

STRIKING BACK AT “EXTORTIONATE” SECURITIES LITIGATION: *SILICON GRAPHICS* LEADS THE WAY TO A TRULY HEIGHTENED AND UNIFORM PLEADING STANDARD

MICHAEL A. DORELLI*

An executive at a prominent west coast software company accepts the apprehensively awaited telephone call. His attorney, with a solemn tone, informs him of his options. Almost a month before, after a drop in the company's stock price of nearly forty percent over a one-week period, a securities fraud class action was filed against the company. The complaint alleged that the company reported “artificially inflated” sales figures during a period in which key officers of the company sold “substantial” amounts of their stock holdings. The complaint stated little else, other than that the timing of the stock sales raises a “strong inference” that the company *fraudulently* overstated its sales figures with the intention of misleading investors and reaping an illegal profit for its officers.

The attorney advises the executive that despite the fact that the class has no evidence that anyone at the company acted “fraudulently,” and despite that the class would not likely be successful if the suit proceeded to trial, the cost of *defending* the suit through trial would far exceed the cost of simply settling the case now. The executive stares down at his desk with his hand over his eyes. His thoughts are consumed by images of the attorneys for the class; a room full of suits, champagne, toasting, and laughter. The size of the settlement would ensure that their share would greatly overcompensate them for the slight effort involved in watching the market for an unfortunate dive in a company's stock price; the painstaking work that must have been involved in drafting the complaint, filed only days after the price drop. Images of the stockholders making up the class enter his mind. Was the lawsuit filed for their benefit? Or was it for the benefit of the men and women in that room; drinking in celebration and confident that it would always be “this easy.” He sighs as he raises his head and returns his attention to the telephone, instructing his attorney to take the only financially reasonable action. “Make the call,” he concedes. He lowers the telephone and returns his head to his hands.

INTRODUCTION

Of the many provisions contained in the Private Securities Litigation Reform Act of 1995¹ that were intended to deter the filing of frivolous securities fraud lawsuits, one of the most controversial is the so-called “heightened pleading requirement,” which requires a plaintiff filing a securities fraud lawsuit under Rule 10b-5² to “state with particularity facts giving rise to a strong inference that

* B.S., 1994, Indiana University—Bloomington; J.D., 1998, Indiana University School of Law—Indianapolis.

1. Pub. L. No. 104-67, 109 Stat. 737 (1995) [hereinafter Reform Act].

2. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1995), makes it unlawful “[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the

the defendant acted with the required state of mind.”³ In his veto message on December 19, 1995, President Clinton named this provision as a principle area of concern.⁴ Specifically, the President claimed that the new pleading requirement would “impose an unacceptable procedural hurdle to meritorious claims being heard in Federal courts. . . . [It erects a] barrier to bringing suit . . . so high that even the most aggrieved investors with the most painful losses may get tossed out of court before they have a chance to prove their case.”⁵ Despite the President’s veto, the Reform Act became law on December 22, 1995.⁶

Section 21D(b)(2) was created in response to concerns regarding abusive or frivolous securities litigation initiated for the purpose of extracting a settlement from a defendant without regard to the actual merits of the lawsuit.⁷ While settlements are generally considered voluntary resolutions by the parties to a lawsuit, and those parties are normally free to go to trial if a satisfactory settlement agreement cannot be reached, securities litigation is among a class of cases in which settlements are not always completely voluntary nor are they accurate with respect to the likely outcome of a trial.⁸ “These settlements are not voluntary in that trial is not regarded by the parties as a practically available alternative for resolving the dispute, and they are not accurate in that the strength of the case on the merits has little or nothing to do with determining the amount of the settlement.”⁹ Defendants to such lawsuits may find settlement preferable to going to trial for several reasons, including the possibility of extensive, costly discovery which is typical of most securities fraud suits and the resulting

statements made, in the light of the circumstances under which they were made, not misleading, . . .” or to engage in other fraudulent practices concerning the sale or purchase of securities.

3. Reform Act, *supra* note 1, at 747 (adding § 21D(b)(2) to the Securities Exchange Act of 1934 [hereinafter Exchange Act]). This amended section of the Exchange Act is codified at 15 U.S.C. § 78u-4(b)(2) (Supp. II 1996).

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

5. *Id.*

6. The House of Representatives overrode the veto by a vote of 319-100 on December 20, 1995. 141 CONG. REC. H15,223-24 (daily ed. Dec. 20, 1995). On December 22, 1995, the Senate overrode the veto by a vote of 68-30. 141 CONG. REC. S19,180 (daily ed. Dec. 22, 1995). The pleading provision to which the President objected remained unchanged.

7. H.R. CONF. REP. NO. 369, 104th Cong., 1st Sess., 141 CONG. REC. H13,702 (daily ed. Nov. 28, 1995) [hereinafter Conference Report].

8. See Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 499 (1991).

9. *Id.* The term “strike suit” has been used to describe such lawsuits, filed for their settlement value independent of their actual merits. See Tim Oliver Brandi, *The Strike Suit: A Common Problem of the Derivative Suit and the Shareholder Class Action*, 98 DICK. L. REV. 355 (1994); Note, *Extortionate Corporate Litigation: The Strike Suit*, 34 COLUM. L. REV. 1308 (1934).

disruption of the defendant's normal business operations.¹⁰

These apparent injustices to defendant corporations serve to line the pockets of predatory plaintiffs' attorneys who often file their lawsuits only days after some event such as a large drop in a company's stock price.¹¹ For example, on January 26, 1996, a lawsuit was filed against Touchstone Software Corporation for allegedly misleading investors.¹² Despite the weak case against Touchstone, the Huntington Beach, California company agreed to a settlement of \$1.3 million in cash and stock.¹³ The company felt that the settlement was cheaper than fighting the case would have been.¹⁴ Plaintiff's attorneys will probably earn between \$325,000 and \$390,000 for doing little more than filing a weak and possibly frivolous complaint.¹⁵ Abusive practices such as this were considered by Congress in enacting the heightened pleading standard of section 21D(b)(2).¹⁶ Congress felt that "[t]he private securities litigation system is too important to the integrity of 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."¹⁷ Congress enacted section 21D(b)(2) both (1) to reduce abusive practices in the securities litigation system through *stricter* pleading requirements, and (2) to resolve the ambiguity created by differing judicial interpretations of Rule 9(b) through a *uniform* standard of pleading.¹⁸

Despite Congress' attempt to reduce the above described abusive litigation practices through the stricter, uniform pleading requirements of section 21D(b)(2), judicial interpretation of this provision since the passage of the Reform Act has not furthered the cause. In the year following the passage of the Reform Act, two courts reported significant decisions on what is meant by a "strong inference" of scienter: *Marksman Partners v. Chantal Pharmaceutical Corporation*¹⁹ and *In re Silicon Graphics, Inc. Securities Litigation*.²⁰ *Marksman*

10. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739-43 (1975); *see also* *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 189 (1994) (stating that defendants may find it necessary as a matter of business judgment to pay a settlement rather than face the expenses and risks of going to trial).

11. Mike France, *Bye, Fraud Suits. Hello, Fraud Suits: New federal legislation isn't stopping class actions*, BUS. WEEK, June 24, 1996, at 127.

12. *Id.*

13. *Id.*

14. *Id.*

15. *Id.* Contingency fee contracts are normally based on a scale that correlates the percentage fee with the amount of work required of the attorney. CHARLES W. WOLFRAM, *MODERN LEGAL ETHICS* § 9.4.2, at 532 (1986). Percentages may range from 25 to 33% if settlement occurs before trial, 33 to 40% if the case reaches trial, and up to 50% if the case is "exceptionally difficult or if an appeal or other posttrial proceeding [is] necessary." *Id.* at n.44.

16. *See* Conference Report, *supra* note 7.

17. *Id.*

18. *Id.*

19. 927 F. Supp. 1297 (C.D. Cal. 1996) [hereinafter *Marksman*].

20. No. 96-0393, 1996 WL 664639 (N.D. Cal. Sept. 25, 1996) [hereinafter *Silicon Graphics*].

applied the Second Circuit's pre-Reform Act "motive and opportunity" test for determining the sufficiency of facts in establishing a strong inference of the defendant's state of mind. Under this test, a plaintiff must plead facts which show that the defendant had (1) a motive to commit securities fraud and (2) an opportunity to commit such fraud.²¹ *Marksman* held that Congress intended to codify the Second Circuit's case law regarding the establishment of a strong inference of scienter rather than to strengthen the pleading requirement beyond that practiced by the courts prior to the Reform Act.²² *Silicon Graphics I* interpreted section 21D(b)(2) as a *strengthening* of the Second Circuit's strong inference standard. The court in *Silicon Graphics I* held that to sufficiently plead scienter, a plaintiff "must allege specific facts that constitute circumstantial evidence of conscious behavior by defendants."²³

If future courts follow the line of reasoning of the court in *Marksman*, section 21D(b)(2) will become nothing more than a codification of Second Circuit case law²⁴ and the abusive practices which the Reform Act sought to redress will continue to occur. It is concluded in this Note that the analysis followed by the court in *Marksman* is flawed. It is suggested that courts in the future should interpret section 21D(b)(2) as did the court in both *Silicon Graphics* decisions: as a strengthening of existing pleading requirements rather than a codification of the Second Circuit's motive and opportunity test for pleading scienter. Part I of this Note discusses Federal Rule of Civil Procedure 9(b), its purposes, and why securities fraud is particularly susceptible to abuse and frustration of those purposes. Part II then discusses the motive and opportunity test in greater detail and describes its inadequacies in light of the problems facing our capital markets. Part III discusses the legislative history of the Reform Act and section 21D(b)(2)

I]. The court in *Silicon Graphics I* granted the plaintiffs leave to amend their complaint. The court later dismissed the plaintiffs' amended complaint with prejudice. *In re Silicon Graphics, Inc. Sec. Litig.*, 970 F. Supp. 746, 768 (N.D. Cal. 1997) [hereinafter *Silicon Graphics II*].

21. *Ross v. A.H. Robins Co.*, 607 F.2d 545 (2d Cir. 1993); *In re Time Warner Sec. Litig.*, 9 F.3d 259 (2d Cir. 1993); *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124 (2d Cir. 1994). Second Circuit case law also establishes that in addition to meeting the motive and opportunity test, plaintiffs may sufficiently plead scienter by alleging facts which constitute "circumstantial evidence of either reckless or conscious behavior." *In re Time Warner*, 9 F.3d at 269.

22. *Marksman*, 927 F. Supp. at 1310-14. *Zeid v. Kimberley*, 930 F. Supp. 431 (N.D. Cal. 1996), was decided shortly after *Marksman*. *Zeid* also evaluated a complaint through application of the motive and opportunity test but, unlike *Marksman*, did not address the issue of whether section 21D(b)(2) was intended to be a strengthening of the Second Circuit's case law. The court simply concluded that satisfaction of the Second Circuit's standard would meet the strong inference requirement of the Reform Act.

23. *Silicon Graphics I*, 1996 WL 664639, at *5. The court in *Silicon Graphics II* continued with this position, that to plead scienter adequately, a plaintiff must "do more than speculate as to defendant's motives or make conclusory allegations of scienter; plaintiffs must allege specific facts." *Silicon Graphics II*, 970 F. Supp. at 766.

24. See Paul H. Dawes, *Pleading Motions Under the Private Securities Litigation Reform Act of 1995*, 958 PLI/CORP. 37, 64-68 (1995).

and shows that Congress intended a *new* pleading requirement which is more strict than the Second Circuit's motive and opportunity test. Part IV analyzes the *Marksman* decision and explains why it is wrong. Finally, Part V analyzes *Silicon Graphics I* and shows that the decision follows a truly "heightened" pleading standard which is consistent with Congress' intent and which strikes an appropriate balance between the need to prevent and redress deceptive and manipulative practices and the maintenance of efficient and respectable capital markets. Part V further explains how *Silicon Graphics II* continues with this view and demonstrates the inadequacies of the *Marksman* approach.

I. RULE 9(B): HIGHER STANDARDS FOR SECURITIES FRAUD LAWSUITS

A motion to dismiss a complaint based on the plaintiff's failure to plead facts sufficient to establish a strong inference of scienter is normally based on Rule 9(b) of the Federal Rules of Civil Procedure.²⁵ Rule 9(b) provides: "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally."²⁶ Thus, Rule 9(b) raises the general pleading standard of Rule 8, which provides in pertinent part, that a party must plead only "a short plain statement of the claim showing that the pleader is entitled to relief"²⁷ It has been argued that the first sentence of Rule 9(b) heightens the pleading standard beyond that of Rule 8 with respect to claims of fraud or mistake, but that the second sentence relaxes this requirement with respect to pleading of the defendant's state of mind.²⁸ The rationale behind relaxing the pleading requirement for the defendant's state of mind is that "it is unrealistic to expect a plaintiff, at the commencement of an action, to be able to present facts specifically demonstrating that a defendant acted with the requisite state of mind. Indeed, in most cases, it may be impossible at the pleading stage, before any discovery has been taken, to meet such a burden."²⁹ However, because the defendant's state of mind is of such integral importance to a claim of securities fraud, and due to the potential for abuse of securities litigation practices,³⁰ this part of Rule 9(b) should not be read as a complete reversion to

25. See John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, 345-46 (1996).

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

27. FED. R. CIV. P. 8(a)(2).

28. See Laurence A. Steckman & Kenneth M. Moltner, *Pleading Scienter in Securities Fraud Cases Under Rule 9(b) -- Is the Pleading of Facts Sufficient to Give Rise to a "Strong Inference" of Fraudulent Intent Really Incompatible with the Federal Rules?*, 1995 ANN. SURV. AM. L. 99, 101-102.

29. Avery, *supra* note 25, at 346. Some courts have followed this line of reasoning in construing the second sentence of Rule 9(b). See, e.g., *Wool v. Tandem Computers*, 818 F.2d 531 (N.D. Tex. 1993).

30. See *supra* text accompanying notes 7-18.

the lax pleading standard articulated by Rule 8.³¹

The purposes of Rule 9(b) indicate that a high standard is necessary for pleading conditions of mind as well as the circumstances constituting the fraud, despite the greater difficulty of ascertaining sufficient facts at the pleading stage. "Courts have held that the purpose of Rule 9(b) is threefold: (1) to provide the defendant with adequate notice of a plaintiff's claims in order to mount a defense; (2) to protect the defendant's reputation from harm; and (3) to prevent the filing of strike suits."³² Of these purposes, the prevention of the filing of strike suits for the purpose of extracting a settlement which is unproportionally large with respect to the merits of the case is probably the more important to most companies.³³ As discussed above, plaintiff attorneys often file lawsuits just days following a large drop in the price of a company's stock and are able to force large settlements from the company due to the company's desire to avoid the large costs of discovery which are normally associated with securities litigation.³⁴ A higher standard of pleading scienter in these cases therefore serves not only to deter future strike suits from being filed, but also clears the current suit from an already congested docket. Some argue that Rule 9(b) is an inappropriate, and likely ineffective, tool for deterring strike suits.³⁵ However, courts have disagreed and have had a tendency to be more demanding in their application of Rule 9(b) to securities fraud actions,³⁶ largely due to the unique susceptibility to the frustration of the purposes of the Rule which is inherent in securities fraud

31. See *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994) ("the relaxation of Rule 9(b)'s specificity requirement for scienter 'must not be mistaken for a license to base claims of fraud on speculation and conclusory allegations.'") (quoting *Wexner v. First Manhattan Co.*, 902 F.2d 169, 172 (2d Cir. 1990)).

32. Jared L. Kopel, *Procedural Reforms, in SECURITIES CLASS ACTIONS: ABUSES AND REMEDIES* 107, 108 n.6 (citing *Farlow v. Peat, Marwick, Mitchell & Co.*, 956 F.2d 982, 987 (10th Cir. 1992); *O'Brien v. National Property Analysts Partners*, 936 F.2d 674 (2d Cir. 1991); *In re Urarco Sec. Litig.*, 148 F.R.D. 561 (N.D. Tex. 1993)); see also *Billard v. Rockwell Int'l Corp.*, 683 F.2d 51 (2d Cir. 1982) ("This Court has previously construed Rule 9(b) strictly in order to minimize strike suits, to protect defendants, particularly accountants and other professionals, from harm to their reputation resulting from ungrounded actions, and to give defendants notice of the precise conduct in issue."); *DeVittorio v. Equidyne Extractive Indus., Inc.*, 822 F.2d 1242, 1247 (2d Cir. 1987) (reiterating the above goals of Rule 9(b)).

33. See Elliott J. Weiss, *The New Securities Fraud Pleading Requirement: Speed Bump or Road Block?*, 38 ARIZ. L. REV. 675, 678 (1996).

34. See Alexander, *supra* note 8.

35. See Note, *Pleading Securities Fraud Claims with Particularity Under Rule 9(b)*, 97 HARV. L. REV. 1432, 1439-43 (1984).

36. 10 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 4527 n.148 (1993) (citing 5 C. WRIGHT & A. MILLER, *FEDERAL PRACTICE AND PROCEDURE* § 1297 at 613-14 (1990)); see also *In re Integrated Resources Real Estate Ltd. Partnerships Sec. Litig.*, 850 F. Supp. 1105, 1140 (S.D.N.Y. 1994) (explaining that Rule 9(b)'s pleading requirements should be applied more strictly in securities fraud cases).

litigation. The Court in *Blue Chip Stamps v. Manor Drug Stores*³⁷ encapsulated the concerns nicely:

There has been widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general. . . . [T]o the extent that . . . [the liberal discovery provisions of the Federal Rules of Civil Procedure] permit a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the process will reveal relevant evidence, it is a social cost rather than a benefit.³⁸

The most effective way to eliminate the social costs which were of concern to the Court in *Blue Chip Stamps* is to prevent a plaintiff preparing to undertake such a “fishing expedition” from ever reaching the discovery stage before presenting evidence sufficient to meet the particularity requirements of Rule 9(b), both with respect to the circumstances constituting the fraud and to the defendant’s state of mind. Admittedly, the defendant’s state of mind cannot possibly be pled with the same particularity as the circumstances of the alleged fraud.³⁹ Therefore, an appropriate balance must be struck between the need to protect the rights of plaintiffs with valid claims, and the need to prevent abuses of the securities litigation process and prevent the resulting damage to the nation’s capital markets.

Despite the general consensus among courts that Rule 9(b) should be read to require some type of particularity in pleading the state of mind of a defendant in a securities fraud action in order to effectuate this needed balance, the circuits have disagreed as to what exactly is required to meet the requirement.⁴⁰ The Second Circuit, and at least three other circuits, have required the plaintiff to allege facts which give rise to a strong inference of scienter.⁴¹ These courts have used variants of the Second Circuit’s “motive and opportunity” test.⁴² Other

37. 421 U.S. 723 (1975).

38. *Id.* at 739-41.

39. *See Avery, supra* note 25, and accompanying text.

40. *Id.* at 346-47.

41. *See In re Time Warner Sec. Litig.*, 9 F.3d 259, 268-69 (2d Cir. 1993); *Tuchman v. DSC Comm. Corp.*, 14 F.3d 1061, 1068 (5th Cir. 1994) (“To plead scienter adequately, a plaintiff must set forth specific facts that support an inference of fraud.”); *Greenstone v. Cambex Corp.*, 975 F.2d 22, 25 (1st Cir. 1992) (“The courts have uniformly held inadequate a complaint’s general averment of the defendant’s ‘knowledge’ of material falsity, unless the complaint also sets forth specific facts that make it reasonable to believe that defendant knew that a statement was materially false or misleading.”); *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) (“Although Rule 9(b) does not require ‘particularity’ with respect to the defendants’ mental state, the complaint still must afford a basis for believing that plaintiffs could prove scienter.”).

42. The motive and opportunity test is described in detail in Part II of this Note. *See infra*, notes 45-66 and accompanying text.

circuits have required much less of plaintiffs in securities fraud suits, apparently placing less weight on the purposes of Rule 9(b) and having less concern for the protection of the efficiency and integrity of our nation's capital markets.⁴³

In response to these concerns and to fulfill the above stated purposes of Rule 9(b), the Reform Act created section 21D(b)(2) in order to mandate the requirement that the plaintiff plead facts sufficient to give rise to a strong inference of scienter.⁴⁴ However, in order to understand that Congress intended to create a truly strengthened standard, higher than even that of the Second Circuit's strong inference and motive and opportunity standard, an analysis of the legislative history of the Reform Act and, in particular, of section 21D(b)(2) is necessary. In order to analyze how the new heightened pleading requirement differs from the pre-Reform Act Second Circuit standard, the Second Circuit's motive and opportunity standard for establishing a strong inference must be examined.

II. MOTIVE AND OPPORTUNITY: THE SECOND CIRCUIT STANDARD

In the Second Circuit, a plaintiff in a securities fraud action must demonstrate:

some factual basis for conclusory allegations of intent. . . . These factual allegations must give rise to a 'strong inference' that the defendants possessed the requisite fraudulent intent. . . . A common method for establishing a strong inference of scienter is to allege facts showing a motive for committing fraud and a clear opportunity for doing so. . . . Where motive is not apparent, it is still possible to plead scienter by identifying circumstances indicating conscious behavior by the defendant, though the strength of the circumstantial allegations must be correspondingly greater. . . .⁴⁵

The court in *Shields v. Citytrust Bancorp, Inc.*⁴⁶ restated this test by requiring plaintiffs to allege facts which give rise to a strong inference of scienter in order to "serve the purposes of Rule 9(b)."⁴⁷ A strong inference could be established

43. See *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1547 (9th Cir. 1994) ("We conclude that plaintiffs may aver scienter generally, just as the rule states - that is, simply by saying that scienter existed."); *Phelps v. Wichita Eagle-Beacon*, 886 F.2d 1262, 1270 n.5 (10th Cir. 1989) (determining that a more relaxed approach to pleading scienter is more consistent with the plain language of Rule 9(b)); *Auslender v. Energy Mgmt. Corp.*, 832 F.2d 354, 356 (6th Cir. 1987) ("[T]he allegation of 'recklessness' on the part of [the defendant] is adequate to satisfy the scienter requirement of Rule 10b-5.").

44. See Reform Act, *supra* note 1, and accompanying text.

45. *Beck v. Manufacturers Hanover Trust Co.*, 820 F.2d 46, 50 (2d Cir. 1987) (this was the Second Circuit's first articulation of the motive and opportunity test for meeting the strong inference requirement for pleading scienter under Rule 9(b)) (citations omitted).

46. 25 F.3d 1124 (2d Cir. 1994).

47. *Id.* at 1128.

by (1) showing that the defendant had both the motive to commit fraud and the opportunity to commit it, or (2) by presenting strong circumstantial evidence of conscious misbehavior or recklessness.⁴⁸ “Motive would entail concrete benefits that *could be* realized by one or more of the false statements and wrongful nondisclosures alleged. Opportunity would entail the means and likely prospect of achieving concrete benefits by the means alleged.”⁴⁹

The rationale which supports this test for determining the sufficiency of a pleading in a securities fraud case is based on the basic, almost simplistic notion that a person who is in a position to benefit from a material misrepresentation is more likely to commit fraud than a person who will not benefit from such a misrepresentation.⁵⁰ This rationale implies that merely because a corporate executive could benefit by the commission of a fraud, subjecting him to all of the dangers and potential abuses of securities litigation is justified. Motive and opportunity, without more, is sufficient to justify potential damage to a corporation’s reputation and a possible extortionate extraction of a settlement from the company. This rationale seems to ignore that it is considered more damaging in our society to convict an innocent party of an offense than it is to let a guilty party go unpunished.⁵¹ Congress, in drafting section 21D(b)(2), and the entire Reform Act for that matter, was particularly concerned with the first risk: that of allowing a meritless suit to survive a motion to dismiss under Rule 9(b), thus permitting the possibility of an extortionate settlement.⁵²

In response to the concern that too many meritless suits would be permitted to proceed and possibly force an unfair settlement, the Second Circuit has attempted to impose relatively strict requirements for establishing a strong inference of scienter through pleading of motive and opportunity to commit fraud.⁵³ For example, pleading that executives have motive to commit fraud

48. *Id.* (The second method of sufficiently pleading scienter, through circumstantial evidence of conscious misbehavior or recklessness, rejected the “fraud by hindsight” method for establishing a strong inference of fraud. Optimistic projections which fail to materialize are insufficient to provide the required inference of scienter. The *Shields* court explained:

The pleading strongly suggests that the defendants should have been more alert and more skeptical, but nothing alleged indicates that management was promoting fraud. People in charge of an enterprise are not required to take a gloomy fearful or defeatist view of the future; subject to what current data indicates, they can be expected to be confident about their stewardship and the prospects of the business they manage.

Id. at 1129). See also VANYO & YODOWITZ, SECURITIES LITIGATION 138-39 (1995).

49. *Shields*, 25 F.3d at 1130 (emphasis added).

50. See Weiss, *supra* note 33, at 684.

51. See Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 ARIZ. L. REV. 711 (1996) (discussing the balancing of the risk of allowing a meritless securities fraud lawsuit to proceed and the risk of keeping legitimate securities fraud claims out of court).

52. See Conference Report, *supra* notes 7, 16 and accompanying text.

53. See VANYO & YODOWITZ, *supra* note 48, at 139 (discussing *Shields*).

because they desire “to prolong the benefits of the positions they hold”⁵⁴ has been held to be insufficient to support a strong inference of scienter.⁵⁵ If a plaintiff could successfully plead motive simply “by alleging the defendant’s desire for continued employment, and opportunity by alleging the defendant’s authority to speak for the company, the required showing of motive and opportunity would be no realistic check on aspersions of fraud, and mere misguided optimism would become actionable under the securities laws.”⁵⁶ Thus, inferences of intent to commit fraud have not generally been found through reliance on “aspirations of financial success that are likely shared by the officers of all corporations.”⁵⁷

Through this “strict” application of the motive and opportunity test, the Second Circuit has found inadequate to establish a strong inference of scienter:

(1) allegations that defendants were motivated to defraud the public because an inflated stock price would increase their compensation;⁵⁸

(2) alleged motives of maintaining good relations with suppliers, encouraging retailers to place orders, forestalling loan defaults, and protecting executives’ positions;⁵⁹

(3) alleged motive of maintaining a company’s high bond rating.⁶⁰

In sum, courts applying the motive and opportunity test have held that “generalized claims that corporate managers acted to retain the benefits of their positions or to enhance their compensation are not sufficiently particular to satisfy Rule 9(b).”⁶¹

However, not all courts applying the motive and opportunity test have held

54. *Shields*, 25 F.3d at 1130; *see also* *Ferber v. Travelers Corp.*, 785 F. Supp. 1101, 1107 (D. Conn. 1991) (“Incentive compensation can hardly be the basis on which an allegation of fraud is predicated. On a practical level, were the opposite true, the executives of virtually every corporation in the United States could be subject to fraud allegations.”).

55. *Id.*

56. *Id.*

57. *Grossman v. Texas Commerce Bancshares, Inc.*, No. 87Civ.6295, 1995 WL 552744, at *11 (S.D.N.Y. Sept. 15, 1995) (“Thus, a court, ‘[i]n looking for a sufficient allegation of motive, . . . assume[s] that the defendant is acting in his or her informed economic self-interest,’ . . . ; and allegations of motives that are generally held by similarly positioned executives and companies are insufficient to sustain a claim under the securities laws . . .”) (quoting *Shields*, 25 F.3d at 1130).

58. *Grossman*, 1995 WL 552744, at *11; *Acito v. Imcera Group, Inc.*, 47 F.3d 47 (2d Cir. 1995) (“Plaintiffs’ allegation that defendants were motivated to defraud the public because of an inflated stock price would increase their compensation is without merit. . . . [T]he existence, without more, of executive compensation dependent upon stock value does not give rise to a strong inference of scienter.”).

59. *In re Crystal Brands Sec. Litig.*, 862 F. Supp. 745, 749 (D. Conn. 1994) (the court believed that these allegations would pertain to virtually any company that manufactures and distributes goods).

60. *Stepak v. Aetna Life & Casualty Co.*, 1994 U.S. Dist. LEXIS 15559, at *60 n.29 (D. Conn. 1994) (holding that such motives constitute general economic interest and are thus insufficient to support an inference of fraud under *Shields*).

61. *Weiss*, *supra* note 33, at 686.

consistently with this limitation. Professor Weiss cites three cases in particular which have held the protection of the executive's position and compensation to be a credible motive from which to infer scienter and fraud.⁶² Weiss argues that cases such as these should not be interpreted with the new section 21D(b)(2), but "courts should not allow plaintiffs to litigate claims of open market fraud on the basis of vague and generalized allegations that could be made with respect to almost any public corporation."⁶³ He proposes that courts "should require plaintiffs to identify with reasonable specificity the economic benefits that defendants stood to realize by misrepresenting material facts."⁶⁴ However, while this sounds more reasonable than permitting generalized assertions of motive and opportunity, in practice it will not likely amount to a more stringent standard. Any plaintiffs' attorney with a little intelligence and creativity could come up with a set of particularized facts that might conceivably support an inference of scienter.⁶⁵

From the analysis in this section, it should be clear that the motive and opportunity standard as it exists in the Second Circuit, while more stringent than other circuits, is not very difficult to overcome through creative lawyering, especially where the accusations are directed at the corporation's officers and directors.⁶⁶ If the abuses and dangers present in the securities litigation forum today are to be met and dealt with in accordance with Congress' intent in developing the Reform Act and section 21D(b)(2), a standard must be developed which is even more demanding than the motive and opportunity test of the Second Circuit. But first, it must be determined exactly what Congress intended when it enacted section 21D(b)(2).

III. STATUTORY INTERPRETATION AND LEGISLATIVE HISTORY OF SECTION 21D(B)(2)

In response to the concerns about the existing problems and abuses in the private securities litigation system described above, Congress held nine hearings on securities litigation from 1993 to 1995.⁶⁷ "Congress [was] prompted by

62. *Id.* at 685-86 (discussing *Morse v. Abbott Laboratories*, 756 F. Supp. 1108 (N.D. Ill. 1991); *Kas v. Caterpillar, Inc.*, 815 F. Supp. 1158 (C.D. Ill. 1992); and *Siebert v. Nives*, 871 F. Supp. 110 (D. Conn. 1994)).

63. Weiss, *supra* note 33, at 686.

64. *Id.*

65. Stout, *supra* note 51, at 712 ("From that point it is determined at least as much by what the judge had for breakfast, as by any legal standard, whether the facts the plaintiff's attorney has presented will be deemed to support a strong inference of fraudulent scienter.").

66. See Elizabeth S. Stong, *Reform, What Reform?*, BUS. LAW TODAY, May/June 1998, at 33, 35 ("Recent surveys show that securities fraud claims based on allegations of accounting irregularities and insider selling rose sharply after the Reform Act.").

67. Avery, *supra* note 25, at 347; see also *Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 103d Cong., 1st Sess. 1-3 (1993) (opening statement of Sen. Christopher J.

significant evidence of abuse in private securities lawsuits to enact reforms to protect investors and maintain confidence in our capital markets.”⁶⁸ Congress heard evidence that the securities markets had been plagued by several types of abusive practices, including:

(1) the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer’s stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action; (2) the targeting of deep pocket defendants . . . without regard to their actual culpability; (3) the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle; and (4) the manipulation by class action lawyers of the clients whom they purportedly represent.⁶⁹

As a part of its attempt to combat the problems of frivolous litigation explained in depth in the Conference Report, Congress enacted a heightened standard for pleading the defendant’s state of mind in a securities fraud claim. This heightened pleading standard is included as section 21D(b)(2) of the Securities Exchange Act of 1934⁷⁰ and reads as follows:

In any private action arising under [the Securities Exchange Act of 1934] in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate [the 1934 Act], *state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.*⁷¹

A. Statutory Interpretation of Section 21D(b)(2)

The language of section 21D(b)(2) is vague and does not alone provide a sound basis for establishing an actual requirement for pleading scienter. The portion of section 21D(b)(2) which is of particular importance for this analysis is the establishment of a *strong inference* of scienter. The question may be stated as follows: Did Congress intend 21D(b)(2) to be a codification of the Second Circuit’s case law concerning the motive and opportunity test for establishing a strong inference of scienter, or did Congress intend a new, more stringent standard to develop?

The specific language of the statute might suggest that Congress intended

Dodd, Chairman of the Subcommittee) (discussing the recent explosion of baseless securities lawsuits filed solely for their settlement value).

68. Conference Report, *supra* note 7.

69. *Id.*

70. Exchange Act, *supra* note 3.

71. Reform Act, *supra* note 1, at 747 (emphasis added).

only to codify the Second Circuit's case law.⁷² It is generally accepted that "where Congress uses terms that have accumulated settled meaning under . . . the common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms."⁷³ The language of the statute, requiring the pleading of facts which establish a "strong inference" of scienter, mirrors language often used by the Second Circuit and other courts following a similar standard.⁷⁴ However, an analysis of the statute's legislative history shows clearly that a codification of Second Circuit case law was not intended. In fact, Congress intended "a new, more stringent body of case law to develop, holding plaintiffs' allegations of fraud to an even more rigorous pleading standard."⁷⁵

B. Legislative History of Section 21D(b)(2)

As discussed in Part II of this Note, the Second Circuit's requirement that a plaintiff plead facts which give rise to a strong inference of scienter "is tempered by a mitigating rule that recognizes that a plaintiff can satisfy the requirement by 'alleg[ing] facts showing a motive for committing fraud and a clear opportunity for doing so.'"⁷⁶ If Congress intended to codify the Second Circuit's motive and opportunity standard, they could have done so by simply including the motive and opportunity language in the final version of 21D(b)(2).⁷⁷ Not only did Congress fail to include such language in the final version, but they *intentionally* refused to include such language. Senator Arlen Specter proposed an amendment to S. 240,⁷⁸ which would have stated that a strong inference of scienter could be established by "alleging facts to show the defendant had both motive and opportunity to commit fraud, or by alleging facts that constitute strong

72. John C. Coffee, Jr., *The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung*, Q253 ALI-ABA 81, 978 (1996).

73. NLRB v. Amax Coal Co., 453 U.S. 322, 329 (1981); *see also* Perrin v. United States, 444 U.S. 37, 42 (1979).

74. *See supra* notes 45-49 and accompanying text (articulating examples of the Second Circuit's strong inference test for pleading scienter).

75. James N. Benedict et al., *The Private Securities Litigation Reform Act of 1995: A Summary and Analysis*, SA90 ALI-ABA 493, 497 (1996).

76. Coffee, *supra* note 72, at 979 (quoting *San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris Cos.*, 75 F.3d 801, 813 (2d Cir. 1996)); *see also* *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994). As discussed in Part I of this Note, the First, Fifth and Seventh Circuits also appear to follow some form of the Second Circuit's motive and opportunity test. *See supra* notes 41-42 and accompanying text.

77. *See Silicon Graphics I*, 1996 WL 664639, at *6 ("The Conference Committee's deletion of the Second Circuit standard from the final bill 'strongly militates against a judgment that Congress intended a result that it expressly declined to enact.'") (quoting *Gulf Oil Corp. v. Copp Paving Co.*, 419 U.S. 186, 200 (1974)).

78. Amend. 1485, S. 240, 104th Cong., 1st Sess. (1995); *see* 141 CONG. REC. S1075 (daily ed. Jan. 18, 1995).

circumstantial evidence of conscious misbehavior or recklessness by the defendant.”⁷⁹ This language is virtually identical to the language commonly used by the Second Circuit,⁸⁰ yet it was omitted from the final Conference Report. Alone, this omission might conceivably suggest that Congress felt that the “strong inference” language of the final version of 21D(b)(2) was clear enough to instruct courts to apply the Second Circuit’s standard. “At most, different circuits might have taken slightly different approaches to when a showing of motive and opportunity raised a strong inference of fraud.”⁸¹

But the omission does not stand alone. The Conference Report⁸² discusses quite clearly Congress’ intended relation between section 21D(b)(2) and the Second Circuit’s motive and opportunity standard for pleading a strong inference of scienter:

Regarded as the most stringent pleading standard, the Second Circuit requirement is that the plaintiff must state facts with particularity, and that these facts, in turn, must give rise to a “strong inference” of the defendant’s fraudulent intent. Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit’s case law interpreting this pleading standard.⁸³

In a footnote to this statement, the Conference Report reads, “For this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness.”⁸⁴

In addition to the language from the Conference Report, further evidence of Congressional intent to strengthen the pleading standard beyond that of the Second Circuit may be derived from President Clinton’s veto message of the Reform Act,⁸⁵ which clearly resolves any possible ambiguities in the legislative history. The President specifically objected to section 21D(b)(2), stating that “the pleading requirements of the Conference Report with regard to a defendant’s state of mind impose an unacceptable procedural hurdle to meritorious claims being heard in Federal Courts.”⁸⁶ He went on to state specifically why the pleading standard was unacceptable in his mind:

79. 141 CONG. REC. S17,959-61 (daily ed. Dec. 5, 1995) (statement of Senator Specter). The full text of the Specter Amendment is available in 2 SWEEPING REFORM: LITIGATING AND BESPEAKING CAUTION UNDER THE NEW SECURITIES LAWS 795-98 (PLI Corp. Law & Practice Handbook Series No. B-924 1996). The Senate passed the Specter Amendment by a vote of 57 to 42 on June 28, 1995.

80. See *supra* note 45 and accompanying text.

81. Coffee, *supra* note 72, at 979.

82. Conference Report, *supra* note 7.

83. *Id.* at H15,215.

84. *Id.* at n.23.

85. Veto Message, *supra* note 4.

86. *Id.*

I am prepared to support the high pleading standard of the U.S. Court of Appeals for the Second Circuit - the highest pleading standard of any Federal circuit court. But the conferees make crystal clear in the Statement of Managers their intent to raise the standard even beyond that level. I am not prepared to accept that.⁸⁷

The President continued by noting the intentional deletion of the provision concerning motive and opportunity which was offered by Senator Specter.⁸⁸ He further noted that Congress “specifically indicated that they were not adopting the Second Circuit case law but instead intended to ‘strengthen’ the existing pleading requirements of the Second Circuit. All this shows that the conferees meant to erect a higher barrier to bringing suit than any now existing”⁸⁹

In answering the President’s Veto Message, Senators Bradley and Domenici argued that section 21D(b)(2) is based only “in part” on the Second Circuit’s motive and opportunity standard.⁹⁰ They explained that even within the Second Circuit, interpretations of the motive and opportunity standard vary, and this is why the Conference Report expressly rejects a *de facto* codification of the Second Circuit standard.⁹¹

However, the argument of Senators Bradley and Domenici, that a partial codification of the Second Circuit standard was intended by Congress, does not conclusively establish that such a codification was intended. Especially due to the proximity of the argument to the President’s Veto Message. And even if such a “partial codification” was intended, the motive and opportunity language proposed by Senator Specter could have easily been included in the final draft of the Conference Report and in the body of section 21D(b)(2). The continued omission of the precise language which would have appeased a large concern of the President concerning the Reform Act “strongly infers” that Congress intended exactly what the President objected to in his Veto Message: a strengthening of existing pleading standards, including that of the Second Circuit.

While this text from the Conference Report seems to make it quite clear that Congress intended not to codify the Second Circuit’s case law regarding motive and opportunity, but to strengthen the requirement beyond that of the Second Circuit, some still claim that the legislative history is ambiguous.⁹² Due to the ambiguity, they claim, the only reasonable interpretation is that Congress intended courts to look to the text of section 21D(b)(2), which further implies that a codification of existing case law using the terms “strong inference” was intended.⁹³

87. *Id.*

88. *Id.*; see also Statement of Senator Specter, *supra* note 79, and accompanying text.

89. *Id.*

90. H.R. CONF. REP. NO. 369, 104th Cong., 1st Sess. 41 (1995) (“In fact, the language of the bill does codify the Second Circuit standard in part -- and the statement of managers says so.”).

91. *Id.*; see also Coffee, *supra* note 72, at 982.

92. See Dawes, *supra* note 24, at 64.

93. *Id.*

This interpretation assumes that the courts are incapable of formulating an intelligent and coherent standard without rigid adherence to an existing body of case law. However, the integrity and effectiveness of the judiciary in the past should instill confidence that our courts are more than capable of developing a standard which will effectively balance the protection of investors from open market fraud with the abuse of the securities litigation system which gave rise to the Reform Act and section 21D(b)(2).⁹⁴

IV. *MARKSMAN PARTNERS* AND APPLICATION OF MOTIVE AND OPPORTUNITY IN THE NINTH CIRCUIT

The first case to address the issue of determining if a strong inference of scienter has been pled is *Marksman Partners, L.P. v. Chantal Pharmaceutical Corp.*⁹⁵ Chantal Pharmaceutical Corp. attempted to use section 21D(b)(2) to dismiss a securities fraud lawsuit alleging that Chantal Burnison, the Chief Executive of the company, withheld damaging information from investors.⁹⁶ However, the court refused to dismiss the suit, holding that the plaintiffs sufficiently pled facts satisfying the motive and opportunity test of the Second Circuit, and thus established a strong inference of scienter as required by section 21D(b)(2).⁹⁷ The court in *Marksman* sets out a well-structured opinion which effectively describes the Second Circuit's standard for establishing a strong inference of scienter. However, the court incorrectly dismisses clear portions of the legislative history and fails to correctly balance the competing factors which gave rise to 21D(b)(2).

A. *The Facts*

Because *Marksman* is a securities fraud case involving an alleged violation of Generally Accepted Accounting Principles (GAAP), the facts are relatively complicated. However, a complete understanding of the facts is necessary to understand the flawed reasoning of the court. Marksman Partners ("Marksman"), a Washington limited partnership, traded common stock of Chantal Pharmaceutical Corporation ("Chantal") between November, 1995, and January, 1996. Chantal Burnison ("Burnison") was the Chairman of the Board and Chief Executive Officer of Chantal Pharmaceutical Corp. during the period involved in the complaint.⁹⁸

Marksman claimed in its complaint that Chantal and Burnison "developed a plan to restore value to Chantal's common stock by reporting high sales

94. Part V describes a standard which effectively balances these concerns.

95. 927 F. Supp. 1297 (C.D. Cal. 1996).

96. See France, *supra* note 11, at 127 (discussing how the goals of the securities litigation system which the Reform Act was intended to accomplish are not materializing due to judicial interpretation of certain provisions, including the heightened pleading requirement of 21D(b)(2)).

97. *Marksman*, 927 F. Supp. at 1312-13 ("Marksman has sufficiently pled facts giving rise to a 'strong inference' of scienter under the 'motive and opportunity' test").

98. *Id.* at 1301.

revenues on what were essentially consignment sales⁹⁹ of [Chantal's principle product] to a distributor. . . . Thereafter, Marksman contend[ed], Chantal began to report dramatically increased revenues."¹⁰⁰

Marksman claims that on July 10, 1995, Chantal announced that it had signed a marketing agreement with Stanson Marketing ("Stanson") of Los Angeles for the purchase by Stanson of Chantal's principle product, Ethocyn. The terms of the agreement allegedly created a consignment sale.¹⁰¹ "Stanson [had] the right to return the product within 60 days in the event it was unable to distribute the product successfully. Further, Stanson had a period of 90 days to pay for any product shipped."¹⁰²

Marksman further claimed that according to GAAP, Chantal was not authorized to report the sales revenues from the Stanson agreement due to the consignment nature of the sale. Despite the GAAP requirements, Chantal allegedly recognized revenue on the sales immediately when the product was shipped. This reporting violation allegedly overstated Chantal's revenues by figures ranging from \$3,000,000 to \$10,000,000.¹⁰³

While information regarding these increased revenues was being released to the public through Bloomberg News Services, during the period between July 1995 and October 1995, Chantal allegedly made a private placement of its stock.¹⁰⁴ Shortly after the private placement of 1,000,000 shares of restricted common stock and 500,000 shares of convertible preferred stock, Chantal's stock price rose from \$4.90 per share to \$12.25 per share.¹⁰⁵ The Los Angeles Business Journal reported that Chantal's stock price increase was the result of the "company's stellar sales figures announced in June and an agreement signed the same month between Chantal and Stanson."¹⁰⁶

Marksman first purchased shares of Chantal common stock on November 17, 1995. At some point in December, Marksman contends that Burnison sold 300,000 shares of her own personally-held stock for over \$20 per share. The net proceeds of Burnison's sale was over \$6.3 million.

On January 6, 1996, Barron's financial journal published an article "questioning Chantal's accounting and whether Chantal's reported revenues represented a true sale, since the risk of ownership of the products did not appear

99. A consignment sale "is one in which goods are delivered by a consignor to a dealer or distributor (the consignee) primarily for sale by the consignee, and the consignee has the right to return any unsold commercial units of the goods in lieu of payment. . . . Because a product return cancels the sale, any sale made with the right of return creates doubt about whether the transaction actually constitutes an exchange." *Id.* (citations omitted).

100. *Id.*

101. *See supra* note 99.

102. *Marksman*, 927 F. Supp. at 1301-02.

103. *Id.* at 1302. Marksman also alleged that Chantal violated GAAP reporting requirements by not disclosing that the agreement with Stanson was a "related party transaction." *Id.*

104. *Id.*

105. *Id.*

106. *Id.*

to have transferred from Chantal to Stanson.”¹⁰⁷ Two days later, Chantal’s stock price dropped 62%.¹⁰⁸

Marksman held 29,000 shares at the time. On January 8, 1996, following the publication of the Barron’s article, Marksman sold all of its shares at an average price of \$7.53 per share, for a net loss of over \$300,000. On February 7, 1996, Marksman filed a class action complaint against Chantal Pharmaceutical Corp. and Burnison,¹⁰⁹ alleging that the defendants fraudulently reported the consignment sales in violation of GAAP reporting requirements in order to artificially inflate the price of Chantal’s stock. Chantal and Burnison filed a motion to dismiss, relying on section 21D(b)(2) of the Reform Act, claiming that Marksman failed to sufficiently plead scienter.¹¹⁰

B. Ninth Circuit Standard Before the Reform Act

Prior to the enactment of the Reform Act, the Ninth Circuit took a relatively lenient approach to determining the sufficiency of a scienter pleading.¹¹¹ These courts read the language of Rule 9(b)¹¹² strictly and found that the condition of mind of the defendant could be “averred generally.”¹¹³

For example, the Ninth Circuit court in *In re GlenFed, Inc. Securities Litigation*¹¹⁴ held that “[w]herever it is material to allege malice, fraudulent intention, knowledge, or other conditions of the mind of any person, it shall be sufficient to allege the same as a fact without setting out the circumstances from which the same is to be inferred.”¹¹⁵ The court felt that anything more would contradict the plain language of Rule 9(b), and that such a change in the standard is a job for Congress and not the courts.¹¹⁶ Other courts in the Ninth Circuit took similar approaches, generally holding that scienter may be plead through conclusory allegations.¹¹⁷

However, the court in *Marksman* conceded that the Reform Act raised the standard of pleading scienter beyond that previously embraced by the Ninth Circuit. “The [Reform Act] leaves little doubt . . . that the lenient *GlenFed*

107. *Id.* at 1303.

108. On January 8, 1996, the stock price dropped from \$19.125 to \$7.31 per share on a trading volume of over 7,000,000 shares.

109. *Marksman*, 927 F. Supp. at 1303.

110. *Id.* at 1304.

111. See John F. Olson et al., *Pleading Reform, Plaintiff Qualification and Discovery Stays Under the Reform Act*, 51 BUS. LAW. 1101, 1109-10 (1996).

112. See *supra* notes 26-29 and accompanying text (discussing Rule 9(b) and strict construction of the Rule’s requirement for pleading the defendant’s state of mind).

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

114. 42 F.3d 1541 (9th Cir. 1994).

115. *Id.* at 1545.

116. *Id.* at 1546.

117. See *Greenwald v. Wells Fargo & Co.*, 12 F.3d 922 (9th Cir. 1993); *Wool v. Tandem Computers*, 818 F.2d 1433 (9th Cir. 1987); *Fecht v. Price Co.*, 70 F.3d 1078 (9th Cir. 1995).

standard can no longer be said to constitute the sum of scienter pleading requirements in a Section 10(b) and Rule 10b-5 case.”¹¹⁸ Where the *Marksman* court erred, however, was in raising the pleading standard only to the existing standard practiced by the Second Circuit.

C. Pleading Standard for Scienter Under Section 21D(b)(2)

The *Marksman* court held that a plaintiff in a securities fraud action may plead scienter by alleging motive and opportunity on the part of the defendant to commit fraud.¹¹⁹ “[T]he motive and opportunity test appears to be consistent with Congress’s intent that scienter be pled with more than conclusory or generic allegations.”¹²⁰ The court was unpersuaded by the defendants’ contention that the Reform Act rejected the Second Circuit’s motive and opportunity standard.¹²¹ The defendants relied on the legislative history of the Reform Act and of section 21D(b)(2). They pointed to the Conference Report, which emphasized that 21D(b)(2) was intended to strengthen existing pleading requirements and therefore did not intend to codify the Second Circuit’s standard.¹²² Despite the seemingly clear legislative history, however, the court found that the motive and opportunity test had not been abandoned.¹²³

First, the court noted that the conference committee, in drafting 21D(b)(2), emphasized that the Second Circuit’s standard is more stringent than the standard of any other circuit. The court thus assumed that case law from the Second Circuit must be the closest approximation of the Reform Act’s new requirements.¹²⁴ Not only is this a weak assumption, but its logic is faulty. If Congress intended to strengthen *existing* pleading standards, and the Second Circuit’s standard is the strongest existing standard, it does not logically follow that Congress intended courts to follow that standard. It may well be that the Second Circuit’s standard comes closest to approximating the standard intended by Congress, but only because it is in fact the strongest standard existing. However, simply because the standard comes closest to that intended by Congress does not mean that it *is* the standard intended by Congress. It seems that the court in *Marksman* attempted to avoid the more difficult analysis which would have followed from applying a truly heightened pleading standard that Congress intended, so it took the easy way out and essentially codified the standard of the Second Circuit.

The *Marksman* court’s second argument for codification of the motive and opportunity test of the Second Circuit was that the precise language of section

118. *Marksman*, 927 F. Supp. at 1309.

119. *Id.* at 1310-11.

120. *Id.* (citing *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994)).

121. *Id.*

122. *Id.* at 1310 (citing H.R. CONF. REP. NO. 369, 104th Cong., 1st Sess. 41 (1995)).

123. *Id.* (“Notwithstanding defendants’ citation to the legislative history, a number of considerations militate against their argument.”).

124. *Id.*

21D(b)(2), that a plaintiff must establish a strong inference of scienter, “mirrors language traditionally employed by the Second Circuit in its application of Rule 9(b) to scienter pleadings.”¹²⁵ The court, however, leaves this argument as essentially conclusory, and fails to recognize that more than one method of establishing a “strong inference” can consistently co-exist. The motive and opportunity test is not the only conceivable method of establishing a strong inference of scienter. Simply because Congress used some of the same general language that the Second Circuit used to describe its pleading standard, it does not follow that Congress intended courts to adopt the Second Circuit’s entire approach for establishing the strong inference.

The court continued to rationalize its decision by stating the restrictions on the motive and opportunity test which have been developed by the Second Circuit to safeguard concerns that the “generic motive”¹²⁶ of increasing capital or revenue based compensation will not be sufficient to establish a strong inference.¹²⁷ However, as argued in Part II of this Note, these safeguards can be overcome through creative lawyering.¹²⁸

Finally, the court explains that “when Congress wishes to supplant a judicially-created rule it knows how to do so explicitly, and in the body of the statute.”¹²⁹ This argument refers to the fact that the Conference Committee’s intentional omission of language pertaining to motive and opportunity appears in a footnote to the Conference Report rather than in its text or in the body of the Reform Act.¹³⁰ However, this argument assumes that when Congress wishes to change a judicially-created rule, it will always follow the same method, regardless of the existence of equally clear methods such as inclusion of the change in a footnote to text which clearly indicates their intention.

The court concludes that the Second Circuit’s motive and opportunity test is therefore consistent with Congressional intent. “Because Second Circuit jurisprudence in the area of securities fraud claims is wholly consistent with both the language and purpose of the [Reform Act], the court finds the ‘motive and opportunity’ test to be a suitable standard to employ in this case.”¹³¹ The court

125. *Id.* (citing *Shields*, 25 F.3d at 1128; *Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1176 (2d Cir. 1993)).

126. *Id.*

127. *See supra* notes 53-61 and accompanying text. The *Marksman* court cites *Grossman v. Texas Commerce Bancshares, Inc.*, No. 87Civ.6295, 1995 WL 552744 (S.D.N.Y. Sept. 15, 1995), which states that “[a]llegations of motive that are generally held by similarly positioned executives and companies [e.g., to improve the company’s financial health or reputation] are insufficient to sustain a claim under the securities laws.” *Id.*; *see also In re Crystal Brands Sec. Litig.*, 862 F. Supp. at 749.

128. *See supra* note 65 and accompanying text.

129. *Marksman*, 927 F. Supp. at 1311 (citations omitted).

130. *See* Conference Report, *supra* note 7, at H15,215.

131. *Marksman*, 927 F. Supp. at 1312. Subsequent to the *Marksman* decision, a line of cases has held similarly that the motive and opportunity standard is consistent with Congress’ intent in drafting section 21D(b)(2). *See, e.g., In re Health Mgmt. Inc. Sec. Litig.*, 970 F. Supp. 192, 201

then proceeded to apply the test to the facts of the case at hand.

D. Motive and Opportunity Applied to the Facts in Marksman

The court in *Marksman* first quickly establishes that Chantal and Burnison had the opportunity to commit fraud. This analysis seems to be sound. The court states that “[t]here is no question about Chantal and Burnison’s ‘opportunity’ to carry out the means, i.e., misrepresentations about Chantal’s financial performance to the public, necessary to accomplish these benefits.”¹³² The court explained that both Chantal and Burnison had significant control over the accounting procedures and financial statements for the corporation during the relevant time period. They also had direct access to pertinent information concerning the financial conditions and operations of the corporation.¹³³

The court’s finding of motive was a bit more involved than the opportunity analysis. *Marksman* based its claim on four alleged motives: (1) to enhance the value of Chantal stock; (2) to successfully complete the private placement of stock; (3) to enhance Burnison’s compensation and prestige; and (4) to sell a large portion of Burnison’s stock at prices which had been artificially inflated by the misleading information.¹³⁴

The court correctly found that the first three motives were insufficient to raise a strong inference of scienter. These alleged motives are too general in nature and are shared by virtually every company in the United States.¹³⁵ Therefore, the court concluded, “*Marksman*’s allegations that misrepresentations were made to increase Chantal’s stock value, which would facilitate sales of the corporation’s stock and increase executive compensation cannot, without more, establish scienter.”¹³⁶

The court found that the last motive, to allow Burnison to sell stock at artificially inflated prices, was sufficient to establish a strong inference of scienter.¹³⁷

(E.D.N.Y. 1997) (holding that “motive and opportunity . . . is sufficient to plead a strong inference of scienter under the [Reform Act]”); *Rehm v. Eagle Finance Corp.*, 954 F. Supp. 1246, 1253 (N.D. Ill. 1997) (concluding that “a scienter pleading standard equivalent to the Second Circuit rule best comports with the language, history, and purpose of the [Reform Act]”); *In re Wellcare Mgmt. Group, Inc. Sec. Litig.*, 964 F. Supp. 632 (N.D.N.Y. 1997). These cases base their holdings on essentially the same reasoning described in this section as utilized by the court in *Marksman*.

132. *Marksman*, 927 F. Supp. at 1312 (citing *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1130 (2d Cir. 1994) (defining opportunity as the “means and likely prospect of achieving concrete benefits by the means alleged”)).

133. *Id.* (citing *Cohen v. Koenig*, 25 F.3d 1168, 1173-74 (2d Cir. 1994) (finding opportunity to commit fraud to be present where the defendants were officers, directors and majority shareholders fully familiar with the company’s operations and accounting procedures)).

134. *Id.*

135. *Id.* (citing *Acito*, 47 F.3d at 54).

136. *Id.*

137. *Id.* (“The last ‘motive’ allegation made by *Marksman*, however, is sufficient to constitute

Allegations that a corporate insider either presented materially false information, or delayed disclosing materially adverse information, in order to sell personally-held stock at a huge profit can supply the requisite “motive” for a scienter allegation. . . . Thus, insider trading activity during the class period may support a strong inference of scienter. . . . A plaintiff, however, must demonstrate that the insider trading activity was “unusual,” . . . , which requires a showing that the trading was in “amounts dramatically out of line with prior trading practices, at times calculated to maximize personal benefit from undisclosed inside information.”¹³⁸

The court found that this motive analysis was met by Marksman’s pleadings that Burnison sold 300,000 of her shares of Chantal stock at an artificially inflated price of over \$20 per share while information concerning revenues from consignment sales which violated GAAP reporting procedures was being released to the public.

E. Incorrect Means to a Probable End

Any 21D(b)(2) case is bound to be highly fact sensitive. Therefore, it is important for courts to state a completely accurate analysis in reaching their conclusions. The *Marksman* case is a perfect example of how such an analysis can be misstated with the illusion that the correct result is being reached. The court in *Marksman* was blessed with a set of facts so clear that the highest conceivable standard for pleading scienter could have been met. Yet the Court chose the simple route of codifying the Second Circuit standard, rather than grappling with the true legislative intent and balancing the risk factors intended to be incorporated into the new pleading standard of 21D(b)(2).

The standard proposed by this Note and which has in fact been followed by courts since the passage of the Reform Act is that a plaintiff must “allege specific facts that constitute circumstantial evidence of conscious behavior by defendants.”¹³⁹ The facts in *Marksman* could have met this heightened standard, while setting precedent that could be followed by courts in other circuits which would be consistent with Congress’ intent in drafting the Reform Act. The *Marksman* court discussed this standard as an alternative ground for finding the pleadings of *Marksman* sufficient to establish a strong inference of scienter.¹⁴⁰ Therefore, it is difficult to understand why the court insisted on codifying the more lenient “motive and opportunity” test.

a sound basis for the scienter element of a Section 10(b) and Rule 10b-5 claim”).

138. *Id.* (quoting *Alfus v. Pyramid Tech. Corp.*, 764 F. Supp. 598, 605 & n.1 (N.D. Cal. 1991) (citations omitted)).

139. *In re Silicon Graphics I*, 1996 WL 664639, at *6.

140. *Marksman*, 927 F. Supp at 1313 (“Even assuming, arguendo, that the ‘motive and opportunity’ test does not yield the requisite ‘strong inference,’ Marksman may still successfully plead a strong inference of scienter under the Second Circuit’s ‘circumstantial evidence’ test.”).

V. *SILICON GRAPHICS* AND THE “CIRCUMSTANTIAL EVIDENCE” TEST

In *Silicon Graphics I*,¹⁴¹ the court rejected the analysis of the *Marksman* court, which determined that the scienter pleading requirements could be sustained by demonstrating motive and opportunity.¹⁴² “The *Silicon Graphics I* court found an intent to exceed that standard not only in the legislative history, but also in the fact that Congress overrode the presidential veto that expressly noted support for the Second Circuit standard and expressed concern that ‘Congress ma[d]e [it] crystal clear in the [conference report] [its] intent to raise the standard even beyond that level.’”¹⁴³

A. *Facts of Silicon Graphics I*

Silicon Graphics, Inc. (“SGI”) is a Delaware corporation with stock traded on the New York Stock Exchange. On January 29, 1996, plaintiffs filed a class action complaint against SGI alleging violations of section 10(b) of the Securities Exchange Act of 1934.¹⁴⁴ Specifically, plaintiffs alleged that SGI “made material misrepresentations about [their] growth prospects and general financial condition, and failed to disclose adverse facts about [the company’s] products, management, and competitors.”¹⁴⁵

In August 1995, SGI stock declined to the high \$20s, from an all-time high of \$44 7/8.¹⁴⁶ The decline in price was the result of “market concern that SGI would be unable to maintain its historic forty percent growth rates given increased competition.”¹⁴⁷ In October 1995, SGI announced a thirty-three percent growth in revenue for the first quarter of the fiscal year. This growth rate was viewed by market analysts as disappointing because of high growth targets announced by SGI earlier in the year.¹⁴⁸ Subsequently, SGI asserted in a press release that the second quarter results would be closer to the company’s growth targets.¹⁴⁹

The stock price fell again in December 1995, when rumors surfaced that the second quarter results might also be below anticipated growth rates.¹⁵⁰ In early January 1996, SGI confirmed the rumors, causing the stock price to fall to \$22

141. No. 96-0393, 1996 WL 664639 (N.D. Cal. Sept. 25, 1996).

142. *Id.* at *6 & n.4.

143. Harvey L. Pitt & Karl A. Goskaufmanis, *Nine Months After the Enactment of Securities Litigation Reform, Courts Are Clarifying the New Limitations Set By the Act*, NAT’LLJ., Oct. 28, 1996, at B5 (quoting H.R. DOC. NO. 104-150, 104th Cong., 1st Sess. 240 (1995)).

144. *Silicon Graphics I*, 1996 WL 664639, at *1. Plaintiffs also filed a derivative action, alleging breach of fiduciary duty and gross negligence by SGI. *Id.*

145. *Id.* at *2.

146. *Id.* at *1.

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.*

per share.¹⁵¹ The plaintiff's class action complaint was filed on January 29, 1996, alleging that "SGI . . . violated federal securities law by issuing false and misleading information about the company after the disappointing first quarter, in an effort to inflate the price of SGI stock for the purpose of selling their own stock at a substantial profit."¹⁵²

*B. Argument for the "Circumstantial Evidence" Test Over the
"Motive and Opportunity" Test*

After discussing the applicability of section 10(b) of the Exchange Act, and Rule 10b-5 thereunder,¹⁵³ the court in *Silicon Graphics I* proceeded to define the standard for pleading scienter under the Reform Act. The court relied heavily on the legislative history of the Reform Act, and section 21D(b)(2) in particular, in holding that Congress intended to enact a pleading requirement more stringent than the motive and opportunity standard of the Second Circuit.¹⁵⁴

The court noted that the Conference Report explicitly states that it "intends to strengthen existing pleading requirements, [and] it does not intend to codify the Second Circuit's case law interpreting the pleading standard."¹⁵⁵ Further, the court recognized that the Senate Bill "included an amendment that would have codified the Second Circuit's standard, and would have allowed a plaintiff to use allegations of recklessness or motive and opportunity to establish fraudulent intent."¹⁵⁶ The intentional omission of this amendment, the court reasoned, shows an intent to create a new standard.¹⁵⁷

The court also considered significant the President's veto message to Congress, in which he expressed concern that Congress had "ma[d]e crystal clear in the Statement of Managers their intent to raise the standard even beyond [that of the Second Circuit]."¹⁵⁸ By overriding the veto, the court reasoned, Congress made clear its intent to "heighten the pleading standard."¹⁵⁹

Finally, the court in *Silicon Graphics I* rejected the plaintiff's legislative

151. *Id.*

152. *Id.* Plaintiff also named nine SGI officers and directors as defendants. *Id.* at n.2.

153. *See* Rule 10b-5, *supra* note 2.

154. *Silicon Graphics I*, 1996 WL 664639 at *5-*6.

155. *Id.* at *5 (quoting Conference Report, *supra* note 7). "For this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness." *Id.* at n.23.

156. *Id.* (citing Amend. 1485, S. 240, 104th Cong., 1st Sess. (1995)).

157. *Id.* "The Conference Committee's deletion of the Second Circuit standard from the final bill 'strongly militates against a judgment that Congress intended a result that it expressly declined to enact.'" *Id.* at *6 (quoting *Gulf Oil Corp. v. Copp Paving Co.*, 419 U.S. 186, 200 (1974)); *People for Environmental Progress v. Leisz*, 373 F. Supp. 589, 592 (C.D. Cal. 1974) (stating that the conference committee's "deletion of proposed amendment from bill is 'significant' and 'persuasive' evidence of Congressional intent).

158. *Id.* (quoting Veto Message, *supra* note 4).

159. *Id.*

history arguments involving statements by certain Senators that the language of section 21D(b)(2) codifies the Second Circuit standard “in part.”¹⁶⁰ The court reasoned that

these are the statements of only a few individual members of a Congress that ultimately adopted the Conference Report and passed the bill as formulated by the Conference Committee. As the Supreme Court has noted, “the authoritative source for finding the Legislature’s intent lies in the Committee Reports on the bill, which ‘represen[t] the considered and collective understanding of those Congressmen involved in drafting and studying proposed legislation.’”¹⁶¹

The court continued, “Committee reports, not ‘[s]tray comments by individual legislators,’ provide the best expression of legislative intent.”¹⁶²

Based on the above excerpts from the legislative history, the court concluded that Congress intended to raise the standard for pleading scienter in a securities fraud claim beyond that existing in the Second Circuit prior to the Reform Act.¹⁶³ “The Court therefore [held] that plaintiff must allege specific facts that constitute circumstantial evidence of conscious behavior by defendants.”¹⁶⁴

C. The “Circumstantial Evidence” Test

“In establishing circumstantial evidence of conscious behavior or actual knowledge, as required by the [Reform Act], [a] plaintiff must do more than speculate as to defendants’ motives or make conclusory allegations of scienter; [a] plaintiff must allege specific facts.”¹⁶⁵ While the court in *Silicon Graphics I* held that this “circumstantial evidence” test was the method by which Congress intended plaintiffs to plead scienter in any securities fraud lawsuit, other courts, primarily in the Second Circuit, have described the test as a possible alternative to the motive and opportunity test.¹⁶⁶ In fact, even the court in *Marksman*, which

160. See *supra* notes 90-91 and accompanying text (discussing the statements of Senators Bradley and Domenici in response to the President’s veto message).

161. *Silicon Graphics I*, 1996 WL 664639, at *6 (citing *Garcia v. United States*, 469 U.S. 70, 76 (1984) (quoting *Zuber v. Allen*, 396 U.S. 168, 186 (1969)); *RTC v. Gallagher*, 10 F.3d 416, 421 (7th Cir. 1993) (stating that the Conference Report “is the most persuasive evidence of congressional intent besides the statute itself”).

162. *Id.* (quoting *In re Kelly*, 841 F.2d 908, 912 n.3 (9th Cir. 1988)).

163. *Id.*

164. *Id.*

165. *Id.* at *12 (citing *Wexner v. First Manhattan Co.*, 902 F.2d 169, 172-73 (2d Cir. 1990); *Denny v. Barber*, 576 F.2d 465, 470 (2d Cir. 1978)).

166. See, e.g., *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128-30 (2d Cir. 1994) (“The requisite ‘strong inference’ of fraud may be established either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness.”); *Beck v. Manufacturers Hanover Trust Co.*, 820 F.2d 46, 50 (2d Cir. 1987) (“it is . . . possible to plead scienter by

held that section 21D(b)(2) was essentially a codification of the motive and opportunity test, endorsed the circumstantial evidence test for situations in which “the ‘motive and opportunity’ test [would] not yield the requisite ‘strong inference’”¹⁶⁷

Courts applying the above test have imposed the additional requirement that “[i]f the ‘circumstantial evidence’ method is used, the strength of the circumstantial allegations must be correspondingly greater.”¹⁶⁸ While courts in the Second Circuit have generally applied the motive and opportunity test in evaluating the sufficiency of a pleading, they have also discussed the requisite strength of the pleadings with respect to the circumstantial evidence test.

For example, in *Marksman*, the court stated that the circumstantial evidence test could be met by showing a violation of Generally Accepted Accounting Principles (GAAP) on the part of the defendants.¹⁶⁹ “A violation of [GAAP] may be used to show that a company overstated its income, which may be used to show the scienter for a violation of Section 10(b) and Rule 10b-5.”¹⁷⁰ The court proceeded to explain that the GAAP violation will not alone be sufficient to establish fraud, but “when combined with other circumstances suggesting fraudulent intent, . . . allegations of improper accounting may support a strong inference of scienter.”¹⁷¹ The court failed, however, to describe what “other circumstances” would be required to raise the pleading to a sufficient level in establishing a strong inference under the circumstantial evidence test.

In *Shields v. Citytrust Bancorp, Inc.*,¹⁷² the court essentially used the circumstantial evidence test to reject the “fraud by hindsight” theory, by which a plaintiff could plead scienter by showing optimistic statements made by a defendant which ultimately failed to materialize.¹⁷³ The court held that “misguided optimism is not a cause of action, and does not support an inference of fraud. [The court thus] rejected the legitimacy of ‘alleging fraud by hindsight.’”¹⁷⁴

While the courts which have addressed the circumstantial evidence test prior to the passage of the Reform Act have not explicitly stated precisely what type of facts are required to establish a strong inference of scienter, they have made clear that the circumstantial evidence must be stronger than mere allegations of motive and opportunity. The court in *Silicon Graphics I* followed this rule in dismissing the plaintiffs’ case for failure to adequately plead scienter on the part

identifying circumstances indicating conscious behavior by the defendant”). See also *In re Time Warner*, 9 F.3d at 269.

167. *Marksman*, 927 F. Supp. at 1313 (citing *Glickman*, 1996 WL 88570 at *14).

168. *Id.* (citing *Glickman*, 1996 WL 88570, at *14); see also *Beck*, 820 F.2d at 50.

169. *Marksman*, 927 F. Supp. at 1313.

170. *Id.* (citing *Wechsler v. Steinberg*, 733 F.2d 1054, 1058-59 (2d Cir. 1984)).

171. *Id.*

172. 25 F.3d 1124 (2d Cir. 1994).

173. See VANYO & YODOWITZ, *supra* note 48, at 138-39 (discussing the effect of *Shields* on the fraud by hindsight theory).

174. *Shields*, 25 F.3d at 1129 (quoting *Denny v. Barber*, 576 F.2d 465, 470 (2d Cir. 1978)).

of the defendants.

D. Application of the Test to the Facts of Silicon Graphics

The court in *Silicon Graphics I* held that “[a]lthough [the] plaintiff does not . . . simply hold predictions up against the backdrop of what actually happened, her allegations nonetheless fall short of pleading a strong inference of fraud.”¹⁷⁵ The plaintiffs attempted to plead scienter by alleging that the defendants were aware of negative internal reports which contradicted SGI’s false and misleading statements and stock sales.¹⁷⁶ Specifically, the plaintiffs claimed that

[E]ach of the Individual Defendants was aware of Silicon Graphics’ fiscal 1996 forecast and budget and of internal reports, comparing Silicon Graphics’ actual results to those budgeted and/or forecasted. Based on the negative internal reports of the Company’s actual performance compared to that budgeted and forecasted, the Individual Defendants each knew Silicon Graphics was plagued by an inability to sell . . . as planned.¹⁷⁷

The court found these allegations too general and common to any company employing an internal reporting system. “Every sophisticated corporation uses some kind of internal reporting system reflecting earlier forecasts; allowing [a] plaintiff to go forward with a case based on general allegations of ‘negative internal reports’ would expose all those companies to securities litigation whenever their stock prices dropped.”¹⁷⁸

The court noted that the Second Circuit has held that “unsupported general claims of the existence of internal reports are insufficient to survive a motion to dismiss. Second Circuit courts require plaintiffs to specifically identify alleged internal reports, providing names and dates.”¹⁷⁹ The court reasoned, therefore, that because the Reform Act raised the pleading standard beyond that of the Second Circuit, “the Court cannot require anything less of [the] plaintiff in this case.”¹⁸⁰ The complaint was dismissed for failure to adequately plead scienter under the circumstantial evidence test.¹⁸¹

E. Silicon Graphics II and the Road to a Uniform and Heightened Standard

Following dismissal, the plaintiffs amended their complaint to include allegations that they felt met the “heightened” standard espoused by the court in

175. *Silicon Graphics I*, 1996 WL 664639, at *12.

176. *Id.*

177. *Id.*

178. *Id.*

179. *Id.* (citing *San Leandro Emergency Med. Plan v. Philip Morris Cos.*, 75 F.3d 801, 812-13 (2d Cir. 1996)).

180. *Id.*

181. *Id.* at *13.

Silicon Graphics I.¹⁸² The amended complaint contained allegations that the defendants were aware of negative internal reports, and that this awareness, coupled with substantial stock sales, gives rise to a strong inference of fraudulent intent.¹⁸³ The court rejected this argument, holding that “plaintiffs must provide more details about the alleged negative internal reports. The allegations should include the titles of the reports, when they were prepared, who prepared them, to whom they were directed, their content, and the sources from which plaintiffs obtained this information.”¹⁸⁴

In finding the plaintiffs’ allegations inadequate, the *Silicon Graphics II* court relied on essentially the same arguments that formed the basis of the court’s decision in *Silicon Graphics I*, as described above. The court went on, however, to discuss the role of recklessness in the “strong inference” debate, an undertaking the court failed to pursue in *Silicon Graphics I*. The court held that to adequately plead fraud, a plaintiff “must create a strong inference of knowing or intentional misconduct.”¹⁸⁵ The court continued, stating that “[k]nowing or intentional misconduct includes deliberate recklessness, . . . [but] [m]otive, opportunity, and non-deliberate recklessness . . . are not alone sufficient to support scienter.”¹⁸⁶ Thus, the court in *Silicon Graphics II* restated the well-reasoned argument for raising the pleading standard beyond that of motive and opportunity, and it clarified the previously unsettled role of recklessness in the strong inference analysis. With this framework, as established by the two *Silicon Graphics* opinions, courts in the future have the tools for refining a truly heightened and uniform pleading standard.¹⁸⁷

182. *Silicon Graphics II*, 970 F. Supp. 746, 749 (N.D. Cal. 1997).

183. *Id.* at 766.

184. *Id.* at 767.

185. *Id.* at 757.

186. *Id.*

187. A line of cases has emerged following the *Silicon Graphics I* decision which has also argued that Congress intended to create a standard more stringent than the motive and opportunity standard. See, e.g., *In re Baesa Sec. Litig.*, 969 F. Supp. 238, 242 (S.D.N.Y. 1997) (holding that allegations of motive and opportunity would no longer be sufficient in themselves to establish scienter); *In re Glenayre Technologies, Inc. Sec. Litig.*, 982 F. Supp. 294, 297 (S.D.N.Y. 1997) (holding that “under the [Reform Act] a showing of motive and opportunity, without more, no longer suffices to raise a strong inference of scienter”). The court in *Glenayre* emphasized that facts relating to motive and opportunity are still relevant to the scienter analysis, despite that they are not dispositive. The court explained that “[s]uch facts must be considered—along with other facts pled—in assessing whether a complaint raises a strong inference of knowing misrepresentation.” *Id.* at 298; see also *Norwood Venture Corp. v. Converse Inc.*, 959 F. Supp. 205, 208 (S.D.N.Y. 1997) (citing *Friedberg v. Discreet Logic Inc.*, 1997 WL 109228 (D. Mass. March 7, 1997), for the proposition that the Reform Act was intended to create a pleading standard “stronger than the existing Second Circuit standard”).

CONCLUSION

By enacting the Private Securities Litigation Reform Act of 1995, Congress hoped to (1) reduce the occurrence of abusive or frivolous securities litigation which has plagued our nation's capital markets and undermined their integrity, and (2) create a degree of uniformity in the litigation practices among the circuits. A primary vehicle for this intended reform is the heightened standard for pleading the defendant's state of mind in a securities fraud lawsuit which must be met by a plaintiff in order to withstand a motion to dismiss.

Since the passage of the Reform Act, however, the goals of Congress have not been realized due to conflicting judicial interpretations within the Ninth Circuit. The court in *Marksman* interpreted the pleading standard of the Reform Act as essentially a codification of the Second Circuit's motive and opportunity standard. This interpretation is inconsistent with the legislative history of the pleading requirement and fails to remedy the abuses in the securities litigation system which initially gave rise to the Reform Act.

The court both in *Silicon Graphics I* and later in *Silicon Graphics II*, however, correctly interpreted the pleading requirement, holding plaintiffs to a higher standard than the motive and opportunity test of the Second Circuit. In *Silicon Graphics I*, the court held that in order to sufficiently plead scienter, plaintiffs "must allege specific facts that constitute circumstantial evidence of conscious behavior by defendants."¹⁸⁸ This standard is sensitive to the goals of Congress in initiating reform and strikes an appropriate balance between the need to prevent and redress deceptive and manipulative practices in securities litigation, and the maintenance of respectable capital markets. Therefore, courts in the future should follow the lead of the *Silicon Graphics* decisions by requiring plaintiffs to plead circumstantial evidence of conscious behavior in order to justify subjecting defendants to the abuses inherent in securities litigation.

188. *Silicon Graphics I*, 1996 WL 664639, at *5.