Note

Clear Support or Cause for Suspicion? A Critique of Collective Scienter in Securities Litigation

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Former Enron employee Clyde Johnson, a thirty-seven-year-old software writer, U.S. Air Force veteran, and father of two, filed for bankruptcy and began looking for shelter after creditors foreclosed on his home.[1] Lisa Bromiley Meier, while more successful in her employment transition to the position of Chief Financial Officer at Flotek Industries, also endured the "Hell in Houston": Every potential employer asked, "[W]ere you corrupt or were you stupid?"[2] Johnson's and Meier's stories are just two examples of the fallout from Enron's meticulous and systematic fraud, and they evidence the effects of the recent trend of corporate malfeasance in America.[3] In Houston alone, approximately 4500 employees lost their jobs in the wake of Enron's collapse[4] and subsequent Chapter 11 bankruptcy.[5]

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1. Christopher Palmeri with Peter Coy, *I Survived Enron*, BUS. WK. ONLINE, Feb. 6, 2006, http://www.businessweek.com/magazine/content/06_06/b3970081.htm.

2. *Id.*

3. WorldCom, Adelphia Communications Corp., and Tyco International, Ltd. have also made newspaper headlines for fraudulent corporate activity. *See* David S. Ruder et al., *The Securities and Exchange Commission's Pre- and Post-Enron Responses to Corporate Financial Fraud: An Analysis and Evaluation*, 80 NOTRE DAME L. REV. 1103, 1107 (2005).

4. John R. Kroger, *Enron, Fraud, and Securities Reform: An Enron Prosecutor's Perspective*, 76 U. COLO. L. REV. 57, 58 (2005).

5. *See* Ruder et al., *supra* note 3, at 1105.

The magnitude of Enron's fraudulent activity in light of the company's prior reputation as an innovator and pioneer[6] has raised the consciousness and concern of the American population. Suspicion and alarm have generated new theories for determining corporate liability. For example, courts have sought to broaden securities litigation pleading standards for scienter by moving away from traditional agency liability principles like respondeat superior.[7] Through the introduction of "collective scienter" theory, plaintiffs may allege that a corporation is *directly* liable for securities fraud under SEC Rule 10b-5 by pleading a material misrepresentation by one employee and the scienter of another employee.[8] Collective scienter proponents are further subdivided by how expansively they apply collective scienter. Weak collective scienter theorists support the adequacy of pleading the scienter of a management-level officer, regardless of whether the officer made a fraudulent misrepresentation.[9] Strong collective scienter theorists alternatively argue that a complaint need not allege scienter on the part of *any* corporate employee.[10] One scholar has articulated the emerging issue well: "If an officer of the company makes the statement and a janitor knows the statement is false, has the corporation acted with fraudulent intent?"[11]

6. Enron won a number of awards for professional excellence, including the *Financial Times*' "Energy Company of the Year" award in 2000 and six consecutive awards from *Fortune*, recognizing it as "America's Most Innovative Company." ENRON AND BEYOND: TECHNICAL ANALYSIS OF ACCOUNTING, CORPORATE GOVERNANCE, AND SECURITIES ISSUES 8 (Julia K. Brazelton & Janice L. Ammons eds., 2002). In 2001, Enron was also listed as the United States' seventh largest corporation by total revenue. *Fortune 500*, FORTUNE, Apr. 16, 2001, at F1.

7. *See* Southland Sec. Corp. v. INSpire Ins. Solutions Inc., 365 F.3d 353, 366 (5th Cir. 2004) (relying on common law agency principles to determine corporate liability).

8. *See, e.g.*, *In re* Dynex Capital, Inc. Sec. Litig., No. 05 Civ. 1897(HB), 2006 WL 314524, at *7 (S.D.N.Y. Feb. 10, 2006).

9. *See, e.g.*, Hill v. Tribune Co., No. 05 C 2602, 2006 WL 2861016, at *12 (N.D. Ill. Sept. 29, 2006) (holding that a corporation's scienter is limited to the senior officers or directors of the corporation); *In re* Sonus Networks, Inc. Sec. Litig., No. Civ.A.04-10294-DPW, 2006 WL 1308165, at *22 (D. Mass. May 10, 2006) (finding that pleading the scienter of the corporate controller satisfied the strong inference standard).

10. *See, e.g.*, *In re Dynex*, 2006 WL 314524, at *7 (noting that the majority of the plaintiff's allegations "relevant to scienter" were adequately directed against Dynex in general).

11. LYLE ROBERTS ET AL., WILSON SONSINI GOODRICH & ROSATI, P.C., RECENT ISSUES IN THE PLEADING OF SCIENTER IN SECURITIES FRAUD CLAIMS 5 (2005), http://www.wsgr.com/PDFSearch/pleading_of_scienter.pdf.

Part I of this Note addresses the current state of corporate and securities law as it relates to pleading standards for securities fraud and to the two versions of collective scienter. Part II examines the alternate versions of strong and weak collective scienter by first examining representative cases and then conducting a theoretical feasibility analysis of each derivation. This bifurcated analysis concludes that collective scienter is poorly supported by case law and fails to comport with securities litigation pleading standards (respecting strong collective scienter) or common law agency principles (regarding weak collective scienter). Part III, through a policy examination of traditional corporate liability, demonstrates that collective scienter unacceptably leads to broad, sweeping corporate liability. This Note concludes by supporting a return to traditional agency principles.

I. ATTRIBUTION OF SCIENTER TO CORPORATIONS: THE CURRENT STATUS OF THEORY AND LAW

The promulgation of the Sarbanes-Oxley Act[12] was perhaps the most prominent, visible regulatory response to Enron and other corporate scandals. The immediate legislative reaction to the scandals was to ratchet up corporate compliance requirements in day-to-day activities and securities management.[13] Such legislative action has encouraged shareholder access to courts, though it is in tension with the drive to discourage opportunistic strike suits.[14] The corporation's unique status as a legal person[15] has further complicated the allegation of corporate liability, creating a battleground between courts that sup-

12. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

13. *See, e.g.*, Sarbanes-Oxley Act of 2002 § 103, 116 Stat. at 755–56 (codified as amended at 15 U.S.C. § 7213 (Supp. 2004)) (creating a public company accounting oversight board); *id.* § 7241 (requiring CEO certification of the company's financial statements and internal financial controls); 15 U.S.C. § 7261(c)(1) (requiring the disclosure of all material off-balance sheet transactions).

14. *See* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 628–29 (4th ed. 2002) (noting that Congress passed the 1995 Private Securities Litigation Reform Act in response to the use of extortionate strike suits by plaintiff classes).

15. Gary S. Rosin, *The Entity-Aggregate Dispute: Conceptualism and Functionalism in Partnership Law*, 42 ARK. L. REV. 395, 466 (1989) ("The legal-person fiction is perhaps most entrenched in corporate law.").

port traditional corporate liability and courts embracing collective scienter.[16]

A. THE FOUNDATION: SECURITIES REGULATIONS

Corporate and securities regulations have been in a state of flux over the past several years.[17] The 1929 Stock Market Crash and Great Depression prompted Congress to enact the Securities Exchange Act of 1934 (the 34 Act).[18] The 34 Act has since remained at the forefront of the battle against corporate corruption.[19] Section 10(b) of the 34 Act makes it "unlawful for any person, directly or indirectly, . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device . . . in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe."[20] While neither section 10(b) nor Securities and Exchange Commission (SEC) Rule 10b-5 explicitly allows an aggrieved party to bring a lawsuit,[21] the judiciary has recognized section 10(b) and Rule 10b-5 as conferring an implied private cause of action.[22]

SEC Rule 10b-5 prohibits fraudulent devices or schemes, material misstatements, material omissions, and any acts or practices that operate as a fraud or deceit upon any person in connection with the sale or purchase of securities.[23] In order to establish a prima facie 10b-5 case, a plaintiff must allege five

16. *Compare* Southland Sec. Corp. v. INSpire Ins. Solutions Inc., 365 F.3d 353, 366–67 (5th Cir. 2004) (applying common law liability principles), *with* Hill v. Tribune Co., No. 05 C 2602, 2006 WL 2861016, at *12 (N.D. Ill. Sept. 29, 2006) (permitting the plaintiff to plead the separate scienter of directors and senior officers).

17. *See, e.g.*, Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified at 15 U.S.C. § 78b (2000)); Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified at 15 U.S.C. § 78u-4 (2000)).

18. Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78nn (West 2004)).

19. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194–95 (1976) ("Federal Regulation of transactions in securities emerged as part of the aftermath of the market crash in 1929."); S. REP. NO. 104-98, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683.

20. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2000).

21. *Id.*; 17 C.F.R. § 240.10b-5 (2006).

22. *See* Scott M. Murray, Comment, Central Bank of Denver v. First Interstate Bank of Denver*: The Supreme Court Chops a Bough from the Judicial Oak: There Is No Implied Remedy to Sue for Aiding and Abetting Under Section 10(b) and SEC Rule 10b-5*, 30 NEW ENG. L. REV. 475, 475–76 (1996).

23. 17 C.F.R. § 240.10b-5.

elements: "(1) a misstatement or omission (2) of material fact (3) made with scienter (4) on which [plaintiffs] relied (5) which proximately caused [the plaintiffs'] injury."[24] Although plaintiffs often validly use 10b-5 to combat securities fraud, in some instances plaintiffs have alleged 10b-5 violations for inappropriate purposes, such as to obtain extortionate settlements and to file opportunistic strike suits. Responding to these concerns, Congress implemented securities litigation reform in 1995.[25]

The Private Securities Litigation Reform Act of 1995 (PSLRA) established special procedures for securities class actions and sought to deter frivolous lawsuits.[26] The PSLRA raised pleading standards for corporate misstatements[27] and scienter.[28] The following discussion examines the standard for pleading scienter.

B. PLEADING SCIENTER UNDER SEC RULE 10B-5 AND THE PSLRA

Understanding the dynamics of pleading scienter is particularly important, and indeed fundamental, to an analysis of collective scienter. Scienter is "a mental state embracing intent to deceive, manipulate, or defraud,"[29] and under 10b-5 the plaintiff must allege that the defendant possessed this scienter at the time of a material misstatement or omission.[30] A corporate actor's mere negligence when making such a misrepresen-

24. *In re* Apple Computer, Inc., 127 F. App'x 296, 299 (9th Cir. 2005) (alterations in original) (quoting DSAM Global Value Fund v. Altris Software, Inc., 288 F.3d 385, 388 (9th Cir. 2002)).

25. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified at 15 U.S.C. § 78u-4 (2000)).

26. Private Securities Litigation Reform Act of 1995 § 101, 109 Stat. at 743–49; *see also* HAZEN, *supra* note 14, at 629.

27. 15 U.S.C. § 78u-4(b)(1) ("In any private action arising under this chapter in which the plaintiff alleges that the defendant . . . made an untrue statement of a material fact; or . . . omitted to state a material fact . . . the complaint shall specify each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading . . . .").

28. *Id.* § 78u-4(b)(2) (mandating the "strong inference" standard in proving the defendant's required state of mind).

29. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193–94 n.12 (1976); *see also* BLACK'S LAW DICTIONARY 1373 (8th ed. 2004).

30. *See Ernst & Ernst*, 425 U.S. at 197 (concluding that a private cause of action under 10b-5 must include an allegation of knowledge or intent to deceive, manipulate, or defraud).

tation does not satisfy the scienter pleading requirement,[31] although an allegation of recklessness is sufficient.[32]

Despite the fine lines courts often draw between intent and knowledge or recklessness and negligence, one common denominator prevails: "the inevitable mention of a 'person' in whom [intent] resides."[33] While the law generally recognizes a corporation as a "person,"[34] courts must still determine how a corporation may possess the mental state required to prove scienter. A court's approach to corporate scienter may thus play a pivotal role in determining the viability of a plaintiff's case in the face of a Federal Rules of Civil Procedure (FRCP) 12(b)(6) motion.[35]

FRCP pleading standards generally adhere to a low standard of notice, requiring only a "short and plain statement" showing that the plaintiff is entitled to relief.[36] The federal rules require, however, that averments of fraud state "the circumstances constituting fraud . . . with particularity."[37] The complaint must specifically identify the alleged fraudulent statements, the party making the statements, the time when the statements were made, and why the statements were fraudulent.[38] The particularity requirement ensures that the defendant receives fair notice of the plaintiff's claim and creates a safeguard against frivolous allegations of wrongdoing.[39] Notably, the FRCP 9(b) particularity standard applies to the

31. *Id.*

32. *In re* Ford Motor Co. Sec. Litig., 381 F.3d 563, 568 (6th Cir. 2004). Recklessness is defined as a "'highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the ordinary standards of care, . . . 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.'" Nordstrom, Inc. v. Chubb & Son, Inc., 54 F.3d 1424, 1435 (9th Cir. 1995) (alteration in original) (quoting Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990)).

33. Patricia S. Abril & Ann Morales Olazábal, *The Locus of Corporate Scienter*, 2006 COLUM. BUS. L. REV. 81, 84.

34. BLACK'S LAW DICTIONARY, *supra* note 29, at 365.

35. FED. R. CIV. P. 12(b); *see also* 15 U.S.C. § 78u-4(b)(3)(A) (2005) ("In any private action . . . the court shall . . . dismiss the complaint if the requirements of paragraphs (1) [the heightened pleading standard for misrepresentation] and (2) [the heightened pleading standard for scienter] are not met.").

36. FED. R. CIV. P. 8(a).

37. FED. R. CIV. P. 9(b).

38. Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1127–28 (2d Cir. 1994).

39. *In re* Sonus Networks, Inc. Sec. Litig., No. Civ.A.04-10294-DPW, 2006 WL 1308165, at *6 (D. Mass. May 10, 2006).

fraudulent act, but not to the state of mind of the individual perpetrating the fraud.[40]

The Private Securities Litigation Reform Act of 1995 implemented heightened standards for pleading fraud in securities litigation.[41] The PSLRA first addressed fraudulent acts by establishing a "clarity and basis" requirement,[42] closely paralleling the particularity requirement under FRCP 9(b). The "clarity and basis" provision required the complaint to "specify each statement alleged to have been misleading . . . [and] the reason or reasons why the statement is misleading."[43]

Further, the PSLRA's new "strong inference" language raised the pleading standards for scienter (from those previously required under FRCP 9(b)) by mandating that a complaint "state with particularity facts giving rise to a *strong inference* [of scienter]."[44] At a minimum, courts agree that the strong inference standard does not require pleading evidence,[45] or even "foreclose[ing] all other 'characterizations of fact.'"[46] The complaint, however, must at least allege facts that surpass a "reasonable" inference of scienter.[47] Beyond such common denominators, there is conflict in characterizing the PSLRA standard. While an allegation of the defendant's motive and opportunity may be sufficient, courts have declined to deem such an allegation as satisfying the PSLRA standard.[48] A number of courts also suggest that the PSLRA scienter criterion may be

40. FED. R. CIV. P. 9(b) ("Malice, intent, knowledge, and other condition of mind of a person may be averred generally.").

41. 15 U.S.C. § 78u-4(b) (2000).

42. *See id.*

43. *Id.*

44. *Id.* (emphasis added).

45. *In re* Stone & Webster, Inc. Sec. Litig., 414 F.3d 187, 199 (1st Cir. 2005); *see also* Hill v. Tribune Co., No. 05 C 2602, 2006 WL 2861016, at *2 (N.D. Ill. Sept. 29, 2006) ("[I]t is not necessary to establish or prove any facts, nor submit evidence in any form.").

46. *In re* Ford Motor Co. Sec. Litig., 381 F.3d 563, 568 (6th Cir. 2004) (quoting Helwig v. Vencor, Inc., 251 F.3d 540, 553 (6th Cir. 2001)).

47. *See* Greebel v. FTP Software, Inc., 194 F.3d 185, 196 (1st Cir. 1999) ("[A] mere reasonable inference is insufficient to survive a motion to dismiss.").

48. *See* 144 CONG. REC. S12,906 (daily ed. Oct. 21, 1998) (statement of Sen. Reed) ("[A]llegations of motive, opportunity, and recklessness, as well as conscious fraud, continue to satisfy the requirements of a 10b(5) pleading."). *But see* Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1283 (11th Cir. 1999) (noting that while the allegation of a defendant's motive and opportunity may be suggestive of scienter, it does not satisfy the PSLRA strong inference standard by itself).

met by pleading recklessness or by alleging "facts giving rise to a strong inference of recklessness."[49] Although Congress has not yet adopted a universal definition for the strong inference standard, PSLRA has clearly raised the FRCP (9)(b) bar for pleading scienter in securities litigation.

C. THE DEFINITION OF THE CORPORATE ENTITY

A corporation is "[a]n entity . . . having authority under law to act as a single person distinct from the shareholders . . . ; a group or succession of persons established . . . [as a] legal personality distinct from the natural persons who make it up," and "exist[ing] indefinitely apart from them."[50] Variety abounds in the interpretation of a corporation's legal liability. Nominalist and realist scholars define the corporate entity differently. The nominalist school argues that corporations are "nothing more than collectivities of individuals,"[51] and essentially views a corporation as a group of people working under a common title.[52] Alternatively, realists favor an "entity" instead of an "aggregate" approach.[53] Realists propose that a corporation has an independent existence and culture separate from its individual employees.[54] Consequently, "[c]orporations can act and be at fault in ways that are different from the ways in which their members can act and be at fault."[55]

Determining how scienter should be attributed to a corporation thus depends on the school of thought a court follows. On the one hand, it is difficult to find a corporation, as defined by the nominalist school, directly liable for securities fraud; a nominalist views the corporation as a mere umbrella under which a group of individuals labors. On the other hand, a court with a realist view is more inclined to find a corporation directly liable for the collective actions and scienter of its officers. Although supporters of collective scienter favor the realist school,[56] no clear majority of courts supports either view.

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49. *See, e.g.*, *In re Ford Motor Co.*, 381 F.3d at 568.

50. BLACK'S LAW DICTIONARY, *supra* note 29, at 365.

51. Eric Colvin, *Corporate Personality and Criminal Liability*, 6 CRIM. L.F. 1, 1 (1995).

52. *Id.* at 1–2.

53. *See id.* at 2.

54. *Id.*

55. *Id.*

56. *See* Abril & Olazábal, *supra* note 33, at 104–05 (favoring the realist school based on a comparative analysis of legislative intent and en banc appel-

D. ATTRIBUTION OF LIABILITY TO CORPORATIONS

1. Respondeat Superior

Notwithstanding differing definitions of the corporate entity, courts historically have relied on the doctrine of respondeat superior to find corporations vicariously liable for the acts of their officers or agents.[57] Respondeat superior, a common law agency principle, holds an employer liable for an employee's or agent's wrongful acts if those acts are committed within the scope of employment.[58] Under respondeat superior, the existence of a corporation's scienter is determined by looking "to the state of mind of the individual corporate official or officials who make or issue the statement . . . rather than generally to the collective knowledge of all the corporation's officers and employees acquired in the course of their employment."[59]

Federal securities regulations have traditionally mirrored common law principles by relying on some form of vicarious liability.[60] Over two decades ago, issues regarding corporate liability centered on two variations of vicarious liability. Under the 34 Act, section 20(a) stipulates that certain "controlling persons" within a corporation are liable for the acts of their employees or agents.[61] Plaintiffs have also used respondeat superior as a source of liability *for the corporation itself* based on

late court opinions).

57. *See id.* at 112; William S. Laufer, *Corporate Bodies and Guilty Minds*, 43 EMORY L.J. 647, 654 (1994) (noting the dearth of additional corporate liability theories that apply under federal and state legislation).

58. RESTATEMENT (SECOND) OF AGENCY § 219(1) (1958); *see also* BLACK'S LAW DICTIONARY, *supra* note 29, at 1338 (defining respondeat superior as a doctrine which holds "an employer or principal liable for the employee's or agent's wrongful acts committed within the scope of the employment or agency").

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

60. *See, e.g.*, William J. Fitzpatrick & Ronald T. Carman, *Respondeat Superior and the Federal Securities Laws: A Round Peg in a Square Hole*, 12 HOFSTRA L. REV. 1, 13 (1983); William J. Seiter, Comment, *Rule 10b-5 and Vicarious Liability Based on Respondeat Superior*, 69 CAL. L. REV. 1513, 1513 (1981).

61. *See* Fitzpatrick & Carman, *supra* note 60, at 2 n.6 ("'Every person who, directly or indirectly, controls any person liable under any provision of this title . . . shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith . . . .'" (quoting Securities and Exchange Act of 1934 § 20(a), 15 U.S.C. § 78t(a) (1976))).

the acts of corporate officers and managers.[62] Thus, plaintiffs can access "deep pockets"—corporate resources—by invoking respondeat superior as a secondary source of corporate liability.[63]

2. Corporate and Collective Scienter

More recently, courts have shifted away from traditional notions of respondeat superior and are instead examining securities complaints under corporate scienter theories, particularly the collective scienter theory. At the foundation of corporate scienter theory is the idea that as a legal person, the fraudulent act and scienter of a 10b-5 violation may exist in the corporation, even if both elements do not intersect in one individual employee.[64]

Some scholars advocate ignoring the scienter of individual human beings altogether, and instead support the attribution of scienter directly to the corporation.[65] Proponents of this more direct corporate scienter theory look at the circumstances accompanying the alleged fraudulent activity by a corporation.[66] These scholars argue that an evaluation of corporate history, common knowledge inside or outside of the corporation, and corporate culture provides evidence of a corporation's collective intent.[67]

Collective scienter is the second mechanism for establishing corporate scienter. Federal district courts increasingly support collective scienter,[68] or the reliance on the collective

62. *See* Jennifer Moore, *Corporate Culpability Under the Federal Sentencing Guidelines*, 34 ARIZ. L. REV. 743, 758–64 (1992).

63. *See* Seiter, *supra* note 60, at 1530 (noting that the doctrine of respondeat superior could act as another source of secondary liability in conjunction with section 20(a)). Some have argued, however, that section 20(a) is the sole source of vicarious liability. *See* Fitzpatrick & Carman, *supra* note 60, at 1–2 (arguing that section 20(a) of the 34 Act, which imposes liability for the acts of employees on "controlling persons," precludes the use of respondeat superior).

64. *See* Abril & Olazábal, *supra* note 33, at 132 (noting that the Sixth Circuit Court of Appeals adopted a realist school perspective in finding a distinct corporate persona independent from the corporation).

65. *See id.* at 151. ("Building on the realist notion that collectives may be separate 'persons' with intent distinct from that of each member, the second part of our rule assesses corporate intent without resort to the fictional attributions and imputations inherent in the respondeat superior and collective knowledge doctrines.").

66. *See id.*

67. *Id.* at 152.

68. *See, e.g.*, Hill v. Tribune Co., No. 05 C 2602, 2006 WL 2861016, at *12

knowledge of corporate employees to establish a corporation's fraudulent intent, despite previous indications that the doctrine was inapplicable.[69] Courts, however, are divided in their application and acceptance of the theory.

Courts supporting a weak version of the doctrine allow plaintiffs to impute scienter onto the corporation only where they plead scienter of upper-level management or corporate officers.[70] In *In re Marsh & McLennan Cos. Securities Litigation*, the district court found that "[w]hile there is no simple formula for how senior an employee must be in order to serve as a proxy for corporate scienter, courts have readily attributed the scienter of management-level employees to corporate defendants."[71] A growing number of federal courts have relied on similar derivations of the collective scienter theory, noting that the scienter of management-level employees may form the basis for corporate scienter, regardless of whether the scienter and fraudulent acts intersect in a single individual.[72]

(N.D. Ill. Sept. 29, 2006); *In re* Sonus Networks, Inc. Sec. Litig., No. Civ.A.04-10294-DPW, 2006 WL 1308165, at *22 (D. Mass. May 10, 2006).

69. ROBERTS ET AL., *supra* note 11, at 5; *see also In re* Apple Computer, Inc., 127 F. App'x 296, 303 (9th Cir. 2005) ("A corporation is deemed to have the requisite scienter for fraud only if the individual corporate officer making the statement has the requisite level of scienter at the time that he or she makes the statement. We have squarely rejected the concept of 'collective scienter' in attributing scienter to an officer and, through him, to the corporation." (citation omitted)); Nordstrom, Inc. v. Chubb & Son, Inc., 54 F.3d 1424, 1435–36 (9th Cir. 1995) (finding that "there is no case law supporting an independent 'collective scienter' theory" and that the corporation could not have the requisite scienter absent a finding of scienter for individual defendants).

70. *Hill*, 2006 WL 2861016, at *12 ("[T]he corporation's scienter is generally limited to being based on knowledge or scienter of a senior officer or director of the corporation, or an employee involved in issuing the alleged misrepresentation.").

71. MDL NO. 1744, 04 Civ. 8144 (SWK), 2006 WL 2057194, at *22 (S.D.N.Y. July 20, 2006). *In re Marsh & McLellan Cos.* dealt with a class action lawsuit in which plaintiffs alleged that Marsh and McLennan "steered unsuspecting clients to insurers with whom [the firm] had lucrative payoff agreements, and that the firm solicited rigged bids for insurance contracts." *Id.* at *1.

72. *See* City of Monroe Employees Ret. Sys. v. Bridgestone Corp., 399 F.3d 651, 686–90 (6th Cir. 2005) (finding that the plaintiffs adequately alleged facts giving rise to a strong inference of recklessness, while dismissing claims against individual defendants for failure to sufficiently plead scienter); *Hill*, 2006 WL 2861016, at *12; *In re* NUI Sec. Litig., 314 F. Supp. 2d 388, 412 (D.N.J. 2004) (holding that stock-based acquisitions by corporate officers and directors at the time of the alleged misrepresentations supported a strong inference of corporate scienter).

A stronger form of the doctrine stipulates that a plaintiff may satisfy the PSLRA strong inference standard for alleging scienter on the part of a corporate defendant by pleading the scienter of any employee or, alternatively, without pleading scienter against *any* specific employees of the corporation.[73] Thus, the stronger version of collective scienter does not require a plaintiff to allege scienter on the part of *any* individual employee in order to survive a motion for dismissal at the pleading stage. Instead, the plaintiff may plead general corporate scienter.[74] Although other courts have applied this broader form of collective scienter,[75] such support represents a significant extension of traditional corporate liability that requires that scienter reside in an individual human being.[76]

II. THE FAILURE OF COLLECTIVE SCIENTER: JUDICIAL AND COMPARATIVE THEORETICAL ANALYSIS

On July 19, 2000, the CEO of Apple Computer, Inc., Steven Jobs, presented a new product in the company's line: the Cube.[77] An innovation in aesthetics (but not necessarily in functionality), the Cube was marketed largely on its visual appeal.[78] Nearly three weeks into the fourth quarter, during a July presentation at the Mac World Conference, Jobs projected a fourth quarter sales volume at 150,000 units and a first year volume at 800,000.[79] Over the course of the next two months of the fourth fiscal quarter, Jobs would confirm these projec-

73. *See, e.g.*, *In re* Dynex Capital, Inc. Sec. Litig., No. 05 Civ. 1897(HB), 2006 WL 314524, at *9 (S.D.N.Y. Feb. 10, 2006) ("A plaintiff may . . . allege[] scienter on the part of a corporate defendant without pleading scienter against any particular employees of the corporation.").

74. *See id.* at *9–10.

75. *See, e.g.*, *In re* WorldCom, Inc. Sec. Litig., 352 F. Supp. 2d 472, 497 (S.D.N.Y. 2005) ("To carry their burden of showing that a corporate defendant acted with scienter, plaintiffs in securities fraud cases need not prove that any one individual employee of a corporate defendant also acted with scienter. Proof of a corporation's collective knowledge and intent is sufficient."); *In re* Oxford Health Plans, Inc. Sec. Litig., 51 F. Supp. 2d 290, 294–96, (S.D.N.Y. 1999).

76. *See* RESTATEMENT (SECOND) OF AGENCY § 275 cmt. b (1958) (implying a requirement that the state of mind exists in the *individual* making or causing the misrepresentation).

77. *In re* Apple Computer, Inc., 127 F. App'x 296, 301 (9th Cir. 2005).

78. *Id.* at 302.

79. *Id.*

tions,[80] but by the end of the fourth quarter Apple had sold only 107,000 Cubes, or two-thirds of the projected volume.[81]

Unknown to investors, manufacturing and functionality flaws plagued the Cube. Over seventy-five percent of the models that came off of the manufacturing line displayed faulty mold lines and visible cracks in the clear casing of the computer.[82] Further, an over-sensitive power switch caused the computer to turn off unexpectedly.[83] The company failed to disclose these problems to investors when it stated projections and issued press releases.[84]

Investors responded to the revelation of these issues by bringing class action lawsuits against Jobs and Apple Computer, alleging that the defendants employed a scheme of fraudulent misrepresentations to inflate company stock prices.[85] The plaintiffs supplemented their allegations with the testimony of twenty-two confidential eyewitnesses and lower-level employees, who stated that they were aware of the manufacturing problems with the Cube at the time of Jobs's statements.[86] Nonetheless, the Ninth Circuit found that the plaintiffs failed to adequately plead facts showing that Jobs himself knew of the manufacturing problems at the time he made his sales projections.[87]

The Apple Computer case, viewed in light of greater public awareness of corporate misconduct, raises the issue of whether courts may hold a corporation directly liable for securities fraud based on the collective knowledge of employees. Federal circuit and district courts have varied widely in their answers. While some case law supports the collective scienter theory,[88] reliance on this case law is misplaced because courts have misinter-

80. *Id.* ("I think we're going to hit our forecasts this quarter, so if [Cubes are] hard to find, I think that's because demand is greater than we thought it would be . . . .").

81. *Id.*

82. *See In re* Apple Computer, Inc., Sec. Litig., 243 F. Supp. 2d 1012, 1018 (N.D. Cal. 2002) ("According to the complaint, [a former Apple senior production supervisor] recalled that at least seventy-five to eighty percent of the Cubes [the supervisor] saw had some 'cosmetic imperfection.'").

83. *In re Apple Computer*, 127 F. App'x at 302.

84. *Id.*

85. *In re Apple Computer*, 243 F. Supp. 2d at 1016–17.

86. *Id.* at 1017.

87. *In re Apple Computer*, 127 F. App'x at 303.

88. *See, e.g.*, *In re* WorldCom, Inc. Sec. Litig., 352 F. Supp. 2d 472, 497 (S.D.N.Y. 2005); *In re* NUI Sec. Litig., 314 F. Supp. 2d 388, 412 (D.N.J. 2004).

preted and misapplied collective scienter standards. This Part proceeds with a case examination of each derivation of the emerging theory. Following each case examination, this Note uses comparative analysis of accepted legal principles to demonstrate the theoretical impracticality of collective scienter.

A. THE STRONG VERSION OF COLLECTIVE SCIENTER IN *DYNEX*: CIVIL AND CRIMINAL PLEADING STANDARDS AND THE GROUP PLEADING DOCTRINE

In *In re Dynex Capital, Inc. Securities Litigation*, the district court adopted the strong collective scienter theory by recognizing a prima facie 10b-5 case when the plaintiff plead scienter without reference to any specific employee.[89] The *Dynex* court's reliance on *In re WorldCom, Inc. Securities Litigation* and *United States v. Bank of New England*,[90] however, was flawed, and comparative analysis to the group pleading doctrine demonstrates that the strong theory of collective scienter fails to satisfy the new PSLRA pleading standards.

1. The *Dynex* Line of Cases

The plaintiffs in *In re Dynex* alleged that Dynex Capital made material misrepresentations regarding the issuance of debt securities that were collateralized by self-originated mortgages.[91] Specifically, they averred that Dynex purchased a significant volume of collateralized mortgages from not-creditworthy mortgagees and failed to disclose this risky business strategy to investors.[92] The plaintiffs pled Dynex's scienter by referring generally to the "defendants" and to Dynex as a corporation.[93] The *Dynex* court held that "[a] plaintiff may, and in this case has, alleged scienter on the part of a corporate defendant without pleading scienter against any particular employees of the corporation."[94]

The court's holding is noteworthy for two reasons. First, it validated a plaintiff's allegation of scienter against a corporation without requiring that the scienter and alleged misrepre-

89. *In re* Dynex Capital, Inc. Sec. Litig, No. 05 Civ. 1897(HB), 2006 WL 314524, at *9 (S.D.N.Y. Feb. 10, 2006).

90. United States v. Bank of New Eng., 821 F.2d 844 (1st Cir. 1987).

91. *In re Dynex*, 2006 WL 314524, at *1.

92. *Id.*

93. *Id.* at *7.

94. *Id.* at *9.

sentation intersect in a single actor.[95] Further, relying on *WorldCom*, *Dynex* extended the weak version of collective scienter by allowing a plaintiff to plead corporate scienter through the scienter of *any* specific individual. While the *Dynex* court correctly applied the *WorldCom* ruling,[96] *Dynex* loses credibility because of an interpretive error in the *WorldCom* decision.

WorldCom held 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."[97] *WorldCom* erroneously culled this standard from *Bank of New England*.[98] *Bank of New England* held that a "collective knowledge [jury] instruction is entirely appropriate in the context of corporate criminal liability."[99] *Bank of New England* reasoned, "The acts of a corporation are, after all, simply the acts of all of its employees operating within the scope of their employment. The law on corporate *criminal* liability reflects this."[100]

WorldCom's reliance on the *Bank of New England* pleading standard is problematic. *Bank of New England* established a standard for corporate *criminal* liability,[101] not *civil* liability as in *WorldCom* or *Dynex*. Although one could argue, given the higher standards of proof in criminal cases, that the standard should apply to civil cases,[102] that argument is flawed. A strict correlation between the criminal procedure standards and Federal Rules of Civil Procedure 8(a)[103] or 9(b)[104] might be more

95. *Id.*

96. Notably, *WorldCom* referred to the plaintiff's burden of proof at the end of a trial, while *In re Dynex* established a pleading standard. Such a distinction is not problematic. *Compare In re* WorldCom, Inc. Sec. Litig., 352 F. Supp. 2d 472, 497 (S.D.N.Y 2005), *with In re Dynex*, 2006 WL 314524, at *2. The higher burden of proof would at least be commensurate with, if not stricter than, pleading standards.

97. *In re WorldCom, Inc.*, 352 F. Supp. 2d at 497.

98. *See* United States v. Bank of New Eng., 821 F.2d 844, 856 (1st. Cir. 1987).

99. *Bank of New Eng.*, 821 F.2d at 856.

100. *Id.* (emphasis added). For an analysis of the criminal law analogy to civil securities lawsuits, see Abril & Olazábal, *supra* note 33, at 98–129.

101. *Bank of New Eng.*, 821 F.2d at 856 (finding that a collective knowledge jury instruction was appropriate).

102. *See* Kevin M. Clermont & Emily Sherwin, *A Comparative View of Standards of Proof*, 50 AM. J. COMP. L. 243, 266 (2002) ("In the United States, the differing criminal and civil standards of proof mean that acquittal of a defendant in a criminal case does not preclude a further civil claim against the defendant based on the same factual allegation.").

103. FED R. CIV. P. 8(a).

tenable if the PSLRA did not mandate heightened standards for pleading in securities lawsuits.[105] While not dispositive, the incongruence between criminal and securities litigation pleading standards raises the question of whether criminal standards should be employed as an analogue to securities pleading standards.

Another area of law recognizes this distinction. In the landmark First Amendment case, *New York Times Co. v. Sullivan*, Justice Brennan expounded on the concern that the assessment of civil penalties for defamation could be "markedly more inhibiting" than the doling out of criminal punishment.[106] Although one may generally assume that criminal penalties are more severe, and therefore warrant higher standards of production and proof, penalties for violations of securities law may be more severe than criminal penalties. Monetary damages and harm to a corporation's reputation are especially grave in an allegation of securities fraud. With the prevalence of frivolous strike suits, the *Sullivan* rationale may suggest that securities litigation standards should be higher than criminal standards, contrary to *WorldCom*'s presumption in relying on *Bank of New England*.

In light of the PSLRA's strong inference requirement, which is tailored to securities suits, one should be hesitant to rely on a criminal law to define pleading standards for scienter. The comparison is particularly inappropriate when courts use it to justify a theory that expands the traditional boundaries of pleading standards.

2. The Strong Version of Collective Scienter: An Analogy to the Group Pleading Doctrine and Analysis of Its Comport with the PSLRA's Purpose

a. The Group Pleading Doctrine Is Relevant to a Critique of Collective Scienter

In addition to strengthening the scienter pleading standard, the PSLRA also requires plaintiffs to allege misrepresentation with particularity.[107] Notably, the group pleading doc-

104. FED R. CIV. P. 9(b).

105. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 21D, 109 Stat. 737, 743–49 (codified at 15 U.S.C. § 78u-4 (2000)).

106. N.Y. Times Co. v. Sullivan, 376 U.S. 254, 277 (1964).

107. Private Securities Litigation Reform Act of 1995 § 21D(b)(1), 109 Stat. at 747.

trine, discussed in Part II.A above, has offered a controversial interpretation of this "clarity and basis" requirement.[108] Under the group pleading doctrine, a plaintiff may rely on the published documents of a corporation, such as prospectuses, press releases, and annual reports, to plead a material misrepresentation on the part of a corporate defendant.[109] Thus, instead of requiring a plaintiff to plead that an individual defendant authored or approved these "group-published" documents, courts allow a plaintiff to link individual defendants to alleged misrepresentations based on the premise that those defendants were likely part of the group of officers or directors that put the documents together.[110]

At first glance, courts' application of the group pleading doctrine to collective scienter seems questionable. Group pleading addresses the misrepresentative *act* in securities fraud, not the *scienter*.[111] Moreover, the group pleading doctrine addresses the attribution of liability to a *person* as opposed to a *corporation*, which is the central issue for collective scienter.[112]

An analogy to the group pleading doctrine, however, is helpful in revealing the inadequacy of the strong version of collective scienter. *Southland Securities Corp. v. INSpire Insurance Solutions, Inc.* held that the group pleading doctrine is inapplicable to the PSLRA pleading standard for scienter.[113] First, *Southland* reasoned that although an allegation that an officer released inaccurate company information can create a *reasonable* inference of negligence, that allegation does not sat-

108. JONATHAN C. DICKEY ET AL., CURRENT TRENDS IN FEDERAL SECURITIES LITIGATION 26 (2006), http://media.gibsondunn.com/fstore/pubs/Current%20Trends%20in%20Federal%20Securities%20Litigation.pdf ("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.").

109. Southland Sec. Corp. v. INSpire Ins. Solutions Inc., 365 F.3d 353, 363 (5th Cir. 2004).

110. *Id.*

111. *See* DICKEY ET AL., *supra* note 108, at 26 ("[W]here the false or misleading information is conveyed in . . . 'group published information' it is reasonable to presume that these are the collective *actions* of the officers." (emphasis added) (quoting Wool v. Tandem Computers, Inc., 818 F.2d 1433, 1440 (9th Cir. 1987), *superseded by statute*, Private Litigation Reform Act of 1995, 109 Stat. at 737, *as recognized in* Hockey v. Medhekar, 30 F. Supp. 2d 1209, 1215 (N.D. Cal. 1998))).

112. *See id.* (noting the impact of the corporate officers' individual actions).

113. *Southland*, 365 F.3d at 365.

isfy the "strong inference" scienter standard.[114] Second, *Southland* found that the complaint must allege facts that give rise to a strong inference "'that *the* defendant acted with the required state of mind'"[115] and that plaintiffs must "distinguish among those they sue" in a complaint.[116] *Southland*'s rationale for refusing to apply the group pleading doctrine to corporate scienter serves as a powerful argument for invalidating the stronger version of collective scienter.

b. An Illustration of How Strong Collective Scienter Fails to Comport with the PSLRA by Establishing Only a Reasonable Inference of Scienter

Consider the allegations of scienter in *Dynex*. The plaintiffs alleged that Dynex "artificially . . . reported delinquencies" on mortgages, erroneously reported cumulative repossessions, and failed to address deficiencies in internal financial controls.[117] *Southland* found that the group pleading doctrine could muster only a *reasonable* inference of negligence.[118] Similarly, the strong version of the collective scienter theory offers little in the way of particularity. Without stipulating precisely *who* knew of the errors in financial reporting, the *Dynex* plaintiffs alleged that the company knowingly or recklessly disregarded disclosure of key facts.[119]

This lack of specificity at the pleading stages departs from the PSLRA strong inference standard. One could draw a reasonable inference that *someone* was negligent in managing the financial controls. To strongly infer, however, that someone knew or recklessly disregarded such information or warning signs epitomizes the type of complaint that the PSLRA seeks to avoid.[120] The allegation requires pleading that it is more likely than not that *someone* (we don't know who!) intentionally or recklessly disregarded the financial reporting problems. Since the PSLRA seeks to ensure particularity in pleading fraudulent

114. *Id.* at 364–65.

115. *Id.* at 364 (emphasis added) (quoting Securities Exchange Act of 1934, 15 U.S.C. § 78u-4(b)(2) (2000)).

116. *Id.* at 365.

117. *In re* Dynex Capital, Inc. Sec. Litig., No. 05 Civ. 1897(HB), 2006 WL 314524, at *7 n.6 (S.D.N.Y. Feb. 10, 2006).

118. *Southland*, 365 F.3d at 365.

119. *In re Dynex*, 2006 WL 314524, at *7 n.6.

120. HAZEN, *supra* note 14, at 629, 633–34; *see also* S. REP. NO. 104-98, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683.

acts and scienter (particularly in response to a "shoot first and ask questions later" approach to litigation),[121] this attenuated assumption is inappropriate.

Further, *Southland* reasoned that the PSLRA requires that plaintiffs "distinguish among those they sue" and "enlighten *each defendant*" of his or her role in the alleged fraud.[122] The strong collective scienter theory fails to comport with this principle; it requires only an allegation of scienter *generally* to the employees of a corporation, and not to any particular person.[123]

The PSLRA's goal of avoiding a "sue them all and let the judge sort it out" mentality provides further support for the *Southland* decision.[124] The legislative history demonstrates that the PSLRA's objective is to force plaintiffs to provide a clearer statement of their claims to the defendant.[125] Alleging scienter generally to the employees of a corporation, without specifically defining a person to whom scienter is attributed or strongly inferred, is too ambiguous and imprecise to meet the PSLRA's scienter standard.[126]

Moreover, Congress enacted the PSLRA in part to combat frivolous strike suits.[127] In noting that corporations serve the country by establishing "strong and vibrant markets," Congress demonstrated a desire to allow corporations to "raise capital by providing investors with their best good-faith assessment of future prospects, without fear of costly, unwarranted litigation."[128] Frivolous strike suits based on bad market news needlessly waste corporate funds and take money out of the pockets of shareholders. Corporations are forced to devote extensive resources to unnecessary or duplicative controls to avoid even an appearance of impropriety based on circumstance, and then must expend further resources to settle nuisance lawsuits.[129] The PSLRA seeks to prevent such "bad news" lawsuits.[130]

121. S. REP. NO. 104-98, at 4, *reprinted in* 1995 U.S.C.C.A.N. 679, 683.

122. *Southland*, 365 F.3d at 365.

123. *In re Dynex*, 2006 WL 314524, at *9.

124. 141 CONG. REC. S17,965 (daily ed. Dec. 5, 1995) (statement of Sen. Dole).

125. *Id.*

126. *See Southland*, 365 F.3d at 364–65.

127. S. REP. NO. 104-98, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683.

128. 141 CONG. REC. S19,035 (daily ed. Dec. 21, 1995) (letter to the House of Representatives from President William J. Clinton).

129. *See* Charles M. Yablon, *The Good, the Bad, and the Frivolous Case: An*

The *Dynex* collective scienter formulation undermines this rationale. By permitting the pleading of scienter generally, and not to a specific person, *Dynex* and the strong form of collective scienter encourage lawsuits based on circumstantial facts (such as an unexpected failure to meet sales projections). The strong collective scienter theory fails to satisfy the PSLRA strong inference standard by disregarding the need to distinguish between allegations of culpable practices and simply connecting bad news to circumstantial evidence.

B. THE WEAK VERSION OF COLLECTIVE SCIENTER: UNCOVERING ERRORS IN *HILL V. TRIBUNE CO.* AND A COMPARISON TO COMMON LAW AGENCY PRINCIPLES

In *Hill v. Tribune Co.*, an Illinois district court adopted the weaker version of collective scienter in reliance on the *Higginbotham v. Baxter International, Inc.* decision.[131] *Higginbotham*, however, perpetuated the weak collective scienter theory by relying, improperly, on *Southland* and *Nordstrom, Inc v. Chubb & Son, Inc.*[132] Further, the weak version of collective scienter deviates from well-established corporate and agency principles, a deviation that Part III demonstrates to be unwarranted and unfeasible.

1. The *Hill* Line of Precedents

In *Hill*, the court applied the weaker version of collective scienter[133] to an allegation that the Tribune Company employed accounting and business schemes to overstate circula-

Essay on Probability and Rule 11, 44 UCLA L. REV. 65, 96 (1996).

130. S. REP. NO. 104-98, at 4, *reprinted in* 1995 U.S.C.C.A.N. at 683 ("These suits . . . are often based on nothing more than a company's announcement of bad news, not evidence of fraud.").

131. Hill v. Tribune Co., No. 05 C 2602, 2006 WL 2861016, at *12 (N.D. Ill. Sept. 29, 2006) (citing Higginbotham v. Baxter Int'l, Inc., No. 04 C 4909, 2005 WL 1272271, at *8–9 (N.D. Ill. May 25, 2005)).

132. *Higginbotham*, 2005 WL 1272271, at *8 ("These cases hold that the requisite scienter must be held by the corporate employee responsible for issuing the alleged misrepresentations or at least that a senior officer or director of the corporation must have the pertinent scienter." (citing Nordstrom, Inc. v. Chubb & Son, Inc., 54 F.3d 1424, 1435–36 (9th Cir. 1995))).

133. *Hill*, 2006 WL 2861016, at *12 ("While senior Tribune officers . . . relied on the Newsday-Hoy Individual Defendants for the circulation figures they reported in SEC filings and press releases, it was incumbent on lead plaintiff to adequately allege that those responsible . . . recklessly relied on the circulation figures that were provided.").

tion numbers for two company-operated newspapers.[134] The plaintiffs argued that the misrepresented circulation numbers artificially inflated financial results over a two-year period.[135] Despite applying the weak collective scienter standard, *Hill* found that the plaintiffs failed to adequately plead scienter on the part of senior-level management officials and consequently failed to properly plead the Tribune's scienter.[136]

a. Higginbotham v. Baxter International, Inc.

While *Hill*'s result was not remarkable, the court notably relied on *Higginbotham v. Baxter International, Inc.* to support the assertion that "the corporation's scienter is generally limited to being based on knowledge or scienter of a senior officer or director of the corporation."[137] Yet *Hill* misinterpreted *Higginbotham*. *Higginbotham* held that the plaintiff must plead *at least* the scienter of a senior officer or director of the corporation, regardless of whether such an officer perpetrated the material misstatement or omission.[138]

Higginbotham relied on a host of cases, primarily focusing on Fifth (*Southland*) and Ninth (*Nordstrom*) Circuit decisions.[139] *Higginbotham*, however, misinterpreted the rules established by these circuits when it asserted that "[t]hese cases hold that the requisite scienter must be held by the corporate employee responsible for issuing the alleged misrepresentations or *at least that a senior officer or director of the corporation must have the pertinent scienter*."[140] Instead, *Southland* and *Nordstrom* addressed the intersection of an act and scienter in a single individual, as opposed to the intersection of an

134. *Id.* at *1, *4.

135. *Id.* at *5.

136. *Id.* at *12 ("Lead plaintiff cannot simply attribute to Tribune the knowledge of lower level employees who were not also responsible for the SEC filings and press releases.").

137. *Id.*

138. Higginbotham v. Baxter Int'l, Inc., No. 04 C 4909, 2005 WL 1272271, at *8 (N.D. Ill. May 25, 2005) (holding that a plaintiff may sufficiently plead by referencing to the scienter of a corporate employee responsible for making the material misrepresentation or a senior officer or director of the corporation).

139. *Id.* (citing Southland Sec. Corp. v. INSpire Ins. Solutions Inc., 365 F.3d 353, 366–67 (5th Cir. 2004)); *see also* Nordstrom, Inc. v. Chubb & Son, Inc., 54 F.3d 1424, 1435–36 (9th Cir. 1995); Piper Jaffray Cos. v. Nat'l Union Fire Ins. Co. of Pittsburgh, 38 F. Supp. 2d 771, 779–80 (D. Minn. 1999); *In re* Cable & Wireless, PLC, Sec. Litig., 321 F. Supp. 2d 749, 772 (E.D. Va. 2004).

140. *Higginbotham*, 2005 WL 1272271, at *8 (emphasis added).

act and scienter among any of the company's upper-level management team.[141]

b. Southland Securities Corp. v. INSpire Insurance Solutions, Inc.

The Fifth Circuit, in *Southland*, ascertained a corporation's scienter based on each individual defendant's scienter, "rather than [based] generally [on] the collective knowledge of all the corporation's officers and employees acquired in the course of their employment."[142] *Higginbotham*'s flaw lies in language that *Southland* did *not* use. *Higginbotham* implied that the act and scienter do not need to intersect in a single individual to find a corporation liable for securities fraud.[143]

Southland did not propose such a rule. In fact, it dismissed any form of collective scienter. First, *Southland* stated that it is "appropriate to look to the state of mind of the individual corporate official or officials *who make or issue the statement*."[144] Thus, *Southland* stipulated that the fraudulent act and scienter intersect in a single individual. *Southland* also rejected collective scienter, citing *Nordstrom*'s assertion that "there is no case law supporting an independent 'collective scienter' theory."[145] The court further established its position by citing *In re Apple Computer, Inc., Securities Litigation*, which cited *Nordstrom*: "'It is not enough to establish fraud on the part of a corporation that one corporate officer makes a false statement that another officer knows to be false.'"[146] Although the Fifth Circuit clearly distanced itself from the collective scienter theory, *Higginbotham* relied on *Southland* to perpetuate the weak permutation of scienter. As a consequence, *Hill*'s holding stands on tenuous ground.

c. Nordstrom, Inc. v. Chubb & Son, Inc.

Oddly, *Higginbotham* also cited *Nordstrom*,[147] despite *Nordstrom*'s clear rejection of collective scienter.[148] There is,

141. *Southland*, 365 F.3d at 366–67; *Nordstrom*, 54 F.3d at 1435–36.

142. *See Southland*, 365 F.3d at 366.

143. *Higginbotham*, 2005 WL 1272271, at *8 ("[A]t least . . . a senior officer or director of the corporation must have the pertinent scienter.").

144. *Southland*, 365 F.3d at 366 (emphasis added).

145. *Id.* (quoting *Nordstrom*, 54 F.3d at 1435).

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

147. *Higginbotham*, 2005 WL 1272271, at *8.

however, nominal evidence that *Nordstrom* accepted the weaker form of collective scienter. *Nordstrom* further cited *In re Warner Communications Securities Litigation* to suggest that a corporation's scienter could be distinguished from the scienter of an individual officer or director, as long as the plaintiff could show that "one or more members of top management knew of the material information . . . but failed to stop the issuance of misleading statements."[149] At first glance, *Warner* appears to have suggested that a corporation's scienter can be established by attributing scienter to one employee and a fraudulent act to another. *Warner*, however, addressed a situation that fit squarely within traditional respondeat superior parameters.

Suppose a corporation's chief executive officer and chief financial officer sign and certify an SEC form 10-K,[150] which, unbeknownst to the officers, contains material misrepresentations of the company's net income and revenues. One reading of *Warner* would suggest that the act of issuing the 10-K, combined with the knowledge of the misrepresentation by a high-level management official, like a corporate controller, would be sufficient to establish corporate scienter.

A closer examination of *Warner*, however, reveals that there is no separation of scienter and act. SEC Rule 10b-5 forbids a person from "omit[ting] to state a material fact necessary" to rectify previously misleading statements.[151] The controller's individual knowledge of the material misstatement, combined with individual his failure to rectify the misrepresentation, satisfies the SEC Rule 10b-5 scienter element. Thus, the act and scienter intersect in a single individual—the corporate controller—and may then be imputed to the corporation under

148. *Nordstrom*, 54 F.3d at 1435–36 ("[T]here is no case law supporting an independent 'collective scienter' theory . . . . [W]e see no way that [appellant] could show that the corporation, but not any individual defendants, had the requisite intent to defraud."). *But see id.* at 1435 ("Theoretically, collective scienter could be a basis for liability."). *Nordstrom*'s concession that collective scienter has a hypothetical application to scienter in securities fraud cases rings hollow. *Nordstrom* supported this assertion by citing to secondary resources, and not case law, and then provided a caveat that support in case law for collective scienter is lacking. *Id.* Thus, the "nod" to objectivity seems more like a "head fake." The *Nordstrom* court conceded the existence of secondary support and then implicitly dismissed it through reference to precedent. *Id.*

149. *Id.* at 1435 (quoting *In re* Warner Commc'ns Sec. Litig., 618 F. Supp. 735, 752 (S.D.N.Y. 1985), *aff'd*, 798 F.2d 35 (2d Cir. 1986)).

150. *See* Sarbanes-Oxley Act of 2002 § 302, 15 U.S.C. § 7241 (Supp. 2004).

151. 17 C.F.R. § 240.10b-5 (2006).

common law respondeat superior. Under these factual circumstances, and without an explicit or implicit endorsement of collective scienter, *Warner* should be read as a traditional respondeat superior case.

2. The Weak Version of Collective Scienter: An Expansion of Agency Law

Common law agency principles, or the relationship between servants and masters, provide the foundation for corporate liability law.[152] Agency law also permeates securities regulations, such as the 34 Act's "controlling person" liability,[153] and judicial decisions.[154]

Where scienter is an element of a cause of action, as with a 10b-5 allegation, the *Restatement (Second) of Agency* explicitly requires that the state of mind exist in the individual making (or at least causing) a misrepresentation.[155] Thus, the plaintiff may not impute the person's scienter to another, separate individual making the misrepresentation.[156] Case law reflects this well-established principle. In *Gutter v. E.I. DuPont de Nemours*, a district court relied on agency principles to hold that "[t]he knowledge necessary to form the requisite fraudulent intent must be possessed by at least one agent and cannot be inferred and imputed to a corporation based on disconnected facts known by different agents."[157]

The imputation of liability to a corporation is a fundamental tenet of agency law and has historically been established through respondeat superior.[158] Collective scienter attempts to expand this method of imposing liability on a corporation[159]

152. *See* RESTATEMENT (SECOND) OF AGENCY § 1(1) (1958) (describing the creation of an agency relationship as "the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control").

153. Securities Exchange Act of 1934 § 20(a), 15 U.S.C. § 78t(a) (2000).

154. *See, e.g.*, *Nordstrom*, 54 F.3d at 1433–34 (evaluating corporate personnel actions under a vicarious liability standard).

155. RESTATEMENT (SECOND) OF AGENCY § 275 cmt. b (1958).

156. *Id.*

157. 124 F. Supp. 2d 1291, 1311 (S.D. Fla. 2000).

158. Abril & Olazábal, *supra* note 33, at 112.

159. *See, e.g.*, Hill v. Tribune Co., No. 05 C 2602, 2006 WL 2861016, at *12 (N.D. Ill. Sept. 29, 2006) (permitting plaintiffs to plead scienter of a senior officer or director, who, without knowledge, recklessly relied on false information provided to him or her); *In re* Sonus Networks, Inc. Sec. Litig., No. Civ.A.04-10294-DPW, 2006 WL 1308165, at *22 (D. Mass. May 10, 2006) (finding that pleading a material misrepresentation on the part of one officer and the sci-

while ignoring fundamental principles of the corporate principal-agent relationship.

Corporations may act only through their officers and directors,[160] and as a result, a corporation can be held liable for fraud *only* if one of its agents or employees can be held liable for fraud.[161] Further, common law agency principles stipulate that "a fraudulent state of mind cannot be imputed to the person" who makes material misrepresentation of fact.[162] Weak collective scienter directly conflicts with this fundamental rule by permitting a plaintiff to plead a material misrepresentation by one employee and the scienter of another.[163]

In *In re NUI, Inc. Securities Litigation*, the district court applied a weak collective scienter theory to find that an associate general counsel's knowledge of a misrepresentation by another party was sufficient to satisfy the PSLRA pleading standard.[164] Agency common law, however, does not permit individual liability for fraud where there is a separation of act and intent.[165] Where the individual is not liable for fraud, a corporation likewise is not held liable for fraud under respondeat superior.[166] Thus, under a proper application of agency law, the *NUI* court should have dismissed the complaint for a failure to properly allege liability on the part of any individual defendant.

The weak version of collective scienter directly conflicts with agency principles, which have traditionally been the foundation of corporate liability. As a result, one must query whether the expansion of corporate liability through collective scienter is warranted or feasible.

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enter of the corporate controller satisfied the strong inference scienter standard); *In re* Dynex Capital, Inc. Sec. Litig., No. 05 Civ. 1897(HB), 2006 WL 314524, at *9 (S.D.N.Y. Feb. 10, 2006) (holding that the averment of scienter on the part of a particular employee or agent satisfies the PSLRA scienter standard).

160. ROBERTS ET AL., *supra* note 11, at 5.

161. *Id.*

162. *Id.*

163. *See, e.g.*, *Hill*, 2006 WL 2861016, at *12 (holding that corporate scienter is limited to upper-level management *or* the employee who "issued" the misrepresentation).

164. *In re* NUI Sec. Litig., 314 F. Supp. 2d 388, 412 (D.N.J. 2004) (noting that the associate general counsel for NUI knew of the alleged bad debt practices).

165. *See* RESTATEMENT (SECOND) OF AGENCY § 275 cmt. b (1958).

166. ROBERTS ET AL., *supra* note 11, at 5.

III. CORPORATE LIABILITY: THE JANITOR'S OFFICE AND RESPONDEAT SUPERIOR

Dynex and *Hill* are merely examples of the strong and weak versions of collective scienter. Their failure to properly rely on precedent renders their holdings and, consequently, their own precedential value suspect. This review, however, suggests only that the cases fail to properly advance the theory through case law. The discussions following each case examination call into question the applicability of collective scienter on theoretical grounds.

Advocates of collective scienter argue that courts should expand or abandon agency laws in favor of standards that encourage the punishment of corporate malfeasance.[167] Although collective scienter may advance worthwhile utilitarian and deterrent public policies, respondeat superior is better policy.

A. THE COLLECTIVE SCIENTER SLIPPERY SLOPE

Respondeat superior embodies inherent limits that the doctrine of collective scienter fails to provide. Like the PSLRA provisions, these limits ensure that corporations do not face frivolous, extortionate strike suits. Common law agency principles described in Part II attribute liability to a corporation (the principal) based on the act and scienter of an employee (the agent) while acting within the scope of his or her employment.[168] Cracking the door open by applying the weak collective scienter theory effectively opens the floodgates to frivolous securities litigation.

In *In re NUI*, the court found that the scienter of an associate general counsel and the act of another individual could be imputed to the corporation.[169] Other cases, such as *In re Marsh & McLennan* and *Hill*, have limited the scope of the theory to "management-level officials."[170] The issue that arises, and pos-

167. *See* Abril & Olazábal, *supra* note 33, at 113, 135 (arguing that respondeat superior is both overinclusive and underinclusive, and supporting a form of collective scienter as applied to a "high managerial agent or member of the board of directors who ratified, recklessly disregarded, or tolerated" a material misrepresentation).

168. RESTATEMENT (SECOND) OF AGENCY § 275 cmt. b (1958).

169. *In re NUI*, 314 F. Supp. 2d at 418.

170. Hill v. Tribune Co., No. 05 C 2602, 2006 WL 2861016, at *12 (N.D. Ill. Sept. 29, 2006); *In re* Marsh & McLennan Cos. Sec. Litig., MDL NO. 1744, 04 Civ. 8144 (SWK), 2006 WL 2057194, at *22 (S.D.N.Y. July 20, 2006) (supporting collective scienter as derived from management-level employees).

sibly without resolution, is where and with whom one might draw the line of accountability.

Under the weak derivation of collective scienter, a corporate officer or director would certainly fall within the "management-level" standard. *NUI*, however, muddled this clear line by suggesting that an *associate* general counsel may also provide the requisite corporate scienter.[171] While *NUI* did not characterize the associate general counsel's responsibility, one may conclude that the court found the attorney to be in a position of fiduciary responsibility such that she should have fully disclosed the misrepresentation. If one were to accept this duty-to-act argument, one must then ask where the line of accountability should be drawn. Would a paralegal have an equal duty to disclose the information? Would a complaint pleading her failure to disclose be adequate under the PSLRA pleading standards? Would a legal secretary, or a corporate controller, or a regional vice president have similar duties to disclose? Without a bright-line definitive characterization of a "management-level employee," the weak collective scienter theory could extend all the way to the janitor's office.

The strong variation of collective scienter provides a more obvious example of how the theory has limitless application. The strong version permits a plaintiff to plead scienter without mention of a specific individual or a duty to act.[172] Where a plaintiff satisfies the PSLRA standards without pleading scienter as to any individual employee, strong collective scienter imposes strict liability on the corporation by requiring only bad news and circumstantial evidence of intent.[173]

Thus, a company incorporated in Delaware, with a headquarters in New York, could be found liable for a 10b-5 violation if the New York CEO releases financial information that a regional manager in Thailand knows to be false. Such a burden is not merely unreasonable, but would slow day-to-day business operations by forcing companies to take unnecessary protective steps. All employees, regardless of their level of responsibility, would have to be aware of their duty to report potential errors. Moreover, corporations would be faced with the inefficient task

171. *In re NUI*, 314 F. Supp. 2d at 410–15.

172. *See id.*

173. *See In re* Dynex Capital, Inc. Sec. Litig., No. 05 Civ. 1897(HB), 2006 WL 314524, at *9 (S.D.N.Y. Feb. 10, 2006) ("A plaintiff may, and in this case has, alleged scienter on the part of a corporate defendant without pleading scienter against any particular employees of the corporation.").

of monitoring compliance with such a mandate. The problem is even more evident in the case of a transnational corporation, where even lower-level management and administrative employees, perhaps without an understanding of the American legal consequences of their action or inaction, would be saddled with a duty to rectify potential misrepresentations.

Collective scienter theorists advance admirable goals. In the wake of Enron and other corporate scandals, the doctrine of collective scienter makes pleading scienter easier for plaintiffs, which perhaps deters corporate wrongdoing. These goals, however, are in tension with the PSLRA's established purpose of *raising* pleading standards in the face of frivolous strike suits.

B. RESPONDEAT SUPERIOR AS A SUPERIOR ALTERNATIVE

Congress implemented the PSLRA in part to clarify pleading standards for securities lawsuits.[174] Moreover, it did not intend the strong inference requirement to be easily satisfied,[175] and the collective scienter theory fails to be sufficiently particular. Common law respondeat superior, however, embodies the precise particularity that legislators sought to achieve with the PSLRA's implementation.

Respondeat superior mandates that the master be liable for the tortious actions of its servants.[176] Moreover, agency law supplements this requirement by permitting the imputation of liability to the master (the corporation) *only if* the fraudulent act and the fraudulent or reckless mind intersect in a single servant (the corporate employee).[177] As a consequence, an allegation under respondeat superior satisfies the PSLRA strong inference standard. The defendant corporation is placed on notice of who committed the fraudulent act and the state of mind of such an individual. Further, corporations are not subject to an untenable situation in which they are potentially liable for securities fraud based on the knowledge or reckless disregard of an employee who is uninvolved in the fraudulent act.

174. *See* HAZEN, *supra* note 14, at 629.

175. *See id.* at 629, 633–34 (noting that the PSLRA implemented new, special standards to combat abuses at the pleading stages of securities litigation).

176. RESTATEMENT (SECOND) OF AGENCY § 1(1) (1958).

177. *See, e.g.*, Gutter v. E.I. DuPont de Nemours, 124 F. Supp. 2d 1291, 1311 (S.D. Fla. 2000).

CONCLUSION

The advocacy for collective scienter is understandable given the highly publicized corporate scandals of the past decade. Such malfeasance undercuts investor confidence and the free flow of the market. The theory, however, is hindered by judicial and theoretical obstacles. Dependence on recent district court cases, as sampled above, is problematic. Further, the collective scienter doctrine fails on theoretical and policy grounds, even without the scrutiny of recent decisions. In the end, each version of the collective scienter doctrine, by ignoring fundamental agency and corporate law principles, fails to satisfy the heightened pleading requirements implemented by the PSLRA. Respondeat superior agency principles continue to be superior to any permutation of collective scienter.