Out on a Limb: Support for a Limited Version of Collective Scienter

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NOTES

OUT ON A LIMB:
SUPPORT FOR A LIMITED VERSION
OF COLLECTIVE SCIENTER

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INTRODUCTION

Scenario A:

Imagine a situation where a company produces electronic goods. In the beginning of 2013, the company releases an electronic widget as its new marquee product. While this widget is revolutionary, it also has some significant safety problems. Soon after the release, the electronic widget begins to catch fire during use. The company did not know of the safety problems when it first released the product. Since the safety problems have arisen, the company’s stock price has dropped significantly. Shortly after the stock price began to decline, the CEO released press statements touting that they considered safety their primary goal and that they had fixed any defects in the electronic widget.

While the company was making these statements, government regulatory agencies were doing their own investigation. They found that the testing procedures the company employed were not adequate, and there was still a significant risk that these new products were dangerous. Moreover, the manufacturer circulated an internal memorandum that stated that the company still did not know the exact reason why the initial model would catch on fire, and the company was unsure of how to proceed.

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After the company made statements claiming to have fixed the defect, the stock price began to rebound. However, soon after, the same problems began to arise in the devices that the company claimed to have fixed. With such significant problems in its marquee product, the stock price, once again, plummeted.

A stockholder brought a claim under Rule 10b-5 of the Securities Exchange Act of 1934, claiming that the company misrepresented the safety of the electronic widget. Plaintiff-stockholders, however, at this stage of the litigation have a very limited amount of information. The plaintiffs know there was a government investigation, but do not know who the report was sent to or who was aware of the investigation. Furthermore, they know that there was an internal memorandum, but they do not know who within the company had access to it. Can the plaintiff shareholders adequately plead that the corporation acted with scienter without identifying specific individuals within the company who knew of the reports?

**Scenario B:**

Assume there is a company, distinct from the company of Scenario A, called Company B. Company B is experiencing the same problems as Company A. Company B released a new marquee electronic widget, which experienced severe safety problems. Company B, however, genuinely believed that it had fixed the problem. The CEO of the company made a statement affirmatively endorsing the product’s safety. The CEO believes the statement he is making is true. The janitor, however, a former electrical engineer who has been cleaning up around the manufacturing plant, has realized that defects still exist in the product. Can the misstatement by the CEO be paired with the janitor’s knowledge of the statement’s falsity in order to sufficiently plead corporate liability for fraud?

**Scenario C:**

Alternatively, consider if Corporation B had two offices, one in New York and one in China. The New York office is the corporate headquarters. The CEO, stationed in the New York office, makes a statement about the safety of the new electronic widgets. A corporate official in the China office, which also houses the manufacturing plant, knows that the statement is
false. Can the misstatement by the CEO in New York be paired with the corporate official’s knowledge in China to adequately plead corporate liability for fraud?

The issue with these hypotheticals is in determining whether plaintiffs can successfully plead a strong inference of scienter, under section 10(b) of the Securities Exchange Act of 1934, against the corporation without being able to plead that any specific individual within the corporation had scienter. Traditionally, a plaintiff can successfully plead that a corporation has scienter when the scienter of an individual within the company can be imputed to the corporation.1 Recently, however, alternate theories have arisen to impute scienter to a corporation without inculpating an individual employee. One of them is collective scienter, which is the subject of this Note.

This Note argues that the correct approach to imputing scienter to a corporation by means of the collective scienter theory is through the absurdity analysis taken by the United States Court of Appeals for the Seventh Circuit. Part I of this Note reviews the Securities Exchange Act, which gave rise to the private right of action in securities fraud litigation. Part I also discusses United States Supreme Court jurisprudence on the private right of action. Furthermore, Part I lays out the framework of Private Securities Litigation Reform Act ("PSLRA"). PSLRA enacted a variety of procedural reforms in securities litigation in an attempt to curb frivolous litigation.2 Part I focuses on the changes that PSLRA caused in securities litigation and the congressional intent behind those changes.

Part II examines the current split of authority among the United States Courts of Appeals for the Fifth, Sixth, and Seventh Circuits over the extent, if any, that collective scienter should be used in pleading that a corporation has scienter. One approach is that of the Fifth Circuit, which considers collective scienter to contradict common law fraud principles.3 The only way to impute liability to a corporation is to look at the required state of

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1 See, e.g., Southland Sec. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 366 (5th Cir. 2004).
3 Southland Sec. Corp., 365 F.3d at 366 (rejecting the use of collective scienter as inconsistent with common law fraud principles).
mind of an individual corporate official.\textsuperscript{4} The United States Court of Appeals for the Eleventh Circuit takes a similar approach, holding that collective scienter is not consistent with PSLRA’s requirement that scienter be pled with particularity.\textsuperscript{5}

Conversely, the Sixth Circuit has adopted a theory of collective scienter.\textsuperscript{6} It allows plaintiffs to plead that the corporation has scienter by pairing the statements of the company to an individual who knew the statements were false, even though it was not the same person who made the statements.\textsuperscript{7}

The last approach, developed by the Seventh Circuit, has been called the “absurdity analysis.”\textsuperscript{8} This analysis allows for a limited version of collective scienter.\textsuperscript{9} Under this analysis, a complaint can adequately plead scienter on the part of the corporation without imputing it to a specific individual if the statement made by the corporation is so dramatic that a corporate official must have known it was false.\textsuperscript{10}

Finally, Part III argues that the correct standard for permitting collective scienter is the one presented by the Seventh Circuit. While many of the purer forms of collective scienter are problematic under the heightened pleading standards enacted by PSLRA, an all-out ban on collective scienter disregards the practical difficulties in being able to effectively impute scienter prior to discovery.\textsuperscript{11}

The Seventh Circuit’s approach is consistent with Congress’s intent in enacting PSLRA and the Supreme Court’s jurisprudence with regard to securities litigation.\textsuperscript{12} Furthermore, it is consistent with the Supreme Court’s decision in \textit{Tellabs, Inc.}

\textsuperscript{4} Id.

\textsuperscript{5} Phillips v. Scientific-Atlanta, Inc., 374 F.3d 1015, 1018 (11th Cir. 2004) (holding that collective scienter did not satisfy the particularity requirement of PSLRA).

\textsuperscript{6} City of Monroe Emps. Ret. Sys. v. Bridgestone Corp., 399 F.3d 651, 685 (6th Cir. 2005) (allowing plaintiffs to use a theory of collective scienter to satisfy the pleading requirements of the PSLRA).

\textsuperscript{7} Id.

\textsuperscript{8} See Makor Issues & Rights, Ltd. v. Tellabs Inc., 513 F.3d 702, 710 (7th Cir. 2008).

\textsuperscript{9} Id.

\textsuperscript{10} Id.

\textsuperscript{11} One reform of PSLRA was to halt discovery during a motion to dismiss. Therefore, plaintiffs only have the tools at hand available to them when alleging scienter.

\textsuperscript{12} See infra Part I.B.
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v. Makor Issues & Rights, Ltd. 13 In Tellabs, the Court reiterated the heightened pleading standard for scienter required to survive a motion to dismiss. 14 The Seventh Circuit's approach maintains this heightened pleading standard that both the Supreme Court and Congress have unequivocally sustained. Moreover, the Seventh Circuit's approach allows courts to take a common sense perspective in the scienter analysis. 15

I. THE LEGAL FRAMEWORK

A. Securities Exchange Act of 1934

In the wake of the Great Depression, Congress enacted the Securities Exchange Act of 1934 16 (“Exchange Act”). The Exchange Act was intended to be a method of regulating the trade of securities in order to protect investors from fraud. 17 To fulfill its congressional mandate, the Exchange Act created the Securities Exchange Commission 18 (“SEC”). The SEC was given broad authority to regulate the securities industry, including the ability to promulgate rules under the Exchange Act. 19 Rule 10b-5

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13 551 U.S. 308 (2007); see infra Part I.C.
14 Tellabs, 551 U.S. at 324.
15 See S. Ferry LP, No. 2 v. Killinger, 542 F.3d 776, 784 (9th Cir. 2008) (“In assessing the allegations holistically as required by Tellabs, the federal courts certainly need not close their eyes to circumstances that are probative of scienter viewed with a practical and common-sense perspective.”).
17 See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (“The 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges.”); see also Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 728 (1975) (“The Securities Exchange Act of 1943 . . . provide[d] for the regulation of securities exchanges . . . to prevent inequitable and unfair practices on such exchanges and markets . . . .”); Browning Jeffries, The Implications of Janus on Issuer Liability in Jurisdictions Rejecting Collective Scienter, 43 SETON HALL L. REV. 491, 498 (2013).
19 The Securities Exchange Act of 1934 (“Exchange Act”) gave the SEC broad powers including the power to register, regulate, and oversee brokerage firms, transfer agents, and clearing agents. The SEC was given the power to regulate various securities exchanges including the New York Stock Exchange and the NASDAQ. Furthermore, the Exchange Act gives the SEC disciplinary powers over certain types of conduct that the Exchange Act prohibits such as fraud and deceptive practices. See The Laws That Govern the Securities Industry, supra note 18.
of the Exchange Act, promulgated in 1948, is a “broad antifraud provision that essentially prohibits all fraud in connection with the purchase or sale of securities.”\(^{20}\) Rule 10b-5 makes it unlawful “[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”\(^{21}\) Rule 10b-5 was a hastily created and broadly defined rule.\(^{22}\) Because of this broad definition, Rule 10b-5 has grown exponentially through judicial activism. As Chief Justice Rehnquist stated, “a judicial oak . . . has grown from little more than a legislative acorn.”\(^{23}\)

Among the regulatory powers that the Exchange Act granted the SEC was the power to bring enforcement actions against violators of section 10(b) and Rule 10b-5.\(^{24}\) While the rule does not mention any private right of action for violations of the provisions, district courts began to recognize an implied private right of action early on.\(^{25}\) The Supreme Court, two decades following the implementation of the act, confirmed this private right of action.\(^{26}\)


\(^{21}\) 15 U.S.C. § 78j(b) (2012); see also 17 C.F.R. § 240.10b-5 (implementing section 10(b) of the Securities Exchange Act of 1934).

\(^{22}\) Marocco, supra note 20 (“I wasted no time; I got some people in, we drafted a rule, we presented it to the Commission, and, without any hesitation, the Commission tossed the paper on the table saying they were in favor of it. One Commission member said, ‘Well, we’re against fraud, aren’t we?’ So, before the sun was down, we had the rule that is now Rule 10b-5” (quoting Milton V. Freeman, Colloquium Foreword, 61 FORDHAM L. REV. S1, S1–S2 (1993))).


\(^{24}\) See supra note 19 (describing the regulatory powers of the SEC).


\(^{26}\) See Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971) (“Hence we do not read § 10(b) as narrowly as the Court of Appeals; it is not ‘limited to preserving the integrity of the securities markets,’ though that purpose is included. Section 10(b) must be read flexibly, not technically and restrictively. Since there was a ‘sale’ of a security and since fraud was used ‘in connection with’ it, there is redress under § 10(b), whatever might be available as a remedy under state law.” (quoting Superintendent of Ins. v. Bankers Life & Cas. Co., 430 F.2d 355, 361 (2d Cir. 1970))); see also Jeffries, supra note 17, at 499.
For a private litigant to establish a Rule 10b-5 claim, the plaintiff must prove (a) a material misrepresentation or omission made by the defendant, (b) a connection between the misrepresentation or omission and purchase or sale of a security, (c) reliance upon the misrepresentation or omission, (d) economic loss, (e) loss causation, and (f) scienter. Satisfying the scienter element is the focus of this Note.

B. The Private Securities Litigation Reform Act ("PSLRA")

Congress has also made it increasingly difficult for private individuals to bring private securities claims. Congress was concerned that an unchecked private right of action could lead to a host of frivolous actions which would undermine the capital markets and harm the entire economy. Therefore, in 1995, Congress enacted the Private Securities Litigation Reform Act ("PSLRA").

Congressional reports prior to the enactment of the PSLRA clearly demonstrate the concerns that Congress had with an unchecked private right of action. Left unchecked, private rights actions can lead to frivolous suits and also impose substantial burdens on law abiding companies. These “nuisance filings” were forcing innocent companies to pay either exorbitant attorney fees or even larger settlements. This, in turn, harms investors, “the very people that securities actions are supposed to protect.”

At the same time, however, Congress also recognized the importance that private rights of action played in enforcing federal securities litigation. Along with SEC civil and criminal
enforcement actions, the private right of action is an effective tool in enforcing federal securities litigation. The private right of action provides investors with an independent avenue of redress without relying on federal authorities such as the SEC to take action. Furthermore, the private right of action enhances confidence in the capital markets by offering another element of deterrence to corporate officers before perpetrating a fraud.

PSLRA attempted to balance these two opposing goals when overhauling the procedural requirements for bringing a securities fraud claim. PSLRA was intended to address a variety of problems with securities litigation by instituting “procedural hurdles” to dissuade nonmeritorious litigation. PSLRA substantially altered securities litigation with one principle change being the pleading standards. PSLRA enacted a heightened pleading standard for plaintiffs claiming securities fraud.

American capital markets to allow this system to be undermined by those who seek to line their own pockets by bringing abusive and meritless suits. Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action. Such 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. This legislation seeks to return the securities litigation system to that high standard.

See id. at 31, reprinted in 1995 U.S.C.C.A.N. 730, 730; PERINO, supra note 30, at 1-6–7 (“Congress expressly adopted the view long espoused by courts, the SEC, and plaintiff's class action attorneys that ‘[p]rivate securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action.’ ” (alteration in original) (footnotes omitted)); see also, Berarducci & Obhof, supra note 28. (recognizing the importance of the private right of action in deterring fraud and other violations).


See id.

PERINO, supra note 30, at 1-6 (“Congress viewed itself as walking a fine line between promoting confidence in the fairness of the litigation system and promoting confidence in the fairness of the capital markets.”).

See Perino, supra note 2 (stating one of Congress's primary goals as reducing the costs that securities class actions impose on the capital markets by discourage the filing of nonmeritorious suits); see also Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 320 (2007).

Other changes included procedures for appointment of lead plaintiffs and lead counsel, limitations on damages and attorney fees, a statutory safe harbor for forward looking statements, a stay of discovery pending a motion to dismiss, and mandatory sanctions for frivolous lawsuits. Berarducci & Obhof, supra note 28.

Before PSLRA, plaintiffs were required to plead fraud in accordance with Rule 9(b) of the Federal Rules of Civil Procedure. Rule 9(b) requires plaintiffs to plead the facts with particularity.\textsuperscript{41} PSLRA raised that standard by requiring plaintiffs to plead falsity and scienter with particularity.\textsuperscript{42} PSLRA first requires that each allegedly false or misleading statement must be pled “with particularity.”\textsuperscript{43} Second, it requires that a complaint must “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”\textsuperscript{44} A strong inference has been defined as one that a reasonable person would deem cogent and at least as compelling as any opposing inference one could draw from the facts alleged.\textsuperscript{45}

This heightened pleading standard has made it difficult for plaintiffs to ever reach the discovery stage.\textsuperscript{46} Therefore, in order to satisfy these pleading requirements, a variety of pleading theories have arisen.\textsuperscript{47} One such theory is collective scienter.

C. Supreme Court Jurisprudence on Private Rights of Action

The Supreme Court, beginning in the early 1990s, decided a series of cases that drastically rolled back the effectiveness of the private right of action. Along with the aforementioned congressional legislation the ability of private investors to succeed in bringing causes of action under Rule 10b-5 has been seriously curtailed.

In \textit{Central Bank of Denver v. First Interstate Bank of Denver},\textsuperscript{48} the Supreme Court took the first swing of the axe at the “judicial oak.” Following the promulgation of Rule 10b-5, lower courts interpreted the rule liberally, allowing plaintiffs to pursue both primary and secondary actors.\textsuperscript{49} Plaintiffs were able to

\textsuperscript{41} \textit{FED. R. CIV. P. 9(b)}.
\textsuperscript{42} 15 U.S.C. § 78u-4(b).
\textsuperscript{43} § 78u-4(b)(1).
\textsuperscript{44} § 78u-4(b)(2)(A).
\textsuperscript{45} \textit{See} \textit{Tellabs, Inc. v. Makor Issues & Rights, Ltd.}, 551 U.S. 308, 324 (2007).
\textsuperscript{47} \textit{See generally PERINO, supra note 30}.
\textsuperscript{48} 511 U.S. 164 (1994).
\textsuperscript{49} David J. Baum, \textit{The Aftermath of Central Bank of Denver: Private Aiding and Abetting Liability Under Section 10(b) and Rule 10b-5}, 44 AM. U. L. REV. 1817, 1822–24 (1995) (documenting the rise of aiding and abetting liability prior to the Supreme Court’s ruling in \textit{Central Bank}).
succeed against a defendant who, while not the primary violator, was engaged in preparation or other activity that helped the primary violators perpetrate the fraud, this was known as aiding and abetting liability. From the enactment of the Rule 10b-5 until 1994, every federal circuit court agreed that plaintiffs were able to succeed against secondary violators in this way. Because of this, private plaintiffs were able to successfully assert claims against a variety of secondary actors, including lawyers and accountants.

In 1994, the Supreme Court overruled thirty years of precedent by holding that private litigants could not utilize an aiding and abetting theory of liability under section 10(b) and Rule 10b-5. The Court strictly interpreted the language of section 10(b) to find that private causes of action do not impose aiding-and-abetting liability. While the Court did not rule on aiding and abetting liability with regards to SEC enforcement actions, Congress took the steps to expressly authorize SEC enforcement actions for aiding and abetting liability. Notably, Congress did not extend aider and abettor liability to the private right of action.

Following the Court’s ruling in Central Bank, the circuit courts adopted various methods for imputing secondary actor liability without using aiding and abetting violations as the foundation of the claim. One such standard was known as “scheme liability.” Scheme liability uses Rule 10b-5(a) and (c)
instead of Rule 10b-5(b).\textsuperscript{59} Using these two sections, plaintiffs had found a loophole to get around the Court’s ruling in \textit{Central Bank}.\textsuperscript{60} Courts would find defendants liable as part of a fraudulent scheme, as long as the scheme encompassed conduct beyond a misrepresentation or omission.\textsuperscript{61} This began a broad interpretation of scheme liability which incorporated many secondary actors into the liability fold.

However, once again, as the judicial oak began to grow, the Supreme Court stepped in to prune it. In \textit{Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.},\textsuperscript{62} the Court narrowed the application of scheme liability by focusing on the reliance element of Rule 10b-5.\textsuperscript{63} The Court held that the plaintiff failed to establish the element of reliance in its Rule 10b-5 claim.\textsuperscript{64} The Court stated the secondary actors had no duty to disclose and no member of the investing public had knowledge of the deceptive acts.\textsuperscript{65} Therefore, to use scheme liability to impute liability to the secondary actors was an “indirect chain,” which the Court found “too remote for liability.”\textsuperscript{66}

While the Court narrowed down a formerly expansive interpretation of scheme liability, it did not extinguish scheme liability entirely. In \textit{Stoneridge}, as is mentioned above, the Court issued a narrow holding which focused only on the issue of reliance.\textsuperscript{67} The holding did not speak to the larger issue of whether the defendant has to actually make the statement to be held liable. The Court explicitly said that the rejection of scheme liability does not necessarily make all secondary actors immune

\textsuperscript{59} Under Rule 10b-5(a) or (c), defendants who use a “device, scheme, or artifice to defraud” may be liable for securities fraud. After \textit{Central Bank}, plaintiffs began using these sections to inculpate secondary actors for misrepresentations made by primary violators of § 10b. In doing so, they created a type of aider and abettor liability outside of Rule 10b-5(b), which the Court struck down in \textit{Central Bank}. \textit{See} \textit{Brent A. Olson, 2 Publicly Traded Corporations: Governance & Reg.} § 11:9 (2015).

\textsuperscript{60} \textit{See} \textit{Marocco, supra} note 20, at 640.

\textsuperscript{61} \textit{See} \textit{Olson, supra} note 59. Under Rule 10b-5(a) or (c) there must be an inherently deceptive act that is distinct from an alleged misstatement. A claim under “scheme liability” cannot be made where the only claim alleged is misrepresentation or omission.

\textsuperscript{62} 552 U.S. 148 (2008).

\textsuperscript{63} \textit{Id.} at 159.

\textsuperscript{64} \textit{See supra} note 27 and accompanying text.

\textsuperscript{65} \textit{Stoneridge}, 552 U.S. at 159.

\textsuperscript{66} \textit{Id.}

\textsuperscript{67} \textit{Id.}
from private suit. The Court reiterated the holding of Central Bank, that the private right of action covers secondary actors who commit primary violations.

The Supreme Court altered the securities litigation landscape once again in 2007 with Tellabs, Inc. v. Makor Issues & Rights, Ltd. Prior to the Supreme Court’s decision, the circuits were split on what constituted a “strong inference of scienter” as required by the PSLRA. Specifically, the circuits were split over what plaintiffs were required to plead to survive a motion for summary judgment. In Tellabs, the Court defined what it meant to plead a “strong inference.” The Court defined this as an inference of scienter that is at least as likely as any plausible opposing inference. While the Court adopted a strict definition of strong inference, the Court did not adopt the strictest. The Court stated that the inference must be more than merely plausible; it did not require that it was the strongest inference.

Along with defining the strong inference of scienter, the Court also instructed courts to view allegations collectively. The Court stated that courts must consider the complaint in its entirety. The question is not whether any individual allegation meets the strong inference of scienter standard but whether the allegations collectively raise a strong inference of scienter.

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68 Id. at 166.
69 Id.
71 Tellabs, 551 U.S. at 324.
72 Id.
73 Id.
74 Id. at 329. Justice Scalia disagreed with the majority’s definition of “strong inference” because it did not require the most plausible inference. In his concurrence, Justice Scalia argued that “the test should be whether the inference of scienter (if any) is more plausible that the inference of innocence.” This would be the normal meaning of the phrase “strong inference” that Congress employed. Id. (Scalia, J., concurring).
75 Id. at 326 (majority opinion).
76 Id.
77 Id.
Finally, the Supreme Court in *Janus Capital Group, Inc. v. First Derivative Traders*\(^7\) defined what it means to make a statement under Rule 10b-5.\(^8\) The Court narrowly interpreted the word “maker” for Rule 10b-5 purposes as “the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it.”\(^9\) The Court further stated that one who merely prepares a statement for someone is not its maker.\(^10\) In doing so, the Court reaffirmed that the private right of action should be given a narrow scope.\(^11\)

In sum, the Supreme Court’s recent history has shown a trend of narrowing private causes of action and liability in securities litigation under Rule 10b-5. The Court has consistently narrowed whom investors can attempt to attach liability to and the methods through which investors attempt to attach liability. It is evident that the Supreme Court is intent on trimming the judicial oak but is unwilling to completely uproot it.

### D. Collective Scienter

It is generally accepted that corporations can act with scienter when an authorized agent makes a false statement, knowing that the statement is false.\(^12\) Courts have adopted respondeat superior-type doctrines to impute knowledge from an agent to the corporation in order to hold the corporation liable for securities fraud.\(^13\) It is universally accepted that the simplest way to raise an inference of scienter for a corporate defendant is to plead that an individual defendant, acting as an agent of the corporation, acted with scienter.\(^14\) This method borrows from common law respondeat superior doctrines and agency principles.\(^15\)

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\(^7\) 131 S. Ct. 2296 (2011).
\(^8\) Id. at 2301.
\(^9\) Id. at 2302.
\(^10\) Id.
\(^11\) Id. at 2303.
\(^13\) Id.
\(^14\) Glazer Capital Mgmt., LP v. Magistri, 549 F.3d 736, 743 (9th Cir. 2008).
\(^15\) See Kevin M. O’Riordan, *Clear Support or Cause for Suspicion? A Critique of Collective Scienter in Securities Litigation*, 91 MINN. L. REV. 1596, 1604 (2007) (explaining respondeat superior holds an employer liable for an employee’s or agent’s wrongful acts if those acts are committed within the scope of employment).
Courts have disagreed, however, over whether plaintiffs can raise a strong inference that a corporation has scienter without pleading scienter to an individual defendant. The theory through which plaintiffs can raise the strong inference that a corporation has scienter without inculpating an individual defendant is known as collective scienter. Collective scienter has taken a variety of forms. Generally, collective scienter “permits the aggregation of one person’s misstatement with the intent of another in a single pleading in order to attribute an allegation of scienter to the corporation, rather than pinpoint a single actor who intentionally misspoke.”

Collective scienter is often broken down into two categories: strong and weak collective scienter. The strong version allows plaintiffs to “allege scienter on the part of a corporate defendant without pleading scienter as to any particular employee.” This is because the corporation is deemed to have a state of mind completely separate from any of its employees. The knowledge deemed corporate knowledge is “an undifferentiated aggregation of its employees’ knowledge.”

The weak version of collective scienter compares the knowledge of one corporate employee to the statements of another. The weak version allows a plaintiff to successfully plead corporate scienter if the plaintiff alleges that a member of management made a false statement when another employee knew that statement to be false. The weak version of collective scienter allows a plaintiff to mix and match an employee who is the speaker with an employee who knows the statement was false. For example, drawing from Scenario B, the weak version of collective scienter would allow the statements made by the CEO to be matched with the janitor’s knowledge of the statement’s falsity to satisfy the scienter standard.

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87 Id. at 1605.
88 Id. at 1606–07.
89 See Crow, supra note 46 at 314.
90 See MICHAEL J. KAUFMAN, SECURITIES LITIGATION: DAMAGES § 24.55 (2014); see also Bondi, supra note 83 at 7.
91 See Bondi, supra note 83 at 10.
92 Id.
93 Id.
94 Id. at 12–13.
95 Id.
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III. THE CIRCUIT SPLIT

A. Fifth Circuit Rejects Collective Scienter on Common Law Fraud Grounds

The Fifth Circuit has rejected the concept of collective scienter in its entirety on the ground that it is incompatible with common law fraud concepts.96 In Southland Securities Corp. v. INSpire Insurance Solutions Inc.,97 the defendant, INSpire, was a software service provider that was alleged to have made a variety of misrepresentations,98 including the release of software with design flaws and the inflation of earning statements.99

The Fifth Circuit held that, for a plaintiff to raise a strong inference that a corporation acted with scienter, the court must “look to the state of mind of the individual corporate official or officials who make or issue the statement.”100 It is insufficient to look “generally to the collective knowledge of all the corporation’s officers and employees acquired in the course of their employment.”101 The act of making the statement and the state of mind must intersect with a single individual.102

The court relied on common law fraud concepts to reach its conclusion.103 In common law fraud actions, the subjective state of mind must exist in the individual making the misstatement.104 In other words, the person who makes the misstatement must also be the one who intended to deceive. Therefore, in a Rule 10b-5 action, the misstatement must be made by the same individual who acted with scienter.105

The plaintiffs in Southland failed to identify any INSpire director, officer, or employee who acted with scienter in the making or issuing of any statements.106 Without a collective scienter theory at the plaintiffs’ disposal, and since the plaintiffs

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96 Southland Sec. Corp. v. INSpire Ins. Solutions Inc., 365 F.3d 353, 366 (5th Cir. 2004).
97 365 F.3d 353.
98 Id. at 360–61.
99 Id.
100 Id. at 366.
101 Id.
102 Id.
103 Id.
104 Id.
105 Id.
106 Id. at 367.
could not show any intersection of scienter and misstatement, the plaintiffs failed to raise a strong inference of scienter on the part of the corporation.\textsuperscript{107}

B. Eleventh Circuit Rejects Collective Scienter as Incompatible with PSLRA

The Eleventh Circuit rejected collective scienter, by emphasizing its incompatibility with the PSLRA.\textsuperscript{108} In two separate cases, the Eleventh Circuit held that scienter must be pled specifically to each defendant.\textsuperscript{109} In \textit{Phillips v. Scientific-Atlanta, Inc.},\textsuperscript{110} the court held that scienter must be found with respect to each defendant and with respect to each alleged violation of the statute.\textsuperscript{111} The court relied on the “plain meaning” of the PSLRA to come to its conclusion.\textsuperscript{112} The PSLRA uses the singular term “the defendant” with respect to alleging scienter.\textsuperscript{113} It requires that plaintiffs, “with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”\textsuperscript{114} For this reason the court concluded that scienter must be pled with particularity to each defendant and that it would be improper to aggregate the knowledge of several defendants when alleging a strong inference of scienter.\textsuperscript{115} Therefore, the court held that pleadings that relied on collective scienter would not survive summary judgment.

Two years later, the court applied the same reasoning in \textit{Garfield v. NDC Health Corp.},\textsuperscript{116} to strike down a theory of weak collective scienter.\textsuperscript{117} There, the court held that the plaintiffs failed to plead scienter with sufficient particularity because they did not allege that the officer who signed a Sarbanes-Oxley

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\begin{itemize}
\item[\textsuperscript{107}] \textit{Id.} at 367–68.
\item[\textsuperscript{108}] \textit{Phillips v. Scientific-Atlanta, Inc.}, 374 F.3d 1015, 1017–18 (11th Cir. 2004).
\item[\textsuperscript{109}] \textit{See} \textit{Garfield v. NDC Health Corp.}, 466 F.3d 1255, 1265 (11th Cir. 2006); \textit{Phillips}, 374 F.3d at 1017–18.
\item[\textsuperscript{110}] 374 F.3d 1015.
\item[\textsuperscript{111}] \textit{Id.} at 1017–18.
\item[\textsuperscript{112}] \textit{Id.}
\item[\textsuperscript{113}] \textit{Id.}
\item[\textsuperscript{114}] \textit{Id.} at 1018 (quoting 15 U.S.C. § 78u–4(b)(2) (2012)).
\item[\textsuperscript{115}] \textit{Id.} at 1017–18.
\item[\textsuperscript{116}] 466 F.3d 1255 (11th Cir. 2006).
\item[\textsuperscript{117}] \textit{Id.} at 1265.
\end{itemize}
\end{footnotesize}
C. The Sixth Circuit Accepts Collective Scienter

Conversely, the Sixth Circuit has embraced a theory of collective scienter.\textsuperscript{120} In City of Monroe Employees Retirement System \textit{v.} Bridgestone Corp.\textsuperscript{121} Bridgestone, a tire company, had safety problems with its tires.\textsuperscript{122} Firestone is a subsidiary of Bridgestone operating in the United States. Shareholders sued Bridgestone and Firestone, alleging several public misrepresentations about the safety and performance of their tires.\textsuperscript{123} Firestone was well aware of many of the safety problems because of internal reports that demonstrated the tires’ safety problems.\textsuperscript{124} Other evidence that the defendants were aware of the defects in their products included a settlement with an insurance company.\textsuperscript{125} Venezuela and the State of Arizona, furthermore, had both notified Firestone of issues they were having with the tires.\textsuperscript{126}

While Firestone was aware of all this information, the CEO of the company had never made any statements concerning the safety of the tires.\textsuperscript{127} Therefore, the plaintiffs could not match the statements to anyone with knowledge of their falsity. The court, however, permitted the plaintiffs to plead a theory of collective scienter.\textsuperscript{128} The plaintiffs aggregated the misleading corporate statements with the knowledge of the CEO and the pleading survived the motion to dismiss.\textsuperscript{129}

\textsuperscript{118} Id. at 1266.
\textsuperscript{119} Id.
\textsuperscript{121} 399 F.3d 651.
\textsuperscript{122} Id. at 656–57.
\textsuperscript{123} Id. at 663–64.
\textsuperscript{124} Id. at 657.
\textsuperscript{125} Id. at 658.
\textsuperscript{126} Id.
\textsuperscript{127} Id. at 690.
\textsuperscript{128} Id. at 690–91.
\textsuperscript{129} Id.
D. The Supreme Court Clarifies the Scienter Standard—Tellabs v. Makor Issues & Rights

After years of disagreement among the circuit courts regarding what constituted a strong inference of scienter, the Supreme Court attempted to clarify the standard in 2007. On appeal from the Seventh Circuit, the Supreme Court defined a strong inference of scienter and offered an analytical framework for courts to employ when determining whether it exists. The Court defined a strong inference of scienter as one that is “at least as compelling as any opposing inference one could draw from the facts alleged.”

Furthermore, the Court also shed light on how courts should analyze scienter allegations. Many circuits took a very individualized approach to determining whether plaintiffs satisfied the pleading standard. The Supreme Court, however, cautioned that it is not the court’s job “to scrutinize each allegation in isolation but to assess all the allegations holistically.” The Court instructed reviewing courts to ask this question: “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?” This holistic analysis is inherently a comparative one. In order to determine the strength of an inference, it is necessary to evaluate opposing inferences. The inference of scienter does not need to be irrefutable. It must, however, be at least as cogent as the nonculpable explanations.

Tellabs has the potential to affect collective scienter in two ways. First, it addresses whether a strong inference, as defined by the Court, can be raised without identifying an individual who both made the statement and acted with the requisite state of mind. Second, it requires that allegations be reviewed

131 Id. at 324.
132 Id. at 326.
133 Id.
134 Id.
135 Id. at 323.
136 Id. at 323–24.
137 Id.
138 Id.
holistically instead of individually. By requiring a holistic view of scienter allegations, the Court is instructing lower courts to take a more common sense approach to allegations.\footnote{See S. Ferry LP, No. 2 v. Killinger, 542 F.3d 776, 784 (9th Cir. 2008).}

E. Tellabs on Remand ("Tellabs II")

On remand, the Seventh Circuit applied the Supreme Court’s definition of strong inference and also addressed the issue of collective scienter.\footnote{Makor Issues & Rights, Ltd. v. Tellabs (Tellabs II), 513 F.3d 702, 704 (7th Cir. 2008).} In discussing collective scienter, the court seemingly adopted the Fifth Circuit’s approach in \textit{Southland}.\footnote{Id. at 708.} The court stated that, in order to establish corporate liability for a Rule 10b-5 violation, the plaintiff must plead scienter by looking at the state of mind of the individual corporate official.\footnote{Id.} It is, therefore, not sufficient to look generally to the collective knowledge of all the corporation’s officers and employees. At first glance, it appears that the Seventh Circuit sounded the death knell of collective scienter.

However, the court did not close the door on collective scienter entirely. The court went on to proffer a hypothetical which breathes life back into collective scienter. The court stated that a strong inference of scienter can be pled without naming a specific corporate individual:

Suppose General Motors announced that it had sold one million SUVs in 2006, and the actual number was zero. There would be a strong inference of corporate scienter, since so dramatic an announcement would have been approved by corporate officials sufficiently knowledgeable about the company to know that the announcement was false.\footnote{Id. at 710.}

This analysis has become known as the “absurdity analysis.”

The absurdity analysis does not fit squarely into either the strong or weak versions of collective scienter; the analysis is a third, very limited, category of collective scienter. This analysis allows for the imputation of scienter to the corporation, outside of the traditional respondeat superior type methods.

\footnote{Id. at 708.}

\footnote{Id.}

\footnote{Id. at 710.}
F. In the Wake of Tellabs

Following the Supreme Court’s decision in Tellabs, Inc. v. Makor Issues & Rights, Ltd.,144 and the Seventh Circuit’s decision in Tellabs II, the circuit courts have not offered definitive views of collective scienter. The general trend among the circuits has been to acknowledge that collective scienter is possible, but to leave the question of how to plead it unanswered.

1. United States Court of Appeals for the Ninth Circuit

The Ninth Circuit in Glazer Capital Management, LP v. Magistri,145 adopted much of the Seventh Circuit’s approach in Tellabs II. In Glazer, a company, InVision, announced that it had entered into a merger agreement with General Electric.146 The merger agreement was a sixty-page document signed by the CEO and COO of InVision.147 Several months later, InVision released a press release which announced possible violations of the Foreign Corrupt Practices Act.148 This announcement put the merger in jeopardy, and caused stock prices to plunge.149

The plaintiffs alleged scienter on the part of InVision based on a theory of collective scienter.150 The plaintiffs alleged that, since the merger agreement contained statements assuring compliance with all laws, the company knowingly made false statements.151 The court found that the plaintiffs did not adequately plead scienter.152 Since the CEO made the statements, the plaintiffs were required to plead scienter with respect to him;153 another employee’s knowledge of the misstatement was insufficient.154

The court, however, recognized that collective scienter may still be possible because it was possible to raise the required inference of scienter with regard to a corporate defendant.

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144 551 U.S. 308, 324 (2007).
145 549 F.3d 736 (9th Cir. 2008).
146 Id. at 739.
147 Id. at 739–40.
148 Id. at 739.
149 Id.
150 Id. at 743.
151 Id.
152 Id. at 745.
153 Id.
154 Id.
without doing so with regard to a specific individual.\textsuperscript{155} It further cited the Seventh Circuit’s hypothetical in \textit{Tellabs II} as one instance where a corporation could be held liable through a theory of collective scienter.\textsuperscript{156} The court stated that “there could be circumstances in which a company’s public statements were so important and so dramatically false that they would create a strong inference that at least \textit{some} corporate officials knew of the falsity upon publication.”\textsuperscript{157}

However, the court noted that much of its analysis was dicta, because the facts presented by \textit{Glazer} were different than the hypothetical in \textit{Tellabs II}.\textsuperscript{158} The court held that, under these facts, the plaintiffs were required to plead that an individual acted with scienter.\textsuperscript{159} To allow the plaintiffs to circumvent the individualized pleading requirement under a collective scienter theory would allow the plaintiffs to satisfy the scienter pleading standard by showing any employee at InVision had knowledge of the violation.\textsuperscript{160} The court held that this would be inconsistent with the pleading requirements of PSLRA.\textsuperscript{161} However, the court left open the question whether any circumstances exist where a theory of collective scienter would be proper.\textsuperscript{162}

2. United States Court of Appeals for the Second Circuit

The Second Circuit’s approach to collective scienter mirrors that of the Ninth Circuit. The Second Circuit, in \textit{Teamsters Local 445 Freight Division Pension Fund v. Dynex Capital Inc.},\textsuperscript{163} held that while the easiest way to raise this inference is to plead scienter to an individual defendant, it was not the only way.\textsuperscript{164} The court acknowledged that the Seventh Circuit’s absurdity analysis was an alternate way to raise a strong inference of scienter and, therefore, the Second Circuit implicitly adopted a version of collective scienter.\textsuperscript{165}

\textsuperscript{155} Id. at 744.
\textsuperscript{156} Id.
\textsuperscript{157} Id.
\textsuperscript{158} Id. at 745.
\textsuperscript{159} Id.
\textsuperscript{160} Id.
\textsuperscript{161} Id.
\textsuperscript{162} Id.
\textsuperscript{163} 531 F.3d 190 (2d Cir. 2008).
\textsuperscript{164} Id. at 195.
\textsuperscript{165} Id. at 195–96.
In *Dynex*, the plaintiff had purchased asset-backed securities that were secured by mortgage loans sold by the defendant, Dynex, and its subsidiary, Merit Securities. After the bonds were issued, an increasing number of borrowers defaulted on their mortgages which caused the value of collateral to decline as well as substantial losses for investors. The defendant later disclosed that it had understated repossession rates on the collateral, and plaintiffs filed an action for securities fraud. The plaintiffs named the principal executive officer of Dynex and the CEO of Merit as defendants, along with the corporate defendants Dynex and Merit. While the court held that the plaintiffs' complaint was insufficient to raise a strong inference of scienter, the court did not foreclose on the possibility of pleading a strong inference of scienter through the collective scienter method.

3. United States Court of Appeals for the Third Circuit

Struggles with *Tellabs*

In *City of Roseville Employees' Retirement System v. Horizon Lines, Inc.*, the Third Circuit approved a method of imputing liability to a corporation by pleading scienter to a specific individual within the company. In discussing collective scienter, like the Ninth and Second Circuit, the court implied an acceptance of the hypothetical presented in *Tellabs II*. Ultimately, though, the court decided that the facts presented did not raise an issue akin to the absurdity analysis. Therefore the court declined to decide whether any of the approaches of collective scienter were viable pleading methods in the Third Circuit.

The dissent, however, offered a strong critique of the majority’s analysis. Specifically the dissent took issue with the court’s individualistic approach to viewing the allegations. The

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166 Id. at 192.
167 Id.
168 Id. at 193.
169 Id.
170 Id. at 196.
171 442 F. App’x 672 (3d Cir. 2011).
172 Id. at 676–77.
173 Id.
174 Id.
175 Id. at 678 (Ambro, J., dissenting).
dissent noted that “reviewing each allegation individually before reviewing them holistically risks losing the forest for the trees.”

After conducting a holistic review of the allegations presented the dissenting opinion found that defendants pled sufficient facts to show that senior executives made false statements with scienter. Therefore, the plaintiffs satisfied the most basic way to impute liability to a corporation. Once again, however, the dissent found it unnecessary to delve further into collective scienter, as the facts presented did not call for it.

The Tellabs decision, which was intended to promote uniformity among scienter pleading, has had only a limited impact on the theory of collective scienter. Some courts have analyzed how the newly defined “strong inference” of scienter would affect collective scienter, but few courts have considered the effects that a holistic analysis would have on pleading scienter through the collective scienter theory. In Rahman v. Kid Brands, Inc., the District Court of New Jersey analyzed the circuit split in light of the strong inference requirement of Tellabs and concluded that collective scienter was still a viable theory, as long as it was confined to the limits outlined in the hypothetical from Tellabs II. The court stated that “it may be possible to plead [collective] scienter against a corporation [but] . . . the alleged wrongdoing to so assert collective scienter would need be ‘extraordinary.’”

Rahman is also one of the few cases that begins to analyze how a holistic approach to the scienter analysis impacts collective scienter. While the court ultimately held that plaintiffs failed to plead sufficient indicia of scienter for the court to apply collective scienter, the court offered a glimpse of what would be sufficient. The plaintiffs alleged that, since the company was issued a warning because of its fraudulent import practices, they satisfied

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176 Id.
177 Id. at 680.
178 Id.
179 Id.
180 See, e.g., Glazer Capital Mgmt., LP v. Magistri, 549 F.3d 736, 745 (9th Cir. 2008) (leaving the possibility of collective scienter as an open issue).
181 See, e.g., City of Roseville Emps. Ret. Sys., 442 F. App’x at 678 (Ambro, J., dissenting) (criticizing the majority opinion for failing to review the allegations holistically).
183 Id. at *20–21.
184 Id. at *20 (quoting City of Roseville Emps. Ret. Sys., 442 F. App’x at 676).
the collective scienter pleading requirement through a totality of the circumstances test.\textsuperscript{185} The court, however, disagreed. The court stated that a single red flag alerting the board to possible misconduct was insufficient to plead collective scienter.\textsuperscript{186} The amended complaint did not allege the pervasiveness of the violations or whether executive officers would have been alerted of them.\textsuperscript{187}

III. THE CORRECT STANDARD: THE SEVENTH CIRCUIT’S “ABSURDITY ANALYSIS”

The Seventh Circuit approach is consistent with the language and congressional intent behind PSLRA. Furthermore, it is also consistent with both the Supreme Court’s jurisprudence on the private right of action generally as well as the Court’s interpretation of the scienter pleading standard in \textit{Tellabs}.

A. Absurdity Analysis Is Consistent with the Twin Aims of PSLRA

The Seventh Circuit’s absurdity analysis is consistent with Congress’s intent in enacting PSLRA.\textsuperscript{188} The purpose of PSLRA was to dissuade frivolous litigation, while preserving meritorious claims.\textsuperscript{189} Permitting a narrow version of collective scienter under the Seventh Circuit’s approach will accomplish both of these goals.\textsuperscript{190}

Allowing collective scienter only in instances where it would be absurd for corporate officials not to be aware of the misstatements maintains a high bar for pleading standards. One of the main critiques of collective scienter is that it will allow plaintiffs to circumvent the heightened pleading standard and conduct a “fishing expedition” in discovery.\textsuperscript{191} This would impose many of the costs that PSLRA had intended to eliminate. Collective scienter under the absurdity analysis would not

\textsuperscript{185} Id. at *22.
\textsuperscript{186} Id.
\textsuperscript{187} Id.
\textsuperscript{188} See supra part III.A.
\textsuperscript{189} See supra part I.B.
\textsuperscript{190} See supra part III.A.
\textsuperscript{191} See PERINO, supra note 30, at 1-8.
encounter this problem. Since the absurdity analysis is limited to extraordinary situations, a flood of plaintiffs would not overcome the pleading hurdles.

Furthermore, accepting the absurdity analysis would do away with the distinction between strong and weak collective scienter and many of the problems that arise with the two theories. Hypothetical B, which matched the janitor's knowledge of falsity with the CEO's statement, is the classic example of weak collective scienter. This example demonstrates the potential ridiculous results that would arise from mixing and matching one person's state of mind with another's statement.\textsuperscript{192} Further, the critique also highlights the problem that weak collective scienter does not define what level of employee can be used in the analysis.\textsuperscript{193} There is no characterization of whether the employees must be corporate officers or management-level employees, or whether the employee can extend all the way down to the janitor's office.

The absurdity analysis is not shackled by the same critiques of weak collective scienter. First, there is no mixing and matching of one person's state of mind and another person's statement. Instead, the analysis rests upon the assumption that there are some statements that are so dramatic, so important to the company, that it is safe to assume that at least one corporate official had the requisite state of mind. Second, there is no danger of relying on a low level employee to impute liability to the corporation. The analysis limits the assumption to corporate officials. The absurdity analysis does not allow for one janitor to impute liability to the entire corporation.

The critique of strong collective scienter is presented in Scenario C. The critique centers on business efficiency. To ensure the complete integration of all information across international offices would be an unreasonable burden. It would slow day-to-day business operations and would force corporations to undertake inefficient compliance monitoring.

\textsuperscript{192} Southland Sec. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 366 (5th Cir. 2004).

\textsuperscript{193} Several lower courts have implied that management-level employees must be involved to impute scienter to a corporation, but there has not been extensive discussion, and some courts fail to make any distinction at all. See, \textit{e.g.}, Higginbotham v. Baxter Int'l Inc., 495 F.3d 753, 757–58 (7th Cir. 2007).
The absurdity analysis, once again, is not saddled with the same unreasonable consequences. With collective scienter, in the context of an absurdity analysis, limited to dramatic announcement about the company, it is not unreasonable to require a company to take extra compliance measures to ensure the statements they are releasing are true and accurate. Day-to-day operations would be minimally affected, because announcements or disclosures that concern ordinary day-to-day business would not be under the gamut of the absurdity analysis.

B. Absurdity Analysis Is Consistent with Supreme Court Jurisprudence on Private Rights of Action

Since the early 1990s, the Supreme Court has continually cut back on the expansiveness of the private right of action in Rule 10b-5 causes of action.194 There is a consistent trend in scaling back expansive doctrines that would otherwise allow plaintiffs to plead and prove liability through less onerous means.195 At the same time, however, the Court has never completely quashed the private right of actions or many of the theories underlying it.196 The Court has generally issued narrow holdings that begin to close the door on innovative or expansive liability methods but do not close it completely.197

Adopting a collective theory of scienter similar to the Seventh Circuit’s approach would fit well in this pattern of jurisprudence.198 Courts could eliminate the possibility of circumventing pleading standards through both the strong and weak collective scienter. This would limit the availability that plaintiffs have in imputing liability to the corporation at the pleading stage. However, it would not make it impossible to plead corporate scienter through methods outside of the classic respondeat superior method. The absurdity analysis would offer a small doorway that could be used in mostly extreme situations for the plaintiffs to clear the pleading hurdle.

194 See supra Part I.C.
195 See id.
196 See id.
197 See id.
198 See id.
C. Absurdity Analysis Fits Squarely with the Strong Inference of Scienter and the Holistic Approach.

Most importantly, the absurdity analysis fits squarely with the Supreme Court’s decision in Tellabs, the last time the Court has spoken on the issue of scienter. To begin, the absurdity analysis is congruent with the definition of strong inference of scienter. The Court defined strong inference as “at least as likely as any plausible opposing inference.” When a dramatic announcement is made by a company, it is very plausible that corporate officers knew the statements were false. The absurdity analysis would not apply to gray areas where there is room for debate over what the corporate officers knew. The analysis inherently adopts the strong inference standard because it is limited to such absurd situations where the inference would most likely be much more cogent than any innocent plausible inference.

Furthermore, the absurdity analysis fits well with the holistic scienter analysis that Tellabs described. In interpreting the holisitic analysis, one court stated, “In assessing the allegations holistically as required by Tellabs, the federal courts certainly need not close their eyes to circumstances that are probative of scienter viewed with a practical and common-sense perspective.” The absurdity analysis fits well with this commonsense perspective. When an important or dramatic announcement is made by a company that is clearly false, it is likely that corporate officers have knowledge of its falsity or were deliberately reckless.

D. Absurdity Analysis Applied to Scenario A

The hypotheticals from the start of this Note demonstrate the effectiveness of the absurdity analysis. In the first hypothetical, a company’s marquee product had a serious mechanical defect. The government investigation, along with the internal reports, demonstrated that the company was aware that the defects existed. However, prior to discovery, plaintiffs are not able to identify exactly which corporate officers knew of the defects.

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200 See S. Ferry LP, No. 2 v. Killinger, 542 F.3d 776, 784 (9th Cir. 2008).
Without any type of collective scienter, the plaintiffs would not be able to impute liability to the corporation. The classic, universally accepted method of imputing liability from a specific individual would be unavailable. While the plaintiffs know the CEO was the person who made the statement, at this point in the litigation, they cannot determine if he was aware of the government investigation or of the internal reports.

However, with a collective scienter theory utilizing the absurdity analysis, the plaintiffs could survive the pleading stage of the litigation. When a company’s marquee product is experiencing serious mechanical problems, it would be absurd for corporate officers of the company not to be aware of it. Therefore, plaintiffs would be able to successfully plead corporate liability through the absurdity analysis of collective scienter.

CONCLUSION

The Seventh Circuit’s absurdity analysis, which has been generally accepted by other jurisdictions, furthers Congress’s purpose in enacting PLSRA and is consistent with Supreme Court jurisprudence. The pleading standard for scienter has been a topic of debate since the enactment of PSLRA, and the Court’s jurisprudence has not presented a clear standard for the circuit courts to apply. Adopting the absurdity analysis will be a substantial step in providing a uniform system of pleading scienter in Rule 10b-5 suits. From a normative perspective, it is important to note that the absurdity analysis will further the broad-based goals of securities litigation. Corporations will not be able to skirt liability through a glorified ignorance defense. Instead, the absurdity analysis will offer an extra measure of protection to the securities market and protect those at the heart of all securities legislation—investors.