What's Mine Is Yours: The Circuit Split Over Collective Corporate Knowledge in Securities Fraud Litigation

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WHAT'S MINE IS YOURS:
THE CIRCUIT SPLIT OVER COLLECTIVE CORPORATE KNOWLEDGE IN SECURITIES FRAUD LITIGATION

Justin Jennewine*

“If crimes are committed, they are committed by people; they are not committed by some free-floating entity. These companies and other entities don't operate on automatic pilot. There are individuals that make decisions - and some make the right decisions, and some make the wrong decisions.” Jed S. Rakoff, United States District Judge1

I. INTRODUCTION

The Great Depression was perhaps the most economically crippling event in American history.2 President Franklin Roosevelt swiftly attributed the initial stages of the depression to the proliferation of big business throughout the country at that time.3 President Roosevelt’s solution to this crisis was the Securities Exchange Act of 1934 (SEA), which came as part of the New Deal legislation.4

In 1934, Congress passed the SEA, instituted to protect investors from stock price manipulation.5 By enacting the SEA, Congress also created the Securities and Exchange Commission (Commission) to oversee the SEA’s enforcement and maintain its effectiveness.6 Through Section 10b, the SEA made it unlawful to manipulate or deceive investors through any means that would contradict the rules and regulations of the Commission.7 Acting under their statutory authority, the Commission promulgated Rule 10b-5, which specifies that it is unlawful for anyone to make false or untrue statements or to omit material facts that are necessary to prevent misleading statements.8

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* Associate Member, 2014-2015; Articles Editor, 2015-2016, University of Cincinnati Law Review.
5. Id. § 78b.
6. Id. § 78d(a).
7. Id. § 78j.
8. 12 C.F.R. § 240.10b-5.
The question then becomes: despite the fact that a corporation is deemed a legal person, how can it commit fraud when the corporation is not a living entity? The answer being that when an officer acts on the corporation’s behalf, the actions, knowledge, and scienter of the officer are imputed to the corporation. However, courts have not agreed on how corporate scienter should be applied. The first issue courts face when deciding this issue is determining which employees are significant enough to have their knowledge imputed on the corporation and whether the individual’s knowledge can be considered collectively or if each individual’s knowledge needs to be considered independently. The second issue courts face is whether it is possible for a plaintiff to successfully plead scienter against a corporate defendant without successfully pleading that any individual acted with scienter.

Originally, the Fifth and Eleventh Circuits agreed that a plaintiff can successfully plead that a corporate defendant acted with scienter only if the officer of the corporation making the fraudulent or misleading statement also acted with scienter. Conversely, the Sixth Circuit, and the Second, Seventh, and Ninth Circuits, to a lesser degree, have said that the knowledge of any employee can be considered collectively and that a strong inference of scienter can be raised with regard to a corporate defendant without finding that an employee of the corporation acted with scienter. With those two positions fundamentally at odds with each other, the Sixth Circuit recently clarified its original position in an attempt to find a middle ground between the two extremes.

This Casenote will determine which circuit has adopted the correct approach for determining corporate scienter and, using this correct approach, answer the question of whether a corporation can act with scienter without sufficient proof that any employee of the corporation acted with scienter. Part II of this Casenote explores the body of law surrounding this issue, including the SEA and the Private Securities Litigation Reform Act of 1995, by analyzing the history, purpose, adaptation, interpretation and enforcement of the legislation. Part III explores the existing case law regarding collective scienter as well as the new “middle ground” proposed by the Sixth Circuit. Part IV analyzes

9. RESTATEMENT (THIRD) OF AGENCY § 7.03 (AM. LAW. INST. 2006).
13. See infra Part II.
14. See infra Part III.
why the “middle ground” rule is the most appropriate way to attach corporate scienter and explains why the Sixth Circuit’s ruling should be read to prohibit a plaintiff from pleading corporate scienter without successfully pleading individual scienter. Finally, Part V provides a summarization of the existing state of the law, explores the implications of the middle ground on securities law in the future, suggests that future courts adopt the Sixth Circuit’s newly created “middle ground” rule for attaching corporate scienter, and recommends that future courts reject the collective scienter theory.

II. BACKGROUND INFORMATION

A. The Securities Exchange Act of 1934

Congress enacted the SEA to regulate the secondary trading of securities through exchanges and over-the-counter markets. While the stated purpose of the SEA was to “perfect the mechanism of a national market system for securities,” courts have found that the underlying motivation was to protect investors from stock price manipulation. Section 10b of the SEA makes it “unlawful for any person . . . to use or employ . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulation as the Commission may prescribe . . . for the protection of investors.” Additionally, the SEA created the Securities and Exchange Commission as the overseeing body of the SEA. The Commission is responsible for promulgating legislation to further the purpose of the SEA. Acting pursuant to that power, the Commission enacted Rule 10b-5, which states that:

It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of intrastate commerce . . . [t]o make any untrue statement of material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

15. See infra Part IV.
16. See infra Part V.
20. Id. § 78d. The Commission is comprised of five commissioners appointed by the President of the United States and approved by the Senate. Id. § 78d(a).
21. See id. § 78j.
The majority of private securities fraud claims are brought under Section 10b and Rule 10b-5, notwithstanding the fact that neither provision explicitly provides for a private cause of action. However, federal courts have long recognized the right of private litigants to seek relief under Rule 10b-5.

To succeed on a claim under Rule 10b-5, the plaintiff must prove that: (1) the defendant(s) made a material misrepresentation or omission; (2) the defendant(s) possessed scienter; (3) the material misrepresentation or omission was connected to the purchase or sale of a security; (4) the plaintiff(s) relied on the defendant’s material misrepresentation or omission; (5) the plaintiff(s) suffered an economic loss; and (6) the economic loss was caused by the plaintiff’s reliance on the defendant’s material misrepresentation or omission. The Supreme Court has interpreted the language of the SEA on more than one occasion. Such was the case in Ernst & Ernst v. Hochfelder, where a prominent dispute arose over the term “scienter.” The Court defined “scienter” as “a mental state embracing intent to deceive, manipulate, or defraud” and held that it was a prerequisite to any claim brought under Section 10b or Rule 10b-5. Both intentional and reckless conduct are adequate to meet the scienter requirement.

B. Securities Litigation Reform

To raise a standard civil complaint under the rules of federal procedure, a complaint only needs to plead a “short and plain statement of the claim showing that the pleader is entitled to relief” and a demand for the relief sought. However, all complaints alleging fraud, including securities fraud cases, must “state with particularity the circumstances constituting fraud.” The person’s mental state could still be alleged generally.

For fifty years, the SEA protected investors from stock price manipulation. The SEA and the regulations promulgated by the
Commission contributed to the creation of the finest financial marketplace in the world.\textsuperscript{32} However, as the marketplace developed and securities fraud litigation became more common, Congress saw a need to protect corporations from fraudulent claims and unnecessary litigation by enacting a heightened pleading standard for plaintiffs.

The 1990s brought an influx of perceived SEA abuses, including frivolous investor lawsuits.\textsuperscript{33} In these so-called “strike suits,” large classes of investors would claim that a corporation violated Rule 10b-5 without any particular facts supporting the allegation.\textsuperscript{34} Congress found that these lawsuits “unnecessarily increase the cost of raising capital and chill corporate disclosure” and were frequently litigated by the same “professional plaintiffs.”\textsuperscript{35} Congress proposed the Private Securities Litigation Reform Act of 1995 (PSLRA) as a solution to this problem.\textsuperscript{36} Through the PSLRA, Congress sought to accomplish three goals: (1) to encourage corporate issuers to voluntarily disclose information; (2) to remove power from lawyers and return power to individuals in private security litigation; and (3) to encourage defendants to fight abusive claims while also allowing plaintiffs to continue to pursue valid claims.\textsuperscript{37} In pursuit of these goals, the PSLRA instituted a heightened pleading which has made it more difficult for plaintiffs to plead a Rule 10b-5 violation.\textsuperscript{38}

The heightened pleading standard for fraud cases contains a scienter element requiring that “the complaint shall, with respect to each act or omission alleged to violate [the act], state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”\textsuperscript{39} Requiring that complaints plead particular facts giving rise...
to a strong inference of the defendant’s mental state is a stricter standard than Federal Civil Procedure Rule 9(b), which only requires that the mental state be pleaded generally.\textsuperscript{40} If a plaintiff does not meet the requirements of the PSLRA, the defendant can file a motion to dismiss the claim and the reviewing court must then dismiss the complaint.\textsuperscript{41} Because the Supreme Court has heard only a handful of cases interpreting the PSLRA, the lower courts have been assigned the task of determining what it means for a defendant to satisfy the scienter requirement.

\textbf{C. Interpretation of the PSLRA}

Courts have grappled with the scienter requirement of the PSLRA since its inception, and the lack of legislative guidance has led to several splits in the law.\textsuperscript{42} The first dispute between circuits concerned the congressional intent behind the PSLRA’s use of the phrase “strong inference” when the court considers a motion to dismiss under Rule 12(b)(6).\textsuperscript{43} In \textit{Tellabs, Inc. v. Makor Issues & Rights, Ltd.}, the Supreme Court found that in order to qualify as a “strong inference,” an inference of scienter “must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of non-fraudulent intent.”\textsuperscript{44} As a general rule, if the argument for the existence of fraud is at least as compelling as the argument that there was no fraud, then the complainant has adequately pleaded scienter.\textsuperscript{45} The Supreme Court decision in \textit{Tellabs} has spurred criticism about its workability, predictability, and constitutionality.\textsuperscript{46}

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\textsuperscript{40} Cf. 15 U.S.C. § 78u-4(b)(2)(A), with FED. R. CIV. P. 9(b).
\textsuperscript{41} See 15 U.S.C. § 78u-4(b)(3).
\textsuperscript{42} See Wunderlich, supra note 3, at 623-26
\textsuperscript{43} Id. at 623. A Rule 12(b)(6) motion to dismiss is a civil procedure motion in which one party asks the court to dismiss the complaint filed against him or her because the complaint fails to state a claim for which relief can be granted. Typically, this means that the complainant failed to plead one or more element of the action. Because pleading standards tend to be quite liberal, motions to dismiss are usually unsuccessful. FED. R. CIV. P. 12(b)(6).
\textsuperscript{44} Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007).
\textsuperscript{45} See generally id.
\textsuperscript{46} See generally Wunderlich, supra note 3. While an understanding of the pleading requirement is fundamental in understanding the current securities fraud jurisprudence, this case is worth mentioning simply because it is an apt demonstration of the confusion that has surrounded the implementation of the PSLRA. There is even strife within the opinion in \textit{Tellabs}. Justice Scalia and Alito, both writing concurrences, argue that the phrase “strong inference” calls for something stricter than what the Court offers. \textit{Tellabs}, 551 U.S. at 329 (Scalia, J., concurring); id. at 333 (Alito, J., concurring). Justice Stevens, however, believes the standard of the Court is too strict and will do nothing more than keep valid claims out of court. Id. at 335 (Stevens, J., dissenting).
\end{flushright}
D. Corporations and Securities Fraud Litigation

The second, and most recent, PSLRA split has centered on the concept of scienter as it relates to corporate defendants. Corporations are legal fictions—they cannot think or act on their own. A corporation acts solely through its agents, but it has a legal status totally distinct from its shareholders and agents. Because corporations cannot make decisions on their own accord, courts and legislatures determine when the actions of an agent can be imputed onto the corporation. Courts are widely in agreement that a corporate defendant has acted with the requisite scienter when a corporate official makes a public statement, including a misstatement, and that official acted with scienter. However, there are situations where the equitable result is less clear. For example, courts struggle to determine how much liability the corporate defendant should bear when a lower level employee was responsible for the misstatement, or when the employee who made the public statement was not the employee who possessed scienter. Courts have historically assigned scienter to the corporate defendant based on two theories: (1) respondeat superior and (2) collective scienter.

Respondeat superior holds that an employer is liable for the actions of his employee when the employee is operating within the scope of his employment. When used in the context of corporate scienter, the theory of respondeat superior, sometimes referred to as "weak-form" corporate scienter, holds that a "corporation is deemed to have the requisite scienter for fraud only if an individual corporate officer making a statement has the requisite level of scienter at the time he or she makes the statement." Respondent superior "is the most accepted method of imputing liability to a corporation" because the corporation is in a better financial position than the employee to compensate the plaintiff.

47. See Bondi, supra note 39, at 2.
48. Id. at 2-3
49. See Southland Sec. Corp. v. INSpire Ins. Solutions Inc., 365 F.3d 353, 366 (5th Cir. 2004).
50. See Heather F. Crow, Comment, Riding the Fence on Collective Scienter: Allowing Plaintiff to Clear the PSLRA Hurdle, 71 LA. L. REV. 313, 314-16 (2010). The first scenario contemplates a CEO making a statement that is proven to be false, but the CEO has no knowledge of its falsehood because a lower level employee did not tell the CEO. The second scenario contemplates the CEO making the same false statement with no knowledge of its falsehood, but the CFO is made aware of the falsehood and tells the lower level employees not to disclose the information. The final scenario contemplates the CEO who knows a product is dangerous, makes no statement about the product, and sits by while the public relations department makes statements that the CEO knows are false.
52. In re Apple Computer, Inc., 127 F. App’x 296, 303 (9th Cir. 2005).
53. Patricia S. Abril, The Locus of Corporate Scienter, 2006 COLUM. BUS. L. REV. 81, 112 (2006). See also Lewis A Kornhauser, An Economic Analysis of the Choice between Enterprise and
However, critics of respondeat superior claim that it is most effective in simple cases that do not include multiple actors, and that the theory fails in many securities fraud cases where the speaker is not the person with scienter.\textsuperscript{54} For situations where respondeat superior is not appropriate, courts may look to the doctrine of collective scienter.

Collective scienter, also known as collective knowledge, works by aggregating the knowledge of a company's employees or agents in order to determine the knowledge of the company.\textsuperscript{55} Contrary to respondeat superior, the strong form of collective scienter does not require the plaintiff to show that the corporate officer responsible for making the statement had the requisite scienter but, simply, that the aggregate of the corporation's employees had "collective knowledge and intent."\textsuperscript{56}

Whichever method a court applies to a given set of facts can drastically change the outcome of a case. One of the most pressing issues courts now face occurs at the pleading stage in a private securities fraud case. The question of debate is whether or not a corporate defendant can have scienter according to Rule 10b-5 if the plaintiff fails to sufficiently plead that any of the individual defendants had scienter. The circuits are currently debating this issue, and there has recently been movement from the Sixth Circuit regarding the appropriate standard. The next section will review the existing case law regarding this topic, including the opinions of each circuit court and the recent proposal by the Sixth Circuit.

### III. An Overview

Six of the thirteen federal circuit courts have weighed in on the issue of whether a corporate defendant can be found to have the requisite scienter when none of the individual defendants are found to possess scienter.\textsuperscript{57} The Second, Seventh, and Ninth Circuits have stated that in the pleading stage of a trial, a corporate defendant can possess scienter according to Rule 10b-5 if the plaintiff fails to sufficiently plead that any of the individual defendants had scienter. The circuits are currently debating this issue, and there has recently been movement from the Sixth Circuit regarding the appropriate standard. The next section will review the existing case law regarding this topic, including the opinions of each circuit court and the recent proposal by the Sixth Circuit.

\textsuperscript{54} See Abril, \textit{supra} note 53, at 116.
\textsuperscript{55} See id. at 86.
\textsuperscript{56} \textit{In re WorldCom}, Inc. Sec. Litig., 352 F. Supp. 2d 472, 497 (S.D.N.Y. 2005).
\textsuperscript{57} See generally \textit{supra} notes 10-12 and accompanying text.

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*Personal Liability for Accidents*, 70 CAL. L. REV. 1345, 1362-63 (1982) (discussing the fact that employees are usually not financially able to compensate a victim).
imputed on the corporation—respondeat superior. In an earlier
decision, the Sixth Circuit fully embraced strong-form collective
corporate scienter. However, the Sixth Circuit’s most recent decision
on the issue seeks a middle ground.

A. Circuits in Favor of Strong-Form Collective Scienter

In Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital,
Inc., the Second Circuit heard a case involving Merit Securities Corp., a
subsidiary of the defendant corporation, Dynex Capital. Merit made
loans to investors interested in manufactured homes and then pooled
those loan obligations into asset-backed securities. After the bonds
were issued, default rates increased rapidly, and each new default was
more financially costly to Merit than the last. Moody’s Investor
Service investigated the bonds after Dynex disclosed that it had
understated the repossession rates on Series 13 Bonds by nearly thirty-
four percent in October 2003. In April 2004, Merit disclosed that it
had identified an internal control deficiency related to the recording of
loan losses. The announcement caused the Series 12 Bond and Series
13 Bond prices to decrease by as much as eighty-five percent.

Teamsters Local 445 Freight Division Pension Fund (“Teamsters”),
which had purchased approximately $450,000 worth of Series 13 Bonds,
filed suit under the SEA against Dynex and Merit, as well as both
companies’ Chief Executive Officers. Teamsters claimed that Dynex
told dealers that they would purchase very risky loans in an attempt to
increase market share in the home financing market but that Dynex
never disclosed this fact to consumers in the offering materials at the
time of sale. The defendants moved to dismiss, claiming that
Teamsters failed to adequately plead scienter, and the district court

59. See Southland Sec. Corp. v. INSpire Ins. Solutions Inc., 365 F.3d 353 (5th Cir. 2004);
61. See In re Omnicare, Inc. Secs. Litig., 769 F.3d 455 (6th Cir. 2014).
62. Teamsters Local 445, 531 F.3d at 190.
63. Id. at 192. Henceforth known as the “Series 12 Bonds” and “Series 13 Bonds.”
64. Id. at 192-93.
65. “Moody’s Investors Service is a leading provider of credit ratings, research, and risk
analysis. Moody’s commitment and expertise contributes to transparent and integrated financial
66. Teamsters Local 445, 531 F.3d at 193. Moody reclassified the bonds from “high quality” to
“speculative” in February of 2004. Id.
67. Id. 193.
68. Id.
69. Id.
granted the motion with respect to the individual defendants.\textsuperscript{70} However, the district court found that Dynex had originated defective loans of borrowers that they should have known were not creditworthy, which is sufficient to establish the inference that officers and employees of the corporate defendant had the motive and intent to commit fraud.\textsuperscript{71}

On appeal, the Second Circuit overturned the district court’s ruling and found that Teamsters had failed to adequately plead scienter on the part of the corporate defendants.\textsuperscript{72} However, the Court concluded that, as a matter of law, it is possible to plead “corporate scienter . . . in the absence of successfully pleading scienter as to an expressly named officer.”\textsuperscript{73}

The Seventh and Ninth Circuit are both in agreement with the Second Circuit’s holding. The Seventh Circuit found that while strong-form collective scienter was inconsistent with the strong inference requirement of the PSLRA, it is still possible to draw a “strong inference of corporate scienter without being able to name the individuals who concocted and disseminated the fraud.”\textsuperscript{74} The Ninth Circuit added that, regardless of the court’s opinion of the Seventh Circuit’s holding, the court could foresee a situation where some public statement was so dramatically false that it would create a strong inference of corporate scienter.\textsuperscript{75}

B. Circuits in Favor of Respondeat Superior

In \textit{Southland Sec. Corp. v. INSpire Ins. Solutions Inc.}, the Fifth Circuit decided a case where the defendant, INSpire, provided administrative services in the property and casualty insurance industry.\textsuperscript{76} Other named defendants included the parent company of INSpire and INSpire’s CEO, CIO, CFO, and Treasurer.\textsuperscript{77} The plaintiffs brought suit claiming that the defendants engaged in a fraudulent scheme to deceive investors about the company’s performance with the intention of inflating the stock price to derive personal gain.\textsuperscript{78} Specifically, the defendants contend that the plaintiffs touted “INSpire’s software products and contracts despite the software’s critical flaws,” issued

\textsuperscript{70} Id.
\textsuperscript{71} \textit{Teamsters Local 445}, 531 F.3d at 195.
\textsuperscript{72} Id. at 197.
\textsuperscript{73} Id. at 196.
\textsuperscript{74} Makor Issues & Rights, Ltd. v. Tellabs Inc., 513, F.3d 702, 710 (7th Cir. 2008).
\textsuperscript{75} Glazer Capital Mgmt., LP v. Magistri, 549 F.3d 736, 744-45 (9th Cir. 2008).
\textsuperscript{76} Southland Sec. Corp. v. INSpire Ins. Solutions Inc., 365 F.3d 353 (5th Cir. 2004).
\textsuperscript{77} Id. at 359.
\textsuperscript{78} Id. at 360.
inaccurate earning statements, violated Generally Accepted Accounting Principles,\textsuperscript{79} and improperly capitalized software development costs.\textsuperscript{80} The trial court granted defendant’s motion to have the case dismissed, finding that the plaintiffs failed to plead the fraud with particularity as required by PSLRA and improperly relied on the group pleadings doctrine.\textsuperscript{81}

On appeal, the Fifth Circuit reviewed the allegations against the individual defendants to determine if the plaintiffs had enough particularized facts to raise a strong inference of scienter. The court began by addressing the plaintiffs’ use of the group pleading doctrine.\textsuperscript{82} The group pleading doctrine is a legal concept that allows plaintiffs to rely on a presumption that statements made in company issued documents\textsuperscript{83} are the collective work of the individuals directly involved in the management on the company.\textsuperscript{84} The Fifth Circuit found that it had never adopted the group pleading doctrine prior to the enactment of the PSLRA and, since the PSLRA, the group pleading doctrine has effectively been abolished by the particularity requirement.\textsuperscript{85} This is significant for the analysis of collective corporate scienter because the court reaffirms the requirement that plaintiffs in a securities fraud suit must “distinguish among those they sue and enlighten each defendant as to his or her particular part in the alleged fraud.”\textsuperscript{86}

Next, the court addressed the claims against the corporate defendant, finding that:

For the purposes of determining whether a statement made by the corporation was made by it with the requisite Rule 10(b) scienter we believe it appropriate to look to the state of mind of the individual corporate official or officials who make or issue the statement . . . rather than generally to the collective knowledge of all

\textsuperscript{79} “The phrase ‘generally accepted accounting principles’ is a technical accounting term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. It includes not only broad guidelines of general application, but also detailed practices and procedures. Those conventions, rules, and procedures provide a standard by which to measure financial presentations.” AUDITING STANDARDS BD., AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, THE MEANING OF PRESENT FAIRLY IN CONFORMITY WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (1992), http://pcaobus.org/Standards/Auditing/Pages/AU411_02.aspx.
\textsuperscript{80} Southland, 365 F.3d at 360.
\textsuperscript{81} Id.
\textsuperscript{82} Id. at 363-64.
\textsuperscript{83} Such as annual reports and press releases.
\textsuperscript{84} Southland, 365 F.3d at 363-64.
\textsuperscript{85} Id. at 364.
the corporation’s officers and employees.\textsuperscript{87}

In support of this position, the court cited to an opinion issued by the Ninth Circuit in Nordstrom, Inc. \textit{v. Chubb & Son, Inc.}, stating that “there is no case law supporting an independent ‘collective scienter’ theory.”\textsuperscript{88} The Fifth Circuit also referenced a district court opinion from within the Ninth Circuit which found that “[a] defendant corporation is deemed to have the requisite scienter for fraud only if the individual corporate officer making the statement has the requisite level of scienter.”\textsuperscript{89} Therefore, the court concluded that to determine if the corporate defendant acted with the requisite scienter, it must first determine if the allegations “adequately show such a state of mind on the part of the individual defendants.”\textsuperscript{90} The Fifth Circuit held that a finding of scienter on the part of the corporate defendant is only possible if the individuals named in the complaint are also found to have acted with the requisite scienter.\textsuperscript{91} The court concluded with a detailed analysis of each fraudulent act alleged by the plaintiff and found that only one of the complaints against the individual defendants was properly pleaded.\textsuperscript{92}

Although addressing a different issue, the Eleventh Circuit commented similarly on the proper interpretation of the PSLRA in \textit{Phillips v. Scientific-Atlanta, Inc.}\textsuperscript{93} The Eleventh Circuit exercised discretion to address the issue of scienter because it closely related to the certified question in the case.\textsuperscript{94} The court held that “scienter must be found with respect to each defendant and with respect to each alleged violation of the statute.”\textsuperscript{95} This language signifies the Eleventh Circuit’s unwillingness to collectively gather violations and apply them to all defendants; rather, the court requires that the plaintiff show facts that each defendant had the proper scienter.\textsuperscript{96}

\begin{itemize}
\item \textsuperscript{87} Id. at 366.
\item \textsuperscript{88} Id. (quoting Nordstrom, Inc. \textit{v. Chubb & Son, Inc.}, 54 F.3d 1424, 1435 (9th Cir. 1995)).
\item \textsuperscript{89} \textit{Southland}, 365 F.3d at 366. (quoting \textit{In re Apple Computer, Inc. Sec. Litig.}, 243 F. Supp. 2d 1012, 1023 (N.D. Cal. 2002)).
\item \textsuperscript{90} Id. at 367.
\item \textsuperscript{91} Id. at 384-85.
\item \textsuperscript{92} Id. at 385. Because the plaintiffs properly pleaded a claim against an individual defendant, it is possible that the corporate defendant could also be found to have acted with the proper scienter to have violated Rule 10b. However, if none of the plaintiffs’ claims against the individual defendants were proper, then the Fifth Circuit would say that the corporate defendant could not have possibly acted with the proper scienter.
\item \textsuperscript{93} 374 F.3d 1015 (11th Cir. 2004).
\item \textsuperscript{94} Id. at 1017.
\item \textsuperscript{95} Id.
\item \textsuperscript{96} Id.
\end{itemize}
The Sixth Circuit first addressed the PSLRA standard for pleading a complaint in *City of Monroe Emps. Ret. Sys. v. Bridgestone Corp.* The plaintiffs claimed that the defendants, Bridgestone Corp., Firestone Inc., and Bridgestone’s CEO, had violated federal securities law by misrepresenting the financial status of the company in the annual reports. Specifically, the plaintiffs claimed that the corporate defendants neglected to fully reveal the true status of a certain brand of tires that, given the high rate of accidents, they should have known were faulty. The defendants were aware of the faults as early as 1993, but there were no efforts to investigate or correct the problem until Bridgestone and Bridgestone’s subsidiary, Firestone, launched a voluntary recall in 2000 after hundreds of deaths and thousands of injuries resulted from the faulty tires.

The plaintiffs alleged that the CEO of Bridgestone had actual knowledge of the misleading statements being produced in the annual reports. The Sixth Circuit held that the knowledge that these statements were false or misleading could be imputed onto the corporate defendants despite the fact that the complaint failed to link the statement to the CEO, who was the only individual defendant named in the complaint. This case was the first to show that corporate defendants could be found to have acted with scienter without finding that any named individual defendants also acted with scienter.

**2. The New Rule**

The Sixth Circuit was given an opportunity to reevaluate its stance on collective corporate scienter in *In Re Omnicare, Inc. Securities Litigation.* The case reached the Sixth Circuit on appeal from the United States District Court for the Eastern District of Kentucky. Plaintiffs, including a proposed class of persons that purchased Omnicare’s common stock between January 2007 and August 2010,
brought a putative securities class action suit against Omnicare, Inc., alleging that the defendants made materially false statements. The group of named defendants included: (1) the corporate defendant Omnicare, Inc.; (2) Omnicare president and CEO, Joel Germunder; (3) Omnicare CFO, David Froesel; and (4) another senior vice president.

Most of the plaintiffs’ allegations stemmed from allegations claimed in a *qui tam* action filed in the Northern District of Illinois by John Stone, Omnicare’s former Vice President of Internal Audits. Mr. Stone performed three audits of Omnicare and said that he discovered widespread problems in the company's submission of Medicare and Medicaid claims. Of the eighteen pharmacies included in the audit, Mr. Stone claimed that all eighteen had “submitted numerous claims during the time period [between 2000 and 2005] . . . without having the required supply documentation retained on file.” According to Mr. Stone, “the error rates were so high that Omnicare knew or should have known that these ‘false’ claims were being made.” However, the trial court dismissed all of Mr. Stone’s original claims.

The plaintiffs filed a consolidated amended complaint alleging five separate violations of rule 10b-5. As a result of these fraudulent behaviors, the plaintiffs claimed that the defendants were able to artificially inflate the stock price of the company. The defendants filed a motion to dismiss the plaintiffs’ amended consolidated complaint. The district court found that the plaintiffs failed to show that any of the named individual defendants were made aware of the results of Mr. Stone’s audits, and even if the CEO had been made aware, the complaint did not allege “sufficient facts to support a conclusion that from [that] knowledge they knew their legal compliance statements were false.”

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105. In a qui tam action, a private party called a relator brings an action on the government’s behalf. The government, not the relator, is considered the real plaintiff. If the government succeeds, the relator receives a share of the award. *Qui tam action*, LEGAL INFO. INSTIT., https://www.law.cornell.edu/wex/qui_tam_action (last visited April 22, 2015).


107. *Id.*

108. *Id.*

109. *Id.* at *10.

110. *Id.* at **11-12. The plaintiffs claimed that: (1) Omnicare falsely represented in its SEC filings that it was in compliance with state and federal regulations; (2) Omnicare falsely represented that its issues with Medicare and Medicaid compliance had been resolved; (3) Omnicare issued false financial reports during the class period on filings with the SEC and falsely reported artificially inflated financial data in its quarterly earnings conference call; (4) Omnicare made material misrepresentations and/or omissions by attributing its success to legitimate business factors; and (5) the named individual defendants knowingly signed false Sarbanes-Oxley certification. *Id.*


112. *Id.* at *13.

113. *Id.* at **33-34.
Because none of the individual defendants, based on the complaint filed, had actual knowledge of the falsity of the statements, the court then considered if an individual who was not a defendant could have his or her knowledge imputed on the corporation.\textsuperscript{114} The court noted that the plaintiffs failed "to cite primary authority where the knowledge of a non-defendant employee, who did not make the compliance statement, was imputed to the company for the purposes of finding that a corporation had actual knowledge."\textsuperscript{115} The court went on to say that even if it was inclined to attach liability to the corporate defendant based on the knowledge of non-defendant employees, the plaintiffs did not allege sufficient facts to support a finding that Omnicare was aware that its compliance statements were false.\textsuperscript{116}

Plaintiffs appealed the decision to the Sixth Circuit where it was accepted in an attempt to clarify its own previous holding on the topic.\textsuperscript{117} The Sixth Circuit began its analysis of scienter by recognizing that the existing law was split among the circuit courts.\textsuperscript{118} The court found that, on one extreme, the Fifth Circuit kept strictly to common-law fraud principles by allowing scienter to be imputed to a corporation only under respondeat superior.\textsuperscript{119} On the other extreme was the Sixth Circuit's previous ruling in \textit{City of Monroe}, in which the Court took a stance that "could expose corporations to liability far beyond what Congress had authorized."\textsuperscript{120} Since then, the Second, Seventh, and Ninth Circuits have weighed in without fully embracing either extreme, but all recognize that it is "possible to draw a strong inference of corporate scienter without being able to name the individuals" responsible for the fraud.\textsuperscript{121}

The Sixth Circuit recognized that "neither [the Fifth Circuit's nor the Sixth Circuit's original view]—when taken to the extreme—is ideal."\textsuperscript{122} Therefore, without overturning its opinion in \textit{City of Monroe}, the Sixth Circuit crafted a middle ground. The new rule is as follows:

The state(s) of mind of any of the following are probative for the purposes of determining whether a misrepresentation made by a corporation was made by it with the requisite scienter under Section 10b:

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\textsuperscript{114} \textit{Id.} at *35-36.
\textsuperscript{115} \textit{Id.} at *35.
\textsuperscript{116} \textit{Omnicare}, 2013 U.S. Dist. LEXIS 42973, at *36.
\textsuperscript{117} \textit{In re Omnicare, Inc. Sec. Litig.}, 769 F.3d 455 (6th Cir. 2014).
\textsuperscript{118} \textit{Id.} at 473-75.
\textsuperscript{119} \textit{Id.} at 473-74.
\textsuperscript{120} \textit{Id.} at 475.
\textsuperscript{121} \textit{Id.} at 474.
\textsuperscript{122} \textit{Omnicare}, 769 F.3d at 475.
a. The individual agent who uttered or issued the misrepresentation;

b. Any individual agent who authorized, requested, commanded, furnished information for, prepared (including suggesting or contributing language for inclusion therein, or omission therefrom), reviewed, or approved the statement in which the misrepresentation was made before its utterance or issuance;

c. Any highly managerial agent or member of the board of directors who ratified, recklessly disregarded, or tolerated the misrepresentation after its utterance.  

The Court found that this new rule was consistent with its prior holding but clarified some of the opinion’s “overly broad” language. Additionally, the court noted that this rule “prevents corporations from evading liability through tacit encouragement and willful ignorance” while also protecting corporations from the liability of the strike suit. The Sixth Circuit found that none of the named defendants satisfied the new “middle ground” test; therefore, the plaintiff had failed to plead scienter with respect to any named individual defendants.

While the district court found no evidence that non-defendant employees could have their scienter imputed on the company if they did not make the statements in question, the Sixth Circuit never explicitly addressed the issue. However, despite the fact that no individual defendants had scienter, the Sixth Circuit still performed an analysis to see if the corporate defendant acted with scienter, suggesting that the court thought it possible. However, the court held that the plaintiffs in this case failed to sufficiently plead facts that would give rise to a strong inference that the company acted with scienter. Accordingly, the circuit court upheld the district court’s dismissal of the plaintiffs’ claim.

123. Id. at 476.
124. Id.
125. Id. at 477.
126. Id. at 483. The court determined that Mr. Stone was both an individual who allegedly furnished information for and reviewed the statements in which the misrepresentations were made and a high managerial agent who ratified or tolerated the misrepresentation. Id.
127. See generally Omnicare, 769 F.3d 455.
128. See id. at 483-84.
129. Id.
130. Id. at 484.
IV. THE "MIDDLE GROUND" RULE IS APPROPRIATE BUT COLLECTIVE SCIENTER IS NOT APPROPRIATE

The problem with the existing case law’s approach to attaching corporate scienter can be broken down into two components: (1) identification and (2) collection. The identification component seeks to answer whether proving corporate scienter requires that the plaintiff be able to point to an individual within the corporation as the cause of the fraud or the misstatement. Identification is the key factor in determining the best method for attaching corporate scienter because it focuses on which employees can have their knowledge imputed. The second component, collection, is concerned with whether knowledge—specifically, the knowledge of individuals within the corporation who lack scienter—can be added together to create enough collective group knowledge to find scienter on behalf of the corporate defendant. Collection is the key factor for the analysis of the collective scienter doctrine. Both components critically affect the way corporate scienter is implemented, and the interpretation of each component will have lasting impacts on securities litigation.

This Part will seek to accomplish two things: (1) briefly review the Sixth Circuit’s proposed rule and determine from the existing case law that the Sixth Circuit’s new “middle ground” rule is the most effective way to attach scienter to corporate defendants; and (2) focus on how courts should apply the “middle ground” rule and offer an answer to the question of whether a plaintiff can use the doctrine of collective scienter to successfully plead corporate scienter if the plaintiff cannot successfully plead scienter on the part of any individual defendant. In comparing the Sixth Circuit’s opinion to the Second Circuit’s opinion in Teamsters, this analysis will determine that the doctrine of collective scienter is inappropriate under the SEA and PSLRA, and that the “middle ground” rule should be read to reject a theory of collective scienter. Any amount of collective scienter runs contrary to the plain language of the PSLRA and works to dilute the effects of the heightened pleading standard.

A. The Most Effective Method for Attaching Corporate Scienter

The Sixth Circuit opinion in In re Omnicare laid out a solution to the existing circuit split regarding how corporate scienter should be applied in securities fraud litigations. The “middle ground” rule proposed that the knowledge of any employee is “probative” of corporate scienter
if he or she "commanded, furnished information for, [or] prepared" the information that lead to the misleading or fraudulent statement. With regard to the identification component, the language of the "middle ground" rule splits the difference between the existing rules of law. The Sixth Circuit expands on the Fifth Circuit's rule, which allowed only the speaker's scienter to be imputed, by identifying three categories of employees that can have scienter imputed to the corporation. However, the Sixth Circuit's rule also narrowed the scope of the Second Circuit's rule by prohibiting all employees from being considered for corporate scienter.

The Sixth Circuit's method of applying corporate scienter is amazingly simple. The court expanded the total number of individuals that could have their scienter imputed on the corporation but required that the plaintiff affirmatively identify any individual that fits at least one of three groups of employees who had a significant impact on the fraudulent statement. The Sixth Circuit's "middle ground" test succeeds in finding a compromise between the other circuit courts while also satisfying the requirements of the PSLRA. The Sixth Circuit appropriately declares that only individuals the plaintiff can identify, and show to fit within one of the three categories, can have their knowledge imputed on the corporation. The test is the appropriate method for attaching scienter to corporate defendants in securities fraud cases under Section 10b and Rule 10b-5.

B. Any Collective Scienter Is Too Much Collective Scienter

1. The Sixth Circuit and the Collection Component

In sharp contrast with its clarity on the concept of identification, the Sixth Circuit's intentions are much less clear with regard to the collection component, because the court never explicitly addresses the

132. *Omnicare*, 769 F.3d at 476.

133. *Id*. The categories are: (1) the speaker of a misrepresentation; (2) anyone involved in the composition or delivery of the misrepresentation; and (3) high-ranking agents or board members who recklessly disregarded or tolerated the misstatements.

134. As compared to the Fifth and Eleventh Circuits who have said that only the speaker of the fraudulent statement can have their knowledge imputed on the corporation. See *Southland Sec. Corp. v. INSpire Ins. Solutions Inc.*, 365 F.3d 353, 366 (5th Cir. 2004).

135. This ensures that those employees who have their knowledge imputed to the corporation actually were involved in the making of the statement.

136. Congress was clear when it enacted the PSLRA; the goal was to prevent fraudulent securities fraud litigation by making it more difficult for plaintiffs to plead a violation of Section 10b and Rule 10b-5. S. REP. NO. 104-98, at 4 (1995).
question of collective scienter. The “middle ground” rule says that the state of mind of the individuals is “probative” of the state of mind of the corporation. Based on this language, the court might imply that the knowledge of any one identified individual is not conclusive of the knowledge of the corporation and should be considered with other individuals’ knowledge. This interpretation is possibly supported by the Sixth Circuit’s application of the “middle ground” rule in In re Omnicare. Despite the fact that the Sixth Circuit found that none of the identified individual defendants acted with scienter, the court still engaged in an analysis to determine if the corporation acted with scienter. This type of analysis would not be necessary unless the court felt that corporate scienter could exist independent from individual scienter. Therefore, if the court believed that corporate scienter could have existed without independent individual scienter, the court was likely looking to see if the individual defendants could collectively have the requisite scienter imputed upon the corporation. If this is correct, the Sixth Circuit embraced the concept of collective scienter that is supported, to varying degrees, by the Second, Seventh, and Ninth Circuits.

However, in the rule’s brief history, district courts within the Sixth Circuit have not applied the rule in this same fashion. Instead, district courts have used the rule to examine appropriate scienter of individuals within the corporation. If the court concludes that individual scienter has not been alleged sufficiently, the individual cannot have his or her scienter imputed to the corporation; each identified individual defendant is reviewed independently of all others. The district courts’ interpretation assumes that the Sixth Circuit did not intend to allow the knowledge of multiple employees to be combined to support a finding

137. See generally In re Omnicare, Inc. Sec. Litig., 769 F.3d 455 (6th Cir. 2014).
138. Id. at 476.
139. It can be argued that if the Sixth Circuit wanted an employee’s knowledge to be considered independent of all other employees’ knowledge then it would use stronger language, such as describing the state of mind as “indicative” or “determinative” rather than “probative.”
140. See Omnicare, 769 F.3d at 483-84.
141. The easiest way to understand collective scienter is with an example. Imagine a group of three people that want to enter a party that costs $10 per group, but none of the individuals have a ten dollar bill. Person A has 4 dollars, and Person B and Person C each have $3 dollars. Independent of one another, none of the individuals could have gotten into the party; however, the individuals can be viewed collectively as having the required $10 to enter the party. Collective scienter operate in much the same way except instead of money, the courts will look at the knowledge of the individual defendants.
143. See generally In re Yum! Brands, Inc. Sec. Litig., 73 F. Supp. 3d 846. See also generally Doshi, 2015 U.S. Dist. LEXIS 9306.
of corporate scienter. If this is correct, then the Sixth Circuit’s “middle ground” rule sided fully with the Fifth and Eleventh Circuits by eliminating collective scienter and requiring any individual to independently have scienter before his or her knowledge can be imputed to the corporate defendant.

While it is possible that the Sixth Circuit intended to embrace the theory of collective scienter, the district courts that have interpreted the Sixth Circuit’s rule in In re Omnicare have correctly found that the Sixth Circuit’s “middle ground” rule does not permit corporate scienter without individual scienter. 144

2. There Cannot Be Corporate Scienter Without Individual Scienter

Corporate scienter cannot be pleaded without identifying an individual defendant that meets the scienter requirement. Under the “middle ground” rule, a plaintiff who has failed to identify anyone with individual scienter under Section 10b and Rule 10b-5 has failed to plead scienter on behalf of the corporate defendant. A finding to the contrary, as the Second, Seventh, and Ninth Circuits deem appropriate, cannot and should not be supported because it: (1) would be contrary to the congressional intent for passing the heightened pleading standard of the PSLRA; (2) would be more akin to a negligence standard which is inappropriate under existing law; (3) would have a chilling effect on corporate disclosures; and (4) would create inconsistent federal law that would have negative policy implications.

i. Contrary to Congressional Intent

The congressional intent behind Section 10b of the SEA and Rule 10b-5 was to create an open and transparent system of corporate disclosure and, wherever possible, prevent corporate officers from defrauding shareholders. 145 As previously discussed, the PSLRA was intended to prevent the abuse of Section 10b and Rule 10b-5 by making it more difficult for plaintiffs to plead a violation of either provision. 146 If the Sixth Circuit adopted the Second Circuit’s approach to collective scienter, it would allow a finding of corporate scienter without ever identifying an individual who acted with the scienter. In this situation, the test would undermine the very standard that it intends to support.

There is no support for the proposition that a named individual

144. For the sake of this Article, the author assumes that the district court interpretations are accurate and that the Sixth Circuit “middle ground” rule rejects collective scienter.
defendant can be found to have knowledge of fraud or a misstatement simply because of the defendant’s title or position in the corporate hierarchy.147 However, the Second Circuit takes it one step farther by allowing the plaintiff to impute scienter to the corporation by alleging that an unnamed individual defendant “must have known enough to know” that the statement was fraudulent. 148 This argument rests on little more than supposition and “encourages plaintiffs to bring cases attempting to rely on the rule by asserting only general allegations of scienter.”149 This would allow plaintiffs to rely on the very same type of vague accusations that Congress found insufficient when passing the PSLRA.150 The Second Circuit’s approach essentially eliminates the “particularity” requirement of the PSLRA, because it is impossible to plead facts that give rise to a strong inference of scienter if the plaintiffs fail to identify an individual who had the fraudulent state of mind. Congress intended to protect corporations from strike suits by making it more difficult for plaintiffs to plead Rule 10b-5 violations. The particularity of the PSLRA is a key component for accomplishing the goals of Congress. Without the particularity requirement, the plaintiff can plead general facts regarding the mindset of the defendants, which is no different than the original pleading requirement under the Federal Rules of Civil Procedure.151 Treating the PSLRA this way ignores its purpose and runs contrary to the congressional intent.

ii. The PSLRA Requires More Than a Negligence Standard

Another serious concern with the Second Circuit’s application of the collective scienter theory is that it alters the standard of care required by the defendant corporation. Under existing law, every circuit court has found that knowledge or recklessness is sufficient to satisfy the pleading requirement under Section 10b or Rule 10b-5.152 However, if the Second Circuit’s rule is accepted and plaintiffs can use the collective knowledge of a group of unidentified individuals, then the plaintiff only has to show negligence under Rule 10b-5 complaints. This would be inappropriate because the Supreme Court has previously stated that it is “quite unwilling to extend the scope of [Section 10b] to negligent

148. Id. at 400-01.
149. Id. at 402
150. Id.
151. See FED. R. CIV. P. 9(b).
The standard advanced by the Second Circuit would be one of res ipsa loquitur where the plaintiff only needs to show that the fraud occurred and that someone within the corporation must have known it was fraudulent or was reckless in not knowing. One of the most frequently articulated examples of the appropriate use of collective scienter comes from the Seventh Circuit. In the Seventh Circuit's opinion in *Makor*, the court says that it is possible to find corporate scienter without finding individual scienter in situations that are especially "dramatic," such as a sales announcement that reported one million units when the actual number was zero. This example plainly represents a scenario that resembles the concept of res ipsa loquitur where the plaintiff can merely plead circumstantial evidence that some employee must have been at fault and, therefore, the corporation is at fault. However, there is nothing that suggests that Congress anticipated this to be the standard required under the SEA, and the Supreme Court has plainly dismissed this approach. Using a standard that falls short of a reckless standard to show a violation of Section 10b or Rule 10b-5 would clearly violate the Supreme Court's interpretation of the SEA and Rule 10b-5.

### iii. Creates a Chilling Effect

The doctrine of collective scienter creates a chilling effect that adversely affects the entire securities industry. While some national exchanges, such as the New York Stock Exchange, have disclosure requirements for their publicly traded companies, courts have held that "there is no general duty on the part of a company to provide the public with all material information." To heighten the pleading standard and insulate the corporations, the PSLRA was enacted which encouraged corporations to disclose information to shareholders without the fear of repercussions if any unintentional misstatements were found in the disclosures.

Collective scienter would remove this insulation and once again expose corporations to frivolous lawsuits. Plaintiffs could plead generally that the collective knowledge of the employees on the

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153. *Id.* at 214.
157. *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1432 (3rd Cir. 1997).
unintentional inaccuracy of a voluntary disclosure was great enough to plead scienter on the part of the corporation. If corporations want to avoid liability in a jurisdiction that permits collective scienter, the “corporations would be required to speak to each and every employee and former employee . . . to ensure that no one possesses knowledge that, when coupled with an unknowing misstatement, would give rise to collective scienter.”158 This type of policing within the business is inefficient for corporations, because it claims resources that should be dedicated to creating shareholder wealth and uses them to prevent frivolous securities lawsuits.

The SEA also requires that corporations make some annual filings and disclosures,159 which makes collective scienter even more costly to the corporation. For these required disclosures, the corporation needs to control the employees whose knowledge will become the basis of the disclosures. Controlling the employees that have the knowledge is the only way to limit the corporate liability with respect to required disclosures. “If a corporation can be charged with securities fraud based on the knowledge of any of its employees or agents” then the corporation has to control every employee.160 Identifying an employee that has knowledge about the disclosure can be extremely costly for a corporation, and the problem is only exacerbated for very large corporations with numerous employees.161

Accepting the theory of collective scienter would incentivize corporations to limit the frequency of their disclosures, which would run contrary to the PSLRA’s purpose of encouraging corporate disclosures and would also create inefficiencies in the securities market. These inefficiencies will ultimately cost the shareholders, because the corporations will focus more resources on avoiding liability as opposed to creating shareholder wealth. This effect runs contrary to the SEA’s purpose of protecting shareholders’ interests.

iv. Inconsistent Federal Securities Law

While scarcely discussed, one of the most significant drawbacks of accepting the collective scienter theory is that the theory will create inconsistent federal law. Even assuming that the Supreme Court accepts collective scienter, the entire application of the theory is subject to the whim of the court hearing the claim. By allowing a plaintiff to argue that the collective knowledge of the corporation meets the scienter

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158. Bondi, supra note 39, at 23.
159. 15 U.S.C. § 78m.
161. See id. at 25.
requirement without requiring the plaintiff to show which individuals acted with scienter is equivalent to saying that the misstatement is dramatic enough that someone in the corporation must have known about it. The problem here lies in the fact that the determination of when a misstatement is considered **dramatic enough** differs from person to person.

The Seventh Circuit’s example of a sales report that predicts $1 million in sales while sales are actually $0, is cited by the Second and Ninth Circuits as an example of a situation where corporate scienter without individual scienter would be appropriate. 162 However, none of the circuit courts that reference this example even attempt to explain why this situation is sufficient.

The average securities litigation settlement in 2013 was approximately $71.3 million, almost $20 million greater than the inflation adjusted average for settlements between 1996 and 2012. 163 With the size of settlements growing, the importance of developing a consistent and equitable method of determining corporate liability in shareholder security litigation suits is critical. Allowing the determination of whether a corporation has met the PSLRA’s scienter requirement based on the subjective perception of the judge yields inconsistencies and blurs the line between acceptable and unacceptable action. By blurring this line, courts make it more difficult for a corporation to self-regulate effectively. The court’s method for determining when collective scienter should be used is nothing more than a shot in the dark, which is inefficient for all parties involved.

Allowing a plaintiff to use the collective scienter theory to plead scienter on behalf of a corporate defendant is inconsistent and will create unpredictable results in securities litigation throughout the federal courts. With potentially hundreds of millions of dollars on the line, the importance of consistency in the determination of corporate liability cannot be understated. The collective scienter theory threatens the stability that is so vital to the securities industry.

### C. The Future of the Law

The Sixth Circuit opinion could have a tremendous impact on existing securities law. The holding offers a reasonable middle ground for

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162. See Makor Issues & Rights, Ltd. v. Tellabs Inc., 513 F.3d 702, 710 (7th Cir. 2008); see also Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital, Inc., 531 F.3d 190, 195-96 (2d Cir. 2008); Glazer Capital Mgmt., LP v. Magistri, 549 F.3d 736, 743 (9th Cir. 2008).

determining which employees can have scienter imputed to the corporation and also requires that at least one individual defendant have scienter before attributing scienter to the corporation. The impact of this decision will be felt by corporations, particularly large corporations with numerous employees, who no longer have to worry that some unnamed, lower level employee will have his or her individual scienter imputed on the corporation. The Sixth Circuit’s interpretation will protect corporations that are senselessly included in litigation from having to decide between expensive litigation to protect their name or an expensive settlement to avoid negative publicity.

1. The Supreme Court

Federal securities law has evolved into one of the most complex areas of law. Unlike other circuit opinions, the holding in In re Omnicare provides clear-cut categories into which employees must fit before their individual scienter can be imputed to the corporation. This new “middle ground” will offer significant consistencies between the district courts within the Sixth Circuit. While not currently before the Supreme Court, the issue of corporate scienter is ripe for the Supreme Court to decide. The Supreme Court should accept either In re Omnicare, or another securities fraud case dealing with corporate scienter, and confirm that the Sixth Circuit’s “middle ground” approach is the most effective method of attaching corporate scienter.

Furthermore, the Court should also eliminate the concept of collective corporate scienter from securities law because it violates the core tenants of the PSLRA. Allowing plaintiffs to plead scienter on behalf of the corporation, without pleading scienter on behalf of any individual within the corporation, gives plaintiffs an opportunity to side-step the heightened pleading standard—a standard implemented to make pleading a securities fraud violation more difficult. Elimination of collective scienter will also create a more consistent set of federal securities laws by shifting the process for determining sufficient evidence to support corporate scienter from subjective judicial determination to an objective application of a judicially-created test.

2. The Legislature

The Commission promulgated the PSLRA in an attempt to prevent strike suits by raising the bar plaintiffs have to overcome when pleading securities fraud suits.\(^\text{164}\) The Second Circuit’s approach of allowing

collective scienter is contrary to the PSLRA’s intent of preventing frivolous suits against corporations. The Second Circuit imputes scienter from the collective knowledge of a pool of employees and allows a plaintiff to impute scienter to a corporation by merely pleading general allegations that create a possibility of corporate wrongdoing. By ignoring the standards that the PSLRA puts in place, the Second Circuit inappropriately alters the substantive law.

Congress does not need to wait for the Supreme Court to interpret this issue. The Legislature can pass an amendment to the SEA expressly prohibiting the knowledge of employees from being collected to find scienter. Such an amendment would specify that corporations can only act with scienter if the plaintiff can plead scienter with respect to a named employee of the corporation. While this method of resolution would definitively clarify any ambiguity in this area, the process would also likely become more complex and require additional time. Regardless of how the statutory language would be structured, Congress would want to make it clear that a corporation can only have scienter pled against it if there is at least one employee of the corporation that also has scienter successfully pled against it.

V. CONCLUSION

In response to increased “strike suits,” the Securities Exchange Commission passed the PSLRA. The act raised the pleading standard for plaintiffs claiming a Rule 10b-5 securities fraud violation. Securities lawsuits that followed resulted in a circuit split over two aspects of the PSLRA. The first question of law was regarding which employees could have their scienter imputed to a corporate defendant. The Fifth and Eleventh Circuits held that only the speaker of the misstatement could have his or her scienter imputed to the corporation. The Sixth Circuit, followed by the Second, Seventh, and Ninth Circuits, held that any employee could have scienter imputed to the corporation. In an attempt to resolve the split, the Sixth Circuit revisited the issue in In re Omnicare. The Sixth Circuit created three

165. See Bonnett, supra note 147, at 400.
categories and held that before an employee can have scienter imputed to the corporation, the plaintiff had to show that the individual fit within one of the three categories.171

The second issue dividing the courts was the theory of collective scienter. The Fifth and Eleventh Circuits denied the theory of collective scienter, holding that each individual must be considered independently from all other individuals.172 However, the Sixth Circuit, and the Second, Seventh, and Ninth Circuits, to a lesser degree, held that two or more employees, who did not meet the scienter requirement individually, could have their combined knowledge imputed to the corporation in an attempt to plead corporate scienter.173 The Sixth Circuit’s “middle ground” rule in Omnicare does not explicitly address the issue;174 however, district court opinions interpreting the Sixth Circuit’s holding have not applied the theory of collective scienter.175

The Sixth Circuit’s “middle ground” rule is the most efficient method for attaching corporate scienter, while also accomplishing the goals of both the SEA and the PSLRA. Additionally, the “middle ground” rule does not apply collective scienter. By leaving collective scienter out of the equation, the Sixth Circuit prevents a chilling effect on corporate disclosures, reduces inconsistencies in federal securities law, and provides an interpretation that is consistent with the language of the PSLRA and the congressional intent.

Moving forward, courts should follow the example set by the Sixth Circuit by adopting the “middle ground” rule. Additionally, courts should abandon the theory of collective scienter, because it is inconsistent with the policies enacted by the Commission and Congress. The Sixth Circuit’s opinion in In re Omnicare offers a major step forward for securities fraud litigation and protects corporations from strike suits that cost corporations millions of dollars each year. The Supreme Court or the Legislature will need to resolve the dispute once and for all, but in the meantime, the Sixth Circuit has provided the appropriate framework for all other courts to follow.

171. See id. at 476.
172. See Southland, 365 F.3d 353; see also Phillips v. Scientific-Atlanta, Inc., 374 F.3d 1015 (11th Cir. 2004).
174. See generally Omnicare, 769 F.3d 455.