THE NEW SECURITIES FRAUD PLEADING REQUIREMENT: SPEED BUMP OR ROAD BLOCK?

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When President Clinton vetoed the Private Securities Litigation Reform Act of 1995, the first provision to which he objected was the one that would require a plaintiff filing a complaint in an action for damages brought under Rule 10b–5 to "state with particularity facts giving rise to a strong inference that the defendant acted with [scienter]."[1] The President objected to this pleading requirement because it would "impose an unacceptable procedural hurdle to meritorious claims being heard in Federal courts."[2] More specifically, he claimed, it would erect a barrier "so high that even the most aggrieved investors with the most painful losses may get tossed out of court before they have a chance to prove their case."[3]

Prior to the President's veto message, this proposed pleading requirement had not attracted much attention. Most observers viewed it as little more than a codification of the Second Circuit's long-standing interpretation of Federal Rule of Civil Procedure 9(b), which requires a plaintiff in an action brought under Rule 10b–5 to plead with particularity "the circumstances constituting fraud."[4] There were few indications that plaintiffs who filed suits under Rule 10b–5 in the Second Circuit had been finding it unduly difficult to satisfy Rule 9(b).[5]

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1. The Private Securities Litigation Reform Act of 1995, Pub. L. No. 104–67, § 101(b), 109 Stat. 747, 104th Cong., 1st Sess. (1995), added this provision to the Securities Exchange Act of 1934 as § 21D(b)(2) (codified at 15 U.S.C.A. § 78u–4(b)(2) (West Supp. 1996).

2. *Private Securities Litigation Reform Act of 1995, Veto Message From the President of the United States*, H. DOC. NO. 150, 104th Cong., 1st Sess. (Dec. 19, 1995), *reprinted in* 141 CONG. REC. H15214–06, *available in* 1995 WL 752858 (daily ed. Dec. 20, 1995) (hereinafter "*Veto Message*").

3. *Id.*

4. The Second Circuit first set forth this requirement in Beck v. Manufacturers Hanover Trust Co., 820 F.2d 46, 50 (2d Cir. 1987), *cert. denied*, 484 U.S. 1005 (1988).

5. *But see infra* text accompanying notes 150–55.

Thus, few thought the proposed pleading requirement would have a dramatic impact on open market fraud litigation.[6]

Congress overrode the President's veto and thus added the new pleading requirement to the Securities Exchange Act of 1934 as § 21D(b)(2).[7] The question remains: Were the President's concerns well founded? Will this new pleading requirement operate as a road block, precluding prosecution of most meritorious claims of open market fraud? Or will § 21D(b)(2) constitute no more than a "speed bump"—an obstacle that may slow down potential plaintiffs, but that will not impede substantially a plaintiff whose claim has merit?

This paper addresses these fundamental questions. It also explores how new § 21D(b)(2) differs from the standards courts in the Second Circuit and elsewhere have been using to determine whether a complaint alleging open market fraud satisfies Rule 9(b). Finally, it suggests strategies that courts should employ when interpreting new § 21D(b)(2) so as to develop a more uniform and coherent body of law than they have developed when interpreting Rule 9(b).

Courts have handed down hundreds of decisions involving the application of Rule 9(b) to complaints alleging open market fraud.[8] In preparing this paper, I focused on decisions in five circuits—the First, Second, Third, Seventh and Ninth—in which most open market fraud cases are litigated. In each, I first identified a recent appellate decision that appeared to set forth a new (or newly refined) interpretation of Rule 9(b): *Greenstone v. Cambex Corp.*,[9] *In re Time Warner Securities Litigation*,[10] *Shapiro v. UJB Financial Corp.*,[11] *DiLeo v. Ernst & Young*,[12] and *In re GlenFed, Inc. Securities Litigation*.[13] Then I concentrated on trial and appellate court decisions handed down subsequent to those decisions.

Part I describes the problem at which new § 21D(b)(2) is directed. Part II explores the interpretive issues that new § 21D(b)(2) poses and concludes that its pleading requirement represents more of a speed bump than a road block to a plaintiff interested in pursuing a claim of open market fraud. Part II further concludes that because of the confused state of the law interpreting Rule 9(b), it is difficult to predict how § 21D(b)(2) will affect open market fraud litigation. Part III suggests lessons that courts should draw from extant decisions interpreting Rule 9(b) and strategies that courts should follow to implement Congress' purpose in enacting § 21D(b)(2).

I. THE PROBLEM

Section 21D(b)(2) can best be understood as a response to a problem posed by the structure of the typical open market fraud case. On Day 1 (D^1),

6. This paper was prepared for a conference that focused on issues involved in securities litigation relating to claims of open market fraud.

7. *See supra* note 1 and accompanying text.

8. A Westlaw search of the ALLFEDS database produced 1236 cases that cited both Rule 9(b) and Rule 10b-5 in the period from the end of 1985 to the end of 1995.

9. 975 F.2d 22 (1st Cir. 1992) (hereinafter *Greenstone*).

10. 9 F.3d 259 (2d Cir. 1993) (hereinafter *Time Warner*).

11. 964 F.2d 272 (3d Cir.), *cert. denied*, 113 S. Ct. 365 (1992) (hereinafter *Shapiro*).

12. 901 F.2d 624 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990) (hereinafter *DiLeo*).

13. 42 F.3d 1541 (9th Cir. 1994) (hereinafter *GlenFed*).

XYZ Corp. issues a public statement (S^1).[14] On some subsequent date (D^2), XYZ Corp. issues a second public statement (S^2) that either contradicts S^1 or is inconsistent with S^1. The price of XYZ Corp.'s stock declines sharply following the issuance of S^2.[15] Shortly thereafter, a plaintiff files a purported class action complaint, seeking tens or hundreds of millions of dollars in damages, on behalf of all persons who purchased the stock of XYZ Corp. between D^1 and D^2.[16]

In a few of the cases that fit this pattern, the information disclosed in S^2 will make it clear that S^1 was false when issued. In most cases that fit this pattern, though, the disparity between S^2 and S^1 will support no more than a reasonable suspicion that XYZ Corp. knew (or recklessly disregarded the possibility that) S^1 was false or misleading on D^1.[17]

However, the information in S^1 and S^2 generally will be sufficient to allow a person who purchased XYZ stock between D^1 and D^2 to file what I will call a "bare bones" complaint alleging that XYZ Corp. violated Rule 10b–5 when it issued S^1. That is, such a purchaser will be able to identify who made the statement at issue, what that person said, where and when she said it, and how the challenged statement injured plaintiff and the class of investors she seeks to represent. In addition to the "who, what, where, when and how"[18] of the alleged fraud, a prospective plaintiff, relying on the difference between S^1 and S^2, also will be in a position to allege, *at least in general terms*, that S^1 was false or misleading on D^1 and that XYZ Corp. (or such other person or persons as were responsible for S^1) acted with an intent to defraud the members of the plaintiff class or with reckless disregard for whether S^1 would have that effect.

The problem with which courts have been grappling—and the problem that § 21D(b)(2) addresses—is how much more to require of a plaintiff before allowing her to litigate a claim of open market fraud. While a bare bones complaint could be viewed as sufficiently particularized to satisfy Rule 9(b),[19]

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14. D^1 and S^1 could represent either a single date and a single statement or multiple dates and statements.

15. Most open market fraud cases involve claims that bad news was not disclosed. A few involve claims that a company failed to disclose positive information. The issue posed by both kinds of cases is much the same.

16. The rules courts follow to appoint lead counsel in class actions give plaintiffs' counsel an incentive to file a class action complaint as soon as possible after the event or events that give rise to a possible open market fraud suit. *See* Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2061–64 (1995). The Private Securities Litigation Reform Act of 1995 mandates new rules for the appointment of lead plaintiffs and class counsel that should reduce attorneys' incentive to file so quickly. *See Private Securities Litigation Reform Act of 1995–Conference Report*, 141 CONG. REC. S17933–04 (daily ed. Dec. 5, 1995), *available in* 1995 WL 713530 (hereinafter *Conference Report*); Private Securities Litigation Reform Act of 1995, Pub. L. No. 104–67, § 101, 109 Stat. 747, 104th Cong., 1st Sess. (1995).

17. Studies have found that open market fraud complaints are filed in a minority of the situations in which a stock's price changes sharply after announcement of unexpected news. I presume that one significant factor plaintiffs' lawyers use in determining whether to file suit is whether the difference between S^1 and S^2 is such as to suggest that S^1 was fraudulent.

18. *See DiLeo*, 901 F.2d at 626.

19. It seems clear that some courts at one time viewed a bare bones complaint as sufficiently particularized to meet the requirements of Rule 9(b). *See, e.g.*, Nicholas v. Poughkeepsie Sav. Bank/FSB, Fed. Sec. L. Rep. (CCH) ¶ 95,606, at 97,839 (S.D.N.Y. 1990)

courts in recent years uniformly have required a plaintiff to plead additional facts before allowing a suit alleging open market fraud to proceed. Courts have imposed these requirements to advance two purposes that Rule 9(b) is intended to serve: protecting the reputations of persons charged with fraud and preventing such persons from being victimized by so-called "strike suits"—open market fraud claims that have no merit but often have substantial settlement value.[20] Of the two, the latter seems to have been more important.

Courts have long recognized that a complaint alleging open market fraud that survives a motion to dismiss often has substantial settlement value even if plaintiffs' claim lacks merit. This is so largely because defendants generally must spend far more than plaintiffs to litigate a case involving a claimed open market fraud.[21] As the Supreme Court pointed out in *Blue Chip Stamps v. Manor Drug Stores*,

> The prospect of extensive deposition of the defendant's officers and associates and the concomitant opportunity for extensive discovery of business documents, is a common occurrence in this and similar types of litigation. To the extent that this process eventually produces relevant evidence which is useful in determining the merits of the claims asserted by the parties, it bears the imprimatur of those Rules and of the many cases liberally interpreting them. But to the extent that it permits a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the process will reveal relevant evidence, it is a social cost rather than a benefit.[22]

Consider how this dynamic relates to the prototypical situation described above. In many instances, the explanation for the disparity between S^1 and S^2 will not be that XYZ misrepresented material facts on D^1 but that events occurred between D^1 and D^2 that XYZ Corp. could not reasonably have foreseen on D^1.[23] If a court allows a plaintiff who filed a bare bones complaint to proceed with discovery in a situation that falls within the latter category, defendants, even though not guilty of any wrongdoing, may find that it is

("allegations of false and misleading statements, who made them, when they were made, and how they were disseminated are sufficient"); *In re* Midlantic Corp. Shareholder Litig., 758 F. Supp. 226 (D.N.J. 1990). *In re* First Chicago Corp. Sec. Litig., 769 F. Supp. 1444, 1453 n.4 (N.D. Ill. 1991), contrasts these cases with *DiLeo* and other more recent interpretations of Rule 9(b).

20. See *In re* Buffets, Inc. Sec. Litig., 1995 WL 702195 (D. Minn. 1995) (quoting TCF Banking & Sav. v. Arthur Young & Co., 706 F. Supp. 1408, 1411 (D. Minn. 1988)), which lists first the fact that Rule 9(b) "deters the use of complaints as fishing expeditions of unknown wrongs designed to compel *in terrorem* settlements." A bare bones complaint serves the third purpose of Rule 9(b), which is to provide a defendant with adequate notice of the conduct deemed fraudulent. *See id.*

21. *See* Janet C. Alexander, *Do The Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 548 (1991); John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 5, 17 (1985).

22. 421 U.S. 723, 741 (1975). Denny v. Barber, 576 F.2d 465, 470 (2d Cir. 1978), first identified these concerns as relevant to Rule 9(b).

23. For example, a sharp increase in a bank's bad debts may reflect either a sharp and unforeseen decline in relevant real estate markets between D^1 and D^2 or that S^1 misrepresented material facts.

cheaper to settle the litigation than to incur the cost of proving that the plaintiff's claim has no merit.[24]

The danger that defendants will find themselves in such a situation can be reduced by requiring plaintiffs to set forth facts, other than the disparity between S^1 and S^2, that suggest S^1 was false or misleading when issued.[25] However, to the extent that courts require plaintiffs to plead such facts, they create a countervailing danger. Defendants usually possess and control the evidence most pertinent to any determination of whether S^1 was false or misleading on D^1. Plaintiffs often can gain access to that information only through discovery. If courts do not take account of plaintiffs' inability to obtain access to such information, they may make it impossible for plaintiffs to satisfy Rule 9(b) in many situations in which fraud has occurred.

Given the dynamics of open market fraud litigation, it seems clear that no pleading requirement can be developed that will allow courts to determine with complete accuracy which complaints have merit and which do not. Any requirement that a plaintiff plead facts additional to those that would be included in a bare bones complaint will reduce strike suits and thus make it more difficult for plaintiffs to use "the litigation process as a device for extracting undeserved settlements."[26] But any such requirement also will make it more difficult for plaintiffs to "deter[] fraud in the securities markets [or] remedy[] it when it occurs."[27] The problem, in short, is how to construct a pleading standard applicable to open market fraud litigation that represents a reasonable trade off between these competing dangers. No standard will do the job perfectly. Knowledge that this is the case, however, "neither indicate[s] a sound basis for decision nor permit[s] avoidance of decision."[28]

II. WHAT DOES SECTION 21D(B)(2) REQUIRE?

In § 21D(b)(2), Congress drew the line as follows:

> In any private action arising under [the Securities Exchange Act of 1934] in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate [the 1934 Act], *state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.*[29]

Before turning to the question of whether this provision constitutes "a sound basis for decision," we must first address a threshold issue: To what "state of mind" does this pleading standard relate?

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24. Assuming that defendants do not expect to be sued again for securities fraud, they will find it to be more efficient to settle whenever the cost of settlement will be less than their litigation costs. *See* Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727, 741 (1995).

25. In most cases, such facts also will suggest that defendants acted with scienter when they issued S^1.

26. *See In re* Time Warner Sec. Litig., 9 F.3d 259, 263–64 (2d Cir. 1993).

27. *Id.*

28. *See id.* at 264.

29. Securities Exchange Act of 1934, as amended, § 21D(b)(2), Pub. L. No. 104–67, § 101(b), 109 Stat. 747, 104th Cong., 1st Sess. (1995) (codified at 15 U.S.C.A. 78u–4(b)(2) (West Supp. 1996)) (emphasis added). The Act further provides that a "court shall, on the motion of any defendant, dismiss the complaint if the requirements of [§ 21D(b)(2)] are not met." *Id.* § 21D(b)(3)(a) (codified at 15 U.S.C.A. 78u–4(b)(3)(a) (West Supp. 1996)).

A. The Required State of Mind

In *Ernst & Ernst v. Hochfelder*,[30] the Supreme Court held that proof that a defendant acted with scienter was a necessary element of a private action for damages under Securities Exchange Act § 10(b) and SEC Rule 10b–5. The Court defined scienter as "a mental state embracing intent to deceive, manipulate or defraud."[31] It reserved the question of "whether, in certain circumstances, [proof of] reckless behavior" will satisfy the scienter requirement.[32]

The Court has not subsequently addressed the question of whether proof of recklessness will suffice.[33] However, federal courts of appeals uniformly have held that it will.[34] The courts of appeals also appear to be reaching a consensus that a standard first adopted at the appellate level by the Seventh Circuit in *Sunstrand Corp. v. Sun Chemicals Corp.*[35] represents the appropriate definition of recklessness:

> Reckless conduct may be 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 and sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.[36]

For purposes of this paper, I assume that the courts of appeals have reached the right conclusion.[37] I also accept the *Sunstrand* court's observation that while this definition of recklessness "might not be the conceptual equivalent of intent as a matter of general philosophy, it does serve as a proper legally functional equivalent of intent...."[38] Consequently, I assume that to satisfy the requirements of § 21D(b)(2) in an action under Rule 10b–5, a plaintiff must state with particularity, in her complaint, facts that give rise to a strong

30. 425 U.S. 185 (1976).

31. *Id.* at 193–94 n.12.

32. *Id.*

33. On two occasions subsequent to *Hochfelder*, the Court again reserved this question. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 378 n.4 (1983); Aaron v. SEC, 446 U.S. 680, 686 n.5 (1980).

34. *See* Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568 n.6 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991) (citing cases from 11 circuits).

35. 553 F.2d 1033 (7th Cir. 1977), *cert. denied*, 434 U.S. 875 (1977).

36. *Id.* at 1044–45. The Ninth circuit most recently adopted this standard in *Hollinger*, 914 F.2d at 1569. *See also* Hackbart v. Holmes, 675 F.2d 1114, 1118 (10th Cir. 1982); SEC v. Carriba Air, Inc., 681 F.2d 1318, 1324 (11th Cir. 1982); Broad v. Rockwell Int'l Corp., 642 F.2d 929, 961–62 (5th Cir. 1981), *cert. denied*, 454 U.S. 965 (1981); McLean v. Alexander, 599 F.2d 1190, 1197–98 (3d Cir. 1979); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1025 (6th Cir. 1979); Cook v. Avien, Inc., 573 F.2d 685, 692 (1st Cir. 1978); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 46–47 (2d Cir. 1978), *cert. denied*, 439 U.S. 1039 (1978).

37. Numerous other commentators have addressed these issues. *See, e.g.*, Kevin R. Johnson, *Liability for Reckless Misrepresentations and Omissions Under Section 10(b) of the Securities Exchange Act of 1934*, 59 U. CINN. L. REV. 667 (1991); Bruce A. Mann, *Rule 10b-: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45 N.Y.U. L. REV. 1206 (1970); Paul S. Milich, *Securities Fraud Under Rule 10b-5: Scienter, Recklessness and the Good Faith Defense*, 11 J. CORP. L. 179 (1986).

38. 553 F.2d at 1045.

inference that the defendant acted with some degree of intent to deceive or defraud.[39]

B. The Fundamental Interpretive Issue

President Clinton explained his objection to § 21D(b)(2) largely by reference to changes that the Conference Committee made in the pleading standard approved by the Senate—a standard that he indicated he was prepared to support.[40] To assess his objection, one therefore must consider both the actions of the Senate and the actions of the Conference Committee.

The Senate Banking Committee developed the antecedent of § 21D(b)(2) as a part of S. 240, the securities litigation reform bill it reported on June 19, 1995.[41] Section 104(b) of the Committee bill provided:

> In any private action arising under [the Securities Exchange Act of 1934] in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate [the 1934 Act], specifically allege facts giving rise to a strong inference that the defendant acted with the required state of mind.[42]

Much of the confusion concerning how courts should interpret § 21D(b)(2) can be traced to the Senate Banking Committee's explanation of the pleading standard it proposed. The Committee first stated that to avoid "additional litigation," it had chosen "a uniform standard modeled upon the pleading standard" that has been used for many years by the Second Circuit.[43] The Committee noted that the Second Circuit's standard, "[r]egarded as the most stringent pleading standard,...requires that the plaintiff plead facts that give rise to a 'strong inference' of defendant's fraudulent intent."[44] But the Committee then added that it "does not intend to codify the Second Circuit's case law interpreting this pleading standard, although courts may find this body of law instructive."[45]

The Committee provided no further guidance as to how the proposed pleading standard should be interpreted or in what respect it believed "the Second Circuit's case law" might be "instructive." It thus made "additional litigation" inevitable, for courts around the country surely would take different

39. The Private Securities Litigation Reform Act of 1995 imposes other state of mind requirements for certain kinds of claims and defendants. Section 102 conditions liability for a "forward looking statement" on proof that defendant acted "with actual knowledge" that the challenged statement was false or misleading. Section 104 allows the SEC to prosecute for aiding and abetting any person who "knowingly provides substantial assistance" to another person who violates the Exchange Act. Section 201 provides that a person found liable in a private action shall be jointly and severally liable "only if the trier of fact specifically determines that such covered person knowingly committed a violation of the securities laws." Pub. L. No. 104–67, §§ 102, 104, 201, 109 Stat. 747, 104th Cong., 1st Sess. (1995). This paper will not analyze how these standards differ from the scienter standard that courts currently apply to actions under Rule 10b–5. It also will not consider how § 21D(b)(2) may affect cases that do not involve claims of open market fraud.

40. *See Veto Message*, *supra* note 2.

41. Specifically, S. 240, 104th Cong., 1st Sess. (1995).

42. *Id.* (as reported by the Senate Committee on Banking, Housing and Urban Affairs).

43. S. REP. NO. 98, 104th Cong., 1st Sess. 15 (1995).

44. *Id.*

45. *Id.*

positions concerning which of the Second Circuit's interpretations they should follow and which they were free to ignore.[46]

Senator Arlen Specter (R-Pa.) attempted to reduce the confusion by proposing to codify the two-part test that the Second Circuit had been using to determine whether a complaint gives rise to a "strong inference" of scienter. His amendment, which the Senate adopted, provided that, for purposes of the proposed pleading standard,

> a strong inference that the defendant acted with the required state of mind may be established either—
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> (A) by alleging facts to show that the defendant had both motive and opportunity to commit fraud; or
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> (B) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness by the defendant.[47]

The Conference Committee deleted this explanatory provision. It also substituted the term "plead with particularity" for the term "specifically allege" in the basic pleading standard.[48] The Conference Report explained that the second change was designed "to conform the language to Rule 9(b)'s notion of pleading with 'particularity.'"[49]

The Committee made several statements that appear germane to its decision to delete Senator Specter's amendment. First, it stated that its goal was "to establish uniform and more stringent pleading requirements to curtail the filing of meritless lawsuits."[50] Then it pointed out that the language of the proposed pleading standard "is based in part on the pleading standard of the Second Circuit."[51] It noted that "the Second Circuit requirement is that the plaintiff state facts with particularity, and that these facts, in turn, must give rise to a 'strong inference' of the defendant's fraudulent intent."[52]

The Committee then described the Second Circuit standard "as the most stringent pleading standard" and stated: "Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard."[53]

By way of explanation, the Committee added the following in a footnote: "For this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness."[54]

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46. Indeed, additional litigation would be necessary even if the Committee had expressed an intent to codify Second Circuit case law, since cases from that circuit leave many questions unanswered. *See infra* text accompanying notes 80–83, 97–101, 106–10.

47. 141 CONG. REC. S9150, S9170 (daily ed. June 27, 1995), *available in* 1995 WL 383008.

48. *Compare supra* text at note 29 *with* text at accompanying note 42.

49. *Conference Report, supra* note 16. Senator Christopher Dodd (D-Conn.), in urging the Senate to override the President's veto, further explained that this change was made in response to a request from the Judicial Conference of the United States "because 'particularity' already has a meaning under law and 'specifically allege' does not." 141 CONG. REC. S19034–01(daily ed. Dec. 21, 1995), *available in* 1995 WL 755359. Senator Dodd submitted a letter from Judge Anthony Scirica requesting that the change be made. *Id.*

50. *Conference Report, supra* note 16.

51. *Id.*

52. *Id.*

53. *Id.*

54. *Id.*, n.23. Senator Dodd, urging the Senate to override the President's veto, asserted that another reason the Conference Committee deleted Senator Specter's amendment was that it

President Clinton asserted that the Conference Report made it "crystal clear" that the Conferees "intended to 'strengthen' the existing pleading requirements of the Second Circuit."[55] He also concluded, at least implicitly, that the Conferees had constructed a barrier to meritorious claims "so high that even the most aggrieved investors with the most painful losses may get tossed out of court before they have a chance to prove their case."[56]

The President may be right. One can fairly read the Conference Report as expressing an intent to create a pleading requirement more stringent than that of the Second Circuit. One also could interpret the statutory language to require a plaintiff to include in her complaint facts sufficient to demonstrate that each defendant acted with an intent to defraud—a standard that plaintiffs would find it virtually impossible to satisfy.

But these are neither the only reasonable interpretations nor the most reasonable interpretations of the Conference Report or, more importantly, of § 21D(b)(2). An alternative reading of the Conference Report is that it expresses an intent only to create a pleading standard more stringent than the relatively relaxed interpretations of Rule 9(b) some circuits have adopted. Even if one agrees that the Conferees intended the new standard to be somewhat more stringent than the Second Circuit's standard, nowhere does the Conference Report indicate what the Conferees understood the Second Circuit's standard to be or how much more stringent they intended the new standard to be.[57]

Creation of an insurmountable barrier to potentially meritorious claims also would defeat the Conferees' overall goal. The Conference Report acknowledges that "[p]rivate securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action" and that "private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs."[58] The Report further states that the goal of reform legislation is "to return the securities litigation system to that high standard,"[59] not to frustrate investors whose claims have merit.

C. What Facts Support an Inference of Scienter?

The Second Circuit has recognized that it is "unrealistic to expect a plaintiff [in a securities fraud case] to plead a defendant's actual state of

incorrectly stated the law of the Second Circuit. The case that first set forth the two-part test also stated that, where plaintiff cites no evidence of motive, "the strength of the circumstantial allegations [indicating conscious misbehavior or recklessness] must be correspondingly greater." 141 CONG. REC. S19034–01 (daily ed. Dec. 21, 1995), *available in* 1995 WL 755359 (statement of Sen. Dodd, citing Beck v. Manufacturers Hanover Trust Co., 820 F.2d 46, 50 (2d Cir. 1987), *cert. denied*, 484 U.S. 1005 (1988)).

55. *Veto Message*, *supra* note 2.

56. *Id.*

57. Given that the pleading standard proposed by the Conference Committee is virtually identical to that proposed by the Senate Banking Committee, *see supra* note 48 and accompanying text, there is no reason why a court should treat the Conference Report as any more authoritative than the Senate Committee Report. Of the two, the former is the more ambiguous as to the meaning of the proposed standard.

58. *Conference Report*, *supra* note 16.

59. *Id.*

mind."[60] Consequently, that court allows plaintiffs to satisfy Rule 9(b) by pleading facts that suggest defendant (a) had a motive and the opportunity to misrepresent material facts in S^1 or (b) consciously or recklessly misrepresented material facts in S^1.[61] Where plaintiff is unable to plead facts suggesting motive, "the strength of [her] circumstantial allegations must be correspondingly greater."[62]

The rationale underlying this two-part test is relatively straightforward. Experience teaches that a person who stands to benefit by misrepresenting material facts is more likely to do so than a person who will realize no benefit from her fraud. Thus, where plaintiff pleads particularized facts that suggest defendant stood to benefit by misrepresenting material facts in S^1, the Second Circuit treats those allegations as sufficiently indicative that plaintiff's case has merit to allow a plaintiff to proceed.[63] Where plaintiff is unable to plead facts suggesting motive, the court will allow her to proceed only if she can allege facts that more directly indicate defendant knew or recklessly disregarded the possibility that S^1 was materially misleading.[64]

Courts in other circuits have not always framed their pleading requirements in exactly the same terms, but a review of the case law suggests that they have relied on much the same general approach to determine whether a plaintiff has met the requirements of Rule 9(b). Indeed, it is hard to imagine how a court might otherwise frame this pleading requirement, unless its objective was to eliminate all suits alleging open market fraud by requiring plaintiffs to plead facts demonstrating defendants' actual state of mind.

Case law is far less consistent with regard to what facts suggest defendant had a motive to defraud, what facts suggest defendant consciously or recklessly engaged in material misrepresentation, and when a court will conclude such facts give rise to a *strong* inference of scienter.

1. Motive and Opportunity

Case law is most clear with respect to motive. Courts uniformly look to whether defendant stood to realize some financial benefit by misrepresenting

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60. Powers v. British Vita, P.L.C., 57 F.3d 176, 184 (2d Cir. 1995) (quoting Drexel Burnham Lambert Group, Inc. v. Microgenesys, Inc., 775 F. Supp. 660, 664 (S.D.N.Y. 1991)).

61. The Second Circuit first set forth this two-part test in Beck v. Manufacturers Hanover Trust Co., 820 F.2d 46, 50 (2d Cir.1987), *cert. denied*, 484 U.S. 1005 (1988).

62. *Id.*

63. Whether a court should view evidence of motive and of a disparity between S^1 and S^2 as sufficient to support a verdict for plaintiff, or even as sufficient to defeat a defendant's motion for summary judgment, present very different questions. At later stages of the litigation, plaintiff will have had access to defendants' files and will have had an opportunity to depose defendants. Thus one could argue that a court, at a later stage of the litigation, should require plaintiff to produce more direct evidence that S^1 was materially false or misleading. At the pleading stage, though, courts uniformly hold that evidence of motive is sufficient to satisfy Rule 9(b).

64. Another way to describe this approach is to say that courts do not allow a plaintiff to plead "fraud by hindsight"—i.e., to satisfy Rule 9(b) by arguing by that the disparity between S^1 and S^2 is sufficient to create a reasonable belief that S^1 "must have been" false or misleading as of D^1. Plaintiff must plead facts indicating either that defendant had a motive to misrepresent material facts on D^1 or that, as of D^1, defendant knew or recklessly disregarded the possibility that S^1 was materially false or misleading.

material facts in S^1.[65] Where plaintiff alleges that defendant sold a significant amount of stock at a price influenced by an alleged material misrepresentation,[66] courts uniformly have held such allegations to be sufficient to support a strong inference of scienter.[67]

Plaintiffs who are unable to cite stock sales often allege that a corporation's managers were motivated to suppress negative information by a desire to maintain their positions, enhance their compensation, or protect the value of their stock holdings. In two recent cases, the Second Circuit held that such allegations, at least when made in general terms, did not satisfy Rule 9(b). *Shields v. Citytrust Bancorp, Inc.*[68] involved claims that a bank delayed releasing news about a sharp decline in the quality of its loan portfolio. The Second Circuit held that the complaint was properly dismissed because "a plaintiff must do more than merely charge that executives aim to prolong the benefits of the positions they hold."[69] It explained:

> If motive could be pleaded by alleging the defendant's desire for continued employment, and opportunity by alleging the defendant's authority to speak for the company, the required showing of motive and opportunity would be no realistic check on aspersions of fraud, and mere misguided optimism would become actionable under the securities laws.[70]

In *Acito v. IMCERA Group, Inc.*,[71] the court held that no inference of fraud could be drawn from plaintiffs' generalized claim that defendants suppressed certain information in order to increase their incentive compensation. It argued:

> 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.... Therefore, we hold that the existence, without more, of executive compensation dependent upon stock value does not give rise to a strong inference of scienter.[72]

In contrast, other courts appear to have allowed plaintiffs to proceed on the basis of generalized allegations of managerial self-interest. Plaintiff in *Morse v. Abbott Laboratories*[73] alleged that Abbott had delayed disclosing that

65. *See* Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1130 (2d Cir. 1994) ("Motive would entail concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged."); *id.* (citing Atlantic Gypsum Co. v. Lloyds Int'l Corp., 753 F. Supp. 505, 514 (S.D.N.Y. 1990)) (the court assumes defendants acted in their "informed economic self-interest.")

66. A defendant also can benefit by buying stock after misleading investors as to positive developments affecting an issuer. However, the vast majority of open market fraud cases involve sales by defendants who allegedly have withheld bad news.

67. *See, e.g.*, Searls v. Glasser, 1993 WL 28746 (N.D. Ill. Feb. 3, 1993) (holding allegations that defendants exercised stock options and immediately sold stock satisfy Rule 9(b)). *But cf.* Searls v. Glasser, 64 F.3d 1061, 1068 (7th Cir. 1995) (granting summary judgment to defendants who had rebutted inference of fraud). Of course, what constitutes significant stock sales can pose difficult line-drawing questions. *See* Jordan Eth & Michael Dicke, *Insider Stock Sales in Rule 10b-5 Corporate Disclosure Cases: Separating the Innocent from the Suspicious*, 1 STAN. J. L., BUS. & FIN. 97 (1994).

68. 25 F.3d 1124 (2d Cir. 1994).

69. *Id.* at 1130.

70. *Id.*

71. 47 F.3d 47 (2d Cir. 1995). *See also* Tuchman v. DSC Communications Corp., 14 F.3d 1061 (5th Cir. 1994).

72. *Id.* at 54.

73. 756 F. Supp. 1108 (N.D. Ill. 1991).

the FDA had found major problems at one of Abbott's laboratories and had issued severe regulatory sanctions against Abbott. The court held that the complaint satisfied Rule 9(b) because "the individual defendants, all directors and/or senior officers, have incentive to withhold disclosure of material information which would have an adverse effect on Abbott. These facts...'afford a basis for believing that plaintiffs could prove scienter.'"[74]

Similarly, plaintiffs in *Kas v. Caterpillar, Inc.*[75] alleged that executives of Caterpillar misrepresented that company's 1989 results by failing to disclose that Caterpillar generated twenty percent of its profits in Brazil as a consequence of unique economic conditions there. The court held plaintiffs had adequately alleged motive because "[i]n the instant case, defendants were controlling persons, insiders, and officers who had everything to gain or lose depending on how the shareholders, and the market in general, perceived their performance."[76]

In *Siebert v. Nives*,[77] the court denied defendants' motion to dismiss on Rule 9(b) grounds because plaintiffs had alleged facts from which, the court concluded, "a credible motive for committing fraud may be inferred."[78] Specifically: "As corporate insiders, these defendants arguably had an interest in keeping the stock price at an artificially inflated level in order to protect their positions and compensation."[79]

Insofar as *Shields* and *Acito*[80] hold that generalized claims that corporate managers acted to retain the benefits of their positions or to enhance their compensation are not sufficiently particular to satisfy Rule 9(b), they seem more consistent with the purposes of § 21D(b)(2) than *Morse*, *Kas* and *Siebert*.[81] Courts should not allow plaintiffs to litigate claims of open market fraud on the basis of vague and generalized allegations that could be made with respect to almost any public corporation. Rather, courts should require plaintiffs to identify with reasonable specificity the economic benefits that defendants stood to realize by misrepresenting material facts.

Plaintiffs, for example, might draw on the executive compensation disclosures in corporate proxy statements to explain how, by inflating the price of a company's stock or the earnings it has reported, that company's executives were able to increase their incentive compensation. The court then could address—as it would in a case involving alleged stock sales—whether the benefits allegedly realized by defendants are sufficiently large to constitute

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74. *Id.* at 1111 (quoting *DiLeo*, 901 F.2d 624, 629 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990)).

75. 815 F. Supp. 1158 (C.D. Ill. 1992).

76. *Id.* at 1165.

77. 871 F. Supp. 110 (D. Conn. 1994) (Cabranes, J.).

78. *Id.* at 118.

79. *Id. See also In re* Wells Fargo Sec. Litig., 12 F.3d 922 (9th Cir. 1993), *cert. denied*, 115 S. Ct. 295 (1994).

80. The comments in this section made about *Shields* and *Acito* also apply to Tuchman v. DSC Communications Corp., 14 F.3d 1061, 1068–69 (5th Cir. 1994).

81. Neither *Morse* nor *Kas* details plaintiffs' allegations, which creates some uncertainty concerning the basis for those decisions. *Morse*, 756 F. Supp. 1108 (N.D. Ill. 1991); *Kas*, 815 F. Supp. 1158 (C.D. Ill. 1992). In *Morse*, the court may have held only that, in relation to the information at issue, Abbott's directors and officers had reason to fear Abbott would suffer financially if information about quality control problems in its laboratory was disclosed, not that a corporation's officers and directors always have a motive to suppress adverse news. *Kas*, however, seems to read *Morse* more broadly. *See* 815 F. Supp. at 1165.

evidence of motive. If the benefits are of sufficient magnitude, the court should hold that the plaintiff has satisfied § 21D(b)(2).

The problem posed by *Shields* and *Acito* is that both courts explain their conclusions partly in result-oriented terms—they seem to suggest that plaintiffs should never be allowed to claim that corporate managers were motivated by a desire to enhance their compensation because *that will make it too easy for plaintiffs to satisfy the motive and opportunity test.*[82] Such reasoning does not withstand scrutiny. It also denies reality. In an era in which many tout incentive compensation as the most effective means of motivating corporate executives to perform efficiently,[83] and such compensation often dwarfs executives' base salaries, it seems more than plausible that some executives will be motivated to misrepresent material facts by a desire to increase the incentive compensation that they appear entitled to receive. Courts should not deny this possibility in cases where plaintiffs plead particularized facts that suggest the presence of such a motive.

2. Conscious or Reckless Misbehavior

What facts constitute strong circumstantial evidence that a defendant consciously or recklessly misrepresented material information? In a case where S^2 makes it clear that historical information in S^1 was false, information drawn from S^2 usually will suffice. Consider *In re Valence Technology Securities Litigation.*[84] Valence made an initial public offering in May 1992 and two additional public offerings in November 1992 and December 1993 to raise capital for the purpose of developing and producing "advanced lithium polymer rechargeable batteries for use in a variety of consumer electronic products, including cellular telephones, portable computers, and automobiles."[85] In each of these public offerings, Valence asserted: "The Company has *completed basic research* for its batteries, has *manufactured* limited quantities of *working prototypes* and is *presently developing* the enhancements necessary to support *commercial introduction* of its products."[86]

Valence subsequently announced that it had received contracts from Motorola and Hewlett Packard worth $100 million and $35 million, respectively, to supply them with advanced lithium polymer rechargeable batteries. Then, in August 1994, Valence announced that it was abandoning its advanced lithium polymer rechargeable battery project and that it had not delivered any batteries to Motorola or Hewlett Packard. The price of Valence stock declined sharply on this news.

Plaintiffs recited these facts and described in detail adverse conditions and technical problems that plaintiffs alleged were known to Valence at the time it made its public offerings. Plaintiffs alleged that these facts demonstrated that Valence had not "completed basic research" and had never developed any "working prototypes." The court held plaintiffs' allegations satisfied Rule 9(b).

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82. *See supra* notes 70, 72 and accompanying text.
83. *See, e.g.*, Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990); Geoffrey Colvin, *How to Pay the CEO Right*, FORTUNE, Apr. 6, 1992, at 60.
84. 1995 WL 274343 (N.D. Cal. May 8, 1995).
85. *Id.* at *1.
86. *Id.* at *3 (emphasis added by court).

The issue becomes somewhat more complex in a case where the information in S^2 is inconsistent with "the earlier, cheerier"[87] information in S^1 but does not establish that S^1 was false or misleading as of D^1. Courts uniformly refuse to allow plaintiffs to claim fraud by pointing to the inconsistency between S^1 and S^2, noting that such a claim amounts to no more than "fraud by hindsight."[88] Instead, courts require plaintiffs to specify facts that were in existence as of D^1 and that suggest S^1 was materially false or misleading. They also require plaintiffs to specify the basis for their claim that defendants knew or recklessly disregarded those facts.[89]

If a plaintiff meets these requirements, two other questions often arise. Must plaintiff also allege facts sufficient to demonstrate that defendant knew or recklessly disregarded the likelihood that S^1 was *materially* misleading or, in a case involving silence, that defendant consciously or recklessly disregarded her duty to speak?

It would appear inconsistent with *Hochfelder*[90] to suggest that a person can be held liable under Rule 10b–5 because she consciously made a statement that she negligently concluded did not omit or misrepresent a *material* fact. The same can be said of a person who violated Rule 10b–5 by remaining silent because she erroneously, but in good faith, believed that she had no duty to speak.

However, it is one thing to say that a defendant cannot be held liable because she negligently concluded that information was not material or that she had no duty to speak, and quite another thing to say that a court should require plaintiffs to plead facts sufficient to create a strong inference that defendant knew (or recklessly disregarded) that a challenged statement was materially misleading or that she had a duty to speak. Were the courts to impose such a pleading requirement, they would protect from the costs of litigation many defendants whose "wrongdoing" consists of no more than negligence—a result entirely consistent with Rule 9(b) and § 21D(b)(2). But such a requirement also would foreclose many suits in which a jury ultimately could conclude that the defendant misrepresented material facts (or failed to speak) with an intent to defraud.

Courts seem to have avoided dealing explicitly with this issue.[91] My review of the case law suggests that they use what might best be called a

87. *See In re* GlenFed, Inc. Sec. Litig., 42 F.3d 1541, 1549 (9th Cir. 1994).

88. Judge Henry Friendly coined this term in Denny v. Barber, 576 F.2d 465, 470 (2d Cir. 1978).

89. Ross v. A.H. Robins Co., 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980), is the leading case setting forth these requirements. The court held that plaintiff must identify the facts they claimed defendants should have known at time defendants made certain challenged statements about the safety and efficacy of the Dalkon Shield and must plead some factual basis for their claim that defendants possessed that information at the time those statements were made.

90. *See supra* notes 30–32 and accompanying text.

91. The most explicit treatment of it I have found is Judge John Newman's dissenting opinion in Powers v. British Vita, P.L.C., 57 F.3d 176 (2d Cir. 1995). Judge Newman argued that Powers' complaint did not support an inference of fraud, because the "'conscious behavior' approach to scienter cannot mean that scienter is adequately pleaded whenever a plaintiff alleges that a defendant is 'conscious' of what it is doing." *Id.* at 192 (Newman, J., dissenting) (citations omitted). The *Powers* majority did not address Newman's argument directly. Rather, it held that the complaint adequately alleged "facts demonstrating 'conscious behavior'" evincing

"sliding scale" approach. The more obvious it is that information was material or that the defendant had a duty to speak, the more inclined a court will be to find that a plaintiff has alleged facts that support an inference of conscious or reckless wrongdoing, and vice versa.[92]

Time Warner[93] illustrates the nebulous quality of the case law in this area. Time Warner needed a large amount of capital to pay down debt. In 1989, Time Warner announced plans to seek that capital by arranging "strategic alliances" with foreign firms. On June 6, 1991, Time Warner announced that its efforts to raise the funds it needed through "strategic alliances" had fallen short and that it would seek capital by means of a potentially coercive rights offering. The price of Time Warner stock dropped from $117 on June 5 to $94 on June 12.[94]

Plaintiffs filed suit alleging, inter alia, that Time Warner had violated Rule 10b–5 by not disclosing its change of plans at an earlier date.[95] The district court dismissed plaintiffs' complaint. The court of appeals reversed. It held, first, that plaintiffs could recover on their "duty to update" theory, because "when a corporation is pursuing a specific business goal and announces that goal as well as an intended approach for reaching it, it may come under an obligation to disclose other approaches to reaching the goal when those approaches are under active and serious consideration."[96]

The court also held that plaintiffs' allegations concerning defendants' motive to delay disclosing Time Warner's change in strategy satisfied Rule 9(b)[97] but that plaintiffs' claim that defendants consciously or recklessly violated their duty to update did not. In discussing motive, the court noted that plaintiffs' complaint adequately alleged that "actionable nondisclosure occurred after May 1."[98] But the court then based its rejection of plaintiffs' claim of conscious or reckless wrongdoing on the seemingly inconsistent conclusion that "the complaint lacks allegations that give rise to a strong inference that Time Warner began to consider the right offering significantly before it was announced."[99]

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an intent to defraud because Powers had alleged that British Vita "took measures to effectuate his removal and gain control of Spartech soon after the ink was dry on the agreements manifesting its benign intentions." *Id.* at 185 (citation omitted). The court found "these allegations of conscious behavior, which go beyond mere non-performance, sufficient to support an inference of intent to defraud." *Id.* The court also stated: "Defendants' decision not to disclose the Plan to Powers despite his clear interest and his position as a director is sufficient conscious behavior to give rise to an inference of fraudulent intent." *Id.* at 189.

92. *E.g., compare In re* Healthcare Compare Corp. Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 98,633 (Feb. 13, 1995) (holding that complaint satisfied Rule 9(b)) and Boltz v. Flagship Partners Ltd. Partnership, 1990 WL 125411 (N.D. Ill. Aug. 22, 1990) (same) *with* Lindner v. Brinckman, 1993 WL 294005 (N.D. Ill. Aug. 4, 1993) (dismissing complaint) and Robin v. Arthur Young & Co., 915 F.2d 1120 (7th Cir. 1990), *cert. denied*, 499 U.S. 923 (1991) (affirming dismissal of complaint).

93. 9 F.3d 259 (2d Cir. 1993).

94. *Id.* at 262.

95. Plaintiffs also asserted several other claims which the court dismissed. *Id.* at 266–67.

96. *Id.* at 268.

97. This aspect of *Time Warner* is discussed in more detail *infra* in the text accompanying notes 106–10.

98. 9 F.3d at 269.

99. *Id.* at 271.

One plausible explanation for the latter conclusion is that the court found the complaint insufficient because it did not give rise to a strong inference that defendants knew (or recklessly disregarded) that information about the rights offering was material or that they had a duty to update Time Warner's prior statements about its financing plans.[100] But the court's opinion does not make clear whether it relied on this or some other rationale.[101]

C. What Do the Courts Mean by a "Strong" Inference of Scienter?

Courts interpreting § 21D(b)(2) surely will embrace existing case law holding that a plaintiff cannot create an inference of scienter simply by characterizing a defendant's conduct as "fraudulent." *Robin v. Arthur Young & Co.*[102] is one of many cases in which courts have dismissed complaints that relied on such characterizations of defendants' behavior. The court there explained:

> Assertions that Arthur Young had knowledge that the prospectus was false and misleading and that Arthur Young knowingly and intentionally aided and abetted the primary violators are nothing more than rote conclusions....[W]hile the defendant's mental state need not be pleaded with particularity, 'the complaint must still afford a basis for believing that plaintiffs could prove scienter.' Plaintiffs' amended complaint fails to do this.
>
> For example, the amended complaint alleges that Arthur Young consented to the use of its report in the prospectus while knowing that the prospectus was false and misleading. Yet it alleges no facts to show how Arthur Young knew that the basis for its decision to issue an unqualified report was no longer sound. How Arthur Young would have known, however, is important in this case....
>
> Plaintiffs' claims that Arthur Young should have known that the prospectus was false and misleading also fail to allege scienter. While reckless conduct may satisfy the scienter requirement, bare allegations that Arthur Young should have known or that its knowledge was due to

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100. *Cf. id.* at 268. Time Warner's managers also could reasonably have concluded that they had no "duty to update." The cases the court cited to support the existence of such a duty dealt with clearly distinguishable situations in which a corporation had issued a new and misleading public statement that conflicted with an earlier statement or in which insiders traded on the basis of material non-public information that conflicted with earlier public statements a company had made. *See* Glazer v. Formica Corp., 964 F.2d 149, 156 (2d Cir. 1992), cited by the majority (holding that nondisclosure of material information is fraudulent only if one is trading or if one otherwise speaks as to a matter to which the undisclosed information is pertinent), and Kronfeld v. TWA, 832 F.2d 726 (2d Cir. 1987), *cert. denied*, 485 U.S. 1007 (1988), cited by Winter, J., dissenting (involving an incomplete and therefore misleading disclosure). Moreover, as the Seventh Circuit recently has pointed out, there is no functional difference between a "duty to update" and a general duty to disclose (which the *Time Warner* court acknowledged does not exist). *See* Stransky v. Cummins Engine Co., Inc., 51 F.3d 1329 (7th Cir. 1995) (distinguishing between information that updates a prior, forward-looking statement, and newly discovered information that demonstrates a prior statement was false or misleading *when made* and holds that only corrective information of the latter kind must be disclosed).

101. *Time Warner* was written by Judge Newman, whose subsequent dissent in *Powers*, *see supra* note 91, suggests that he believes a plaintiff must plead facts that suggest not only that defendant made a materially misleading statement or failed to disclose material information, but that defendant knew or recklessly disregarded the possibility that her conduct was unlawful.

102. 915 F.2d 1120 (7th Cir. 1990), *cert. denied*, 499 U.S. 923 (1991).

a reckless disregard of the truth are not sufficient to turn a possible negligence or malpractice action into an action for securities fraud.[103]

Several more complex interpretive questions will arise, though, when courts turn to the question of when more particularized allegations should be deemed to give rise to a "strong inference" of scienter. The first is how to relate this requirement to the well-established rule that a court, when reading a complaint, shall draw all reasonable inferences in favor of plaintiff.[104] Nothing in the language or the legislative history of § 21D(b)(2) directs courts to abandon this rule. The Second Circuit, when passing on motions to dismiss under Rule 9(b), draws all reasonable inferences in favor of plaintiff.[105] Consequently, a court should dismiss a complaint under § 21D(b)(2) only if, *when reasonably construed in the manner most supportive of plaintiff's allegations*, it fails to set forth with particularity facts that give rise to a strong inference of scienter.

The *Time Warner* court's discussion of motive illustrates the Second Circuit's application of this approach. Plaintiffs argued that defendants had delayed disclosing Time Warner's plan to raise funds through a rights offering in the hope that, when the offering was made, Time Warner would realize a higher price for its stock.[106] Defendants ridiculed this claim, noting that whenever Time Warner announced the rights offering, it would be required to wait several weeks before actually selling stock.[107] During that period, defendants claimed, investors surely would incorporate news of rights offering into their valuations of Time Warner stock. Consequently, defendants could not realistically have expected to realize a benefit from any delay in announcing the offering.

The court acknowledged that defendants' argument had some merit,[108] but then stated: "Since the laws of economics have not yet achieved the status of the law of gravity, we cannot say, *on a motion to dismiss*, that plaintiffs cannot prove that a motive existed."[109]

Plaintiffs, the court continued, should have an opportunity to prove that defendants' goal was to increase the price at which Time Warner could sell stock, even if that goal was unrealistic.[110] To reach this conclusion, the court

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103. *Id.* at 1127 (citation omitted).
104. *See* Conley v. Gibson, 355 U.S. 41, 45–46 (1957).
105. Mills v. Polar Molecular Corp., 12 F.3d 1170, 1174 (2d Cir. 1993).
106. *Time Warner*, 9 F.3d at 269.
107. *Id.*
108. Judge Ralph Winter wrote a spirited dissent supporting defendants' claim. *See Time Warner*, 9 F.3d 259, 272 (2d Cir. 1993) (Winter, J., dissenting).
109. *Id.* at 271 (emphasis added).
110. *Compare* Thornton v. Micrografx, Inc., 878 F. Supp. 931, 938 (N.D. Tex. 1995), in which the court, applying Second Circuit law, stated:

> Plaintiffs draw inferences of wrongdoing based upon a nonsensical premise. Why would the Defendants expend so much time and effort to conceal facts and misrepresent information to a host of securities analysts, successfully orchestrating the artificial inflation of Micrografx stock to $32 a share, and then sit back *while the stock slides daily for seven weeks to half that price* to begin enjoying the fruits of their fraud by selling their stock? And when they finally sell their stock, sell it back to Micrografx for $15 to $16 per share, which for the majority of the stock was some ten percent less than the current market price? Plaintiffs' unpersuasive explanation appears to be, 'they committed fraud, they just weren't very good at it.' The Court refuses to leave its common sense at the

must have drawn all inferences in favor of plaintiffs when reading their complaint.

Time Warner's discussion of motive also is pertinent to a second interpretive issue: that what facts "give rise to a strong inference" of scienter of necessity will depend, to a considerable degree, on the eyes of the beholder.[111] Consider, for example, the contrast between the approach taken by the *Time Warner* court and that taken by the Seventh Circuit in *DiLeo v. Ernst & Young*.[112]

The complaint in *DiLeo* resembled the hypothetical bare bones complaint discussed above. Concluding that it should be dismissed for failure to satisfy Rule 9(b), the court set forth a pleading standard that appeared to be somewhat less demanding than that of the Second Circuit: "Because only a fraction of financial deteriorations reflects fraud,...plaintiffs may not proffer the different financial statements and rest. [Plaintiffs] must point to some [additional] facts *suggesting that the difference is attributable to fraud*."[113]

Facts that *suggest the difference between* S^1 *and* S^2 *is attributable to fraud*, one can assume, often will not be sufficient to give rise to a *strong inference* of fraud.

Plaintiffs appear to have based their claim of fraud against defendant Ernst & Whinney ("E&W") on one fact—that it had been motivated by a desire to earn audit fees. One inclined to draw all reasonable inferences in plaintiffs' favor might have held this was sufficient to create a suspicion of fraud.

The court was not so inclined or, perhaps more accurately, it concluded that such an inference would not be reasonable. Its reasoning was as follows:

> An accountant's greatest asset is its reputation for honesty, followed closely by its reputation for careful work. Fees for two years' audits could not approach the losses E & W would suffer from a perception that it would muffle a client's fraud. And although the interests of E & W's partners and associates who worked on the Continental audits may have diverged from the firm's,...covering up fraud and imposing large damages on the partnership will bring a halt to the most promising career. E & W's partners shared none of the gain from any fraud and were exposed to a large fraction of the loss. It would have been irrational for any of them to have joined cause with Continental.
>
> People sometimes act irrationally, but indulging ready inferences of irrationality would too easily allow the inference that ordinary business reverses are fraud. One who believes that another has behaved

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> courthouse steps, and concludes that the Plaintiffs have failed to make the requisite showing of scienter to support their securities fraud claims.

Id. (footnote omitted).

111. *See In re* Healthcare Compare Corp. Sec. Litig., 75 F.3d 276, 285 (7th Cir. 1996) (Ripple, J., dissenting):

> Reasonable minds can—and will—differ on the adequacy of the factual specificity in an allegation of fraud. The issue is, by its nature, case specific and neither the case law of this circuit nor the case law of the other circuits can make any claim to being a seamless garment.

112. 901 F.2d 624 (7th Cir. 1990), *cert. denied*, 498 U.S. 941 (1990).

113. *Id.* (emphasis added).

> irrationally has to make a strong case.... The complaint does not come close.[114]

DiLeo highlights another issue as well. The court there side-stepped the question of whether plaintiff must plead with particularity facts suggesting that defendant acted with scienter or whether a complaint that details the "circumstances constituting fraud" and suggests the possibility of fraud will suffice. The Ninth Circuit, sitting *en banc*, recently confronted this issue. In *GlenFed*,[115] it held that Rule 9(b) requires a plaintiff to do no more than plead with particularity "the circumstances constituting fraud." The second sentence of Rule 9(b), the Ninth Circuit reasoned, makes it clear that a plaintiff may aver scienter "simply by saying that scienter existed."[116] Plaintiff is not required to plead facts that satisfy the Second Circuit's "strong inference of scienter" test.

From this, one might conclude that § 21D(b)(2) will have a major impact on open market fraud cases brought in the Ninth Circuit. That, however, is not at all clear. The *GlenFed* court described its pleading requirement as follows:

> To allege fraud with particularity, a plaintiff must set forth *more* than the neutral facts necessary to identify the transaction. The plaintiff must set forth what is false or misleading about a statement, and why it is false. In other words, the plaintiff must set forth an explanation as to why the statement or omission complained of was false or misleading. A plaintiff might do less and still identify the statement complained of; indeed, the plaintiff might do less and still set forth some of the circumstances of the fraud. But the plaintiff cannot do anything less and still comply with Rule 9(b)'s mandate to set forth with particularity those circumstances which *constitute* the fraud.[117]

The *GlenFed* court went on to discuss how this requirement applies to different kinds of open market fraud cases. It pointed out that where S^2 appears to demonstrate that S^1 was materially false, that alone usually will be sufficient to support an inference of scienter.[118] The court also noted that in most other cases, even though Rule 9(b) does not require a plaintiff to set forth facts from which scienter can be inferred, a requirement that plaintiff "[s]et[] forth contemporaneous statements or conditions [that indicate S^1 was misleading] may well have the incidental effect of causing plaintiff to allege circumstances from which scienter can be inferred."[119]

Whether a complaint that would satisfy the *GlenFed* court also would meet the requirements of § 21D(b)(2) depends in large part on how courts construe this new statutory provision.[120] Consider, in this regard, Judge Louis

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114. *Id.* at 629. The court added that the complaint "offers only rote conclusions," *id.*, but its reference to two years of audit fees appears to belie this statement.

115. *In re* GlenFed, Inc. Sec. Litig., 42 F.3d 1541 (9th Cir. 1994).

116. *Id.* at 1547.

117. *Id.* at 1548.

118. *Id.* at 1549.

119. *Id.*

120. Another important issue is what a court considers to be a particularized fact. In Fecht v. Price Co., 70 F.3d 1078, 1082–84 (9th Cir. 1995), *cert. denied*, 116 S. Ct. 1422 (1996), plaintiffs pled "the circumstances constituting fraud" largely by reciting statements made by defendants and then asserting in rather general terms that the contrary of those statements was true. Defendants argued that this amounted to no more than pleading fraud by hindsight. The court disagreed and held that the complaint satisfied Rule 9(b). *Id.* at 1084. *See also* Warshaw v. Xoma Corp., 74 F.3d 955 (9th Cir. 1996) (relying on *Fecht* and reaching a similar conclusion).

Pollak's decision in *In re Valuevision International Inc. Securities Litigation.*[121] Plaintiffs there argued that defendants

> had at least two plausible reasons for intentionally misleading the public into believing that it was likely that they would obtain financing. First, defendants were trying to convince National Media's board to accept the deal; if Valuevision had been more candid about the contingencies attendant on obtaining the necessary financing, National Media might not have agreed to pursue the deal. Second, by giving the impression that financing would not present an obstacle, defendants attempted to ward away other potential bidders for National Media.[122]

Judge Pollak stated: "Although this explanation of defendants' possible motives for committing fraud is perhaps plausible, the explanation amounts to no more than plaintiffs' best guesses."[123] Consequently, he reasoned, were plaintiffs required to plead facts sufficient to give rise to "a strong inference of scienter," he would dismiss their complaint. However, he continued, Third Circuit precedent only required plaintiffs to plead with particularity "the circumstances constituting fraud." That, he held, they had done.[124]

Whether Judge Pollak would have analyzed this case in exactly the same terms had he been bound by § 21D(b)(2) poses an interesting question. One can easily imagine him concluding that what he had disparaged as "plaintiffs' best guesses" in fact suggested a motive to deceive, especially if all reasonable inferences were drawn in favor of plaintiff. Whether Judge Pollak would in fact reach this conclusion, it seems to me, probably would turn less on the language of § 21D(b)(2) than on how much weight he (or any other judge) was prepared to give to another factor that Judge Pollak discussed: The weight to be given to the fact that most of the information relevant to plaintiff's claim was "peculiarly within defendant's knowledge or control."[125] That issue is discussed in Part III.

D. Summary

It is difficult to predict what impact § 21D(b)(2) will have on the conduct of open market fraud litigation. In recent years, courts have not allowed plaintiffs to proceed on the basis of bare bones complaints that merely characterized defendants' statements as false or misleading and asserted that defendants acted recklessly or with an intent to deceive or defraud. But while courts uniformly have begun to require plaintiffs to specify additional facts that suggest a higher probability that a challenged statement was false or misleading, decided cases provide little by way of guidance as to how much in the way of factual allegations courts are likely to require before they consider such allegations sufficient to demonstrate "circumstances constituting fraud" or to give rise to "a strong inference of scienter." Similarly, it is hard to tell the difference between facts that will be deemed to support a suspicion of scienter and facts that will be deemed to give rise to a strong inference of scienter. The conclusion that decided cases most clearly support is that the attitude with which

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Courts in the First, Second and Seventh Circuits, in my view, probably would not consider such allegations to be sufficiently particular (or sufficiently factual) to satisfy Rule 9(b).

121. 896 F. Supp. 434 (E.D. Pa. 1995) (Pollak, J.).
122. *Id.* at 446.
123. *Id.*
124. *Id.* at 447.
125. *Id.*

a court approaches an open market fraud case is more likely to determine the result that court reaches than is the pleading standard that the court applies.

III. SUGGESTIONS FOR THE COURTS

A decision as to whether any set of allegations gives rise to "a strong inference of scienter" almost always will be highly fact specific. Such a decision need not be predominantly subjective. One goal of § 21D(b)(2) is to create a uniform federal pleading standard applicable to claims of open market fraud. To achieve that goal, courts should strive to interpret new § 21D(b)(2) in as objective a fashion as possible. This section suggests approaches that courts might use and points out pitfalls that courts should avoid if they are to develop a coherent and rational body of case law interpreting § 21D(b)(2).

A. Articulate and Evaluate Inferences

Decisions by courts in the First Circuit interpreting Rule 9(b) provide the best model for how courts should proceed. *Greenstone v. Cambex Corp.*,[126] a decision written by Judge (now Justice) Steven Breyer, set the tone.

Plaintiffs claimed that Cambex misled investors by not disclosing that IBM Credit was likely to sue Cambex with regard to one aspect of its business: selling memory boards for use in IBM computers and accepting IBM memory boards as "trade-ins." Plaintiffs filed suit after IBM Credit sued Cambex and the price of Cambex stock dropped from $18 to about $12 per share.[127] Defendants moved to dismiss pursuant to Rule 9(b).

What makes *Greenstone* noteworthy is the care with which Judge Breyer evaluated plaintiff's allegations and explained why they were not adequate to create the requisite inference of fraud.[128] The crux of the plaintiff's claim was that Cambex knew in 1989 or 1990 that a lawsuit by IBM Credit was probable. The plaintiff relied on four factual allegations to support this claim. Judge Breyer first explained why three of those allegations were not sufficiently particular to support the inferences plaintiff urged the court to draw:

> First, the complaint points out that IBM Credit did, in fact, bring a lawsuit in early 1991, only a few months after Cambex filed a financial statement that omitted to mention this potential future liability. The bringing of the lawsuit tends to show its earlier likelihood. And, the existence of that likelihood helps support (in an evidentiary sense) an inference that defendants knew about that likelihood.
>
> We can understand how sometimes a later lawsuit...might constitute fairly strong evidence of earlier knowledge.... But, sometimes the later lawsuit would not readily permit such an inference. All depends upon the lawsuit's subject matter and the underlying circumstances. In this case, the appellant's complaint is not specific. It describes IBM Credit's

126. 975 F.2d 22 (1st Cir. 1992).
127. *Id.* at 23–24.
125. The court held that Rule 9(b) requires a plaintiff to set forth "specific facts that make it reasonable to believe that defendant knew that a statement was materially false or misleading." *Id.* at 25. At least in concept, this standard appears to be less demanding than the standard set by § 21D(b)(2), in that facts sufficient to support a "reasonable belief" that a defendant knew a statement was false or misleading may not be sufficient to support a "strong inference" that a defendant had such knowledge. Because the court affirmed dismissal of plaintiff's claim, one cannot tell whether this theoretical distinction would have had much practical importance in *Greenstone*.

> allegations in general terms; it does not set forth the IBM Credit lease language; nor does it offer any factual reason to believe that Cambex feared a lawsuit based on that language. To the contrary, the complaint makes clear that Cambex publicized its IBM memory 'trade-in' practice with a candor that seems inconsistent with knowledge of illegality or fear of a lawsuit....
>
> Second, the complaint says that a Cambex officer sold stock in Cambex before IBM Credit filed its lawsuit. Insider trading in suspicious amounts or at suspicious times, of course, could help the appellant. But the complaint does not tell us when the Cambex officer sold the stock. And, the complaint indicates that the insider sold his shares at an average price under $14, only about 75 cents higher than the $13.25 price at which Cambex stock sold after IBM Credit announced its suit. The stock sale allegation does not help the plaintiff.
>
> Third, the complaint says that the defendants' 'knowledge is shown by the fact that Cambex agreed with its customers to "restore" IBM memory units at the end of the customer's lease term with IBM credit.' This fact tends to show that Cambex believed it was supposed to return IBM memory boards in leased computers to IBM. But, it also shows that Cambex did so. It shows nothing about Cambex's knowledge of the likely legality or illegality of Cambex accepting IBM memory boards and re-leasing them during the period of the IBM computer's lease from IBM Credit. One can as easily argue that Cambex thought returning the boards to the IBM machine would satisfy IBM Credit, as argue the contrary.[129]

Judge Breyer found more salient to plaintiff's claim of fraud his fourth allegation, that Cambex quickly settled the lawsuit by agreeing to pay more than $5 million to IBM Credit:

> We agree that this allegation helps the appellant. She can reasonably argue that it helps to support a chain of inferences: 1) that the suit was valid, 2) that its underlying assertion (that IBM Credit's leases gave IBM Credit the right to control Cambex's use of IBM memories) was true, 3) that Cambex must have known this earlier, and 4) that Cambex therefore must have known earlier that a lawsuit (or the equivalent) was probable.[130]

He concluded, however, that "this single, factual keystone" was "not strong enough to bear the great overarching weight of factual inference the plaintiff wishes it to support."[131]

> Our conclusion, in part, reflects logic. The inferential links are weak. Does the quick settlement, for example, suggest pre-lawsuit knowledge and recalcitrance or post-lawsuit surprise? And, how does the fact of settlement circumvent the vagueness of pre-lawsuit circumstances we have discussed above?
>
> Our conclusion, in part, reflects precedent. The complaint before us resembles too closely the complaints in...other "fraud by hindsight" cases to permit a different result here.
>
> Finally, our conclusion, to a degree, reflects policy. Given the costs of lawsuits to the parties, the public problems associated with overcrowded court dockets, and the correlative public and private benefits of settlements, we fear a rule of law that would discourage settlements by

129. *Id.* at 26 (citations omitted).
130. *Id.* at 26–27.
131. *Id.* at 27.

permitting securities fraud plaintiffs to make their claims by pointing to later-settled lawsuits and nothing more.[132]

The Court of Appeals and district courts in the First Circuit have followed a similar approach in several subsequent cases involving claims of open market fraud. In *Serabian v. Amoskeag Bank Shares, Inc.*,[133] plaintiffs asserted that Amoskeag had fraudulently misrepresented its allowance for loan losses ("ALL") and its loan administration practices. The district court dismissed the complaint under Rule 9(b). The appellate court reversed in part.

The Court of Appeals held plaintiffs had satisfied Rule 9(b) by "juxtapos[ing]...allegations showing internal awareness of review problems and inadequate loan loss reserves with the company's public statements characterizing its loan review capabilities as 'strong' and its ALL approach as 'conservative.'"[134] The court also held sufficient to meet the requirements of Rule 9(b),

> [a] series of allegations [that] do more than simply identify management problems or point to statements that put a positive spin on the company's circumstances, without indicating how or why defendants should have known the descriptions were inaccurate. Rather, these paragraphs present a contrast between what company officials were hearing internally about their loan review effectiveness and the adequacy of their ALL, and what the company was telling the public at the same time.[135]

The court pointed out that "plaintiffs specifically identify the internal reports and the public statements underlying their claims, providing names and dates."[136] It explained:

> Although this section of the complaint would be strengthened if it contained specific examples of problem loans requiring a higher ALL, the summaries of the auditors' and consultants' reviews serve the same purpose. Both permit an inference that the bank knew, or should have known, that its public statements were inconsistent with the actual conditions then being reported to them.[137]

The district court analyzed plaintiff's factual allegations with similar care in *Steiner v. Unitrode Corp.*[138] In 1987, the Department of Defense ("DOD") suspended Unitrode as a supplier due to serious quality control problems in its semiconductor operations. Early in 1988, Unitrode issued an annual report to shareholders in which it stated:

> We have put our problems behind us.... Unitrode's discrete Semiconductor division emerges from fiscal year 1988 stronger, more focused, and better organized than at almost any time in its twenty-eight year history.... Never before in Unitrode's history had any division of the company not passed an audit, and never before has the government been as serious and stringent in its examination. As a result, *we have made certain that every procedure, every manual and every piece of*

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132. *Id.* (citations omitted).
133. 24 F.3d 357 (1st Cir. 1994).
134. *Id.* at 364.
135. *Id.* at 365.
136. *Id.*
137. *Id.* (citation omitted). The court also distinguished these allegations from a number of others that amounted to no more than claims of "fraud by hindsight," which it held had properly been dismissed.
138. 834 F. Supp. 40 (D. Mass. 1993).

equipment is in compliance, and we have retrained every operator in every aspect of his/her job.[139]

Early in December 1989, Unitrode announced that it once again faced quality control problems in its semiconductor division, DOD again stopped shipment of Unitrode semiconductors, and Unitrode announced substantial losses attributable to returns of defective semiconductors and a write-down of its semiconductor inventory. Plaintiff sued under Rule 10b–5; he asserted that Unitrode's later quality control problems provided "an adequate factual basis to raise the inference that [Unitrode] knowingly misled the public" in its 1988 annual report.[140] Defendants moved to dismiss on the ground that plaintiff simply alleged "fraud by hindsight."

The court agreed with plaintiff that "the fact that serious problems of quality control re-emerged, in the same division of Unitrode's business which was deficient in 1987, gives rise to an inference that defendants knowingly misled the public when they made statements such as [the statement quoted above]."[141]

The court acknowledged that defendants could have made the challenged statements in good faith and only later learned that Unitrode had not dealt effectively with the quality control problems. But it reasoned that plaintiffs were not required in their complaint "to foreclose all alternative explanations of the facts supporting their allegations of fraud."[142]

Another district court employed a similar approach in *Van de Velde v. Coopers & Lybrand*[143] to analyze a claim that Coopers & Lybrand ("C&L") had recklessly issued an unqualified opinion for Ferrofluidics, Inc., a client

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139. *Id.* at 44 (quoting annual report).

140. *Id.*

141. *Id.* at 45. The court also rejected defendants' argument that plaintiff was claiming mismanagement, not fraud.

> Here, plaintiff alleges that a company, faced with severe financial difficulties due to quality control problems, represented publicly that special efforts to control these problems had been undertaken and accomplished. That similar quality control problems, as severe as alleged by plaintiff, reemerged 18 months later gives rise to an inference that defendants were more than mere bad managers, and knowingly misled the public. This inference is reinforced by the fact that no public disclosure of renewed quality control difficulties was made until six days prior to [DOD's] reimposition of a shipping hold on certain of Unitrode's semiconductors.

Id.

142. *Id.* The court added that plaintiff "need not prove his case at this early stage." *Id.* For support, the court cited Scheuer v. Rhodes, 416 U.S. 232, 236 (1974), in which the Court observed that "the question is not whether the claimant will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims. Indeed it may appear on the face of the pleadings that a recovery is very remote and unlikely but that is not the test." To the extent that this statement suggests a plaintiff should be allowed to litigate a securities fraud case when it appears "on the face of the pleadings that a recovery is very remote and unlikely," one could view it as inconsistent with § 21D(b)(2). Whether such pleadings give rise to a sufficiently strong inference of fraud, however, would appear to depend on what inferences in favor of plaintiff a court is prepared to draw from such pleadings, *see supra* text accompanying notes 111–14, and what a court believes is necessary to support a "strong inference" of scienter. In this regard, see also Lindner Dividend Fund, Inc. v. Ernst & Young, 880 F. Supp. 49, 57 (D. Mass. 1995), in which the court argued: "Facts are susceptible to objective verification while conclusions are often empirically unverifiable. Conclusions represent the pleader's reactions to and inferences from the underlying facts."

143. 899 F. Supp. 731 (D. Mass. 1995).

firm that had improperly recognized as income in Fiscal Year 1992 two large sales of the control systems Ferrofluidics produced. Plaintiffs contended that Ferrofluidics could not satisfy any of the generally accepted criteria for recognizing revenue because the sales were "either subject to financial, performance, acceptance or other contingencies that were not satisfied, and/or the equipment was not substantially complete at the time Ferrofluidics recorded the sale."[144] Plaintiffs argued that C&L should be liable because it issued an unqualified audit opinion with respect to the challenged financial statements.

Responding to C&L's argument that the complaint did not sufficiently support plaintiffs' claim that they had acted with scienter, the court discussed how five "red flags" plaintiffs had identified should have signaled to C&L, at the time of its audit, that the questioned sales were out of the ordinary. The court acknowledged that the complaint was "devoid of allegations that Coopers was given any specific information that would lead it to believe that revenue was improperly recognized."[145] However, it pointed out that, "at this stage in the proceedings," it was "obligated to construe the facts in the light most favorable to the plaintiffs. Which party's view of the facts would be vindicated by a complete examination of the record remains an open question."[146]

Finally, the court rejected C&L's contention that plaintiffs, in addition to pleading facts suggesting that C&L had been reckless, were obliged to provide some evidence that C&L had a motive for approving Ferrofluidics' allegedly "slipshod accounting," reasoning that to do so "would verge on converting the 'recklessness' standard into an 'actual intent' standard."[147]

These decisions illustrate how courts, by carefully explaining why plaintiffs' allegations do or do not satisfy § 21D(b)(2), should be able to construct a rational framework of law interpreting that new pleading standard. Such a framework would place plaintiffs and plaintiffs' attorneys on notice that, before filing suits alleging open market fraud, they had better be prepared to explain both the inferences they expect the court to draw from the facts they plan to allege and why those inferences are reasonable. It also would assist potential plaintiffs and their attorneys in assessing how likely it is that a court would conclude that a given set of factual allegations "give[s] rise to a strong inference of scienter."[148]

B. Avoid Generalizations and Broad Behavioral Assumptions

At the other extreme from the First Circuit are courts that have framed their holdings in unduly general terms or have relied on broad behavioral

144. *Id.* at 733 (quoting Complaint ¶ 29).

145. *Id.* at 736. The court also agreed that "a negative inference could be drawn from the fact that the complaint does not make certain allegations that would make the inference of scienter much easier." *Id.*

146. *Id.* (citation omitted).

147. *Id.* at 737 (internal citation omitted).

148. Plaintiffs and plaintiffs' attorneys who file complaints without giving thought to these questions may then run a substantial risk of facing sanctions under FED. R. CIV. P. 11. *See* Pub. L. No. 104–67, § 101(b), 109 Stat. 747 (1995) (adding § 21D(c) to the Securities Exchange Act of 1934, codified at 15 U.S.C.A. § 78u–4(c) (West Supp. 1996)). How the courts will interpret Rule 11(b) as it relates to new § 21D(b)(2) is a question that is beyond the scope of this paper. However, Thornton v. Micrografx, Inc., 878 F. Supp. 931 (N.D. Tex. 1995), may illustrate the kind of situation in which a plaintiff will face sanctions. *See supra* note 110.

assumptions to support their conclusions. Courts that follow these approaches run the danger that they will preclude prosecution of potentially meritorious claims or will facilitate prosecution of non-meritorious claims.[149]

1. Generalizations

Perhaps most troubling are the Second Circuit's decisions in *Shields* and *Acito*, insofar as they can be read to suggest that a plaintiff should never be allowed to claim that corporate managers were motivated to misrepresent material facts by a desire to enhance their incentive compensation.[150] *Grossman v. Texas Commerce Bancshares*[151] illustrates the dangers inherent in this line of reasoning. Plaintiff there charged Texas Commerce Bancshares ("TCB") with having misrepresented its loan loss reserves. Plaintiff pointed out that TCB had had a very strong record of earnings growth and, as a consequence, was one of only two U.S. banks with an AAA credit rating.[152] That rating allowed TCB to borrow large amounts in the commercial paper market on terms more advantageous than were available to banks with less stellar earnings records. This lowered TCB's cost of funds and further enhanced its profitability.[153]

Plaintiff also alleged that the SEC and the Office of the Comptroller of the Currency had found that TCB had understated substantially its loan loss reserves.[154] Plaintiff claimed that TCB had a strong economic motive for this misrepresentation: to maintain its AAA credit rating, its low cost of funds, and the resulting profits.[155]

The court rejected this claim of motive. It read *Acito* and *Shields* as "caution[ing] against finding inferences of fraud in aspirations of financial success that are likely shared by the officers of all corporations."[156] Consequently, the court reasoned, "allegations of motives that are generally held by similarly positioned executives and companies are insufficient to sustain a claim under the securities laws."[157] This led it to conclude:

> Every company's executives likely wish to report positive financial health so that the company can reap the varied benefits that flow from an image of financial stability. More particularly, the executives of every company that uses commercial paper to obtain funds likely desire to

149. The conference report makes clear that Congress' intent was to preserve private securities litigation, which the committee termed "an indispensable tool with which defrauded investors can recover their losses without having to rely on government action," while preventing abusive practices in the conduct of such litigation. *Conference Report, supra* note 16.

150. To the extent that this is what these cases hold, the courts' reasoning is entirely result-oriented. In *Acito*, for example, the court stated: "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." Acito v. Imcera Group, Inc., 47 F.3d 47, 54 (2d Cir. 1995). As noted above, *see supra* text accompanying notes 80–83, *Shields* and *Acito* more accurately can be read to hold that broad, general assertions that managers were motivated by a desire to enhance their compensation are not sufficiently particular to satisfy Rule 9(b). So read, they are less troubling than decisions that appear to allow plaintiffs to satisfy Rule 9(b) by making generalized allegations concerning managers' motives. *See supra* text accompanying notes 80–81.

151. 1995 WL 552744 (S.D.N.Y. Sept. 15, 1995).

152. *Id.* at *2–*4.

153. *Id.*

154. *Id.* at *3–*4.

155. *Id.* at *10.

156. *Id.* at *11.

157. *Id.*

> maintain high credit ratings and a strong image of financial health so that the company will have continued access to such funds. If scienter could be pleaded by alleging a defendant's desire for the benefits which flow from an image of financial stability, 'the required showing of motive and opportunity would be no realistic check on aspersions of fraud.'[158]

This conclusion is absurd. The court's observation that "the executives of every company that uses commercial paper to obtain funds likely desire to maintain high credit ratings and a strong image of financial health" may be correct. But it does not follow that to allow plaintiff to proceed would eliminate "the required showing of motive and opportunity" as a "check on aspersions of fraud." In contrast with *Acito* and *Shields*, the plaintiff in *Grossman* did not rely on generalized claims of motive that could be made with respect to a large number of corporations. Instead, he provided a cogent explanation, backed up by specific factual allegations, of how TCB benefited from its AAA credit rating and why that gave TCB a strong motive to misrepresent the quality of its loan portfolio. He showed how, by putting off the "inevitable day of reckoning,"[159] TCB stood to realize substantial financial benefits from its alleged fraud.

In few other cases are plaintiffs likely to be able to plead facts that suggest maintaining a given credit rating is of comparable importance to a firm that allegedly misrepresented material facts.[160] Where plaintiffs can plead such facts, courts should hold they have satisfied § 21D(b)(2). After all, the purpose of § 21D(b)(2) (and of Rule 9(b)) is not to screen out broad categories of meritorious claims, but to ensure that, before plaintiffs are allowed to impose on defendants the heavy burden of responding to claims of fraud, plaintiffs are

158. *Id.* (quoting Shields v. CityTrust Bancorp, Inc., 25 F.3d 1124, 1130 (2d Cir. 1994)).

159. *Compare Shields*, 25 F.3d at 1130.

160. San Leandro Emergency Medical Group Profit Sharing Plan v. Phillip Morris Cos., Inc., 75 F.3d 801 (2d Cir. 1996), held that plaintiff's allegation that Phillip Morris delayed disclosing its plan to reduce the price of Marlboro cigarettes for the purpose of facilitating the sale of $700 million in debt securities did not create a sufficiently strong inference of motive. Given Phillip Morris' size and profitability, as well as the fact that Phillip Morris reduced prices in an effort to increase its long-term profits, this conclusion seems reasonable.

The court's explanation of its holding, however, is potentially problematic.

> *We do not agree that a company's desire to maintain a high bond or credit rating qualifies as a sufficient motive for fraud in these circumstances,* because '[i]f 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.'

Id. at 814 (quoting *Acito*, 47 F.3d at 54) (emphasis added). Given what happened in *Grossman*, the danger exists that other courts will ignore the emphasized phrase and interpret *San Leandro* to hold that allegations relating to a firm's credit rating can never suffice to establish motive.

Glickman v. Alexander & Alexander Servs. Inc., 1996 WL 88570 (S.D.N.Y. Feb. 29, 1996), suggests that courts will not always so proceed. There, too, plaintiff pled that defendant corporation was motivated to misrepresent its financial results by a desire to improve its credit rating and enhance its stock price. The court, relying on *Shields* and *Acito*, held that plaintiff's generalized allegations to this effect were not sufficiently particular to satisfy Rule 9(b). But the court then went on to explain in considerable detail the "factual vacuum" that also rendered insufficient plaintiff's claim that defendants' alleged fraud was designed it promote "two more specifically pleaded transactions." *See id.* at *11–*13 (pointing out how unlikely it was that defendants decided not to follow certain accounting procedures in 1991 for the purpose of facilitating an acquisition and a sale of preferred stock that did not occur until 1993).

required to develop facts sufficient to support a strong inference that a fraud has occurred.[161]

2. *Behavioral Assumptions*

DiLeo poses a similar problem. Relying on economic theory, the court stated that it would presume to be "irrational" any claim that a public accountant had a motive to join in her client's fraud.

The implications of this statement are not entirely clear, largely because the court also noted that plaintiff's conclusory claim that the defendant accountants had knowingly or recklessly misrepresented material facts did not "come close" to supporting an inference of scienter.[162] From this, one could conclude that *DiLeo* holds only that a plaintiff cannot satisfy Rule 9(b) by making a generalized claim that an accounting firm was motivated to join in clients' frauds by its desire to continue earning audit fees. Such a claim could be made with regard to virtually all accounting firms.

However, *DiLeo* seems to go farther—to say that, because of the stake every public accountant has in maintaining her reputation for honesty and careful work, courts should view very skeptically any complaint that asserts a public accountant joined in a client's fraud. This line of reasoning is problematic in part because the court relied only on economic theory, rather than on facts in the record. The theory is belied by widespread evidence that in recent years many accountants have in fact participated in or willingly overlooked their clients' frauds.[163]

DiLeo also ignores the behavioral insights that underlay Judge Henry Friendly's opinion in *United States v. Simon*.[164] There accountants who had been found guilty of criminal securities fraud argued on appeal that the government had produced no proof of criminal intent. Judge Friendly acknowledged that the prosecution had not produced any evidence that defendants had been motivated by financial gain. He held, however, that the jury could have found that defendants' motive was to cover up their derelictions and those of their predecessors in prior audits of the corporation involved. Defendants argued that such a finding would have been unreasonable because they could not rationally have expected a cover up would succeed. Judge Friendly responded that some evidence suggested defendants may have thought a cover-up would succeed. More significantly, he noted that "men who find themselves in bad situations of their own making do not always act with full rationality."[165] In essence, and in sharp contrast with *DiLeo*, his reasoning was

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161. As noted above, *see supra* text accompanying notes 80–82, courts should adopt a similar approach with regard to claims relating to incentive compensation and other perquisites of office.

162. *DiLeo*, 901 F.2d 624 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990).

163. *See* Lee Burton, *Ledgerdemain? Coopers & Lybrand Revised Notes of Audit a Year After the Fact*, WALL ST. J., Nov. 25, 1995, at A1 (describing one particular claim of fraud and noting that settlements of malpractice suits "now devour an astonishing 12% of accounting and auditing revenues of the Big Six accounting firms.").

164. 425 F.2d 796 (2d Cir. 1969) (Friendly, J.), *cert. denied*, 397 U.S. 1006 (1970). Some might consider *Simon* dated. However, the opinion is rooted in a view of human behavior that the years have not changed. In this regard, *see In re* Leslie Fay Cos., Sec. Litig., 835 F. Supp. 167, 174 (S.D.N.Y. 1993); *In re* Fischbach Sec. Litig., 1992 WL 8715 (S.D.N.Y. Jan. 15, 1992), discussed in *infra* text accompanying notes 169–72.

165. 425 F.2d at 809.

that he found it perfectly conceivable that the accountants involved had joined in their client's fraud, even though, as a reasonable person, he considered their actions to be "irrational."

The question remains: What weight should a court give to plaintiff's claim that an accountant was motivated by a desire to earn audit fees or to cover up previous wrongdoing? As with claims relating to executives' positions or compensation, a court should not accept as sufficient to satisfy § 21D(b)(2) generalized allegations that a plaintiff could make about any accountant. But where a plaintiff argues particularized facts that suggest an accountant stood to realize substantial benefits by joining in a client's fraud,[166] the court should assess her arguments on their merits, rather than reflexively characterizing the plaintiff's claim as "irrational."

Even where allegations relating to motive are not sufficient, standing alone, to give rise to a strong inference of scienter, a court should not disregard them. Recall that where a plaintiff is unable to provide any evidence of motive, the Second Circuit requires "the strength of the circumstantial allegations [indicating conscious or reckless behavior to] be correspondingly greater."[167] The corollary of this rule would appear to be that where plaintiff can provide some evidence of motive, though not enough to satisfy Rule 9(b), she should be allowed to proceed on the basis of correspondingly weaker circumstantial allegations that defendants acted consciously or recklessly.

The court's approach in *Van de Velde*[168] is consistent with this line of reasoning. The same can be said of *In re Fischbach Corp. Securities Litigation*[169] and *In re Leslie Fay Cos., Inc. Securities Litigation,*[170] two cases in which plaintiffs contended that an accountant was "motivated not to 'open his eyes' to the underlying facts, since this would place him in a position of terminating his profitable financial situation and exposing his associate, or continuing to participate in the fraudulent activity, but not without his cherished modicum of deniability."[171]

In both cases, plaintiffs also alleged facts suggesting that the defendant accountants had been reckless. Both defendants, relying on *DiLeo*, moved to have the complaints dismissed. Both courts rejected defendants' motions, reasoning that "[t]he combination of [the alleged] motivation and [an] otherwise unlikely degree of mere carelessness gives rise to an inference of absolute disregard for the facts."[172]

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166. For example, a plaintiff might argue that the accountant in charge of an audit was motivated to join in a client's fraud because, under the compensation structure of the accounting firm in question, she derived a substantial portion of her annual income from the audit fees that clients paid.

167. *See supra* text accompanying note 62.

168. *See supra* text accompanying notes 143–47.

169. 1992 WL 8715 (S.D.N.Y. Jan. 15, 1992).

170. 835 F. Supp. 167, 174 (S.D.N.Y. 1993).

171. *Id.* (citing *Fischbach*, 1992 WL 8715 at *6).

172. *Id. But see* Duncan v. Pencer, 1996 WL 19043 (S.D.N.Y. Jan. 18, 1996), in which the court first held that plaintiffs' allegations relating to a defendant accounting firm's motive were not sufficiently particular to satisfy Rule 9(b) and then concluded (erroneously, in my view) that plaintiffs' specific description of how that defendant had violated generally accepted auditing standards also did not satisfy the Rule because plaintiffs had made no allegations of fraudulent intent. As *Van de Velde* notes, such an approach creates an "actual intent" pleading standard for claims against accountants. *See supra* text accompanying note 147.

C. *Defendants' Control of Information*

In *Time Warner*, the Second Circuit observed that Congress' "'interest in deterring fraud in the securities markets and remedying it when it occurs'...*is served by recognizing that the victims of fraud often are unable to detail their allegations until they have had some opportunity to conduct discovery of those reasonably suspected of having perpetrated a fraud....*"[173]

No Second Circuit case discusses in any detail how defendants' control of the information most relevant to plaintiff's claims should affect a court's determination of whether a complaint alleging open market fraud meets the requirements of Rule 9(b).[174] Courts thus must look elsewhere for guidance as to how to evaluate this factor when interpreting § 21D(b)(2).

The Third Circuit has also has recognized the need for courts to "be 'sensitive' to the fact that application of the Rule [9(b)] prior to discovery 'may permit sophisticated defrauders to successfully conceal the details of their fraud.'"[175] In contrast to the Second Circuit, though, Third Circuit cases provide guidance for how courts should proceed. Their general approach is that courts should "relax[] the [particularity] rule when factual information is peculiarly within the defendant's knowledge or control."[176]

However, the Third Circuit has made clear that a plaintiff cannot satisfy Rule 9(b) simply by making a "boilerplate allegation" that the necessary information "lies in defendants' exclusive control."[177] To give substance to the heightened pleading requirements of Rule 9(b), the Third Circuit requires a plaintiff to make an "effort to obtain, before filing the complaint, the information needed to plead with particularity."[178] It further specifies that the plaintiff's efforts should involve "thoroughly investigat[ing] all possible sources of information, including but not limited to all publicly available relevant information...."[179] The plaintiff then must plead facts sufficient to suggest that

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173. *In re* Time Warner Sec. Litig., 9 F.3d 259, 263 (2d Cir. 1993) (emphasis added) (citation omitted). The court continued:

> On the other hand, there is the interest in deterring the use of the litigation process as a device for extracting undeserved settlements as the price of avoiding the extensive discovery costs that frequently ensue once a complaint survives dismissal, even though no recovery would occur if the suit were litigated to completion.

Id.

Plaintiffs' lawyers often emphasize the difficulty of prosecuting claims of open market fraud without access to defendants' records. *See, e.g.*, David J. Bershad et al., *A Dissenting Introduction, in* SECURITIES CLASS ACTIONS: ABUSES AND REMEDIES 5, 8 (Edward J. Yodowitz et al. eds., 1994).

174. Ouaknine v. MacFarlane, 897 F.2d 75 (2d Cir. 1990), is typical. It holds that Rule 9(b) is satisfied when "the allegations lie peculiarly within the opposing parties' knowledge and are accompanied by [factual] information [pled on information and belief] that raises a strong inference of fraud." *Id.* at 81.

175. Shapiro v. UJB Fin. Corp., 964 F.2d 272, 284 (3d Cir. 1992), *cert. denied*, 113 S. Ct. 365 (1992) (quoting Christidis v. First Pa. Mortgage Trust, 717 F.2d 96, 99–100 (3d Cir. 1983)).

176. *Id.* at 285 (quoting *In re* Craftmatic Sec. Litig., 890 F.2d 628, 645 (3d Cir. 1990)).

177. *Id.*

178. *Id.*

179. *Id.* In an earlier case where the plaintiffs had alleged simply that "there was no reasonable basis" for defendants' projections, the Third Circuit held:

> Under a flexible interpretation of Rule 9(b), plaintiffs need not necessarily allege the specific information at defendants' disposal at the time the projections were

the defendant's statements were fraudulent or must delineate "the nature and scope" of her efforts to develop such facts.[180]

One possible interpretation of the Third Circuit's decisions is that a plaintiff need not plead any facts that support an inference of fraud, so long as she delineates "the nature and scope" of her efforts to develop such facts and the court judges those efforts to have been "thorough."[181] However, it would be difficult to reconcile such a standard with § 21D(b)(2), which appears to require the plaintiff *to set forth facts* that provide actual support for the plaintiff's claim that defendants acted with scienter.

Another interpretation of Third Circuit decisions is possible, one which can be reconciled with § 21D(b)(2) and which also takes account of the difficulties plaintiffs face in pleading fraud with particularity prior to conducting discovery. Congress' goal in enacting § 21D(b)(2) was to protect issuers and others from frivolous and insufficiently researched claims, not to impede meritorious claims of securities fraud. Consistent with that goal, it would be perfectly appropriate for courts to require plaintiffs to seek out publicly available information about an issuer, its products or services, its customers, its principal rivals, and trends in the industry or industries in which the issuer operates. In today's world, a good deal of such information is likely to be available through use of the "information superhighway."

As a result of such research, a plaintiff may be able to develop information sufficient to plead with particularity facts that give rise to a strong inference of fraud. Where the plaintiff can do so, the "access to information" issue will be moot.[182]

In other cases, though, such research probably will enable a plaintiff to set forth some facts[183] that support an inference of scienter but not enough facts to give rise to a strong inference of scienter. Assume that the plaintiff then makes the plausible assertion, on information and belief, that other relevant

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> made. However, plaintiffs must accompany their allegations with facts indicating why the charges against defendants are not baseless and why additional information lies exclusively within defendants' control.

Craftmatic, 890 F.2d at 646. The court held that plaintiffs' complaint did not satisfy Rule 9(b) and remanded to allow plaintiffs an opportunity to replead.

180. *Shapiro*, 964 F.2d at 285.

181. It is not clear whether the Third Circuit would so hold. Lerch v. Citizens First Bancorp., Inc., 805 F. Supp. 1142 (D.N.J. 1992), can be read to suggest that such pleading would satisfy Rule 9(b), but the plaintiff there also pled facts that appear to constitute strong circumstantial evidence that the defendant's challenged statements were false when made. *But cf. In re* UJB Fin. Corp. Sec. Litig., 1993 WL 418974 (D.N.J. Sept. 13, 1993), which relied on *Lerch* to uphold an amended complaint filed by the plaintiffs in *Shapiro*, even though the only new facts the plaintiffs appear to have pled were that they "specifically averred the nature and scope of their efforts to obtain information by reviewing Defendants' public filings and disclosures." 1993 WL 418974, at *2.

182. *See, e.g.*, Walsh v. Chittenden Corp., 798 F.2d 1043 (D. Vt. 1992), in which plaintiffs pled specific facts, relating to a bank's loan portfolio, that created a strong inference the bank had deliberately understated its loan loss reserve and mischaracterized its loan portfolio. At the same time, a court should be careful not to impute to investors constructive knowledge of all information that can be found on the "information superhighway." If they do, they will place plaintiffs in a "Catch 22" situation. *But cf.* Whirlpool Fin. Corp. v. GN Holdings, Inc., 67 F.3d 605, 610 (7th Cir. 1995) (suggesting that, for purposes of notice provision of statute of limitations, plaintiffs will be deemed have notice of all information available on the "information superhighway.").

183. In addition to the information that a plaintiff would include in a bare bones complaint.

facts (the nature of which the plaintiff should be able to specify) are within the defendants' exclusive possession and control. How should a court react?

The court's ultimate task is to decide whether the facts alleged by the plaintiff give rise to a strong inference of fraud. The Third Circuit's decisions sensibly suggest that information about the investigation a plaintiff has conducted, the facts she has uncovered, and the kinds of potentially relevant data the plaintiff has been unable to find all are likely to be relevant to that determination. All that information provides the court with a context within which it can evaluate the facts that the plaintiff has alleged and determine whether the plaintiff's claim appears to have merit. Put differently, courts should treat data about the investigation the plaintiff has conducted as relevant to its judgment about whether the facts the plaintiff has alleged support an inference of fraud that is sufficiently strong to justify allowing the plaintiff to continue prosecuting her claim.[184]

IV. CONCLUSION

Congress' principal purpose in passing § 21D(b)(2) was to require more of plaintiffs before fully allowing them to impose on defendants the costs associated with defending a class action involving allegations of open market securities fraud.[185] There is little evidence, however, that Congress intended to impose on plaintiffs a pleading requirement so burdensome that it would sound the death knell of open market fraud litigation.

President Clinton had some basis to be concerned that defendants would be able to use § 21D(b)(2) to block prosecution of many meritorious claims of securities fraud. But experience suggests that such an outcome is unlikely. The Second Circuit has relied on its "strong inference of scienter" for many years, yet plaintiffs have continued to prosecute many open market fraud cases in that Circuit. The same is true in other circuits that have applied heightened pleading standards to securities fraud cases in recent years. In fact, examination of reported cases suggests that the principal effect of § 21D(b)(2) may be to add unnecessarily to motion practice in open market fraud cases,[186] not to eliminate meritorious claims. In several instances in recent cases in which courts have dismissed complaints for failure to plead fraud with the requisite particularity, plaintiffs have apparently not found it too difficult to file amended complaints that the courts thereafter have held satisfy the requirements of Rule 9(b).[187]

184. In *In re* Valuvision, 896 F. Supp. 434, 447 (E.D. Pa. 1995), Judge Pollak took explicit account of this factor in holding that plaintiffs' complaint satisfied Rule 9(b).

185. Section 21D(b)(3)(B) of the 1934 Act, added by § 101(b) of the new Act provides for a stay on discovery until motions to dismiss have been decided.

186. At the conference on Securities Litigation Legislation, Judge William Browning suggested that § 21D(b)(2) is likely to give rise, directly or indirectly, to three motions in most securities fraud cases. William D. Browning, *Comment on "The New Securities Fraud Pleading Requirement"*, 38 ARIZ. L. REV. 709 (1996) In addition to motions to dismiss under that section, he said, defendants regularly will move, pursuant to new § 21D(b)(3)(B), to stay discovery pending disposition of their motion to dismiss and plaintiffs will move pursuant to the same provision to allow discovery "to preserve evidence or to prevent undue prejudice." § 21D(B)(3)(B).

187. *Compare In re* Abbott Labs. Sec. Litig., 813 F. Supp. 1315 (N.D. Ill. 1992) *with In re* Abbott Labs. Sec. Litig., 1993 WL 147498 (N.D. Ill. May 6, 1993); *compare* Goldsmith v. Technology Solutions Co., 1993 WL 150035 (N.D. Ill. May 7, 1993) *with* Goldsmith v. Technology Solutions Co., 1994 WL 323317 (N.D. Ill. July 27, 1994); *compare In re* Healthcare Compare Corp. Sec. Litig., 1994 WL 262730 (N.D. Ill. June 2, 1994) *with In re*

One might well ask, what is accomplished by such an exercise, one that is likely to be repeated with increasing frequency under § 21D(b)(2)?

The answer to this question has two parts. First, there is no way to know in how many other cases in which complaints were dismissed plaintiffs abandoned their claims. There also is no way to know in how many of those cases plaintiffs abandoned their claims because no evidence of fraud was to be found and in how many plaintiffs abandoned potentially meritorious claims solely because they decided it would be too difficult or too expensive to make the effort necessary to uncover facts sufficient to plead fraud with the necessary particularity.

This leads to the second part. Given that fraud is a serious claim and that defendants must bear a high proportion of the costs of litigation once discovery begins, it is not unreasonable *per se* for Congress to impose on plaintiffs the burden of undertaking more serious and extensive inquiries before initiating such litigation. One inevitable effect of Congress' decision will be to increase somewhat the number of cases in which open market fraud will go unremedied.[188] But a second inevitable effect will be to decrease somewhat the number of cases in which defendants will be forced incur the cost of defending (or settling) non-meritorious claims.

Both of these kinds of error will be present no matter what pleading standard courts employ. Whether § 21D(b)(2) will create a better balance between them will depend in large part on how the courts interpret this new statutory provision. This Article suggests some approaches courts could use to create a body of law that will support Congress' desire to reduce frivolous litigation while preserving what I believe was Congress' overarching goal: maintenance in the United States of what most acknowledge to be the world's fairest and most efficient securities markets.

Healthcare Compare Corp. Sec. Litig., 1995 WL 64900 (N.D. Ill. Feb. 13, 1995); and *compare* Stack v. Lobo, 1995 WL 241228 (N.D. Cal. Apr. 20, 1995) *with* Stack v. Lobo, 1995 WL 552171 (N.D. Cal. Sept. 15, 1995).

188. This is so because plaintiffs will not be able to meet the heightened pleading standard of § 21D(b)(2).