

The Private Securities Litigation Reform Act and Particularity: Why Are Some Courts in an Alternate Universe?

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The focus of this Article is to suggest that the judicial decision-making process is often not as rational and objective as we would like to believe. Bias often affects the decision making of judges, sometimes to the extent that it appears that the writer of the opinion is living in an alternate universe.

As we progress professionally, and become more steeped in our biases, we sometimes move toward creating a world that exists in our heads and has little relation to the “real” world. While this assertion will be developed in the context of courts’ interpreting “particularly” in the Private Securities Litigation Reform Act, the Article first examines a recent and highly significant Supreme Court decision, Stoneridge Investment Partners, LLC v. Scientific-Atlanta.

The Article then focuses upon two cases, In re Spectrum Brands, Inc. Securities Litigation and In re Silicon Graphics Inc. Securities Litigation, to illustrate what I have called the “alternate universe” type of thinking that some courts have employed. In these two cases, the courts have either ignored or been unaware of sound management practices, the existence of which would have supported the “particularity” these courts found wanting in the pleadings. Some courts appear oblivious to both the widely recognized practice of manufacturing earnings and the economic incentives that exist for management to do just that. While courts employ a presumption that senior management is informed when applying the business judgment rule, all too often they also, in effect, employ a presumption that senior management is not informed when critiquing the specificity of plaintiffs’ pleadings. If senior management is not informed about the economic situation of the company that they represent to the public, representations which later turn out to be false, what then are they doing that justifies the million-dollar compensation packages that they enjoy?

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The net effect of these two conflicting presumptions—that management is informed and that management is not informed—is to eviscerate the accountability of senior management for the misrepresentations it introduces into the securities markets.

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INTRODUCTION

Last year's Institute for Investor Protection Conference at Loyola University Chicago School of Law focused upon Law and Economics.¹ Lawyers, like economists, presume their profession is governed by "rational behavior." After all, don't law schools teach their constituents to "think like a lawyer," that is rationally and objectively, unfettered by emotional or other extraneous considerations? However, Daniel Kahneman, a Nobel Prize winner and keynote speaker for last year's Conference, has argued that decision making by economists or lawyers is not as objective, rational, or detached as professionals suppose.²

In *Thinking, Fast and Slow*, Kahneman draws a distinction between thinking fast—a quick, intuitive process predicated upon the accumulation of vast amounts of information, often selectively retrieved (the source of bias)³—and thinking slow—a deliberative, thoughtful process that, unfortunately, involves the expenditure of substantial energy.⁴

The focus of this Article is to suggest that the judicial decision-making process is often not as rational and objective as we would like to believe. Bias often affects the decision making of judges,⁵ sometimes to the extent

1. *A Law and Policy Research Institute*, LOY. U. CHI. SCH. L. INST. INVESTOR PROTECTION, <http://www.luc.edu/law/centers/investor/> (last visited Feb. 23, 2014). Articles stemming from the Conference included Daniel Kahneman, *Behavioral Economics and Investor Protection: Keynote Address*, 44 LOY. U. CHI. L.J. 1333 (2013), Russell Korobkin, *Daniel Kahneman's Influence on Legal Theory*, 44 LOY. U. CHI. L.J. 1349 (2013), Charles W. Murdock & Barry Sullivan, *What Kahneman Means for Lawyers: Some Reflections on Thinking, Fast and Slow*, 44 LOY. U. CHI. L.J. 1377 (2013), Richard A. Posner, *Behavioral Finance Before Kahneman*, 44 LOY. U. CHI. L.J. 1341 (2013), Jed S. Rakoff, *Conjoining "Recklessness" in Securities Fraud Cases to Moral Culpability*, 44 LOY. U. CHI. L.J. 1447 (2013), and Thomas Ulen, *A Behavioral View of Investor Protection*, 44 LOY. U. CHI. L.J. 1357 (2013).

2. DANIEL KAHNEMAN, *THINKING, FAST AND SLOW* 8–15, 203–04 (2011).

3. *Id.* at 21–22.

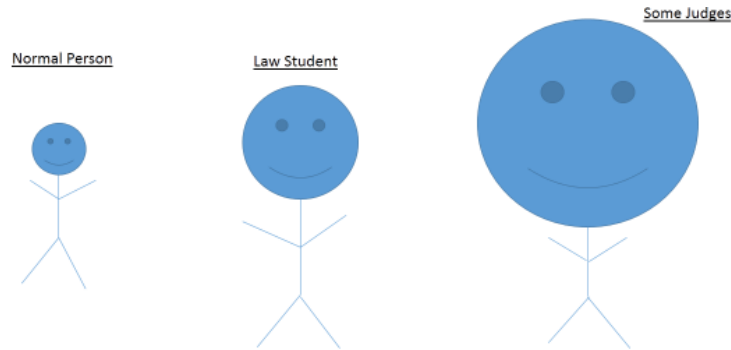
4. *Id.* at 31–34; *see also id.* at 39–49 (discussing the physiological and psychological effects of expending mental energy).

5. Kahneman has an interesting study of parole judges in Israel and how their decision making is affected by what he calls the "default" or easy option when combined with how tired they are. *Id.* at 43–44; Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (the Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L.J. 83, 84 (2002) (also suggesting that judges have a bias in favor of disposing cases as early as possible); *see also* PHILIP G. ZIMBARDO & MICHAEL R. LEIPPE, *THE PSYCHOLOGY OF ATTITUDE CHANGE AND SOCIAL INFLUENCE* 162 (1991) ("[D]espite all good intentions to 'let the facts speak for themselves,' . . . cognitive response process[es] are all affected in subtle ways by one's existing point of view.").

that it appears that the writer of the opinion is living in an alternate universe.

At this year's Symposium,⁶ my PowerPoint presentation somewhat irreverently illustrated the progression of some lawyers from a normal citizen to esteemed judge as follows:

Evolution of Lawyers: Alternate Universes



As we progress professionally, *and become more steeped in our biases*, we sometimes move toward creating a world that exists in our heads and has little relation to the “real” world. While this assertion will be developed in the context of courts’ interpreting “particularly” in the Private Securities Litigation Reform Act (“PSLRA”),⁷ let me first examine a recent and highly significant Supreme Court decision, *Stoneridge Investment Partners, LLC v. Scientific-Atlanta*,⁸ which I have criticized in an article published earlier this year.⁹

I will then focus upon two cases, *In re Spectrum Brands, Inc. Securities Litigation*¹⁰ and *In re Silicon Graphics Inc. Securities Litigation*,¹¹ to illustrate what I have called the “alternate universe” type of thinking that some courts have employed. In these two cases, the courts have either ignored or been unaware of sound management practices, the existence

6. INST. FOR INVESTOR PROT., LOYOLA UNIV. CHI. SCH. OF LAW, STRATEGIES FOR INVESTIGATING AND PLEADING SECURITIES FRAUD CLAIMS CONFERENCE AGENDA (Oct. 25, 2013), available at http://www.luc.edu/media/lucedu/law/centers/investor/pdfs/conference_brochure.pdf.

7. Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

8. 552 U.S. 148 (2008).

9. See Charles W. Murdock, Janus Capital Group, Inc. v. First Derivative Traders: *The Culmination of the Supreme Court's Evolution from Liberal to Reactionary in Rule 10b-5 Actions*, 91 DENV. U. L. REV. (forthcoming 2014).

10. 461 F. Supp. 2d 1297 (N.D. Ga. 2006).

11. 183 F.3d 970 (9th Cir. 1999), *abrogated on other grounds by* S. Ferry LP, No. 2 v. Killinger, 542 F.3d 776 (9th Cir. 2008).

of which would have supported the “particularity” these courts found wanting in the pleadings. The courts employ a presumption that senior management is informed when applying the business judgment rule, but then employ a presumption that senior management is not informed when critiquing the specificity of plaintiffs’ pleadings. The net effect of these two conflicting presumptions is to eviscerate the accountability of senior management for the misrepresentations it introduces into the securities markets.

I. ALTERNATE UNIVERSE THINKING AS PRACTICED BY THE SUPREME COURT

Consider the following facts, which the Supreme Court accepted as true in *Stoneridge*. The Court began by stating:

Charter, a cable operator, engaged in a variety of fraudulent practices so its quarterly reports would meet Wall Street expectations for cable subscriber growth and operating cash flow. The fraud included misclassification of its customer base; delayed reporting of terminated customers; improper capitalization of costs that should have been shown as expenses; and manipulation of the company’s billing cutoff dates to inflate reported revenues. In late 2000, Charter executives realized that, despite these efforts, the company would miss projected operating cash flow numbers by \$15 to \$20 million.¹²

What is the significance of the foregoing? The Court accepted the fact that Charter was already engaged in fraudulent practices but, even so, was concerned that “its quarterly reports” (most significantly, its revenues and cash flow) “would [not] meet Wall Street expectations.”¹³

So what did Charter do? According to the Court:

To help meet the shortfall, Charter decided to alter its existing arrangements with respondents, Scientific-Atlanta and Motorola Respondents supplied Charter with the digital cable converter (set top) boxes that Charter furnished to its customers. Charter arranged to overpay respondents \$20 for each set top box it purchased until the end of the year, with the understanding that respondents would return the overpayment by purchasing advertising from Charter. The transactions, it is alleged, had no economic substance; but, because Charter would then record the advertising purchases as revenue and capitalize its purchase of the set top boxes, in violation of generally accepted accounting principles, the transactions would enable Charter to fool its auditor into approving a financial statement showing it met projected

12. *Stoneridge Inv. Partners, LLC*, 552 U.S. at 153.

13. *Id.*

revenue and operating cash flow numbers. Respondents agreed to the arrangement.¹⁴

What do we know from the foregoing? In order to meet Wall Street expectations, to wit, in order to avoid a precipitous drop in the price of its stock, Charter and respondents concocted a scheme to manufacture revenues and cash flow.¹⁵ Respondents, as suppliers, agreed with their customer to overcharge the customer. Is this acting in the “ordinary course as suppliers?”¹⁶ According to the Court, petitioner had sought to assert a securities claim “beyond the securities markets—the realm of financing business¹⁷—to purchase and supply contracts—the realm of ordinary business operations. The latter realm is governed, for the most part, by state law.”¹⁸ Was there anything “ordinary” about this fraudulent activity? How can a rational Court look at a scheme in which a supplier agreed, first, to substantially overcharge a customer and, second, to purchase unwanted advertising, and then characterize the activity as being in “the realm of ordinary business operations”?

Did this merely affect the price of Charter’s stock in some “attenuated way,”¹⁹ or was the whole purpose of these transactions to affect the price of Charter’s stock? According to the facts, the purpose of these new arrangements with respondents was to enable Charter to meet Wall Street expectations, i.e., maintain its stock price. Yet, in contradiction to the facts that it accepted, the Court, to support its conclusion that these fraudulent transactions were in “the realm of ordinary business operations . . . governed, for the most part, by state law,”²⁰ asserted that the securities laws “do[] not reach all commercial transactions that are

14. *Id.* at 153–54.

15. After the fraud was discovered,

Charter was forced to restate its 2000 and 2001 financials. For 2000, this resulted in reduced revenues of \$108 million and increased expenses of \$87 million. For 2001, this resulted in reduced revenues of \$146 million and increased expenses by \$146 million. Plaintiffs note that as a result, Charter’s reported growth rate for 2001 was reduced by one half.

In re Charter Commc’ns, Inc. Sec. Litig., No. MDL 1506, 4:02-CV-1186, 2004 WL 3826761, at *13 (E.D. Mo. Oct. 12, 2004).

16. *Stoneridge Inv. Partners, LLC*, 552 U.S. at 166.

17. Here the Court also misapprehends the nature of the securities markets. Basically there are two markets: the distribution market and the trading market. While the distribution market (the realm of public offerings) does indeed provide financing to businesses, the trading market—by far the larger—enables those who buy in the distribution market to “get out” in the trading market, and also provides the opportunity for subsequent trading in such shares. Respondents’ fraud was aimed at the trading market. This market is not in the realm of financing businesses.

18. *Id.* at 161.

19. *Id.* at 162.

20. *Id.* at 149.

fraudulent and affect the price of a security in some attenuated way.”²¹ To say that the transactions only affected the price in some attenuated way, when the whole purpose of the transaction was to affect the price, is simply not rational.

Nonsensical as the foregoing statement of the Court may be, the best example of alternate universe thinking by the Court is in its understanding, or more correctly misunderstanding, of what factors influence the price of stock.

When an investor purchases shares of stock, the investor is not buying something like an apple or a car, which can be consumed or used, but rather a claim on the future earnings of the business. Moreover, the hope is that earnings will grow in the future. Thus, the value of a share of stock is a function of the business model of the business, which in turn is a function of the transactions underlying the earnings of the business—both the magnitude and direction of such underlying transactions. And, for companies with a high price-earnings ratio, substantial growth is necessary to hold the price of the stock.

One approach to valuing a company posits that $1/P/E = CR = RFR + \beta(MR - RFR) - G$, where the discount rate (DR) = $RFR + \beta(MR - RFR)$.²² If the discount rate approaches the market return where β , or volatility, is one, then a price-earnings (“P/E”) ratio of 25 translates to a capitalization rate of 4%,²³ and, if the market rate is 12%, then the growth rate must be 8%.²⁴ If earnings do not continue to grow, but rather drop, this becomes a double hit to the price of the stock. Reduced growth raises the capitalization rate, thus lowering the P/E ratio. Since the price of the stock is a function of the P/E ratio and the earnings, when earnings drop and the P/E ratio drops, there is a compound impact on stock price. That is why you frequently see a precipitous drop in stock price, as illustrated in *Stoneridge*, *Spectrum Brands*, and *Silicon Graphics*, the cases upon

21. *Id.* at 162.

22. See Cindy Andresen, *Discount Rate . . . Capitalization Rate . . . Multiple. What Do These Mean to the Value of My Company?*, HENRY & HORNE, LLP (Oct. 1, 2013), <http://www.hhcpa.com/blogs/business-valuation-litigation-blog/discount-rate-capitalization-rate-multiple-what-do-these-mean-to-the-value-of-my-company/> (discussing how “discount rate,” “capitalization rate,” and “multiple” affect the valuation of a company). P/E is the price-earnings ratio; CR equals capitalization rate; RFR equals risk-free rate (e.g., ten year treasury bond rate); MR equals market rates (Ibbotson’s study of historic stock market returns); and G equals growth. *Capital Asset Pricing Model - CAPM*, INVESTOPEDIA, <http://www.investopedia.com/terms/c/capm.asp> (last visited Feb. 24, 2014).

23. Because the P/E ratio is the reciprocal of the capitalization rate, $25 = 1/CR$; consequently, the capitalization rate is 4%.

24. $CR = DR - G$, or $4\% = 12\% - G$; therefore growth equals 8%.

which this Article focuses.²⁵

The Court asserted that there is no authority for a rule that “in an efficient market investors rely not only upon the public statements relating to a security but also upon the transactions those statements reflect.”²⁶ But that is exactly what investors rely upon. Assume a company reports sales revenues of \$2.0 million. What you then see is an annual or quarterly report with the indication “Revenue \$2.0 million” in the income statement. As a caricature, that number could be a total fabrication, or it could be the sum of a number of sales transactions. Investors rely, not on some abstract number in financial statements that reflects some fantasy, but rather upon the fact that the company had numerous sales transactions aggregating to \$2.0 million. In shorthand fashion, we say that investors rely upon the integrity of the number, but this means that there are underlying transactions that support the number. The Court is effectively saying that when someone buys an apple, all the person buys is the skin; the person does not assume or care whether there is fruit inside the skin.

The Court also stated that respondents’ “deceptive acts were not communicated to the public.”²⁷ Yet, in its statement of facts, it acknowledges that the purpose of respondents’ fraud was to enable Charter to provide “quarterly reports [which] would meet Wall Street’s expectations for cable subscriber growth and operating cash flow.”²⁸ The Court then adds that “[n]o member of the investing public had knowledge, either actual or presumed, of respondents’ deceptive acts.”²⁹ It seems to be well understood that judicial opinions are often written by clerks.³⁰ Let us hope so in this case; otherwise, it would be an embarrassment for the Court to assert that a cause of action was denied because the plaintiff did not know of the fraud. The plaintiff never knows of defendant’s fraud. If plaintiff knew, plaintiff could not assert that he

25. See Tables at the conclusion of this Article for charts reflecting the stock prices of the above three companies and the market drop in price after the misrepresentations of management were disclosed.

26. *Stoneridge Inv. Partners, LLC*, 552 U.S. at 160.

27. *Id.* at 159.

28. *Id.* at 153.

29. *Id.* at 159.

30. See Bainbridge & Gulati, *supra* note 5, at 84 (“[J]udges are known to delegate much of the work of drafting their decisions to their law clerks, who are typically recent law school graduates.”); see also *The Cycle: Posner on Politics in the Courtroom* (MSNBC television broadcast Oct. 28, 2013) [hereinafter Posner], available at <http://www.msnbc.com/the-cycle/watch/posner-on-politics-in-the-courtroom-57973827693> (interviewing Judge Posner, who stated that judges “tend to not have a lot of knowledge about anything that is outside of legal books” and that “that’s a weakness”).

or she was deceived!

Distinguished legal scholars have asserted that “[j]udges are not sophisticated thinkers about market dynamics” and “have little expertise on matters of corporate and securities laws.”³¹ Such an assertion is well supported by the inept analysis of the Court in *Stoneridge*.

What is particularly distressing about the inability of the Supreme Court to understand that Charter and respondents had engaged in securities fraud was the fact that, at the time of the Court’s decision, Charter executives had already been sentenced to prison for having engaged in the scheme to overpay for set-top boxes in exchange for purchasing advertising.³²

II. THE ALTERNATE UNIVERSE AND PSLRA’S REQUIREMENT OF PARTICULARITY

With the Supreme Court living in an alternate universe, lower courts can hardly be blamed for being out of touch with reality. This assertion will be tested in the context of applying the concepts of particularity and specificity.

A. Particularity in General

The PSLRA instructs federal courts to focus upon particularity in pleadings in two instances. When plaintiff asserts that a defendant has made a false or misleading statement, plaintiff must specify each misleading statement and the reasons why such statement is misleading and, if the allegation is made on information and belief, “the complaint shall state with particularity all facts on which that belief is formed.”³³ In addition, with respect to scienter, the complaint shall “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”³⁴

In the abstract, who could quarrel with the requirement that pleadings be specific and set forth particularized allegations? Nor could one object

31. Bainbridge & Gulati, *supra* note 30, at 89–90.

32. See Associated Press, *Former Charter Executives Sentenced*, L.A. TIMES, Apr. 23, 2005, <http://articles.latimes.com/2005/apr/23/business/fi-charter23> (“Four former Charter Communications Inc. executives received sentences Friday ranging from 14 months in prison to two years of probation for their roles in an accounting scandal at the nation’s third-largest cable television provider The government said [former CFO] Kalkwarf in August 2000 gave money to Charter’s suppliers of digital set-top boxes, asking them to charge the firm \$20 more per set-top box, then having them return the money as advertising revenue. As a result, Charter falsely included more than \$17 million as revenue and cash flow for 2000.”).

33. 15 U.S.C. § 78u-4(b)(1)(B) (2012).

34. *Id.* § 78 u-4(b)(2)(A).

to the proposition that “[c]onclusory allegations that a defendants’ [sic] conduct was fraudulent and deceptive are not sufficient.”³⁵ But, as Ross Perot stated when running for President, “the devil is in the details”³⁶ and, in the case of specificity, how specific must details be in order to pass muster as sufficiently specific? Recall, the pleadings being examined by the courts must meet the test of specificity without the benefit of discovery.³⁷

B. Particularity as Analyzed in Spectrum Brands

1. The Basic Facts

Consider now the allegations of plaintiffs in *In re Spectrum Brands, Inc. Securities Litigation*.³⁸

Plaintiffs alleged that Spectrum had engaged in illegal channel stuffing³⁹ in the fourth quarter of 2004 and the first quarter of 2005 by giving customers, such as Walmart, deep discounts and other incentives to purchase batteries, even when the customers were overstocked already, in order to inflate the price of Spectrum stock.⁴⁰

In press releases and conference calls with analysts, Spectrum touted strong quarterly results, growth over prior periods, and earnings exceeding First Call estimates.⁴¹ Some of these statements were incorporated in the company’s quarterly Securities and Exchange Commission (“SEC”) filings.⁴² In its annual and quarterly reports, Spectrum represented that it recognized revenue “upon shipment to the customer, which is the point at which all risks and rewards of ownership of the product are passed,”⁴³ and that “our general policy is not to accept[]

35. *In re Spectrum Brands, Inc. Sec. Litig.*, 461 F. Supp. 2d 1297, 1306 (N.D. Ga. 2006) (citation omitted) (internal quotation marks omitted).

36. See Dallas Morning News, *Perot, terming Clinton speech ‘very positive,’ is wary of details*, BALTIMORE SUN, Feb. 18, 1993, http://articles.baltimoresun.com/1993-02-18/news/1993049236_1_perot-clinton-dallas.

37. See 15 U.S.C. § 78u-4(b)(3)(B) (“In any private action arising under this chapter, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.”).

38. 461 F. Supp. 2d 1297.

39. Illegal channel stuffing is the practice of “providing excess supply to distributors in order to create a misleading impression in the market of the company’s financial health.” *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 598 (7th Cir. 2006).

40. *In re Spectrum Brands*, 461 F. Supp. 2d at 1301.

41. *Id.* at 1302–04.

42. *Id.* at 1303.

43. *Id.* at 1304.

product returns for battery sales.”⁴⁴ Walmart was Spectrum’s largest customer⁴⁵ and plaintiff alleged that Spectrum “permitted some customers, particularly Walmart, to return any product that they failed to sell.”⁴⁶ Notwithstanding these representations, Spectrum never disclosed its practice of permitting some major customers to return unsold product.⁴⁷

2. “Robbing” Sales from a Subsequent Quarter to Enhance Sales in the Prior Quarter

In dismissing the complaint, the court stated that “[p]laintiffs present[ed] a number of generalized conclusory allegations, supplement[ed] them with a few averments of specific fact, and, from that mix, offer[ed] their conclusion that securities fraud occurred.”⁴⁸ The court added that “[p]laintiffs’ channel-stuffing allegations consist[ed] only of generalized assertions regarding [d]efendants’ corporate culture and business practices. Plaintiffs fail[ed] to identify any specific transactions or communications to support their conclusory channel-stuffing based claims.”⁴⁹

a. The Allegations as to Channel Stuffing

So, let us look at these so-called conclusory allegations. This is the first allegation analyzed by the court:

To induce SPC’s customers, including Best Buy, Menards, Wal-Mart, Kmart, Shopco, and Toys R Us, to order unwanted product and to pull sales forward into earlier quarters, SPC gave its customers deeper discounts, longer payment terms, and credits towards future purchases. The highest levels of management at SPC engaged in this channel-stuffing.⁵⁰

Standing alone, this allegation could fit the description of conclusory. This is a perspective allegation with little factual specificity. But consider this next allegation:

According to a former national account manager, K-mart stores had on average between 52 to 100 weeks of Rayovac batteries, with some stores holding 250 weeks of C and D batteries. This same witness stated that Wal-Mart had 30–50 weeks of product in inventory and even though everyone knew in January 2005 that Wal-Mart’s inventory

44. *Id.*

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.* at 1307.

49. *Id.* at 1309.

50. *Id.*

levels and weeks on hand were way up, SPC continued to offer Wal-Mart incentives to take additional product because “we needed to make the numbers.”⁵¹

It is incredulous that the court not only would fail to find this sufficiently specific, but also that the court’s ire would not be raised at practices so totally antithetical to sound business practices.

Plaintiff further alleged:

Wal-Mart’s inflated inventory was confirmed by a former sales analyst, employed at SPC during the Class Period, who recalled at least “30 weeks on hand” and stated, “We all knew what was going on, we front loaded the stores in August and September 2004 for the Christmas holiday.” This witness reiterated that executive-level management handled every aspect of the Wal-Mart account because the Company was so dependent on this relationship.⁵²

With respect to the August and September shipments, what Spectrum was doing was pulling sales that should have been in the 12/30 quarter back into the 9/30 quarter. But even this form of channel stuffing would not be sufficient to create thirty to fifty weeks of inventory. The channel stuffing by Spectrum must have been massive. Now consider how the court viewed the foregoing allegations:

Plaintiffs’ allegations as to Wal-Mart and K-Mart state that those stores had multiple weeks of battery inventory [on] their shelves, but Plaintiffs fail to allege facts to show that this level of inventory was unusually high for that time of year, what special incentives, if any, were offered to the customers, that Wal-Mart or K-Mart accepted the incentives or bought additional batteries in response thereto, or to show any of the other circumstances of the transaction.⁵³

Has the court never heard of “just-in-time” inventory control? I have grandkids still in grammar school that understand “just in time.”⁵⁴

Walmart is regarded as one of the best-managed companies in the country. According to *TIME*, “Walmart is supposed to have the most sophisticated supply chain management system in the industry.”⁵⁵ Does this sound like a company that has “30–50 weeks of product in

51. *Id.* at 1309–10.

52. *Id.* at 1310.

53. *Id.*

54. The concept of “just-in-time” inventory control means that a company seeks to have inventory delivered a short period before it needs to be available, rather than having an extensive amount of expensive inventory in storage. This practice reduces the company’s capital or borrowing needs. Otherwise, the company would need additional capital or borrowings to finance holding higher levels of inventory. This would reduce return on investment by either increasing capital or increasing interest expense.

55. Bill Saporito, *The Trouble Lurking on Walmart’s Empty Shelves*, *TIME* (Apr. 9, 2013), <http://business.time.com/2013/04/09/the-trouble-lurking-on-walmarts-empty-shelves/>.

inventory”⁵⁶ Can you imagine any company, even a poorly managed one, having 250 weeks of inventory,⁵⁷ namely, five years, on hand? The court justifies its conclusion that such an allegation was not specific by asserting that plaintiffs failed to “allege facts” to show that this level of inventory was unusually high for that time of year.⁵⁸ To borrow logic from the scienter area, is the inference that 30 to 50 (or up to 250) weeks of battery inventory was attributable to seasonal demand as compelling as the inference that the company was channel stuffing to manufacture earnings?⁵⁹

Moreover, if Walmart or Kmart had not “accepted the incentives or bought additional batteries in response thereto,”⁶⁰ how did they end up with 30 to 50 to 100 to 250 weeks of batteries in inventory?

Another confidential informant testified as follows:

In another instance during September 2004, a former Channel Manager recalled offering ShopCo an additional 30 days onto the standard payment terms “because they weren’t ready to take their Christmas inventory yet.” Rather than wait and ship the batteries under normal terms when the customer wanted them, the Company enticed the customer with promotional terms and discounts so that future quarter’s revenue could be pulled back into the current quarter.⁶¹

The court found this allegation lacking as well:

Although this example identifies the time, the customer, and the alleged incentive offered, it does not assert facts to show that ShopCo accepted the offered incentive or responded to it by purchasing more product, when such purchases were made, in what amounts, whether ShopCo had an unusually high level of existing inventory in the first place, or any other of the circumstances of the alleged transaction. On its face, this allegation reveals legitimate marketing and incentive practices engaged in by most companies.⁶²

This is not a practice engaged in by most companies. When a company offers deep discounts to a customer in order to pull earnings and revenue from a later quarter into an earlier quarter, the company is moving toward variable cost pricing⁶³ or, worse, selling an item below cost. The net

56. *In re Spectrum Brands*, 461 F. Supp. 2d at 1309.

57. *Id.*

58. *Id.* at 1310.

59. *Cf. Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 323 (2007) (requiring comparison of plausible opposing inferences in determining scienter on the pleaded facts).

60. *In re Spectrum Brands*, 461 F. Supp. 2d at 1310.

61. *Id.*

62. *Id.*

63. For a definition and explanation of variable cost pricing, see Mark P. Holtzman, *Extreme Accounting: Variable-Cost Pricing*, FOR DUMMIES, <http://www.dummies.com/how-to/content/extr>

effect is that, to pull “\$X” of sales from a later quarter into an earlier quarter, the company will realize less than “\$X,” because of the discounts, thereby lowering overall profitability. While this does not make economic sense, this is a cost in order to manufacture the earnings necessary to (temporarily) meet analysts’ expectations. This is simply “mortgaging [the] future to meet monthly and quarterly goals.”⁶⁴ If, in the following quarter, the company does not meet expected revenues and earnings *plus* the diverted revenue and profits, the company must again play the channel stuffing game or then suffer the burden of not meeting analysts’ expectations in the subsequent quarter. Eventually, the Ponzi scheme must end.

The court concluded:

Plaintiffs do not allege facts sufficient to show whether the alleged channel-stuffing practices were widespread or anecdotal, whether they involved hundreds rather than millions of dollars worth of product, or how the alleged channel-stuffing transactions at the end of the quarters differed from sales made at other times during the quarter. Without this particularity, Plaintiffs have pled insufficient context for the representations and omissions alleged.⁶⁵

Once again, in what universe is the court living? From the foregoing, the court cannot conclude whether the channel stuffing was “widespread or anecdotal.”⁶⁶ Plaintiffs had alleged that the company was dependent upon its relationship with Walmart and that Walmart had thirty to fifty weeks of batteries in inventory.⁶⁷ Does this not create an inference that the practice was widespread? Moreover, the question is not whether such channel stuffing was widespread or anecdotal, but rather whether it was significant. A build-up of thirty to fifty weeks of batteries is hardly insignificant. Rather it is a major event.

And while the court wonders whether these practices involved “hundreds rather than millions of dollars worth of product,”⁶⁸ isn’t this an irrational query in light of the fact that we are talking about a massive amount of inventory held by a major (or the major) customer of the company? Would truckloads of batteries represent merely “hundreds . . . of dollars worth of product”?⁶⁹ The court apparently has no idea of how many batteries could fit into a tractor-trailer. I would advise the court not

eme-accounting-variablecost-pricing.html (last visited Feb. 27, 2014).

64. *In re Spectrum Brands*, 461 F. Supp. 2d at 1312.

65. *Id.* at 1310–11.

66. *Id.* at 1310.

67. *Id.* at 1309–10.

68. *Id.* at 1310.

69. *Id.*

to enter a contest to guess how many gumballs are in a glass jar!

Moreover, when there is a massive build-up of inventory as delineated in the complaint, it is likely that channel stuffing was a long-standing practice. As indicated above, channel stuffing is a form of Ponzi scheme: you rob sales from the second quarter (“Q2”) to enhance the first quarter (“Q1”); then it becomes necessary to rob sales from the third quarter (“Q3”) to enhance Q2. But the channel stuffing diversion in Q3 may likely exceed Q2 because then Q3 diversion needs not only to replace what was “robbed” in Q2 but also to enhance Q2. Like all Ponzi schemes, Spectrum Brands’ Ponzi scheme came to a halt on July 25, 2005 when it announced that “sales would fall woefully short of previous estimates.”⁷⁰

b. Shipping Unwanted Truckloads of Batteries

But excess inventory allegations were not the only channel stuffing allegations that plaintiffs set forth to support earnings manipulations. Plaintiffs also alleged:

On the last day of the 4Q2004, a large tractor trailer truck full of batteries was shipped prematurely to a retail customer, only to let it sit in that customer’s parking lot for three days because they refused to accept the product which had been delivered early. SPC recorded this revenue in the 4Q2004 because it “shipped” within the quarter, but management knew the customer would not accept the product at that time since delivery terms had not been established for that time.⁷¹

To this, the court responded that plaintiffs failed “to identify the customer, the approximate value of the product, whether the product was eventually accepted by the customer, or whether it was returned to Spectrum Brands.”⁷²

This also is a tunnel vision response by the court. It is immaterial whether the product was “eventually accepted . . . or . . . returned.”⁷³ In channel stuffing the issue is not necessarily whether a sale was made, but rather whether it was pulled back into a prior quarter. With respect to the value, again, does the court have any sense as to what a battery costs and how many batteries can be contained in “a large tractor trailer truck”? It has been said that it is more difficult to plead securities fraud at the pleading level than it is to prove securities fraud at trial.⁷⁴

70. *Id.* at 1317.

71. *Id.* at 1312.

72. *Id.* at 1313–14.

73. *Id.* at 1314.

74. *See, e.g.*, John M. Wunderlich, *The Importance of the Prefiling Phase for Securities-Fraud Litigation*, 45 LOY. U. CHI. L.J. 737, 749 (2014) (asserting that the motion to dismiss in securities fraud class actions has been “transformed . . . into a significant barrier”).

There were also additional allegations with respect to shipping product not ordered by the customer. For example: “SPC sent five tractor trailer trucks to a customer on the last day of the quarter, only to have them returned full a week later after the customer refused the product.”⁷⁵

Notwithstanding extensive factual allegations with respect to inventory build-up at customers and shipping truckloads of product that customers did not want, the court concluded, with respect to the allegations:

Reviewing the allegations as a whole, they do not inform the Court whether the alleged improper return practices were widespread or isolated, whether any of the alleged return requests were granted, whether the returns were completed, whether they typically involved hundreds rather than millions of dollars of product, or whether the alleged de facto return policy affected end-of-quarter sales any differently than it did sales at other times.⁷⁶

Again, recall that these pleadings are prepared without benefit of discovery, often on the basis, as here, of confidential informants.⁷⁷ Does the court expect these informants to download computer files or convert company documents in order to give the court the details it seeks? Isn't the court living in another universe when it expects this sort of detail at the pleading stage?

3. The Requisite Particularity with Respect to Scienter According to *Spectrum Brands*

Since the court held that the allegations of channel stuffing were not sufficiently particularized, it also determined, inter alia, that this precluded a finding that the individual defendants had acted with scienter.⁷⁸ But the court also went on to determine that sales of over

75. *In re Spectrum Brands*, 461 F. Supp. 2d at 1312.

76. *Id.* at 1314.

77. Some federal courts, led by Judge Easterbrook of the Seventh Circuit, have been wary of the testimony of confidential informants. In *Higginbotham v. Baxter International Inc.*, Judge Easterbrook gratuitously and, I would assert, erroneously, concluded that information supplied by confidential sources must be “discounted,” usually “steep[ly].” 495 F.3d 753, 757 (7th Cir. 2007). According to Judge Easterbrook, “It is hard to see how information from anonymous sources could be deemed ‘compelling’ or how we could take account of plausible opposing inferences. Perhaps these confidential sources have axes to grind. Perhaps they are lying. Perhaps they don’t even exist.” *Id.* This is another example of alternate universe type thinking. Judge Easterbrook has more confidence in mind games, in which we weigh the strength of one inference against the strength of another inference, than he does in the statements of real people. What confidential informants testify to is fact, not subjective inferences. They may or may not be correct. That is a subject for cross-examination. But, to suggest that they may not even exist is ludicrous. It would be a very unwise attorney who would risk disbarment by creating testimony from witnesses that do not exist.

78. *In re Spectrum Brands*, 461 F. Supp. 2d at 1315.

60,000 shares of Spectrum Brands' stock, or more than 25% of the holdings of one executive, for proceeds exceeding \$2.3 million, were not suspicious because of the "temporal distance"⁷⁹ between the stock sales and the July 28, 2005 announcement that sales would fall "woefully short of previous estimates."⁸⁰ The sales were made within six months of the announcement (on February 2, May 20, and May 23, 2005).⁸¹ However, the court focused upon the "fact" that they had been made more than two months prior to the announcement.⁸²

This focus upon two months (sixty-one days) being significant, but sixty-nine days (May 20 to July 28) not being significant, is another example of living in an alternate universe. Channel stuffing often involves bringing sales back from a subsequent quarter into a prior quarter. By definition, the fraud will not be disclosed for ninety days, plus the period from the end of the subsequent quarter until disclosure is made. Thus, 100 days or more may expire between the time of the wrongful activity and the indirect announcement of its existence by virtue of lower revenues in the following quarter. If the channel stuffing extends over more than one quarter, the time span between commencement of the channel stuffing and the subsequent reduced revenues will be even longer. Consider the multi-quarter channel stuffing or Ponzi game described earlier.⁸³

On the other hand, executives are generally aware well before the end of the prior quarter as to whether forecasts will be met. And, if the channel stuffing has been ongoing, the executives will know months in advance that the house of cards they are building may eventually collapse. Consequently, stock sales by an executive four months, or even longer, before an announcement that forecasts are no longer being met are very consistent with the conclusion that the executive is selling to take advantage of the higher price due to channel stuffing. The blind eye that some courts use to evaluate whether stock sales are suspicious will also be explored in connection with *Silicon Graphics*.⁸⁴

The approach of the *Spectrum Brands* court could be described as failing to see the forest for the trees. It looked at each allegation and, in nitpicking fashion, found some reason to find the allegation deficient. Stepping back and looking at the totality of the facts alleged, it would be

79. *Id.* at 1316–17.

80. *Id.* at 1317.

81. *Id.*

82. *Id.*

83. *See supra* note 70 and accompanying text.

84. *See infra* notes 85–131 and accompanying text.

hard to draw any conclusion in *Spectrum Brands* other than management was purposefully engaging in channel stuffing to manufacture earnings.

III. PARTICULARITY AS TO SCIENTER: ALTERNATIVE UNIVERSE THINKING IN *SILICON GRAPHICS*

A. *The Silicon Graphics Facts*

The facts, as alleged in *Silicon Graphics*, reflect particularly pernicious conduct by corporate management. Silicon Graphics, Inc. (“SGI”) was a “growth company,” trading at a high price earning multiple.⁸⁵ As discussed earlier, to sustain such a stock’s price, earnings must continue to grow and a drop in earnings will have a compound negative impact on stock price: earnings will be lower and the multiple applied to the earnings will also be lower due to reduced growth.⁸⁶

SGI, in July 1995, reported 45% revenue growth for fiscal year (“FY”) 1995 and projected similar growth for FY 1996.⁸⁷ At this time, the company also announced that it planned to produce a line of graphic design computers (“Indigo2”), which it planned to ship in volume by September 30, 1995, the end of the first quarter of FY 1996.⁸⁸ The company assured investors that the Indigo2 line would help sustain the 40% growth rate.⁸⁹ These announcements caused the stock price for SGI to reach an all-time high of \$44 7/8 on August 21, 1995.⁹⁰

Unfortunately, revenue growth for Q1 in 1996 was only 33%.⁹¹ To counter a feared drop in the price of the company’s stock, senior executives made a series of announcements over a three-month period that the first quarter results were outliers and that the company would achieve its projected 40% growth rate for FY 1996.⁹² However, in January 1996, the company announced that revenue growth was much lower than expected and the price of the company’s stock plummeted to \$21 1/8.⁹³

85. The combination of earnings of \$1.44 a share and a stock price of \$44 7/8 reflects a price-earnings ratio of approximately 30:1.

86. See *supra* notes 22–25 and accompanying text.

87. *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 980 (9th Cir. 1999), *abrogated on other grounds by* S. Ferry LP, No. 2 v. Killinger, 542 F.3d 776 (9th Cir. 2008).

88. *Id.*

89. *Id.*

90. *Id.*

91. *Id.* at 981.

92. *Id.*

93. *Id.* at 982.

B. The Representations by Senior Management That Later Proved to Be False

In September, October, November, and December, senior management made a series of announcements that the company was not experiencing any supply problems and that the Indigo2 workstations were shipping in volume. These are the September representations:

September 19, 1995: McCracken told Morgan Stanley that there were “no supply constraints” on the Indigo2.

September 21, 1995: McCracken announced at an industry conference that Indigo2 sales growth “was accelerating.”

September 22, 1995: McCracken told Morgan Stanley that “that there is no problem with [Indigo2], nor is there an engineering halt.”

September 26, 1995: SGI announced “volume shipments” of the Indigo2 workstation.⁹⁴

In connection with its announcement on October 19, 1995 that first-quarter revenues had only grown 33%, which would likely cause a drop in the price of the company’s stock, the company also assured analysts and investors that the first-quarter results reflected only a temporary pause and that the 40% revenue goal would be achieved:

October 19, 1995: SGI issued a press release reporting that the Indigo2 was shipping in volume.

October 19, 1995: In a conference call, McCracken and other officers told securities analysts and institutional investors that SGI’s sales force reorganization had been successful. The officers attributed the shortcoming in first quarter growth to a “temporary pause” in OEM sales, and a brief drop in demand from the U.S. Government and French businesses. SGI assured investors that (1) there were no manufacturing problems with or supply constraints on the Indigo2; (2) demand was strong for the workstation, and it was being shipped in volume; (3) the Indigo2 upgrade was on schedule and would be introduced in January 1996 as planned; and (4) the goal of 40% revenue growth for FY96 would be achieved.

October 19, 1995: McCracken stated during an interview that SGI’s first quarter performance was “probably less” than the growth the company would see during FY96.⁹⁵

As a result of these representations, the price of SGI stock dropped only slightly.⁹⁶

In early November, the representations as to growth and shipping volume were repeated:

94. *Id.* at 981.

95. *Id.*

96. *Id.*

November 2, 1995: SGI officers held a press conference for securities analysts and investors, stating that (1) SGI would still achieve its goal of 40% revenue growth; (2) the failure to meet growth expectations for the first quarter resulted from temporary sales force reorganization problems and a temporary pause in OEM sales; (3) Indigo2 sales were beating expectations, and the product was now shipping in volume after some initial problems with the Toshiba ASIC chips; (4) development of the Indigo2 upgrade was proceeding as scheduled; and (5) SGI's second quarter performance would exceed its first quarter performance.

Early November 1995: SGI's first quarter report to shareholders included a letter from McCracken stating that the Indigo2 "began shipping in volume in September."⁹⁷

Following these announcements, there was an increase in the price of the company's stock from \$31 to \$36 to \$38 3/4, and senior management sold 388,188 shares of SGI stock.⁹⁸

In December, when rumors circulated that SGI would experience a shortfall in its projections and the price of the stock began to fall, executives made the following representations:

December 15, 1995: McCracken and another SGI executive told Dean Witter that (1) SGI did well in November; (2) SGI's sales force productivity was improving; (3) SGI's sales to the U.S. government and in Europe were likely to improve; and (4) SGI would meet its goal of 40% growth for the second quarter.

Mid-December 1995: McCracken and another SGI executive told Smith Barney that despite sluggish sales, SGI would meet its goal of 40% growth.⁹⁹

When these latter representations were made, the second quarter was only a few days short of being complete. It defies reason to suggest that, with only a few days left in the thirteen-week quarter (much of the remaining time being holidays), the chief executive officer ("CEO") could truthfully assert that 40% growth rate would be achieved when, a couple of weeks later, the company would announce that revenue growth was much lower than expected.

The district court had held that plaintiff must allege not only the misleading statements but also why the statements were inaccurate. In this regard, plaintiff alleged the following:

- SGI's North American sales reorganization had been unsuccessful, resulting in diminished sales, below SGI's targets;

97. *Id.* at 981-82.

98. *Id.* at 982.

99. *Id.*

- SGI was unable to produce sufficient Indigo2 IMPACT workstations to meet consumer demand or internal growth targets because it was not receiving sufficient components from Toshiba;
- The components received from Toshiba were submitted without necessary design verification tests, resulting in a low yield of usable parts;
- SGI failed to qualify Toshiba to provide a sufficient quantity of component parts, resulting in low volume production;
- SGI sales in Germany and the United Kingdom were materially below expectations;
- SGI sales in France were much worse than expected;
- SGI's original equipment manufacturer sales were trending downward;
- SGI was at a competitive disadvantage with Hewlett Packard because it could not ship Indigo2 IMPACT workstations; and
- SGI was at a competitive disadvantage with Sun Microsystems because Sun products were better than SGI's.¹⁰⁰

The accuracy of plaintiff's allegations was confirmed when, on January 2, 1996, the company announced disappointing second-quarter results and acknowledged that revenue growth for FY 1996 would be much lower than expected. The price of the stock fell to \$21 1/8.¹⁰¹ A couple weeks later, the company's management admitted to securities analysts that the company had been unable to fill Indigo2 orders because of a shortage in the supply of the computer chips.¹⁰²

C. The Bases of Plaintiff's Allegations As to Knowledge

The district court had determined that plaintiff's allegations as to the misleading statements and why they were misleading fulfilled the requisite particularity.¹⁰³ The case was dismissed, however, for failure to adequately allege facts that would give rise to a strong inference of scienter.

1. The Reports and Forecasts Prepared for Management

Plaintiff had alleged:

Each 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

100. *In re Silicon Graphics, Inc. Sec. Litig.*, No. C-96-0393, 1996 WL 664639, at *11 (N.D. Cal. Sept. 25, 1996).

101. *In re Silicon Graphics*, 183 F.3d at 982.

102. *Id.*

103. *In re Silicon Graphics*, 1996 WL 664639, at *8.

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, i.e., ship, as many Indigo2 IMPACT Workstations as planned¹⁰⁴

This allegation, however, did not meet the district court's view of the requisite specificity:

The Court finds that plaintiff's allegations are not specific enough to raise a strong inference of fraud. Every sophisticated corporation uses some kind of internal reporting system reflecting earlier forecasts; allowing 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.¹⁰⁵

The District Court considered plaintiff's allegations as to internal reports to be "boilerplate" because complaints filed in other cases had also referenced internal reports as being the basis for holding senior executives accountable.¹⁰⁶ But plaintiff's allegations as to internal reports were hardly boilerplate. The following are the reports, which plaintiff alleged provided the senior executives with information contrary to that which they were publicly disclosing:

SGI routinely produces at least three types of internal status reports: (1) daily reports; (2) monthly financial reports; and (3) "Stop Ship" reports. The daily reports include manufacturing, sales, and financial data. Monthly reports are broken down into "Flash Reports," which are prepared immediately at the end of the month and which summarize the company's performance, and "Monthly Financial Statements/Packages," which are more detailed reports that SGI distributes within ten days of the close of the month. "Stop Ship" reports notify upper management of manufacturing problems and their likely effect on volume shipments.¹⁰⁷

2. What Should Senior Management Know?

Before returning to the court's analysis, let us consider the foregoing allegations of plaintiff in their entirety, but focus upon two aspects: the shipping of Indigo2 workstations and the growth in revenues to support a 40% growth rate. McCracken, the CEO of the company, on three occasions in September stated that there were no problems in shipping the Indigo2 workstations; in October he stated that there were no manufacturing problems or supply constraints with respect to the Indigo2

104. *Id.* at *12 (ellipsis in original).

105. *Id.* (emphasis added).

106. *Id.* at *12 n.11.

107. *In re Silicon Graphics*, 183 F.3d at 984 n.14.

workstations and, on the same day, the company issued a press release reporting that the Indigo2 workstations were shipping in volume; in November, the CEO sent a letter to shareholders stating that Indigo2 workstations began shipping in volume in September.¹⁰⁸

With respect to growth, in October, McCracken stated that the goal of 40% revenue growth for FY 1996 would be achieved; in November, he again stated that the company would achieve its goal of 40% revenue growth; and, in December, McCracken told two different investment bankers that the company would meet its goal of 40% growth for the second quarter.¹⁰⁹

Now consider the company itself. SGI was a highflying tech company in a highly competitive environment.¹¹⁰ To maintain growth required constant innovation, new products, or updated products. The company had just announced that its Indigo2 workstations would add \$1 billion to revenue, almost a 50% increase.¹¹¹ Does it not strain credulity to suggest that, in these circumstances, the CEO of the company would not be on top of the status of production efforts for the Indigo2 workstation? If McCracken was aware of the production problems and denied them, he is lying. If he was not aware of them and made the highly positive statements that he did, he was clearly reckless. In either case, the fact of making the statements, which were untrue when made, should suffice to sustain a strong inference of scienter without any detail as to the manner in which he obtained the knowledge of the manufacturing problems.

Now consider the allegations of the complaint as to the knowledge of the executives, particularly paragraph 30:

A key management tool for Silicon Graphics' top executives was Silicon Graphics' annual budget or forecast, by which the Company's Board, after input from top executives, set performance goals and then closely monitored the Company's actual performance, compared to those budgeted and/or forecasted. Silicon Graphics prepared its fiscal 1996 forecast and budget by mid-1995 and then updated it thereafter.

108. *Id.* 981–82. In addition, at a press conference on November 2, 1995, held by the company's officers for security analysts and investors, the officer stated that the Indigo2 workstation sales "were beating expectations, and the product was now shipping in volume after some initial problems with the Toshiba ASIC chips." *Id.* at 982. It is unlikely that McCracken was neither at the conference nor knew of it and the representations that were being made.

109. *Id.* at 981–82.

110. As alleged in the complaint, "Silicon Graphics stock traded at a price earnings multiple reserved for premier growth companies with track records of meeting market expectations for high profit growth." Complaint at 28, ¶ 34, *In re Silicon Graphics*, 1996 WL 664639 (No. C-96-0393), available at <http://securities.stanford.edu/filings-documents/1011/SGI96/001.html>.

111. Robert D. Hof, *SGI's Rise and Decline*, BUS. WK. (Aug. 4, 1997), <http://www.businessweek.com/1997/31/b35383.htm>.

Silicon Graphics' fiscal 1996 budget or forecast, which included 40%+ revenue growth, was dependent upon Silicon Graphics obtaining \$1 billion in revenue from its Indigo2 IMPACT™ Workstation product line and increased North American revenues resulting from a reorganization of its North American Field Operations direct sales force. Each 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' business was not performing as well as publicly represented, that Silicon Graphics was plagued by an inability to sell, *i.e.*, ship, as many Indigo2 IMPACT™ Workstations as planned due to an inadequate supply of ASICchips from Toshiba, serious and persistent problems with Silicon Graphics' North American direct sales force resulting in reduced productivity, *i.e.*, revenue shortfalls, weak OEM sales and weak sales in Germany and France and thus Silicon Graphics could not possibly achieve near to 40% growth in the second quarter of fiscal 1996 or fiscal 1996 as a whole.¹¹²

Would you consider this “mere boilerplate”? That is the characterization given by both the district court and the circuit court.¹¹³ To support their conclusion that this was mere boilerplate, both courts took judicial notice of the fact that five other securities class-action complaints had also referred to “negative internal reports.”

This again is “alternate universe type” thinking. The creation of budgets and forecasts, and the updating and dissemination of the same, are sound business practices that should be employed by every company. But, since every well-managed company employs such practices, apparently, in the view of the courts, allegations as to the existence of such practices becomes “mere boilerplate” and, thus, lacking in particularity. Or, phrased differently, the court is presuming that senior management is not informed about key activities of the company—the antithesis of the presumption under the business judgment rule.

But paragraph 30 was not the only detail furnished by plaintiff as to the internal mechanisms to keep senior management informed. The circuit court acknowledged that plaintiff relied upon a series of internal reports to keep senior management informed, to wit: “(1) daily reports, including manufacturing, sales, and financial data, (2) monthly financial

112. Complaint, *supra* note 110, at 25–26.

113. *In re Silicon Graphics*, 183 F.3d at 984; *In re Silicon Graphics*, 1996 WL 664639, at *12 n.11.

reports, which included summary Flash Reports and more detailed ‘Monthly Financial Statements/Packages,’ and (3) ‘Stop Ship’ reports, which notify upper management of manufacturing problems and their likely effect on volume shipments.”¹¹⁴

This sort of detail as to the internal reports is clearly not boilerplate. Nevertheless, it clearly was not sufficiently “particular” or “specific” to satisfy the court. According to the court:

In this case, Brody’s complaint does not include adequate corroborating details. She does not mention, for instance, the sources of her information with respect to the reports, how she learned of the reports, who drafted them, or which officers received them. Nor does she include an adequate description of their contents which we believe-if they did exist-would include countless specifics regarding ASIC chip shortages, volume shortages, negative financial projections, and so on. We would expect that a proper complaint which purports to rely on the existence of internal reports would contain at least some specifics from those reports as well as such facts as may indicate their reliability.¹¹⁵

Recall that none of this information is publicly available. Moreover, the pleading must survive a motion to dismiss without the benefit of discovery.¹¹⁶ Unless the situation of the company is so dire that it falls into bankruptcy and there is a report by the bankruptcy trustee,¹¹⁷ or the situation is so egregious, as in Enron, that the board of directors commissions a study,¹¹⁸ the primary source for information will be confidential informants. Once again, does the court expect such informants to misappropriate documents and computer records of the company for delivery to plaintiff? Expecting the sort of detail required by the court represents living in an alternate universe, divorced from the reality of the real world.

D. The Alternate Universe Thinking Regarding Whether Stock Sales Are Suspicious in Silicon Graphics

The unrealistic approach as to whether stock sales are suspicious has

114. *In re Silicon Graphics*, 183 F.3d at 984.

115. *Id.* at 985.

116. 15 U.S.C. § 78u-4(b)(1)(B) (2012).

117. See *Spiegel Bankruptcy Report to Be Released*, AP NEWS ARCHIVE (Sept. 12, 2003), <http://www.apnewsarchive.com/2003/Spiegel-Bankruptcy-Report-to-Be-Released/id-e7b32a038fb87e5770839aa12ae0ea20> (describing the findings made by a independent examiner for the SEC who uncovered illegal acts perpetrated by Spiegel Inc. leading up to its bankruptcy, which included withholding negative reports from the SEC).

118. See REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. (Feb. 1, 2002), available at <http://news.findlaw.com/wsj/docs/enron/sicreport/>.

already been discussed in connection with *Spectrum Brands*.¹¹⁹ There the court held that the stock sales more than two months prior to the announcement that sales in a subsequent quarter would fall “woefully short of previous estimates” were not suspicious because of the “temporal distance” between the alleged fraud and subsequent disappointing results.¹²⁰ But, as discussed, by definition, channel stuffing requires more than three months before the effect is disclosed, and even longer when the channel stuffing occurs over multiple quarters.¹²¹ To understand this requires real-world analysis.

Similarly, the court in *Silicon Graphics* held that the sale of 388,188 shares of stock totaling \$13,821,053 in proceeds was not suspicious.¹²² I have extensively critiqued the naïveté of the court in another article,¹²³ but it is worthwhile to briefly review it here in the context of alternate reality type of thinking. First of all, the price range was from \$36 to \$38 per share, whereas the price dropped to \$21 1/8 when the disappointing second-quarter results were announced.¹²⁴ Thus, senior management avoided a \$6 million loss. People have gone to jail for stealing much less. An ordinary person would believe that there are six million reasons why senior management might try to manipulate the price of the stock.

The court found that none of the sales by the six insiders were suspicious. One person, Burgess, sold 75% of his shares for \$8.7 million.¹²⁵ However, the court did not find this suspicious because he had acquired the shares when his company was acquired by SGI and could not sell shares until after September.¹²⁶ Thus there are two plausible explanations: (1) he sold because he knew that the public representations were false and the price of the stock would fall, or (2) he sold because he wanted to diversify his holdings. But isn't the inference that he sold because he was aware of negative inside information just as compelling as his desire to immediately diversify? The man on the street would probably say yes; the *Silicon Graphics* majority said no.

Another insider, Kelly, a senior vice president, also sold a significant

119. See *supra* notes 79–84 and accompanying text.

120. *In re Spectrum Brands, Inc. Sec. Litig.*, 461 F. Supp. 2d 1297, 1317 (N.D. Ga. 2006).

121. See *supra* note 83 and accompanying text.

122. *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 986 (9th Cir. 1999), *abrogated on other grounds* by *S. Ferry LP, No. 2 v. Killinger*, 542 F.3d 776 (9th Cir. 2008).

123. See Charles W. Murdock, *Corporate Corruption And the Complicity of Congress And the Supreme Court-The Tortuous Path from Central Bank to Stoneridge Investment Partners*, 6 BERKELEY BUS. L.J. 131, 177–81 (2009).

124. *In re Silicon Graphics*, 183 F.3d at 982.

125. *Id.* at 987–88.

126. *Id.*

proportion of his stock (43.6%), but he realized *only* \$743,000, which was *insignificant* when compared to the total amount of shares sold by the insiders.¹²⁷ Again, a lot of people have gone to jail for stealing less than \$743,000 and someone living in today's universe would hardly consider that "insignificant."

Sales by the other four insiders were not considered suspicious, because they only sold from 2.6% to 7.7% of their shares.¹²⁸ However, the court was able to come up with such low percentages by aggregating in the denominator not only the shares owned but also the shares upon which they had an option.¹²⁹ If we look at the sales of the shares that they had actually owned and paid for, the percentages rise from 16.8% to 79.7%.¹³⁰

To minimize the percentage of shares sold by including in the unsold shares the shares subject to options is again an example of alternate universe type thinking. If the company is heading downward, and SGI eventually went into bankruptcy,¹³¹ shares under option are worthless. However, with respect to shares that have been acquired upon the exercise of options, the executive has a sunk cost, which he or she will lose if the price of the shares will plummet. Thus, there is motivation to get out while the getting out is good.

Consequently, selling a sizable portion of that which you already own, and for which you have paid the price, would again, for the man in the street, create a strong inference that the motivation was to take advantage of negative inside information.

IV. WHAT DO EXECUTIVES DO TO EARN THEIR MONEY?

Consider this from another perspective. McCracken's cash compensation, in 1996 dollars, was approximately \$1.4 million, exclusive of the value of an option to acquire 200,000 shares.¹³² The options were issued at a price of \$27 per share and had an implied value of approximately \$4 million to \$8 million, depending upon whether the

127. *Id.* at 987.

128. *Id.*

129. *Id.* at 986–87.

130. Murdock, *supra* note 123, at 179.

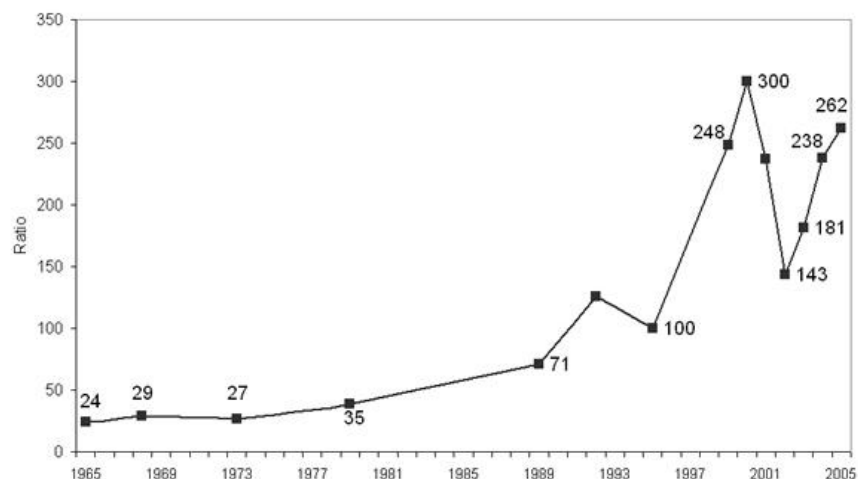
131. Peter Burrows, *The Sad Saga of Silicon Graphics: The Final Chapter*, BLOOMBERG BUS. WK. (Apr. 1, 2009), http://www.businessweek.com/the_thread/techbeat/archives/2009/04/the_sad_saga_of.html.

132. Silicon Graphics, Inc., Information Concerning Solicitation and Voting (Proxy Statement) 7 (Sept. 20, 1996), available at <http://www.sec.gov/Archives/edgar/containers/fix020/802301/000912057-96-021047.txt>.

stock price grew at 5% or 10%.¹³³ What do we expect a CEO to do in order to justify such compensation? Is he or she entitled to be uninformed? Is he or she entitled not to be aware of significant aspects of the company's operations?

In 1995 and 1996, McCracken's compensation appeared to be above average.¹³⁴ For decades, CEO pay has been vastly outstripping that of the average worker. See chart below:¹³⁵

Ratio of CEO to Average Worker Pay (1965–2005)



In 2012, the median CEO pay for companies with over \$1 billion in revenues was \$15.1 million.¹³⁶ When CEOs are receiving 200 to 300 times as much as the average worker, it is not unreasonable to ask that they fulfill their responsibility to direct and oversee the operations of the company. It is also not unreasonable to expect courts to hold senior executives accountable for being informed and for being aware of key factors affecting the performance of their company.

After the massive Enron fraud in the late 1990s and early 2000s,

133. *Id.* at 8.

134. *Two Decades of CEO Pay*, FORBES, <http://www.forbes.com/lists/2012/12/ceo-compensation-12-historical-pay-chart.html> (last visited Mar. 6, 2014).

135. Lawrence Mishel, *CEO-to-worker pay imbalance grows*, ECON. POL'Y INST. (June 21, 2006), http://www.faculty.umb.edu/gary_zabel/Courses/Phil%20108%20-%2007%20S/UBI%20and%20RWH/CEO-to-worker%20pay%20imbalance%20grows.htm.

136. Gretchen Morgenson, *An Unstoppable Climb In CEO Pay*, N.Y. TIMES, June 29, 2013, http://www.nytimes.com/2013/06/30/business/an-unstoppable-climb-in-ceo-pay.html?pagewanted=all&_r=0.

Congress enacted the Sarbanes-Oxley Act of 2002¹³⁷ in an attempt to constrain corporate corruption in the securities markets.¹³⁸ Section 302 of the Act¹³⁹ required the SEC to require by regulation that the CEO and the chief financial officer (“CFO”) certify that they have reviewed the annual and quarterly reports filed with the SEC, that the signing officers have established and maintained internal controls to ensure that material information relating to the issuer is made known to the officers, and that, based on the officers’ knowledge, the report does not contain any untrue statement or any omission to state material facts necessary in order that the stated facts not be misleading.¹⁴⁰

By the enactment of this provision, it was hoped that senior corporate management would earn its salary, to wit, establish adequate internal controls to ensure an accurate flow of information to the senior executives. William Miller, former chairman of the Federal Reserve Board, in testifying about the need for a *criminal* deterrent for executives issuing misleading financial statements, stated with respect to wrongdoing that there should be a “high likelihood of detection and a high probability . . . there will be serious punishment.”¹⁴¹ With respect to the responsibility of senior officers, he stated that they are not auditors but, with respect to requiring certification, we would expect that they would “exercise due diligence . . . make proper investigation . . . hire honest people . . . supervise them properly, and . . . involve themselves in making sure that procedures are in place to assure that the statements are correct.”¹⁴²

Courts should expect no less.

However, courts have been wary of permitting plaintiffs to use the fact of certification of financial statements as evidence of the senior officers’

137. Pub. L. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

138. See Charles W. Murdock, *Sarbanes-Oxley Five Years Later: Hero or Villain*, 39 LOY. U. CHI. L.J. 525 (2008) (describing the corporate scandals that led to the Sarbanes-Oxley Act, its provision, and the impact that it had over the first five years of its enactment); see also Steven A. Ramirez, *The Virtues of Private Securities Litigation: An Historic and Macroeconomic Perspective*, 45 LOY. U. CHI. L.J. 669 (2014).

139. Pub. L. No. 107-204, § 302, 116 Stat. 745, 777–78 (codified at 15 U.S.C. § 7241).

140. To get to the actual language, which the certification must follow, requires a bit of mental gymnastics. You first need to go to Rule 13a-14, which will send you to form 10-K, Item 15, which will then take you to Item 601 of regulation S.-K. 17 C.F.R. § 229.601 (2013).

141. *Penalties for White Collar Crime: Hearings before the Subcomm. on Crime & Drugs of the S. Judiciary Comm.*, 107th Cong. 327 (2002) (statement of G. William Miller, former Secretary of the Treasury, former Chairman of the Federal Reserve Board, and Chairman, G. William Miller & Co.), available at <http://www.gpo.gov/fdsys/pkg/CHRG-107shrg86740/html/CHRG107shrg86740.htm>.

142. *Id.*

scienter. For example, one circuit court has summarized the appropriate approach as follows:

The Eleventh Circuit recently addressed the interaction of Sarbanes-Oxley and the scienter requirement for securities fraud claims in *Garfield v. NDC Health Corp.*, 466 F.3d 1255, 1266 (11th Cir. 2006). The court rejected a reading that would permit a strong inference of scienter from the certification alone. “If we were to accept [this] proffered interpretation of Sarbanes-Oxley, scienter would be established in every case where there was an accounting error or auditing mistake made by a publicly traded company, thereby eviscerating the pleading requirements for scienter set forth in the PSLRA.” *Id.* The court, however, went on to hold that such an inference was proper “if the person signing the certification had reason to know, or should have suspected, due to the presence of *glaring* accounting irregularities or other ‘red flags,’ that the financial statements contained material misstatements or omissions.” *Id.* This interpretation of the statute is plausible.¹⁴³

Here the court would only hold senior management accountable if there were “glaring accounting irregularities” or other “red flags.” This is a pretty minimalist standard for holding highly paid corporate executives accountable. The expectation of due diligence set forth by Mr. Miller would seem to be a more appropriate standard for senior management to fulfill.

V. THE PREVALENCE OF MANUFACTURING EARNINGS

The instinct to manufacture earnings is well understood in the business community. Over fifteen years ago, Arthur Levitt, the then chairman of the SEC, expressed his concern:

Increasingly I have become concerned that motivation to meet Wall Street earnings expectations may be overriding common sense business practices. Too many corporate managers, auditors, and analysts are participants in a game of nods and winks. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation.

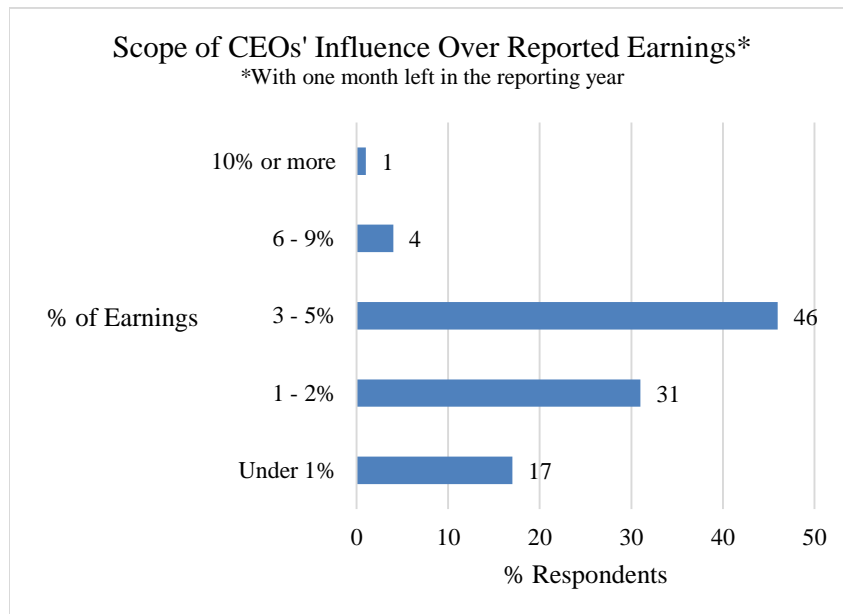
As a result, I fear that we are witnessing an erosion in the quality of earnings, and therefore, the quality of financial reporting. Managing may be giving way to manipulation; Integrity may be losing out to illusion.¹⁴⁴

143. *Cent. Laborers’ Pension Fund v. Integrated Elec. Servs. Inc.*, 497 F.3d 546, 555 (5th Cir. 2007) (emphasis added), *quoted in* *Plumbers and Pipefitters Local Union 719 Pension Fund v. Zimmer Holdings, Inc.*, 673 F. Supp. 2d 718, 748 (S.D. Ind. 2009).

144. Arthur Levitt, *The Numbers Game*, U.S. SEC. & EXCH. COMM’N SPEECH ARCHIVES (Sept. 28, 1998), <http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt>.

One of the five prevalent techniques to manufacture earnings that he discussed was manipulating the recognition of revenue—“recognizing it [(revenue)] before a sale is complete, before the product is delivered to a customer, or at a time when the customer still has options to terminate, void or delay the sale.”¹⁴⁵ This is what Spectrum Brands was doing.

Data reported by *CFO Magazine* supports former chairman Levitt’s concern that manipulating earnings may be widespread. As the chart below indicates, over half of CFOs indicated that, with only a month left in the fiscal year, they could move reported earnings by 3% to 5%, or more:¹⁴⁶



Isn’t the practice of manufacturing earnings something of which federal courts should be aware, since they frequently deal with cases involving financial considerations? Could they not take judicial notice of this practice so as to inform their consideration of whether allegations are sufficiently particular? Could they not take judicial notice of the fact that a truckload of batteries is worth tens of thousands of dollars, not hundreds of dollars?

145. *Id.*

146. Don Durfee, *Management or Manipulation?*, CFO MAG. (Dec. 1, 2006), <http://ww2.cfo.com/accounting-tax/2006/12/management-or-manipulation/>.

VI. THE SUPREME COURT'S INSTRUCTION TO CONSIDER THE FOREST, NOT JUST THE TREES

A year after *Spectrum Brands* was decided, the Supreme Court handed down its decision in *Tellabs, Inc. v. Makor Issues & Rights Ltd.* where it held that, in order to plead a strong inference of scienter, the inference must be “cogent and at least as compelling as any opposing inference.”¹⁴⁷ However, the Court also instructed that “courts must consider the complaint in its entirety,” including “documents incorporated into the complaint by reference, and matters of which a court could take judicial reference.”¹⁴⁸ In other words, do not focus merely on some individual trees but take a look at the forest as a whole. And, in the case of *Spectrum Brands*, could not the court take notice of the fact that major retailers implement “just-in-time” inventory practices?

The Supreme Court has also observed that “individual pieces of evidence, insufficient in themselves to prove a point, may in cumulation prove it. The sum of an evidentiary presentation may well be greater than its constituent parts.”¹⁴⁹

While the instruction of the Supreme Court should have tempered courts in relying upon *Spectrum Brands*, the case is still “alive and well.” The court, in *City of Omaha Police & Fire Retirement System v. The Timberland Co.*,¹⁵⁰ quoted *Spectrum Brands*' statement that the allegation that customer “stores had multiple weeks of . . . inventory on their shelves” insufficient where the complaint failed to further allege that “this level of inventory was unusually high for that time of year.”¹⁵¹ However, in *Timberland*, plaintiffs' allegations were not nearly as specific as those in *Spectrum Brands* and the court was not unreasonable in seeking more detail. It may be that the difference between the two cases was in the recall capabilities of the confidential witnesses.

VII. CONFLICTING PRESUMPTIONS: EXECUTIVES ARE INFORMED VERSUS EXECUTIVES ARE NOT INFORMED

What is paradoxical about the approach of many courts is that they indulge two conflicting presumptions whose common thread is to insulate executives from liability and undercut corporate accountability.

147. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 324 (2007).

148. *Id.* at 322.

149. *Bourjaily v. United States*, 483 U.S. 171, 179–80 (1987).

150. *City of Omaha Police & Fire Ret. Sys. v. Timberland Co.*, No. 11-CV-277-SM, 2013 WL 1314426 (D.N.H. Mar. 28, 2013).

151. *Id.* at *13 (quoting *In re Spectrum Brands, Inc. Sec. Litig.*, 461 F. Supp. 2d 1297, 1310 (N.D. Ga. 2006)).

Spectrum Brands, by condoning channel stuffing, by assuming that senior executives were unaware of the practice, and by determining that a sale of \$2.3 million of stock was not sufficiently suspicious to infer scienter (because more than two months intervened between the sale of the stock and the announcement that “sales would fall woefully short of previous estimates”),¹⁵² thereby presumed that senior management was not aware of core business operations.

Moreover, *In re Silicon Graphics, Inc., Securities Litigation*,¹⁵³ was even more egregious in essentially indulging a presumption that senior corporate executives were uninformed. In *Silicon Graphics*, the court explicitly relied upon the business judgment rule in one part of the opinion. The rule, as the court stated, is a presumption that senior executives are informed: “Under the business judgment rule, directors are presumed to make sound business decisions, and to inform themselves properly prior to making those decisions.”¹⁵⁴

On the other hand, in the bulk of the opinion, the court essentially presumed that senior executives were not informed. As discussed below, plaintiff’s allegations that there were internal reports which described serious supply problems and the inability to ship product¹⁵⁵ did not, according to the court, create an inference that senior management was reckless when senior managers made statements that the product was shipping in volume and that there were no supply problems.¹⁵⁶ In other words, the court presumed that the executives were not informed about dramatic events that would, when acknowledged a couple of months later, cause a precipitous drop in the price of the company shares.¹⁵⁷ The announcement of actual results confirmed that the executives had lied about the company’s situation.¹⁵⁸

The two presumptions—that executives are informed and that executives are not informed—are obviously antithetical to each other. The net effect of the presumptions, unfortunately, is that they withhold judicial scrutiny of the actions of corporate executives and encourage

152. *In re Spectrum Brands*, 461 F. Supp. 2d at 1317.

153. See *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970 (9th Cir. 1999), *abrogated on other grounds by* *S. Ferry LP, No. 2 v. Killinger*, 542 F.3d 776 (9th Cir. 2008). The rise and fall of SGI is described in Robert D. Hof, *The Sad Saga of Silicon Graphics*, BUS. WK. (Aug. 4, 1997), <http://www.businessweek.com/1997/31/b35381.htm>.

154. *In re Silicon Graphics*, 183 F.3d at 990 (citing *Grobow v. Perot*, 539 A.2d 180, 189 (Del. 1988)).

155. *Id.* at 980–82.

156. *Id.* at 988.

157. *Id.*

158. *Id.* at 982.

reckless behavior.

CONCLUSION

The proposition that judges “tend not to have a lot of knowledge about anything that is outside of legal books”¹⁵⁹ is clearly a weakness. But if judges are going to deal with financial matters, they ought to familiarize themselves with concepts such as “just-in-time inventory,” and they should appreciate that high P/E ratio companies need to achieve high growth rates that are difficult to maintain. With so much of executive compensation tied to the price of the employer’s stock, courts should also have sufficient understanding of human nature to realize that a strong temptation may exist to manipulate the price of a company’s stock—a practice that former SEC Chairman Levitt cautioned about fifteen years ago.

Courts also need to understand that, in exchange for multi-million-dollar salaries, senior management is expected to fulfill its oversight responsibilities by doing due diligence. Sarbanes-Oxley mandated a functioning system of internal controls which the CEO and CFO were required to certify. Even without this mandate, in order to manage a company competently, there needs to be a system of weekly and monthly reports to keep senior management informed. If such a system is in place, then courts should recognize that, when public disclosures turn out to be false, there is a strong inference that senior management was reckless, if not lying. If there is no such system in place, then senior managers are reckless in making aggressive statements that turn out not to be true.

In addition, courts need to appreciate the paradox created when, often in the same case, they apply the business judgment rule which presumes that senior management is informed and making thoughtful decisions, while also rejecting an inference that senior management is aware of situations within the company that repudiate public statements as to the condition of the company. Management cannot be both informed and uninformed.

But the problem is not just a lack of knowledge by many courts, but a bias¹⁶⁰ in favor of management. Recent studies have indicated that half

159. Posner, *supra* note 30.

160. Bias is not used here in the pejorative sense of evil motivation, but rather the underlying beliefs and attitudes which we hold and which bear upon our interpretation of the so-called “facts.” See, e.g., PHILIP G. ZIMBARDO & MICHAEL R. LEIPPE, *THE PSYCHOLOGY OF ATTITUDE CHANGE AND SOCIAL INFLUENCE* 162 (1991). The authors note:

But despite all good intentions to “let the facts speak for themselves,” biases based on our existing attitudes can sneak into our perception and interpretation of the “facts.” What we notice in a message, how we interpret ambiguous message

the members of Congress are millionaires.¹⁶¹ While there are undoubtedly few judges in that category, judges tend to come from the elite ranks of an elite profession. While they have neither contact with nor empathy for drug defendants who come before them, they may well live near the white-collar defendants who were sued in securities cases and they certainly have similar educational and cultural backgrounds. But, as the tables in this Article demonstrate, when management lies or tells half-truths, and the investing public is deceived, this is not a victimless crime.

The PSLRA does require averments to be made with particularity. And “particular” does not mean “general” or “vague.” But while the PSLRA may have been sparked by concern over vexatious litigation, the PSLRA is part of the securities laws that were enacted to “insure the maintenance of fair and honest markets,”¹⁶² to guard against “manipulation and sudden and unreasonable fluctuations of securities prices,”¹⁶³ and “for the protection of investors,”¹⁶⁴ not for the protection of management. Moreover, as the article by Wendy Couture¹⁶⁵ demonstrates, concern about the vexatiousness of securities litigation may be overblown.

Professor Bainbridge has developed the proposition that courts like to employ heuristics to resolve litigation at the earliest possible point.¹⁶⁶ Courts, in interpreting “particularity,” like to employ the “who, what, when, where, and how” test.¹⁶⁷ But unrealistic, nitpicking application of this approach, focusing on the trees but not the forest—in other words the alternate universe approach—undercuts the purposes and policies of the securities laws, and eviscerates management accountability in the corporate sphere.

information, and which beliefs in knowledge are conjured from memory during the cognitive response process are all affected in subtle ways by one’s existing point of view.

Id.

161. Eric Lipton, *Half of Congress Members Are Millionaires, Report Says*, N.Y. TIMES, Jan. 9, 2014, http://www.nytimes.com/2014/01/10/us/politics/more-than-half-the-members-of-congress-are-millionaires-analysis-finds.html?_r=0.

162. 15 U.S.C. § 78b (2012).

163. *Id.* § 78b(4).

164. *Id.* § 78j(b).

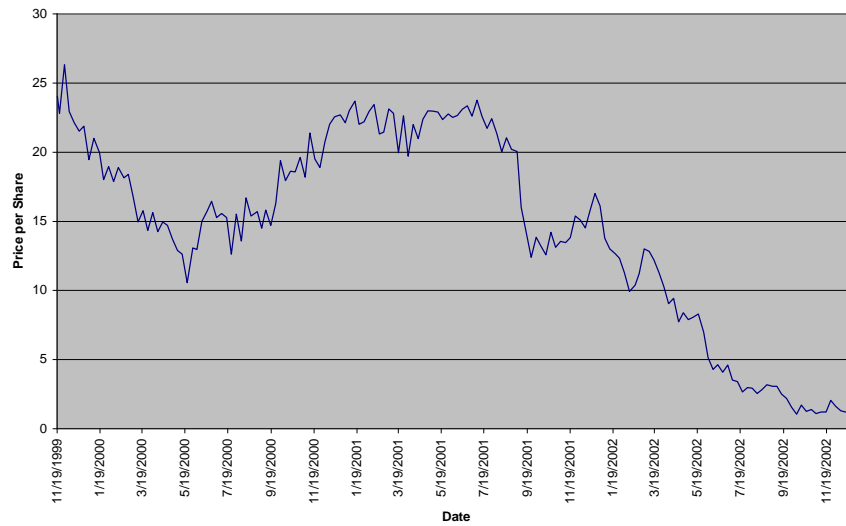
165. Wendy Gerwick Couture, *Around the World of Securities Fraud in Eighty Motions to Dismiss*, 45 LOY. U. CHI. L.J. 553 (2014).

166. Bainbridge & Gulati, *supra* note 30, at 108.

167. *E.g.*, *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 998 (9th Cir. 1999), *abrogated on other grounds by* *S. Ferry LP, No. 2 v. Killinger*, 542 F.3d 776 (9th Cir. 2008).

TABLES

Charter Communications Inc. Jun '99 - Dec '02



Spectrum Brands, Inc. Aug. '04 - Dec. '07

