

45 Loy. U. Chi. L.J. 653

Loyola University Chicago Law Journal

Spring 2014

Conference Articles

PLEADING SECURITIES FRAUD CLAIMS: THE GOOD, THE BAD, AND THE UGLY

Sharon Nelles^{a1} Hilary Huber^{aa1}

Copyright (c) 2014 Loyola University Chicago School of Law; Sharon Nelles; Hilary Huber

Table of Contents

Introduction	653
I. The PSLRA	654
A. The Purpose of the PSLRA	654
B. The PSLRA's Heightened Pleading Standard	656
C. Additional Changes Under the PSLRA	659
II. Post-PSLRA Motions to Dismiss	659
III. Securities Fraud Pleadings: The Good, The Bad, The Ugly	661
A. The Good	661
B. The Bad	663
C. The Ugly	665
Conclusion	668

Introduction

In 1995, Congress enacted the Private Securities Litigation Reform Act (“PSLRA”)¹ in “response to perceived abuses in securities fraud litigation.”² The purpose of the PSLRA was to “prevent an onslaught of *654 expensive and frivolous lawsuits when stock prices plummet, which could force corporations to settle meritless claims to avoid the expense of discovery and trial.”³ Since the PSLRA's enactment, the plaintiffs' bar has become increasingly critical of certain of its provisions--particularly its heightened pleading standard.⁴ Although some criticism may be justified, much of it ignores that the PSLRA was intended to place the burden on plaintiffs to ensure they have a valid basis for bringing a securities fraud suit. With diligent pre-filing investigations, plaintiffs should be able to gather facts that adequately state a claim for securities fraud, where such fraud truly exists. This Article proceeds in three parts. First, it briefly describes the PSLRA and how the Supreme Court's decision in *Tellabs, Inc. v. Makor Issues & Rights, Inc.*⁵ addressed some of the PSLRA's purported ambiguities. The second Part briefly addresses some commentators' contentions that the PSLRA and *Tellabs* created insurmountable hurdles for plaintiffs at the motion to dismiss stage. Third, it walks through some examples of “the good, the bad, and the ugly” of securities fraud pleadings, with a focus on the “scienter” and “misstatements or omissions” elements of a securities fraud claim. This third Part focuses on the--often problematic--use of confidential witnesses to meet the PSLRA's heightened pleading standards.

I. The PSLRA**A. The Purpose of the PSLRA**

The PSLRA “was intended to address concerns that had been raised about abuses believed to be associated with securities class action lawsuits.”⁶ As its plain language indicates, the PSLRA was not enacted *655 preemptively; it was enacted to address a very real issue. Prior to the PSLRA, the availability of “wide-ranging discovery gave plaintiffs' lawyers incentives to ‘file

[frivolous] lawsuits in order to conduct discovery in the hopes of finding a sustainable claim not alleged in the complaint.”⁷ In the normal course of civil litigation, once a complaint was filed, “plaintiffs’ lawyers were free to impose massive costs on defendants in the form of discovery requests.”⁸

At that time, many defendants “believed that they were victims of meritless lawsuits which alleged ‘fraud by hindsight.’”⁹ In such suits, the plaintiff would file a lawsuit immediately following a drop in a company’s stock price, claiming that the drop served as “evidence that the issuer and its agents had been misrepresenting the company’s operations or performance in order to inflate its stock price.”¹⁰ More often than not defendants were right: plaintiffs filed frivolous or meritless lawsuits against “‘deep pocket’ defendants--whether or not these defendants actually committed fraud--solely for their settlement value.”¹¹ A defendant, faced with the potentially enormous costs of responding to discovery requests, would often cave to the pressure to settle.¹² This meant that innocent parties would settle frivolous securities class actions to avoid a “potentially ruinous jury verdict.”¹³ These settlement costs, not insubstantial themselves, were generally born by current shareholders.

The PSLRA was intended to curb these frivolous suits and decrease the number of “vexatious, even extortionate class action filings” that marked the pre-PSLRA securities litigation landscape.¹⁴ The statute has three mechanisms to achieve this end: (1) a heightened pleading standard, (2) a discovery stay during the pendency of any motion to dismiss, and (3) a mandate that courts conduct an inquiry under [Rule 11 of the Federal Rules of Civil Procedure](#).¹⁵

***656 B. The PSLRA's Heightened Pleading Standard**

As noted above, the way that the PSLRA attempts to discourage frivolous litigation is through a heightened pleading standard. The PSLRA effectively replaced [Rule 9\(b\) of the Federal Rules of Civil Procedure](#) as the applicable pleading standard in private securities suits.¹⁶ It requires a plaintiff alleging securities fraud based on misleading statements or omissions of material facts to “specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.”¹⁷ Misleading statements or omissions must have been misleading at the time the statements were made; this prevents plaintiffs from asserting liability based on events subsequent to the alleged fraud.¹⁸

The PSLRA further requires that plaintiffs “state with particularity [the] facts giving rise to a strong inference that the defendant acted with the required state of mind.”¹⁹ This requirement is a “sharp break” from [Federal Rule of Civil Procedure 9\(b\)](#).²⁰ Under the PSLRA, “‘a plaintiff can no longer plead the requisite scienter element generally.’”²¹

Congress did not define the phrase “strong inference” or set forth a rubric for courts to use to determine whether a plaintiff pled facts sufficient to allege a “strong inference” of scienter. Although it is axiomatic that an “inference” is a logical conclusion deduced by considering relevant facts,²² ambiguity remained as to what facts courts should consider as they try to determine whether a plaintiff sufficiently alleged scienter and what makes an inference “strong.” This ambiguity resulted in a circuit split, with courts across the country applying different standards to determine whether a plaintiff alleged a “strong *657 inference” of scienter.²³ For example, in the Seventh Circuit, a complaint would survive if “a reasonable person could infer that the defendant acted with the required intent.”²⁴ The court did not require a comparison of the relative strength of competing inferences (i.e., the court would not compare a defendant’s innocent explanation for a drop in a stock price with the plaintiff’s alleged fraud).²⁵ In the Sixth Circuit, however, “the strong inference requirement create[d] a situation in which ‘plaintiffs [were] entitled only to the most plausible of competing inferences.’”²⁶ In other words, a court would have to decide whether the plaintiff’s allegation of fraud was the most plausible explanation for a stock price decline.

In light of the circuit split, approximately twelve years after the PSLRA's enactment, the Supreme Court decided *Tellabs, Inc. v. Makor Issues & Rights, Inc.*, in which it provided some guidance on the troublesome and unsettled “strong inference” requirement in the PSLRA.²⁷ The Court decided that on a motion to dismiss, the trial court judge must accept all factual allegations in the complaint as true, and then compare all of the culpable and nonculpable explanations that could be drawn from them.²⁸ An inference is “strong” only when the culpable explanation is at least as likely as the non-culpable explanation.²⁹ The inference “must be cogent and compelling, thus strong in light of other explanations.”³⁰

Although it seemed like the Supreme Court's *Tellabs* decision should have resolved the pre-PSLRA circuit split over the “strong inference” requirement, there remained a post-*Tellabs* divergence between the lower courts.³¹ In accordance with *Tellabs*, it would seem that judges should have begun their analysis of a securities fraud claim by making a *658 “holistic” inquiry considering whether all of the facts alleged in the complaint raise a “strong inference” of scienter.³² However, courts in different circuits have applied *Tellabs* differently. For example, post-*Tellabs*, the Second Circuit continues to hold that a plaintiff may establish a “strong inference” of scienter “by particularized allegations showing (1) that defendants had the ‘motive and opportunity’ to commit fraud, or (2) there was strong circumstantial evidence of ‘conscious misbehavior or recklessness.’”³³ In doing so, the Second Circuit has effectively reaffirmed its pre-*Tellabs*, arguably plaintiff-friendly, jurisprudence.³⁴

The Ninth Circuit continues to apply its pre-*Tellabs* case law as well-- but courts in this circuit applied a different test than those in the Second Circuit before *Tellabs* and thus continued to do so after *Tellabs*.³⁵ The Ninth Circuit articulated a two-part test to determine whether a plaintiff has sufficiently alleged scienter: (1) the court must determine whether any of the allegations, standing alone, are sufficient to create a strong inference of scienter and (2) if no allegation is alone sufficient, then the court must conduct a “holistic” review of all of the allegations “to determine whether the insufficient allegations combine to create a strong inference of intentional conduct or deliberate recklessness.”³⁶

This post-*Tellabs* circuit split with respect to pleading “scienter” makes it difficult to pin down precisely what standard of particularity is required for the allegations to be considered a “strong inference.” Thus, litigants in different circuits need to be cognizant of the standards in their circuit and remain aware as the “strong inference” standard continues to evolve.

*659 C. Additional Changes Under the PSLRA

As stated above, the PSLRA includes two additional requirements that differentiate securities fraud suits from “standard” civil litigation. First, the PSLRA provides that “all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.”³⁷ Second, the PSLRA requires courts to conduct a [Rule 11](#) inquiry upon final adjudication of the suit.³⁸ If the court determines that compliance with [Rule 11](#) is lacking, then it must impose sanctions on the plaintiff for filing a frivolous suit.³⁹

II. Post-PSLRA Motions to Dismiss

Securities fraud is a complicated area of law that continues to evolve as courts in different circuits decide post-PSLRA, post-*Tellabs* motions to dismiss securities fraud claims. Nevertheless, virtually every time a plaintiff files a complaint alleging securities fraud, the defendant moves to dismiss that complaint.⁴⁰ Some commentators have argued that the PSLRA's heightened pleading requirements, discovery stay, and mandatory Rule-11 inquiry have transformed the motion to dismiss into a significant access barrier for plaintiffs.⁴¹ Some courts have even called the 10b-5 motion to dismiss an “acid test,”⁴² an “eye of

a needle made smaller and smaller over the years by judicial decree and congressional action,”⁴³ and a return to “a ‘demurrer-like’ process that *660 creates considerable hurdles that a plaintiff must overcome before any discovery is permitted.”⁴⁴

However, considering that the express purpose of the PSLRA is to minimize the number of frivolous securities fraud suits,⁴⁵ it should come as no surprise that it is now more challenging for a plaintiff to survive a motion to dismiss than it was before the law's enactment.⁴⁶ It bears noting that the imposition of additional requirements on plaintiffs attempting to plead a viable securities fraud claim has not made defending against such claims commensurately easier on defendants once a complaint is filed. After all, in some respects, the PSLRA merely requires plaintiffs to do what they should have done anyway--ensure there is a cognizable basis for a fraud claim, supported by articulable facts, before filing their suit. Moreover, whereas plaintiffs often have years to investigate and gather facts to develop their claims before filing the complaint, defendants are often forced to respond to the complaint within a matter of weeks.⁴⁷

Some commentators have gone so far as to say that the Supreme Court's Tellabs analysis “tilts steeply in favor of plaintiffs who, as masters of their own complaints, can buttress their claims with as many documents and witnesses as they please.”⁴⁸ These commentators maintain that Tellabs was in fact a pro-plaintiff decision because it held that a plaintiff only has to show that their allegations are merely as likely as any other nonculpable explanation.⁴⁹ “In contrast, Tellabs limits defendants to making their argument for exculpatory inferences based only on the complaint that plaintiffs have written and such public documents as have traditionally been relied upon by courts in determining a motion to dismiss.”⁵⁰

Securities fraud suits implicate billions of dollars and have “bet the *661 company implications” for defendants. There should be high hurdles and careful scrutiny. Those who argue that the PSLRA imposes unreasonable pleading standards or that its (rarely invoked) Rule 11 provision⁵¹ is too harsh must consider that if there truly is a cognizable basis to bring a fraud claim, then a diligent pre-filing investigation should lead to evidence that supports that claim. And with this evidence, regardless of the state of the post-Tellabs law in a given circuit, there is a great likelihood that the complaint will survive a motion to dismiss. Successfully pleading a securities fraud claim is not as daunting a task as it may seem. The next Part addresses some of the good, the bad, and the ugly of securities fraud pleadings using some well-known and/or recent examples from case law.

III. Securities Fraud Pleadings: The Good, The Bad, The Ugly

A. The Good

We begin with “the good” and focus on a case with which most readers are likely familiar: *Matrixx Initiatives, Inc. v. Siracusano*.⁵² In *Matrixx Initiatives*, the Supreme Court itself applied the Tellabs standard for the first time. The case presented the question of whether a plaintiff (*Siracusano*) could state a claim for securities fraud based on the failure of *Matrixx Initiatives, Inc.* (“*Matrixx*”) to disclose reports of adverse events associated with one of its products (a nasal spray that was said to shorten the lifespan of a cold) even though the reports did not disclose a “statistically significant number of adverse events.”⁵³

The Court found the following alleged facts sufficient to show scienter under the PSLRA:

1. *Matrixx* was concerned enough about the information it received regarding the adverse effects of its product that it hired a consultant to review the product, participated in animal studies, and convened a panel of physicians and scientists in response to an academic researcher's presentation about how *Matrixx's* product caused users to lose their sense of smell;
2. *Matrixx* successfully prevented the academic researcher from using its product's name in his presentation; and

3. Matrixx issued a press release suggesting that studies had *662 confirmed that its product did not cause users to lose their sense of smell when, in fact, Matrixx had not conducted any studies of its own and the scientific evidence at that time was insufficient to determine whether the product did or did not have that effect.⁵⁴

The Court considered these facts “collectively,” as required by its Tellabs decision, and determined that they established a “‘cogent and compelling’ inference that Matrixx elected not to disclose the reports of adverse events . . . because it understood their likely effect on the market.”⁵⁵ Employing the Tellabs standard, the Court held, “[A] reasonable person’ would deem the inference that Matrixx acted with deliberate recklessness (or even intent) ‘at least as compelling as any opposing inference one could draw from the facts alleged.’”⁵⁶

Matrixx demonstrates that plaintiffs have available and should take advantage of a combination of different sources and inferences to show scienter at the pleading stage. The facts corroborating the claims here--for example, the fact Matrixx had prevented the academic researchers from using its product's name in their presentation--were gathered before discovery and without the plaintiffs taking any unethical or unreasonable measures.⁵⁷

Although some may consider Matrixx unusual because of the existence of publically available research about a well-known product in that case, there are numerous cases in which plaintiffs were likewise able to gather facts sufficient to adequately plead a securities fraud claim in less public circumstances. Consider, for example, *Borneo Energy Sendirian Berhad v. Sustainable Power Corp.*⁵⁸ Here, plaintiff Borneo Energy Sendirian Berhad (“Borneo Energy”), learned that the defendant, Sustainable Power Corp. (“Sustainable Power”), had a technology that it claimed could produce “‘Vertroleum,’ a biofuel, from various materials, including palm waste.”⁵⁹ Borneo Energy was “interested in developing the potential of such waste.”⁶⁰

Borneo Energy alleged that Sustainable Power's representatives made a number of representations about its products upon which it *663 relied when it purchased shares of Sustainable Power's stock.⁶¹ A few months after the stock purchase, the Securities and Exchange Commission (“SEC”) sued Sustainable Power for securities fraud arising from representations similar to those it made to Borneo Energy.⁶² Shortly thereafter, Borneo Energy brought a private litigation alleging securities fraud against Sustainable Power. Finding that Borneo Energy adequately pleaded misrepresentation, the court explained:

The complaint specifies the speaker (Rivera), the statements (representations about Vertroleum and test results relating to it, Sustainable Power's business, the existence of contracts to sell Vertroleum, the presence of plans to generate electricity from biogas, that Sustainable Power was being audited and would shortly be able to produce audited financials and other information, and the omitted information about the SEC investigation into Rivera). The complaint also specifies the date, place, and circumstances of the statements, and the basis for alleging that they were fraudulent when made.⁶³

On the basis of these allegations, the court found that the complaint “alleged with particularity that Rivera knew that the Vertroleum did not meet the certain biofuel standards or fertilizer standards, although it was represented to meet them.”⁶⁴ In other words, these alleged facts met the heightened standard required to plead the “misrepresentation” element of a securities fraud claim. Borneo Energy, like Matrixx, shows that gathering the facts necessary to state a non-frivolous securities fraud claim does not require extraordinary measures. Prospective plaintiffs should investigate whether the SEC or other regulatory agencies have brought any charges against the potential defendant that would help bolster the claims in a securities fraud civil litigation.

B. The Bad

Next, we turn to some examples of “the bad”--securities fraud pleadings that simply do not rise to the level of particularity necessary under the PSLRA. In *In re Boston Scientific Corporation Securities Litigation*, the First Circuit considered a plaintiff

shareholders' security fraud claims against a medical device manufacturer.⁶⁵ Finding the complaint did not adequately plead scienter, the First Circuit explained:

In cases where we have found the pleading standard satisfied, the *664 complaint often contains clear allegations of admissions, internal records or witnessed discussions suggesting that at the time they made the statements claimed to be misleading, the defendant officers were aware that they were withholding vital information or at least were warned by others that this was so.⁶⁶

No such direct evidence was pled in the complaint here. In fact, the plaintiffs did not identify any basis for imputing wrongful intent.⁶⁷ And the allegedly omitted information was not of such powerful importance that wrongful intent could reasonably be inferred.⁶⁸ In short, the plaintiffs failed to allege any facts that tended to show securities fraud--let alone created a strong inference of such fraud.

The Third Circuit likewise affirmed the dismissal of a securities fraud claim in *Barnard v. Verizon Communications Inc.*,⁶⁹ in which the district court found that the complaint did not meet the heightened pleading requirements of the PSLRA.⁷⁰ The Third Circuit held that what was already the plaintiff's second amended complaint "did not provide any facts from which one could ascertain whether the defendants made any actionable misrepresentations or omissions at all."⁷¹ The "closest" the plaintiff came to alleging a misrepresentation or omission was a reference to one of the defendants' annual statements, but the plaintiff "failed to indicate how, if at all, the annual statements could be interpreted as material misrepresentations or omissions."⁷²

These complaints exemplify precisely the kind of securities fraud suits the PSLRA was designed to prevent. Even after multiple attempts to plead their claims, these plaintiffs did not sufficiently allege a securities fraud claim. This failure was not because the PSLRA's heightened pleading requirements are onerous or unreasonable, but rather because the complaints lacked any facts corroborating the plaintiffs' respective fraud claims. Indeed, it seemed that no such corroborating facts existed. Thus, while some may argue that the PSLRA has made it unreasonably difficult to survive a motion to dismiss, the reality is that dismissal of these meritless cases before discovery commences serves the PSLRA's purpose by eliminating weak or frivolous claims as early as possible.

*665 C. The Ugly

One unfortunate side effect of the PSLRA appears to be the rise of unscrupulous behavior by plaintiffs and/or their counsel during the pre-filing investigation period and when stating the allegations in the complaint. This behavior exemplifies the "ugly" side of securities fraud pleadings. This Section considers two examples of the "ugly," both of which involve confidential witness statements.⁷³

First, in *City of Pontiac General Employees' Retirement Systems v. Lockheed Martin Corp.*,⁷⁴ the defendants moved to dismiss the complaint and the court stayed discovery until it ruled on the defendant's motion, pursuant to the PSLRA.⁷⁵ Eventually, the court denied the motion to dismiss, basing its decision in part on the alleged statements of confidential witnesses set forth in the complaint.⁷⁶

After issuing its denial of the motion to dismiss, the court lifted the discovery stay and the discovery process ensued, during which the defendants deposed the individuals who served as the confidential witnesses in the complaint.⁷⁷ Based on those depositions, the defendants learned, and later asserted in their motion for summary judgment, that several of the confidential witnesses on which the complaint relied "'recanted' statements attributed to them" and/or "denied making such statements in

the first place.”⁷⁸ The plaintiffs contended that the recanting confidential witnesses changed their stories because of pressure from the defendants.⁷⁹

Noting that the parties’ “competing assertions raised serious questions, going well beyond the legal issues presented by summary judgment,” and in the interest of protecting “the integrity of the adversary process itself,”⁸⁰ the court sua sponte directed the five confidential witnesses to appear in court, along with the plaintiffs’ *666 private investigator.⁸¹ After hearing the witnesses testify in court, the judge determined that some of the confidential witnesses “had been lured by the investigator into stating as ‘facts’ what were often mere surmises, but then, when their indiscretions were revealed, felt pressured into denying outright statements.”⁸²

This determination led the presiding judge, the Honorable Jed Rakoff, to directly address “the ugly” of securities fraud pleadings in his order on the motion for summary judgment: “While [the PSLRA was] designed to give district courts a ‘gatekeeper’ responsibility to derail dubious class action lawsuits at the outset, an unintended consequence has been to cause plaintiffs’ counsel to undertake surreptitious pre-pleading investigations designed to obtain ‘dirt’ from dissatisfied corporate employees.”⁸³ Judge Rakoff further stated:

It seems highly unlikely that Congress or the Supreme Court [in its Tellabs decision], in demanding a fair amount of evidentiary detail in securities class action complaints, intended to turn plaintiffs’ counsel into corporate “private eyes” who would entice naive or disgruntled employees into gossip sessions that might help support a federal lawsuit.⁸⁴

In the next example, *City of Livonia Employees’ Retirement System v. Boeing Co.*,⁸⁵ the plaintiffs also relied on a confidential witness’s statements to support their allegations of securities fraud in their amended complaint. The plaintiffs’ counsel “represented to the court that the confidential source was a former Boeing senior structural analyst and chief engineer who worked on the 787 team.”⁸⁶ Further, “[p]laintiffs led the court to believe that the confidential source had direct ‘access to’ and ‘firsthand knowledge [about]’” the facts at issue in that case.⁸⁷ The defendants moved to dismiss the amended complaint, and the court “summarily denied” the motion, based in part on its belief that the confidential witness had personal knowledge of the fact attributed to him in the complaint.⁸⁸

The defendants’ counsel later deposed the confidential witness, who “consistently denied that he was the source of the information attributed *667 to him in the second amended complaint”--and in fact denied he was ever employed by Boeing.⁸⁹ Armed with this testimony, the defendants filed a motion for reconsideration of the denial of their motion to dismiss, which the court granted.⁹⁰ Upon reconsideration, the court dismissed the amended complaint with prejudice, explaining:

The second amended complaint would have been dismissed, possibly with prejudice, as insufficient under the PSLRA [if not for the confidential witness statement]. It matters not whether, as plaintiffs argue, [the confidential witness] told their investigators the truth, but he is lying now for ulterior motives. The reality is that the informational basis for [the allegations attributed to him are] at best unreliable and at worst fraudulent⁹¹

As it turned out, the plaintiffs’ counsel never even met with the confidential witness before “adding the confidential source allegations to the second amended complaint, and counsel apparently never verified the hearsay reports of their investigators concerning [the confidential witness’s] position at Boeing or the basis of his purported personal knowledge.”⁹² The court noted that the “unseemly conflict between plaintiffs’ confidential source and plaintiffs’ investigators could have been avoided by reasonable inquiry on the part of plaintiffs’ counsel before filing the second amended complaint.”⁹³

Here, counsels' failure to conduct a reasonable inquiry to determine whether confidential witness sources were credible before using their statements in the complaints cost the plaintiffs their case.⁹⁴ If counsel had determined early on that the confidential sources were questionable, they could have used other evidence, or perhaps tried to find another confidential witness, to sufficiently allege the plaintiffs' fraud claims. If no such evidence existed, then plaintiffs' counsel should not have filed the complaint.

As Judge Rakoff recognized in *City of Pontiac*, the PSLRA was intended to discourage plaintiffs from filing frivolous securities fraud suits--not to encourage them to engage in unethical or unprofessional behavior in an attempt to piece together a securities fraud claim. Counsel must remember that credibility plays a large role in a court's *668 decisions throughout the course of litigation, and to lose or put in question the credibility of the plaintiff, counsel, or the lawsuit during the pleading stage could have dire repercussions, even if the complaint survives.

Conclusion

The PSLRA must raise the bar for securities fraud plaintiffs if it is to achieve its goals of preventing frivolous or meritless securities fraud claims. However, if plaintiffs take the pre-filing investigation period seriously and gather facts that enable them to adequately plead their securities fraud claims, those claims should be able to survive a motion to dismiss. Moreover, if plaintiffs fail to clear the PSLRA's hurdles with their first complaint, they almost always will be permitted to file an amended complaint--and if they cannot meet the PSLRA's standards by that point, then perhaps they do not have a viable claim. Pleading an adequate securities fraud claim can be done and it can be done with a reasonable amount of effort. It is the plaintiffs' responsibility to do the work necessary to uncover the facts supporting any allegations of fraud--and to do it ethically--before filing a lawsuit.

Footnotes

- a1 **Sharon Nelles** is a partner in Sullivan & Cromwell LLP's Litigation Group. Sharon represents financial institutions and global companies in high-profile civil litigations and related regulatory, congressional, and criminal investigations, and enforcement actions. She is currently active in many matters arising from the subprime mortgage crisis and frequently conducts investigations for corporate clients, special committees, and boards of directors.
- aa1 Hilary Huber started at Sullivan & Cromwell LLP in 2012 after a one-year clerkship. Since joining the firm, she has been a part of teams representing financial institutions and global companies in commercial litigation matters, particularly related to the issuance and trading of securities and alleged fraudulent practices in connection with lending activities, as well as breach of contract disputes.
- 1 Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).
- 2 *Swack v. Credit Suisse First Boston*, 230 F.R.D. 250, 258 (D. Mass. 2005) (citing *In re Galileo Corp. S'holders Litig.*, 127 F. Supp. 2d 251, 260 (D. Mass. 2001)).
- 3 *In re Accelr8 Tech. Corp. Sec. Litig.*, 147 F. Supp. 2d 1049, 1053-54 (D. Colo. 2001).
- 4 See, e.g., Wendy Gerwick Couture, *Around the World of Securities Fraud in Eighty Motions to Dismiss*, 45 Loy. U. Chi. L.J. 553, 559 (2014) (showing that 53% of analyzed cases were dismissed bases on insufficient scienter allegations); Charles Murdock, *The Private Litigation Securities Reform Act and Particularity: Why Are Some Courts in an Alternate Universe?*, 45 Loy. U. Chi. L.J. 616, 630 (2014) (arguing that the PSLRA's heightened particularity requirement has resulted in illogical or inconsistent applications of the Act by courts); Steven A. Ramirez, *The Virtues of Private Securities Litigation: An Historic and Macroeconomic Perspective*, 45 Loy. U. Chi. L.J. 669, 727 (2014) (arguing that "for securities litigation to achieve its deterrent and compensatory purposes" securities pleading standards must revert to their pre-PLSRA status).

- 5 551 U.S. 308 (2007).
- 6 U.S. Sec. & Exch. Comm'n, Office of the Gen. Counsel, Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995 5-6 [hereinafter SEC Report], available at <http://www.sec.gov/news/studies/lreform.txt>.
- 7 Id. at 6-7.
- 8 Id. at 6.
- 9 Id.
- 10 Id.
- 11 Id.
- 12 Id.
- 13 Id. at 7.
- 14 *City of Pontiac Gen. Emps. Ret. Sys. v. Lockheed Martin Corp.*, 952 F.Supp.2d 633, 634-35 (S.D.N.Y. 2013).
- 15 15 U.S.C. §§ 78u-4(b)-(c) (2012).
- 16 See *Rahman v. Kid Brands, Inc.*, 736 F.3d 237, 242 n.3 (3d Cir. 2013) (comparing Rule 9(b) with the pleading standards under the PLSRA).
- 17 15 U.S.C. § 78u-4(b)(1)(B).
- 18 *Rahman v. Kid Brands, Inc.*, No. 11-1624(JLL), 2012 WL 762311, at *5 (D.N.J. Mar. 8, 2012) (noting that “liability cannot be imposed on the basis of subsequent events” (quoting *In re NAHC, Inc. Sec. Litig.*, 306 F.3d 1314, 1330 (3d Cir. 2002))).
- 19 15 U.S.C. § 78u-4(b)(2).
- 20 *Institutional Investors Grp. v. Avaya, Inc.*, 564 F.3d 242, 253 (3d Cir. 2009).
- 21 Id. (quoting *Mizzaro v. Home Depot, Inc.*, 544 F.3d 1230, 1238 (11th Cir. 2008)). Compare 15 U.S.C. § 78u-4(b)(2) (“[Plaintiffs must] state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”), with Fed. R. Civ. P. 9(b) (“Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally.”).
- 22 See Black's Law Dictionary 778 (9th ed. 2009) (defining inference as “a conclusion reached by considering other facts and deducing a logical consequence from them”).
- 23 See *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319-20 (2007) (contrasting the Second Circuit's and Seventh Circuit's approach to evaluating plaintiffs' allegations of scienter upon a motion to dismiss).
- 24 *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 602 (7th Cir. 2006), rev'd, 551 U.S. 308.
- 25 Id.
- 26 Id. (quoting *Fidel v. Farley*, 392 F.3d 220, 227 (6th Cir. 2004)).
- 27 *Tellabs*, 551 U.S. 308.
- 28 Id. at 310.
- 29 Id.
- 30 Id.

- 31 See Michael J. Kaufman & John M. Wunderlich, [Resolving the Continuing Controversy Regarding Confidential Informants in Private Securities Fraud Litigation](#), 19 *Cornell J.L. & Pub. Pol'y* 637, 640 (2010) (positing that the Court “injected considerable uncertainty into the pleading game” when it handed down its opinion in *Tellabs*); John M. Wunderlich, Note, [Tellabs v. Makor Issues & Rights, Ltd.: The Weighing Game](#), 39 *Loy. U. Chi. L.J.* 613, 682-84 (2008) (contrasting circuit's and district courts' approaches to “strong inference” post-*Tellabs*).
- 32 See *Tellabs*, 551 U.S. at 326 (“[T]he court's job is not to scrutinize each allegation in isolation but to assess all the allegations holistically. In sum, the reviewing court must ask: When the allegations are accepted as true and taken collectively, would a reasonable person deem the inference of scienter at least as strong as any opposing inference?” (citations omitted)).
- 33 Arunesh Sohi, [Circuits in Disarray Before and After Tellabs v. Makor: A Call For the Supreme Court to Weigh in on Securities Fraud Pleading Requirements Again](#), 38 *Sec. Reg. L.J.* 215 (2010).
- 34 *Id.*
- 35 See [Zucco Partners, LLC v. Digimarc Corp.](#), 552 F.3d 981, 987 (9th Cir. 2009) (“[W]e hold that the Court's decision in *Tellabs* does not materially alter the particularity requirements for scienter claims established in our previous decisions, but instead only adds an additional ‘holistic’ component to those requirements....”).
- 36 [N.M. State Inv. Council v. Ernst & Young](#), 641 F.3d 1089, 1095 (9th Cir. 2011) (citing [Zucco Partners, LLC](#), 552 F.3d at 991-92.).
- 37 15 U.S.C. § 78u-4(b)(3)(B) (2012).
- 38 15 U.S.C. § 78u-4(c).
- 39 *Fed. R. Civ. P.* 11.
- 40 See Renzo Comolli, Sukaina Klein, Ronald I. Miller & Svetlana Starykh, *NERA Econ. Consulting, Recent Trends in Securities Class Action Litigation: 2012 Full-Year Review* 16 (2013) [hereinafter *NERA, Recent Trends*], available at http://www.nera.com/nera-files/PUB_Year_End_Trends_01.2013.pdf (“A motion to dismiss was filed in more than 96% of all cases. Of the 4% of cases without a motion to dismiss, virtually all ended with settlements.”).
- 41 See Michael J. Kaufman & John M. Wunderlich, [Toward a Just Measure of Repose: The Statute of Limitations for Securities Fraud](#), 52 *Wm. & Mary L. Rev.* 1547, 1582-83 (2010) (asserting that heightened pleading standards increase the likelihood a claim will be dismissed); John M. Wunderlich, [The Importance of the Prefiling Phase for Securities-Fraud Litigation](#), 45 *Loy. U. Chi. L.J.* 737, 740 (2014) (arguing that heightened pleading standards and increased focus on the prefiling phase of securities litigation have created “access barriers” to plaintiffs filing securities suits).
- 42 [Eminence Capital, L.L.C. v. Aspeon, Inc.](#), 316 F.3d 1048, 1052 (9th Cir. 2003) (per curiam).
- 43 [Alaska Elec. Pension Fund v. Flowserve Corp.](#), 572 F.3d 221, 235 (5th Cir. 2009) (per curiam).
- 44 [City of Pontiac Gen. Emps. Ret. Sys. v. Lockheed Martin Corp.](#), 952 F. Supp. 2d 633, 635 (S.D.N.Y. 2013).
- 45 SEC Report, *supra* note 6, at 6.
- 46 See *NERA, Recent Trends*, *supra* note 40, at 17 (“[Thirty-one percent] of [securities] cases continue[] past the motion to dismiss, at least in part. In an additional 5% of cases, dismissal was granted, though without prejudice.”); see also [In re Accelr8 Tech. Corp. Sec. Litig.](#), 147 F. Supp. 2d 1049, 1053-54 (D. Colo. 2001) (discussing heightened pleading standards under the PLSRA).
- 47 Compare 28 USC § 1658 (2012) (setting the statute of limitations for a private securities claim as two to five years), with *Fed. R. Civ. P.* 12 (giving defendants twenty-one days to respond to a compliant and summons).
- 48 Christopher J. Keller and Michael W. Stocker, ‘*Tellabs*’: PSLRA Pleading Test Comparative, Not Absolute, *N.Y. L.J.*, Oct. 3, 2007, <http://www.newyorklawjournal.com/id=900005492538#>.
- 49 *Id.*

- 50 Id.
- 51 See Couture, *supra* note 4, at ___ (stating that out of thirty-nine opinions analyzed, only four opinions made [Rule 11](#) findings and in only one of those four cases did the court impose a [Rule 11](#) sanction).
- 52 [131 S. Ct. 1309 \(2011\)](#).
- 53 Id. at 1303.
- 54 Id.
- 55 Id. 1324-25 (citing [Tellabs, Inc. v. Makor Issues & Rights, Ltd.](#), 551 U.S. 308, 323-24 (2007)).
- 56 Id. at 1325 (citing [Tellabs](#), 551 U.S. at 324).
- 57 See Brief for Respondents at 5-17, [Matrixx Initiatives, Inc.](#), 131 S. Ct. 1309 (No. 09-1156) (describing the plaintiffs' evidence supporting their allegations of scienter and materiality).
- 58 [646 F. Supp. 2d 860 \(S.D. Tex. 2009\)](#).
- 59 Id. at 863.
- 60 Id.
- 61 Id. at 864.
- 62 Id. at 868.
- 63 Id.
- 64 Id.
- 65 [686 F.3d 21, 26-27\(1st Cir. 2012\)](#).
- 66 Id. at 31.
- 67 Id.
- 68 Id.
- 69 [451 F. App'x 80 \(3d Cir. 2011\)](#).
- 70 Id. at 85.
- 71 Id.
- 72 Id.
- 73 The use of confidential witnesses in securities fraud pleadings has raised a number of ethical issues that have been written about in great detail. See e.g., Kaufman & Wunderlich, *supra* note 31, at 661-62 (discussing the appropriate inquiry for assessing the validity of confidential witnesses); Gideon Mark, [Confidential Witnesses in Securities Litigation](#), 36 *J. Corp. L.* 551, 551 (2011) (examining two issues presented by relying on confidential witnesses in securities pleadings). This Article does not purport to address even a small number of those issues; it merely considers a couple of noteworthy examples from recent case law.
- 74 No. 11 Civ. 5026(JSR), [2013 WL 3389473 \(S.D.N.Y. July 9, 2013\)](#).
- 75 Id. at *1 (citing [15 U.S.C. § 78u-4\(b\)\(3\)\(B\) \(2012\)](#)).
- 76 Id. at *2.

- 77 Id.
- 78 Id.
- 79 Id.
- 80 Id.
- 81 Id.
- 82 Id. at *3.
- 83 Id.
- 84 Id. at *4.
- 85 No. 09 C 7143, 2011 WL 824604 (N.D. Ill. Mar. 7, 2011) aff'd in part, vacated in part, 711 F.3d 754 (7th Cir. 2013).
- 86 Id. at *3.
- 87 Id.
- 88 Id.
- 89 Id.
- 90 Id.
- 91 Id. at *2.
- 92 Id.
- 93 Id. at *4.
- 94 The appellate court affirmed the district court's dismissal with prejudice. The appellate court vacated in part and remanded the case, however, "for consideration, pursuant to 15 U.S.C. § 78u-4(c)(1), (2), of whether to impose Rule 11 sanctions on the plaintiffs' lawyers and if so in what amount." *City of Livonia Emps. Ret. Sys. v. Boeing Co.*, 711 F.3d 754, 762 (7th Cir. 2013).

45 LYUCHILJ 653