with scienter.")

38 62 F.3d at 963 (citing *Nordstrom, Inc. v. Chubb & Son, Inc.*, 54 F.3d 1424, 1435 (9th Cir. 1995)).

39 618 F. Supp. 735, 752-53 (S.D.N.Y. 1985).

misrepresentations or at least that a senior officer or director of the corporation must have the pertinent scienter."[40]

The Eighth Circuit. In *Piper Jaffray Cos. Inc. v. National Union Fire Insurance Co.*, 38 F. Supp. 2d 771 (D. Minn. 1999), the defendant insurance company argued that the plaintiff insured, "faced direct, independent corporate liability pursuant to Section 20(b) of the Securities Exchange Act and Rule 10b-5 under a theory of 'collective scienter,'" relying on *In re Warner Communications Securities Litigation,* 618 F.Supp. 735, 752 (S.D.N.Y. 1985). The district court rejected this argument, finding that the defendant had quoted *Warner* out of context, and that *Warner* "does not introduce the possibility of collective scienter." 38 F. Supp.2d at 779. The court concluded that "while theoretically, collective scienter could be a basis for liability, there is no case law supporting an independent 'collective scienter' theory," and therefore corporate liability "requires a demonstration that at least one agent of the corporation — an insured officer or director or an uninsured employee — possessed the requisite scienter." 38 F.Supp.2d at 779-80.

The Ninth Circuit. In *In re Read-Rite Corp. Securities Litigation*, 335 F.3d 843 (9th Cir. 2003), the Ninth Circuit disapproved prior district court decisions suggesting that some form of "group scienter" was permissible under the PSLRA. The court rejected the notion that "facts critical to a business's core operations or an important transaction generally are so apparent that their knowledge may be attributed to the company and its key officers."

In *In re Apple Computer Inc.*, 243 F. Supp. 2d 1012 (N.D. Cal. 2002), the court found that allegations that senior management had a "hands on management style" and that the CEO "runs every aspect of the business" were insufficient. "It is not enough for plaintiffs to allege that defendants could have known about problems, or even that they should have known about them. Plaintiffs must allege something approaching actual knowledge on the part of [the CEO] or other . . . officers who made statements regarding the company." The court expressly stated

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40 *Higginbotham v. Baxter Int'l., Inc.*, 2005 WL 1272271, *8 (N.D. Ill. May 25, 2005). The court "distinguished *In re NUI Securities Litigation,* 314 F. Supp. 2d 388, 410-13 (D.N.J. 2004), on the grounds that in that case there were (a) adequate allegations linking the alleged misrepresentations to a company stock offering; and (b) allegations of knowledge on the part of a "senior management official whose knowledge could be attributed to NUI." The other case cited by plaintiffs was *In re WorldCom, Inc. Securities Litigation*, 352 F. Supp. 2d 472, 497 (S.D.N.Y. 2005), which states that, "[t]o carry their burden of showing that a corporate defendant acted with scienter, plaintiffs in securities fraud cases need not prove that any one individual employee of a corporate defendant also acted with scienter. Proof of a corporation's collective knowledge and intent is sufficient." The Northern District of Illinois observed that *WorldCom*'s holding relied "on the nature of an accounting firm and it having collective responsibility for the results of an audit that was conducted by numerous employees," and declined to follow that holding to the extent that it was not limited to accounting firms.

that "the Ninth Circuit has rejected the concept of 'collective scienter' in attributing scienter to a corporation."

The Eleventh Circuit. n *Phillips v. Scientific-Atlanta, Inc.,* 2004 U.S. App. LEXIS 12288, at *1 (11th Cir. June 22, 2004), the Eleventh Circuit held that "factual allegations may be aggregated to infer scienter," but scienter "must be inferred for each defendant with respect to each violation." The Court noted that it was joining the First, Second, Fifth, Eighth, and Ninth Circuits in interpreting the PSLRA "to permit the aggregation of facts to infer scienter." *Id.* at *4. With respect to defendants, however, the Court held that "the most plausible reading [of the PSLRA] in light of congressional intent is that a plaintiff, to proceed beyond the pleading stage, must allege facts sufficiently demonstrating *each* defendant's state of mind regarding his or her alleged violations." *Id.* at *8 (emphasis added). The Court expressly reserved judgment as to the "group pleading" doctrine, explaining that the complaint before it "contains factual allegations amply linking each defendant to his alleged violations of the statute and attributing the required scienter to each defendant with respect thereto. Accordingly, for purposes of this appeal, Plaintiffs need not rely upon the group pleading doctrine." *Id.* at *14.

3. Pleading Scienter Through "Motive And Opportunity" Allegations

Stock Trading Allegations. Although trading in the issuer's securities by corporate insiders is not in and of itself probative of scienter, courts have consistently held that unusual or suspicious sales of stock by insiders during the class period can contribute to a strong inference of scienter.[41] Courts also generally agree upon the factors to be considered in determining whether trading is unusual or suspicious enough to support a strong inference of scienter. These factors include:

(1) the number of insiders trading;[42]

(2) the timing of the trades;[43]

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[41] *See Greebel v. FTP Software, Inc.*, 194 F.3d 185, 197-98 (1st Cir. 1999); *Rothman v. Gregor*, 220 F.3d 81, 94 (2d Cir. 2000); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 540 (3d Cir. 1999); *In re PEC Solutions, Inc. Sec. Litig.*, 125 Fed. Appx. 490, 498-99 (4th Cir. 2005); *Abrams v. Baker Hughes, Inc.*, 292 F.3d 424, 435 (5th Cir. 2002); *PR Diamonds, Inc. v. Chandler*, 364 F.3d 671, 691 (6th Cir. 2004); *Navarre Corp.* 299 F.3d at 747; *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 986 (9th Cir. 1999).

[42] *See Rothman*, 220 F.3d at 94; *Advanta*, 180 F.3d at 540; *Abrams*, 292 F.3d at 435; *Florida State Board of Administration v. Green Tree Fin. Corp.*, 270 F.3d 645, 559 (8th Cir. 2001); *In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1093 (9th Cir. 2002).

[43] *See Greebel*, 194 F.3d at 206-07; *Rothman*, 220 F.3d at 94-95; *Advanta*, 180 F.3d at 540-41; *In re PEC Solutions, Inc. Sec. Litig.*, 125 Fed. Appx. 490, 498-99 (4th Cir. 2005);

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(3) the total amount of stock sold;[44]

(4) the percentage of shares traded (taking into account exercisable options, warrants and other relevant securities);[45]

(5) the profit received;[46]

(6) the insider's historical trading patterns;[47]

(7) whether some defendants did not sell;[48] and

(8) if there are other judicially noticeable explanations, such as the trader's recent or impending departure from the corporation.[49]

If the insider's trading is not unusual and suspicious in time and amount, no inference that the trading reflects scienter is warranted. In *In re Alpharma Securities Litigation*, 2004 U.S. App. LEXIS 11681, at *40-41 (3d Cir. June 15, 2004), for example, the Third Circuit affirmed that plaintiffs failed to plead motive and opportunity through insider trading where the complaint

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Abrams, 292 F.3d at 435; *PR Diamonds*, 364 F.3d at 691 (6th Cir. 2004); *Navarre Corp*, 299 F.3d at 747; *Silicon Graphics*, 183 F.3d at 986.

44 *See Greebel*, 194 F.3d at 206; *In re PEC Solutions, Inc. Sec. Litig.*, 125 Fed. Appx. 490, 498-99 (4th Cir. 2005); *Abrams,* 292 F.3d at 435; *PR Diamonds, Inc.* 364 F.3d at 691; *Green Tree Fin. Corp.*, 270 F.3d at 559; *Silicon Graphics*, 183 F.3d at 986.

45 *See Rothman,* 220 F.3d at 94; *Advanta*, 180 F.3d at 540-41; *PEC Solutions, Inc.*, 125 Fed. Appx. at 498-99; *Abrams*, 292 F.3d at 435; *Southland Sec. Corp. v. Inspire Insurance Solutions Inc.*, 365 F.3d 353, 368 (5th Cir. 2004); *Green Tree Fin. Corp.*, 270 F.3d at 559; *Silicon Graphics*, 183 F.3d at 987.

46 *See Rothman*, 220 F.3d 81, 94 (2d Cir. 2000); *Advanta*, 180 F.3d at 540-41; *In re PEC Solutions, Inc. Sec. Litig.*, 125 Fed. Appx. 490, 498-99 (4th Cir. 2005); *Florida State Board of Administration v. Green Tree Fin. Corp.*, 270 F.3d 645, 559 (8th Cir. 2001); *Ronconi v. Larkin*, 253 F.3d 423, 435 (9th Cir. 2001).

47 *See Greebel*, 194 F.3d at 206; *Advanta*, 180 F.3d at 540-41; *Inspire Insurance Solutions*, 365 F.3d at 368; *In re Navarre*, 299 F.3d at 747; *Silicon Graphics*, 183 F.3d at 986.

48 *Ronconi v. Larkin,* 253 F.3d 423, 435 (9th Cir. 2001); *Silicon Graphics,* 183 F.3d at 987; *Advanta,* 180 F.3d at 540; *Acito,* 47 F.3d at 54.

49 *Wietschner v. Monterey Pasta Co.,* 294 F. Supp. 2d 1102, 1116-17 (N.D. Cal. Nov. 4, 2003).

did not allege that the defendants' trades were "unusual in scope (*e.g*., compared to their total level of compensation or the size of previous sales) or timing (*e.g*., compared to the timing of past trades)."[50]

Motive Based On Performance-Based Compensation Incentives. Courts generally have not permitted plaintiffs to plead scienter based on allegations that senior management of the issuer were motivated to commit fraud by a desire to cash in on stock options or other performance-based incentive compensation. "If scienter could be pleaded on that basis alone, virtually every company in the United States that experiences a downturn in stock price could be forced to defend securities fraud actions."[51] The desire to increase personal compensation, standing alone, is insufficient.[52]

Although the mere allegation that the defendant's compensation depends on corporate value or earnings does not, by itself, establish motive, some courts have held that unusually large performance-based incentives can provide a legally sufficient motive to manipulate a company's financial statements. In *Florida State Board of Administration v. Green Tree Financial Corp.*, 270 F.3d 645, 661 (8th Cir. 2001), the court held that the special circumstances of a CEO's particularly large earnings-based $102 million bonus, combined with the unusual timing of the fraud in the last year of the CEO's contract, were sufficient to establish motive.

Motive Based On Earning Professional Fees. Allegations that underwriters and auditors had an incentive to participate in accounting fraud to earn professional fees do not meet the heightened pleading standards of the PSLRA or Rule 9(b).[53] If such generalized allegations of

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50 *See, e.g., In re Vantive Corp. Sec. Litig.,* 283 F.3d 1079, 1092-93 (9th Cir. 2002); *Advanta,* 180 F.3d at 540; *Ronconi v. Larkin,* 253 F.3d 423, 435 (9th Cir. 2001).

51 *Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995).

52 *See, e.g., Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 83 (1st Cir. 2002) (fact that executive compensation depended on the company's earnings is not enough to establish scienter); *Plevy v. Haggerty,* 38 F. Supp. 2d 816, 833 (C.D. Cal. 2004) (same); *Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1068 (5th Cir. 1994) ("[I]ncentive compensation can hardly be the basis on which an allegation of fraud is predicated."); *PR Diamonds, Inc. v. Chandler*, 364 F.3d 671, 687, 692-93 (6th Cir. 2004) ("motives common to corporations and executives generally . . . suggest no more than a general motive for success, not fraud:); *In re Green Tree Fin. Corp. Stock Litig*., 1999 WL 6841173, at 11-12 (D. Minn. August 24, 1999).

53 *GSC Partners CDO Fund v. Washington*, 368 F.3d 228, 238 (3d Cir. 2004); *Stone & Webster*, 2005 WL 1654040, at *24 (1st Cir. 2005); *Melder v. Morris*, 27 F.3d 1097, 1104 (5th Cir. 1994) (generalized allegations about motive to earn a fee would effectively eliminate the scienter requirement as to underwriters); *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) ("An accountant's greatest asset is its reputation for honesty,

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motive could suffice, "every underwriter, law firm, accountant, and investment advisor whose compensation or commission depended on the completion of an initial public offering would have a motive to commit fraud, which would make Rule 9(b) wholly meaningless." *Fisher v. Offerman & Co.*, 1996 U.S. Dist. LEXIS 14560 at *22 (S.D.N.Y. 1996).

In *Fidel v. Farley*, 392 F.3d 220 (6th Cir. 2005), for example, the plaintiff alleged that Ernst & Young was motivated to join in a fraud allegedly committed by its audit client, Fruit of the Loom, by its desire to keep Fruit of the Loom as a client, and to continue earning significant fees from that relationship. The court found that although plaintiffs' allegations suggested that

> Ernst & Young "benefited from its relationship with Fruit of the Loom, it would be mere speculation to rely on this evidence to establish that Ernst & Young acted knowingly or recklessly in preparing the audit report . . . . Further, Ernst & Young would always be motivated to maintain positive relations with a current client, and there is no indication that its motive to retain Fruit of the Loom as a client was any different than its general motive to retain business. Absent any allegations that Ernst & Young's fees from Fruit of the Loom were more significant than its fees from other clients or that Fruit of the Loom represented a significant portion of Ernst & Young's revenue, it is difficult to surmise how Ernst & Young's desire to keep Fruit of the Loom as a client would be any different from its desire to keep any client and thus be indicative of fraud."[54]

Motive Based on M&A Transactions. There is a split of authority concerning whether a plaintiffs may plead scienter by alleging only that corporate officers had a motive to increase the corporation's stock price in connection with a stock-based transaction. Many courts have rejected stock-based corporate transactions as a basis for pleading a motive to commit fraud, recognizing that "[i]n every corporate transaction, the corporation and its officers have a desire to complete the transaction, and officers will usually reap financial benefits from a successful transaction." *See In re Exxon Mobile Corp. Sec. Litig.*, 387 F. Supp. 2d 407, 428 (D.N.J. 2005). Accordingly, those courts will not "cannot find that the use of stock in [a] merger, standing alone, is sufficient to plead scienter." *Id.* at 429. This is because "[s]imilar situations arise in every merger; thus, allowing a plaintiff to prove a motive to defraud by simply alleging a corporate defendant's desire to retain his position with its attendant salary, or realize gains on

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[Footnote continued from previous page]

followed closely by its reputation for careful work. Fees for two years' audits could not approach the losses [the accountant] would suffer from a perception that it would muffle a client's fraud.") *Danis v. USN Communications, Inc.*, 73 F. Supp. 2d 923, 941 (D. Ill. 1999); (underwriters fee, standing alone, is insufficient); *Reiger v. Altris Software, Inc.*, 1999 U.S. Dist. LEXIS 7949, at *10-12 (S.D. Cal. 1999) (same); *Acito v. Imcera Group, Inc.*, 47 F.3d 47, 53-54 (2d Cir. 1995); *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1427 n.7 (9th Cir. 1994); *Melder v. Morris*, 27 F.3d 1097, 1102 (5th Cir. 1994); *Shields v. Citytrust Bancorp.*, 25 F.3d 1124, 1130 (2d Cir. 1994).

[54] 392 F.3d at 232-33.

company stock, would force the directors of virtually every company to defend securities fraud actions . . . every time that company effected a merger or acquisition."[55]

In *GSC Partners CDO Fund v. Washington*, 368 F.3d 228, 232 (3d Cir. 2004), the Third Circuit affirmed dismissal of a securities fraud complaint arising from "a classic corporate love story." The plaintiffs had purchased notes issued to finance an acquisition by the defendant company, which went bankrupt shortly thereafter upon restatement of the acquisition target's financials. Plaintiffs alleged that the note offering circular was false and misleading, and that defendants had motive to mislead investors so as to consummate the acquisition. Affirming the district court's determination that this motive failed to establish scienter, the Court explained that "[i]n every corporate transaction, the corporation and its officers have a desire to complete the transaction, and officers will usually reap financial benefits from a successful transaction. Such allegations alone cannot give rise to a 'strong inference' of fraudulent intent."[56] In contrast, the Northern District of Ohio found that the "temporal proximity of [an] acquisition . . . and the subsequent disclosure of problems . . . supports an inference of scienter," in combination with allegations of insider trading.[57]

Other courts have held that stock-based corporate transactions may provide a legally cognizable motive at least in circumstances in which the alleged transaction is not a routine corporate event. In *Goldstein v. MCI WorldCom*, 340 F.3d 238, 249-50 (5th Cir. 2003), the Fifth Circuit recognized that MCI WorldCom's proposed stock-based merger with Sprint was not a "routine corporate event" as defendants claimed. The court noted that "[w]hile WorldCom characteristically engaged in numerous mergers and reverse-mergers, there was little 'routine' about the Sprint merger," which WorldCom's CEO, Bernie Ebbers, had "promoted . . . as a 'crucial event' for the future of WorldCom." *Id.* The court nevertheless rejected the motive allegations as inadequate under Fifth Circuit law on the grounds that motive and opportunity allegations are insufficient to establish the required "strong inference" of scienter and plaintiffs

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[55] *Phillips v. LCI Int'l, Inc.*, 190 F.3d 609, 623 (4th Cir. 1999); *see also Leventhal v. Tow*, 48 F. Supp. 2d 104, 115 (D. Conn. 1999) (rejecting allegation that defendants had motive to increase stock price to get more favorable terms in stock-for-stock transactions and issuance of debentures).

[56] *Id.; see also, e.g., In re Loral Space & Communications Ltd. Sec. Litig.,* 2004 U.S. Dist. LEXIS 3059 at *18 (S.D.N.Y. Feb. 27, 2004) (holding that plaintiffs failed to establish a strong inference of scienter where they alleged that defendants' motive to conceal poor financial results was to secure additional financing on the best terms possible; this "generalized" motive cannot establish scienter because it can be imputed "to any publicly-owned, for profit endeavor") (quoting *Chill v. Gen. Elec. Corp.*, 101 F.3d 263, 268 (2d Cir. 1996).

[57] *In re Firstenergy Corp. Sec. Litig.,* 2004 U.S. Dist. LEXIS 7604, at *33 (N.D. Ohio May 3, 2004).

failed adequately to buttress their motive and opportunity allegations with other allegations that, if true, would constitute direct or circumstantial evidence of fraud.[58]

C. SCIENTER IN FINANCIAL FRAUD AND RESTATEMENT CASES

Financial fraud cases frequently arise after a company has announced disappointing financial results, a change in accounting policies or practices,[59] or a restatement of prior period financial statements.[60] As with pleading scienter in securities fraud cases in general, the plaintiff must "state with particularity facts giving rise to a strong inference that the defendant acted with the requisite state of mind."[61]

There are no rules as to what factual allegations will satisfy the PSLRA's pleading standard for this class of cases. The analysis is very fact-specific, and has been described by the Sixth Circuit as an "untidy, case-by-case concept."[62] The Second and Sixth Circuits, for example, require that the plaintiff show that a non-fiduciary accountant's conduct "approximate an actual intent to aid in the fraud being perpetrated by the audited company."[63] The Ninth Circuit, moreover, has held that to constitute accounting fraud, the "accounting practices [must] be so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decision if confronted with the same facts." *Fidel*, 392 F.3d at 227; *DSAM*, 288 F.3d at 390. Nevertheless, the cases reveal some salient factors that courts have consistently evaluated in determining whether there is adequate support for a strong inference of scienter. The following sections discuss these common factors.

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58 *MCI* WorldCom, 340 F.3d at 251-54. *See also Rothman*, 220 F.3d at 81, 93 (holding that allegations of corporate transaction involving payment in both cash and stock can constitute legally cognizable motive); *Baan*, 103 F. Supp. 2d at 19-20 (stating that a loan assumed by the defendant's company using Baan stock as collateral was "suspicious," but ultimately concluding that the connection was too tenuous because the allegations did not show that the defendant used the money for personal gain).

59 *See, e.g., In re Cabletron Sys., Inc.*, 311 F.3d 11 (1st Cir. 2002); *Ganino v. Citizens Utility Co.*, 228 F.3d 154 (2d Cir. 2000).

60 *See, e.g.*, *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385 (9th Cir. 2002); *Fla. State Bd. of Admin v. Green Tree Fin. Corp.*, 270 F.3d 645 (8th Cir. 2001).

61 15 U.S.C. § 78u-4(b)(2) (2000) (emphasis added).

62 *PR Diamonds, Inc. v. Chandler*, 364 F.3d 671, 684 (6th Cir. 2003).

63 *Rothman v. Gregor*, 220 F.3d 81, 98 (2d Cir. 2000); *Fidel v. Farley*, 392 F.3d 220, 227 (6th Cir. 2004).

1. Failure To Comply With GAAP, GAAS, and Internal Company Policies

The courts have held generally that mere violations of Generally Accepted Accounting Principles ("GAAP") and Generally Accepted Auditing Standards ("GAAS"), by themselves, do not establish scienter.[64] Some courts have held that failure to comply with GAAP or conduct an audit consistent with GAAS may nonetheless serve as evidence of scienter, with more significant violations providing more powerful evidence of scienter.[65] Some courts have held that specific facts concerning alleged GAAP violations can raise stronger or weaker inferences of scienter, such as the magnitude of the error or the likelihood that the error was inadvertent. *In re Baan Co. Sec. Litig.*, 103 F.Supp.2d 1, 21 (D.D.C. 2000). The First Circuit has held that significant violations of GAAP and "accounting shenanigans" can serve as evidence of scienter.[66] The Ninth Circuit likewise has stated that "[w]hen significant GAAP violations are described with particularity in the complaint, they may provide powerful indirect evidence of scienter."[67]

Those courts that do not accept allegations that a company or its auditor failed to apply GAAP or GAAS appropriately as sufficient, in and of themselves, to establish scienter have accepted such allegations as sufficient when combined with other allegations giving rise to the

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64 *See Barrie v. Intervoice-Brite, Inc.*, 397 F.3d 249, 264 (5th Cir. 2005); *Daou Sys., Inc. v. Daou*, 411 F.3d 1006, 1023 (9th Cir. 2005); *Adams v. Kinder Morgan, Inc.*, 340 F.3d 1083, 1105 (10th Cir. 2003); *PR Diamonds*, 364 F.3d at 684; *In re K-Tel Int'l, Inc. Sec. Litig.*, 300 F.3d 881, 894 (8th Cir. 2002); *Ziembra v. Cascade Int'l, Inc.*, 256 F.3d at 1194, 1208 (11th Cir. 2001); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 203 (1st Cir. 1999); *Stevelman v. Alias Research Inc.*, 174 F.3d 79, 84 (2d Cir. 1999); *In re Rent-Way Sec. Litig.*, 209 F. Supp. 2d 493, 511 (W.D. Pa. 2002); *In re Cree, Inc. Sec. Litig.*, 333 F. Supp. 2d 461, 477 (M.D.N.C. 2004); *SEC v. Sys. Software Ass'n. Inc.*, 145 F. Supp. 2d 945, 958 (E.D. Ill. 2001); *Chu v. Sabratek Corp.*, 100 F. Supp. 2d 815 (E.D. Ill. 2000); *In re U.S. Office Prod. Sec. Litig.*, 326 F. Supp. 2d 68, 77 (D.D.C. 2004); *In re Baan Co. Sec. Litig.*, 103 F. Supp. 2d 1, 21 (D.D.C. 2000).

65 *See, e.g., PR Diamonds, Inc. v. Chandler,* 364 F.3d 671, 694 (6th Cir. 2004) (stating that "[i]t is well-settled that violations of GAAP and GAAS, standing alone, do not create an inference of scienter, much less a strong one," but that "when the alleged accounting errors are sufficiently basic and large, their existence, in combination with other factors, may support the requisite scienter inference.") (internal citations omitted).

66 *See Aldridge v. A.T. Cross Corp.*, 284 F.3d 72 83 (1st Cir. 2002); *Cabletron*, 311 F.3d at 39.

67 *Daou*, 4111 F.3d at 1016 (quoting *In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d 1248, 1273 (N.D. Cal. 2000)).

requisite "strong inference" of fraudulent intent.[68] For example, in *Barrie v. Intervoice-Brite, Inc.*, 397 F.3d 249, 264 (5th Cir. 2005), the Fifth Circuit held as sufficient allegations of on-going GAAP violations combined with allegations identifying a witness who submitted a report on the company's accounting errors to the defendant during the period of violations.

In *Lovelace v. Spectrum Software, Inc.*, 78 F.3d 1015, 1021 (5th Cir. 1996), the Fifth Circuit held that a plaintiff cannot establish scienter based upon the company's changing auditors due to a difference in judgment regarding GAAP. The court noted that GAAP is a term of art encompassing a wide range of acceptable accounting procedures. *Id.* The Tenth Circuit, on the other hand, has stated that an outside auditor's challenge to an allegedly improper transaction strengthens an inference of scienter.[69]

Violations of internal company policies at the defendant's direction can support a claim of scienter. In *Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1192 (10th Cir. 2003), for example, the Tenth Circuit based a finding that plaintiffs adequately pleaded a strong inference of scienter on allegations that senior management violated company revenue recognition guidelines by overriding an employee credit manager's recommendation that the company not recognize revenue from a specific transaction.[70]

2. Missing "Red Flags" or Failing to Monitor

Many courts hold that a plaintiff may establish recklessness by alleging specific facts that, if true, would demonstrate that the defendants failed to review or check information that they had a duty to monitor or ignored obvious signs of fraud (*i.e.,* "red flags").[71] In *PR Diamonds, Inc. v. Chandler,* 364 F.3d 671, 695 (6th Cir. 2004), the Sixth Circuit stated that "[a] red flag creating a strong inference of scienter consists of '[a]n egregious refusal to see the obvious, or to investigate the doubtful.'"

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[68] *See, e.g., Adams*, 340 F.3d at 1105; *Stevelman*, 174 F.3d at 84.

[69] *See Adams*, 340 F.3d at 1106.

[70] *Id.* at 1192; *see Daou*, 411 F.3d at 1023-24 (finding that allegations that executives directed revenue recognition on particular transactions in violation of the company's stated policy contributed to a strong inference of scienter).

[71] *Kushner*, 316 F.3d at 727; *Novak v. AnnTaylor, Inc.*, 216 F.3d 300, 308 (2d Cir. 2000); *In re Stone & Webster, Inc. Sec. Litig.*, 2005 WL 1654040, at *24 (1st Cir. July 14, 2005) (to be published in F.3d); *In re BellSouth Corp. Sec. Litig.*, 355 F. Supp. 2d 1350, 1374 (N.D. Ga. 2005) (stating that relevant factors include the magnitude of the accounting error, whether the defendant had prior notice of the error, and whether the defendant played a role in calculating and disseminating the financial statements).

Nevertheless, courts have held that some types of "red flags" do not support an inference of scienter. In *Chill v. General Electric Co.*, 101 F.3d 263, 270 (2d Cir. 1996), the Second Circuit held that General Electric could not be deemed to have been reckless by failing to investigate the accounting practice of a subsidiary that had shown extraordinary profits and success. The Third Circuit, in *In re Alpharma, Inc. Securities Litigation,* 372 F.3d 137, 150-51 (3d Cir. 2004), similarly held that a parent corporation was not reckless in failing to investigate a subsidiary's accounting policies and procedures where the subsidiary's revenue is not central to the parent's business and the defendants did not actually know that a whistleblower had raised concerns about the subsidiary's accounting.

Further, in *Ottman v. Hander Orthopedic Group, Inc.*, 353 F.3d 338, 351 (4th Cir. 2003), the Fourth Circuit held that even if the subsidiary's financial results or a particular line of business is large compared to the company as a whole, there is no strong inference of scienter when the accounting problem is not obvious. In that case, the court concluding that even though the company's acquired business made up more than half of its revenue and facilities, those facts alone did not "demonstrate that the relatively subtle revenue recognition practices were so obvious that the [defendants] must have been aware of it."

In *Abrams v. Baker-Hughes Inc.*, 292 F.3d 424, 434 (5th Cir. 2002), the Fifth Circuit held that the resignations of key accounting officials were not, in and of themselves, enough to constitute a "red flag" for purposes of pleading scienter on the part of the corporation or its senior management. The court recognized, however, that the plaintiffs' complaint might suffice if they were to include additional allegations that the resigning officials, their replacements, or the defendants knew that the officials resigned because of perceived accounting errors or irregularities. *Id.*

3. Inferring Knowledge Based Upon A Person's Position In the Company

Although plaintiffs frequently attempt to establish scienter through a person's position in a company, these allegations typically do not meet the PSLRA's pleading standard. The title or job functions an employee has do not, by itself, show awareness of improper accounting.[72] In *PR Diamonds*, the Sixth Circuit held that, although high-level managers may be presumed to be aware of matters central to a business's operations, they may not be presumed to know of specific accounting issues. 364 F.3d at 688. Courts have split on whether allegations that an executive had a "hands on" management style can establish a strong inference of scienter. Some

[72] *Strong & Webster,* 2005 WL 1654040, at *8; *Daou*, 411 F.3d at 1024; *Alpharma*, 372 F.3d at 149; *PR Diamonds*, 364 F.3d at 688; *Adams*, 340 F.3d at 1106; *Abrams*, 292 F.3d at 432; *Cree*, 333 F. Supp. 2d at 475; *Johnson v. Tellabs, Inc.*, 303 F. Supp. 2d 941, 968 (N.D. Ill. 2004); *Baan*, 103 F. Supp. 2d at 22.

courts have concluded that these allegations are insufficient.[73] Other courts have expressly concluded that a defendant's deep involvement in and micromanagement of a company, at least when combined with other allegations, can support a strong inference of scienter.[74] In *Nursing Home Pension Fund, Local 144 v. Oracle Corp.*, 380 F.3d 1226, 1231-34 (9th Cir. 2004), for example, the Ninth Circuit concluded that the plaintiff established a strong inference of scienter based in part on allegations that the defendant was a micromanager and had a "detail-oriented management style."

Courts are divided as to whether one can impute knowledge to an officer whose subordinate is alleged to have known of accounting improprieties. In *Adams v. Kinder-Morgan, Inc.*, the Fourth Circuit held that the CFO's awareness of fraud "reduce[d] the likelihood that [the CEO] was ignorant of the fact." *Adams*, 340 F.3d at 1106. Several other circuits have refused to impute the knowledge of subordinates to their superiors.[75]

4. Knowledge Of Or Access To Contradictory Information

Some courts have held that a plaintiff may sufficiently plead scienter by alleging that the defendant had access to specific information contradicting the corporation's financial disclosures, provided that the information is identified in sufficient detail.[76] In *Florida State Board of Administration v. Green Tree Financial Corp.*, 270 F.3d 641, 665 (8th Cir. 2001), the Eighth Circuit concluded that the plaintiff established a strong inference of scienter by alleging that the defendants had assured investors that they had reviewed data relevant to assumptions they made concerning certain accounting issues, but that the actual data that defendants claimed to have reviewed actually discredited the assumptions on which the accounting was based. Other courts have held that, as with "access to information" allegations generally, mere alleging that a defendant had access to certain information concerning a failure to comply with GAAP or GAAS, without alleging that the defendant actually was aware of those failures, is not sufficient to establish scienter for pleading purposes.[77]

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[73] *See Goldstein v. MCI WorldCom*, 340 F.3d 238, 251 (5th Cir. 2003); *Johnson*, 303 F. Supp. 2d at 962.

[74] *See Daou*, 411 F.3d at 1028; *Nursing Home Pension Fund, Local 144 v. Oracle Corp.*, 380 F.3d 1226, 1231-34 (9th Cir. 2004).

[75] *See, e.g.*, *Alpharma*, 372 F.3d at 150; *MCI WorldCom*, 340 F.3d at 252; *Kushner v. Beverly Enter., Inc.*, 317 F.3d 820, 828 (8th Cir. 2003); *In re Read-Rite Sec. Litig.,* 335 F.3d 843, 848 (9th Cir. 2003).

[76] *Novak*, 216 F.3d at 308; *Abrams*, 292 F.3d at 432; *see also Johnson*, 303 F. Supp. 2d at 963.

[77] *See DSAM*, 288 F.3d at 390-91 (holding that an auditor's access to documents revealing improper revenue recognition at the time it conducted an audit amounted to showing of

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5. The "Magnitude Of The Fraud" Theory

There has been considerable disagreement in the case law concerning how the magnitude of an accounting error contributes to an inference of scienter. Some courts have concluded that the magnitude of an error may be probative in determining scienter.[78] The court in *Rothman v. Gregor*, 220 F.3d 81, 92 (2d Cir. 2000), for example, concluded that a $73.8 million write-off of $87 million in royalty advances made it less plausible that the defendant software publisher did not know that its accounting for the royalty advances was materially incorrect. Nevertheless, even a very large write-off may not provide much support for scienter when a company has taken other similarly large write-offs in the recent past.[79]

In contrast, the Sixth Circuit in *Fidel v. Farley,*[80] has held that an error's magnitude cannot support a strong inference of scienter. The reasoned that allowing the magnitude of fraud to contribute to an inference of scienter "would eviscerate the principle that accounting errors alone cannot justify a finding of scienter." *Id.* at 231.

6. "Channel Stuffing" Allegations

Channel stuffing refers to the practice of "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

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negligence rather than strong inference of deliberate recklessness); *see also Ziembra*, 256 F.3d at 1210 (concluding that "red flag" of possessing documents and information that should have revealed need for changes to audit opinion raised, at best, inference of gross negligence).

[78] *See Adams*, 340 F.3d at 1106; *Green Tree*, 270 F.3d at 666; *Rothman*, 220 F.3d at 92; *In re Homestore.com, Inc. Sec. Litig.*, 252 F. Supp. 2d 1018, 1044 (C.D. Cal. 2003); *Rent-Way*, 209 F. Supp. 2d at 506-07.

[79] *See MCI WorldCom*, 340 F.3d at 251 (holding that top-level officers may not have known of accounting problems resulting in a $685 million write-off in 2000 given that the company took a $768 million write-off in 1999).

[80] 392 F.3d 220, 231 (6th Cir. 2005) (concluding that one could not infer that an auditor acted with scienter because the audited company wrote down $220 million in inventory). *But see PR Diamonds, Inc. v. Chandler,* 364 F.3d 671, 694 (6th Cir. 2004) (stating, in *dicta,* that "when the alleged accounting errors are sufficiently basic and large, their existence, in combination with other factors, may support the requisite scienter inference").

of earnings in later quarters."[81] Courts have found that there is nothing inherently wrong with the practice of channel stuffing and that there often are legitimate reasons for it.[82]

Courts, however, have recognized that some channel stuffing allegations may be used to support an inference of scienter. In *Greebel v. FTP Software, Inc.*, 194 F.3d at 202-03 (1st Cir. 1999), plaintiffs argued that "evidence of channel stuffing support[ed] their contention that management knew that revenues during the Class Period would be low and attempted to hide that fact by shifting income through channel stuffing (which remained undisclosed) and by artificially inflating income through improper revenue recognition." The First Circuit held that "[i]n this context, the channel stuffing evidence has some probative value," but "that value is weak" in the absence of other particularized allegations and evidence suggesting that the channel stuffing actually resulted in improperly recognized revenue. *Id.* at 203. Likewise, in *Broudo v. Dura Pharmaceuticals*, *Inc.*, 339 F.3d 933, 940 (9th Cir. 2003), the Ninth Circuit held that channel stuffing allegations may "have some probative value" in supporting allegations of a defendant's awareness of falsity," but that channel stuffing allegations in and of themselves do not support the required strong inference of scienter.

In *Aldridge v. A.T. Cross Corporation*, 284 F.3d 72, 82 (1st Cir. 2002), the First Circuit held that plaintiff's complaint, which included channel stuffing allegations, was sufficient to survive a motion to dismiss. Although the court noted that allegations of financial incentives to load sales into earlier accounting periods were not enough by themselves to establish a strong inference of scienter, the channel stuffing allegations combined with other allegations concerning price protection and take-back sales arrangements, failures to adhere to GAAP reserve and disclosure requirements, and the individual defendants' alleged financial motives to overstate the corporation's profits were sufficient to withstand the defendants' motion to dismiss.[83]

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81 *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 202 (1st Cir. 1999).

82 *See, e.g., id.* at 202 (finding that there is nothing inherently improper about channel stuffing); *Johnson v. Tellabs, Inc.*, 262 F. Supp. 2d 937, 950 (N.D. Ill. 2003) (stating that "there certainly is nothing inherently wrong with offering incentives to customers to purchase products"); *Broudo v. Dura Pharmaceuticals, Inc.*, 339 F.3d 933, 940 (9th Cir. 2003); *In re Cabletron Sys., Inc.*, 311 F.3d 11, 34-5 (1st Cir. 2002) (stating that channel stuffing might be legitimate depending on the specific facts); *see also Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 81 (1st Cir. 2002) (suggesting that unusually high volumes of sales may have been attributable to holiday sales). *But See Sekuk Global Enterprises v. KVH Industries, Inc.*, 2005 U.S. Dist. LEXIS 16628, at *45-6 (D. R.I. 2005) (finding a suggestion of large scale fraud based on channel stuffing activities alleged to have included waived shipping costs not accounted for in financial statements, granting of unconditional rights of return in violation of Defendant's stated policies and lifting of credit restrictions).

83 *See id.* at 83-84; *see Johnson v. Tellabs, Inc.,* 262 F. Supp. 2d 937, 949, 957 (N.D. Ill. 2003) (holding as insufficient to raise required strong inference of scienter channel

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7. Special Factors for Auditors

Allegations of fraud by auditors present unique pleading issues. Not only must a plaintiff plead facts that, if true, would demonstrate that the corporation engaged in a financial fraud, but the plaintiff must also plead facts that support a strong inference that the outside audit firm also knew (or was reckless in not knowing) that persons within the corporation were engaged in the alleged fraud. Pleading such facts can be particularly difficult in cases in which the allegations against the corporation suggest that individuals within the corporation engaged in conduct designed to circumvent the corporation's internal controls — that is, to hide the fraud from the corporation's internal accounting staff and/or the outside auditors. Indeed, the Second Circuit has held that allegations as to scienter on the part of outside auditors must "'approximate actual intent to aid in the fraud being perpetrated by the company.'"[84]

In *PR Diamonds, Inc. v. Chandler,* 364 F.3d 671, 695 (6th Cir. 2004), the Sixth Circuit held that "[t]o support an inference of fraudulent scienter, allegations of GAAP and GAAS violations must extend in nature and magnitude beyond merely the materiality threshold." The allegations of GAAP and GAAS violations must "'cry out' scienter" *id.* and must be "so grievous as to suggest that [the auditor's] work was 'no audit at all.'" *Id.* Thus, it is not sufficient to allege, for example, that an auditor had "access" to confidential corporate information or that the auditor's "personnel were regularly present at [the corporation's] headquarters throughout the class period and had continual access to, and knowledge of, [the corporation's] confidential financial and business information." *Id.* at 695-96.

Some courts, including the court in the *PR Diamonds* case, have suggested that as an auditor's access to and involvement in a company's operations increases, the support for an inference of scienter likewise increases.[85] Other courts have held that it cannot be inferred that an auditor necessarily knows all aspects of a company's business simply because it has been the company's auditor for some time.[86] Even those courts placing some weight on "unfettered access" allegations have required plaintiffs to plead specific facts demonstrating what the auditor actually "learned from its access to the company's confidential information." *Fidel v. Farley,* 392 F.3d at 229-30.

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stuffing allegations that did not identify specific terms of any channel stuffing arrangements, individuals involved, or the documents reflecting terms of specific transactions).

[84] *Rothman v. Gregor,* 220 F.3d 81, 98 (2d Cir. 2000) (quoting *Decker v. Massey-Ferguson, Ltd.,* 681 F.2d 111, 120-21 (2d Cir. 1982)).

[85] *Id.*, 364 F.3d at 696; *Fidel v. Farley,* 392 F.3d 220, 229-30 (6th Cir. 2005); *Microstrategy,* 115 F. Supp. 2d at 653.

[86] *See, e.g., Rothman*, 220 F.3d at 98.

D. PLEADING FRAUD ON "INFORMATION AND BELIEF"

The PSLRA requires securities fraud complaints containing allegations of fraudulent statements or omissions on the basis of information and belief to "state with particularity all facts on which that belief is formed." 15 USCS § 78u-4(b)(1). An increasing number of courts have applied this pleading requirement to examine the plausibility of specific allegations in determining whether a plaintiff has pleaded either falsity or scienter with the required specificity.

The PSLRA requires not only that plaintiffs plead both falsity and scienter with particularity, but also "if an allegation regarding the statement or omission is made on information and belief," plaintiffs must "state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). The purpose of the PSLRA's "information and belief" pleading requirement "is to avoid 'speculation' about defendants' knowledge and intent, because '[i]t is not sufficient for a plaintiff's pleadings to set forth a belief that certain unspecified sources will reveal, after appropriate discovery, facts that will validate her claim.'"[87] When the sources do not bear sufficient indicia of reliability, allegations derived from those sources must be disregarded for purposes of a defendant's motion to dismiss.[88]

In the years immediately following enactment of the PSLRA, many plaintiffs attempted to circumvent the information and belief pleading requirement by alleging facts based upon an "investigation of counsel," which they contended was not the same as pleading on "information and belief." Courts almost universally rejected this argument. In *In re Silicon Graphics, Inc. Securities Litigation,* 183 F.3d 970, 985 (9th Cir. 1999), for example, the court held that "[i]t is irrelevant whether a plaintiff uses the phrase 'information and belief' when alleging false representations because allegations of misrepresentations not made on personal knowledge are presumed to have been made on information and belief." In *In re Vantive Corp. Securities Litigation,* 283 F.3d 1079, 1085 (9th Cir. 1999), the court held that "[a]llegations are deemed to have been made on information and belief until the plaintiffs demonstrate that they have personal knowledge of the facts."

One current subject of debate is whether, and to what extent, a securities fraud plaintiff must identify in the complaint each witness who provided information upon which the plaintiff's allegations are based. Most courts have held that "there is no requirement that [the sources] be named, provided they are described in the complaint with sufficient particularity to support the

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[87] *In re McKesson HBOC, Inc. Sec. Litig.,* 126 F. Supp. 2d 1248, 1270-71 (N.D. Cal. 2000) (quoting *In re Silicon Graphics, Inc. Sec. Litig.,* 183 F.3d 970, 985 (9th Cir. 1999)).

[88] *In re Daou Sys., Inc. Sec. Litig.,* 397 F.3d 704, 710 (9th Cir. 2004); *Nursing Home Pension Fund, Local 194 v. Oracle Corp.,* 380 F.3d 1226, 1230 (9th Cir. 2004); *Silicon Graphics,* 183 F.3d at 979; *Feasby v. Industri-Matematik Int'l Corp.,* 2003 U.S. Dist. LEXIS 22791, at *12 (S.D.N.Y. Dec. 19, 2003); *Green Tree Fin. Corp. Stockholders Litig.,* 61 F. Supp. 2d 860, 871-72 (D. Minn. 1999).

probability that a person in the position occupied by the source would possess the information alleged."[89] In *Novak v. Kasaks,* 216 F.3d 300, 313-314 (2d Cir. 2000), the Second Circuit held

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[89] *Novak*, 216 F.3d at 313-14; *In re Cabletron Sys., Inc*., 311 F.3d 11, 29-30 (1st Cir. 2002) (adopting *Novak* standard); *Cal. Pub. Employees' Ret. Sys. v. Chubb Corp.*, 394 F.3d 126, 146-47 (3d Cir. 2004) ("We join the Second Circuit and adopt this [Novak] standard as the appropriate standard for courts to employ when assessing the sufficiency of allegations made on information and belief pursuant to 15 U.S.C. § 78u-4(b)(1) . . . . Our approach to assessing the particularity of allegations made on information and belief necessarily entails an examination of the detail provided by the confidential sources, the source's basis of knowledge, the reliability of the sources, the corroborative nature of other facts alleged, including from other sources, the coherence and plausibility of the allegations, and similar indicia."); *ABC Arbitrage Plaintiffs Group v. Serje Tchuruk,* 291 F.3d 336 (5th Cir. 2002) (adopting *Novak* standard); *In re K-Tel Int'l Sec. Litig.*, 300 F.3d 881, 890 (8th Cir. 2002) (quoting *Parnes v. Gateway 2000, Inc.*, 122 F.3d 539, 549-50 (8th Cir. 1997)); *In re Daou Sys. Sec. Litig.*, 2005 U.S. App. LEXIS 14945, 12 (9th Cir. 2005) (stating that plaintiff's complaint should be evaluated "by this circuit's adoption of the Second Circuit's standard for evaluating personal sources of information"); *Nursing Home Pension Fund v. Oracle Corp.*, 380 F.3d 1226, 1233 (9th Cir. 2004); *In re Cree, Inc. Sec. Litig.*, 333 F. Supp. 2d 461, 472 (D.N.C. 2004), (citing *Novak* and holding that "[a] source need not be named if the complaint provides sufficient facts to support the source's allegations."); *Morse v. McWhorter*, 200 F. Supp. 2d 853, 862 (D. Tenn. 2000) (quoting *Havenick v. Network Exp., Inc.*, 981 F. Supp. 480, 526 (E.D. Mich. 1997), and requiring plaintiffs "to draw a specific nexus between the allegedly fraudulent statements and the facts upon which the allegation of fraud is dependent, or, at least, a clear statement of why and how the plaintiff has reached the conclusion that a particular statement is fraudulent."); *D.E. & J L.P. v. Conaway*, 284 F. Supp. 2d 719, 739 (D. Mich. 2003) ("the PSLRA does not require Plaintiffs to reveal the names of these sources"); *Pacholder High Yield Fund, Inc. v. Cucuz* (*In re Hayes Lemmerz Int'l, Inc. Equity Sec. Litig*.), 271 F. Supp. 2d 1007, 1018 n.8 (D. Mich. 2003) ("after carefully combing the page cited by Cucuz in *Silicon Graphics*, the Court cannot find where the Ninth Circuit requires the sources be named [and] applying *Novak*, Plaintiffs have pleaded sufficient detail to put the Defendants on notice regarding the source of the information"); *In re Empyrean Bioscience, Inc. Sec. Litig.*, 255 F. Supp. 2d 751, 758-759 (D. Ohio 2003) ("A plaintiff need not, however, specifically name confidential sources provided the facts pled 'provide an adequate basis for believing that the defendants' statements were false" (quoting *Novak*, 216 F.3d at 314)); *Keithley*, 268 F. Supp. 2d at 900 ("a rule requiring the actual identity of sources is too stringent"); *Fidel v. AK Steel Holding Corp*., 2002 U.S. Dist. LEXIS 18887 (D. Ohio 2002) ("we agree with the Second Circuit's conclusion that plaintiffs need not name confidential sources of information 'as long as they supply sufficient specific facts to support their allegations'" (citing Novak, 216 F.3d at 314)); *Johnson v. Tellabs,* 303 F. Supp. 2d 941, 952 (D. Ill. 2004) (citing *Novak* and holding that "facts alleged in the complaint must be 'sufficient to support a reasonable belief as to the misleading nature of the statement or omission,'" including any "confidential source's

[Footnote continued on next page]

that, "[n]otwithstanding the use of the word 'all,' paragraph (b)(1) does not require that plaintiffs plead with particularity every single fact upon which their beliefs concerning false or misleading statements are based." Instead, "a complaint can meet the new pleading requirement imposed by paragraph (b)(1) by providing documentary evidence and/or a sufficient general description of the personal sources of the plaintiffs' beliefs."[90] In *In re Cabletron Systems, Inc*., 311 F.3d 11, 29-30 (1st Cir. 2002) the First Circuit added that "[t]o evaluate whether a confidential source is relaying first-hand knowledge or merely speculating, the court examines 'the level of the detail provided by the confidential sources, the corroborative nature of the other facts alleged (including from other sources), the coherence and plausibility of the allegations, the number of sources, the reliability of the sources, and similar indicia.'" *Id.* at 29-30.

In *ABC Arbitrage Plaintiffs Group v. Serje Tchuruk,* 291 F.3d 336 (5th Cir. 2002), the Fifth Circuit broke the *Novak* standard down into three alternative steps:

(1) if plaintiffs rely on confidential personal sources and other facts, their sources need not be named in the complaint so long as the other facts, *i.e.,* documentary evidence, provide an adequate basis for believing that the defendants' statements or omissions were false or misleading;

(2) if the other facts, *i.e.,* documentary evidence, do not provide an adequate basis for believing that the defendants' statements or omissions were false, the complaint need not

[Footnote continued from previous page]
position . . ., the time period such he held such a position, his access to information and whether the allegations are based on his personal belief."); *Piser v. Lunn Partners, LLC*, 2004 U.S. Dist. LEXIS 4282 (D. Ill. 2004) (holding that plaintiff "must provide documentary evidence or a sufficient general description of the confidential, personal sources his information and belief is based upon"); *Friedman v. Rayovac Corp.*, 295 F. Supp. 2d 957, 986 (D. Wis. 2003); *Riggs Ptnrs, LLC v. Hub Group, Inc.*, 2002 U.S. Dist. LEXIS 20649 n. 10 (D. Ill. 2002); *In re Allscripts, Inc. Sec. Litig.*, 2001 U.S. Dist. LEXIS 9206 (D. Ill. 2001); *In re Theragenics Corp. Sec. Litig.*, 105 F. Supp. 2d 1342, 1355 (D. Ga. 2000) ("After extensively reviewing the Reform Act, its legislative history, and more than 50 cases, this Court agrees with the approach of the Second Circuit in its recent Novak decision"; "where plaintiffs rely on confidential personal sources but also on other facts, they need not name their sources as long as the latter facts provide an adequate basis for believing that the defendants' statements were false" and "even if personal sources must be identified, there is no requirement that they be named, provided they are described in the complaint with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged.").

[90] *Id.* at 313-14. With respect to documentary evidence, the Second Circuit requires "specif[ication of] who prepared internal company reports, how frequently the reports were prepared and who reviewed them." *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 73 (2d Cir. 2001).

name the personal sources so long as they are identified through general descriptions in the complaint with sufficient particularity to support the probability that a person in the position occupied by the source as described would possess the information pleaded to support the allegations of false or misleading statements made on information and belief; and

(3) if the other facts, *i.e.,* documentary evidence, do not provide an adequate basis for believing that the defendants' statements or omissions were false and the descriptions of the personal sources are not sufficiently particular to support the probability that a person in the position occupied by the source would possess the information pleaded to support the allegations of false or misleading statements made on information and belief, the complaint must name the personal sources.[91]

In *In re Silicon Graphics, Inc. Securities Litigation*, 183 F.3d 970, 984 (9th Cir. 1999), the Ninth Circuit "read the statutory command that a plaintiff plead all the 'facts' with 'particularity' to mean that a plaintiff must provide a list of all relevant circumstances in great detail." In other cases, the Ninth Circuit, like the Second Circuit in *Novak*, has held that plaintiffs need not identify confidential sources to meet the requirements of the PSLRA's information and belief provision under certain circumstances."[92] The Ninth Circuit has found sufficient particularity where plaintiffs provided each witness's "job description and responsibilities, title, and to which . . . executive the witness reported."[93] Like the First Circuit, the Ninth Circuit also has held that information and belief allegations should be judged based on "the level of detail provided by the confidential sources, the corroborative nature of the other facts alleged (including from other sources), the coherence and plausibility of the allegations, the number of sources, the reliability of the sources, and similar indicia."[94]

The Tenth Circuit's approach to the PSLRA information and belief provision is similar to that of the Second Circuit, although with regard to sources, it is less stringent. In *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1099 (10th Cir. 2003), the Tenth Circuit adopted "an approach similar to the Second Circuit's in *Novak* of evaluating the facts alleged in a complaint to determine whether, taken as a whole, they support a reasonable belief that the defendant's statements identified by the plaintiff were false or misleading." The *Kinder-Morgan* approach requires evaluation of the following criteria:

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[91] *Id.* at 353.

[92] *In re Daou Sys. Sec. Litig.*, 2005 U.S. App. LEXIS 14945, 12 (9th Cir. 2005) (stating that plaintiff's complaint should be evaluated "by this circuit's adoption of the Second Circuit's standard for evaluating personal sources of information").

[93] *Daou*, 2005 U.S. App. LEXIS 14945 at 13-14.

[94] *Id.* (quoting *Cabletron*, 311 F.3d at 29-30).

(1) the level of detail provided by the facts stated in a complaint;

(2) the number of facts provided;

(3) the coherence and plausibility of the facts when considered together;

(4) whether the source of the plaintiff's knowledge about a stated fact is disclosed;

(5) the reliability of the sources from which the facts were obtained; and

(6) any other indicia of how strongly the facts support the conclusion that a reasonable person would believe that the defendant's statements were misleading.

A plaintiff will be deemed to have pled the facts with sufficient particularity if, upon "measuring the nature of the facts alleged against these indicia, a reasonable person would believe that the defendant's statements were false or misleading." *Id.*

Unlike the Second Circuit's approach in *Novak,* however, in the Tenth Circuit, "plaintiffs are not required to disclose the documentary or personal sources from which they learned the facts alleged in an information and belief complaint." *Id.* at 1103. In *Kinder-Morgan,* the Tenth Circuit stressed "that the PSLRA did heighten the standard for pleading securities fraud, and where a plaintiff does not identify the sources of the facts stated in the complaint, the facts alleged in an information and belief complaint will usually have to be particularly detailed, numerous, plausible, or objectively verifiable by the defendant before they will support a reasonable belief that the defendant's statements were false or misleading." *Id.* In deciding whether "the facts alleged support a reasonable belief that the defendant's statements were false or misleading," Tenth Circuit courts evaluate "the level of detail, number, and coherence and plausibility of the allegations; whether the allegations are specific enough to be verified or refuted by a defendant without requiring the complaint to disclose how the plaintiff learned of such facts or experts to prove such facts at trial; whether the sources of the facts are disclosed and the reliability of those sources;" and similar, relevant factors. *Id.* at 1102-1103.

E. MATERIALITY

1. Pleading Materiality Generally

"[T]o be actionable, a misrepresentation or omission must pertain to material information that the defendant had a duty to disclose."[95] Indeed, in *Basic v. Levinson,* 485 U.S. 224, 238 (1988), the Supreme Court held that "to prevail on a Rule 10b-5 claim, a plaintiff must show that the statements were misleading as to a material fact. Is it not enough that a statement is false or incomplete, if the misrepresented fact is otherwise insignificant."

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[95] *City of Monroe Employees Retirement Sys. v. Bridgestone Corp.,* 399 F.3d 651, 669 (6th Cir. 2005).

The test of materiality under Section 10(b) is whether there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Id.* at 231-22. Courts have held that materiality is a "relative concept." *See, e.g., In re Donald Trump Casino Sec. Litig.*, 7 F.3d 357, 369 (3d Cir. 1993). That is, a court must evaluate an alleged misrepresentation or omission in context — a particular "misrepresentation or omission significant to a reasonable investor in one document or circumstance may not influence a reasonable investor in another." *Id.* Courts generally will not dismiss a complaint at the pleading stage on materiality grounds unless the alleged misrepresentations "are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance." *Feinman v. Dean Witter Reynolds, Inc.,* 84 F.3d 539, 540-41 (2d Cir. 1996). Nevertheless, the cases reflect a few exceptions to that general rule.

2. Vague Statements And Puffery

Federal courts consistently have recognized that "vague and general statements of optimism" are not material and, therefore, are not actionable under the federal securities laws.[96] This is because "'[p]rofessional investors, and most amateur investors as well, know how to devalue the optimism of corporate executives, who have a personal stake in the future success of the Company.'"[97] As the Sixth Circuit put it in *In re Ford Motor Co. Securities Litigation,* 381 F.3d 563, 570-71 (6th Cir. 2004), federal courts "everywhere 'have demonstrated a willingness to find immaterial as a matter of law certain kinds of rosy affirmation heard from corporate managers and numbingly familiar to the marketplace — loosely optimistic statements that are so vague, [and] so lacking in specificity . . . that no reasonable investor could find them important

[96] *See, e.g., Rosenzweig v. Azurix Corp.,* 332 F.3d 854, 869 (5th Cir. 2003) (holding that generalized, positive statements about a company's competitive strengths, experienced management, and future prospects are not actionable because they are immaterial); *Next Century Comm. Corp. v. Ellis,* 318 F.3d 1023, 1028 (11th Cir. 2003) (holding that predictions as to future share price based on continued "strong performance" constitute "mere 'puffing'"); *In re K-tel Int'l, Inc. Sec. Litig.,* 300 F.3d 881, 897 (8th Cir. 2002) (holding as inactionable "[i]mmaterial statements include vague, soft, puffing statement or obvious hyperbole" upon which no reasonable investor would rely); *Nathenson v. Zonagen, Inc.,* 267 F.3d 400, 404, 419 (5th Cir. 2001) (holding that "broad, general statements" about "positive" and "statistically significant" test results of a new drug were puffery); *Novak v. Kasaks,* 216 F.3d 300, 315 (2d Cir. 2000) (holding that "statements containing simple economic projections, expressions of optimism, and other puffery are insufficient" to attach liability); *In re Advanta Corp. Sec. Litig.,* 180 F.3d 525, 538 (3d Cir. 1999); *Lasker v. N.Y. State Elec. & Gas Corp.,* 85 F.3d 55, 58 (2d Cir. 1996) (holding that corporation's self-praise about its business strategy is "not considered seriously by the marketplace and investors in assessing a potential investment").

[97] *Id.* (quoting *In re VeriFone Sec. Litig.*, 784 F. Supp. 1471, 1481 (N.D. Cal. 1992), *aff'd*, 11 F.3d 865 (9th Cir. 1993).

to the total mix of information available.'" Thus, "vaguely optimistic platitudes that are constantly bandied about in the marketplace" generally are not actionable.[98]

For example, courts have dismissed as mere puffery the following statements:

- "Our fundamentals are strong."[99]
- "We're doing well and I think we have a great future."[100]
- "Business will be good this year."[101]
- "Everything is clicking . . . . New products are coming in a wave, not a trickle."[102]
- "I am optimistic about [the company's] performance during this decade."[103]
- We sell "the best tires in the world."[104]
- "Rigorous testing under diverse conditions at our proving grounds around the world helps ensure reliable quality for original equipment customers."[105]
- We are "one of the best-managed high growth operators in the food retailing industry."[106]
- "We aim to be a quality leader."[107]

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98 *In re Allaire Corp. Sec. Litig.*, 224 F. Supp. 2d 319, 322 (D. Mass. 2002).

99 *Rosenzweig,* 332 F.3d at 869.

100 *In re Syntex Corp. Sec. Litig.,* 855 F. Supp. 1086, 1095 (N.D. Cal. 1994), *aff'd*, 95 F.3d 922 (9th Cir. 1996).

101 *Id.*

102 *Id.*

103 *Id.*

104 *City of Monroe Employees Retirement Sys. v. Bridgestone Corp.,* 399 F.3d 651, 670-71 (6th Cir. 2005).

105 *Id.*

106 *Longman v. Food Lion, Inc.,* 197 F.3d 675, 684 & n.2 (4th Cir. 1999).

- We have "dedicated ourselves to finding even better ways of delivering . . . safer vehicles to [the] consumer."[108]

- "We want to ensure that all our vehicles have world-class quality [and] develop cars and trucks that are defect-free."[109]

- We have achieved "substantial success" in integrating our sales forces.[110]

- We are "optimistic" about earnings and "should deliver income growth consistent with . . . historically superior performance."[111]

- "We are well prepared for the holiday season and believe it will clearly differentiate us as the leader in our segment of online retail."[112]

Notwithstanding this rule, in some cases "vague statements expressing confidence" in a product or a business may not deemed to be "mere puffery" if the plaintiff is able to allege specific facts that, if true, would demonstrate that (1) the statements are not genuinely believed, (2) there is no rational basis for the speaker's belief, or (3) the speaker is aware of undisclosed facts seriously undermining the accuracy of the statement.[113] In *In Separacor, Inc. Securities Litigation,* 308 F. Supp. 2d 20, 32 (D. Mass. 2004), for example, the court held that a corporation's statements of optimism about the competitiveness of a new drug in the marketplace, and prospects for FDA approval of that drug, were not inactionable puffery because the company's optimistic statements were undermined by specific and detailed allegations concerning the defendants' alleged knowledge of serious side effects associated with the drug

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[Footnote continued from previous page]

107 *Ford,* 381 F.3d at 570-71.

108 *Id.*

109 *Id.*

110 *Grossman v. Novell, Inc.,* 120 F.3d 1112, 1121 (10th Cir. 1997).

111 *San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos.,* 75 F.3d 801, 811 (2d Cir. 1996).

112 *In re Cybershop.com Sec. Litig.,* 189 F. Supp. 2d 214, 229 & 232 (D.N.J. 2002).

113 *In re Separacor, Inc. Sec. Litig.*, 308 F. Supp. 2d 20, 32 (D. Mass. 2004); *Nursing Home Pension Fund v. Oracle Corp.*, 242 F. Supp. 2d 671 (N.D. Cal. 2002).

and an FDA policy of zero tolerance for such side effects, which rendered it unlikely that the drug would ever obtain regulatory approval.[114]

3. The Bespeaks Caution Doctrine

The "bespeaks caution" doctrine provides that forward-looking statements are not actionable when accompanied by cautionary language which adequately discloses the risks involved with an investment in the issuer's securities. In *In re Donald J. Trump Casino Securities Litigation,* 7 F.3d 357, 370-71 (3d Cir. 1993), which provides that when "forecasts, opinions or projections are accompanied by meaningful cautionary statements, the forward-looking statements will not form the basis for a securities fraud claim if those statements did not affect the 'total mix' of information . . . . In other words, cautionary language, if sufficient, renders the alleged omissions or misrepresentations immaterial as a matter of law."

Prior to the PSLRA, a majority of the circuits had adopted the doctrine.[115] Congress codified the bespeaks caution doctrine by incorporating it into the three-prong safe harbor for disclosures of forward-looking information. 15 U.S.C. § 78u-5; 15 U.S.C. § 77z-2. Although most cases now are decided under the statutory safe harbor, the common law bespeaks doctrine continues to apply in cases in which defendants' forward-looking disclosures are not entitled to safe harbor protection, such as forward-looking statements appearing in a prospectus issued in connection with an issuer's initial public offering. 485 U.S. 244 (1988).

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114 *Separacor*, 308 F. Supp. 2d at 31-33.

115 *Grossman v. Novell, Inc.,* 120 F.3d 1112, 1120-22 (10th Cir. 1997); *Olkey v. Hyperion 1999 Term Trust, Inc.,* 98 F.3d 2, 5 (2d Cir. 1996); *Gasner v. Board of Supervisors,* 103 F.3d 351, 358 (4th Cir. 1996); *Saltzberg v. TM Sterling/Austin Assocs., Ltd.,* 45 F.3d 399, 400 (11th Cir. 1995); *In re Worlds of Wonder Sec. Litig.,* 35 F.3d 1407, 1413 (9th Cir. 1994); *Kline v. First Western Gov't Sec., Inc.,* 24 F.3d 480, 489 (3d Cir. 1994); *Rubenstein v. Collins,* 20 F.3d 160, 167 (5th Cir. 1994); *Romani v. Shearson Lehman Hutton,* 929 F.2d 875, 879 (1st Cir. 1991); *Mayer v. Mylod,* 988 F.2d 635, 640 (6th Cir. 1993); *Moorhead v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 949 F.2d 243-245-46 (8th Cir. 1991); *In re Convergent Technologies, Inc. Sec. Litig.,* 948 F.2d 507, 516 (9th Cir. 1991); *Sinay v. Lamson & Sessions Co.,* 948 F.2d 1037, 1040 (6th Cir. 1991); *I. Meyer Pincus & Assocs., P.C. v. Oppenheimer & Co.,* 936 F.2d 759, 763 (2d Cir. 1991); *see also Raab v. Gen. Physics Corp.,* 4 F.3d 286, 290 (4th Cir. 1993); *Isquith v. Middle S. Utils., Inc.,* 847 F.2d 186, 203 (5th Cir. 1988); *Luce v. Edelstein,* 802 F.2d 49, 56 (2d Cir. 1986); *Huddleston v. Herman & McLean,* 640 F.2d 534 (5th Cir. 1981); *Acme Propane, Inc. v. Texaco Inc.,* 844 F.2d 1317 (7th Cir. 1988); *Polin v. Conductron Corp.,* 552 F.2d 797, 806 n.28 (8th Cir. 1977).

4. Merger Negotiations

The leading case setting forth the standard of materiality under the federal securities laws — *Basic Inc. v. Levinson*, 485 U.S. 244 (1988), did so in the context of merger negotiations. There, the Supreme Court set forth the standard for determining the materiality of contingent or speculative information or events. In such cases, the Supreme Court held that materiality "'will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.'" *Id.* at 238 (quoting *SEC v. Texas Gulf Sulphur,* 401 F.2d 833, 849 (2d Cir. 1968)). In the context of a merger, given the importance of the event in the life of a corporation, inside information regarding the merger can become material at an earlier stage than would be the case in a lesser transaction even though the failure rate of mergers at early stages is high. *Id.* at 239.

The Supreme Court made clear that the materiality of merger discussions in particular cases will depend on the facts. The *Basic* court set forth a multitude of facts a fact finder could look to determine materiality — the "indicia of interest in the transaction at the highest corporate levels," "board resolutions," "instructions to investment bankers, and actual negotiations between principals or their intermediaries may serve as indicia of interest." *Id. Basic* directs the fact finder to "consider . . . the size of the two corporate entities and of the potential premiums over market value." *Id.* "No particular event or factor short of closing the transaction need be either necessary or sufficient by itself to render merger discussions material." *Id.*

In *SEC v. Ginsburg*, 362 F.3d 1292 (11th Cir. 2004), the court considered the materiality of merger discussion under the test set forth in *Basic*. There, the defendant communicated nonpublic information regarding merger discussion to family members who traded on that information. The court concluded that, in light of the facts — the significance of the merger and the discussion of a specific price per share — the merger discussions altered the total mix of information available. *Id.* at 1303.

In *Brody v. Transitional Hospitals Corp.,* 280 F.3d 997 (9th Cir. 2002), the Ninth Circuit rejected a similar claim. That case arose out of a stock repurchase plan announced by Transitional Hospitals Corp. ("THC") in August 1996. In a March 19, 1997 press release, THC discussed the progress and extent of the stock repurchase program, but did not publicly disclose a February 24 written offer to acquire the company. On April 1 the third party increased its offer to purchase THC, and over the next few weeks two competing bidders submitted offers. On April 24, 1997, THC issued a press release stating that THC had "'received expressions of interest from certain parties who have indicated an interest in acquiring'" it. *Id.* at 999. The court rejected plaintiff's argument that the March 19 and April 24 press releases were misleading, explaining that often statements do not mislead even when they are incomplete or fail to include all relevant facts, and that, to be misleading, an omission "must affirmatively create an impression of a state of affairs that differs in a material way from the one that actually exists." *Id.* at 1006. Specifically, the court found that the March 19 press release was not misleading because it "neither stated nor implied anything regarding a merger," and that the April 24 press release "did not give the impression that THC had not received actual proposals from three parties or otherwise mislead readers about the stage of negotiations." *Id.*

F. LIABILITY FOR THIRD-PARTY STATEMENTS

1. Entanglement Theory

Generally, securities issuers are not liable for false or misleading statements made by independent third parties.[116] Questions of liability for third-party statements most frequently arise in the context of predictions or forecasts in securities analysts' reports. Despite a company's general immunity from such statements, liability may attach where a company has "sufficiently *entangled* itself with the analysts' forecasts to render those predictions 'attributable to it.'"[117] Once a company becomes sufficiently entangled with a third-party statement, it assumes a duty to correct any false or misleading information contained in the statement or face liability under Rule 10b-5 as if it issued the statement itself.[118]

"Entanglement" theory was first developed by the Second Circuit in *Elkind v. Liggett & Myers, Inc.,* 635 F.2d 156 (2d Cir. 1980). In *Elkind,* plaintiff shareholders alleged, among other things, that Liggett failed to correct misleading analyst reports created with the company's assistance. According to the court, whether the reports are attributable to the company turns on whether "officials of the company have, by their activity, made an implied representation that the information they have reviewed is true or at least in accordance with the company's views," giving rise to "a duty to correct material errors" in that information. *Id.* at 163. Although Liggett "did examine and comment on a number of reports, . . . its policy was to refrain from comment on earnings forecasts." *Id.* As such, "Liggett did not place its imprimatur, expressly or impliedly, on the analysts' projections" and, therefore, assumed "no duty to disclose its own forecasts or to warn the analysts (or the public) that their optimistic view was not shared by the company." *Id.*

Variations on *Elkind*'s "entanglement" theory have been utilized in every circuit. Entanglement most frequently occurs through "adoption" or "ratification" and the related doctrines of conduit theory and "comfort statements." Currently, there is no universally-accepted bright line test for determining what action (or inaction) renders a company liable for third-party statements, necessitating a case-by-case inquiry and leaving many questions unanswered.[119]

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[116] *See, e.g.*, *Southland Sec. Corp. v. INSpire Ins. Solutions Inc.*, 365 F.3d 353, 373 (5th Cir. 2004); *Raab v. Gen. Physics Corp.*, 4 F.3d 286, 288 (4th Cir. 1993).

[117] *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 163 (2d Cir. 1980) (emphasis added).

[118] *See, e.g., In re Burlington Coat Factory*, 114 F.3d 1410, 1429 (3d Cir. 1997); *Elkind*, 635 F.2d at 164; *Schaffer v. Timberland Co.*, 924 F. Supp. 1298, 1310–11 (D.N.H. 1996).

[119] *See Schaffer,* 924 F. Supp. at 1315.

Regardless of the precise formulation of entanglement theory asserted, because the allegation of entanglement "is central to the overall allegation of securities fraud, it must be pleaded with the . . . degree of specificity" required under Federal Rule of Civil Procedure 9(b) and the PSLRA.[120] As such, the complaint must establish a "significant and specific, not merely casual or speculative, entanglement between the defendants and the analysts."[121] At a minimum, the pleading should include "who supplied the information to the analyst, how the analyst received the information, and how the defendant was entangled with or manipulated the information and the analyst."[122] More specifically,

> [t]he pleading should (1) identify the specific forecasts and name the insider who adopted [or ratified] them; (2) point to specific interactions between the insider and the analyst which allegedly gave rise to the entanglement, and (3) state the

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[120] *Southland*, 365 F.3d at 373; *accord Bielski v. Cabletron Sys.*, 311 F.3d 11, 37 (1st Cir. 2002) (inquiring whether "the complaint contains allegations which, favorably construed and viewed in the context of the entire pleading, could establish a significant and *specific*, not merely casual or speculative, entanglement" (emphasis added)); *In re Time Warner Sec. Litig.*, 9 F.3d 259, 264–66 (2d Cir. 1993) (holding that unattributed statements in analyst's reports were insufficient under Rule 9(b); *In re Crown Am. Realty Trust Sec. Litig.*, 1997 U.S. Dist. LEXIS 14609, *54 (D. Pa. 1997) (stating it is necessary "[t]o plead an imputation theory with sufficient particularity . . . under Rule 9(b)) (citing *Raab v. Gen. Physics Corp.*, 4 F.3d 286, 288 (4th Cir. 1993))); *Raab*, 4 F.3d at 288 ("[N]owhere does the complaint plead with any specificity who alleged supplied this information to [the analysts], how it was supplied, or how [the defendant] could have controlled the content of the statement."); *Albert Fadem Trust v. Am. Elec. Power Co.*, 334 F. Supp. 2d 985, 1027 (D. Ohio 2004) ("[P]laintiff must plead [entanglement] allegations with particularity and state who supplied the information to the analyst, how the analyst received the information and how the defendant was entangled with . . . the analyst."); *In re Navarre Corp. Sec. Litig.*, 299 F.3d 735, 743-744 (8th Cir. 2002) (concluding investors' claim of entanglement was "insufficient under the PSLRA pleading standard" because it was "hardly the stuff of particularity"); *In re Caere Corp. Sec. Litig.*, 837 F. Supp. 1054, 1059 (N.D. Cal. 1993) ("[S]ince the allegation of entanglement is central to the overall allegation of securities fraud, plaintiffs . . . should plead entanglement with the degree of specificity required under [Rule 9(b)]."); *In re Sun Healthcare Group, Inc. Sec. Litig.*, 181 F. Supp. 2d 1283, 1292 (D.N.M. 2002) (outlining the specificity requirements for pleading entanglement); *In re Miller Indus. Sec. Litig.*, 12 F. Supp. 2d 1323, 1329–30 (D. Ga. 1998) (same); *In re Newbridge Networks Sec. Litig.*, 926 F. Supp. 1163, 1172 (D.D.C. 1996) (holding that conclusory allegations of entanglement with analysts' reports are "insufficient to pass muster under Rule 9(b)").

[121] *Bielski v. Cabletron Sys.*, 311 F.3d 11, 37-38 (1st Cir. 2002).

[122] *Southland,* 365 F.3d at 373.

dates on which the acts which allegedly gave rise to the entanglement occurred.[123]

"[A]n entanglement claim will be rejected if it merely suggests or assumes that company insiders provided the information on which analysts or other outsiders based their reports."[124] In addition, a pleading that "simply mouth[s] the required conclusion of law" or consists of nothing more than "unlinked factual allegations" of entanglement will not suffice.[125] Finally, this heightened pleading standard typically prevents a company from being held liable for third-party statements based on *unnamed* company sources.[126]

2. Adoption

"Adoption" refers to the pre-publication entanglement of a company (or company insiders) in the preparation of an analyst's report. Adoption theory has been expressly accepted, with varying requirements, in every circuit to reach the issue.[127] In general, adoption occurs

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123 *Id.* at 373-74.

124 *Bielski*, 311 F.3d at 38.

125 *Burlington Coat Factory*, 114 F.3d at 1430.

126 *See In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 263–67 (2d Cir. 1993).

127 *See, e.g.*, *Bielski v. Cabletron Sys.*, 311 F.3d 11, 37–38 (1st Cir. 2002) ("Liability may attach where the defendants have expressly or impliedly adopted the statements . . . ."); *Elkind*, 635 F.2d at 164 (suggesting adoption occurs when a company "place[s] its imprimatur, expressly or impliedly, on the analysts' projections"); *In re Burlington Coast Factory Sec. Litig.*, 114 F.3d 1410, 1430 (3d Cir. 1997) (approving of district court's use of "adopt or endorse" test to determine corporate liability for third-party statements); *Raab v. General Physics Corp.*, 4 F.3d 286, 288–89 (4th Cir. 1993) (holding that company had not adopted or become sufficiently entangled with analysts' report because it exercised no control over the report); *Southland Sec. Corp. v. INSpire Ins. Solutions Inc.*, 365 F.3d 353, 373-74 (5th Cir. 2004) ("[I]nvestors must demonstrate that the statements were adopted by the defendants."); *Albert Fadem Trust v. Am. Elec. Power Co.*, 334 F. Supp. 2d 985, 1027 (D. Ohio 2004) (utilizing an adoption analysis to determine whether company was sufficiently entangled with analyst reports); In re *Navarre Corp. Sec. Litig.*, 299 F.3d 735, 743 (8th Cir. 2002) ("[I]nvestors must demonstrate that the statements were adopted by the defendants."); In re *Caere Corp. Sec. Litig.*, 837 F. Supp. 1054, 1060 (N.D. Cal. 1993) ("A defendant has not adopted an analyst's forecast unless he has 'sufficiently entangled [himself] with the analysts' forecasts.") (quoting *Elkind*, 635 F.2d at 163)); In re *Sun Healthcare Group, Inc. Sec. Litig.*, 181 F. Supp. 2d 1283, 1292 (D.N.M. 2002) ("Defendants must have placed their imprimatur, expressly or impliedly on the analyst's projections.") (internal quotation

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when a company or a company insider places its imprimatur on analyst's report, impliedly[128] or expressly.[129]

For a company to be held liable for the adoption of misleading statements in an analyst's report, it typically must have exercised some level of control over the report.[130] This "control" standard for adoption was first developed by the Fourth Circuit in *Raab v. General Physics Corporation*, 4 F.3d 286 (4th Cir. 1993). In *Raab*, plaintiffs claimed General Physics misled its shareholders in a variety of ways, including through a Goldman Sachs research report that loosely attributed erroneous information to General Physics. *Id.* at 288. The court rejected plaintiffs' argument, concluding that their complaint "failed to plead facts from which it could be inferred that General Physics exercised the kind of control over the Goldman Sachs report that would render it liable for statements made therein." *Id.* at 289. More specifically, the court explained that plaintiffs failed to "plead with any specificity who allegedly supplied th[e] information to Goldman Sachs, how it was supplied, or how General Physics could have controlled the content of the statement." *Id.* at 288. According to the court, while a company is required to speak truthfully to its investors, it is not required to police the statements of others over which it has no control. Without a minimum level of control over the report, statements attributed to a company "could be taken out of context, incorrectly quoted, or stripped of important qualifiers."[131]

Since *Raab*, some courts have further restricted adoption theory to require a "'two-way flow of information,' in which the corporate defendant provides misleading information to the analyst, the analyst relies on the information in preparing a securities report, and the defendant

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marks and citations omitted)); In re *Miller Indus. Sec. Litig.*, 12 F. Supp. 2d 1323, 1329 (D. Ga. 1998) (holding that a company can be liable for third-party statements that can be attributed to the company); In re *Newbridge Networks Sec. Litig.*, 926 F. Supp. 1163, 1171 (D.D.C. 1996) ("Allegations based on this theory of liability must legally support a conclusion that the company adopted, endorsed or sufficiently entangled itself with the forecasts to render them attributable to him." (quoting In re *Syntex Corp. Sec. Litig.*, 855 F. Supp. 1086, 1097 (N.D. Cal. 1994)).

128 For example, when a company or a company insider provides misleading information to the analyst who, in turn, uses the information in his report.

129 For example, when a company edits or reviews an analyst's report prior to its publication.

130 *See, e.g.*, *Barrie v. Intervoice-Brite, Inc.*, 397 F.3d 249, 261 (5th Cir. 2005) (affirming district court's requirement that defendant exercise "control" over the analysts' report).

131 *Id. But see Bielski v. Cabletron Sys.*, 311 F.3d 11, 38 (1st Cir. 2002) ("A test that required 'control' would give company officials too much leeway to commit fraud . . . by using analysts as their mouthpieces.").

then somehow endorses or approves the report before or after its release."[132] Under this model, a one-way flow of information (*e.g.*, from corporate insider to analyst, from analyst to stockholder) does "not support adoptive liability."[133]

3. Ratification

Ratification occurs when a company, after publication of a report, makes an express or implied "representation that the information they have reviewed is true or at least in accordance with the company's views."[134] In contrast to adoption, ratification does not require that the misleading information in a third-party statement be attributable to a company or company insider or that such statements be imputed to the company. Rather, ratification requires only that a company has, in some fashion, expressed approval of the contents of the statement.[135] Of course, a company can only be held liable for ratifying a third-party statement if it knew the statement was false or misleading or otherwise lacked a reasonable basis at the time of the ratification.[136]

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132 *In re Stratosphere Corp. Sec. Litig.*, 66 F. Supp. 2d 1182, 1199–1200 (D. Nev. 1999); *see Schaffer v. Timberland Co.*, 924 F. Supp. 1298, 1310 (D.N.H. 1996) (holding that a two-way flow of information is necessary for adoption).

133 *Stratosphere*, 66 F. Supp. 2d at 1200.

134 *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 164 (2d Cir. 1980); *see, e.g.*, *In re Crown Am. Realty Trust Sec. Litig.*, 1997 U.S. Dist. LEXIS 14609, *53–54 (D. Pa. 1997) (approving of *Elkind*'s conclusion that post-publication implied endorsement constitutes ratification); *Southland Sec. Corp. v. INSpire Ins. Solutions Inc.*, 265 F.3d 353, 373 (stating that company who impliedly approves of third-party misstatement can be held liable for statement); *Stack v. Lobo*, 903 F. Supp. 1361, 1374 (N.D. Cal. 1995) (holding that distribution of analysts' reports in investor relations package implies approval or reports and constitutes entanglement).

135 *See In re Cypress Semiconductor Sec. Litig.*, 891 F. Supp. 1369, 1377 (N.D. Cal. 1995) (noting the "subtle, yet important distinction" that, unlike adoption, ratification "does not depend upon imputing the analysts' statements to the company . . . . Rather, the corporation's implied representation that the analysts' forecasts are accurate is itself actionable.")

136 *See Elkind*, 635 F.2d at 163.

4. Conduit Theory

Conduit theory is applicable when a company provides false or misleading information to analysts "with the intent that the analysts communicate those statements to the market."[137] This theory prevents a company from escaping liability simply because its own fraud is carried out by the statements of third parties.[138] Although "one could characterize a company's intentional or reckless misrepresentations to analysts as a form of entanglement with statements in analysts' reports . . . that rely on misrepresentations,"[139] conduit theory is different from adoption or ratification in that the company itself has committed the fraud and is held primarily liable.[140] Although this difference would seem to permit a court to bypass the entanglement inquiry altogether, courts continue to conflate conduit theory with allegations of entanglement.[141]

5. "Comfort" Statements

The law is unsettled as to whether a company's expression of "comfort" with a third-party statement (*e.g.*, an analyst's projection) renders the company liable for any false or misleading information in the statement or report. According to some courts, "[t]o say one is

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137 *In re Navarre Corp. Sec. Litig.*, 299 F.3d 735, 743 (8th Cir. 2002).

138 *See Cooper v. Pickett*, 137 F.3d 616, 624 (9th Cir. 1997).

139 *In re Cirrus Logic Sec. Litig.*, 946 F. Supp 1446, 1467 n.12 (N.D. Cal. 1996).

140 *See Cooper*, 137 F.3d at 624 ("[C]orporate defendants may be directly liable under 10b-5 for providing false or misleading information to third-party securities analysts.") (superseded by statute on other grounds); *In re Crown Am. Realty Trust Sec. Litig.*, 1997 U.S. Dist. LEXIS 14609, *54 n.2 (noting that "[b]ecause a company official spoke, . . . [conduit theory] is a form of direct liability and does not involve the imputation of the analyst's statement back to the company").

141 *See, e.g.*, *Southland Sec. Corp. v. INSpire Ins. Solutions Inc.*, 365 F.3d 353, 373 (5th Cir. 2004) ("The investors could also allege that defendants used the analysts as a conduit, making false and misleading statements to securities analysts with the intent that the analysts communicate those statements to the market."); *Barrie v. Intervoice-Brite, Inc.*, 397 F.3d 249, 262 (5th Cir. 2005) (holding that a conduit theory complaint must specify "who supplied the information to the analyst, how the analyst received the information, and how the defendant was entangled with . . . the analyst" (quoting *Southland*, 365 F.3d at 373)); *Albert Fadem Trust v. Am. Elec. Power Co.*, 334 F. Supp. 2d 985, 1027 (D. Ohio 2004) ("To prove such 'entanglement,' plaintiffs must allege that defendants used the analysts as conduits"); *In re Navarre Corp. Sec. Litig.*, 299 F.3d 735, 743 (8th Cir. 2002) (stating that conduit theory is an additional method of attributing third-party statements to a company).

'comfortable' with an analyst's projection is to say that one adopts and endorses it as reasonable."[142] However, other courts have reached opposite conclusions, holding that comfort statements are not specific enough to be actionable.[143]

G. ISSUES UNDER SECTION 11

1. Tracing

Section 11 of the Securities Act provides that:

> In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact necessary to make the statements therein not misleading, any person acquiring such security . . . may, either at law or in equity, . . . sue.[144]

The phrase "any person acquiring such security" under the terms of the statute, means any person acquiring such security under the registration statement at issue.[145] The plaintiff need not have purchased the stock directly from the issuer, but he must prove that he purchased the security under the registration statement at issue, not some other registration statement.[146] Thus, many courts have held that aftermarket purchasers who can "trace" their purchase to the registration statement at issue, have standing to sue under Section 11.[147] The tracing

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[142] *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1429 (3d Cir. 1997); *see Schaffer v. Timberland Co.*, 924 F. Supp. 1298, 1314 (D.N.H. 1996) ("[S]tatements of comfort may be actionable where the statements are sufficiently specific.").

[143] *See Malone v. Microdyne Corp.*, 26 F.3d 471, 479 (4th Cir. 1993) (concluding that a comfort statement "was certainly not specific enough to perpetrate fraud on the market"); *cf.*, *Burlington Coat Factory*, 114 F.3d at 1429 n.15 (acknowledging "the possibility of situations where the expression of agreement is so enthusiastic that no reasonable investor would attach relevance to it").

[144] 15 U.S.C. § 77k(a).

[145] *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076, 1080 (9th Cir. 1999); *DeMaria v. Anderson,* 318 F.3d 170, 176 (2d Cir. 2003); *Lee v. Ernst & Young LLP,* 294 F.3d 969, 976-77 (8th Cir. 2002).

[146] *Hertzberg,* 191 F.3d at 1080; *DeMaria,* 318 F.3d at 176; *Lee,* 294 F.3d at 976-77; *Joseph v. Wiles*, 223 F.3d 1155, 1159 (10th Cir. 2000).

[147] *See, e.g., Rosenzweig v. Azurex Corp.*, 332 F.3d 854, 873 (5th Cir. 2003); *DeMaria,* 318 F.3d at 176 (noting that it is "the long-standing practice in this circuit [to] permit suit under § 11 by those who can 'trace' their shares to the allegedly defective registration

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requirement arises only where there has been more than one offering of otherwise indistinguishable securities under multiple registration statements.[148]

Where, however, a plaintiff has purchased securities identical to those issued under the registration statement at issue before the registration statement was filed — an earlier offering — that plaintiff must plead facts that, if true, would demonstrate that the plaintiff can actually trace her stock to the specific offering and registration statement in dispute.[149] "It follows that a

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statement"); *Lee,* 294 F.3d at 976-77 (holding that standing under § 11 exists for plaintiffs who can make a prima facie showing that the shares they purchased "can be traced to the registration statement alleged to be false and misleading"); *Wiles*, 223 F.3d at 1159 (same); *Hertzberg,* 191 F.3d at 1080 (same); *Versyss Inc. v. Coopers & Lybrand,* 982 F.2d 653, 657-58 (1st Cir. 1992); *Shapiro v. UJB Fin. Corp.,* 964 F.2d 272, 286 (2d Cir. 1992); *Barnes,* 373 F.2d at 273 & n.2. There is authority in the Third Circuit holding that, to have standing to sue under Section 11, a plaintiff must have purchased the securities at issue *in an initial public offering*. In *Ballay v. Legg Mason Wood Walker, Inc.*, the Third Circuit, albeit in dicta, noted that the Securities Act regulates "initial distributions" of securities and specifically that Section 11 of the Securities Act is of "limited scope." 925 F.2d 682, 691-692 (3d Cir. 1990). Reasoning that Section 12 of the Securities Act, like the rest of the act, including Section 11, was limited to initial distributions, the court held that purchasers in the secondary market had no claim under Section 12. *See id*. at 692. The opinion in *Ballay* thus makes clear that standing to sue under Section 11 is limited to those purchasing directly in the initial public offering for the securities in the registrations statement at issue.

Since the Third Circuit Court of Appeals' opinion *Ballay*, several district courts in the Third Circuit have held that secondary market purchasers have no standing to sue under Section 11. *See Brosious v. Children's Place Retail Stores*, 189 F.R.D. 138, 144 (D.N.J. 1999); *Gannon v. Continental Ins. Co.*, 920 F. Supp. 566, 575 (D.N.J. 1996). In both *Brosious* and *Gannon* the courts held that *only* persons purchasing pursuant to an initial offering have cognizable claims under Section 11 and that open market purchasers did not have standing to pursue Section 11 claims. Significantly, in *Brosious* held that, given that secondary market purchasers have no standing to sue under Section 11, they may not be included within a class action with respect to claims under Section 11. *See Brosious*, 189 F.R.D. at 144-145.

[148] *Rosenzweig,* 332 F.3d at 873.

[149] *See Barnes v. Osofsky,* 373 F.2d 269, 273 (2d Cir. 1967); *Klein v. Computer Devices, Inc.*, 591 F. Supp. 270, 273 (S.D.N.Y. 1984); *Lilley v. Charren,* 936 F. Supp. 708, 718 (N.D. Cal. 1996); *Guenther v. Cooper Life Sciences, Inc.,* 759 F. Supp. 1437, 1439 (N.D. Cal. 1990); *McFarland v. Memorex Corp.,* 493 F. Supp. 631, 642 (N.D. Cal. 1980); *see generally* Paul C. Curnin & Christine M. Ford, "The Critical Issue of Standing Under Section 11 of the Securities Act of 1933," VI *Fordham J. Corp. & Fin. L.* 155, 157

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plaintiff in order to have a valid § 11 cause of action, must plead and prove that his stock was issued pursuant to the particular registration statement alleged to be defective . . . . If he fails to do this, his § 11 claim must be dismissed."[150] Absent a direct allegation that the plaintiff purchased the security issued under the registration statement at issue, the complaint must be dismissed.[151]

2. Section 144A and Private Offering Exemptions

Section 11 of the Securities Act provides that:

> In case any part of the registration statement . . . contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security . . . may, either at law or in equity, in any court of competent jurisdiction, sue . . . every underwriter with respect to such security.[152]

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(2001). In *Abbey v. Computer Memories, Inc.,* 634 F. Supp. 870, 875 (N.D. Cal. 1986), the court addressed tracing in the context of a motion for summary judgment and described the process through which securities are traded and accounted for by brokerage firms and the Depository Transfer Corporation. Although the court addressed a motion for summary judgment, the court's opinion demonstrates how hard it could be for plaintiffs to plead, with particularity, that securities purchased on the open market at some point following a secondary offering are traceable to a specific registration statement.

150 *Klein,* 591 F. Supp at 273 (quoting *Lorber v. Beebe,* 407 F. Supp. 279, 286 (S.D.N.Y. 1966)).

151 *Id.*

152 15 U.S.C.A. § 77k. The term "underwriter" is defined in the Securities Act to refer to:

> any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph, the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

15 U.S.C. § 77b(11).

A registration statement is an essential element of a Section 11 claim.[153] The SEC crafted Rule 144A as an express exemption to the requirement that a registration statement be filed in connection with an offering of securities where the placement is "deemed not to have been offered to the public."[154] Rule 144A(b) provides:

> "Any person, other than the issuer or a dealer, who offers or sells securities in compliance with the conditions set forth in paragraph (d) of this section shall be deemed not to be engaged in a distribution of such securities and therefore not to be an underwriter of such securities within the meaning of sections 2(11) and 4(1) of the [Securities] Act.[155]

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153 *In re Enron Corp. Sec., Derivative & "ERISA Litigation,"* 258 F. Supp. 2d 576, 644, n.44 (S.D. Tex. 2003).

154 17 C.F.R. § 230.144A & § 230.144A(c).

155 17 C.F.R. § 230.144A(b). Paragraph (d) of Rule 144A provides that:

(d) Conditions to be met. To qualify for exemption under this section, an offer or sale must meet the following conditions:

(1) The securities are offered or sold only to a qualified institutional buyer or to an offeree or purchaser that the seller and any person acting on behalf of the seller reasonably believe is a qualified institutional buyer. In determining whether a prospective purchaser is a qualified institutional buyer, the seller and any person acting on its behalf shall be entitled to rely upon the following non-exclusive methods of establishing the prospective purchaser's ownership and discretionary investments of securities:

(i) The prospective purchaser's most recent publicly available financial statements, Provided That such statements present the information as of a date within 16 months preceding the date of sale of securities under this section in the case of a U.S. purchaser and within 18 months preceding such date of sale for a foreign purchaser;

(ii) The most recent publicly available information appearing in documents filed by the prospective purchaser with the Commission or another United States federal, state, or local governmental agency or self-regulatory organization, or with a foreign governmental agency or self-regulatory organization, Provided That any such information is as of a date within 16 months preceding the date of sale of securities under this section in the case of a U.S. purchaser and within 18 months preceding such date of sale for a foreign purchaser;

(iii) The most recent publicly available information appearing in a recognized securities manual, Provided That such information is as of a date within 16 months preceding the date of sale of securities under this section in the case of a

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Section 11 provides a cause of action only for purchaser of securities issued pursuant to a registration statement and not for purchasers of unregistered securities issued through a private placement.[156] The court in *Livent* described the process of how a Rule 144A private placement — typically referred to as an Exxon Capital exchange offer — is set up. Rule 144A "permit[s] unlimited resales of securities that have never been registered under the 1933 Act, so long as all such sales are made to a specific class of large institutional investors."[157] The *Livent* court noted that Rule 144A offering to Qualified Institutional Buyers ("QIB"s) are typically followed by SEC registered exchange offers where the issuer offers to the holders of Rule 144A securities similar securities which have been registered and are freely resalable.[158] As the *Livent* court noted, under these conditions:

> Participants in the exchange offer receive freely resalable securities only if they are not affiliated with the issuer, acquired the original securities in the ordinary course of business and do not have an arrangement with the issuer for the distribution of the exchange securities. Under these circumstances, the exchange of privately placed securities for similar registered securities occurs without subjecting the holders to classification as underwriters.[159]

Thus, such private purchasers escape the underwriter designation and are deemed not to be engaged in the distribution of covered securities. As such, they can re-sell those securities without filing a registration statement, thereby also escaping any potential Section 11 liability. *Id.* There is no Section 11 liability for "initial purchasers of unregistered securities who were not

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> U.S. purchaser and within 18 months preceding such date of sale for a foreign purchaser; or
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> (iv) A certification by the chief financial officer, a person fulfilling an equivalent function, or other executive officer of the purchaser, specifying the amount of securities owned and invested on a discretionary basis by the purchaser as of a specific date on or since the close of the purchaser's most recent fiscal year, or, in the case of a purchaser that is a member of a family of investment companies, a certification by an executive officer of the investment adviser specifying the amount of securities owned by the family of investment companies as of a specific date on or since the close of the purchaser's most recent fiscal year.
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> 17 C.F.R. § 230.144A(d).

[156] *See In re Livent, Inc. Noteholders Sec. Litig.*, 151 F. Supp. 2d 371 (S.D.N.Y. 2001).

[157] *Id.,* 151 F. Supp. 2d at 431 (citing Hazen, § 4.26.1, at 302).

[158] *Id.*, 151 F. Supp. 2d at 431.

[159] *Id.* (citing Exxon Capital Holding Corp., SEC No-Action Letter (May 13, 1988), Morgan Stanley & Co. Incorporated, SEC No-Action Letter (June 5, 1991)).

directly involved in the preparation of the registration statement or in the subsequent exchange for registered securities of unregistered securities that the initial purchasers no longer held."[160]

H. ISSUES UNDER SECTION 12(A)(2)

1. What Is A "Prospectus"?

Section 2 of the Securities Act defines the term "prospectus" to mean —

> any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security; except that (a) a communication sent or given after the effective date of the registration statement (other than a prospectus permitted under subsection (b) of section 10 [15 US § 77j(b)]) shall not be deemed a prospectus if it is proved that prior to or at the same time with such communication a written prospectus meeting the requirements of subsection (a) of section 10 [15 U.S.C. § 77j(a)] at the time of such communication was sent or given to the person to whom the communication was made, and (b) a notice, circular, advertisement, letter, or communication in respect of a security shall not be deemed to be a prospectus if it states from whom a written prospectus meeting the requirements of section 10 [15 U.S.C. § 77j] may be obtained and, in addition, does no more than identify the security, state the price thereof, state by whom orders will be executed, and contain such other information as the Commission, by rules or regulations deem necessary or appropriate in the public interest and for the protection of investors, and subject to such terms and conditions as may be prescribed therein, may permit.[161]

Section 10 of the Securities Act details what must be included in a prospectus:

(a) Information required in registration statement; documents not required. Except to the extent otherwise permitted or required pursuant to this subsection or subsections (c), (d), or (e) —

(1) a prospectus relating to a security other than a security issued by a foreign government or political subdivision thereof, shall contain the information contained in the registration statement, but it need not include the documents referred to in paragraphs (28) to (32), inclusive, of schedule A [15 U.S.C. § 77aa];

(2) a prospectus relating to a security issued by a foreign government or political subdivision thereof shall contain the information contained in the

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160 *Id.*

161 15 U.S.C. § 77b.

registration statement, but it need not include the documents referred to in paragraphs (13) and (14) of schedule B [15 U.S.C. § 77aa];

(3) notwithstanding the provisions of paragraphs (1) and (2) of this subsection (a) when a prospectus is used more than nine months after the effective date of the registration statement, the information contained therein shall be as of a date not more than sixteen months prior to such use, so far as such information is known to the user of such prospectus or can be furnished by such user without unreasonable effort or expense;

(4) there may be omitted from any prospectus any of the information required under this subsection (a) which the Commission may by rules or regulations designate as not being necessary or appropriate in the public interest or for the protection of investors. 15 U.S.C. § 77j(a).

In *Gustafson v. Alloyd*, 513 U.S. 561 (1995), the Supreme Court addressed whether communications related to a private secondary offering were a prospectus. Looking at the provisions of Section 2 and Section 10 together, the Supreme Court concluded that the term "prospectus" is limited to a:

> [D]ocument that, absent an overriding exemption, must include the "information contained in the registration statement." By and large, only public offerings by an issuer of a security, or by controlling shareholders of an issuer, require the preparation and filing of registration statements. *Id.* at 570.

Prospectuses are thus limited to documents related to public offerings by corporations or their controlling shareholders. *Id.*

2. "Seller" Status

Section 12(2) of the Securities Act provides that any person who offers or sells a security by means of a prospectus or oral communication that makes misstatements or omissions of material fact "shall be liable to the person purchasing such a security from him." 15 U.S.C. 77l(2). Liability under Section 12 is not limited to the immediate seller of securities.

In *Pinter v. Dahl,* 486 U.S. 622 (1988), the United States Supreme Court held that "the language of Section 12(1) contemplates a buyer-seller relationship not unlike traditional contractual privity," its scope is not limited to those who pass title. *Id.* at 642. Because "solicitation is the stage at which an investor is most likely to be injured," the Court held the term "seller" to include one "who successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner." *Id.* at 646-47.

"Solicitation" does not encompass all activities related to the purchase transaction. The *Pinter* Court held that liability under Section 12 did not extend to persons whose participation was "collateral to the offer or sale." *Id.* at 650. Moreover, the Court rejected a test for "seller" that imposed liability on persons whose actions were merely a "substantial factor" in causing the purchase. *Id.* at 650 & n.25. Finally, the *Pinter* court held that the language of Section 12, which makes a participant liable to the "person purchasing such a security from him," precludes

actions against remote sellers, and focuses the inquiry on the relationship between the purchaser and the participant, rather than on the latter's degree of involvement in the transaction. *See id.* at 652.

A plaintiff is limited under Section 12, however, to a suit against his immediate seller — a buyer cannot recover against his seller's seller. *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1216 (6th Cir. 1996). Thus, a plaintiff will have no claim against a corporation under Section 12, even if that corporation issued the statements on which the purchasers relied where the securities at issue were firmly underwritten. *See, e.g., PPM Am. v. Marriott Corp.*, 853 F. Supp. 860 (D. Md. 1994).

3. Public Versus Private Offerings

Prior to *Gustafson,* there was a split of authority as to whether Section 12(a)(2) applied to private offerings as well as public offerings. *See, e.g., Metromedia Co. v. Fugazy*, 983 F.2d 350 (2d Cir. 1992). However, with the Supreme Court's holding in *Gustafson* that a private contract for sale is not a "prospectus" under this provision, the "predominant view is that under this precedent § 12(a)(2) applies only to public offerings and therefore aftermarket purchasers lack standing to bring a claim under § 12(a)(2)."[162] Thus, private transactions are not subject to Section 12(a)(2).[163]

I. STATUTE OF LIMITATIONS DEFENSES

1. The Actual And Inquiry Notice Standards

In *Lampf, Pleva, Lifkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991), the Supreme Court established a uniform statute of limitations for actions brought pursuant to Rule 10b-5: such actions "must be commenced within one year after the discovery of the facts constituting the violation *and* within three years after such violation." *Id.* at 364 (emphasis added). In other words, "plaintiffs have one year from the date of discovery of a violation to file an action. Defendants who may be liable for such a violation, however, are safe from any liability arising from the violation if the action is not brought within three years of the violation itself."[164]

Congress extended the limitations period applicable to securities claims in the Sarbanes-

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[162] *In re Flag Telecom Holdings, LTD.,* 308 F. Supp. 2d 249, 256-57 (S.D.N.Y. 2004); *see also Laser Mortg. Mgmt., Inc. v. Asset Securitization Corp.,* 2001 WL 1029407, at *7-8 (S.D.N.Y. Aug. 17, 2001); *Waltree Ltd. v. ING Furman Selz LLC,* 97 F. Supp. 2d 464, 469 (S.D.N.Y. 2000).

[163] *Lewis v. Fresne*, 252 F.3d 352 (5th Cir. 2001).

[164] *Anixter v. Home-Stake Prod. Co.*, 939 F.3d 1420, 1434 (10th Cir. 1991).

Oxley Act of 2002.[165] Under Sarbanes-Oxley,

> a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, as defined in section 3(a)(47) of the Securities Exchange Act of 1934 . . . may be brought not later than the earlier of (1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation.[166]

It has been noted that the two- and five-year periods are "stated disjunctively," and so "a complaint . . . would be timely if it was filed two years after discovering the facts evidencing the securities fraud, *or* five years after the fraudulent conduct."[167]

Every circuit that has addressed the issue since *Lampf* has found that a party should be deemed to have discovered the fraud, and thus the shorter one-year (or two under Sarbanes Oxley) begins running, when the party is on either actual or "inquiry" notice of the violations.[168] Although there is no uniform definition of inquiry notice, the Second Circuit has held that inquiry notice occurs "when the circumstances would suggest to an investor of ordinary intelligence the probability that she has been defrauded."[169] However, the circuits differ over when the statute of limitations should begin running if a party is on inquiry notice — several

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165 Pub. L. No. 107-204, 116 Stat. 745 (2002), codified in part at 28 U.S.C. § 1658(b).

166 28 U.S.C. § 1658(b).

167 *Tello v. Dean Witter Reynolds, Inc.*, 410 F.3d 1275, 1279 (11th Cir. 2005) (applying *Lampf* and post-*Lampf* 11th Circuit "inquiry notice" standard to the statute of limitations under SOX).

168 *See Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 167 (2d Cir. 2005); *La Grasta v. First Union Sec., Inc.*, 358 F.3d 840, 846 (11th Cir. 2004); *New England Health Care Employees Pension Fund v. Ernst & Young, LLP*, 336 F.3d 495, 500 (6th Cir. 2003), *cert. denied*, 540 U.S. 1183 (2004); *Young v. Lepone*, 305 F.3d 1, 8 (1st Cir. 2002); *Kauthar SBN BHD v. Sternberg*, 149 F.3d 659, 670 (7th Cir. 1998); *Sterlin v. Biomune Sys.*, 154 F.3d 1191, 1196 (10th Cir. 1998); *Great Rivers Coop. of Southeastern Iowa v. Farmland Indus., Inc.*, 120 F.3d 893, 896 (8th Cir. 1997); *Brumbaugh v. Princeton Partners*, 985 F.2d 157, 162 (4th Cir. 1993); *see also Livid Holdings Ltd. v. Salomon Smith Barney, Inc.*, 403 F.3d 1050, 1059-60 (9th Cir. 2005) (noting that the Ninth Circuit has "declined to adopt either an inquiry or actual notice standard," but nonetheless applying a "modified inquiry notice standard" to the case at bar); *Mathews v. Kidder, Peabody & Co.*, 260 F.3d 239, 251 n.15 (3d Cir. 2001) (addressing inquiry notice in a civil RICO securities-fraud case but citing to other circuits' 10b-5 "inquiry notice" cases).

169 *Lentell*, 396 F.3d at 168 (quoting *Levitt v. Bear Stearns & Co.*, 340 F.3d 94, 101 (2d Cir. 2003).

circuits start it running at the point where the investor first learns of facts that suggest fraud,[170] others delay the limitations period until the point where a reasonable investigation would have uncovered the fraud,[171] and still others delay the limitations period only if the plaintiff can show a diligent investigation.[172]

The First Circuit. In *Young v. Lepone*, 305 F.3d 1 (1st Cir. 2002), the First Circuit cataloged much of the inquiry notice jurisprudence around the country and held that the statute of limitations runs "when the plaintiff in the exercise of reasonable diligence discovered or should have discovered the fraud of which he complains." *Id.* at 8. The court in *Young* reviewed the different circuits' methods for timing the start of the limitations period and examined "the principles underlying the one-year limitations period," including the need for any inquiry notice standard to —

> strike a delicate balance between the staunch federal interest in requiring plaintiffs to bring suit promptly once they have been apprised of their claims . . . and the equally strong interest in not driving plaintiffs to bring suit . . . before they are able . . . to discover the facts necessary to support their claims. *Id.* at 9.

The court determined that the period should begin running not "on the date that sufficient storm warnings first appear," but on the later date on which, "following the receipt of sufficient storm warnings," a reasonable investor "exercising reasonable diligence . . . would have unearthed the fraud." *Id.* at 9-10.

Young specifically addressed the burdens of pleading on the plaintiff and defendant. *Id.* at 8-9 (citations omitted). To claim the benefit of the statute of limitations by asserting that the plaintiff was on inquiry notice more than two years before she brought the action, the defendant must first specifically plead "the existence of such warnings." Should the defendant meet this burden of proof, the plaintiff must show diligence in investigating the alleged fraud; otherwise, the two year limitations period would begin running at the moment when the duty to investigate first arose, rather than when a reasonable investigation would have uncovered the fraud. *Id.*

The Second Circuit. In *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 168 (2d Cir. 2005), the Second Circuit held that plaintiffs have a duty to investigate "when the circumstances would suggest to an investor of ordinary intelligence the probability that she has been defrauded." However, the court stressed that "the existence of fraud must be a probability, not a possibility." 396 F.3d at 168. Whether the clock on the Sarbanes-Oxley two-year limitations period starts running upon inquiry notice depends on the conduct of the plaintiff:

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[170] *See, e.g.*, *Great Rivers Coop.*, 120 F.3d at 896.

[171] *See, e.g.*, *New England Health Care*, 336 F.3d at 501.

[172] *See, e.g.*, *Lentell*, 396 F.3d at 168.

> (i) [I]f the investor makes no inquiry once the duty arises, knowledge will be imputed as of the date the duty arose; and (ii) if some inquiry is made, we will impute knowledge of what an investor in the exercise of reasonable diligence should have discovered concerning the fraud, and in such cases the limitations period begins to run from the date such inquiry should have revealed the fraud.[173]

The court noted its "reluctan[ce] to foreclose such claims as untimely absent a manifest indication that plaintiffs could have learned the facts underpinning their allegations more than a year prior to filing." *Id.* at 169.

To place an investor on inquiry notice, information "must be such that it relates *directly* to the misrepresentations and omissions the Plaintiffs allege in their action against the defendants,"[174] and the defendant should be able to show "that plaintiffs could have learned the facts underpinning their allegations more than a year prior to filing."[175] The court looks skeptically at "words of comfort from management" designed to falsely allay investors' fears of fraud: "reassuring statements will prevent the emergence of a duty to inquire . . . only if an investor of ordinary intelligence would reasonably rely on the statements to allay the investor's concern."[176] In terms of the actual evidence to be weighed at the pleading stage, the Circuit has examined corporate records[177] or publicly available media articles[178] in at least two separate cases.

The Third Circuit. The Third Circuit compiled its own catalog of inquiry notice jurisprudence in *Mathews v. Kidder, Peabody & Co.*, 260 F.3d 239 (3d Cir. 2001), a 2001 case that nominally concerned RICO violations but revolved around whether the plaintiff was on inquiry notice securities fraud principles. *Id.* at 251. The court held that, "in the context of a RICO action predicated upon a securities fraud claim, . . . a plaintiff is on inquiry notice whenever circumstances exist that would lead a reasonable investor of ordinary intelligence,

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173 396 F.3d at 168 (quoting *LC Capital Partners, LP v. Frontier Ins. Group*, 318 F.3d 148, 154 (2d Cir. 2003)).

174 *Id.* at 168 (citation omitted) (emphasis in original).

175 *Id.* at 169 (citation omitted).

176 *LC Capital*, 318 F.3d at 155.

177 *See LC Capital*, 318 F.3d at 155 (finding "storm warnings" "on the face of the detailed complaint and in related publicly available documents," including letters from defendant corporation to shareholders).

178 *See Lentell*, 396 F.3d at 169-70 (dismissing "numerous generic articles on the subject of structural conflicts . . . in the financial press" relied on by the district court (but apparently not referenced in the pleadings) as insufficient to prove inquiry notice).

through the exercise of reasonable due diligence, to discover his or her injury." *Id.*

Subsequently, the court in *In re NAHC, Inc. Securities Litigation,* 306 F.3d 1314, 1318 (3d Cir. 2002), applied this test. Citing extensively to *Mathews*, the court held that the limitations "period begins to run when the plaintiffs discovered or in the exercise of reasonable diligence should have discovered the basis for their claim against the defendant." *Id.* at 1325 (citation omitted). This inquiry

> depends on whether they had sufficient information of possible wrongdoing to place them on "inquiry notice" or to excite "storm warnings" of culpable activity. The test for 'storm warnings' is an objective one, based on whether a "reasonable investor of ordinary intelligence would have discovered the information and recognized it as a storm warning." Plaintiffs need not know all of the details or "narrow aspects" of the alleged fraud to trigger the limitations period; instead, the period begins to run from "the time at which plaintiff should have discovered the general fraudulent scheme." *Id.* at 1325-26 (citations omitted).

These cases have listed the kind of evidence that may suffice to show storm warnings. "[T]he burden is on the defendant to show the existence of 'storm warnings,'"[179] as demonstrated by

> substantial conflicts between oral representations of the brokers and the text of the prospectus, . . . the accumulation of information over a period of time that conflicts with representations that were made when the securities were originally purchased, or any financial, legal or other data that would alert a reasonable person to the probability that misleading statements or significant omissions had been made.[180]

Because any inquiry into the existence of storm warnings is "totally objective," investors in the Third Circuit "need not be aware of the suspicious circumstances or understand their import" to be on inquiry notice. Instead, "investors are presumed to have read prospectuses, quarterly reports, and other information relating to their investments."[181]

As with the First and Second Circuits, the Third Circuit holds that plaintiffs on inquiry notice have "a duty to exercise reasonable diligence to uncover the basis for their claims,"[182] and bear the burden of "show[ing] that they exercised reasonable due diligence and yet were unable

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179 *Mathews*, 260 F.3d at 252.

180 *NAHC*, 306 F.3d at 1326 (quoting *Mathews*, 260 F.3d at 252) (omission in original).

181 *Id.*

182 *NAHC*, 306 F.3d at 1326.

to discover their injuries."[183] Otherwise, a plaintiff is "held to have constructive notice of all facts that could have been learned through diligent investigation during the limitations period."[184]

The Fourth Circuit. Inquiry notice jurisprudence in the Fourth Circuit after *Lampf* is not extensive. In *Brumbaugh v. Princeton Partners*, 985 F.2d 157, 162 (4th Cir. 1993), the Fourth Circuit held a plaintiff's claim to be time-barred under inquiry notice in an action which was brought prior to *Lampf* and to which *Lampf* could not be applied retroactively. The Circuit has not spoken authoritatively on the issue since. *See, e.g.*, *Glaser v. Enzo Biochem, Inc.*, 126 Fed. Appx. 593, 597-98 (4th Cir. 2005).

Brumbaugh advocated "applying a stringent standard to securities claims arising from transactions long past," and required a plaintiff to make a "reasonable investigation of the possibility of misrepresentation once . . . on inquiry notice." 985 F.2d at 162. The Fourth Circuit may not allow time for an investigation before starting the limitations period: "Commencement of a limitations period may not . . . await the dawn of complete awareness." *Id.*

The Fifth Circuit. "The Fifth Circuit has only conclusorily referred to and appeared to accept the inquiry notice/storm warning rule in securities cases, but has not addressed it in detail."[185] In *Topalian v. Ehrman*, 954 F.2d 1125, 1135 (5th Cir. 1992), the court held that plaintiff's claims were time-barred under the prior existing state statute of limitations scheme, and that *Lampf* did not serve to revive the claims. Although the court effectively provided a definition of inquiry notice, holding that "[t]he controlling date for purposes of the running of the respective statutes of limitations is when a purchaser of securities knew — or in the exercise of reasonable diligence, should have known — of the alleged wrongdoing," it did so in the context of the prior existing limitations scheme, and did not address inquiry notice under *Lampf*. *Id.* at 1133. The Fifth Circuit has not returned to the issue since then, and the few district courts in the Fifth Circuit to address inquiry notice have cited *Topalian* but also conducted their own analyses of other circuits' jurisprudence to define inquiry notice under *Lampf*. *See In re Dynegy, Inc. Sec. Litig.*, 339 F. Supp. 2d 804, 845 (S.D. Tex. 2004); *Enron*, 2004 WL at *8.

Typical of these cases is *In re Dynegy, Inc. Securities Litigation*, 339 F. Supp. 2d at 845, in which the court quoted Fifth Circuit precedent predating *Lampf* to hold that "[a] plaintiff who has learned of facts which would cause a reasonable person to inquire further must proceed with a reasonable and diligent investigation, and is charged with knowledge of all facts such an investigation would have disclosed." But the court noted that the circuits "do not agree on

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183 *Mathews*, 260 F.3d at 252.

184 *NAHC*, 306 F.3d at 1326 (citation omitted).

185 *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 2004 WL 405886, at *8 n.28 (S.D. Tex. Feb. 25, 2004).

precisely what constitutes a storm warning." *Id.* at 846. The court noted, however, that disclosures in the media, a sudden stock price drop, a bankruptcy filing, an SEC investigation, and disclosures in a prospectus all have held by other courts to constitute a storm warning sufficient to constitute inquiry notice,[186] but that the facts "constituting storm warnings" must "'relate[] directly to the misrepresentations and omissions the [p]laintiffs later allege'" and give rise to "a level of more than mere suspicion . . . 'sufficiently confirmed or substantiated' to a point at which the victims are incited to investigate."[187] The court further noted that a securities claim may be addressed on a motion to dismiss "'[w]here . . . the facts needed for determination of when a reasonable investor of ordinary intelligence would have been aware of the existence of [wrongdoing] can be gleaned from the compliant and papers such as the prospectuses and disclosure forms that are integral to the complaint."[188]

The Sixth Circuit. In *New England Health Care Employees Pension Fund v. Ernst & Young, LLP*, 336 F.3d 495, 497 (6th Cir. 2003), the Sixth Circuit concluded that, "[l]ike a number of [its] sister circuits, . . . inquiry notice is sufficient to trigger the running of the . . . limitations period." The court defined inquiry notice to mean "the point at which the plaintiff should have discovered the fraud through reasonably diligent inquiry." *Id.* at 499. The court held that, once a plaintiff is on inquiry notice, the plaintiff has "a duty to investigate, and . . . the limitation period begins to run only when a reasonably diligent investigation would have discovered the fraud." *Id.* at 501. Quoting the First Circuit's opinion in *Young v. Lepone*, the Sixth Circuit held that this standard is the best "balance between the staunch federal interest in requiring plaintiffs to bring suit promptly . . . and the equally strong interest in not driving plaintiffs to bring suit . . . before they are able, in the exercise of reasonable diligence, to discover the facts necessary to support their claims.'" *Id.* at 501.

The Seventh Circuit. The Seventh Circuit imputes "discovery" of fraud to an investor "when he is put on inquiry notice — *i.e.,* when he becomes aware of facts that would have led a reasonable person to investigate whether he might have a claim — of his claims under Rule 10b-5." *Marks v. CDW Computer Ctr., Inc.*, 122 F.3d 363, 367 (7th Cir. 1997). In turn, "the statute of limitations begins to run at the point an investor has 'learned or should have learned the facts that he must know to know that he has a claim.'"[189] This inquiry "is a question of fact, and as

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[186] *Id.* (internal citations omitted).

[187] *Id.* (quoting *Ritchey v. Horner,* 244 F.3d 635, 640-41 (8th Cir. 2001); *Fujisawa Pharmaceutical Co., Ltd. v. Kapoor,* 115 F.3d 1332, 1335 (7th Cir. 1997); and *Newman v. Warnaco Group, Inc.,* 335 F.3d 187, 193 (2d Cir. 2003)).

[188] *Id.* at 846-47 (quoting *Marks v. CDW Computer Centers, Inc.,* 122 F.3d 363, 367 (7th Cir. 1997)).

[189] *Id.* (quoting *Law v. Medco Research, Inc.*, 113 F.3d 781, 785 (7th Cir. 1997)).

such is often inappropriate for resolution on a motion to dismiss under Rule 12(b)(6)."[190]

Defendants in the Seventh Circuit bear the burden of showing

> facts constituting inquiry notice [which are] sufficiently probative of fraud — sufficiently advanced beyond the stage of a mere suspicion, sufficiently confirmed or substantiated — not only to incite the victim to investigate but also to enable him to tie up any loose ands and complete the investigation . . . . [W]hat is important is how easy it is to obtain the necessary proof by a diligent investigation.[191]

In *Law v. Medco Research, Inc.*, 113 F.3d at 786, the court held that "[s]uspicious circumstances, coupled with ease of discovering . . . whether the suspicion is well grounded, may cause the statute of limitations to start to run." However, the court in *Law* refused to find that the plaintiff was on inquiry notice at the time urged by defendants because "the *defendants* had not shown what the investors could have done prior to the time the suit was filed to obtain the necessary facts," and "the *defendants* failed to show that a reasonably diligent investor would have brought suit" earlier. The later panel remarked that a court could not require a plaintiff "to affirmatively plead specific facts showing that there was no information" constituting inquiry notice, because this would require the plaintiff "to somehow 'prove a negative' in his complaint, a nonsensical result." *Id.* at 368 n.2.

"[I]nquiry notice does not begin to run unless and until the investor is able, with the exercise of reasonable diligence (whether or not actually exercised), to ascertain the information needed to file suit." *Id.* at 368. It does not matter "whether an investor actually exercised due diligence, but whether diligence would have paid off." *Id.* However, this matters less than it might in other circuits because the Seventh Circuit appears not to allow any additional time for investigation after an investor first becomes aware of storm warnings before running the limitations period: if "[c]laims under § 10(b) . . . must be brought within one year of the discovery of the violation,"[192] if "[d]iscovery occurs when a potential plaintiff has inquiry or actual notice,"[193] and if inquiry notice means "knowledge of the facts that would lead a reasonable person to *begin* investigating,"[194] then the one-year limitations period begins at the same time the plaintiff is to begin investigating. In sum, the Seventh Circuit requires a higher

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[190] 122 F.3d at 367; *but see Kauthar SBN BHD v. Sternberg*, 149 F.3d 659, 670 (7th Cir. 1998).

[191] *Marks*, 122 F.3d at 368 (quoting *Fujisawa Pharmaceutical Co. v. Kapoor*, 115 F.3d 1332, 1335 (7th Cir. 1997)).

[192] *Kauthar*, 149 F.3d at 670.

[193] *Id.*

[194] *Id.* (emphasis added).

threshold showing to constitute inquiry notice — the "suspicious circumstance [must] place the potential plaintiff in possession of, or with ready access to, the essential facts that he needs"[195] — but gives the investor less leeway in filing his claim once that showing is made.

The Eighth Circuit. In *Great Rivers Cooperative of Southeastern Iowa v. Farmland Industries*, 120 F.3d 893, 896 (8th Cir. 1997), the Eighth Circuit confirmed its pre-*Lampf* opinion that, "even if a victim does not actually know of a misrepresentation, the one-year limitation period begins to run when the victim should have discovered the misrepresentation through the exercise of reasonable diligence." The court echoed the Seventh Circuit in cautioning that "the facts relied upon to support inquiry notice must rise to a level of more than mere suspicion; they must instead be 'sufficiently confirmed or substantiated' to a point at which the victims are incited to investigate."[196]

The Eighth Circuit's test for inquiry notice is "an objective standard based upon facts known to the victim. Inquiry notice exists when the victim is aware of facts that would lead a reasonable person to investigate and consequently acquire actual knowledge of the defendant's misrepresentations."[197] Because a failure to comply with the statute of limitations is an affirmative defense, the Eighth Circuit has held that defendants "bear the burden of establishing it."[198]

The Eighth Circuit has broken down the test into "components":

> [A] court must determine: (1) the facts of which the victim was aware; (2) whether a reasonable person with knowledge of those facts would have investigated the situation further; and (3) upon investigation, whether the reasonable person would have acquired actual notice of the defendant's misrepresentations.[199]

The first part of the test investigates the actual knowledge of the victim, rather than assuming that the victim knew all the facts that a hypothetical "reasonable" investor in the marketplace might know: "A victim must be aware of some suspicious circumstances, some 'storm warnings,' to trigger the duty to investigate . . . . The determination of awareness is by its terms

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195 *Fujisawa*, 115 F.3d at 1337 (citation omitted).

196 *Ritchey v. Horner*, 244 F.3d 635, 640-41 (8th Cir. 2001) (quoting *Fujisawa*, 115 F.3d at 1335).

197 *Great Rivers Coop.*, 120 F.3d at 896.

198 *Ritchey*, 244 F.3d at 639.

199 *Id.*

a factual analysis."[200] However, this "does not mean that an injured party will necessarily avoid the statute of limitations by turning a blind eye"[201] because "a fact finder may decide that a victim of fraud was indeed aware of public information. Further, there might be circumstances where the evidence of awareness is so overwhelming that there is no genuine dispute on the issue."[202]

This test has led the Eighth Circuit to resolve each of the three "components" of the test in turn. In the first prong of the test, the court must subjectively review "the relevant facts known to plaintiffs,"[203] but "assume[s] the facts of [the plaintiff's] knowledge as he alleges them."[204] For purposes of the second prong of the test — investigating whether the facts known to the plaintiff "would have alerted a reasonable person" — the court reviews "the totality of the circumstances,"[205] which may be "far too factual to be resolved at the summary judgment stage."[206] Courts in the Eighth Circuit, however, "have found facts sufficient as a matter of law to alert a reasonable investor of the possibility of a misrepresentation . . . when the record contains evidence that plaintiffs received information directly contrary to the complained -of misrepresentation."[207]

The Ninth Circuit. The Ninth Circuit has "considered, but not made a final determination on whether actual or inquiry notice of the alleged fraud triggers the running of Rule 10b-5's statute of limitations."[208] In *Berry v. Valence Technology, Inc.*, 175 F.3d 699, 703 (9th Cir. 1999), the Ninth Circuit addressed the plaintiffs' argument "that *Lampf* established an

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200 *Great Rivers Coop.*, 120 F.3d at 897. *Compare Mathews*, 260 F.3d at 252 (holding that investors "need not be aware of the suspicious circumstances or understand their import" to be on inquiry notice).

201 *Id.*

202 *Id.*

203 *Ritchey*, 244 F.3d at 639.

204 *Great Rivers Coop.*, 120 F.3d at 897. *See also Ritchey*, 244 F.3d at 639-40 (focusing exclusively on plaintiffs' assertions and descriptions of their knowledge and state of mind).

205 *Great Rivers Coop.*, 120 F.3d at 898.

206 *Ritchey*, 244 F.3d at 640.

207 *Id.* (citing *Cooperativa de Ahorro y Credito Aguada v. Kidder, Peabody & Co.*, 129 F.3d 222, 224-25 (1st Cir. 1997)).

208 *Livid Holdings Ltd. v. Salomon Smith Barney, Inc.*, 403 F.3d 1050, 1059 (9th Cir. 2005).

actual discovery standard for triggering the statute of limitations." The court concluded that "*Lampf* does appear unequivocal on this point: 'The 1-year period, by its terms, begins after *discovery* of the facts constituting the violation.'" *Id.* The court rejected the defendants' argument that inquiry notice was preferable "on policy grounds" because "[t]o the extent policy considerations are relevant here, . . . it is far from clear that inquiry notice is the more desirable standard." *Id.* at 704 n.6. However, the court noted that, "contrary to the specific guidance issued by the Court," "every circuit to have addressed the issue since *Lampf* has held that inquiry notice is the correct standard." *Id.* at 704.

The court in *Berry* noted that "[i]f we were to adopt inquiry notice, we would agree with the Tenth Circuit's formulation of that standard." *Id.* The court quoted *Sterlin v. Biomune Systems*, 154 F.3d 1191 (10th Cir. 1998), under which "inquiry notice . . . triggers an investor's duty to exercise reasonable diligence and . . . the one-year statute of limitations period begins to run once the investor, in the exercise of reasonable diligence, should have discovered the facts underlying the alleged fraud." *Berry,* 175 F.3d at 704. According to the Ninth Circuit, *Sterlin* articulated a two-part inquiry, asking whether the alleged storm warnings "raise[d] sufficient suspicion of fraud to cause a reasonable investor to investigate the matter further," and if so, "when should a reasonably diligent investor have discovered the facts underlying the alleged fraudulent activity?" *Id.* The Ninth Circuit then stated that "for a press article to put shareholders on inquiry notice, there must be some reasonable nexus between the allegations made in the article and the nature of the action subsequently brought." *Id.*

The Ninth Circuit most recently addressed the statute of limitations issue in *Livid Holdings Ltd. v. Salomon Smith Barney, Inc.,* 403 F.3d 1050 (9th Cir. 2005). In that case, the court stated that, "[s]ince *Berry*, this court has left the notice standard unresolved and applies both the actual notice and inquiry-plus-due-diligence standards in applicable cases." *Id.* at 1059. The court refused to determine at the pleading stage whether the plaintiff investors were or were not on inquiry notice under either the actual or the inquiry notice standards. *Id.* at 1059-60.

Understandably, the Ninth Circuit's position has caused some confusion among other courts, which disagree on how to interpret *Berry*'s holding and dicta. In *Young v. Lepone*, 305 F.3d 1, 9-10 (1st Cir. 2002). The First Circuit cited *Berry* as support for its assertion that "the majority view" of inquiry notice was that "the statute of limitations begins to accrue on the . . . date on which an investor, alerted by storm warnings and thereafter exercising reasonable diligence, would have discovered the fraud." In contrast, the Third Circuit described *Berry* as evincing the Ninth Circuit's "preference for an actual notice standard,"[209] and the Sixth Circuit cited *Berry* for the proposition that "[t]he Ninth Circuit has indicated — in dictum — an inclination toward the actual discovery standard."[210]

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[209] *In re NAHC, Inc. Sec. Litig.*, 306 F.3d 1314, 1325 (3d Cir. 2002).

[210] *New England Health Care Employees Pension Fund v. Ernst & Young, LLP*, 336 F.3d 495, 501 n.4 (6th Cir. 2003), *cert. denied*, 540 U.S. 1183 (2004)

The Tenth Circuit. The Tenth Circuit used *Lampf* to "set . . . straight" its statute of limitations standards, which had seen the "blending [of] distinct and discrete doctrines into a fungibility that creates an exception to Section 13 that virtually swallows the rule." *Anixter v. Home-Stake Prod. Co.*, 939 F.3d 1420, 1433 (10th Cir. 1991). Under the new standard, "[i]f a putative plaintiff *should* have discovered the cause of action, suit must be filed within one year of the day the discovery should have been made." *Id.* at 1434. "[M]ere 'inquiry notice'" suffices to start the running of the statute of limitations, triggered by "sufficient storm warnings to alert a reasonable person to the possibility that there were either misleading statements or significant omissions involved in the sale" of securities. *Id.* at 1437. It is for the plaintiff to "plead and prove facts showing that his claim was timely with respect to both the one year and three year limitations periods." *Id.* at 1434.

In *Sterlin v. Biomune Systems,* 154 F.3d 1191, 1196 (10th Cir. 1998), the court refined the inquiry notice standard in considering whether "inquiry notice can[] exist [before] the facts underlying the cause of action are discoverable," or whether the limitations period runs "without regard to when a plaintiff could reasonably have discovered the facts underlying his claims." The court sided with the plaintiff in holding that "inquiry notice alone may not be the determinative factor, at least when a reasonable investor could not reasonably have discovered the facts underlying the alleged fraud until some time after being placed on inquiry notice." *Id.* Instead, the court read its own Tenth Circuit precedent as "recogniz[ing] that when the plaintiffs could not have reasonably discovered the facts underlying the alleged fraud until some period after they were put on inquiry notice, the limitations period should not begin to run upon inquiry notice." *Id.* at 1199.

After an extensive analysis of the other circuits' differing approaches to triggering the limitations period, the court held that "inquiry notice . . . triggers an investor's duty to exercise reasonable diligence and that the limitations period begins to run once the investor, in the exercise of reasonable diligence, should have discovered the facts underlying the alleged fraud." *Id.* at 1201. However, this "duty to exercise reasonable diligence" does *not* require a plaintiff to "show the actual exercise of diligence in order to 'toll' the limitations period" as it does in some circuits.[211] Instead, the court asks "whether a reasonably diligent plaintiff would have discovered the fraud," and begins the limitations period at the first date where this hypothetical plaintiff would have.[212]

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211 *Id.* at 1202 n.20. *Compare, e.g.*, *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 168 (2d Cir. 2005) ("if the investor makes no inquiry once the duty arises, knowledge will be imputed as of the date the duty arose").

212 154 F.3d at 1202 n.20.

Applying this standard to a motion to dismiss on the pleadings granted by the lower court, the court in *Sterlin* found that an article in *Barron's* magazine[213] was indeed "sufficient evidence of the possibility of fraud" to constitute inquiry notice and trigger the plaintiff's duty to investigate,[214] and that this duty was not "dissipated" by "dear shareholder" letters from the defendant company's CEO which disparaged claims in the article.[215]

The Eleventh Circuit. In *Theoharous v. Fong,* 256 F.3d 1219, 1229 (11th Cir. 2001), the Eleventh Circuit affirmed the dismissal of a securities fraud action on statute of limitations grounds, holding that discovery of a securities violation "occurs when a potential plaintiff has inquiry or actual notice of a violation." In *Fong,* the court followed the Seventh Circuit's formulation of inquiry notice, holding that inquiry notice occurs when "a reasonable person [would] begin investigating the possibility that his legal rights had been infringed." *Id* at 1229. Finally, the court in *Fong* quoted the Tenth Circuit in *Sterlin* for the proposition that "[i]nquiry notice is triggered by evidence of the *possibility* of fraud, not full exposition of the scam itself."[216] The court reaffirmed this standard in three years later in *La Grasta v. First Union Securities*, 358 F.3d 840, 845-46 (11th Cir. 2004), but held that "[a] statute of limitations bar is an affirmative defense, and . . . plaintiff[s] [are] not required to negate an affirmative defense in [their] complaint."

In *Tello v. Dean Witter Reynolds, Inc.*, 410 F.3d 1275 (11th Cir. 2005), the Eleventh Circuit departed somewhat from the Seventh Circuit's inquiry notice jurisprudence. The court noted that "the Seventh Circuit, whose definition of factual discovery of a securities fraud we adopted" in *Fong*, the statute of limitations begins to run at the point "the investor is able, with the exercise of reasonable diligence (whether or not actually exercised), to ascertain the information needed to file suit," *Id.* at 1284, but did not explicitly provide for time to investigate the fraud. The Circuit also cited the Tenth Circuit's opinion in *Sterlin* to "[a]llow time for appropriate investigation for financially injured plaintiffs to obtain the evidence of securities fraud needed to file suit." *Id.* at 1285. In line with the Tenth Circuit standard, the court held that "inquiry notice triggers reasonable diligence in investigating the fraud," *Id.* at 1284 and that courts should allow some time for this investigation, but "[t]he determination of *when* inquiry notice occurred and *how much* investigation is reasonable for filing suit are necessarily fact-specific to each case . . . [and] particularly suited for a jury's consideration." *Id.* "[A]n investor

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[213] The court made no comment on the propriety of considering this article on a motion to dismiss; indeed it is not clear from the opinion whether the article was brought to the court's attention by the defendant, or whether the district court considered the article *sua sponte*.

[214] *Id.* at 1204.

[215] *Id.*

[216] *Id.* (quoting *Sterlin v. Biomune Sys.*, 154 F.3d 1191, 1203 (10th Cir. 1998)) (alteration in original).

who receives storm warnings and does not investigate . . . will have this knowledge imputed to him." *Id.* Although the court in *Tello* did not directly state when this should be imputed should the investor not exercise due diligence, the court quoted the Seventh Circuit in holding that the statute of limitations "begins to run . . . when . . . the plaintiff learns, or should have learned through the exercise of ordinary diligence in the protection of one's legal rights, enough facts to enable him by such further investigation as the facts would induce in a reasonable person to sue within a year." *Id.* (quoting *Fujisawa*, 115 F.3d at 1334).